

# International Political Economy: An Introduction to Approaches, Regimes, and Issues

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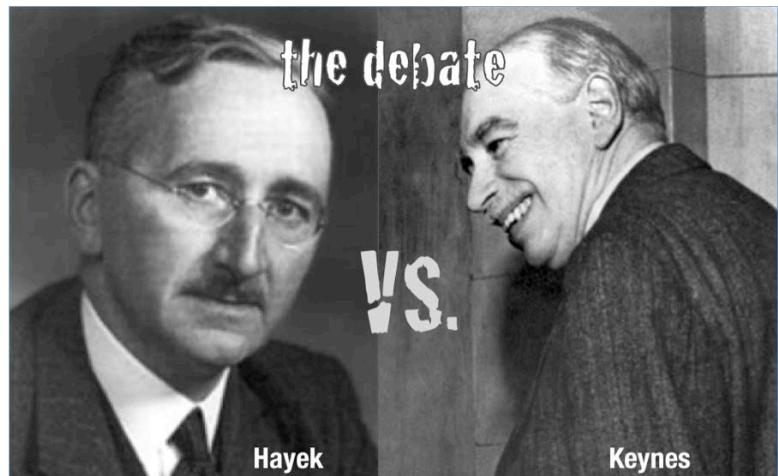
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# Chapter 1

## Demystifying the Complex World of International Political Economy

### Introduction

There are many books on international political economy, or IPE for short. Not surprisingly, each contains its own assumptions and views about the key concepts, issues, and concerns of IPE. Sometimes the authors of these various books hold the same assumptions and share the same, or at least very similar, views about how the world works. Sometimes they don't. In fact, as we will see in a few of the chapters that follow, the perspectives of the people who write and think about IPE are often dramatically, if not fundamentally, different. You may already have an inkling that mainstream economists and radical economists (e.g., Marxists) do not agree on many central issues and concepts. But even among those who seem to share basic ideas, there can be sharp disagreements. Within the broad school of **neoclassical economics**, for



**Figure 1.1.** On the left is Friedrich Hayek and on the right, John Maynard Keynes. The debate between these two influential economists is still unresolved.

*Image sources: The photo of Keynes is in the public domain, and is free to use for publication purposes. The photo of F. Hayek is licensed under the Creative Commons-Share Alike 3.0 unported license, and was released by the Mises Institute. The mash-up of the two photos was done by the author.*

example, there is an intense and still-unresolved debate between those who believe that markets must be left alone and those who believe that government intervention in markets is sometimes necessary. This debate is encapsulated in the ideas of, and debates between, two famous economists—**John Maynard Keynes** and **Friedrich Hayek**. Keynes, who died in 1946, is best known for his ideas about the importance of “pump priming,” which refers to deficit spending by governments in times of recession or depression. The goal is to increase demand and create a virtuous circle: higher demand means more need for workers, more workers keeps demand strong, and strong demand keeps the economy going. Keynes’s ideas, it is important to note, are far from dead: the global recession that began around 2008 spurred the United States government to engage in **stimulus spending**—a type of pump priming—and other policies (including maintaining historically low interest rates and **quantitative easing**). These are all Keynesian policy prescriptions. Hayek, by contrast, expressed profound confidence in the ability of markets to take care of themselves, and saw only a very limited role for governments at the national level, one based on ensuring a relatively stable supply of money. Hayek is most famous for his classic book, *The Road to Serfdom*, first published in 1944. In *The Road to Serfdom*—which has become one of the bibles of **libertarianism**, along with Ayn Rand’s *Atlas Shrugged* (1957)—Hayek argued strongly that government control of economic planning inevitably leads to the loss of individual freedom. While his ideas were marginalized in the 1940s and 1950s, they found a much more receptive audience beginning in the 1970s; since then, Hayek’s writings have developed a very strong and even fervent following, especially among policymakers in the United States and Great Britain.

Significantly, the debate between followers of Keynes and followers of Hayek has been going on since the late 1930s. Think about this for a moment: in seventy-odd years, mainstream economists have yet to reach consensus on a fairly basic issue (i.e., Does stimulus spending work or doesn't it?). Indeed, in an important respect, the disagreement today is even stronger than in the past, when there were long periods in which one or the other view held sway. While neoclassical economists continue to debate a range of issues, it is important to emphasize from the outset that neoclassical economics is not the same as international political economy. As I will discuss in detail below, IPE is a distinct field of inquiry. There is, to be sure, some overlap between the two fields—neoclassical economics and IPE—but there are also areas of very strong divergence. One of the most salient differences is embedded in the terminology itself. International *political* economy considers politics and economics to be inextricably intertwined, while neoclassical economics asserts that economics and politics are—and should be—two essentially separate areas or processes.

We will consider this issue in much more detail below. For now, it is also important to emphasize that, as a field of study, IPE is much more strongly connected to the discipline of political science than it is to economics. The reason for this is clear: IPE is an outgrowth of international relations, or IR for short. IR, a major subfield within political science, has traditionally focused on the struggle for power between and among states. Although a diverse and heterogeneous field in its own right, IR has long been dominated by a particular theoretical perspective known as realism. Realism, in turn, has long held a heavy bias toward “high politics,” which refers to all matters considered vital to the survival of the state. In practical terms, this entails a near exclusive focus on military-strategic issues. Economic concerns, therefore, are relegated to the domain of “low politics” and, as the term

implies, are considered relatively unimportant. For many scholars, however, both the dismissal of economic concerns as unimportant and the implicit separation of politics from economics is unwarranted: in a nutshell, this is what led to the emergence of international political economy as a distinct field of study (beginning in the 1970s).

### **What Is Globalization (and Why Is It Important)?**

Interestingly, in moving away from IR, IPE scholars continued to use the word *international* to describe the field. Yet, as most of us recognize, the world is increasingly characterized by the phenomenon referred to as globalization. There are, unfortunately, not only many ways to define the term *globalization*, but there is also no general consensus on how it *should* be defined. We cannot resolve the debate here; for now, then, suffice it to say that globalization is a complex and multidimensional (economic, political, social, technological, and cultural) process that involves a compression of time and space (Harvey 1989). The time-space compression, most simply, is a situation in which geographic distance has become less and less an obstacle to communication and information flows, to production, and to the movement of goods, people, ideas, and capital around the world. Time-space compression is represented in many developments, but nowhere is it more evident than in the Internet and other forms of information technology. Today ordinary citizens can instantaneously communicate with thousands, even millions of people across the globe at the press of a button via [Twitter](#) (or the Chinese version, [Weibo](#)), [Facebook](#), or [Pinterest](#); the cost of this communication, moreover, is practically nil for the individual user. Somewhat slower, but still significant, are video-sharing sites such as [YouTube](#), which are used by regular people, influential organizations, governments, and powerful corporations

alike. In 2012, for example, the group Invisible Children posted a video called [\*Kony 2012\*](#), which appealed for Joseph Kony's capture and arrest for his role in the commission of crimes against humanity and war crimes against civilian populations in Uganda. The video has generated almost 100 million hits (as of June 2013).

Globalization, as the foregoing discussion suggests, also means increasing interconnectedness, through which the actions and activities of states, societies, organizations, and peoples in one place can have significant reverberations in many other places, virtually anywhere on the planet. Such descriptions of globalization have become trite, but nonetheless, the implications of globalization remain immense, especially for the field of international political economy. Indeed, as we have already seen, in the era of globalization, the label *international* may well have become anachronistic. The term *era*, it should be noted, is generally defined as “a long and distinct period of history with a particular feature or characteristic.”<sup>1</sup> The era of globalization, therefore, necessarily implies that what exists today is meaningfully different from the past. This does not mean that globalization is an entirely novel phenomenon. It is not. But as one scholar put it, “globalization did not figure continually, comprehensively, intensely, and with rapidly increasing frequency in the lives of a large proportion of humanity until around the 1960s” (Scholte 2001, p. 17).

A key implication of globalization is in the de-linking of specific processes, relations, and activities from specific territories. Territorial and political space—as in a country such as the United States, Brazil, or China—still matters a great deal, but globalization is challenging the still-prevailing idea of a single territorial state as the exclusive site for organizing political, economic, and social relations. This means, in turn,

that the state is losing its unrivaled status. We will return to this issue below (in the section “Putting the Global in International Political Economy”), so for now it is enough to say that globalization has expanded the influence and power of a range of nonstate or transnational entities. Corporations, of course, are among the most important of these entities, but so too are **nongovernmental organizations (NGOs)**, regulatory agencies, associations, social movements, and the like—many of which “treat the whole planet as their actual or potential clients” (Scholte 2001, p. 16).

### Why Do Scholars Disagree?

Earlier I discussed the disagreements that exist among economists, between various disciplines and fields of study—such as neoclassical economics and IPE, or IPE and IR—and among scholars and analysts more generally. Left unaddressed, however, is the question of why such disagreements exist in the first place. That is, why don’t scholars and others who think about economics, politics, or international political economy agree on how things work? Why can’t they even seem to agree on what factors or processes are most important in the world (political) economy? There are many answers, but perhaps the most fundamental reason has to do with the subject itself: as with all *social* sciences, IPE ultimately studies the behavior and actions of human beings, which means that, unlike the physical world of the natural sciences, the social world is populated by subjects with the capacity to think, learn, and make willful choices. To understand the difference, just imagine if atoms, planets, and chemicals had minds and wills of their own. Certainly, the task of physicists, astronomers, and chemists would be far more difficult than it is already. But it is not only individual consciousness that separates the social from the natural sciences. The

social world is also composed of historically contingent structures, institutions, and systems of belief (i.e., cultures). The term *historically contingent* means that major elements of our social world are the product of specific and sometimes unique processes and circumstances that make, say, the United States meaningfully different from Japan, or Japan different from France, and so on. In every country, too, there are often dramatic differences—including differences in national identity and culture—between different time periods, such as Japan in 1850 compared to Japan in 2013. To fully understand or explain the social world, then, it is not enough that we find the “universal key” to individual behavior (which some social scientists claim to have done with the concept of **rationality**); we must also try to understand how the broader social, economic, and cultural contexts in which individuals live alter, shape, and constrain—in both subtle and dramatic ways—the behavior of people and the types of societies, polities, and economies they produce. Given this, a grand totalizing theory (a single theory that explains everything) is exceedingly hard to imagine.

## The Social World as an Open System

From a different perspective, we can say that the social world is, by nature, an open system, which basically means that the subjects or objects (e.g., forces or factors) we want to study cannot be isolated from other subjects or objects in the environment. In many of the natural sciences, by contrast, objects of study *can* be isolated, albeit not always completely. The whole point of many experiments in the natural sciences, in fact, is to create closed or quasi-closed systems so that regular sequences of events can be observed under carefully controlled conditions (Sayer 1992). It is this ability to create closed systems that has led to the precision and predictive success of certain sciences like physics and astronomy. On the

other hand, there are some natural sciences—e.g., meteorology, geology, and the environmental sciences more generally—that do not have the ability to directly experiment with closed systems, although they can sometimes borrow from closed-system sciences to establish rough predictions and explanations (ibid.). It is the relative lack of precision and predictive power in these more open-system natural sciences that has led to some intense and even fundamental disagreements, which may or may not be amenable to resolution in the long run. One of the

### The planet: An open system



**Figure 1.2.** The science on climate change is complicated because the planet is an open system, which means that scientists are unable to isolate or control for a wide range of potentially relevant variables.

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most prominent examples of this is the continuing debate over **global warming**. After decades of intense research, for example, there is near-universal scientific consensus on theories related to the greenhouse effects of global warming, yet because the global environment is inherently open, there continues to be room for debate.

In general, the difficulties posed by open systems in the environmental sciences pale in comparison to those in the social sciences, where subjects also have the added capacity for learning and self-change; this means that the subjects of study are, in principle, never exactly the same from one time period to the next (or even from one minute to the next). Thus, it should be even less surprising that sharp theoretical disagreements in IPE not only

exist, but also show no sign of ever disappearing. The basic reason, to repeat, is clear: the inherent openness of social systems means that there will always be strict limits on what we can know (although there are many stalwart social scientists—including, no doubt, several of your past or current professors—who never have accepted this, and probably never will). Given these limitations, the goal of this book is *not* to provide a definitive, much less objective exposition on international political economy. I especially do not want to tell you the “proper” or “correct” way to think. Rather, I want to provide you with knowledge that will enable you to develop your *own* ideas and frameworks of analysis. In this regard, I have two other related goals. First, I wish to get you to think more clearly and explicitly about your own (theoretical) assumptions, values, and beliefs. This is a critical step, since many students often do not understand the basis and/or implications of their own beliefs about the world. It is this lack of self-understanding that leads to inconsistent, sloppy, and sometimes contradictory thinking. Second, I want to introduce you to a variety of ways of understanding, explaining, and interpreting the world political economy. In the process, however, I also want to help you make much better sense of the conflicting perspectives and approaches in the field of IPE.

## Defining International Political Economy: The First Step

So far we have seen the term *international political economy* numerous times, but we have not yet discussed its meaning. Before we get



**Figure 1.3.** In the traditional view, the relationship between the state and the market is seen as adversarial, like two boxers fighting. However, this is not the only way—nor is it necessarily the best way—to conceptualize the relationship between the state and the market.

*Source: Library of Congress, New York World-Telegram & Sun Collection.* [saylor.org](http://www.saylor.org/books)

<http://www.loc.gov/pictures/resource/cph.3c14335/>  
“No copyright restriction known”

to the nitty-gritty, though, a few words of warning are in order. First, there is no universal agreement on how IPE should be defined—although this is definitely changing. This means the discussion that follows will not be as simple or straightforward as you might expect (or want). At the same time, a careful reading of this section will provide you with a better foundation for understanding and interpreting the concepts, issues, and problems that are examined throughout the remainder of this book. Second, it is also important to emphasize, at the outset, a key point: *definitions are important*. A big reason for this is that they tell us what to include in our analysis and what to leave out. Put in slightly different terms, definitions within a given area of inquiry tell us what is considered legitimate—what matters, or what is relevant—within that field, as well as how it is supposed to be studied.

We can certainly see this in the more common definitions of international political economy.

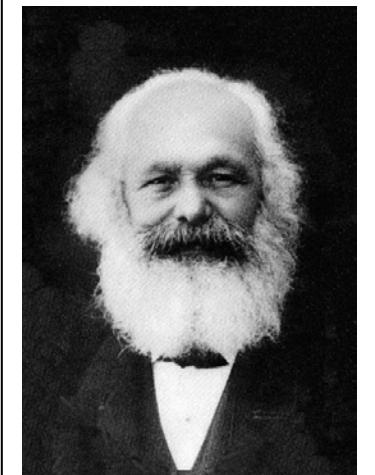
Consider this somewhat dated definition from a once-popular textbook, which tells us that international political economy “is the study of the *tension* between the market, where individuals engage in self-interested activities, and the state, where those same individuals undertake collective action . . .” (emphasis added; Balaam and Veseth 1996, p. 6). This seemingly innocuous definition is based on several important, but unstated assumptions.

First, it suggests that there are only two significant subjects of international political economy: (a) markets, which are composed of self-interested individuals (and the firms that they operate), and (b) states, which are the primary political institutions of the modern international system. Further, it suggests that a clear-cut distinction exists between economic or market-based activities and political or state-centered ones. Second, this definition tells us that the most important aspect of the relationship between markets and states is based on *tension*, which is “a strained state or condition resulting from forces acting in opposition to

each other.”<sup>2</sup> In other words, the definition presupposes that markets and states relate to one another in fundamentally adversarial ways.

On the surface, there is nothing terribly objectionable about this definition of international political economy. Markets and states are obviously important, and it seems apparent that a strong degree of antagonism *can* exist between them. However, in looking below the surface, problems begin to arise. The exclusive focus on states and markets, in particular, is exceedingly narrow. In the definition, for example, states represent the political world, but if political society is defined *solely* in terms of the state, then whole categories of other actors, issues, and activities are essentially eliminated from view, or at least relegated to the outer margins of the field. According to the foregoing definition, in other words, we don’t even get to ask the question, “Who are the most important **actors** in world politics?”

Yet this would seem to be a crucial question. What if states are not as all-powerful as the definition suggests? What if there are other powerful actors out there in the world? What would this mean to our understanding of how the world works? In addition, defining state-market relations as “tense,” or adversarial, rules out other possible aspects of that relationship. Can the state-market relationship, for instance, be reciprocal or mutually constitutive? (*Mutually constitutive* means, most simply, that two entities cannot exist apart from one another, or that each part exists on account of and for the other part.) Again, using the foregoing definition, we cannot even ask these types of questions. Yet such questions—and the answers to them—are vital to the study of international political economy.



**Figure 1.4.** Marx’s theory is often misunderstood, but it arguably still has much to tell us about the world economy. The class-analytical basis of Marxist analysis is particularly important. Chapter 2 will discuss his theory in more depth.

*Source: Unknown. This image is in the public domain because its copyright has expired.*

Let us take a closer look at the issue of the assumed “tension” or antagonism between the state and the market. A number of scholars have convincingly argued that states and markets are inextricably bound together. Karl Polanyi, to cite one scholar whose work we will focus on later in this chapter, provided a convincing argument that the emergence and subsequent development of a “market society” was made possible by the enormous and continuous intervention of the state. Similarly, Charles Tilly’s now-classic study, *Coercion, Capital, and European States, AD 990–1990*, showed that the development of the modern state in countries such as Britain and France paved the way for capitalist development. At a more basic level, another prominent scholar, Albert O. Hirschman (1977), convincingly argued that the “invention of capitalism depended on the creation of a new type of political actor—an individual liberal subject who was the product of a liberal state” (Blyth 2009).

In vivid contrast to the state-centered definition of international political economy is the Marxist view, which, generally speaking, focuses on the social relations of production. From a Marxist perspective, the key aspect of political economy (note that **Marxism** does not distinguish between IPE and political economy more generally) is the inescapable conflict between opposing class interests—that is, between the owners of the means of production (i.e., modern capitalists) and wage laborers (i.e., workers). The questions and answers that result from a definition that focuses on the tension between states and markets versus one that focuses on opposing class interests are, needless to say, likely to be quite different. Yet, as with the more conventional or mainstream definition, Marxists also tell us on whom we should focus all, or the bulk of, our attention—i.e., **social classes**—and how we should conceptualize the relationship between the key actors: as conflict-ridden. There is no middle ground here, either. This definition, then, can be just as problematic as the first if

we assume that the world is more complex than the definition indicates, which I think it is. Let us just consider one problem. In the Marxist definition, no mention is made of the state. The reason for this, at least to Marxists, is clear: (classical) Marxists considered the state to be an appendage, or tool, of the dominant class. That is, the state existed to serve the interests of capitalists. Period. It is difficult, however, to sustain this argument, since we can, with relative ease, find evidence that states can and do act against the interests of dominant economic actors—not always, but more than just occasionally. Recognition of this fact, by the way, has compelled contemporary Marxists to offer up the notion of **relative autonomy**, which acknowledges that states are, indeed, actors with their own interests, but that they are “relatively autonomous” because they can never be totally independent of dominant class interests.

As I suggested above, things are changing. David Balaam (one of the authors cited in the first definition), for example, later amended his conceptualization of IPE by adding societies into the mix. Specifically, he (and a different co-author) wrote, “as a *subject area* or field of inquiry ... [international political economy] involves tensions amongst a variety of state, market, and societal actors and institutions” (emphasis in the original; Balaam and Dillman 2011, p. 7). This amended definition clearly expands the range of relevant actors (and could easily include social classes); it also explicitly introduces another type of actor—namely, **institutions**. We will learn more about institutions later; for now, suffice it to say that many scholars, and perhaps most, agree on broadening the domain of IPE (although the amended definition still insists on restricting IPE to the “tensions amongst” these actors). More generally, then, we are seeing a shift to an inclusive definition of IPE. This has had significant implications. Most importantly, it has allowed hitherto excluded or ignored

actors, activities, and issues to finally be fully incorporated into the mainstream. Over the years, for example, we have seen more emphasis on a range of societal or nonstate actors: corporations, labor unions, **social movements**, criminal organizations, nongovernmental organizations (NGOs), religious institutions, **epistemic communities**, and so on. We have also seen an expansion of issue areas. Twenty years ago, most IPE textbooks would focus on a limited number of topics, especially international trade and monetary relations, international finance, and international debt and development. Today, such issues as the global environment, cross-border migration, social movements (including indigenous peoples' movements), poverty and hunger, nationalism, **gender**, and race/ethnicity are considered appropriate topics of study in international political economy.

### **Putting the Global in International Political Economy**

In the introduction to this chapter, I briefly discussed a significant limitation of IPE, a limitation that stems from the use of the term *international*. Strictly speaking, *international* applies only to relations between and among **sovereign states**. The term also implies a clear distinction between the national and the international—between what goes on *inside* states and what goes on *outside* states. With just a little reflection, though, it is clear that a great deal of, and likely most, economic activity that occurs in the world today is conducted—and sometimes controlled—by nonstate actors in ways that transcend national boundaries. Most of us know, for example, that large corporations engage in all sorts of economic transactions and activities that cut across borders: from buying, selling, and trading products and services, to building and investing in global chains of production (whereby a single product is designed, manufactured, assembled, distributed, and marketed in various locations

throughout the world), to forging strategic alliances with other corporations based in a range of different countries. We even have a special name for these types of firms: **transnational corporations**, or TNCs for short.

The ability of TNCs to quickly and (relatively) cheaply move operations and assets—physical, financial, technological, et cetera—across borders is a fairly recent phenomenon. To be sure, for a very long time corporations have had operations in multiple territories, but establishing and maintaining a presence across the globe was a slow, arduous, and expensive undertaking. As technological, financial, and political barriers have begun to fall away—as the world, according to a popular saying, has become “smaller” (this refers to the notion of time-space compression, which I discussed earlier)—the costs associated with operating on a transnational basis have decreased rapidly. Today, according to UNCTAD (United Nations Conference on Trade and Development),

there are over 82,000 TNCs with as many as 810,000 foreign affiliates (UNCTAD 2009, p. 222). Consider just one well-known example: Toyota Motor Corporation. Toyota has operations and facilities in 27 countries and regions, and its products are sold in 160

**Table 1.1. Revenue of World's Largest Corporations (by Sales) Compared to GDP of Selected Countries, 2011 (in U.S. \$ Billions)**

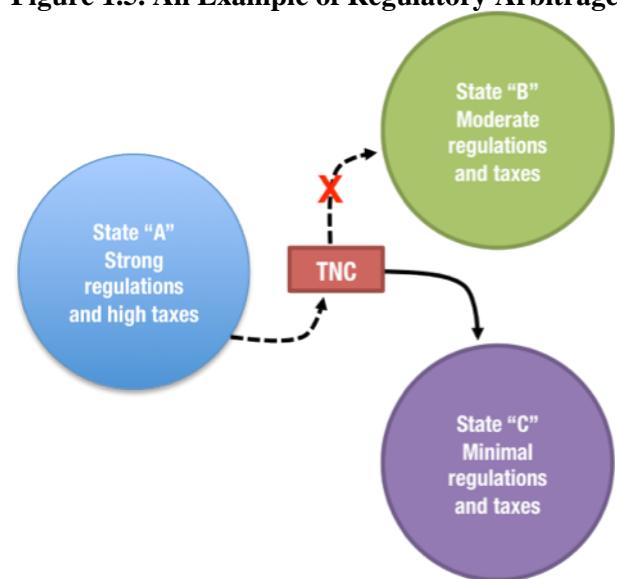
| Country     | GDP   | Corporation           | Sales |
|-------------|-------|-----------------------|-------|
| Austria     | 419.2 | Wal-Mart Stores       | 421.8 |
| UAE         | 360.1 | Shell (Netherlands)   | 369.1 |
| Thailand    | 345.6 | ExxonMobil (U.S.)     | 341.6 |
| Greece      | 303.1 | BP (UK)               | 297.1 |
| Chile       | 248.4 | Sinopec-China         | 284.8 |
| Ireland     | 217.7 | PetroChina            | 222.3 |
| Philippines | 213.1 | Toyota (Japan)        | 202.8 |
| Algeria     | 190.7 | Chevron (U.S.)        | 189.6 |
| Romania     | 189.8 | Total (France)        | 188.1 |
| Kuwait      | 176.7 | ConocoPhillips (U.S.) | 175.6 |

Sources: Statistics for corporations comes from Forbes.com (“World’s Biggest Public Companies 2011”), available at [http://www.forbes.com/lists/2012/18/global2000\\_2011.html](http://www.forbes.com/lists/2012/18/global2000_2011.html); data for GDP comes from the International Monetary Fund, “Report for Selected Countries and Subjects,” in the World Economic Outlook Database, April 2012, available at <http://www.imf.org/external/pubs/ft/weo/2012/01/weodata/inde>

countries. Toyota's revenues, moreover, totaled almost \$203 billion in 2011, which was more than the GDP of 150 countries. Indeed, as a group, corporations—not states—directly control most of the world's productive, financial, and technological resources. The combined sales of the top ten corporations in the world in 2011 were \$2.69 trillion, which is larger than the GDP of all but four countries (the United States, China, Japan, and Germany). While a comparison of corporate revenue to GDP is admittedly simplistic, it nonetheless gives a general sense of the economic size of corporations relative to most states. Where, when, and how TNCs decide to invest, manufacture, and/or distribute their products is therefore of considerable importance to the world political economy. The rise of the transnational corporation, in sum, means that we can no longer just talk about states (actually, this has been true for quite some time). This does not mean, however, that corporations have surpassed states as the primary sources of power in the global economy. They have not. Yet, it does mean, to repeat, that we can no longer analyze the international political economy as if only states have power.

Indeed, many scholars argue that TNCs are now able to directly challenge states' authority to regulate their activity. Consider this simple, but oft-cited example: by threatening to limit or close down their operations in a given location, corporations can compel governments to modify local regulations or standards for health, safety, wage levels, and/or the environment—a phenomenon dubbed **regulatory arbitrage**. In

**Figure 1.5. An Example of Regulatory Arbitrage**



In an era of globalized production, states have more difficulty regulating and taxing TNCs, since corporations can easily relocate some or all of their operations to countries with minimal regulations and taxes. Mobility and their productive capabilities give TNCs significant power in the world economy.

*Source: Created by author.*

essence, TNCs are telling states, including the most powerful ones: “If you want our business, then you have to play by *our* rules.” Another example can be found in the area of corporate tax arbitrage—an issue that became particularly salient in 2013, when Apple Computer was criticized for “offshore profit shifting” in order to cut dramatically the taxes it pays in the United States. Again, this is not to say that TNCs have necessarily become the equals of the largest and most powerful states; instead, it means that the relationship between states and large corporations is not as clear-cut or unilateral as it once appeared to be. In fact, even the most powerful state in the world—the United States—is not immune from corporate power. In the area of international trade, for instance, it is well understood

**Figure 1.6. Charles E. Wilson: “What’s good for GM ...”**



The actual quote by Wilson (left), former CEO of General Motors, came in response to a question at a Senate committee hearing on his nomination to become secretary of defense. He was asked if he could make a decision as secretary of defense that would go against the interests of GM. Wilson said that he could, but added, “I cannot conceive of one, because for years I thought that what was good for our country was good for General Motors, and vice versa” (quoted in Hyde 2008). *This work is in the public domain in the United States because it is a work prepared by an officer or employee of the United States government as part of that person's official duties under the terms of Title 17, Chapter 1, Section 105 of the U.S. Code.*

that U.S. policy is influenced, and even sometimes dictated, by the interests of corporations. A noteworthy example of this was the decision, by the Bush administration in 2002, to impose tariffs on imported (foreign) steel. Many observers have argued that it was pressure from the U.S. steel industry that drove the administration’s policy decision, rather than the interests of the country as a whole. This may seem an obvious point, but it is a very important one to keep in mind: if state action is even partially determined by nonstate actors, this tells us again that we

cannot focus exclusively on what states themselves do. (As we will see, too, such policy decisions are complicated: Bush's actions may have pleased steel-producing companies, but they hurt steel-*consuming* companies, as well as consumers.)

## Globalization: A Reprise

The increasingly important role that TNCs (and other **transnational actors**) are playing in the world today can be attributed, in large part, to globalization. Again, *globalization* is one of those terms about which there is no broad-based consensus. While some see it as an over-hyped myth, others argue that it has already brought about fundamental changes to the world. I am more sympathetic to the latter view. That is, I believe that globalization is a critical phenomenon that must be accounted for in any examination of international political economy. To repeat, globalization is a complex, multidimensional, and ongoing *process*. The most salient aspects of globalization—that is, those aspects most people think about when they hear the term *globalization*—are economic. Economic globalization is more than the simple extension of economic activities across borders, which has been going on for centuries. Instead, it refers to the *functional integration* of economic activities across borders (Dicken 1998). Imagine a network with connections crisscrossing the globe; each point (or node) has a different, sometimes very specialized function, whether in manufacturing, finance, transport, marketing, sales, or something else. Each point of activity relies on other nodes to do their part in creating or sustaining a larger whole. This is, in very simple terms, functional integration. One important implication of this condition is a *de-nationalization* of corporations. For the most part, we still tend to think of corporations as essentially American, German, Chinese, Mexican, and so on. Yet, when

corporate operations are part of a globalized network, nationality matters less and less—or, perhaps more accurately, it matters in different ways. In the past, to paraphrase a famous quote by the former head of GM, what was good for General Motors (or any other U.S. company) was good for the country. In the era of globalization, this is not necessarily the case. What is good for GM *might* be good for the United States, but it also might be good for Russia, China, the European Union, Brazil, India, and a slew of other countries where GM invests and sells its products. At the same time, the de-nationalization of TNCs does not mean that political borders have, or will necessarily, become irrelevant. Political space still matters! At the most basic level, we know this because of a point we already covered—namely, that states and markets are mutually constitutive. Doremus et al. put it this way: “Without stable political foundations, markets collapse” (1998, p. 3).

Globalization, I must emphasize, is not only about deepening *economic* integration and interconnectedness. Another key aspect of globalization is occurring in the realm of ideology, values, and beliefs. This means, in part, that people throughout the world are beginning to communicate—albeit as a product, to a significant extent, of advances in information technology (IT)—in terms of a common discourse centering around human and political rights (especially democracy), social, economic, and environmental justice, and global governance. Just how meaningful this “globalization of ideas” might be is still open to debate, but we can see evidence of its impact with increasing frequency: from the peasant rebellion in Chiapas, Mexico, to the Arab Spring, from the protests against sweatshop labor in the garment districts of New York, Honduras, Haiti, and Los Angeles to the Occupy Wall Street (OWS) movement in the United States and Europe. What is significant about—and common to—all these cases is that, to varying extents, each is based on an appeal to a set of

rights that were once almost entirely within the domain of the state. Even more significant is the fact that social, political, and civil rights are now becoming part of a relatively autonomous and transnational source of authority that is increasingly being used to delegitimize state actions (Sassen 1995), as well as the activities of TNCs. The protests against Nike, Reebok, and other corporations that “exploit” workers in poor countries are a good example of the latter. In short, the globalization of ideas, like the globalization of production and finance, is showing the potential to challenge the authority of states and other powerful global actors both within and outside national borders.

On the surface, the changes that globalization are bringing about appear to be moving us in a generally positive direction: toward a weakening of central control (by states, for example) and toward a greater dispersion of power among a plethora of institutions, groups, and individuals—that is, toward a more democratized world. On this point, some argue that the Internet and other advances in information technology are helping to empower and give voice to people whose concerns may not otherwise be heard—primarily because governments can no longer unilaterally control or even mediate the flow of information. While there is certainly some truth to this argument, we need to understand that the processes of globalization can be complex, highly uneven, and contradictory. For example, while the Internet has undoubtedly opened new possibilities for global democracy, it also provides an opportunity for the state to keep tabs on its citizens more effectively and less obviously than ever before, and at a much lower cost to boot. Just think, for example, how much easier it has become for states to gather, store, analyze, and *instantly* access information about millions of individual citizens. This point was made crystal clear when it was revealed, in June 2013, that the National Security Agency (NSA) has been engaged in a

vast surveillance program that scooped up *every* call placed on the Verizon network (over a set period of time), and then subjected this metadata to patterned analysis. Granted, the targets of this operation were “foreign terrorists,” but the targets could have just as easily been U.S. citizens. The same applies to corporations, the most powerful of which are able to exert tremendous influence on the development of the Internet and information technology more generally. Indeed, as corporations become more geographically dispersed, the need for centralized, top-level control becomes even stronger (Sassen 1995). This means, in many cases, not less concentration of power, but more—and generally in fewer and fewer places. On this point, consider that, of the 82,000 TNCs I mentioned earlier, a mere 147 wield control over 40 percent of the economic value of all TNCs through a complicated web of ownership relations (Vitali, et al. 2011, p. 6).

**Table 1.2. List of the Top 20 Corporate Power Holders**

| Rank | Economic Actor Name          | Country (HQ location) |
|------|------------------------------|-----------------------|
| 1    | Barclays PLC                 | GB                    |
| 2    | Capital Group Companies      | USA                   |
| 3    | FRM Corp                     | USA                   |
| 4    | AXA                          | FR                    |
| 5    | State Street Corporation     | USA                   |
| 6    | JPMorgan Chase & Co          | USA                   |
| 7    | Legal & General Group PLC    | GB                    |
| 8    | Vanguard Group, Inc.         | USA                   |
| 9    | UBS AG                       | CHINA                 |
| 10   | Merrill Lynch & Co           | USA                   |
| 11   | Wellington Management LLP    | USA                   |
| 12   | Deutsche Bank AG             | GER                   |
| 13   | Franklin Resources, Inc.     | USA                   |
| 14   | Credit Suisse Group          | CHINA                 |
| 15   | Walton Enterprises LLC       | USA                   |
| 16   | Bank of New York Mellon Corp | USA                   |
| 17   | Natixis                      | FR                    |

|    |                     |     |
|----|---------------------|-----|
| 18 | Goldman Sachs Group | USA |
| 19 | T. Rowe Price Group | USA |
| 20 | Legg Mason          | USA |

Source: Glattfelder (2010, p. 200)

According to critics, it is not only the “usual suspects” that we need to worry about.

In the era of globalization, another relatively new set of actors—international institutions and organizations—are beginning to exercise more and more influence over more and more peoples and societies, but without any of the responsibility typically attached to policymaking entities in democratic societies. On this point, Barnett and Finnemore, in their book *Rules for the World: International Organizations in World Politics* (2004), assert that international organizations, such as the International Monetary Fund, engage in an ironic process of spreading liberal norms around the world without any democratic oversight. They refer to this as “undemocratic liberalism.” Others have leveled the same charges against another increasingly important international organization, the World Trade Organization (WTO). Kapoor (2004), for example, claims the WTO primarily acts as a vehicle for forcing liberal economic practices on countries and peoples around the world, but without a meaningful degree of legitimacy and democratic accountability. These are complicated issues, which we will return to in later chapters. The key point to remember is simply this: there is nothing inherently democratizing in the process of globalization.

It is the complex and contradictory nature of the changes being brought about by globalization that compels us to go beyond the territorial and substantive boundaries of mainstream IPE. A simple, but not necessarily trivial step in this regard is to abandon the

concept of *international* political economy and replace it with *global* political economy (GPE). The move from IPE to GPE does not mean, however, that we must also abandon the traditional concerns of international political economy. States still matter (a great deal), but so do societal actors. Increasingly, then, the activities and concerns of states constitute only part of a much larger, more complex picture. One prescient scholar, writing 15 years ago, summed up the issue nicely: “The structure of global political economy contains the ‘old’ international economy within a new framework which is based in the territory of states, but not necessarily ‘national’ in terms of purpose, organization, and benefit” (Tooze 1997, p. 221). Placing the international economy within the framework of the broader global economy should also move us beyond a second restrictive boundary of mainstream IPE: the state-market dichotomy.

## **Political Economy and the State-Market Dichotomy**

Earlier I pointed out that conventional IPE textbooks tend to treat the market (economics) and state (politics) as separate entities, each operating according to its own, largely independent logic. While not entirely unjustified, the separation of the market and the state into mutually exclusive zones has always been problematic. One reason for this is clear: a market economy cannot exist, much less operate, without some kind of political order. This is not a new observation, nor is it one with which many (political) economists, even neoclassical economists, would disagree. There is, however, a great deal of disagreement over exactly what kind of political order is needed. Some take a minimalist view: the best political order is one in which the state *only* provides the legal-institutional framework for enforcing contracts and protecting private property (this is a view with which

most neoclassical economists would agree). Others are convinced that the most appropriate political order is one in which the state plays an active and direct role in a much wider range of economic activity. Rather than discuss, in detail, the full range of different perspectives on this issue, it might be better to concentrate on just one. In this regard, I would like to introduce you to **Karl Polanyi**, who I mentioned earlier and whose work offers a useful perspective for understanding the state-market relationship.

### *Polanyi and the State-Market Dichotomy*

Almost 70 years ago, Polanyi wrote about the inextricable connection between the emergence and subsequent development of the market economy and the modern state. In one of his most important works, *The Great Transformation*, Polanyi explains how the “road to the free market was opened and kept open by an enormous increase in continuous, centrally organized and controlled interventionism [on the part of the state]” (1944, p. 140). This was necessary because the market economy, as we know it, required a very unnatural action—i.e., turning land, money, and especially labor into commodities, or things to be bought and sold. To accomplish this required a great deal of political power, exercised primarily through the state. For Polanyi, it is not difficult to see why this was so. Prior to the advent of the market economy, labor and land were decidedly not commodities; rather, they were “no other than the human beings themselves of which every society consists and the natural surroundings in which it exists” (*ibid.*, p. 71). To turn them into commodities required an intentional and sometimes highly coercive effort, which only the state was capable of carrying out.

Once created, the so-called free market continued to rely on the exercise of state power. As Polanyi put it, “Just as, contrary to expectation, the invention of labor-saving machinery had not diminished but actually increased the uses of human labor, the introduction of free markets, far from doing away with the need for control, regulation, and intervention, enormously increased their range … even those … whose whole philosophy demanded the restriction of state activities, could not but entrust the self-same state with new powers, organs, and instruments required for the establishment of *laissez-faire*” (ibid., p. 140). In other words, the expansion of control, regulation, and intervention is an inevitable outcome of a “free” market. This is a crucial insight, and one that allows us an even stronger understanding of the mutually constitutive—or dialectical—relationship of the state and the market. Nor is it, in retrospect, a particularly controversial view. Nonetheless, it was not a generally accepted proposition when Polanyi first wrote about it, and still today, among many neoclassical economists and popular pundits, there is a strong conviction that markets can and should be kept isolated from the meddling of states. This conviction, it is important to point out, is based on the assumption that, for the market to operate efficiently, it must stand apart from the state. As I have already discussed, though, even in the mainstream, there are some economists who implicitly recognize that this separation is problematic. Among scholars of international political economy, more importantly, it is fair to say that Polanyi’s views are generally accepted (although there certainly may be disagreement on specific points). In other words, there is an understanding that markets and states are interdependent, or mutually constitutive: each depends on the other, and therefore they cannot be analytically separated. This is, in an important way, a starting point of IPE.

Polanyi also examined the relationship among the market, state, *and* society. He argued that the state continuously plays a critical role of mediating between the market and society (on this point, it is important to note that Polanyi indirectly challenged the older Marxist view that saw states as tools of the dominant class; indeed, while Polanyi drew from Marxist analysis, his own work opposed Marxism on important issues [see Block 2003]). That is, the state helps to establish and maintain the framework within which market activity takes place, but it also provides social protection to society from the inevitable “destruction” wrought by market forces. The concrete result of state intervention between the market and society has been a range of political orders or arrangements. Some of these we call capitalist, others we call socialist or communist. And, of course, there are versions in between, including the modern **welfare state**, of which the United States is just one example. No one of these arrangements, I should emphasize, can be said to be necessarily superior to another. This is because various political orders represent, at base, a mixture of different values, such as efficiency, equity, security, justice, and so on. Which value is given the highest priority and which is given the lowest reflects decisions made by individual societies, albeit within the context of a broader international/transnational system. Thus, to say, for example, that economic efficiency is more important than any other value is not to make an objective or scientific statement that must apply to all cultures and societies. Rather, it is to make a subjective or **normative judgment**, which typically reflects how the tension between the market and society has played out over time. Overall, then, Polanyi’s framework allows us to see that even a very narrow conception of politics as state action cannot be seen as standing in opposition to the market, or economics. Politics, including the exercise of state

power, is fundamental to the market. In this sense, politics *is* economics. Students of IPE should keep this point firmly in mind.

### **International/Global Political Economy Defined (Finally!)**

In light of the rather lengthy discussion above, let us now return to the basic question: what is international, or global, political economy? In the end, the definition I use is simple. International political economy is an area of study. As an area of study, it is concerned with, as Susan Strange (a prominent IPE scholar) puts it, “the social, political, and economic arrangements affecting the *global* systems of production, exchange and distribution, and the mix of values reflected therein” (emphasis added; 1994, p. 18). This definition has the advantage of expanding—rather than limiting—the range of questions, concerns, and issues considered relevant to the study of international political economy, whether at the local, national, international, or global level (although not everyone would consider this an advantage). Moreover, it does not lead us to think that any one arrangement or set of values is superior to another; nor does it suggest that certain relationships or dynamics, such as tension or conflict between states and markets, or between opposing social classes, should or must be the focus of study. Similarly, it does not force us to view the world through a particular set of (theoretical) lenses. In short, Susan Strange’s definition encourages us to look at the complex reality of international political economy in an open manner. (Note: to avoid confusion, I will use the term IPE throughout this book, even though I prefer the alternative, GPE, or global political economy.)

Another important advantage of Professor Strange’s definition is that it encourages us to think critically about the global or world economy. On first thought, it may not be

apparent to you why this is so. If anything, you might feel just the opposite. The reason, however, is fairly simple: the definition we've chosen forces us to ask questions about what and who matters in the world economy, and *why*. It also pushes us to question many of the basic assumptions and values that underlie dominant and alternative perspectives of IPE. This occurs whenever we ask questions such as: are states still the dominant players in the world economy? To what extent have states lost control of the economic and political activity within their borders? What impact, if any, is the globalization of production, finance, and ideology likely to have on the world? How has globalization transformed relationships of power in the world? Where does the line between the domestic and the international, or between the economic and the political, lie? What is the relationship between democracy and capitalism? Are social justice, political equality, and human rights compatible with the “free” market? Not only do these and many other important questions flow from the definition given to us by Susan Strange, but also, the answers are far from obvious. By asking such questions and developing our answers to them we are, of course, engaging in a highly critical and evaluative process.

## The Significance of Power

Thus far, we have covered a number of important definitional issues and posed some key questions. But there is another question we must address in any study of international political economy. In political science, the study of politics revolves around the issue of power. Power is also a central concept in IPE. Yet, in many introductory textbooks on IPE there is, curiously, very little discussion about just what power *is*. Many writers seem to take for granted that power is an unproblematic, even self-evident concept. If pressed for a more

formal conceptualization, however, most might agree with Robert Dahl's oft-quoted definition, which asserts that power is the ability of actor A to get actor B to do something he or she would not otherwise do (Dahl 1957). Certainly, this way of looking at power has merit. Sending in thousands of heavily armed troops to keep workers from blocking access to a factory, for instance, is an exercise of (coercive) power whereby A (the state) gets B (workers) to do something they don't want to do. Conversely, when workers *are* successful, they can force their company to increase wages, provide more benefits, or otherwise improve the conditions of work—all actions that the company would otherwise not have taken. You can probably think of dozens of similar examples that occur on a regular basis. This type of coercive, or *interventional*, power is clearly important. But it is hardly the case that most—or even a significant fraction—of what happens everyday in the political economy can be attributed to such direct applications of force or coercion by one actor against another. Most activity in the world political economy, instead, occurs as part of a process wherein power is exercised in a far less direct or interventional manner.

Thus, to understand power we need to begin by ridding ourselves of the idea that power is the same as brute force, or, as Mao Zedong put it, that it only “grows out of the barrel of a gun.” Before we consider other ways to look at power, however, let us return to the claim I made above—namely, that excluding power from

**Figure 1.7. A quote from Chairman Mao Zedong (*The Little Red Book*, 1964)**



“Every Communist must grasp the truth: Political power grows out of the barrel of a gun.”

Pictured: From *ARMOR* magazine: The Chinese Type 98 Main Battle Tank

*This image is a work of a U.S. military or Department of Defense employee, taken or made during the course of an employee's official duties. As a work of the U.S. federal government, the image is in the public domain.* [saylor.org](http://saylor.org)

analyses of the international political economy is a fundamental problem. Why is this the case? That is, why is a firm understanding of power essential to the study of IPE (or GPE)? Part of the reason for this is, I hope, already apparent to you: to the extent that markets play (or do not play) a dominant role in the economic life of a country or system of countries, they do so as a consequence of a political process. In this process, it is the distribution of power in society that determines, to a very large extent, the rules and values that govern economic and social relations. Power (or a particular structure of power), in this sense, is required to create and sustain the framework within which economic activity takes place. An efficient and productive market system, in particular, cannot exist where private property rights are not respected, where contracts cannot be enforced, or where domestic security is weak or nonexistent. Yet, protecting property rights, enforcing contracts, and providing security require a great deal of power, which—it is important to emphasize—must be exercised by a nonmarket actor like the state. To better appreciate this point, consider what happens to societies racked by social and political upheaval. In Somalia, to cite one of the most disturbing examples, orderly market activity is hardly possible when there is no centralized and legitimate political authority capable of governing the entire country.

The rather sorry condition of Russian capitalism in the decade following the collapse of Soviet communism presents a less extreme example. In that case, the financial and political power of the once-feared Russian (Soviet) state proved insufficient to create an orderly and effective framework for a smooth transition to capitalism. Power, instead, rested in the hands of a corrupt oligarchy, who essentially wrote their own rules—rules that were designed to funnel huge sums of money into their hands at the expense of the larger economy and the rest of Russian society. When **Vladimir Putin** took office in 1999,

however, things began to change very quickly, as he reasserted state control over important aspects of the Russian economy. Indeed, the Russian economy got back on relatively firm footing and did exceptionally well during his eight years as president, from 2000 to 2008 (see figure 1.8). This is not to say that Putin single-handedly solved Russia's economic problems (he did not); rather, it is to emphasize the political aspects of capitalist development—unless, of course, the resurgence of Russia's economy and the rise of Putin were entirely coincidental, which is a possibility.

**Figure 1.8. Russian GDP Growth Rates, 1990–2011**

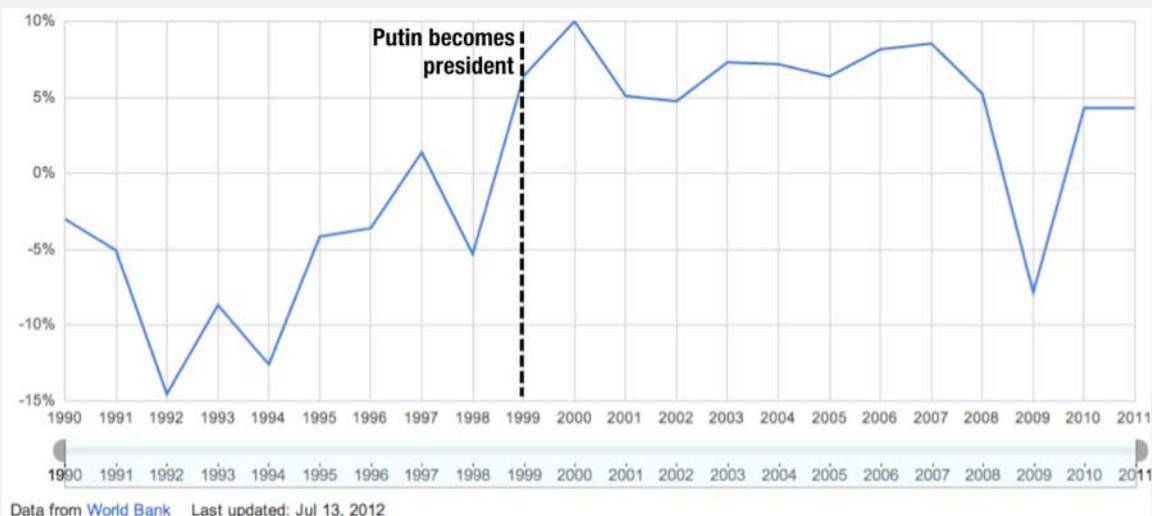


Chart generated by Google based on data from the World Bank: <http://www.google.com/publicdata/>.

Most economists would accept the fact that power is required to create and sustain the general framework within which economic activity takes place. Yet they might also argue that, for capitalist markets in particular, this power must be exercised in a neutral manner. Once the framework for market activity is created, in other words, all actors should

have an equal chance to compete and flourish—if, that is, the highest level of efficiency is to be achieved. Thus, power becomes largely irrelevant in terms of understanding what goes on within well-functioning markets, since everyone is equally empowered. This view, however, ignores two critical issues. First, power is not just needed to create a general framework, but (as I have emphasized several times already) is also needed to *sustain* that framework. Second, power is never equally distributed. In a political/economic system, power is typically distributed in a skewed—often extremely skewed—manner. To ignore power, then, is to ignore a particularly important aspect of reality.

## Sources of Power

Before moving on, let us make one more point related to the Russian case, which reinforces a key argument in this section—that power is not a simple matter of who has the most guns. If it were, the Russian state (with control of the military) should easily have been able to put a stop to the corruption that, in the eyes of one prominent American expert, had “poisoned the Russian political process … [and] undermined the Russian fiscal system” (Sachs 1999, p. 31) prior to 2000. The Russian case suggests, in other words, that power has *multiple* sources, of which the control over the means of violence (or force) in society is but one. This raises an obvious question: what are other sources of power and how significant are they in relation to one another? Think about this question before you continue reading: again, what are the sources of power in an economy and a society? On this question, most of us would concede that wealth is clearly another source of power in society. But is wealth always trumped by military force? If not, under what conditions is wealth a more significant source of power? Many of us have also heard the saying, “The pen is mightier than the sword,” which encapsulates the rather bold claim that *ideas* are stronger than armies. Can this really be true? Do ideas—ideology or knowledge—constitute a source of power equal, or at least comparable, to military force (or wealth)? Consider, for example, the idea of nationalism or national identity. This idea, which Lind (1994) described as the “world’s



**Figure 1.9.** Winston Churchill in 1916 holding a giant pen: “After all, some say the pen is mightier than the sword.”

*Source: F. H. Townsend in Punch. This image is in the public domain because its copyright has expired.*

most powerful force” (p. 87), should not be underestimated. Many have argued that its binding power is largely responsible for both the stability and instability of the modern state system, and is the force that makes large-scale war possible. After all, why else would ordinary citizens risk their lives to fight wars from which they have little to gain and everything to lose?

Still, there are no easy answers to any of these questions, or to the questions I posed above. But one thing is clear: power is not one-dimensional. This is a simple yet crucial point, because the study of political economy must not only pay serious attention to the importance of power itself, but to the many different aspects or kinds of power as well. My intention in the last part of this chapter (and throughout this book) is to do just that. The primary focus, however, will be on the distinction between *coercive* power and *structural* power. Both, as we will see, are important, but structural power (as I suggested above) has far more day-to-day relevance to the world.

### *Structural and Coercive Power*

When someone holds a gun to your head and demands you give him all your money, this is coercive power. The United States under George Bush undertaking a massive military campaign to overthrow Saddam Hussein in 2003 is also an example of coercive power. But when Iranians, Cubans, or North Koreans (the people or the governments) conduct financial transactions in U.S. dollars (both domestically and internationally), or when workers agree to do dangerous and difficult jobs for little pay, are these also purely reflections of coercive power? My view is that they are not. The latter two examples reflect structural power. One of the key differences between coercive and structural power may already be apparent: the

exercise of coercive power reflects an interventional, clear-cut cause-and-effect relationship, wherein the intervention of the more powerful agent *directly* causes the weaker agent to do something he or she would not have otherwise done. Structural power, by contrast, is not easily reduced to such a simple equation of force. For example, workers who agree to do dangerous and difficult jobs for little pay do so because they have few other options, not because they are directly forced to do so (at least in democratic countries). Iran, Cuba, and North Korea, to use our other example, do not use U.S. dollars because the American government (or anyone else) forces them to; rather, these ostensibly anti-American countries use dollars because the U.S. dollar is the primary global currency. The structure of the international financial system, in other words, creates a framework (and a financial hierarchy) that strongly influences and/or limits the choices available to most actors. In particular, those who occupy peripheral positions within this structure are subject to rules, values, and practices over which they have little to no control. They agree to abide by the rules of the system because failing to do so is very costly. Occasionally, dominant actors in this structure will attempt to use their advantageous positions in an interventional manner, but this is not common.

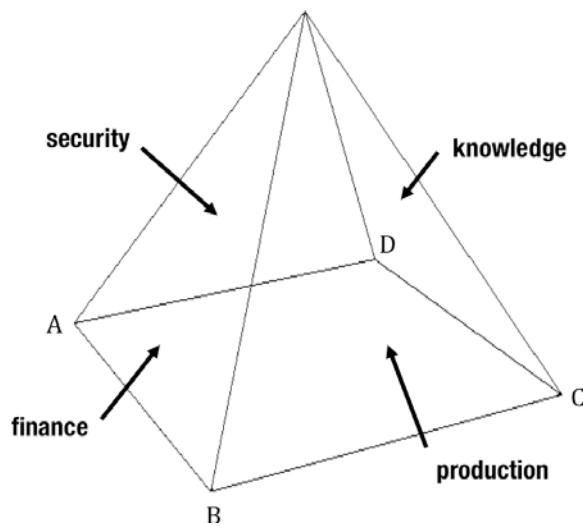
Those who occupy central positions within the structure of international finance, on the other hand, have the power to write the rules (to some extent) or to define the framework itself—usually in ways that put them in an advantageous position. This has certainly been true in the case of the United States, which played a key role in shaping the international financial system following World War II via the **Bretton Woods system**. (I will discuss the Bretton Woods system in much greater depth in subsequent chapters.) It is important to understand, however, that structural power is not just a broader, more generalized version of

coercive power. To see why this is so, consider the following three related points. First, we need to recognize that once a framework or structure is created, all actors—from the most powerful to the weakest—become subject to the same system of constraints and opportunities (albeit on different terms). In the international financial system, this might mean that a “weak” currency can become a source of strength. Consider, in this regard, China: throughout the 1990s and into the first decade of the 2000s, Chinese authorities intentionally worked to keep their currency, the *renminbi*, weak relative to the dollar. This helped to spur China’s extraordinarily fast growth in exports (a weaker currency means that Chinese products have a competitive advantage in world trade, since they are cheaper than would otherwise be the case). In other situations, monetary policy can be transformed into an exercise in political symbolism, and support “of the national currency may be promoted as a glorious stand on behalf of the imagined community—the ultimate expression of *amor patriae*” (Cohen 1998, p. 121). Conversely, a strong currency may become a source of weakness for governments, particularly if authorities attempt to preserve an international role for a currency whose popularity has begun to fade (*ibid.*, p. 122). This happened to Britain after World War II. In the future, it may well happen to the United States.

Second, we need to understand that structural power is based on a network of (historically constituted) relationships that extend well beyond the interaction of two individual actors. This may sound abstruse, but it is really not. Consider, for example, the relationship between a student and a teacher. Teachers have power over students *not* because teachers are necessarily smarter, stronger, or wiser than their students. And it is certainly not because teachers are richer. Rather, a teacher has power over a student because he or she can assign a grade that others—such as a parent, an honor society, a law or medical school

admissions committee, a potential employer—will use as a basis for determining the “quality” (and sometimes fate) of the student. A student’s well-being, in other words, “is

**Figure 1.10. The Dimensions of Structural Power**



This figure shows the four dimensions of structural power discussed by Susan Strange. Different actors will have varying degrees of power, from very little to preponderant, in the different dimensions, but it is unlikely that a single actor can be dominant in all four. The four dimensions are separate, but inter-related.

*Source. Image created by author, but is based on illustration in Strange (1994), p. 27.*

affected by the grade only through the mediation of human beings [or institutions] situated outside the classroom, who use the grade as a sign that results in their administering ‘harm’ [or benefit] to the student—for example, by denying him access to the opportunity to further his education” (Wartenberg 1990, p. 145). In this situation, power is exercised not by the teacher *per se*, but by a range of external actors, who, in turn, are also part of a larger framework of action. This aspect of structural power also helps us understand its context-dependent nature. In the case of the

student-teacher relationship, we can easily see the significance of the broader context: the power of the teacher, for example, will necessarily erode if the grade no longer functions as a means of access to a decent job (which may help to explain why discipline is a major problem in many of the poorest urban schools). In the international political economy, to put this issue very simply, this means that an exclusive focus on dyadic relations (e.g., the

United States–China relationship) will not tell us all we need to know. We need to evaluate the relationship in terms of the broader structures and institutions of the global economy.

Third, we must recognize that structural power is *reciprocal*. This means that, in any relationship of power, both parties have a degree of power no matter how wide the disparity may seem. Again, this may seem an abstruse or perhaps trite point. But it is a crucial one, for it tells us that power is never absolute—that there are always structural limits to power. This suggests, in turn, that power relationships are rarely, if ever fixed. We can see this in the constantly shifting relationships between capital and the state, between capitalists and workers, and between rich and poor countries. Understanding the structural limits of power is important if we want to understand, first, how and why things change in the international political economy, and second, what the possibilities for change are. Indeed, without understanding the reciprocal nature of structural power, it would be hard to explain how or why change in the political economy ever takes place. After all, if those who lack power also lack the capacity to challenge those with power, how can unequal relations of power change, once established?

Taken together, these three aspects of structural power can help us develop a deeper, more realistic understanding of international or global political economy. But these are not the only aspects of structural power with which we should be concerned. Susan Strange argues that structural power should be separated into four distinguishable but integrally related structures: security, production, finance, and knowledge. Each of these structures, Strange notes, highlights critical aspects of power, which are generally ignored or glossed over in more conventional analyses (especially those that focus on coercive power). Yet, according to Strange, each is no more than a statement of common sense. The security

structure, for instance, is simply the framework of power that provides protection to human beings from both natural and man-made threats. Those who provide this protection (or security) acquire a certain kind of power that lets them determine, and perhaps limit, the range of choices or options available to others (Strange 1994, p. 45). It is here that states tend to dominate, especially in terms of providing security against external threats.

The production structure includes all the arrangements that determine what is produced, by whom, by what methods, and on what terms. Those who control or dominate the production structure clearly occupy a position of power in any society, in part because the production structure is the primary means of creating value and wealth. The finance structure determines who has access to money, how, and on what terms. Money itself, however, is not critical; rather, it is the ability to control and create credit that really counts. As Strange puts it, “whoever can so gain the confidence of others in their ability to create credit will control a capitalist—or indeed a socialist—economy” (p. 30). The knowledge structure—perhaps the most overlooked and underrated source of power—“determines what knowledge is discovered, how it is stored, and who communicates it by what means to whom and on what terms” (p. 121). To appreciate the significance of the knowledge structure, Strange points to the example of the Catholic Church in medieval Christendom: the extraordinary power of the church was, first and foremost, a reflection of its ability to dominate the knowledge structure—to establish itself as the *only legitimate source* of moral and spiritual knowledge. A contemporary example is the debate surrounding climate change and global warming. The scientific community is clearly responsible for generating knowledge about climate change, but there has been an intense struggle among a variety of both state and nonstate actors over how that knowledge is interpreted, communicated, and

constructed. How this struggle plays out will have immense implications for arguably one of the most important issues facing the world today.

These four structures of power, according to Strange, are inextricably connected, and no one dimension is inherently or necessarily more important than any of the others. “Each is supported, joined to and held up by the other three” (1994, p. 26). This reinforces a point I made earlier—namely, that power grows not merely out of the barrel of a gun, but also (for example) from the factories that manufacture guns, from the technical knowledge needed to produce weapons, from a belief system that legitimizes mass violence against others, from a financial system that provides credit to create the weapons industry, and so on.

Understanding this multifaceted nature of power is critical for anyone who wants to make sense of the international or global political economy. Consider, on this point, the power of



**Figure 1.11.** Jamie Dimon, CEO of JPMorgan Chase

*Source: Financial Times.  
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transnational corporations: one cannot explain the increasing significance and autonomy of TNCs—and the concomitant erosion of state sovereignty—without paying serious attention to changes in the underlying structures of power. For example, it is now almost undeniable that changes in the system of global finance have seriously eroded the capacity of states to control credit—the lifeblood of any capitalist enterprise. As this power erodes, state authority diminishes, which leaves the door open for those who are better positioned to deal with transnationally mobile funds—e.g., TNCs, international banks, fund

managers, and even a few wealthy asset holders (such as George Soros)—to exert greater control, not just on how funds are allocated, but also over government policy that deals with finance. On this point, consider the 2012 Senate Banking Committee hearing involving Jamie Dimon, CEO of JPMorgan Chase. The hearing was meant to examine the reasons behind a multibillion-dollar loss tied to the bank’s trading of credit derivatives. As one observer put it, “The senators should have interrogated Dimon about his role in moving toward that reckless gambling strategy,” which posed a threat to the entire financial system. “Instead, they mostly cowered and cringed and sat mute with thumbs in their mouths, while Dimon evaded, patted himself on the back, and blew the whole derivative losses episode off as an irrelevant accident caused by moron subordinates” (Tiabbi 2012). An even more telling example of financial power took place that same year, when banking giant HSBC admitted to violations covering \$200 *trillion* worth of transactions involving Mexican and Columbian drug cartels—groups that were allegedly tied to terrorist organizations. Surely, this would warrant a major sanction by the world’s most powerful country, the United States. Instead, HSBC was fined a paltry \$4.2 billion. No HSBC executives were even charged with criminal wrongdoing, because, in the view of U.S. Attorney General Eric Holder, the bank and its executives were simply “too big to jail.”

Changes in corporate power, in sum, cannot properly be understood without considering the financial structure of power. The issue, of course, is far more complicated than I have suggested here. Certainly, we need to examine all the structures of power, and the different aspects of state-business relations in the global political economy, to achieve an adequate understanding. The basic lesson, however, should be clear: questions of structural power must be addressed.

A second example I would like to discuss is perhaps the most problematic. Many of you probably agree that large corporations are capable of exercising structural power. But what about ordinary citizens working together in grassroots organizations, unions, or broad-based social movements? What is the source, if any, of their power? Can such groups even hope to have a meaningful impact on the world economy? For example, do the groups who challenge neoliberal globalization—such as those who participated in protests against the World Trade Organization in Seattle in December 1999, the 2011 G20 Summit in Cannes (France), or those in the 2011–12 Occupy Wall Street movement—have any chance of succeeding? Or are they simply wasting their time? The easy answer, of course, is that they are wasting their time. States, despite an erosion of sovereignty, are still extremely powerful and coercive institutions. Corporations, if anything, are getting stronger. Ordinary citizens, on the other hand, have neither armies nor wealth; they seem powerless. We have learned, however, that social power is invariably reciprocal and context dependent. The reciprocal nature of social power, for instance, tells us that states and corporations, to a significant

**Figure 1.12. A Lone Protestor—The WTO Protests in 1999 (Seattle)**



This shot was taken by J. Nardin during the protests in Seattle, Washington, in November 1999.

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degree, depend upon the perception or belief that their activities are legitimate. In this sense, global capitalism survives because a large majority of the world's population *believes* it serves their interests. Take away or undermine this belief and the system itself is threatened. This helps us understand, I might add, why capitalism is not just an economic system, but (according to some critics) a cultural system as well. Capitalism (or neoliberalism), in other words, is an ideology that convinces people that it is the only rational—even conceivable—way of organizing an economy and society. This is the basic message underlying the writings of **Antonio Gramsci**, who coined the phrase *cultural hegemony* to describe how the ruling class is able to manipulate a society's culture so that the values, norms, and interests of the ruling class become the values, norms, and interests of the society as a whole. At a more concrete level, however, it is important to recognize that societal actors

have many tools at their disposal—tools that have become more effective in the era of globalization. These include the type of mass protests and demonstrations I alluded to above (i.e., the 1999 protests against the WTO in Seattle, etc.), as well as internet-based campaigns, consumer boycotts, and the like.

In a similar vein, the context-dependent nature of social power tells us to look at broader forces that exist outside, say, the relationship between citizens and corporations. What effect, for example, will the spread of political liberalism (e.g., democracy) and human rights across the globe have on the capacity of citizens to exercise power? What of the seeming dispersion of control over access to information via the Internet? What role can transnational institutions, such as the Catholic Church, or transnational religions, such as Islam, play? I do not want to try answering any of these questions now; rather, I would like you just to think about the ways in which a structural analysis of power compels us to address hitherto hidden or obscured aspects of important issues. This is perhaps the best way to learn about the complex and sometimes confusing world of international or global political economy.

## **Chapter 1: Conclusion**

We have covered a lot of ground in this chapter, which has likely left you more confused than enlightened. To a certain extent, this was my intention. That is, one of the purposes of this introductory chapter was to introduce you to the increasingly complex world of international or global political economy. At the same time, there are a number of basic points that I want you to keep firmly in mind as you read the remainder of this book. First, in IPE, there is no definitive approach or theory. If anything, disagreements and

debates define the field. This does not mean, however, that IPE is a chaotic mess. It is not. There are, as we will see in the following two chapters, a number of extremely well-developed, coherent, and insightful perspectives around which the field as a whole revolves. Second, just as there is no definitive theory, there is no common agreement on how to define what IPE includes—at least beyond the traditional concerns of international trade, finance, and production. Third, globalization has introduced important, even centrally important, elements of novelty into the international-global political economy. It is, in particular, changing relations of power, bringing in a range of additional actors (societal or nonstate), and altering global dynamics through technological innovation. Fourth, regardless of theoretical differences and debates, the study of IPE requires that we take questions of power—what power is, who or what has power, how power is distributed and exercised—extremely seriously. Power is not external to the world economy; it is part and parcel of the world economy, and of the social world as a whole.

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<sup>1</sup> *Oxford Dictionaries Online*, s.v. “era,” accessed August 20, 2013,  
[http://oxforddictionaries.com/definition/american\\_english/era](http://oxforddictionaries.com/definition/american_english/era).

<sup>2</sup> *Oxford Dictionaries Online*, s.v. “tension,” accessed August 20, 2013,  
[http://oxforddictionaries.com/definition/american\\_english/tension](http://oxforddictionaries.com/definition/american_english/tension).

## Chapter 2

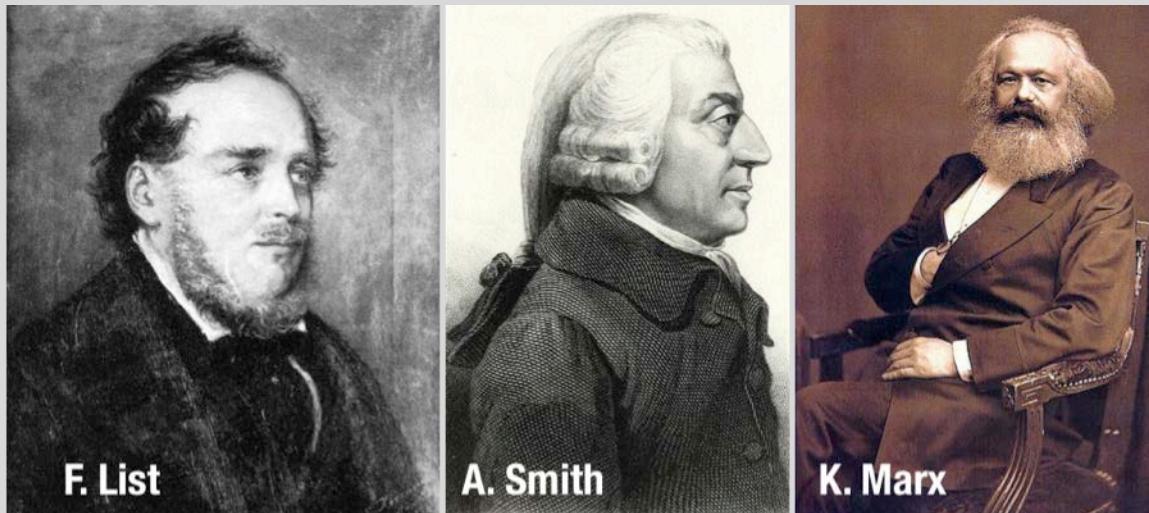
### Foundational Theories of IPE: An Unconventional Introduction to Mercantilism, Liberalism, and Marxism

#### The Three Major Perspectives of IPE: Still Going Strong?

IPE, as we have already seen, is a contentious field. This does not mean, however, that there is a complete lack of agreement among IPE scholars. In fact, for a long time, research in IPE has been broadly divided into three major schools, or perspectives, which we can classify as mercantilist, liberal, and Marxist. Each of these perspectives has been around for a long time. Mercantilism is the oldest of the three, dating back as early as the 16<sup>th</sup> century (perhaps even earlier). As a coherent politico-economic theory, however, many scholars point to **Friedrich List** (1789–1846) as the intellectual father of mercantilist thought. *The National System of Political Economy* (first published in 1841) is List's best-known work on the subject. List, it is important to note, mounted his defense of mercantilism as a response to classical economics and, more specifically, to the writings of **Adam Smith** (1723–1790), whose *An Inquiry into the Nature and Causes of the Wealth of Nations* (or more simply, *Wealth of Nations*), published in 1776, quickly became one of the basic treatises of the liberal perspective. Marxism, then, is the youngest of the three. Karl Marx published his most famous work, *Das Capital*, in 1867 (later, his colleague **Friedrich**

Engels used Marx's notes to publish two additional volumes, in 1885 and 1894). Marx, too, wrote *Das Capital* partly as a critique of classical economics, but also as a larger examination of the social and historical forces that shape human society.

**Figure 2.1. The “Big Three”: Friedrich List, Adam Smith, and Karl Marx**



*All images are in the public domain.*

The original mercantilists believed that a country's economic prosperity came from its stocks of precious metals, and that the best way to increase these stocks was to limit imports through tariffs and other protectionist policies, while maximizing exports, thus creating a trade surplus. Despite its relatively old beginnings, mercantilism is far from a moribund tradition. Indeed, mercantilism enjoyed a strong revival in the latter part of the 20<sup>th</sup> century, due in no small measure to Japan's rapid ascent to the status of economic superpower in the few decades following World War II. In fact, Japan's rate of economic growth in the early postwar period was unprecedented: no country had ever achieved so much economic progress in so little time. Consider, on this point, that Japan's per capita

income in 1950 was less than half of the Western European average, and yet, by 1970 Japan had virtually caught up. It did this by quintupling per capita income, while Western Europe only doubled its income in the same period of time (see table 2.1, “Comparative Per Capita GDP Figures”). The key point is this: many scholars argue that the Japanese state—practicing an updated form of mercantilism or, most simply, neo-mercantilism—was primarily responsible for the country’s stunning economic success.

The *neo* in neo-mercantilism highlights a number of distinctions from the older version. First, the emphasis on holding precious metals was replaced by holding **foreign exchange reserves** (usually in the form of U.S. dollars). Second, the newer form of mercantilism is much more strongly concerned with developing a country’s domestic manufacturing capacity; this led to a strong emphasis on **infant industry protection**. Third, in neo-mercantilism, especially as it developed in the 20<sup>th</sup> century, states were expected to play a much more sophisticated and interventionist role in the national economy. For example, instead of just engaging in protectionism, states were charged with identifying and helping to develop strategic and targeted industries (i.e., industries considered vital to long-term economic growth) through a variety of means, including tax policy, subsidization, banking regulation, labor control, and interest-rate management. States also had to fulfill a disciplinary role in the domestic economy—to essentially take the place of the **invisible hand** of the market by ensuring adequate levels of competition. The Japanese state fulfilled these roles, some argue, almost perfectly. Japan, moreover, was not alone: South Korea, Taiwan, Singapore, and most recently China, have closely followed Japan’s state-directed lead to achieve remarkable economic growth. The case of China is particularly instructive in this view, since the Chinese Communist Party (CCP) still governs the country: in China, in

short, we have a seeming paradox whereby a highly interventionist and authoritarian political party is presiding over one of the most dynamic capitalist economies of the past 20 years (I will have much more to say about the case of China later in this book). The proof of the continued relevancy of mercantilism, therefore, is in the pudding. (Few researchers actually use the terms *mercantilism* or *neo-mercantilism* to describe their work. Instead, they have adopted less politically loaded terms, one of the most prominent of which is the *statist perspective*; a more specific term, typically used to refer to the East Asian economies (especially Japan, South Korea, and Taiwan), is the *developmental state approach*.)

**Table 2.1. Comparative Per Capita GDP Figures (in international dollars\*), Selected Countries and Years**

|                       | <b>1950</b>  | <b>1970</b>  | <b>1980</b>   | <b>1990</b>   | <b>2000</b>   | <b>2008</b>   |
|-----------------------|--------------|--------------|---------------|---------------|---------------|---------------|
| Mexico                | 2,365        | 4,320        | 6,320         | 6,085         | 7,275         | 7,979         |
| <b>Japan</b>          | <b>1,921</b> | <b>9,714</b> | <b>13,428</b> | <b>18,789</b> | <b>20,738</b> | <b>22,816</b> |
| Sri Lanka             | 1,253        | 1,499        | 1,830         | 2,424         | 3,597         | 4,895         |
| Ghana                 | 1,122        | 1,424        | 1,157         | 1,062         | 1,265         | 1,650         |
| Philippines           | 1,070        | 1,764        | 2,376         | 2,197         | 2,377         | 2,926         |
| <b>Taiwan</b>         | <b>916</b>   | <b>2,537</b> | <b>5,260</b>  | <b>9,938</b>  | <b>16,872</b> | <b>20,926</b> |
| Egypt                 | 910          | 1,254        | 2,069         | 2,523         | 2,936         | 3,725         |
| <b>South Korea</b>    | <b>854</b>   | <b>2,167</b> | <b>4,114</b>  | <b>8,704</b>  | <b>14,375</b> | <b>19,614</b> |
| Western Europe (avg.) | 4,569        | 10,169       | 13,154        | 15,908        | 19,176        | 21,672        |

**Key Points.** This table shows the rapid economic ascendance of three East Asian economies, Japan, Taiwan, and South Korea, since 1950. Note that Taiwan and South Korea started as two of the poorest countries in the world, but by the end of 2008 had essentially caught up with Western Europe in terms of per capita income. Japan accelerated more quickly: by 1970, Japan had already achieved the same basic income level as Western Europe. At the same time, other countries have tended to fall further behind, relatively speaking. Consider Mexico: in 1950, its per capita income was about half of per capita income in Western Europe, but in 2008, it had dropped to about one-third. In addition, Mexico, which was richer than all the East Asian countries in 1950, was substantially poorer than all three as early as 1990.

\* The international dollar, also known as the Geary-Khamis dollar, is a hypothetical unit of currency that has the same purchasing power that the U.S. dollar had in the United States at a given point in time. In the data above, 1990 is used as the benchmark year for comparisons that run from 1950 to 2008. While the international dollar is not widely used, for per capita GDP comparisons across a range of countries over a relatively long period of time, it is a useful measure. The World Bank and the International Monetary Fund do use the international dollar in some of their published statistics.

Source: Maddison (2008)

Marxism, too, is far from a dead tradition. Admittedly, this might sound strange given the collapse of the Soviet Union, and the apparent embrace of the market by most remaining socialist countries, including mainland China and Vietnam. Even North Korea has been forced to take tentative steps toward market reform. “Communism,” in this sense, has clearly failed, and this failure is supposed to have completely discredited Marxism and all its variants. (I put quotation marks around *communism* because, in classical Marxist theory, what existed in the former Soviet Union and other countries was not, and could not be, communism—a point that is discussed further in figure 2.2.) However, while it is certainly true that **central planning** in **command economies** has proven to be an utter disaster, it is *not* necessarily true that all or even most of the Marxist critique of capitalism has been negated by historical and contemporary realities. In fact,

just the opposite is the case, at least according to advocates of Marxism. Global and national income inequality, for example, remains extreme: according to an analysis by Ortiz and Cummins (2011), in 2007, the richest 20 percent of the world’s population controlled 83 percent of the world’s income, while the poorest 20 percent controlled just 1.0 percent. This differential actually

**Figure 2.2. What Is Communism?**



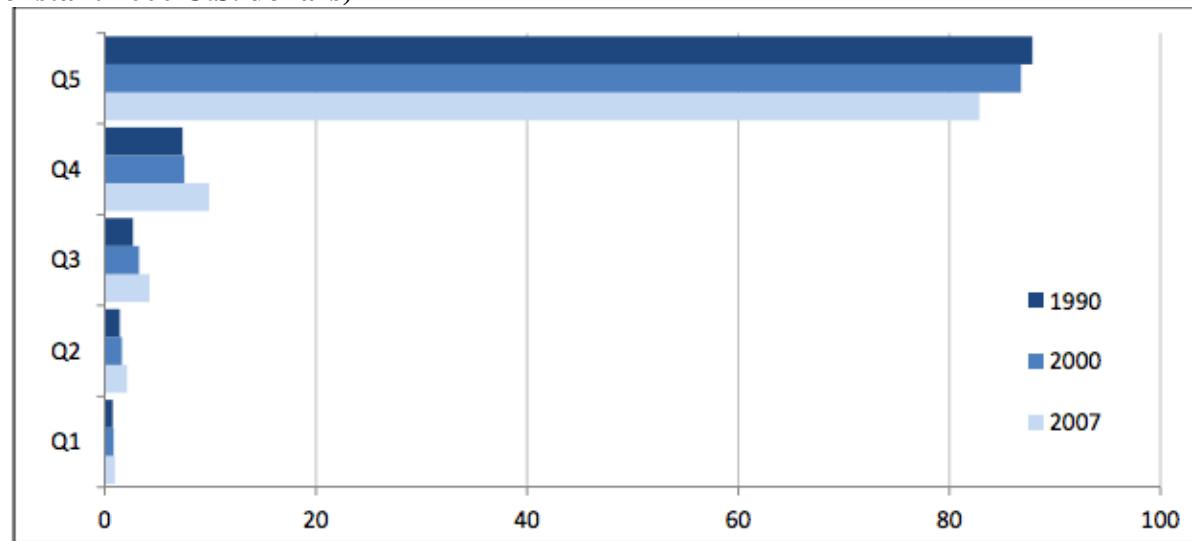
Many people—including scholars—assume that “communism” in the former Soviet Union was the same as Marxism. Yet, in classical Marxist thought, this is decidedly *not* the case. According to Marx, communism was a historical stage, but to reach this stage, it was necessary to first pass through capitalism. Why? Because communism required a firm economic or material foundation that only capitalism could provide. In this view, then, no society could skip the capitalist stage. Yet this is precisely what the Soviet Union (and China, Vietnam, Cuba, North Korea, etc.) tried to do. In so doing, however, they were doomed to failure. In this sense, we might say that Marx predicted the collapse of the Soviet Union before it was ever created, just as he predicted China’s turn toward capitalism.

*Image: The work (image) is not an object of copyright according to Part IV of Civil Code No. 230-FZ, Article 1258 of the Russian Federation.*

[saylor.org](http://saylor.org)

represents an improvement from 1990 (when the respective figures were 87 percent and 0.8 percent respectively), but it is nonetheless indicative of, as the authors put it, “an incredibly unequal planet” (p. 11). Exploitation of labor, moreover, shows no sign of lessening; in fact, in parts of the world—e.g., Ghana and Côte d’Ivoire (also known as the Ivory Coast)—the problem of child labor and even child *slave* labor has become endemic. In 2011, for instance, it was estimated that more than 1.8 million children throughout West Africa were working in the cocoa industry (Hawksley 2011), and tens of thousands of them were forced to work without payment (Manzo 2009)—the very definition of slavery. At the same time, the global candy and chocolate industry, located primarily in wealthy Western countries, had revenues of \$118 billion the same year, and it was predicted that with the “high level of value addition during the production process … the industry’s major players [are expected] to realize high profit margins and perform well in 2012” (IBIS World 2012).

**Figure 2.3. Global Income Distribution by Population Quintiles in 1990, 2000, and 2007 (in constant 2000 U.S. dollars)**



Each quintile (e.g., Q1) represents 20 percent of the observable world population. The figure includes all individuals for which data is available, from the poorest quintile in the Democratic Republic of Congo to the richest quintile in Luxembourg.

Source: Ortiz and Cummins (2011), p. 11.

The planet and its environment, Marxists will also point out, are being destroyed by rapacious corporations, and the capitalist system overall is becoming more and more unstable: the global financial crisis of 2008—a crisis that lasted four or five years—is certainly testament to this. This crisis, however, is simply another in a long line of increasingly more frequent financial and economic crises, including the Latin American debt crisis of the 1980s, the U.S. savings-and-loan crisis (1985), the U.S. stock market crash of 1987, Japan’s asset bubble collapse (1990), Black Wednesday in Europe (1992), the Mexican peso crisis (1994), the Asian financial crisis (1997), the Russian financial crisis (1998), the Argentine financial crisis (1999), and the dot-com crash (2000), among many others. Marxists tell us that all of these crises are cut from the same cloth. In particular, they all reflect the inherent instability and volatility of a global capitalist system that has become increasingly reliant on financial speculation for profitmaking. To be sure, some actors will always make huge sums of money from the speculative bubbles that finance capitalism produces, and this can create the illusion that everything still works. “But”, as Wallerstein (2008) succinctly put it, “speculative bubbles always burst, sooner or later.” In fact, they not only burst with unnerving regularity, they also emerge time and time again. The reason is clear: the traditional avenue for generating large-scale corporate profits is choked off by excessive production, investment, and competition; thus, financial speculation serves as one of the few roads, if not the only major road, still open to capital accumulation on a sufficient scale. Indeed, we can expect an acceleration of this trend, since the world’s productive capacity will continue to outpace its consumptive capacity. We will come back to this basic

point later; suffice it to say for now that reports of Marxism's death, to paraphrase Mark Twain, have been greatly exaggerated.

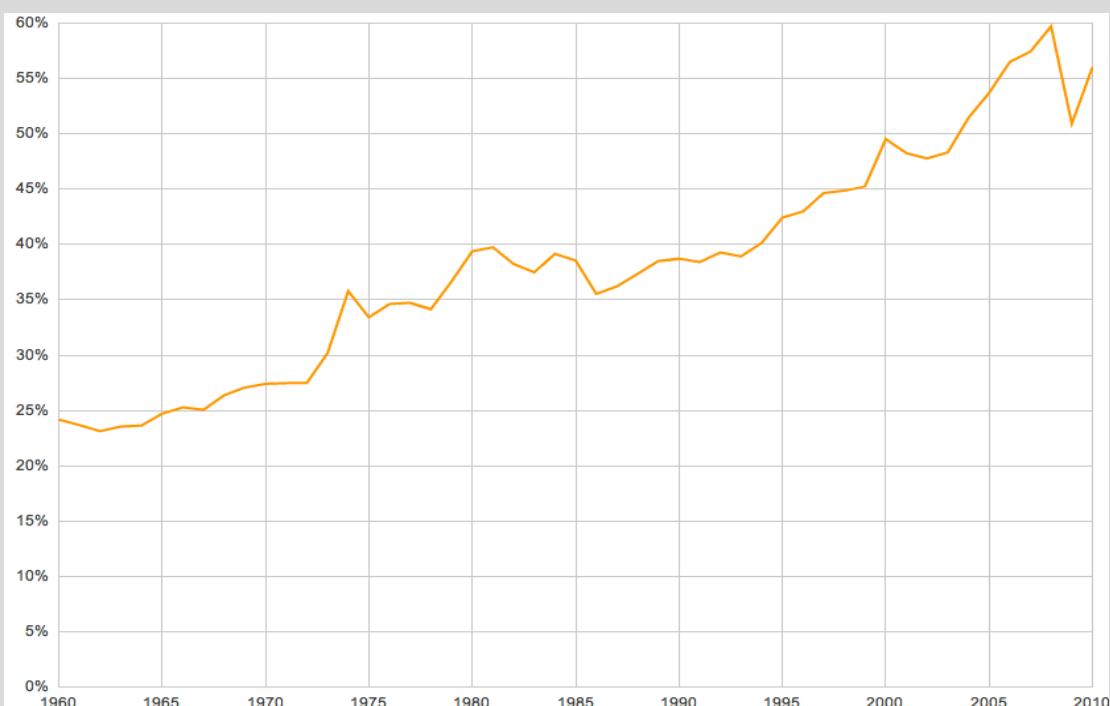
Of the three perspectives, liberalism has had the strongest and most sustained following: it is the mainstream approach in economics, although not necessarily in IPE, and has been for quite some time. (An important note: the word *liberalism* here does not refer to, say, the progressive political orientation of the Democratic Party in the United States; instead, it refers to the classical principles of individual liberty and limited government.) As I suggested in chapter 1, there is no single liberal economic theory. Instead, there are a variety of theoretical positions, some of which can differ quite significantly from others, even with regard to some fairly basic assumptions. That said, there are core features on which most liberal economic analysts agree. In this regard, a good place to start is with the market, and more specifically the free market. A market, in the most general sense, is any place where the sellers of a particular good or service can meet with the buyers of that good or service to conduct an exchange or transaction. A free market refers to exactly the same arrangement, but is conditioned on voluntary and unrestricted exchanges. This includes trade between and among countries—i.e., international trade. This leads to a key assumption in the liberal view: (voluntary) exchanges in free markets, whether between individuals or between countries, generally result in mutual benefit. Rothbard (2006) put it this way: “Trade, or exchange, is engaged in precisely because both parties benefit; if they did not expect to gain, they would not agree to the exchange” (n.p.).

The beauty of the free market—and another basic area of agreement—is that it tends to operate in a largely self-regulating fashion. This means, in part, that while the free market can and does experience problems, the market process will automatically resolve these

problems. Consider, on this point, a recurring phenomenon: throughout history, free markets have experienced regular ups and downs (i.e., periods of strong economic growth followed by periods of economic slowdown or recession). In the simplest terms, we can say that these so-called boom-and-bust cycles are caused by a temporary imbalance between supply and demand. One reason for this imbalance is overinvestment. The logic here is easy to understand: in a growing market, market actors will take advantage of new opportunities for profitmaking by ramping up investment to meet still-rising consumer demand. At some point, though, demand becomes sated (through the entry of more and more firms, through a change in consumer tastes, etc.), and a large number of companies will find themselves unable to sell their products. They go bankrupt, workers lose their jobs, and demand may be further weakened (as incomes decline). If this happens on a nationwide basis, a country's entire economy may go into recession. If it happens on an international basis, the world economy may go into recession. For many liberals, the prescription for how to solve this problem is clear: do nothing. Or, rather, leave the market alone to self-correct. In the foregoing example, the process of self-correction is readily apparent: as companies go bankrupt and leave the market, supply dwindles and supply and demand come back into balance, or equilibrium. The strongest and most efficient producers continue to thrive, while others seek out new, more profitable opportunities elsewhere. Investment soon recovers, workers are hired back, overall demand increases, and the economy starts to grow again. The result is an economic boom. These boom periods more than make up for the economic losses suffered in the bust periods. Self-regulation, in short, keeps markets operating smoothly and at maximum efficiency over the long run.

To liberals, the proof of their point of view is also in the pudding. To see this, liberal economists and their supporters tell us to simply look around the world. The breakdown of communist rule in the Soviet Union and Eastern Europe, for example, clearly confirmed what many people already took for granted: the self-evident superiority of liberal economic principles,

**Figure 2.4. Trade as a Percentage of World GDP**



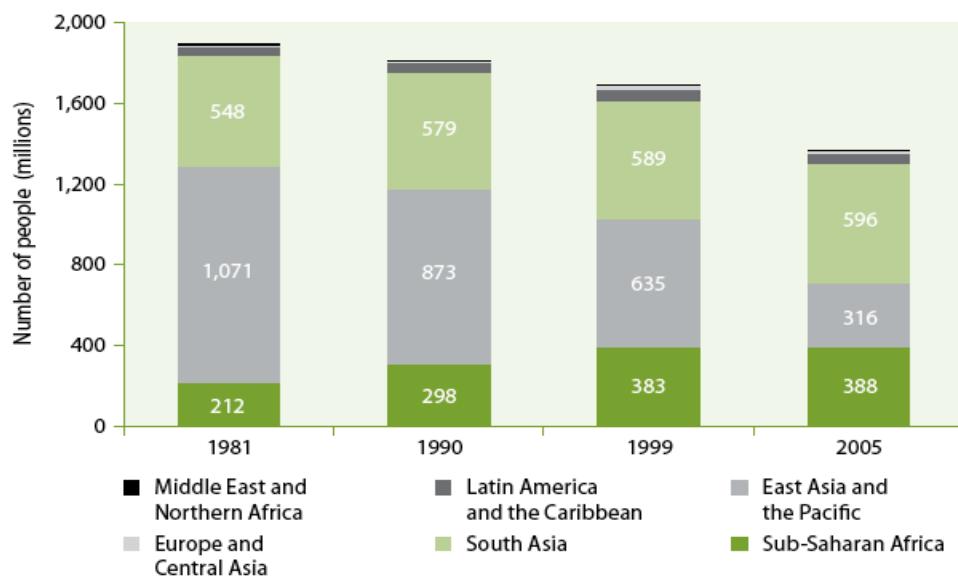
This chart shows a steady increase in world trade (measured as a percentage of gross domestic product) between 1960 and 2010. The dip in 2008–2009 is due to the global recession; by 2010 a strong recovery was already in evidence.

Chart generated by Google based on data from the World Bank: <http://www.google.com/publicdata/>.

meaning **laissez-faire**, comparative advantage, free trade, and competition. In addition, China's embrace of market reform, beginning in 1979, followed by that country's economic takeoff and ascendancy—which we are witnessing right now—is just another example of the

power of unleashed market forces (prior to 1979, China's centrally planned economy had only succeeded in creating a slow-moving, industrially backward leviathan.) Moreover, while mercantilists (and neo-mercantilists) point to the success of Japan and other East Asian economies, liberals tell us that success was more mirage than reality. To see this, just look at Japan for the past twenty-plus years (since 1990). Its economy has been mired in a prolonged slump, with high levels of inefficiency, low productivity, and corruption—a wicked combination that has been summed up by the term **crony capitalism**. Even some individuals who once lauded Japan and the rest of East Asia's **neo-mercantilist** success now argue that, for those countries to continue to prosper, their governments must learn to get out

**Figure 2.5. Number of People Living on Less Than \$1.25 (PPP\*) a Day**



This figure shows that the total number of people living on less than \$1.25 a day (the amount typically used to indicate severe poverty) has been slowly, but steadily declining since 1981. While a direct connection between increasing world trade and decreasing global poverty cannot be made, a strong case can be made that trade does contribute to poverty reduction (see, for example, Wiig, Tøndel, and Villanger 2007).

\* PPP stands for purchasing power parity. It is both a theory about exchange-rate determination and a tool used to make more accurate comparisons among countries. For further discussion of PPP, see Suranovic (2010) [His article is available on the Saylor.org site at <http://www.saylor.org/site/wp-content/uploads/2012/10/Chapter-17.pdf>]

Source: Figure is copied directly from UN Department of Economic and Social Affairs (2009, p. 16).

of the way of private enterprise; what worked in the past, in other words, will no longer work today, since global competition has made it impossible for government bureaucrats to keep up with increasingly rapid changes in the world economy. More generally, we can easily see that the opening of borders to freer trade, despite recent economic problems, has increased economic growth and likely helped to decrease poverty on a global scale. There is much more evidence that liberals can point to; suffice it to say, for now, that the free market has not only proven, time and time again, to be the only rational basis for countries, both individually and collectively, to prosper, but it has also proven to be tremendously resilient and adaptable.

## *The Continuing Debate*

How is it that all three of these contending perspectives continue to be relevant today? After all, one would think that after more than a century of debate, one perspective would have proven clearly superior to the others. But this has not happened. We already covered one of the major reasons for this in the previous chapter—namely, the nature of the subject itself. We cannot, therefore, expect to resolve the issue here. There are also other, less obvious, reasons, which will be addressed later. For now, though, it will be useful to adopt an admittedly unconventional approach, not only to help you get a better grasp of the differences among mercantilists, liberals, and Marxists, but also to give you a sense of the obstacles to finding the one “true” account of IPE. Specifically, I would like to engage you in a conversation involving three scholars representing the three main perspectives of IPE.



*We catch the action in a dingy office as three middle-aged and somewhat gruff scholars debate how to organize their new think tank on international political economy. After hours of discussion, however, they can't even agree on whether what they do is political or economic. In any case, the members of this contentious trio are: Friedrich the Mercantilist, Joanna the Liberal, and Karl the Marxist. In the midst of their discussion, in walks a bright-eyed but somewhat confused looking student.\**

*Karl:* If you're looking for the cafeteria, it's outside and to the right. Now, get out, we're busy.

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\* The original author of the conversation that follows is Wayne Le Cheminant, who wrote it as part of the requirements for a class on international political economy taught by Professor Lim at California State University, Los Angeles. Other contributors are Karen Tan, Tri Ta, and John Brown, all of whom were also students in Professor Lim's class. Professor Lim edited and significantly expanded upon parts of the original paper for this chapter.

*Student:* Oh, I'm sorry. I just had lunch. I'm really looking for the "Group of Three." The student newspaper has been reporting that the G-3 is starting up a new think tank here on campus, and I need to ask them about some very important matters. You see, I'm planning to major in international political economy, but to be perfectly honest, I'm not even sure what that is. All I know is that it's supposed to be important.

*Karl:* Yes, yes, we're the G-3. But if you're unsure of yourself, this isn't the place for you. Except for *me*, my colleagues all suffer from a bit of befuddlement themselves. None of them seems to know what *really* matters.

*Student:* Well, if that's the case, maybe I should leave. After all, if you can't even agree among yourselves ...

*Friedrich:* No, stay. Karl here tends to exaggerate and he's a little too serious to boot. We may not see eye to eye on everything, but I can certainly agree with some of what he says, especially how we should be wary of the rich and powerful—who, we all know, won't hesitate to crush the weak in order to protect their own self-interests. Even my esteemed liberal (or should I say neoliberal?) colleague agrees that self-interest is vitally important. Isn't that right, Joanna?

*Joanna:* Don't mock me, Fred. You know that I believe self-interest to be of paramount importance. But you also know that we cannot let the self-interest of government officials interfere with individual choice. Anyway, we're wasting time here, and none of us really has time to waste, so let's get down to brass tacks. Young man, what do you think we can do for you?

*Student:* Well, I was hoping you could answer a few questions about IPE. You know, help me get a better grasp of what the field is all about.

*Friedrich:* Well, well! That's the reason we decided to create our new think tank to begin with. Go ahead—give us a shot.

(Before Karl and Joanna can disagree, the student begins to speak.)

*Student:* Okay, here goes nothing. It seems that in international political economy there are a bunch of different theories out there. In fact, there seem to be at least three distinct schools of thought, which all of you obviously already know. Aside from the three major schools, there also seems to be a figurative avalanche of sub-schools, splinter groups, varying interpretations, and confusing debates that I guess make sense to those doing the talking, but which seem completely irrelevant to the average person.

*Friedrich:* Quite impressive, young man. You seem to know a little more than you first let on. Now, let's see what I can do to set you straight ...

*Student* (interrupting): Hold on a minute! That's not all I have to say. I've also been told, or at least led to believe, that scholarship and research are supposed to lead to the truth of *something*. Well, here's my million-dollar question: Where's the truth? Or, should I ask, *is* there a truth in IPE? That is, is there *one* school of thought that I can look to in order to truly understand the relationship between politics and economics in world affairs? Or is it possible that all the schools simply provide small portions of a larger truth that exists out in the world someplace? In fact, perhaps all of these competing schools of thought are slowly moving toward the same version of the truth? Wasn't it Aristotle who said, "Truth ... is the work of everything intellectual" (cited in Ackrill 1987, p. 418)? You three don't seem to work in the traditional sense of the word, so you must be intellectuals. Ergo, your work ought to be producing truth.

*Karl:* Of course, you're right young man. At least I'm in the business of discovering the truth; as for the others, they purport to be working on the truth, but I'm not at all convinced. They seem much more concerned about justifying their own privileged positions in the world—keeping themselves in power with an ideology disguised as theory, as it were.

*Joanna:* Karl, you really must temper your comments. We're certainly no less concerned with the truth than you. In fact, economic liberals, especially my neoclassical friends, have even developed a rigorous—and by rigorous, I mean highly mathematical—methodology practically guaranteed to find the truth ... sooner or later.

*Student:* Excuse me, but this is exactly what I mean. Both of you claim to be searching for the truth, but at least from my rather rudimentary knowledge of your theories, what you say is completely different. My point is this: if one of your theories is true or correct, then the others must be incorrect. Or, if your theories are somehow parts of a larger puzzle, they are all still incorrect unless you can show the possibility of a synthesis or unification of the theories, which seems unlikely.

*Joanna* (looking annoyed): So what is it that you want from us? It seems you already have things figured out. Besides, I'm getting tired of all this talk about the truth. As I said, in my work, I'm always searching for the truth, as you mean it. But, I'm much more interested in *results*. As I like to say: the proof is in the pudding, and it's clear that free markets lead to prosperity, choice, and liberty. Why, just look at the world around you—the collapse of communism, the triumph of **Anglo-American capitalism**, the spread of democracy ...

*Student* (interrupting): Wait a second, now. Before you go on, I'd like to answer your question. You asked what *I* want. What I want is simple: answers.

*Joanna*: What sort of answers, young man? And, mind you, don't be impertinent.

*Student*: Sorry, ma'am. Basically, I want to know what these three theories, or perspectives, of IPE really are. Also how, and on what basis, do they differ? Moreover, I want to know how deep these differences go.

*Friedrich*: Ah, that will be easy. Mercantilism is ...

*Student* (impertinently): Not so fast, my friend. After you cover the basic points, I want you to answer the bigger questions I mentioned earlier—namely, how each of your respective schools of thought relates to the truth. After that, I want you to tell me how and why the study of any of your theories might be important to *me*. More generally, I want you to tell me what relevance your work has to anything in this, or any, world.

[A long silence ensues as Joanna, Karl, and Friedrich, a little stupefied, exchange uneasy glances. Friedrich breaks the silence.]

*Friedrich*: Listen, my fellow IPErs, we cannot let this outsider—this *whippersnapper*—come here and scare us. In fact, if we back down, it would only embolden him more. He might even try to move in on our operation here—take us over, if you will.

*Joanna*: For once, Fred's right. Besides, this sort of competitive challenge will only make us more efficient and productive thinkers in the long run.

*Friedrich* (standing up): Why, thank you, Joanna. That's the first time you've agreed with me for as long as I can remember. Shall I be the first to speak?

*Karl*: Be our guest, Fred. You are, after all, the senior member here.

*Friedrich* (now facing the student): Well, then. Let me start by saying that mercantilism is not so much a theory as it is a politico-economic strategy. Perhaps this is why our critics accuse of us of being unscientific and even amoral. Mercantilism is neither.

*We simply recognize that economic processes do not take place in a vacuum, but in an inherently unequal and power-ridden world.*

That said, let me highlight an important assumption of mercantilism. Namely, mercantilists, and I am not ashamed to apply that label to

myself, view the modern state as the main player (or actor) in world affairs. This is primarily because we live in a dog-eat-

dog, everyone-for-himself world; in such a world, a strong state is necessary to provide protection against external threats, be they economic, political, or military.

Simply put, it's a matter of self-help: in the *real* world, you can't rely on anyone else to protect your interests, so you *must* do it yourself—if you don't, you will almost certainly be subject to the whims and desires of your richer and more powerful neighbors, and nobody wants that, do they? From an *economic* standpoint more specifically, this means that states must also pursue a set of economic policies designed to maximize their own wealth, for, as we all know, wealth and power go

**Figure 2.6. A Dog-Eat-Dog World**



For mercantilists, the world is a tough, unforgiving place, where only the strong survive. In this world, all states must use whatever tools they have to help them not only survive, but also prosper. Liberals forget that, in the real world, “free trade” is a luxury.

*Source. Permission is granted to copy this image under the terms of the GNU Free Documentation License.*

together like bread and butter. I think there is no denying the truth of this statement.

What do you say, my dear boy?

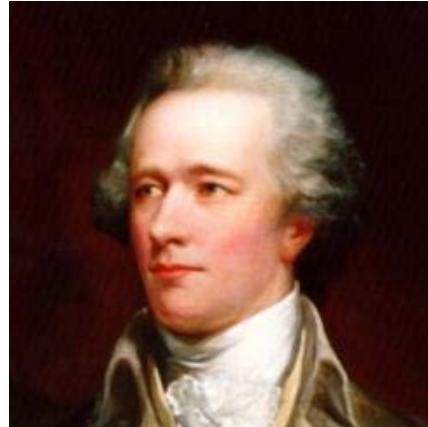
*Student:* Well, so far, it's hard to disagree.

*Friedrich* (smiling): Exactly. But let me continue. Mercantilism, as should already be apparent, is a very practical—or, as I like to say, realistic—perspective. Indeed, our most important forebears were, first and foremost, men of action rather than cloistered intellectuals. Take for example one of the most famous of our ilk: the great

American statesman **Alexander Hamilton** [1755–1804]. Hamilton, as you should know, was a steadfast advocate of a strong and active central government, one that had a duty to promote and protect the nation's manufacturing industries. To *promote* American industry, Hamilton wanted to establish a healthy credit system in the United States—but he knew this would require strong support on the part of the

federal government. Thus, Hamilton urged, among other things, the creation of a *national* bank to facilitate the expansion of both public and private credit, which he correctly understood as more useful than gold and silver. To *protect* American industry, Hamilton argued that the federal government must grant **subsidies** to domestic industries, promote internal improvements, and impose **tariffs** or **duties** on foreign products. In this sense, Hamilton was a “protectionist,” but this is not the

**Figure 2.7. Alexander Hamilton:  
An American Mercantilist**



Hamilton, a seminal figure in early American history, was a strong advocate of mercantilist policies.

*The image of Hamilton is in the public domain.*

nasty word that our liberal friends would have you believe. For what is a protectionist but someone who wishes to defend and promote the interests of his country and by extension, his people, his community, and his family? [Pointing to the student.] What can be wrong with this?

*Student:* Nothing that I can see.

*Friedrich:* My, my. You are an apt pupil, are you not? In any case, I should point out that Hamilton's ideas not only won the day—particularly in his debates against Thomas Jefferson—but also gradually created the basis for American economic policy, both foreign and domestic, for the entire nineteenth century. Today, of course, the United States is unarguably the world's economic powerhouse, and has been so for quite some time now. Would the U.S. have achieved that position were it not for the mercantile policies expounded upon by Hamilton? I think not! Nor is America the only example: Germany, Japan, South Korea, Taiwan, China. Mercantilists all, I say! [Friedrich begins pounding his fists on the table.] What more could you ask for in terms of relevance!

*Joanna and Karl* (in unison): Take it easy, Fred.

*Friedrich* (a bit chastened): Quite sorry. I will try to restrain my passion. Now where was I? Oh, yes. Let me say a few words about another famous mercantilist, Friedrich List. List is a somewhat disparaged soul, as are all mercantilists. Perhaps it is because he was not only unafraid to take on the intellectual establishment of his time, he was also an unabashed nationalist. Yet, it is the writings of men like List that often help us see the truth of the real world. This is most apparent in List's ideas vis-à-vis liberalism, or “cosmopolitan” economy, as he liked to call it. For example, he

argued that the so-called advantages of international trade and **comparative advantage** [see below for additional discussion], while fine in the abstract, neglect the cold realities of unequal power and wealth in the world. In this respect, it's no accident that the Brits, back in the nineteenth century, were in favor of free trade—their industries were the envy of the world. Recall that in the late 19<sup>th</sup> century, Britain was known as the “workshop of the world.” The British could, at the time, outcompete anyone, so to them “free trade” meant British dominated trade and, more important, a British dominated world. Besides, the British only encouraged free trade when it suited their interests, unless you argue that their colonial empire was free, which quite obviously was not the case. We can, moreover, say the same thing about the United States, especially since 1945, when American leaders became the leading advocates of free trade. It was after 1945, of course, that the United States emerged not only as the leading military power in the world, but also as the unchallenged economic power. Think about this: Why was Britain only an advocate of free trade once it established its economic dominance? Why was the United States a mercantile state for most of its history, but then suddenly a cheerleader for free trade after it emerged as the world’s top economy? Is this sheer coincidence? I think not!

**Table 2.2. Relative Shares of World Manufacturing Output, 1750–1880**

| Country/Region        | 1750 | 1800 | 1830 | 1860 | 1880 |
|-----------------------|------|------|------|------|------|
| United Kingdom        | 1.9  | 4.3  | 9.5  | 19.9 | 22.9 |
| Hapsburg Empire       | 2.9  | 3.2  | 3.2  | 4.2  | 4.4  |
| France                | 4.0  | 4.2  | 5.2  | 7.9  | 7.8  |
| German States/Germany | 2.9  | 3.5  | 3.5  | 4.9  | 8.5  |
| Italian States/Italy  | 2.4  | 2.5  | 2.3  | 2.5  | 2.5  |

|               |     |     |     |     |      |
|---------------|-----|-----|-----|-----|------|
| Russia        | 5.0 | 5.6 | 5.6 | 7.0 | 7.6  |
| United States | 0.1 | 0.8 | 2.4 | 7.2 | 14.7 |
| Japan         | 3.8 | 3.5 | 2.8 | 2.6 | 2.4  |

These figures show the relative share of world trade from 1750 to 1880, a period in which the UK rose from being a relatively minor player in the 18<sup>th</sup> century, to the strongest economic player by the late 1880s. Not coincidentally, a mercantilist will point out, it was only around the middle of the 19<sup>th</sup> century, by which time the UK was the top economy in the world, that the country abandoned protectionism and advocated free trade. For example, in 1846, Britain repealed the Corn Laws that had protected agricultural producers, and began to lower tariffs. In 1860, “Britain eliminated all remaining protectionist duties and maintained a tariff only to raise fiscal revenue on a few imported consumption items that were either not produced at home or were already subject to domestic excise tax” (Irwin 1993, p. 147).

*Source:* Kennedy (1989), p. 149.

My main point is this: the principles of *liberal* IPE are most strongly advocated by countries—or groups of people, regardless of their nationality—that have the most to gain from a more open economic system. But those who would suffer from so-called free trade and free markets oppose these principles. It should come as no surprise, then, that there

**Figure 2.8. Pat Buchanan and Ross Perot: American Mercantilists**



Both Buchanan and Perot ran for president several times. Of the two, Buchanan was and still is an unapologetic economic “patriot.” In a 2012 editorial entitled “We Need More Economic Nationalists,” Buchanan writes, “[Global] free trade makes suckers and fools out of patriots.” Perot, in general, was more moderate, but one of his famous lines comes from his criticism of NAFTA, the free-trade agreement among the U.S., Canada, and Mexico. As he put it, NAFTA would lead to a “giant sucking sound,” as he argued that lower wages in Mexico would suck up hundreds of thousands of American jobs.

*Picture of Ross Perot is licensed under Creative Commons Attribution-Share Alike 3.0 Unported; picture of Pat Buchanan is licensed under the GNU Free Documentation License.*

are always intense debates, even within the wealthiest countries, about the advisability of open markets. This was clearly the case in the United States, where battles over protectionist trade policies started in the early 1800s between Northern industrialists and Western farmers, on the one hand, and Southern planters and Northeastern merchants on the other hand. And it has continued right up to today. Witness, for example, the relative success of political figures like **Pat Buchanan** and **Ross Perot** (yes, I know my references are a bit dated, young man, but I'm rather old myself), who fought the Republican establishment tooth and nail over the issues of free trade and **NAFTA (North American Free Trade Agreement)**. At heart, both men are mercantilists—although they would prefer to call themselves “economic patriots”—who are committed, first and foremost, to the welfare of the United States. By contrast, we should also not be surprised that many political leaders in the so-called **Third World** are advocates of liberal economic policies. Occupying privileged positions, such leaders have much to gain from implementing liberal policies. This is true even if most of their compatriots suffer from the ravages of free markets. But even the Third World leaders who aren’t willing to open their economies are eventually *forced* to do so by U.S.-dominated institutions like the **IMF** and **World Bank**.

*Student:* What do you mean “forced”? How can international banking institutions, such as the IMF, force countries to open their economies?

*Friedrich:* Actually, this is something Karl is much more interested in. However, the short answer is this: countries in the Third World—perhaps a better term might be *developing world*—do not have well-developed and competitive industries, and

therefore are unable to generate the foreign exchange they need to import necessary goods, such as oil, food, **capital goods**, medicine, and so forth. Almost all have also borrowed money from international sources to finance the little industry and infrastructure they do have. These loans must be paid back in hard currencies, such as U.S. dollars. If, for any reason, these countries cannot pay for essential imports or make payments on their loans, they need to borrow more money, but usually the only organization willing to lend that money under such circumstances is the IMF. The richest countries, though, largely control the IMF. Naturally, they want something in return for their “generosity,” and what they typically ask for—demand, really—is “market liberalization.” That is, through the IMF, the rich countries demand that poor countries open their markets in return for access to a short-term “bailout” loan.

This is called **conditionality**.

*Student:* I can see your point. It seems Hamilton and List really knew what they were talking about.

*Friedrich:* Precisely, my dear boy. However, lest you think that Mr. List’s only contribution was to show the problems with the liberal perspective, I must point out that he made other important intellectual contributions. In his most important book, *The Natural System of Political Economy*, for example, List helped us understand that it is not wealth *per se* that is important to a nation, but “productive power.” By this he simply meant the *capacity* to make or manufacture a good, rather than the mere possession of that good, or of the specie—i.e., gold and silver—to buy it. To List, the power to produce was important because it developed the necessary foundation of human skills, technological know-how, and industrial expertise necessary for long-term

prosperity. To develop this capacity, however, is not a simple thing. For it requires a nation to “sacrifice and give up a measure of material prosperity in order to gain culture, skill, and powers of united production” in the long run. But will people, on their own, sacrifice material prosperity for the sake of the nation at large? Certainly not. But, even if they do, who will help channel the extra resources into the right areas? The answer, my friend, is obvious: *the state*. My dear boy, can you think of any contemporary examples that confirm what List said? I’ve already given you a hint, or rather the answer, so just think back to what I said earlier.

*Student* (scratching his head): Well ...

**Table 2.3. Top Ten Largest Companies in China and Global Rank (by revenue), 2012**

| Rank* | Company Name                          | State-owned | Revenues<br>(U.S.\$ millions) | Industry           |
|-------|---------------------------------------|-------------|-------------------------------|--------------------|
| 5     | Sinopec Group                         | Yes         | 375,214                       | Oil                |
| 6     | China Petroleum                       | Yes         | 352,338                       | Oil                |
| 7     | State Grid                            | Yes         | 259,142                       | Utilities          |
| 54    | Industrial & Commercial Bank of China | Yes         | 109,040                       | Banking            |
| 77    | China Construction Bank               | Yes         | 89,648                        | Banking            |
| 81    | China Mobile Communications           | Yes         | 87,544                        | Telecommunications |
| 84    | Agricultural Bank of China            | Yes         | 84,803                        | Banking            |
| 91    | Noble Group                           | No          | 80,732                        | Energy             |
| 93    | Bank of China                         | Yes         | 80,230                        | Banking            |
| 100   | China State Construction Engineering  | Yes         | 76,024                        | Construction       |

\*Rank is from *Fortune* magazine’s annual list of the world’s 500 largest corporations, or the “Global 500.”

Source: [http://money.cnn.com/magazines/fortune/global500/2012/full\\_list/](http://money.cnn.com/magazines/fortune/global500/2012/full_list/)

*Friedrich* [visibly impatient]: Back when I was a younger man, I would have said Japan or South Korea, but the best example right now is China. Just think about this: China is ruled by the Chinese Communist Party, or CCP. The CCP still runs things in China, including the economy. In fact, some of the largest companies in the world today, such as Sinopec and China National Petroleum, are owned and controlled by the Chinese government (see table 2.3). And there's little doubt that the CCP protects and subsidizes Chinese companies, whether state-owned or private. And guess what else? Over the past two decades, China has transformed itself into the second largest economy in the world, and while it still earns a lot of money through the export of cheap, low quality goods, it is also moving into value-added, high-technology sectors—at a very rapid pace.

*Student*: Wow, I didn't realize that. So what you say must be the truth! I can clearly see that there is a great deal of competition among states today. I can also see how important power is. The strong, mainly Western, states can dictate to other states what they can and cannot do. I mean, during the 1990s, Iraq couldn't even sell its own oil without getting permission from the West! The strong states even have their own exclusive clubs, like the **OECD**, **NATO**, the **G8**, the **G8+5**, the **BIS**, and the **Davos Forum**, and a few others. I'm not sure what these clubs do, but they must be designed to promote the interests of *only* their members, or else why would they be exclusive in the first place? Why, now that I think about it, I can even see that globalization is nothing more than an effort by the strong and wealthy states to force everyone to open their markets, not because the whole world will benefit, but because open

markets mean more profit, more wealth, and more power for those who already have it! Surely, the rest of you must agree?

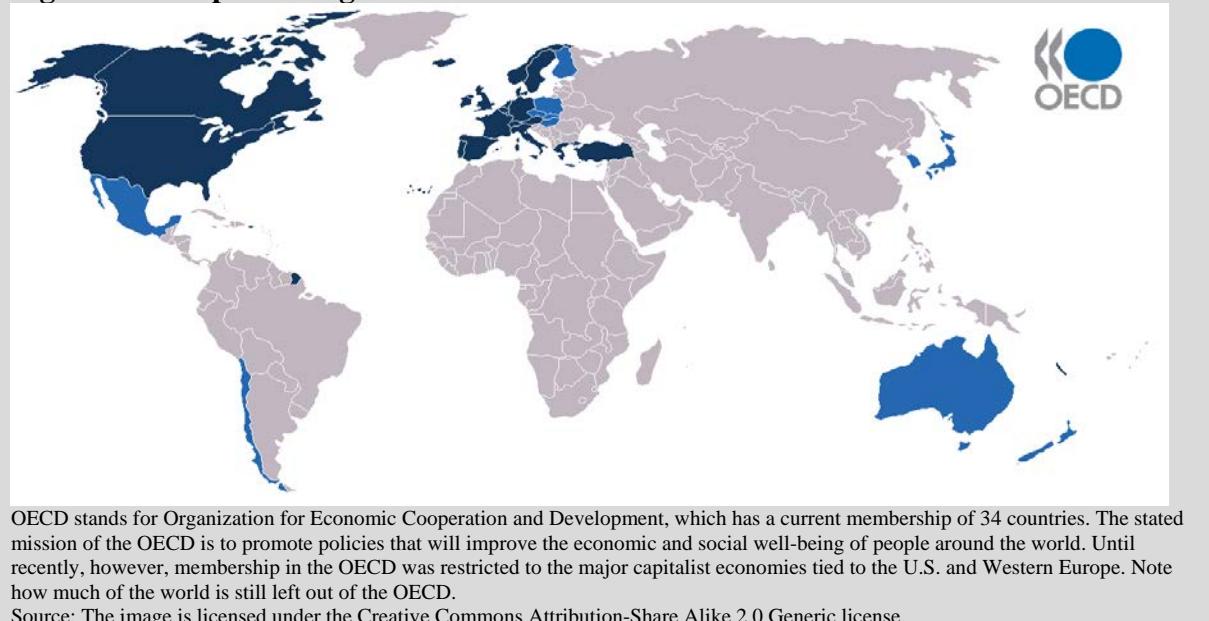
*Joanna:* Well, I agree that Fred tells a good *story*, which is adequate as bedtime reading, but it's not at all satisfactory as *science*.

*Friedrich:* Now, be nice, Joanna.

*Joanna:* Young man, before you take to heart what Friedrich here has said, you might want to hear me out first. Then you can decide where the truth really lies. In fact, the liberal perspective of IPE is a thorough critique of all that you heard above, and more. [Note: as we saw in chapter 1, there are several liberal variants, such as classical and neoclassical economics, Keynesian economics, libertarianism, and the like.]

To begin, let me state a principle that is common to most, if not all liberal perspectives: namely, that free-functioning markets, based on a division of labor (i.e., specialization) and mutually advantageous trade, will ultimately lead to the

**Figure 2.9. Map Showing Members of the OECD**



OECD stands for Organization for Economic Cooperation and Development, which has a current membership of 34 countries. The stated mission of the OECD is to promote policies that will improve the economic and social well-being of people around the world. Until recently, however, membership in the OECD was restricted to the major capitalist economies tied to the U.S. and Western Europe. Note how much of the world is still left out of the OECD.

Source: The image is licensed under the Creative Commons Attribution-Share Alike 2.0 Generic license.

greatest good for all—for individuals, societies, countries, even the entire world. Moreover, achieving this “greater good,” by which I mean general prosperity, does not require force or coercion of any kind; nor does it require planning on the part of any authority, centralized or not. Indeed, this is the beauty of a liberal economy: it is an essentially spontaneous, voluntary, and self-regulating system guided only by the “invisible hand” of which Adam Smith spoke so eloquently. The invisible hand, by the way, is the metaphor used by Smith to describe the principle by which a benevolent society emerged from the unintended consequences of individuals acting in their own interests—or as Smith put it, on the basis of “self-love.” All of this is encapsulated in the famous phrase that Smith borrowed from the French: *laissez-faire, laissez-passer*, which simply means, “Let things proceed without interference.”

There are several other liberal assumptions that you should know. The most important of these, perhaps, is that human beings—or larger collectivities of individuals like the nation-state—pursue or act in their own *self-interests*. This concept is embodied in Smith’s idea of self-love and has been extremely important to the development of liberal economics, which is something I’ll talk about in a second. Before I do this, though, I should say that the idea that people act in their own self-interests—in other words, that we are rational actors—has been criticized as highly unrealistic. To be sure, the concept of rationality is an abstraction or simplification of a much more complex reality. We liberals understand this. But abstractions are *necessary* for theorizing: if one doesn’t abstract, one can’t hope to make sense of the world. We just happen to believe—and with good reason I might add—that much

can be learned by trying to reduce human behavior to its *essence*, while recognizing that culture, religion, history, and yes, even power, as well as a whole host of other factors, are likely to affect and shape the actions of human beings in ways that cannot be wholly predicted. Trying to identify the essence of human behavior does not mean, moreover, that liberals are heartless monsters—something we have also been accused of by our critics. In fact, liberals, almost by definition, are fundamentally concerned with improving the human condition. That is, we are committed to understanding how all societies can achieve democracy, freedom, and prosperity!

I realize all of this may seem old hat to you, young man. But, I really cannot emphasize enough the importance of these principles, which are so basic to most liberals.

*Student:* Oh, no. It's all quite interesting, although I'm not yet sure how your story is better than the one told by Friedrich.

*Joanna:* I will get to that in a moment. First, though, let me go back to a point I raised earlier, namely, that the development of political economy, as a science, owes a great debt to Adam Smith. Smith's brilliant concept of the invisible hand, for instance, allowed us to see that there can be "spontaneous order" in the seeming chaos of human activity. This was an extremely important insight because it essentially made social or economic *science* possible (Vaughn 1998). Although the reason for this is not readily apparent, it is not particularly complicated either. To put it simply, in order to develop a scientific understanding of the social world, it is first necessary to develop a concept that allows us to speak of regularities, patterns, or general

tendencies existing in human society—Smith’s invisible hand did just this. Before Smith came up with the idea of the invisible hand there was no real alternative to conceiving of all social institutions and practices, on the one hand, as products of carefully conceived and fully orchestrated social engineering, or, on the other hand, as the result of natural or supernatural phenomena beyond the ken of human understanding.

There is, however, a fundamental problem with these two choices: the former is obviously wrong, since human beings are clearly *not* infallible, God-like creatures, while the latter means that the concepts of *explanation* and *understanding* must be confined to religious dogma, superstition, or mere speculation/opinion. The idea that the unplanned and uncoordinated actions of myriad individuals acting in their own self-interest could lead to the creation of orderly (and highly efficient) social institutions, like the market, by contrast, literally set our minds and our intellects free. I’m sure you can see the importance of Smith’s insights, can’t you?

*Student:* Yes, I think so. Essentially, Smith’s ideas provided a basis for applying the methodology of the natural sciences to the social sciences. Is that it?

*Joanna:* Precisely! Although Smith’s framework did not allow for the use of sophisticated mathematics, he clearly laid the first bricks in the foundation of neoclassical economics, which is the epitome of social-scientific reasoning and analysis. The concept of self-love, for example, may sound fuzzy and unscientific, but it was translated by later economists into the concept of rationality, which allowed the development of more sophisticated mathematical models.

*Student:* You keep talking about “sophisticated mathematics,” but why is this so important?

*Joanna:* That's a good question. The reason is simple: mathematics is *the* language of science. It is precise, logical, and objective. And it is only through precision, logic, and objectivity that we might discover *the* truth, which seems to be one of your main requirements.

*Student:* Are you saying, then, that those who don't speak the language of mathematics aren't capable of speaking the truth?

*Joanna:* In an important sense, the answer is yes. Even if some or most of what they say is valid and useful, unless we can translate their stories, or narratives, into science, we can never know if what they say is *the* truth. But I am beginning to digress here. I started off talking about liberal perspectives of IPE, and not all liberals speak the language of science; a few even have different views of such central concepts as *laissez-faire* and the invisible hand. Some “revisionist” liberals, for example, believe that markets sometimes need a little outside help to operate smoothly and efficiently. In this regard, you probably already know something about John Maynard Keynes, who convinced a lot of people—scholars, politicians, and bureaucrats alike—that government intervention is occasionally necessary to maintain full employment, control inflation, and encourage economic growth. Keynes’s ideas started to die out in the 1980s and 1990s, but he certainly had a huge impact on all of our lives. Indeed, his ideas were resurrected in the U.S. in order to deal with the financial crisis of 2007. So, if you want relevance all you have to do is think about Keynes and his legacy. As Keynes himself said: “The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who

believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist" (1936, pp. 383–84)—or, as I might add, some defunct *liberal* economist.

But Keynes is not the only revisionist out there who sees an expanded role for the government. One more recent argument revolves around the idea of endogenous growth—sorry for the use of jargon here—which holds that investments in human capital, innovation, and knowledge are main contributors to economic growth. A key implication of this view is that the long-term growth of a national economy is dependent on certain policy measures, such as subsidies for research and development and education. Needless to say, this contrasts with most other models of economic growth in neoclassical economics, and provides even more space for the government than Keynes envisioned. In my view, this is a slippery slope, but I mention it to give you a sense of the variety of revisionist perspectives within liberal economics. [Note: For further discussion of endogenous growth, see Romer (1986) and Lucas (1988).]

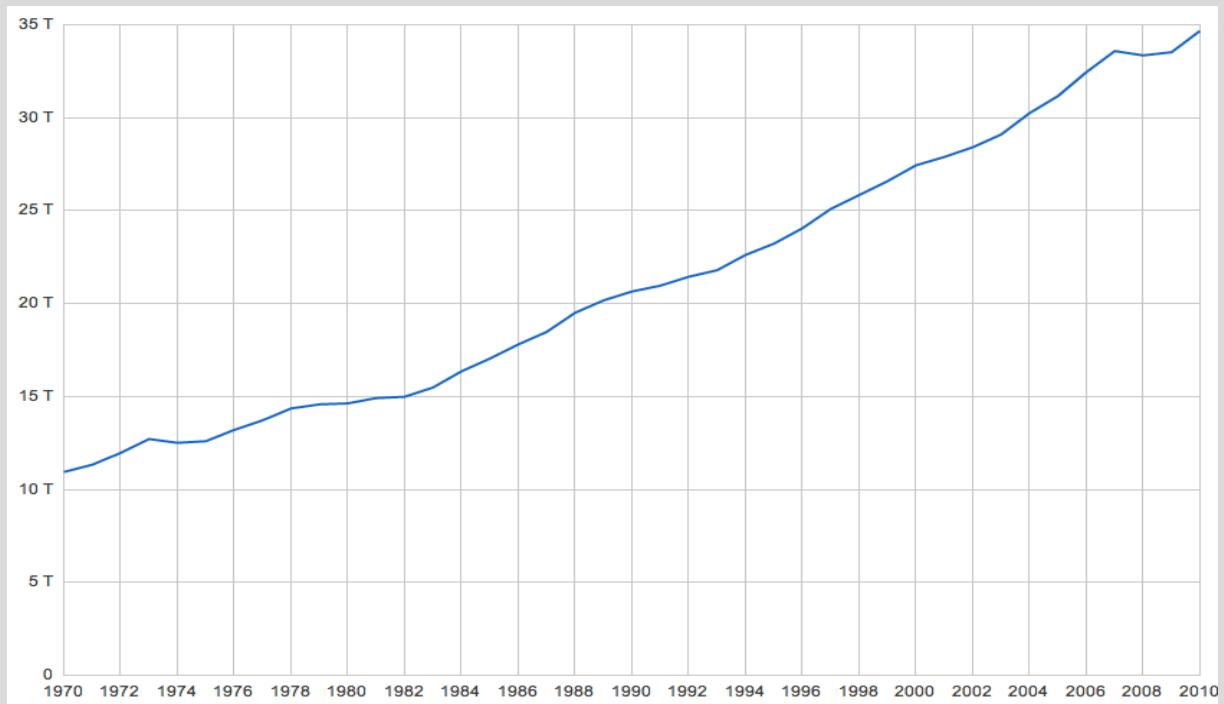
Significantly, even when you consider certain arguments originally put forth by mercantilists, we can see that an understanding of liberal principles changes things. Consider, on this point, an argument normally associated with mercantilism called hegemonic stability theory. The standard version of *hegemonic stability*, which is the phrase most typically used to describe this perspective, portrays the hegemon (which is defined as the predominant military-economic-political power) as sort of an interventionist kingpin: as the kingpin, it maintains a degree of order or stability in the international economy by underwriting and, when necessary,

enforcing the rules that govern the system (the different sets of rules are also referred to as international regimes). Without the stabilization provided by the hegemon, in other words, the world markets would not only operate inefficiently, but could fall apart completely. From a *liberal perspective*, this is true because, like domestic markets, international markets operate best when certain **public goods** are present. These include such things as a sound financial system, free trade, peace, and security. In a domestic market, the state provides these goods and pays for them by collecting taxes from its citizens. This doesn't work at the international level, however, since all states are ostensibly sovereign. The only way around this problem is if one state can afford to bear most of the costs of providing international public goods. This is where the hegemon comes back in: because it is, by definition, the most efficient and productive economic power in the world, it can recover the costs of underwriting the system through a general increase in world trade (because it will end up trading more). In this sense, I might note, we can still see that the principle of rationality is operating, since a hegemon is ultimately acting in its own interest. In this liberal view of hegemony, then, the hegemon is clearly benefiting, but so too is everyone else! In other words, it's not the my-gain-is-your-loss world of mercantilism, which, I should emphasize, is a key (but usually hidden) assumption of that approach. Do you understand what I'm saying here? [Note: We will learn more about HST in chapter 3.]

*Student:* Why, yes ... I think I do. Mercantilists start off with the premise that we live in a **zero-sum** world. Based on that assumption, Friedrich's argument is logically sound. But, liberals like you, Joanna, start off with the premise that we live in a **positive-**

**sum** world—your gain is my gain and vice versa—which not only means the **beggar-thy-neighbor** strategies of mercantilists are logically flawed, but actually

**Figure 2.10. Growth in World Adjusted Net National Income (Constant \$U.S.), 1970–2010**



Between 1970 and 2010, world net national income, in constant terms, increased from just under \$11 trillion to almost \$34.7 trillion, an increase of more than 300 percent. This helps to illustrate the liberal emphasis on the positive-sum nature of capitalist development. In this view, one country's gain is not another country's loss; instead, as long as there is free and fair trade, both benefit because the economic "pie" is getting bigger.

Chart generated by Google based on data from the World Bank: <http://www.google.com/publicdata/>.

make us all worse off. It's pretty darn clear, too, that we don't live in a zero-sum world—why, just look at how much the world economy has grown in the last few decades, not to mention the last few centuries. It sure does appear that we're all getting rich at the same time, which is what you seem to be implying, Joanna. Wow, I didn't realize assumptions could be so important.

*Joanna:* You're finally seeing the light—or should I say the truth. And you're exactly right: assumptions are key. You've got to understand the assumptions that underlie a theory before you can properly evaluate what that theory is saying. The assumption that free-functioning markets lead to positive-sum results, for example, underlies the theory of *comparative advantage*, which is another key element of most liberal perspectives.

Fred, you'll remember, argued that international trade only benefits the most economically advanced nations—but you've already seen the logical flaw in the mercantilist position. What you also need to know, though, is that David Ricardo [1772–1823] provided the original insights as to why the liberal perspective is superior.

Basically, Ricardo showed that even when one country (country A) can produce each of two products at less cost than another country (country B), it will still be worthwhile for them to trade. For example, if country A can produce *both* wine and semiconductors cheaper (and better) than country B, it would still make economic sense for country A to specialize in that product for which it has a relative advantage. That is, if country A is a very efficient producer of semiconductors, but not quite as efficient as a wine-maker, it will be better off concentrating on semiconductors, which it can then trade for wine from country B. Country A is clearly better off, but so is country B, since it can now import semiconductors at a much lower cost than would have otherwise been the case. So, you see, they both win! In the *long run* there are only winners and losers—and this is the problem with mercantilism—when one country attempts to alter the “natural” basis for mutual gain

by constructing protectionist barriers or by giving domestic industries other unfair advantages. Friedrich's argument, then, sounds persuasive because he and other mercantilists are narrowly focused on short-term and highly exclusionary gains at the expense of long-term and general prosperity. I hope, dear student, that you are now fairly convinced that the mercantilist position is fundamentally flawed.

**Table 2.4. Trade and Comparative Advantage: Opportunity Costs and Efficiency**

| Before specialization | Hours Worked | Production and Consumption |
|-----------------------|--------------|----------------------------|
| US Worker             | 10           | 20 pounds of rice          |
|                       | 10           | 1 iPhones                  |
| Chinese Worker        | 10           | 10 pounds of rice          |
|                       | 10           | 2 iPhones                  |

| After specialization | Hours Worked | Production        | Consumption                    |
|----------------------|--------------|-------------------|--------------------------------|
| US Worker            | 20           | 40 pounds of rice | 20 pounds of rice<br>2 iPhones |
| Chinese Worker       | 20           | 4 iPhones         | 20 pounds of rice<br>2 iPhones |

This is a very simple example of how trade and comparative advantage might work. In the example, a U.S. worker can produce more rice than a Chinese worker, but fewer iPhones over 10 hours. The Chinese worker, by contrast, produces only half the rice an American worker can produce in the same 10 hours, but can produce two more phones. If workers specialize—U.S. workers focusing on producing rice and Chinese workers on phones—and then trade, workers in both countries are better off. In the example above, neither country possesses an absolute advantage—meaning one country is better at producing *both* rice and iPhones—but even if one of them did, it would still make sense to specialize and trade, with American workers focusing on what they are best at producing (and vice versa).

Source: Tables are adapted from Ralph Byrns, "Comparative Advantage and Absolute Advantage," [http://web.archive.org/web/20130615222305/http://www.unc.edu/depts/econ/byrns\\_web/Economicae/Essays/ABS\\_Comp\\_Adv.htm](http://web.archive.org/web/20130615222305/http://www.unc.edu/depts/econ/byrns_web/Economicae/Essays/ABS_Comp_Adv.htm) • The author (Byrns) has granted provisional permission to use his materials for educational purposes only.

*Student:* You do make a convincing case; in fact, it's pretty difficult to disagree with anything you've said. If I think about great capitalists like Henry Ford or Bill Gates, I can easily see that when individuals are left to their own devices and ingenuity, they are able to come up with a product or system that makes them immensely wealthy, but that also benefits countless other people. If I remember correctly, Henry Ford—and his ideas about the assembly line, for example—made his workers and their communities better off, his investors better off, and his country better off. But, he also—I think—made the world better off, since his innovations obviously didn't prevent the Germans, British, Italians, Japanese, Swedes, and others from following suit. And what Henry Ford did for the automobile, Bill Gates has done for the computer. It's certainly hard to argue that his innovations in software and programming haven't made the world a more productive, prosperous, and just plain better place. How can we begrudge Gates his fabulous wealth when he's obviously done so much good? It all makes perfect sense, now that you've explained things to me. Certainly, if governments around the world would just stop meddling in markets, rely on their comparative advantages, and give their citizens the freedom to make a profit, everyone would be better off. I can even see how this *laissez-faire* approach is fundamentally democratic.

*Joanna:* You've obviously been listening well. I might add, too, that when you combine liberal ideas with the language of science and centuries of historical evidence (like the rise of the liberal West and the collapse of Soviet and Eastern European communism), you have a powerful combination.

*Karl:* Powerful, yes. But only in its ability to fool most of the people most of the time. For if liberalism was really all that you say it is, the world should be on the cusp of Utopia. Just think about the logic of the free-market ideal, which tells us that power is irrelevant, greed leads to prosperity for all, individual freedom is assured, and peace and democracy will spread throughout the world *if only* governments let people pursue their own self-interests unfettered by all but the most minimal controls, laws, and regulations. Sheer poppycock! Why, just look around you. Billions of people still live in poverty, misery and degradation—and not just in the developing world, but right in the midst of the richest country the world has ever seen. Just the other day, I came across an astounding statistic: according to a study by scholars at the University of Michigan and Harvard University, the number of families living on \$2 or less a day in the United States is almost 1.5 million—more than double the figure 15 years earlier (cited in Bello 2012).

*Student:* You mean you disagree? To me, liberalism sounds so logical, so objective, so scientific, so convincing. How could what Joanna says be wrong?

*Karl:* Unfortunately, my young friend, she couldn't be more wrong. Why don't you sit back while I tell you a different story? Before I begin, though, I must ask you to listen carefully and with an open mind, for you have no doubt been bombarded by propaganda about the supposed evils of Marxism. Also, I am equally sure that what you think you know about Marxism is colored by the now more than two-decades-old collapse of the Soviet Union and Eastern Europe, which liberals have gleefully pointed to as evidence of its utter failure as an ideology and as a real-world program of action. Needless to say, the liberals have it all wrong. Before I tell you why,

though, let me start off by emphasizing that Marxist IPE, like liberal IPE, is a fairly diverse body of work with many different strands. There are, however, a few concepts that clearly distinguish Marxist perspectives from the others you have heard about thus far. Can you guess what these concepts might be?

**Table 2.5. People Living on Less Than \$2 Day, 1981–2008 (Selected Years)**

| Region                          | 1981           | 1984           | 1990           | 1996           | 2002           | 2008          |
|---------------------------------|----------------|----------------|----------------|----------------|----------------|---------------|
| East Asia and Pacific           | 1313.58        | 1317.68        | 1335.77        | 1142.54        | 986.73         | 661.73        |
| Europe and Central Asia         | 36.05          | 29.78          | 32.13          | 53.11          | 37.47          | 10.52         |
| Latin America and the Caribbean | 86.92          | 104.5          | 97.88          | 102.04         | 117.82         | 70.79         |
| Middle East and North Africa    | 52.1           | 51.5           | 53.2           | 57.46          | 57.18          | 44.84         |
| South Asia                      | 811.48         | 855.84         | 960.13         | 1049.11        | 1121.7         | 1127.5        |
| Sub-Saharan Africa              | 287.98         | 324.21         | 389.66         | 466.45         | 534.02         | 563.22        |
| <b>Total</b>                    | <b>2588.11</b> | <b>2683.51</b> | <b>2868.77</b> | <b>2870.71</b> | <b>2854.92</b> | <b>2478.6</b> |

This table shows the number of people in different regions living on less than \$2 day (in PPP terms), based on calculations by the World Bank. Currently, the World Bank uses \$1.25 as the cut-off point for severe poverty—and based on that figure, poverty has declined significantly since 1981. However, at less than \$2 a day, many people cannot afford basics such as food, shelter, and access to clean water. It is worth noting, too, that as many as 1.4 million families in the U.S. live on less than \$2 a day, per person, a number that more than doubled between 1996 and 2012 (Bello 2012).

Source: World Bank (2013) at <http://iresearch.worldbank.org/PovcalNet/index.htm?0.3>

*Student:* I don't really know, but I've heard a few terms or phrases connected with Marxism,

like *class struggle, exploitation, alienation* ... things like that.

*Karl:* Yes, all those concepts are important, although it's important that you first understand

the intellectual foundation of Marxism, which is something called **historical materialism**.

*Student:* That sounds pretty abstract and not particularly relevant. What does it mean?

*Karl:* I can understand your reservations. But historical materialism is not a difficult concept to grasp, and it is certainly relevant to your life—even if you don’t realize it yet. Let me explain. The term *materialism* refers to the simple, yet profound, idea that economic or material forces play *the* key role in shaping the world as we know it, as well as our individual consciousness. In the **feudal** world (the era just prior to capitalism), for example, society was organized around a predominantly agricultural mode of production. This meant, among other things, that those who owned or controlled agricultural land—the landlords—necessarily occupied the top rungs of the socioeconomic hierarchy, while those who actually worked the land (i.e., peasants or serfs) were much, much lower down. Even more important is the nature of the relationship between lord and peasant, which was based on inequality and exploitation. In other words, the *economic organization* of feudal society virtually dictated an oppressive system of class relations centered on land ownership. As you know, however, the feudal system did not last. It eventually gave way to capitalism, which, needless to say, is based on an entirely different mode of production—one that privileges ownership, not of land *per se*, but of the means of production. With a new mode of production, as you might guess, comes a new set of class relations, which helps to explain why, to a significant extent, the monarchs, lords, and other rulers of the past have been reduced to fodder for the tabloids and paparazzi of today (especially in the most advanced capitalist countries). Consider the British royal family: the Queen has the “right to rule,” but her role is mostly symbolic. Even if she were to exercise her royal prerogatives (e.g., the right to refuse a government’s

request to dissolve Parliament and call an election), real power lies not with the royal family, or even with the British Parliament. Instead, real power lies with Britain's leading capitalists. Of course, the concept of materialism is a little more complicated than this, but I think you get my point, do you not?

*Student:* Yes, I believe I do. But why do Marxists use the phrase *historical* materialism?

*Karl:* Marx used the adjective *historical* before materialism to highlight his point that history is marked, or defined, by epoch-making shifts in the dominant mode of production. As I just mentioned, the shift from feudalism to capitalism represented one such shift. But we can also expect another: from capitalism to communism (where socialism is a sort of intermediate step). In this sense, historical materialism is a theory of history (Crane 1991, p. 9), since it purports to tell us not only how history unfolded in the past, but how it *will* unfold in the future. In a similar vein, Marx used the term *historical* materialism because he saw human societies as embedded in their own past, and thus he regarded history as the necessary *method* for any adequate understanding of the world (Abrams 1982, p. 35).

In this sense, historical materialism is also important because it establishes the basis for a *scientific understanding* of society. To Marx, in other words, history was obviously not some random or haphazard (and therefore unpredictable and unexplainable) series of events, but part of a single, nonrepetitive process that obeys discernable laws. While Marx recognized that historical laws are different from the laws of physics or chemistry, he believed that they could still be used as the basis for a scientific understanding of human society. Here, I might mention that Marx saw the process of historical change as comparable to the geological sciences, which are

based on an understanding and analysis of a cumulative but continuous process of change (Berlin 1973, p. 57). Unlike the geological sciences, however, the historical development of humankind, in Marx's view, is irreversible and necessarily progressive: every new epoch is characterized by greater freedom, equality, and prosperity. Capitalism, in this view, is an unequivocally significant improvement over feudalism. But it is not, contrary to what liberals may have you believe, the final stage of our historical development.

**Figure 2.11. Historical Stages in Marxist Thought**



Marx argued that human society evolves, moving from one historical stage to the next. Each new stage represents a progression from the previous stage, but each stage is necessary. In other words, it is not possible to skip a stage (as the Soviet Union, China, and other so-called communist countries tried to do). Why? Because each stage provides the material or economic foundation needed to move forward: moving to the communist stage requires the productive capacity of capitalism.

*Image Source: Created by author. Image of stage is from <http://www.pptbackgrounds.net/stage-background-content-slide-backgrounds.html> (according to site, "This [background image] is free to download, ready to use."*

*Student:* So what you're saying is capitalism is better than what it replaced, but that it still represents a lower stage of historical progress?

*Karl:* Precisely.

*Student:* I'm not sure I buy your argument. The world is not perfect—obviously—but that may only be because so many people are still misinformed about the virtues of a liberal economy. I really can't realistically imagine a better world than the one we have right now. And, honestly, hasn't the market mechanism proven itself to be superior to anything else? Hasn't it created a more efficient, more prosperous, more democratic, and ultimately freer society for all of us? Wouldn't we all be better off if we simply accepted the rationality and efficacy of market forces—even if they don't produce perfect results for everyone?

*Joanna:* Ahh, the joy of a lesson well taught . . .

*Karl:* Don't interrupt, Joanna. You had your turn, now let me have mine!

*Joanna* (grinning): I'm so sorry, Karl. Please go ahead.

*Karl:* Thank you. Now where was I? Oh, yes. The points you bring up, young man, are ones that Marx addressed long ago. You see, historical systems, like capitalism, originally arose to meet the needs of human beings. However, as time went by, these systems began to acquire a life of their own, so to speak. Thus, rather than simply serving the interests of the humans who created them, they eventually came to be seen as existing independently of—or even above—those needs and interests. When this happens, the relationship between people and the institutions they create is sometimes reversed in that the requirements and values of the system take precedence over the needs of human communities. This is precisely the case with the capitalist system, which many people portray as a natural creation whose authority and basic values we—as human beings—have no business challenging. Why, just

look around you. Our lives are increasingly being governed by what the supposedly impersonal market “says” is good or bad.

The market, for example, tells us that greed (or unfettered self-interest) is good, because it creates an incentive for innovation and higher levels of productivity. If greed also results in extreme income inequality, this is good, too. This is not an exaggeration. For example, in an article in *Forbes* magazine, a bastion of free-market ideas, John Tamny wrote, “income inequality is beautiful” (2013). It is beautiful, Tamny argued, because it is “gaps in wealth that drive creativity among the citizenry. Seeing the immense wealth possessed by the most successful, those not in the rich club strive mightily to join the wealthy; their innovations redounding to individuals of all income classes.” If income inequality is beautiful, then equality must be ugly, or bad. This means, too, that exploitation is good. After all, it is what the market dictates.

In particular, we are implicitly, but unmistakably, told that the entire world should be governed by one overriding principle, namely, *efficiency*. We are told that capitalism should not be questioned because it creates unrivaled efficiency (which it does). But why should efficiency be the preeminent value of human society? What about other values—or measures of progress—such as distributive and social justice, human rights, political equality, and so on? Why should all these values be trumped by efficiency? [Note: The question of which values take precedence over others is a core element of the definition of international political economy we discussed in chapter 1.]

Clearly, though, historical systems do not achieve dominant status on their own. Instead, such status is achieved through the assiduous efforts of those social classes who hold power. During feudal times, for example, it was the landowners and the nobility who took on this role. I should stress, though, that the effort to legitimize an oppressive system is not merely the result of brute force; rather, it is a comprehensive effort that involves imposing an intricate set of cultural, religious, and intellectual values on society at large. Thus, even though these values are meant to benefit a single, privileged class, they are often accepted by everyone in society, including those on the very bottom rung of the social ladder. This is a point made brilliantly by Antonio Gramsci in his writings about cultural hegemony. [Note: We briefly discussed Gramsci's ideas in chapter 1.]

Getting people to believe that God himself ordained that some men should be kings and others peasants is a perfect example of this. Today, of course, we know that kings are no closer to God than the rest of us. In our present system, however, a new king—or, dare I say, God—has arisen: the market. The fact that you, dear student, can't imagine a better world than what exists now or that you are ready to passively accept the premise that whatever the market dictates must, by definition, be just and good, only means that you have been successfully co-opted—your consciousness is the consciousness of the market.

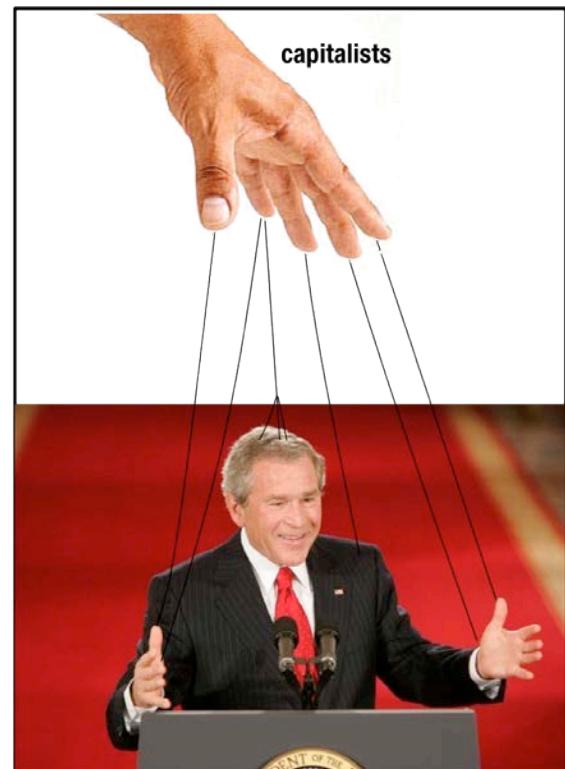
But don't feel bad. Just as in feudal times, those in power have used their control over intellectual life, the political and legal systems, and cultural and religious institutions to get you to think the way you do. In short, they have created an illusory common interest, which can fool even the most steadfast blue-collar

worker. In this regard, Joanna is simply another mouthpiece for the capitalist class, even if she doesn't realize it. Her liberal ideas, which she holds up as "science" and "the truth," are nothing more than a self-serving justification for an inherently exploitative and oppressive system.

*Student:* I never thought of it that way. But when I think of how we use the market to justify all the inequality, injustice, oppression, and exploitation that continue to exist in the world, I find it hard to dispute what you say.

Why, just the other day I read an older article that justified child labor by saying that, no matter how horrible and exploitative it may be, it is acceptable as a mutual "exchange that *benefits* both the buyer and the seller" (Khoury, 1998). And then, during the 2012 Republican campaign for president, Newt Gingrich talked about abolishing child-labor laws in the U.S.: he actually wanted to replace adult janitors at schools with children as young as nine years old, saying that such labor was good for the kids who otherwise would never develop an appropriate work ethic. I must admit that the argument is somewhat appealing, but it does seem perverse to hire children to take the place of

**Figure 2.12. Marxist View of the State**



In Marxism, the state is at least partly an instrument—or *puppet*—of the dominant class. Thus, when Bush advocated for a war against Iraq, he was not expressing a national interest; instead, he was expressing a class interest.

*Source. Image of George W. Bush is in the public domain. Added elements are by the author.*

adult workers.

*Karl:* I do believe, my boy, that you are beginning to truly understand a little about Marxism. Your education, however, is still incomplete. Capitalism, as I have said, is a unique historical system. As with all historical systems, it has its own distinguishing characteristics, the most salient of which is a class structure consisting of those who own the means of production (i.e., the bourgeoisie, or capitalists) and those who possess only the capacity to work (the proletariat). The division between these two social classes is a fundamental feature of the capitalist system and, as such, is the starting point for any analysis of society. This, I might note, is a critical difference between Marxism and the other perspectives you have heard about. Liberals, for example, start their analysis with a sort of generic individual, while mercantilists start with the state. You do understand why this is a significant, don't you?

*Student:* Well, I can't say I do. What does it matter whether you focus primarily on the individual, the state, or class?

*Karl:* My dear boy, it matters a great deal. A focus on the state, for example, presupposes that it is an independent or autonomous actor, which means that a state's actions are not shaped or determined by a more basic force. To Marxists, however, there *is* a more basic force, namely, class relations. Look at it this way: any attempt to understand the actions of the state that starts—and ends—by examining the attributes and/or actions of the state itself would be like trying to understand the movement of planets by examining only the attributes of planets themselves. In other words, just as one cannot ignore gravitational forces in astronomy or physics, one cannot ignore

class forces in political economy. Consider the following question: Why do states go to war? If we try to answer this question by focusing solely on the attributes of states, we might say that states go to war in order to protect the national interest or, perhaps, to correct an imbalance of power. We might even say that some states are naturally aggressive. But does this really tell us what we need to know? Certainly not. We do not know, for example, how or why the national interest is defined the way it is; nor do we know what causes an imbalance in power relations or why states become aggressive in the first place. **Class-based analysis**, by contrast, can answer all of these questions. While Marxists may not agree on the exact causes of specific wars, most would agree with the idea that wars are invariably fought to protect or promote the interests of the dominant class, which in the modern period is the capitalist class. Thus, when the typical soldier lays his life on the line, he is not protecting his interests or even the interests of his country at large, but the relatively narrow interests of the ruling class. Sadly, then, the people who actually fight the wars (i.e.,

**Figure 2.13. Picture of a Foxconn Factory Sign**



Foxconn, a subsidiary of Hon Hai Precision Industry Co. (Taiwan), produces products for Apple, Amazon, Sony, Nintendo, Microsoft, and others, using low-cost labor in China.

*Image is licensed under GNU Free Documentation License.*

the proletariat), usually work against their own interests—more often than not, in fact, they end up killing those with whom they should be making common cause. I think, my boy, you could not ask for much more relevance than this. A focus on individuals, I should add, is misguided for

precisely the same reasons—i.e., an over-emphasis on the role of **agency**. As with states, individual actors cannot operate independently of the social structures in which they find themselves. What this means is that individual action does not and cannot take place in a social vacuum—social or class structures, in other words, force individuals to take up definite roles in relation to one another and to the means of production. We would expect, therefore, fundamental differences in interests and opportunities to exist between, say, Tim Cook (CEO of Apple) and one of the thousands of young Chinese who work for less than \$17 a day (Economix Editors 2012)—a princely sum for many poor Chinese—in one of the many factories used by Apple in China, factories that are operated, I might note, by Foxconn, a subsidiary of Hon Hai Precision Industry Co., which is a Taiwan-based company.

*Student:* I think I'm getting a clearer picture of the importance of both social class and structure, which neither Friedrich nor Joanna even mentioned. But is Marx saying that agency is completely irrelevant?

*Karl:* Not at all. As Marx himself so aptly put it (in one of his most famous quotes): “Men make their own history, but they do not make it just as they please; they do not make it under circumstances chosen by themselves, but under circumstances directly encountered, given and transmitted from the past” (Marx 1853 [1963], p. 15). Marx, in other words, understood that people have the capacity of free will, but that it is always exercised within a particular context that cannot be ignored or dismissed.

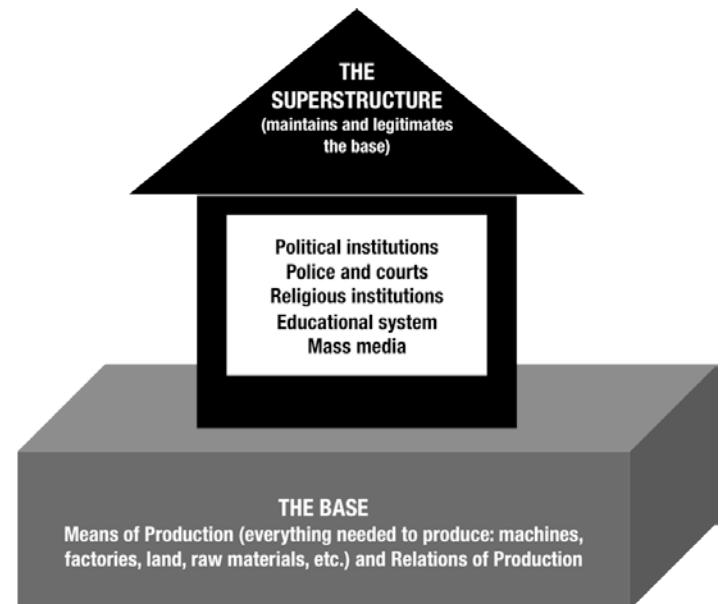
*Student:* Okay. I see what you're saying. But, how does all this talk about social class and structure relate to the real world?

*Karl:* The answer, my boy, is clear. As I said earlier, social or class structures force individuals to take up definite roles in relation to one another and to the **means of production**. This means, for example, that capitalists and workers are locked into a fundamentally antithetic relationship—in other words, it is almost impossible for the two classes to form a peaceful and mutually advantageous relationship. Why? Quite simply because the actions of both sides are shaped and constrained by their positions in the division of labor and by the broader dynamics of the capitalist system. This is easy enough to see in the real world. Consider, if you will, a good-hearted capitalist—a man who wants to provide a better life for his workers and his community. What would he do to achieve this? Well, he could raise wages, provide better health benefits, build a childcare center, fund a generous retirement program, etc. As a capitalist, however, doing such good deeds raises his costs; his firm, in short, becomes less competitive vis-à-vis other firms. If these other firms further undercut him by moving production offshore—say, to Indonesia, where the state uses its military and police powers to break unions and suppress wages—the good-hearted capitalist may not be able to compete at all. If this happens, he may be forced to lay off workers, reduce wages, eliminate health care benefits, ignore environmental and safety regulations, or cease production altogether; or he may move *his* factory overseas, too. So, the next time you hear of a factory closing its doors to move to another country—or even to another state where unionization is weaker—you might want to keep this in mind. The main point, to repeat, is this: the imperatives of competition, accumulation, and profit-maximization make it

*necessary* for capitalists to exploit the workers they employ. This is the essential *context* of capitalism, which we simply cannot ignore.

Of course, we need not feel sorry for the capitalist, for he is the exploiter, not the exploited, which is where the problem really lies. For the more a capitalist exploits his workers, the better off he is. Obviously, to Marxists at least, this is a fundamentally untenable relationship, but one that survives—and even thrives—because the capitalist system is based on an equally fundamental truth: an imbalance of power between the classes. I have already talked about one of the more important implications of this imbalance, namely, the fact that those who have power in virtue of the division of labor also possess the power to define the legal and political **superstructure** of society. (The superstructure is what exists *above* the foundation, which in Marxism, is comprised of the ideologies and institutions of society.) That is, they can use the state, religion, law, custom, and academic institutions to naturalize their positions of economic advantage. But the structural imbalance of power also means that the tension between the exploiter and the exploited can never really disappear; in other words, the capitalist system—as with

**Figure 2.14. Base and Superstructure**



In the Marxist view, the base determines the types and functions of the institutions that make up the superstructure. Thus, the state enforces private property rights over other "rights" in a capitalist society; education serves to produce a small elite, and a much larger pool of "worker bees"; religion serves as the "opiate of the masses"; while the mass media encourage consumption and spread the "gospel" of the market.

*Image designed by author.*

the other exploitative systems of the past, like slavery and feudalism—contains within it the seeds of its own destruction in the form of inherent **contradictions**, of which the primary one is usually seen as being between the forces of production on the one hand, and the relations of production on the other.

Here it is important to understand, as I suggested earlier, that Marx saw capitalism as the most productive system ever known to humankind. In this regard, Marx also understood that capitalism was a *necessary stage* in human history, for only capitalism can provide the material and social basis needed for the next and final stage of historical development, namely, communism. Liberals, of course, focus only on the productive potential of capitalism. What they fail to see or account for, however, is that a system of production premised on ever-increasing levels of inequity between classes cannot survive forever. Ultimately, the increasing disparity and out-and-out impoverishment of the working class will lead to the transformation, or overthrow, of the capitalist system.

*Student:* Hold it right there. You had me going for a while. But, how can you talk about the impoverishment of the working class when clearly that isn't happening? Certainly, in all advanced capitalist economies, the general population—capitalists and workers alike—have been earning more and doing better. Even in some former developing countries such as South Korea, Taiwan, Brazil, and a few other places, the industrial working class has made huge strides in the past few decades. If we just extrapolate from these experiences, it is easy enough to see that, while poverty may never be completely eliminated, most of the world's population will reach a reasonable, even comfortable, standard of living in the foreseeable future.

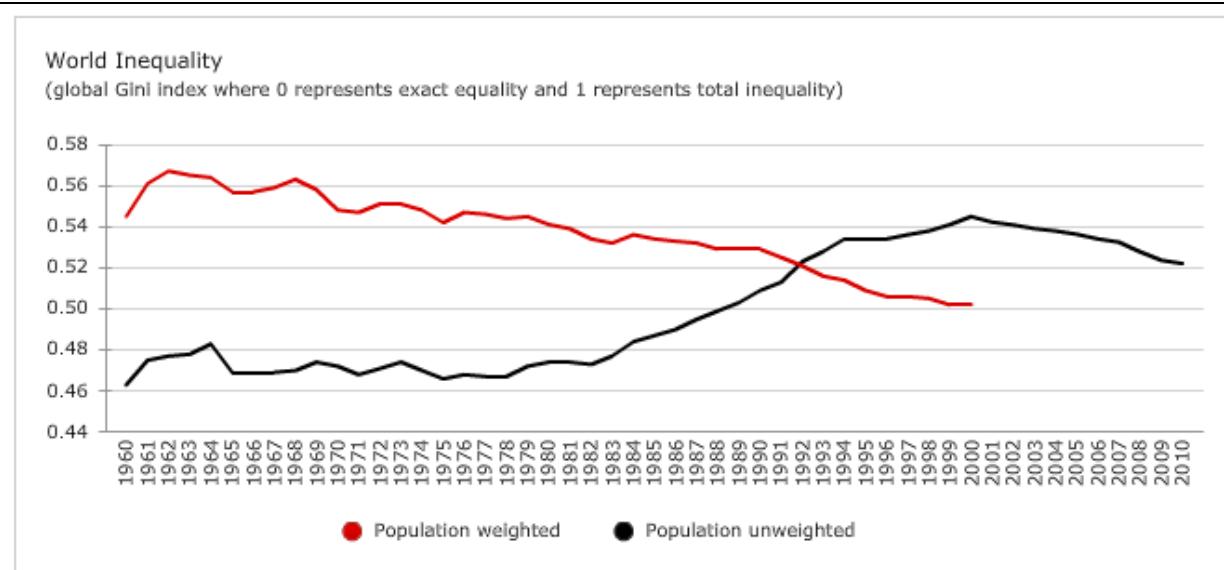
*Karl:* First, my dear boy, you are committing a serious error in logic, something called the fallacy of composition. This is to assume that what one actor can do in a given set of circumstances must also be possible for an indefinite number of actors to do simultaneously (without, that is, leading to undesirable consequences). For example, one man may pollute a river and still catch edible fish. But if a million men were to do so simultaneously, the river would be destroyed and no one would be able to catch any fish, edible or not. So, yes, it is true that *some* workers have fared quite well, but *always* at the expense of other workers—to paraphrase an old saying by Will Rogers, in order to pay Paul, and thereby gain his support, the capitalist must rob Peter. In other words, the phenomenon of the so-called affluent working class is a politically expedient solution to a much deeper problem.

Second, you must also remember that Western capitalism was literally built on the blood, sweat, and tears of the peoples of the Third World. This is something that most liberals conveniently ignore, but it is an *irrefutable historical fact*: early capitalism was based on the enslavement and super-exploitation of African, Asian, and Indian peoples; the outright plunder of astronomical amounts of precious metals, land, and raw materials, particularly from Latin America; and the political, social, and economic domination of most of the world—which, obviously, continues to this day. None of this, I might mention, has anything to do with individual choice, freedom, or democracy, despite what liberals would have you believe. Finally, you are ignoring the contradictory tendencies that *underlie* the capitalist system. Consider this simple example: to continue to make a profit, capital must minimize costs, especially the cost of labor. This is done by outsourcing to underdeveloped countries, by automation, or some other laborsaving method. These strategies are effective:

over time, they lead to a decline in wages. But as wages decline, so does the market for many goods—since workers make less and since there are fewer workers, there are fewer consumers with money to buy goods. This, of course, means lower profits, which puts more pressure on firms to cut costs. Do you see the dilemma?

*Student:* Umm, yes, I think I do . . .

*Karl:* (Interrupting the student) I am, of course, simplifying a complex argument. Marx's writings have been subject to a great deal of debate and scrutiny, among both those who are sympathetic to the Marxist view and those who are not. The main point, however, is that exploitation, poverty, and suffering have not diminished at all on a *global scale*. And there is no sign that this will or can change in the future. As any number of commentators (Marxists and non-Marxists alike) have pointed out, while the post–World War II period has seen a tremendous increase in global wealth, we have also seen a tremendous increase in the disparity between the richest and the poorest of the world. Among the three perspectives, only Marxism has been able to explain, in theoretically consistent terms, why this has happened.



**Figure 2.15.** The figure compares the population-weighted **Gini index** (red line) with the unweighted Gini index (black line). The population-weighted index declines almost consistently from 1962 onward. This is mainly due to the phenomenal economic growth in China and India relative to richer countries. Because China and India together account for over one-third of the world's population, these two countries have a very strong impact on the population-weighted Gini results. *But if China and India are removed from the calculation, the population-weighted Gini index trends upward after 1982 (as does the unweighted Gini index), meaning that overall income inequality is increasing in the rest of the world.* This graph, we should note, does not unequivocally support the Marxist view, but it does show that global inequality, even accounting for China and India, was significantly higher in 2000 than it was in 1960.

Source (graph and text): <http://www.conferenceboard.ca/hcp/hot-topics/worldinequality.aspx>

*Student:* There are many parts of your argument that make sense to me. After all, any reasonable person would have to wonder how such an extraordinarily productive system as capitalism can, after hundreds of years, still leave millions, really billions, of people in utter destitution, both materially and spiritually. It also seems apparent to me that, if liberals were correct, those capitalist societies with the least amount of government intervention would not only be the most prosperous, but also largely free of social problems and societal conflict. But this certainly doesn't seem to be case. Why? Perhaps it is because, as both you and Friedrich have pointed out, liberals almost entirely ignore questions of power. Still, I

must admit that I am now more confused than ever. You all, in your own way, seem to be stating the truth. But that can't be possible, given the fact that your disagreements are obviously more than skin deep. The only conclusion I can reach, then, is that there is no truth, at least in IPE.

(Looking dejected) I think I'll just major in something else.

• • •

The foregoing conversation suggests that IPE is not only a highly contentious field, but also a seemingly chaotic one. My intention, though, is not to confuse you, but to encourage you to open your mind to different ways of understanding and/or explaining the international or global political economy. As I hope you have seen, none of the three major perspectives (and all their derivatives) should be ignored or, worse yet, dismissed. Indeed, despite the somewhat playful tone of the conversation among Friedrich, Joanna, Karl, and the student, I believe that all three of these major perspectives must continue to be taken quite seriously. This is important whether or not you already hold strong views. For those of you who don't already have a clear position, for example, taking the three perspectives seriously will, I hope, encourage wider and more disciplined thinking about global political economy. That is, by looking at any particular issue, event, or process from Marxist, mercantilist, and liberal perspectives you will not only consider a larger range of possibilities than would otherwise be the case, but you will do so in a more systematic manner. For those of you who may already have a clearly defined position, taking the other perspectives seriously will, I hope, compel you to critically examine—and defend—your own assumptions and ideas at a deeper, more substantive level than you may be used to. At the same time, the foregoing conversation is intended to encourage, on your part, a healthy

degree of skepticism: any claim or analysis that purports to tell “the truth” about the operation and dynamics of the global economy, in other words, should be treated with caution and care.

None of what is covered above is meant to suggest that the only important conversation (or debate) in IPE is among Marxists, mercantilists, and liberals. There are many other conversations, some of which are discussed in more depth in chapter 3. The question for now, then, is: How should students of IPE deal with or approach these various conversations? Here are a few suggestions. First, use these conversations as a convenient way to identify the key points of contention in IPE. These key points of contention are not always visible at the surface; many are hidden in the differing assumptions, axioms (self-evident truths), and core ideas on which all theories are based. This chapter is meant to highlight some of the most important of these. Second, use the ongoing debates in IPE as a still vital *foundation* for understanding and explaining the global political economy. For, despite the limitations of each of the various perspectives, a great deal of valuable and useful work has been done on a variety of important issues, areas, and problems. As long as you explicitly recognize that research done from a Marxist, liberal, or mercantilist perspective reflects a particular set of assumptions and values (rather than a timeless truth), such work can be, and almost certainly is, quite useful. Third, use the theoretical conversations as an important starting point for reexamining old questions, or for asking entirely new questions about the international or global political economy. As discussed in chapter 1, the questions researchers ask are vital to the process of understanding and explanation. Keep all these suggestions in mind as you continue your exploration of the global political economy.

# Chapter 3

## Contemporary Theories of International Political Economy

### Introduction

In the previous chapter, we learned about three of the most important foundational schools of thought, or theoretical perspectives, in IPE. These foundational theories, as we have seen, are still relevant today, and still inform the thinking of scholars and nonscholars alike. In fact, those of you reading this book likely subscribe to one or the other of the foundational theories—at least in part—because the ideas from those theories have become so deeply embedded in our world. There are, however, a number of relatively new, or contemporary, theories about which any student of IPE needs to be aware (“relatively new,” in this case, means that they have been around for the past three or four decades—still a long time, but recall that Marxism, the youngest of the foundational theories, dates back to 1867, while liberalism dates back to the late 1700s). These include revisions and/or offshoots of traditional approaches, but also include a number of approaches that do not fit easily into the mercantilist, liberal, or Marxist camps. Indeed, contemporary theories include a diverse body of approaches that question the most basic assumptions upon which the traditional theories rest. Variously called postpositivist, constitutive, constructivist, or reflectivist, this category of approaches challenge the still widely held belief that the social sciences can produce an objective or value-free truth. Instead these approaches—I will use the term *constructivism* as a catchall—argue that the social world is unavoidably subjective. Admittedly, the arguments made by proponents of constructivism can be abstruse at times, but the basic lessons are well worth considering. This will be the topic of the last part of this chapter.

To begin, however, we will take a good look at what is known as hegemonic stability theory (HST), which we briefly discussed in chapter 2. HST is a derivation of mercantilism, although as many scholars have pointed out, it is a hybrid theory, as it contains elements of mercantilism (or realism), liberalism, and even Marxism. Its closest association, however, is with mercantilism. The connection with mercantilism may not be immediately apparent, but it is not difficult to discern. As you read about hegemonic stability theory, then, consider these basic questions: Who is the main actor in this approach? Who or what has power, and how is power distributed? How is power exercised? Following the discussion of hegemonic stability theory, we will turn our attention to *post-hegemonic theory*. This is an admittedly nebulous and potentially confusing term, which is perhaps unavoidable, since it refers to a wide variety of approaches, all of which attempt to explain the dynamics of international or

global political economy in an era in which hegemonic power—and more specifically, U.S. hegemony—has become more and more contestable over time. On this point, consider the title of one particularly influential book—*After Hegemony*, written by Robert Keohane (1984). Keohane himself uses the term *post-hegemonic* many times to emphasize how key dynamics in the international political economy, especially cooperation, are not *strictly* determined by hegemony. Keohane was primarily interested in the role of international regimes, but other post-hegemonic arguments seriously consider the role and power of nonstate, or transnational, actors in the global political economy. More specifically, in this extended section, we will consider the role of **multilateral institutions**—e.g., the IMF, the World Bank, the WTO—and corporate and nongovernmental organizations (NGOs). We will also discuss, in some depth, the basic problems with state-centric approaches. Finally, we will look at the two-level game approach. Although often treated as a theory, the two-level game approach works better as a method of analysis. My intention, I should make clear at the outset, is not to provide an in-depth exploration of contemporary theories and approaches. Instead, I will provide an admittedly broad and simplified outline of several of the more important—or more interesting—perspectives to emerge in the past few decades or so, as either useful extensions of, or viable challengers to the three traditional approaches.

## Hegemonic Stability Theory

The theory of hegemonic stability got its start in the 1970s with the work of Charles Kindleberger (1973), who focused on the reasons for the **Great Depression**. His basic argument was simple: the root cause of the economic troubles that bedeviled Europe and much of the world in the 1920s and 1930s was the absence of a benevolent hegemon—that is, a dominant state willing and able to take responsibility for the smooth operation of the international (economic) system as a whole. Taking responsibility, in large part, meant acting as an international **lender of last resort**, as well as a consumer of last resort (DeLong and Eichengreen 2012). More specifically, as a lender of last resort, the hegemon provides access to loans (especially long-term loans) when the normal flow of international lending has dried up; this is also referred to as counter-cyclical lending. Counter-cyclical lending, in turn, is critical to the maintenance of **currency convertibility**, which refers to the ease with which a country's domestic currency can be converted into gold or a

**Figure 3.1. North Korea and Currency Convertibility**



Few countries today will accept North Korea's official currency (known as the *won*) as payment for their goods. The reason is quite simple: North Korean currency is exceedingly difficult to exchange for U.S. dollars or other hard currencies. This means that North Korea must pay for its imports (1) with U.S. dollars or other hard currencies, or (2) through barter (that is, exchanging actual goods for goods from another country). Earning U.S. dollars is difficult for North Korea, since it produces few internationally competitive goods. This is a major reason why the country relies heavily on arms exports, and has been implicated in counterfeiting U.S. currency.

For most countries today, currency convertibility is not a problem, but North Korea remains an exceptional case because of the inflexibility of its leadership, which remains committed to central planning and near-total control of North Korean society.

*Pictured: North Korean 10 won note (image is licensed under the Creative Commons Attribution-Share Alike 3.0)*

**hard currency.** Here is the basic problem: when a currency becomes relatively inconvertible, trade in goods tends to decrease, since many countries are unwilling to accept the inconvertible currency as payment. After all, if currency (from Country A) cannot be converted into gold or, say, U.S. dollars, then the only way it can be used is to buy goods from Country A. (See figure 3.1 for a contemporary example of this issue.) International trade is also negatively impacted if there is no consumer of last resort. In this case, as the consumer of last resort, the hegemon maintains an open market, and encourages other countries to follow suit. If the hegemon or *potential* hegemon closes or restricts access to its market, as the United States did in 1930 with the **Smoot-Hawley Tariff Act**, the effects on international trade are usually disastrous. The Smoot-Hawley Tariff Act had particularly damaging effects because of the asymmetrical (economic) power of the U.S.: as the dominant economy in the world, the U.S. decision to erect higher protectionist barriers essentially gave the green light to all other countries to do the same. However, once the U.S. fully accepted its role as the hegemon, as it did in the immediate aftermath of World War II with the construction of the Bretton Woods system (BWS), an opposing dynamic was set in place. At the same time, when U.S. commitment began to waver (a phenomenon referred to as benign neglect), international confidence in the dollar-based monetary order quickly began to wane.

The hegemon is willing to take on these responsibilities, it is important to emphasize, for self-interested reasons: as the world's dominant economy, the hegemon has the most to gain, relatively speaking, from a stable and growing international economic system. At the same time, the existence of a hegemon does not prevent economic shocks and downturns from taking place. Instead, it plays a central role in ensuring that such events do not devolve into full-blown economic crises or depressions. As Kindleberger (1973) explained it, prior to the onset of the Great Depression:

The shocks to the system from the overproduction of certain primary products such as wheat; from the 1927 reduction of interest rates in the United States ... from the halt of lending to Germany in 1928; or from the stock-market crash of 1929 were not so great. Shocks of similar magnitude had been handled in the stock-market break in the spring of 1920 and the 1927 recession in the United States. The world economic system was unstable unless some country stabilized it, as Britain had done in the nineteenth century and up to 1913. In 1929, the British couldn't and the United States wouldn't. When every country turned to protect its national private interest, the world public interest went down the drain, and with it the private interests of all. (p. 291)

**Figure 3.2. Smoot and Hawley, April 1929**

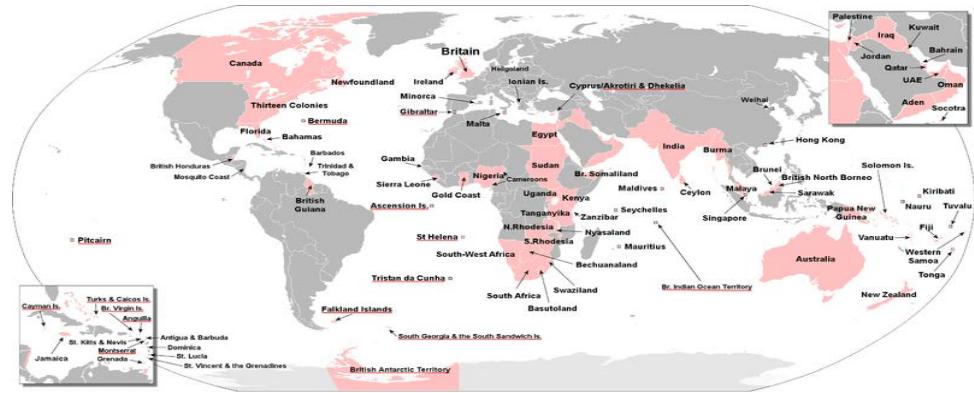


Willis C. Hawley (left) and Reed Smoot (right), standing together shortly after the signing of the Smoot-Hawley Tariff Act.

*Source: Library of Congress. According to the library, there are no known restrictions on the use of this photograph.*

The period between the two world wars (also known as the interwar period, which ran from 1919 to 1938) was, as Kindleberger suggests, a transitional period. The old hegemon, Great Britain, had lost the capacity to stabilize the international system, while the new (latent) hegemon, the United States, did not yet understand the need to take on that role—or the benefits of doing so. The result, of course, was a worldwide depression that did severe damage to almost every major economy. Kindleberger's analysis of the interwar period was convincing to many. It led to a flurry of additional scholarship and to the emergence of

**Figure 3.3. The Decline of British Hegemony**



Why did Britain lose its hegemonic position? There are, not surprisingly, many explanations. One popular explanation focuses on the British commitment to building a system of international trade while relying primarily on its advantage in financial and commercial services (as opposed to manufacturing). Because of this dependence, as Gamble (2001) explained it, Britain “needed a visible trade deficit rather than a visible trade surplus in order to stimulate economic development in other parts of the world economy which boosted demand for British banking, shipping, and insurance services.” Over time, however, this eroded Britain’s once-strong lead in industrial power; other countries began to catch up, especially Germany and the United States. Both these countries, “moved to protect their new industrial sectors from British competition and both contested the inclusion of so much of the world in Britain’s sphere of influence through formal colonial links and through the informal links of investment and trade. At the same time both increasingly exploited the open access to the British market which adherence to the policy of free trade allowed. The impact of this on British politics was dramatic. It created the first great bout of introspection about economic decline amidst fears that British industry could no longer compete with the energy and technological sophistication of the Americans and the Germans.” An immediate consequence was that the costs of hegemony grew even higher, as Britain endeavored to expand its own sphere of influence. In the end, the costs were too high to bear.

hegemonic stability theory as a widely accepted explanation, not only for the dynamics of the world economy, but also for the dynamics of international relations more generally.

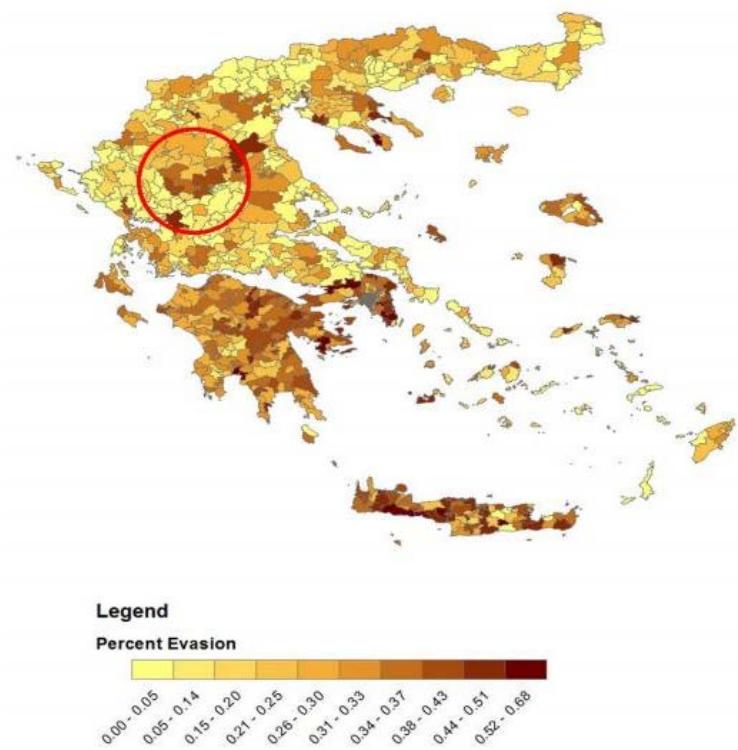
Indeed, hegemonic stability theory has been embraced by **realists**—who represent the long-dominant school of thought in international relations theory—as a general explanation for the existence of cooperation among states through most of the postwar period. In the realist view, the hegemon mitigates the effects of **anarchy** by acting as the rule enforcer for the international system (as a concept in international relations theory *anarchy* refers to a situation in which there is no overarching political authority that exists beyond individual states). Without a rule enforcer, states are usually unwilling to cooperate on a sustained and universal basis. Consider, on this point, a simple question: Would people, in general, willingly pay taxes to maintain, say, a police and judicial system if there were no threat of sanctions for noncompliance? To be sure, some people, perhaps even most, would *voluntarily* comply. But a significant number of others would not. For the latter group, they obey because there is a clear-cut rule-enforcer—a higher authority in the form of the state—that is capable of compelling compliance when necessary by punishing rule-breakers. (See

figure 3.4 for the real-world case of rampant tax evasion in Greece.) The issue is dramatically compounded if a public good (mentioned in the previous chapter) is at issue. A *public good* is something that is both nonexcludable and nonrivalrous. In simpler language, this means that once a good is created, it is available to everyone, but also that the use or “consumption” of that good by one individual does not reduce its availability to others. Domestic law and order is a public good: once a police and judicial system is in place, everyone benefits from it, even if they did not contribute to its creation; nor does use of the police or judicial system reduce their availability to others. The problem is easy to see: if an individual can benefit from domestic law and order (or any other public good) without paying for it, he will simply not pay. Instead, he will let others pay, and **free-ride** on their contributions. Free-riding may seem unfair, but it is both common and completely **rational** behavior. Internationally, free-riding is a major impediment to cooperation. After all, if every state is sovereign, then no other state, group of states, or international organization has the *authority* to collect taxes or otherwise compel compliance with international agreements and norms meant to produce global public goods.

Hegemonic stability theory, however, posits that a dominant actor can fulfill the role of a higher authority by using its overarching power and disproportionate control of resources. The hegemon, to put it bluntly, can either force or cajole “lesser states” to comply with the rules (of the international political economy). In this regard, it begins to look like “might makes right,” but hegemonic stability theory also presumes that the hegemon generally has more to gain from encouraging *voluntary* cooperation than from engaging in conflict and violence to compel cooperation. This is especially the case when considering economic issues, such as the construction of a liberal international economic order. This leads to a key question: Why does the hegemon actually play the role the theory describes? We already have a general answer—namely, because doing so brings a net benefit to the hegemon. But another way

**Figure 3.4. Tax Evasion in Greece**

Tax evasion in Greece is almost a national sport. A study by three economists concluded that tax dodging in Greece costs the country’s government about \$36 billion a year, an amount equivalent to roughly 15% of annual economic output, and about half the country’s budget shortfall in 2008 and one-third in 2009 (Artvanis, Morse, and Tsoutsoura 2012). These numbers bring up the question, why is tax evasion so rampant in Greece? One reason is a lack of enforcement, especially against high-income earners: medical doctors, dentists, lawyers, architects, and engineers. These professions, notes Brad Plumer (2012), writing for the *Washington Post*, happen to be well represented in the Greek parliament. It is important to understand, though, that if one can get away with not paying taxes, doing so is rational behavior.



The map above shows the top zip codes that avoid taxes in Greece.  
Image source: Reproduced from Artvanis, Morse, and Tsoutsoura (2012), p. 35.

to answer this question is to examine specific and important cases. One such case is the international monetary system (IMS), which refers to the rules and established practices that facilitate international trade and investment. In the postwar period, the IMS has largely revolved around the Bretton Woods system, the core elements of which stayed in place until 1971. Since we will examine the IMS and Bretton Woods system in some depth later in this book, for now, we will take a broad look at them.

### *Bretton Woods, the Hegemon, and the International Monetary System*

At first glance, the construction of the postwar IMS seems to be a very good fit for hegemonic stability theory. The Bretton Woods system, for example, was clearly a product of American power and influence. Delegates from around the world met in the United States to create the system, but there is no doubt that the United States was in charge of the entire process. In this respect, it is worth noting that Great Britain was given an important role to play, but British interests and desires were clearly secondary. U.S. dominance was manifested, in particular, by the adoption of the U.S. blueprint for the IMF, one that defined the IMF not as a world central bank, but instead as a promoter of economic growth through international trade and financial stability (Boughton 1998). The U.S. plan was chosen over a competing one prepared by John Maynard Keynes, the most influential and well-respected economist of the time (the U.S. plan was written by Harry Dexter White). Not surprisingly, the Bretton Woods system codified the U.S. dollar as *the* international currency. This gave the United States an advantage that few other countries enjoyed. Thomas Friedman (1994) provides an easy-to-understand explanation of this advantage:

[The United States] prints green paper with George Washington's and Ben Franklin's and Thomas Jefferson's pictures on it. These pieces of green paper are called "dollars." Americans give this green paper to people around the world, and they give Americans in return automobiles, pasta, stereos, taxi rides, hotel rooms and all sorts of other goods and services. As long as these foreigners can be induced to hold those dollars, either in their mattresses, their banks or in their own circulation, Americans have exchanged green paper for hard goods. (Cited in Cohen 1998, p. 124.)

At the same time, the system of rules and institutions—including the establishment of a

**Figure 3.5. Harry D. White and J. M. Keynes at Bretton Woods**



Assistant Secretary of the U.S. Treasury, Harry Dexter White (left) and John Maynard Keynes, honorary advisor to the UK Treasury at the inaugural meeting of the International Monetary Fund's Board of Governors in Savannah, Georgia, United States, March 8, 1946.

*Image Source: The image is in the public domain in the United States because it is a work prepared by an officer or employee of the United States Government as part of that person's official duties under the terms of Title 17, Chapter 1, Section 105 of the U.S. Code.*

pegged rate or adjustable peg currency regime, the **gold-exchange standard (GES)**, and two international financial institutions, the IMF and the World Bank—was designed to ensure general stability in the international monetary system, a benefit to all. Significantly, in the very early postwar period, international monetary relations remained shaky, in part because the IMF lacked the resources necessary to deal with the financial demands following the end of World War II. Fortunately, by the end of the 1940s, the United States had become willing to shoulder much more of the burden for maintaining global monetary stabilization. Cohen (2001) notes that American hegemony was exercised in three ways. First, the United States itself maintained a relatively open market, giving rebuilding economies a place to sell their goods. In fact, the United States not only maintained an open market, but also allowed some countries, especially Japan, one-way access to the U.S. market (that is, while Japan was given access to the U.S. market, the U.S. did not demand reciprocal access to the Japanese market). Second, the United States provided significant long-term loans; initially, this was through the **Marshall Plan** and related programs, and later funding went through the reopened New York capital market. Third, “a liberal lending policy was eventually established for provision of shorter term funds in times of crisis” (p. 97). U.S. policymakers, Cohen also points out, did not necessarily intend to take on a hegemonic role, but once that happened, “they soon came to welcome it for reasons that were a mixture of altruism and self-interest” (*ibid.*).

### *Criticisms of Hegemonic Stability Theory*

In a detailed analysis of the relationship between hegemony and the international monetary system, Eichengreen (1987) concluded that hegemonic stability theory is helpful for understanding the smooth operation of the early Bretton Woods system, and it is also useful in explaining some of the difficulties in the interwar period (p. 57). At the same time, he argues that hegemony alone only tells part of the story. One reason is clear: hegemony is essentially a transitory phenomenon (p. 58). On this point, Corden (1990) asserts that hegemony typically lasts only two or three decades. And while there is a great deal of debate over the starting and end points of hegemony,<sup>3</sup> if Corden is correct, this means that there must be other factors and forces at play to explain why, for example, the postwar international monetary system remained relatively stable even after American hegemony was lost in the early 1970s. Not surprisingly, Corden himself has an argument: the international monetary system has worked, he writes, “because on the monetary side it is more like a

**Table 3.1. Marshall Aid Recipients, Amounts**

| Country        | Cumulative (U.S.\$ millions) |
|----------------|------------------------------|
| Austria        | 468                          |
| Belgium        | 777                          |
| Denmark        | 385                          |
| France         | 2296                         |
| Germany        | 1448                         |
| Greece         | 376                          |
| Iceland        | 43                           |
| Ireland        | 13                           |
| Italy          | 1204                         |
| Netherlands    | 1128                         |
| Norway         | 372                          |
| Portugal       | 70                           |
| Sweden         | 347                          |
| Switzerland    | 250                          |
| Turkey         | 137                          |
| United Kingdom | 3297                         |

Source: Schain (2001)

‘nonsystem,’ every country doing what it chooses, though in some consultation with the other six [members of the G7] … with only intermittent acts of coordination, especially with regard to exchange-rate intervention” (p. 19). This statement clearly suggests that the stability of the international monetary system was perhaps never dependent on hegemony; rather, it was based, at most, on a loose collaboration among major economic powers. In this scenario, the United States might still be the dominant player, but it is not U.S. dominance per se that ensures stability.

Others do not go quite as far as Corden. I already mentioned Robert Keohane (1984), who argued that hegemony—while on the wane—continued to exert influence in the international political economy into the 1980s (and beyond). More importantly, he and others have argued that international *systems* (such as the international monetary system) do exist, and are partly dependent on hegemony, but also partly (really, significantly) dependent on international regimes. One of the most oft-cited definitions of regimes is by Stephen Krasner, who defined a regime as a set of explicit or implicit “principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue-area (1983, p. 1).<sup>4</sup> Together, Keohane, Krasner and others helped develop regime theory, which provides an alternative to HST. Regime theory is premised, in part, on the idea that shared interests lead to voluntary cooperation among states, and that over time, cooperation on certain issues can become embedded through the creation of regimes. Regimes, it is important to note, serve three key purposes: (1) they provide information about the behavior of all participating states, usually through monitoring and self-policing; (2) they reduce the costs of future agreements (i.e., a regime makes it unnecessary for states to repeatedly negotiate over the same issues); and (3) they generate the expectation of cooperation among members. There is, of course, much more to regime theory, but the main point is that regimes make long-term cooperation possible without a hegemon.

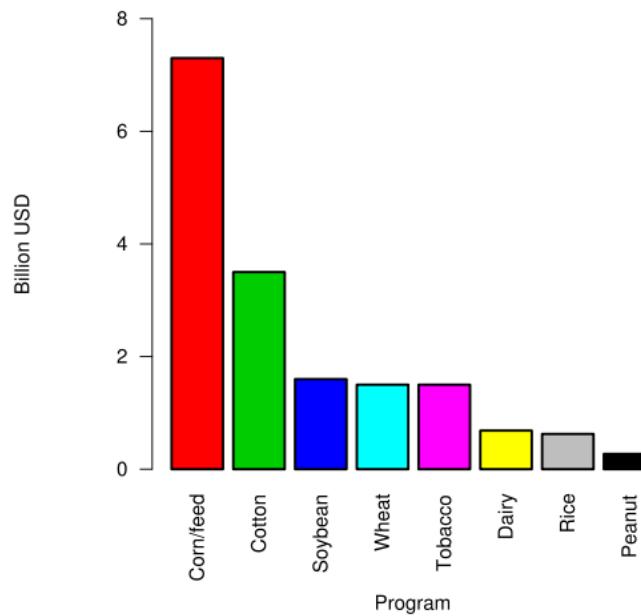
Another, less evident, criticism revolves around the tacit ethnocentric bias of hegemonic stability theory. This bias becomes particularly evident when the theory is applied to the United States. To a significant extent, advocates of hegemonic stability theory portray the United States as a “benevolent” hegemon, which suggests that much of what the United States does as hegemon is based less on self-interest, and more on nobility and largesse—doing good for the whole world, even if the rest of the world is ungrateful or too self-serving to realize this. Robert Gilpin, one of the best-known advocates of hegemonic stability theory, for instance, blithely wrote, “Societies freely enter into extensive market relations only when the perceived gains are much greater than the perceived costs or when the market relations are forced on them by a *superior society*” (emphasis added; 1981, p. 129). Grunberg (1990), moreover, argues that hegemonic stability theory has “a built-in, ethnocentric bias simply in the sense that it links the fate of the world with the United States” (p. 247). This suggests that the world needs the United States to fulfill its destiny as the most powerful and dominant state, and to question, still less challenge, U.S. dominance only invites a self-defeating struggle.

Closely tied to the criticism of ethnocentric bias is the contention over what constitutes a global public good. We are told by advocates of hegemonic stability theory that the international system of free trade, the international monetary system, and a **neoliberal economic order** more generally, are all clear-cut examples of public goods. Critics charge, though, that viewed “from below”—that is, from the perspective of poorer, less industrialized, and less privileged countries—these “goods” are primarily good for the

richest and most powerful countries, and especially for the United States. They tell us that we must question the often-unquestioned assumption of what constitutes a public good at the international or global level (Snidal 1985, p. 613). Free trade, for example, does little to help the poorest countries that have extremely limited capacity to compete effectively in international markets. This is true even when comparative advantage is taken into account. After all, the poorest countries are competing against other poor countries on the basis of low labor costs, and the richest countries continue to produce a full range of products and services irrespective of their comparative advantages. To top it off, when richer countries selectively protect their most vulnerable markets from international competition—as the United States does with many of its agricultural markets (see figure 3.6, “U.S. Farm Subsidies”)—the notion of hegemonic benevolence becomes extremely problematic.

There are other criticisms as well. For our purposes, however, it is enough to understand that, as appealing as the theory is on first glance, closer analysis reveals potentially significant flaws. This is not to say that hegemonic stability theory should be dismissed. Far from it. Instead, as with any theoretical approach (including the three traditional approaches we covered in the chapter 2), the key assumptions, principles, and insights should be evaluated with a critical eye. We should also remember that the international or global political economy is not an event, but an ongoing process. This means, in part, that dynamics within the system can, and likely do, vary over time. Thus, it could very well be the case that hegemonic stability theory explains important aspects of international economic stability in certain situations, but not in others. Or, equally likely, it could be that stability is a product of multiple independent factors. On this point, recall our discussion in chapter 1 on the distinction between *international* political economy and *global* political economy. In IPE, the focus is on what states do. In GPE, by contrast, analysts understand that states are only one of many actors, and that the basis of state power (which lies largely in the security structure) is neither the only, nor necessarily the most important, basis for power in the world economy. These last points provide a useful segue into the next section, a discussion of post-hegemonic theories.

**Figure 3.6. U.S. Farm Subsidies (2005)**



Source: Congressional Budget Office (via the Associated Press)

This graph shows the level of subsidies provided to U.S. agricultural industries in 2005. Subsidies are a form of protectionism, as they lower the cost of production for producers of a particular good, making it more difficult for foreign producers to compete.

*Image source: The image is licensed under the Creative Commons Attribution-Share Alike 3.0 Unported license.*

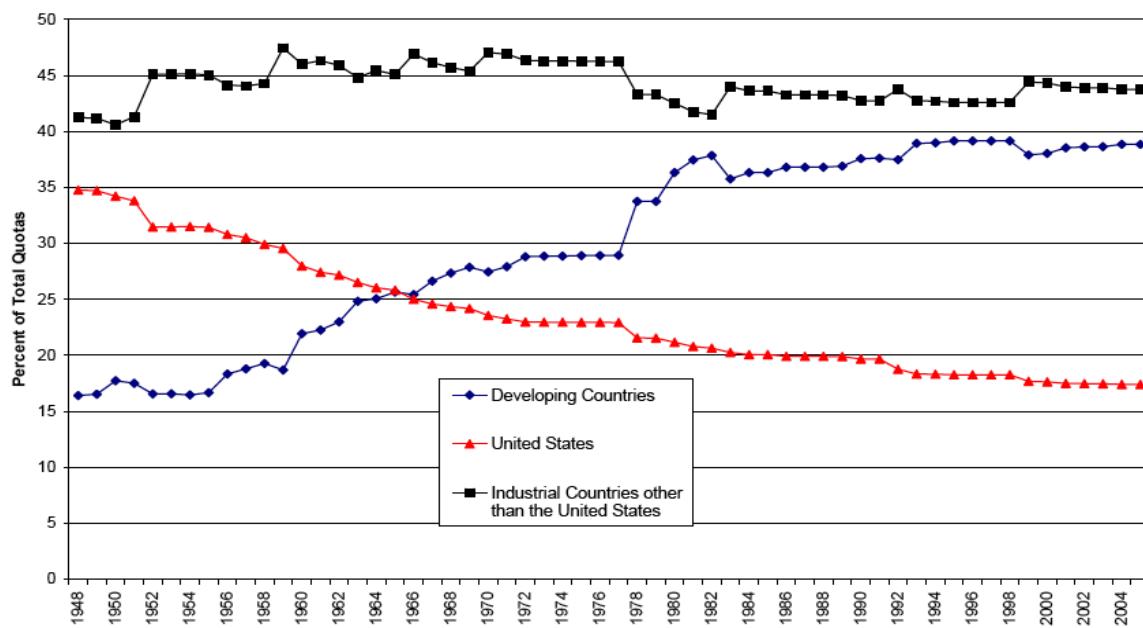
## Post-Hegemonic Theories

In the 1970s and 1980s, when hegemonic stability theory was at its peak, many (but certainly not all) IPE scholars took for granted that states were necessarily the key players in the world economy. It is no surprise, then, that a lot of analytical attention was paid to the most dominant state—the hegemon. We might say that the world has changed since then, although it is probably more accurate to say that there has been a change in the ways in which many scholars and other observers view the world. Whatever the case, one thing is fairly clear: states are not the only significant actors, and even the most powerful of states (i.e., the hegemon) has a limited capacity to influence and shape the global political economy. This is a starting point for *post-hegemonic theories* (PHTs)—a vague and potentially confusing term. To simplify our terminology, then, we can say that PHTs, most generally, are theories that pay serious attention to actors or entities other than the state. These other actors include international organizations (or multilateral institutions), international regimes, corporations, nongovernmental organizations, epistemic communities, social movements, and so on. There is also a much stronger emphasis on the nonsecurity or nonmilitary sources of power, especially power in the production and knowledge structures, but also including intangible or intersubjective sources of power such as ideology, culture, norms, and values.

Among the many types of actors, one area of particular interest has been multilateral institutions, some of the most prominent of which are the United Nations, the International Monetary Fund (IMF), the World Bank, the World Trade Organization, and the European Union. We might legitimately ask: Aren't these institutions just proxies for state power, and don't they simply reflect the interests of states? The short answer is: yes and no. On the one hand, multilateral institutions are unequivocally the product of state action and interests. Even more basically, their membership is comprised entirely of states. In this view, then, there is no reason to focus on the institutions themselves, since they simply do what the states, and especially dominant states, want them to do. Consider, on this last point, how power is exercised in the IMF: voting power is linked explicitly to financial contributions (called quotas) from member states; the higher a state's contribution, the more votes it gets (see figure 3.8, "Distribution of IMF Quotas by Income Group"). Quotas, in turn, are based on a member's relative economic position in the world.<sup>5</sup> Even in the United Nations, the most important decisions are left to just five countries—the United States, Russia, China, France, and Great Britain—who all retain permanent seats on the **Security Council**, and who can exercise veto power on any decision made by the Security Council. From a Marxist perspective, then, we might say that institutions are the tools of the dominant states. (It is important to recognize, however, that not all Marxists would agree with the foregoing statement, since *social classes*, not states, are the dominant actors.)

On the other hand, once created, multilateral institutions often—although not necessarily—begin to take on a life, and interests, of their own. That is, they begin to operate, at least to some extent, as independent actors in their own right. Thus, while the United States and other rich industrialized countries may have preponderant voting power in the IMF, this does not automatically mean that everything the IMF does reflects U.S. power. Among scholars who focus on multilateral institutions, there is a great deal of debate regarding the autonomy—or lack thereof—on the part of multilateral institutions, but almost all would agree that institutions, at a minimum, serve a vital function as mechanisms for coordination, collaboration, and cooperation at the international level. Whatever the case, institutions are an increasingly important part of the world economy, and an increasingly important reason—many scholars argue—for international stability, in both the economic and political realms. With this in mind, let's take a closer look at the role of institutions.

**Figure 3.8. Distribution of IMF Quotas by Income Group, 1948–2004**



This graph shows the percentage in quotas/votes for the U.S. individually, richer industrialized countries (except the U.S.) as a group, and developing countries as a group. Although the U.S. share has declined significantly over the years, it is still the largest single contributor by far; moreover, the richer (mainly Western countries) still have well over 50 percent of total votes. In fact, in 2011, just eleven countries (the U.S., Japan, Germany, the UK, France, Italy, Canada, Netherlands, Belgium, Switzerland, and Australia) accounted for more than 50 percent of total votes, out of a total membership of 187 countries.

*Source: The graph is reproduced exactly from Bloomberg and Broz (2006), p. 20.*

### The Role of Multilateral Institutions

Theoretically speaking, institutions (and regimes) fit comfortably within the liberal tradition, although institutionalists can be found in a range of theoretical camps within IPE. With this caveat in mind, in the liberal tradition, there has long been an emphasis on **pluralism** and the potential for cooperation (as opposed to conflict). The key question, from

this perspective, has centered on how the interests of multiple actors, including both state and nonstate actors, can be reconciled in a manner that provides stability and mutual benefit to all. Or in simpler terms: How is cooperation possible? Before answering, I should emphasize that liberals and others who focus on institutions must deal with the issue of **anarchy**, a key concept in international relations theory. Anarchy, most simply, is the absence of overarching political authority within a particular political system, such as the international system today. The existence of anarchy makes cooperation at the international or transnational level very difficult to achieve, since all states are ostensibly sovereign, and therefore of equal standing in the international community. In hegemonic stability theory, this problem is resolved by the existence of a hegemonic state. In some versions of post-hegemonic stability theory, by contrast, the problem is resolved through multilateral institutions. So what exactly do these institutions and regimes do?

#### *What Do Institutions Do?*

Most generally, international institutions help to create a stronger, more durable basis for trust between and among states (*trust* can be defined as a belief in reciprocal cooperation—i.e., “If I do *x*, then you will do *y*”). Trust is a major component of cooperation. Or, to put the issue in negative terms, we can say that the greatest obstacle to international cooperation is distrust, or the prospect of cheating, by other states. International institutions help to alleviate the problem of distrust by providing a forum in which the intentions of various countries are revealed, and by providing a mechanism for monitoring, reporting, and policing the activities of all participants, and, in some cases, adjudicating disputes. In principle, these functions could be carried out without institutions, but in practice this is extremely difficult to achieve when more than a handful of states are involved. Thus, institutions provide, perhaps, the most (and often only) viable means for effective and efficient trust-building in world politics. In particular, institutions allow for regularized interactions. Regularized interactions raise the level of communication, increase the flow of information, and generally provide a stronger basis for sustained interaction. Institutions can also significantly reduce the likelihood of free-riders. This is true even where there is no effective enforcement mechanism (which is the case in the large majority of international institutions). Instead of enforcement, for

**Figure 3.9. Criteria for Joining the European Union**



According to the European Union’s website, any European country may apply for membership if it respects the democratic values of the EU and is committed to promoting them. More specifically, the EU lays out three key criteria for membership:

- Stable institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities.
- A functioning market economy and the capacity to cope with competition and market forces in the EU.
- The ability to take on and implement effectively the obligations of membership, including adherence to the aims of political, economic, and monetary union.

In addition, the EU has specific rules in 35 different policy areas that are negotiated separately. Candidates for membership must agree on how and when to adopt and implement rules in these 35 areas, and must provide guarantees on the date and effectiveness of the measures they intend to complete in order to satisfy the negotiated requirements. (Source: [http://ec.europa.eu/enlargement/policy/conditions-membership/index\\_en.htm](http://ec.europa.eu/enlargement/policy/conditions-membership/index_en.htm))

example, institutions may require minimum standards for membership: that is, before a state is allowed to join, it must agree to, and make concrete progress toward, specific benchmarks (see figure 3.9, “Criteria for Joining the European Union”). To put it more simply, the motto of some international institutions might be: “No Free-Riders Allowed.” The effectiveness of entry requirements presupposes clear benefits to membership in an international institution.

Rather than continue this discussion at an abstract level, we will consider one of the more effective and important international institutions—the World Trade Organization (WTO). The WTO is a descendant of the **General Agreement on Tariffs and Trade (GATT)**. The most salient difference between the WTO and the GATT is that the former is a permanent or standing international institution, while the latter was a series of trade negotiations (or “trade rounds”) that began in 1947. The GATT, however, was not originally intended to be the main multilateral forum for the discussion of international trade. Another organization, the International Trade Organization (ITO) was supposed to play this role, but concerns, especially within the United States, on how the organization might infringe on domestic economic matters, led to the ITO Charter never entering into force. While the ITO floundered, the GATT succeeded in liberalizing international trade, primarily through tariff concessions: the first round of negotiations resulted in a package of trade rules and 45,000 tariff concessions affecting \$10 billion of trade, which was about one-fifth of total world trade at the time (WTO, n.d. [a]). Subsequent rounds also primarily focused on tariff concessions, but in the Uruguay Round (1986–1994) a much broader array of issues was negotiated, including the establishment of the WTO in 1995. The Uruguay Round was a mixed bag: there was obvious success in the end, but achieving that success took nearly a decade, which included several periods of near collapse in talks (1988–89).

**Table 3.2. GATT Trade Rounds**

| Year      | Place/name                     | Subjects covered  | Countries |
|-----------|--------------------------------|---|-----------|
| 1947      | Geneva                         | Tariffs   | 23        |
| 1949      | Annecy                         | Tariffs   | 13        |
| 1951      | Torquay                        | Tariffs   | 38        |
| 1956      | Geneva                         | Tariffs   | 26        |
| 1960–1961 | Geneva<br><i>Dillon Round</i>  | Tariffs   | 26        |
| 1964–1967 | Geneva<br><i>Kennedy Round</i> | Tariffs and anti-dumping measures   | 62        |
| 1973–1979 | Geneva<br><i>Tokyo Round</i>   | Tariffs, nontariff measures, “framework” agreements   | 102       |
| 1986–1994 | Geneva<br><i>Uruguay Round</i> | Tariffs, nontariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc. | 123       |

Source: WTO ([http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/fact4\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm))

Since its creation, the WTO has not only continued the work of the GATT, but has also created a much stronger basis for trust building and cooperation. One of the main developments in this regard is the **Dispute Settlement Panel** (DSP), which has the power to resolve trade disputes between and among member countries. While not an enforcement mechanism per se, it provides the basis for ensuring reciprocity in a manner that few other international institutions can match. More specifically, if a state is found to have broken a multilateral trade rule, the WTO allows affected states to legally retaliate by imposing countervailing tariffs. Not surprisingly, more than a few states have threatened to withdraw from the WTO when DSP decisions have gone against them. Significantly, though, none have (Balaam and Dillman 2011, p. 143). Other countries, including the United States, have refused to publicly acknowledge wrongdoing in the face of an adverse WTO ruling, but have nonetheless complied. In 2003, for example, the Bush administration dropped duties on imported steel (the United States referred to these as “safeguard measures”) following a decision by the DSP that the duties were illegal. Interestingly, the U.S. trade representative at the time, Robert Zoellick (who would later become president of the World Bank Group from 2007–2012) argued that the decision had been made independently of the WTO ruling; indeed, at no time did the United States ever admit it had breached WTO rules (BBC News 2003). If the U.S. had not dropped its duties, however, the affected countries were ready to retaliate legally—that is, with the blessing of the WTO.

None of this is to say that the WTO has solved all issues in international trade. It has not. Recent WTO trade rounds have seen deep fissures develop, especially between wealthy and poorer countries on the issues of agriculture, services, intellectual property rights, and other areas.<sup>6</sup> These fissures have revealed the limits of cooperation and trust within even a strong institutional framework when the interests of participants are very far apart. At the same time, without an institutional framework, many broad-based cooperative arrangements could likely never be created. International trade, in this regard, provides a good case in point. There is, however, another issue that provides an even better example: global climate change.

#### *Institutions and Global Climate Change*

Global climate change is an immensely complicated and controversial issue, both scientifically and politically. Building consensus and cooperation among states, therefore, has been a monumental task. Nonetheless, once policymakers in most states—*influenced, in no small part, by an epistemic community made up of climate scientists and others (an epistemic community, according to Peter Haas, is a network of professionals with expertise and competence in a particular domain and an authoritative claim to policy-relevant knowledge [1992, p. 3])*—concluded that global warming represented a real and

**Figure 3.10. United Nations Climate Change Conference, Doha, Qatar, 2012**



Source: [UNclimatechange](#). Licensed under the Creative Commons Attribution 2.0 Generic license.

significant threat, they were able to use existing institutional arrangements, especially the United Nations, to address the issue on a collective, rather than individual, basis. More specifically, multilateral negotiations designed to address global climate change began in 1990 under the auspices of the UN General Assembly; by May 1992, a **convention** on climate change was adopted at the UN Conference on Environment and Development (popularly known as the **Earth Summit**, in Rio de Janeiro, Brazil). Negotiations continued through several institutional bodies, leading to the adoption of the **Kyoto Protocol** in December 1997. The **protocol** entered into force in February 2005 after the requisite minimum of 55 parties had deposited their instruments of ratification, acceptance, and approval of accession. The protocol required monitoring and recording of CO<sub>2</sub> emissions, and for some states (referred to as Annex I Parties) a specified reduction in greenhouse gas emissions. There were many countries that delayed ratification; ultimately, however, the only major holdout was the United States, which accounted for 36 percent of all 1990 emissions. The noncooperation of the world's largest emitter of greenhouse gases—and therefore the world's biggest free-rider—should have doomed any compliance with the protocol, but it did not. Indeed, among the 36 Annex I Parties committed to an actual reduction in greenhouse gas emissions, the majority did achieve lower emissions.<sup>7</sup> Moreover, the Kyoto Protocol, which was set to expire at the end of 2012, was extended to 2020 during the **Doha Climate Conference**.<sup>8</sup>

The foregoing summary obscures the complexity and extraordinary difficulty of reaching agreement on climate change. As Haas (2000) points out, the first scientific warnings of global climate change appeared in the 19<sup>th</sup> century, but even after renewed scientific warnings occurred in the 20<sup>th</sup> century, it took 23 years to finally develop the first, admittedly weak, international measures (p. 567), which were embodied in the UN Framework Convention on Climate Change (UNFCCC) in 1992. In this regard, it is easy to dismiss the importance of international organizations, but once the UNFCCC was established, international organizations shifted from being passive *arenas* for negotiations to independent *actors*. In particular, the United Nations Environment Program (UNEP), according to Haas, was "able to translate new information emanating from the scientific community into effective policy-oriented programs," while its executive heads became "vigorous exponents of environmental protection and research in public, in private with heads of state, and also in private negotiations." Even more, Haas continued, "[t]hey were generally able to effectively cope with disagreements among member states and avoid institutional deadlock" (2000, p. 568). International organizations carried out a number of other functions as well: they encouraged the dissemination of innovations to other actors; they set the agenda for member states; distributed information; built national monitoring and research capacity; helped industry and societal groups identify new practices; trained and assisted governments to enforce international commitments; structured bargaining forums; and empowered new national and transnational political coalitions (Haas 2000, p. 571).

#### *A Transnational World Full of Transnational Actors*

Despite the focus on institutions, the foregoing discussion still seems to depict a state-centric world. Appearances, however, can be deceiving. The WTO, for instance, can be considered an independent actor insofar as its decisions do not merely reflect the interests of dominant states, and especially the hegemonic state. The ruling against the United States on steel imports is a good indication of this. Similarly, the Kyoto Protocol seemed to contradict U.S. interests (although, it should be noted that the protocol was endorsed by the executive

branch but rejected by the legislative branch). While the United States failed to ratify the protocol, not only did the institutional framework that made the protocol possible survive, but so too did the protocol itself. It is also important to emphasize, on this last point, why the U.S. legislature refused to ratify the Kyoto Protocol. The main reason can be boiled down to domestic politics. This means, most generally, that it wasn't the United States as a monolithic state actor making the decisions, but rather individual politicians responding to pressures from industry-based interest groups, oil companies, and other corporations that rely heavily on traditional sources of energy. Even more, the issue became part of a partisan political struggle, with support for climate change legislation becoming identified with the Democratic Party. This meant that Republicans, even those who might have been concerned with climate change in the past, chose sides based on partisanship. There were additional actors playing a role as well, especially environmental NGOs, who were strong advocates of ratification.

To say that domestic politics helps explain the U.S. rejection of the Kyoto Protocol suggests that the actors involved were purely domestic actors involved in domestic-only politics. But this was hardly the case. (We will look more closely at domestic politics below.) The key nonstate actors clearly had interests and concrete connections or relationships that transcended national borders, and even without such interests or connections, the consequences of their actions have had ramifications beyond the borders of the United States. As such, these actors were all involved in "international relations" in almost the same way that states are. Yet, because these actors are not states, it is more accurate to say that they were involved in "transnational relations." Thus, they are **transnational actors**, a term that is preferable to *nonstate actor*, as the latter suggests that states are naturally dominant (Willets 2001, p. 357). In recognizing that transnational actors can influence and even dictate the policy of states, we automatically enter a new, far more pluralistic world. In the state-centered world, there are around 200 actors (states), the large majority of which seem to have little impact on the world economy or on world politics. If we disregard the poorest and smallest states, this would leave us with a slate of just a few dozen main actors in the interstate world. In the transnational world, by contrast, there are hundreds, if not thousands, of potential main actors. There are, for example, more than 82,000 transnational corporations with 810,000 subsidiaries spread across the world; thousands of nongovernmental organizations whose activities and interests routinely cross national borders; and dozens of **diasporic**, epistemic, and other types communities. Of course, just as with states, not every one of these transnational actors has an impact on the world economy or world affairs more generally. But some clearly do. It is hard to discount, for example, the power of global corporations such as Exxon Mobil: this company is one

**Table 3.3. Number of TNCs and Foreign Affiliates, Selected Years and Countries**

| Country        | Year | Parent Corporations | Foreign Affiliates |
|----------------|------|---------------------|--------------------|
| United States  | 1990 | 3,000               | 14,900             |
|                | 2000 | 3,235               | 15,712             |
|                | 2005 | 2,360               | 13,667             |
| United Kingdom | 1991 | 1,500               | 2,900              |
|                | 1996 | 1,059               | 2609               |
|                | 2003 | 2,607               | 13,176             |
| Germany        | 1990 | 6,984               | 11,821             |
|                | 2002 | 6,609               | 9,268              |
|                | 2006 | 5,935               | 9,631              |
| Japan          | 1992 | 3,529               | 3,150              |
|                | 2001 | 3,371               | 3,870              |
|                | 2006 | 4,663               | 4,500              |
| South Korea    | 1991 | 1,049               | 3671               |
|                | 2002 | 7,460               | 12,909             |
|                | 2007 | 7,460               | 14,869             |
| China          | 1989 | 379                 | 15,966             |
|                | 2002 | 359                 | 424,196            |
|                | 2005 | 3,429               | 280,000            |

Source: Cited in Selden (2010), table 1. Original source data derived from table 1, Saskia Sassen, “The Global City Perspective. Theoretical Implications for Shanghai,” in *Shanghai Rising: State Power and Local Transformations in a Global Megacity*, pp. 9–10, based on UNCTAD, *World Investment Report* (1998, 4; 2004, 273, 274; 2008, 211). The figure for China’s foreign affiliates bears further checking.

of the largest in the world by revenue, with 37 oil refineries in 21 countries that, together, have a combined daily refining capacity of 6.3 million barrels. Another major oil company, Royal Dutch Shell, controls oil production in the Niger Delta region of Nigeria. Since the early 1990s, Shell has been engaged in a struggle with an indigenous population, the Ogoni. While conventional IR theory tells us that the Nigerian state calls the shots, it is fairly clear that Shell has been able to exert tremendous influence over the Nigerian state in its dealings with the Ogoni people. In one particularly infamous case, Shell was implicated in the unlawful execution of nine Ogoni activists; in 2009, Shell agreed to pay \$15.5 million to settle a legal action in which the company was formally accused of having collaborated in the execution of the “Ogoni Nine” (Pilkington 2008).

It is relatively easy to argue that major transnational corporations are important actors in the world economy, but can we make a similar argument about other transnational actors? Let’s consider a rather unorthodox example of an NGO: Al-Qaeda. Mosisés Naím asked, in *Foreign Policy* (2002, p. 100) magazine, “What does al-Qaeda have in common with Amnesty International and Greenpeace?” The answer, according to the author is that “all three are loose networks of individuals united by a shared passion for a single cause, and thanks to cheaper communication and transportation, each can project globally.” I mention al-Qaeda as an example of an NGO because its influence on global affairs is unquestioned.

Yet if this single, poorly funded (relatively speaking) nongovernmental organization can have such a major impact, it stands to reason that other NGOs, even those that use far less violent tactics, can also have an impact. Consider, on this point, a far more innocuous NGO, the International Air Transport Association (IATA). The IATA partners with governments and international organizations to provide an effective regime for navigation, safety standards, and the general regulation of commercial aviation (cited in Willets 2001, p. 372). Clearly, this is an important function in the world economy.

In short, to argue that the power and presence of these actors do not matter—as many traditional IPE and IR scholars do—is becoming less and less defensible. We already covered why this is the case in chapter 1, so I will not go over the same ground here. Instead, let us consider the issue from a slightly different perspective by addressing the question, why has a state-centric approach become increasingly problematic?

### *Problems with the State-Centric Approach*

I have already suggested one reason for questioning the focus on states—namely, the notion that states are somehow unitary or monolithic actors. Put another way, state-centric analyses tend to take for granted that states are *holistic entities*, almost literally thinking with one mind and speaking with one voice. This notion depicts the state, at least to some extent, as the Borg, a fictional alien race in the television series *Star Trek*. The Borg is a collection of individual species that have been thoroughly assimilated into a collective, or “hive.” There are no individual interests or desires—only a single “hive mind” that connects and controls every individual Borg. Although this comparison is admittedly oversimplified and overdrawn, it is not entirely unfair. Analysts who treat the state as a holistic entity presume that the interests of the many specific groups and organizations within any country, no matter how powerful they may be, are largely immaterial to explaining state behavior. In their view, there is only one relevant interest in explaining state behavior: the *national* interest. Critics argue that this is an unrealistic view of states’ decision-making process. We need to consider what goes on within the state, how different groups influence, shape, and even determine state behavior. Once we admit that there are competing groups shaping state policy, each with varying degrees and types of power, and each with its own interests, the picture becomes more complex, but also more realistic. And, again, when those interests are no longer contained within a single set of national boundaries, we have the beginning of transnational (as opposed to international) theory. One particularly influential argument in this vein is given to us by Anne-Marie Slaughter, who asserts that states, while not disappearing, are

**Figure 3.11. A Borg from Star Trek**



The image depicts an individual Borg from the TV series *Star Trek*. The Borgs are individuals, but they think and act as a single collective unit.

*Source: Science Fiction Museum and Hall of Fame. The image is licensed under Creative Commons Attribution-Share Alike 3.0.*

“disaggregating into … separate, functionally distinct parts.” These parts, which include the courts, regulatory agencies, executives, and even legislatures, are not only disaggregating, they are also “networking with their counterparts abroad, creating a dense web of relations that constitutes a new, transgovernmental order” (1997, p. 184).

The second problem with the state-centric approach is the tendency for realists and others to treat all states as essentially equal because all states are sovereign. Specifically, the state-centric approach implicitly treats the most powerful states as the benchmark for all states. Thus, because the United States or China or Germany are still capable of influencing the world economy in major ways, so too must be Costa Rica, Albania, and Zanzibar. Of course, this is a gross exaggeration: no one would argue that Zanzibar has the capacity to impact the world economy to the same extent as the United States. And yet, the state-centric approach still tells us, in principle, that the weakest of states is more important than the strongest transnational actor (see table 3.4 for a comparison of the largest and smallest states). Consider, on this point, the country of Nauru: it has a population of 10,000 people and a GDP of \$60 million. Is it reasonable to imply that tiny Nauru is more significant than, say, Exxon Mobil, a company with revenues of \$354 billion, profits of \$30.4 billion, and assets of \$302.5 billion (in 2009)? Exxon Mobil even has eight times more employees—82,100—than Nauru has people. Indeed, even many NGOs exceed some countries in one or more significant dimensions. The Art of Living, an educational and humanitarian NGO, for example, operates in 153 countries and has 2.5 million members. NGOs such as Oxfam, CARE, World Vision, and Save the Children have significant financial strength and large contingents of workers—World Vision, for example, has over 23,000 employees. Politically, too, many of the largest, most well known NGOs have significant clout, at both the national and transnational level. We should not forget, too, that NGOs include criminal, guerilla, and terrorist organizations, and it is almost impossible to deny their (increasing) influence in world affairs. In fact, one tiny, highly dispersed organization, al-Qaeda, arguably has had a larger impact on world affairs than all but the most powerful states over the past decade or so.

**Table 3.4. Differences between Largest and Smallest States, Selected Indicators**

| Country       | Largest  | Measure                     | Smallest     | Country |
|---------------|--|-----------------------------|--------------|---------|
| China         | 1,339,190,000  | ← Population →              | 10,000       | Nauru   |
|               | <i>China's population is almost 134 thousand times the population of Nauru.</i>              |                             |              |         |
| United States | \$14,991,300,000,000   | ← GDP →                     | \$37,000,000 | Tuvalu  |
|               | <i>U.S. GDP is 405 thousand times larger than Tuvalu's GDP.</i>                              |                             |              |         |
| United States | \$711,000,000,000  | ← Military Spending →       | \$4,600,000  | Gambia  |
|               | <i>U.S. annual military budget is more than 154 thousand times Gambia's military budget.</i> |                             |              |         |
| Russia        | 17,098,242   | ← Area (km <sup>2</sup> ) → | 1.95         | Monaco* |
|               | <i>Russia is 8.77 million times larger in landmass than Monaco.</i>                          |                             |              |         |

\*Vatican City, a sovereign entity, is smaller than Monaco.

### *Transnational Theory*

Once we acknowledge that states are not monolithic and that there are dramatic differences among states, on the one hand, and between states and nonstate or transnational actors on the other hand, it becomes clear that we need a framework that can accommodate a full range of actors, relationships, and issues. We need, in short, a *transnational* theory. A transnational theory requires a multidimensional, structural understanding of power, one that does not privilege military power (or power in the security structure). It also requires an understanding of how power is manifested or exercised in different places, and with respect to different issues: security, finance, the environment, production, trade, human rights, democracy, migration, poverty, and so on. In different places and on different issues, state and transnational actors will play different roles, have varying degrees of influence and interest, and have varied tools at their disposal. In some places and on some issues, states may be dominant, while in other places and on other issues, transnational actors will play the central roles.

Equally important, the distinction between “high politics” and “low politics” must be eliminated. In the past, state-centric approaches classified all nonmilitary, nonsecurity issues as low politics, clearly implying that these were less important issues—and also implying that security was a separate realm, largely disconnected from economic, social, and cultural processes. But this distinction has always been extremely problematic. To see this, all one has to do is consider the fallout of the Great Depression: the consequences were not just widespread economic misery, but the most destructive international war—i.e., World War II—the world has ever witnessed. The causes of World War II are undoubtedly complex, but as David Kennedy (n.d.) writes, the genesis of the war can be found in the “lingering distortions of trade, capital flows, and exchange rates occasioned by the punitive **Treaty of**

**Versailles.**" To this list, Kennedy adds that a "rigidly doctrinaire faith in laissez-faire, balanced budgets, and the gold standard ... added up to a witches' brew of economic illness, ideological paralysis, and consequent political incapacity as the Depression relentlessly enveloped the globe" (n.p.). Whether or not one agrees entirely with Kennedy's analysis, one thing is clear: economic policies and (ideological) principles played a key role in the process leading to World War II. Economics, in short, simply cannot be subordinated or dismissed as "low politics." And what was true in the first half of the 20<sup>th</sup> century is even truer today, in an era of deeper interdependence and globalization.

The example above also highlights a third point: the importance of keeping firmly in mind the inescapable linkage among political, economic, and socio-cultural processes. To a large extent, this is what international/global political economy is all about. These connections have always been present, but they are more acute and pervasive today than ever before. This leads to the final key point in transnational theory—that the increasing interconnectedness of the world must be given full consideration. The old saying, "When the United States sneezes, the world catches a cold" (meaning that what the U.S. does or does not do has an impact everywhere) is still pertinent. But it also works increasingly from the other end; that is, given the high degree of interconnectedness today, seemingly inconsequential events in "faraway" places can have global repercussions. One of these "faraway" places is Tunisia, a place the large majority of Americans could not find on a map. On December 17, 2010, however, the action of a single person led to an extraordinarily significant series of events that has affected the entire world. On that date, a street vendor named Mohamed Bouazizi set himself on fire as a protest against police harassment. His act of self-immolation led quickly to widespread anti-government protests in Tunisia, and ultimately to the ousting of President Zine El Abidine Ben Ali only 28 days later. Ben Ali had ruled Tunisia for 23 years. The protests in Tunisia inspired protests and anti-government movements—dubbed the **Arab Spring**—throughout the Middle East and North Africa (MENA): in Algeria, Yemen, Egypt, Bahrain, Syria, Lebanon, Libya, and elsewhere. Interconnectedness, in this case, created a snowball effect that, to a significant extent, reached almost every part of the globe. The European Union and the United States, in particular, were drawn into several conflicts, the most salient of which was Libya. In Libya, the EU committed military forces, via a no-fly zone, on behalf of anti-government forces. The result was the capture and death of Muammar Gaddafi in 2011—a man who had ruled Libya for more than 40 years. Of course, Bouazizi's action was not *the* cause of the Arab Spring; there were many other factors. But his action is a clear demonstration of how interconnected and transnational the world has become.

### Summing Up

**Figure 3.12. French Support of Mohamed Bouazizi**



A demonstration in France in support of Mohamed Bouazizi, the "Hero of Tunisia."

Source. Antonine Walter. The image is licensed under the Creative Commons Attribution-Share Alike 2.0 Generic license.

For our purposes, a full-blown discussion of transnational theory is not necessary. For now, it is enough to keep in mind that, as reasonable as it may seem, an exclusive focus on states is shortsighted and even wrongheaded. In many cases and on many issues, states are only one of several important actors, and not necessarily the most important. Keep in mind, too, that the very concept of the state as a unified and rational actor that speaks for an entire country is an abstraction. When we talk about the state, in other words, we are not talking about a singular entity making decisions in the same way an individual person does. Instead, a state is a complex and oftentimes disjointed amalgamation of institutions and agencies, of people, of norms and (legal) principles, of ideologies and values, of territory and resources. Thus, we must be careful not to anthropomorphize the state. This is not to say that the state-as-an-actor approach is a bad thing. It is not. Conceptually, it *is* useful to think of the state as a coherent entity, and many important insights have been derived from this abstraction. At the same time, the abstraction is frequently taken too far, leading analysts to neglect other important actors within a country, and, equally important, what goes on *inside* of states. This leads us back to an issue we encountered briefly above, namely, the relationship between domestic and international politics.

## Two-Level Games and IPE

Earlier I mentioned the importance of domestic politics. My emphasis was on the implicit relationship between domestic and international/global politics. This relationship has been an important area of inquiry among IPE scholars and others, especially those who focus on the formulation of foreign policy. They have even developed a special term for this relationship: *two-level games*. The general concept of two-level games has been around for a long time, but Robert Putnam, a well-known political scientist, is generally credited with formalizing the term. To Putnam, the opening question is simple: Do domestic politics influence international politics, or do international politics influence domestic politics? His answer is equally simple: “Both, sometimes” (Putnam 1988, p. 427). Putnam’s basic argument echoes much of what we covered in the previous section, but he provides us with a cleaner framework of analysis, one based on a game-playing metaphor.

In this metaphor, domestic or international negotiations can be depicted as a two-level game. The first level (Level 1) involves the people who actually negotiate an issue, endeavoring to reach an agreement that is satisfactory to all parties. The negotiators might be high-level cabinet officials, heads of state, diplomats, party leaders, union heads, CEOs, and so on. In the simplified model, we presume that each side (there may be many more than two sides) is represented by a single leader or chief negotiator. In Putnam’s model, we also presume that the chief negotiator has no independent policy preference, but is primarily concerned with achieving an agreement that he can sell to his constituents. The second level (Level II) involves separate discussions with various constituent groups, whose support is needed to “ratify” a negotiated agreement (Putnam uses the term *ratify* generically to refer to any process that is required to endorse or implement a Level I agreement). These two levels are not meant to be “descriptively accurate” (p. 436); Putnam understands that actual negotiations are far more complicated, interactional, and fluid. Still, as with the state, the two levels are useful analytic constructs that allow us to more easily grasp the core elements of a public policy decision. On this point, the requirement that any Level I agreement must be ratified at Level II provides a crucial theoretical link between the two levels.

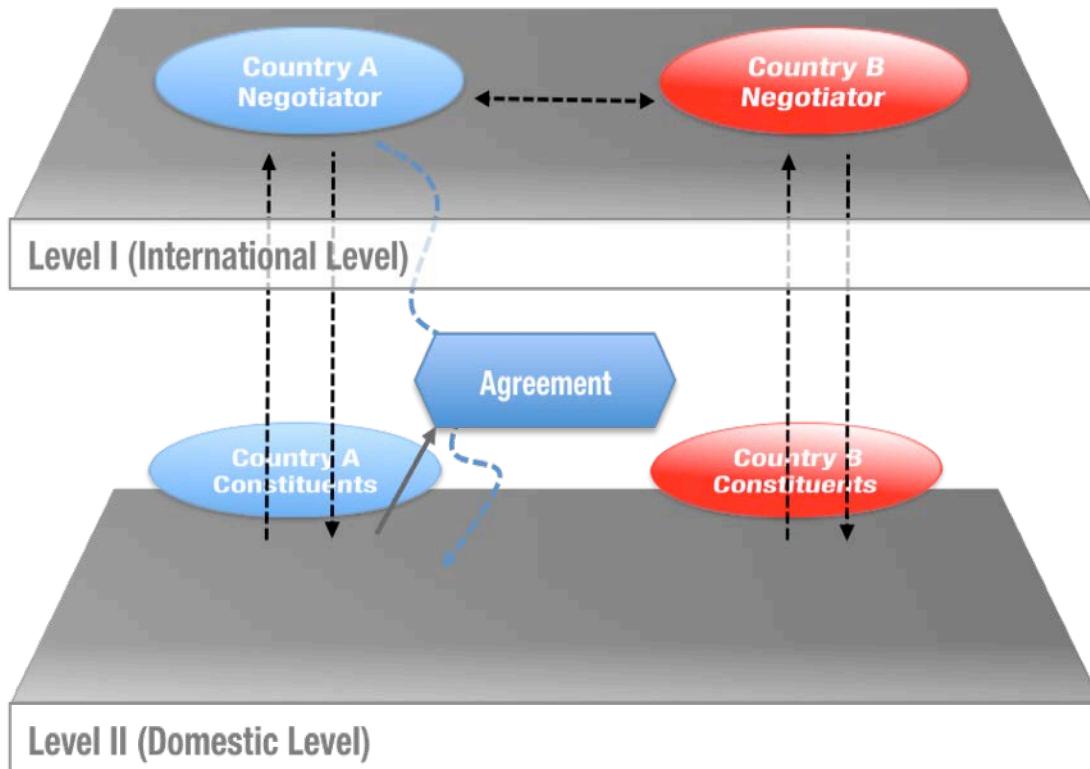
Another key element of Putnam's framework is what he calls "win-sets." As the term implies, a win-set is the set of all possible Level I agreements that would "win"—that is, gain the necessary majority among the key constituent groups. In this regard, even before (international) negotiators come to the table, they are influenced by domestic factors. The reason is clear: if the chief negotiator goes beyond the range of the win-set, he or she knows that an agreement made at Level I will not be ratified at Level II. This is both a constraint and an advantage. As a constraint, the chief negotiator has little wiggle room for bargaining; however, as a bargaining advantage, the negotiator can use a small domestic win-set as an excuse for a hard-line position: "I'd like to accept your proposal, but I could never get it accepted at home" (p. 440). The relative size of domestic win-sets, of course, will vary considerably depending on the issue being negotiated, but it is safe to say that virtually all issues negotiated at the international level are influenced by domestic win-sets. On this point, too, Putnam puts forth clear guidelines on the circumstances that affect win-set size. He argues that there are three sets of factors:

- *The distribution of power, preferences, and possible coalitions* among Level II constituents.
- *Level II political institutions* (including constitutional rules and procedures as well as established institutional norms): For example, a two-thirds vote for treaty ratification versus a majority vote; informal consensus building among all major constituent groups (as in Japan); autonomy of the state from social forces (in general, authoritarian states have larger win-sets because Level I decisions do not always require Level II ratification, as they do in democracies).
- *Level I negotiators' strategies*: Individual negotiators can employ strategies to expand or constrict the size of the domestic win-set. For example, in the Carter White House, many inducements were offered to wavering senators to ratify the Panama Canal Treaty.

In addition to the three sets of factors listed above, Putnam also discusses three other factors that can affect the relationship between the two levels. These are: (1) uncertainty about the size of the win-set (both the opponent's and one's own) on the part of Level I negotiators; (2) international pressures, which reverberate within domestic politics, tipping the domestic balance and thus influencing international negotiations; and (3) the role of the

chief negotiator and his or her personal preferences (this could lead to a Level I decision that

**Figure 3.13. A Highly Simplified Representation of the Two-Level Game**



This image shows the (partial) interaction between the domestic and international levels. Negotiators in Level I do not act in a vacuum: their positions almost always reflect the interests, concerns, and power of domestic constituents (Level II); this is manifested in the win-set they develop and propose. Once an agreement is reached at Level I, it must then be “ratified” at Level II. This does not always happen—e.g., the Kyoto Protocol was rejected by domestic actors in the U.S.

*Image Source: Created by author, but based on similar image in Borsuk et al. (2010), available at [http://engineering.dartmouth.edu/sedg/climate\\_change.html](http://engineering.dartmouth.edu/sedg/climate_change.html)*

cannot be ratified and implemented at Level II).

There is much more detail and substance to Putnam’s argument than is evident in this summary, but the basic point should be clear: understanding and explaining how states make decisions requires taking into account the “entanglements,” as Putnam puts it, of international and domestic politics. The two-level games approach is one way to do this because it recognizes that “central decision-makers strive to reconcile domestic and international imperatives simultaneously” (p. 460). We should also note, as Putnam does, that his two-level approach can accommodate, or “in principle be married to such diverse perspectives as Marxism, interest group pluralism, **bureaucratic politics**, and **neo-**

**corporatism**" (p. 442). This makes Putnam's two-level approach more a **method** than a theory, but this is not a problem. Indeed, I recommend that, as we move through our discussion of specific issues in international/global political economy in subsequent chapters, you see how this two-level *method* can be usefully "married" to the traditional and contemporary theories of IPE.

## Constructivist Approaches to IPE

Our theoretical discussion thus far has centered on approaches that, for the most part, assume that the world's economic and political systems have a primarily concrete, or objective, existence. This should not be a surprise. It is, after all, just common sense, right? In fact, almost everyone engages in this sort of "theorizing" all the time. General and taken-for-granted statements such as, "Be realistic," "That's just the way it is," or "There's nothing you can do to change it," reflect the same sort of assumptions about the world. These statements, in other words, are based on the presumption that there is a fixed, entirely objective reality. This means, in turn, that there are certain things in the world—certain aspects of our reality—that just cannot be changed, no matter how much we would like them to or no matter how hard we try. For much of the 20<sup>th</sup> century, moreover, social scientists generally subscribed to the same view of the world.

More specifically, most rarely questioned the idea that the world of economics and politics was different, in a fundamental sense, from the world that physicists, chemists, geologists, and other natural scientists focus on in their studies—i.e., the natural or physical world. But consider this difference: while natural scientists study *things* (material objects), social scientists study, well, human beings. (To be sure, some natural scientists—e.g., biologists—study human beings, too. But they are primarily concerned with the physical processes, structures, and functions of humans as organisms.) More generally, social scientists study the *social* world. This means that social scientists study human society—the motives, decisions, and actions of individuals, groups, organizations, institutions, and whole countries, as well as (or especially) their interactions. The ultimate objects of study in social science are human beings—beings not only capable of thinking, feeling, understanding, and learning, but also of creating, sustaining, and changing the core elements of the world in which they live. This makes studying the social and physical worlds fundamentally different. Even more, social scientists, as human beings themselves, are an integral part of the world they study, which makes separating themselves from that world exceedingly difficult, if not impossible. This is the starting point for constructivist theories, which, at the simplest level, challenge the assumption of objectivity.

### *Objectivity vs. Subjectivity*

Before continuing with this point, let us take a step back and briefly reconsider the notion of objectivity in the social sciences, particularly in regard to the theories with which we are familiar. Mercantilism, liberal economic theory, and Marxism all operate on the assumption that there are basic, largely invariable laws that govern human society. One of the main goals of each theory, then, is to identify and understand these laws so that we can explain and predict how the world works. Thus, liberal economics tells us that human behavior can be reduced to self-interest, a characteristic that is unchanging across time and space. Mercantilism, in turn, assumes a world of unremitting struggle for power and security among self-interested, sovereign states, while Marxism posits that material forces largely

determine the type of world we live in. Built into each of these assumptions is the firmly held conviction that our theories of the social world are completely separate from that world. Put another way, in an objective view of the world, we assume, for instance, that what we *think* about how states interact with each other at the international level has nothing to do with how they *actually* interact. Again, we are told, this is only common sense. This view, however, has been challenged by an increasing number of scholars, including natural scientists. Indeed, it is within the “hardest” of natural sciences—physics—that many cogent arguments can be found. As Niels Bohr, a Nobel Laureate in physics, said, “It is wrong to think the task of physics is to find out how nature *is*. Physics concerns what we can say about nature ...” (emphasis added, cited in McCloskey, 1994, p. 41). Even more to the point, Werner Heisenberg wrote, “Natural science does not simply describe and explain nature; it is part of the *interplay* between nature and ourselves: it describes nature as exposed to our method of questioning” (emphasis added; cited in *ibid.*). Of course, Bohr and Heisenberg are speaking of a field in which the primary objects of study are not human beings. In the social sciences, then, we can expect that the interplay between our reality and ourselves will likely be even more important.

What does this mean in more concrete terms? To find out, let’s revisit an example we considered earlier—namely, the primary manner in which states interact with one another. There are many ways to think about this, but mercantilism (and realism) tells us, as we have seen several times already, that the nature of interstate relations is defined by a constant struggle for power and security. In this view, our understanding of the world (of international relations) tells us that no state can let down its guard, even for a minute. The world is “Darwinian”: only the strongest survive and prosper. Thus, if political leaders in Country A believe this view of the world, they will naturally put it into practice. This means that they will build a strong military, create and produce destructive weapons, be suspicious of neighboring

**Figure 3.14. The Logic of the Self-Fulfilling Prophecy**



*Image Source: Created by author, but based on an image by Kaufman (2012).*

countries and peoples, and so on. When other countries see what Country A is doing, they do the same. We then come full circle: in Country A, the original views of the political leaders are seemingly confirmed as neighboring countries build up strong (and threatening) armies. This means Country A must redouble its efforts, which leads to another round of military build-up, and then another, and so on. This is a simplistic example, but one that nicely illustrates how our theories of the nature of international relations can lead to a self-fulfilling prophecy (Wendt 1992). The end result is, in fact, an objectively dangerous reality. But it is a reality that is in large measure *socially constructed*; that is, it is a reality that is fundamentally premised on—and continuously reproduced via—our ideas (beliefs, perceptions, and theories) as much as, if not more than, on objective conditions.

On first glance, all of this may sound terribly—and dangerously—naïve, as critics of constructivist theory have repeatedly pointed out. On this point, though, just think about two real-world cases. The first case is U.S.-Soviet relations during the **Cold War**. Both sides operated on the assumption that relations between capitalist and socialist states were unavoidably conflictual; thus, it was necessary to do everything possible to protect against the threat the other side presented. In the 1980s, however, something strange happened: within the Soviet Union, the once firmly held belief that the West represented an existential threat began to break down (Wendt 1992, p. 420). Ultimately, this led to a radical shift in Soviet policy—and a voluntary dissolution of the Soviet Union—based on a very different understanding of what the United States represented. Instead of viewing the United States as a threat, the Soviet leadership began to see the possibility of a peaceful relationship. U.S. reassurance further reinforced these views, and a new type of relationship was born, a relationship symbolized by the ending of the Cold War. The second case is the formation and development of the **European Union**, a process that began rather modestly with the formation of the **European Coal and Steel Community** (ECSC) in 1950. The motivation for the ECSC, however, was more than just economic: it was widely viewed as the first concrete building block for pan-European cooperation, integration, and peace. In this regard, it represented a *belief* that Europe could construct a new postwar reality. To a very significant extent, this new reality was created, as war and violent conflict among the major Western European countries, thus far, has been completely eliminated since the end of World War II.

The cases of U.S.-Soviet relations and the European Union suggest that socially constructed changes only work in one direction. This is far from the case. One counter-example should suffice to make this point. In 2002, George W. Bush introduced the phrase “Axis of Evil” in his State of the Union address. This was part of a long process of constructing certain countries as existential threats, not only to the United States, but also to the entire world. The three members of this evil axis were Iran, Iraq, and North Korea. Significantly, none of these countries had or has world-beating military capacity, and although all three were accused of attempting to build nuclear weapons—which North Korea succeeded in doing—there are other countries with significant nuclear arsenals, such as Pakistan and China, that were and are deemed less threatening. This tells us that objective military power does not determine what is dangerous and what is not. Identifying a country as an existential threat, however, must be reinforced in practice. The United States did this with Iraq until the 2003 invasion, and continues to do so with Iran. The construction of Iraq as a mortal threat worked exceedingly well: most Americans and much of the world believed that Saddam Hussein’s regime was a real danger, and this allowed the Bush

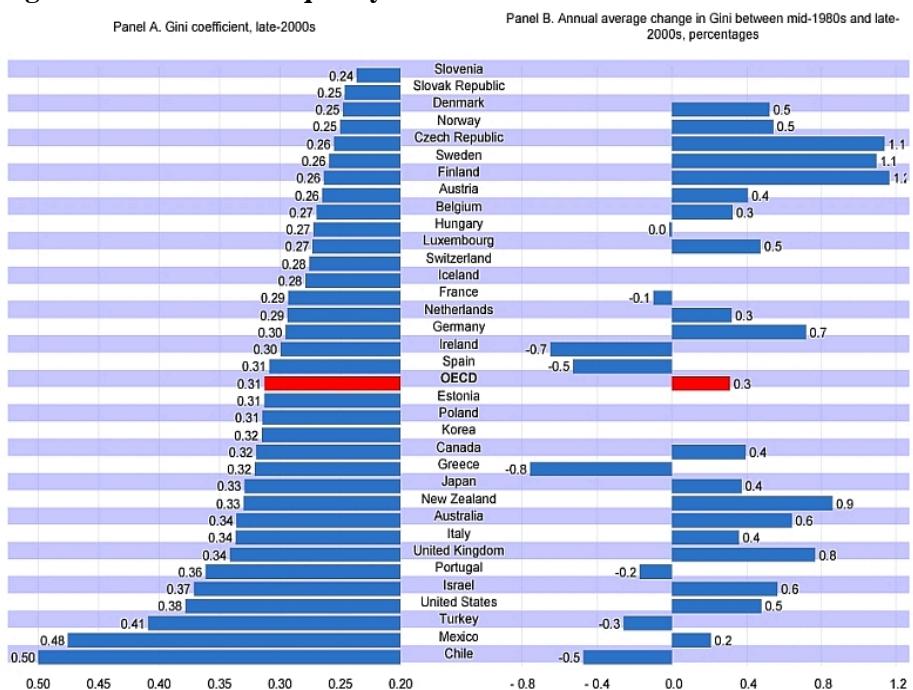
administration to carry out an unprecedented preemptive war against what was, in essence, a state with little actual or potential military capacity. In the case of Iran, distrust of the regime is palpable and has been so for a very long time. Yet, this did not have to be the case: shortly after 9/11, for example, Iran extended an olive branch to the Bush administration, but this diplomatic gesture was summarily rejected. Instead of pursuing the possibility of a better relationship, the Bush administration further aggravated the hostility between the two countries.

### *Constructivist Theories and IPE*

How does this relate to an understanding of the international or global political economy? Most saliently, it strongly suggests that so-called objective theories do not necessarily describe a reality that *has to be*, but instead describe a fundamentally malleable reality. Marxism, for instance, argues that class struggle is an unavoidable aspect of capitalist reality, and that capitalism necessarily produces severe exploitation, alienation, inequality, and so on. In the Marxist reality, these social problems can be overcome, but only with the complete collapse of the capitalist system; reform, in other words, is not possible. Constructivist theories recognize that capitalism has very real, very serious consequences; they also recognize that capitalism is a deeply embedded, extremely powerful structure. Yet they leave open the possibility of significant change to this structure through purposeful collective action. This is precisely what many of the anti-globalization protestors are trying to do in their actions against global neoliberalism: they are challenging the *idea* that the values of the (neoliberal) market—e.g., efficiency, deregulation, unfettered competition—should take precedence over other values such as equity, social and environmental justice, and so on. It is easy to dismiss these efforts as meaningless noise, but consider this reality: in the world today, there are already several types or varieties of capitalist systems that produce very different results—in terms of equity and social and environmental justice—for their societies.

Among the wealthiest capitalist economies, for example, there are significant differences in terms of income inequality (see figure 3.15, “Income Inequality

**Figure 3.15. Income Inequality in OECD Countries**



This chart shows the Gini Index numbers for all OECD countries. The key point to note is the significant differences among the countries, which indicates that, while some inequality cannot be avoided, there are many things individual countries can do to effect the overall level of income inequality.

Source: OECD (<http://www.oecd.org/social/inequality.htm>)

in OECD Countries”). Scandinavian and some Eastern European countries have extremely low levels of income inequality, while others—most notably the United States, Mexico, and Turkey—have very high levels of income inequality. This is not an accident. There are also significant differences, to cite one more example, in terms of the level of state intervention in the national economy. In some countries, the state plays a direct and ubiquitous role in the economy (e.g., China), while in other countries, the state’s role is much more limited (although never absent). There are many other important and complicated issues related to how capitalist systems vary; for now, though, just keep in mind that the reality of capitalism is socially constructed.

Constructivist approaches, to repeat, tell us that there are *always* different possibilities. Put another way, they tell us that current realities, because they are not God-given or somehow predetermined by human nature, are historically contingent social structures. This means, in part, that they emerged through an interactive process involving a complex mix of material and nonmaterial—or ideational—factors, which includes collective human action. Capitalism, in particular, did not emerge fully formed; instead, it developed and expanded gradually (on a global basis) over a very long stretch of time. Significantly, too, the early development of capitalism took place hand-in-hand with the emergence and development of the (modern) **national state** in Western Europe. The combination of capitalism and a national state proved to be highly effective in making war<sup>9</sup>—an extremely important attribute during a period of almost constant warfare in Europe. Both capitalism and the national state, it is crucial to add, required an ideational base before they could thrive. On this point, it is worth remembering that Adam Smith was a philosopher more than an economist, and his *idea* that the pursuit of self-interest was good for society as a whole—and not just the self-interested individual—was a crucial part of his overall argument about the virtues of capitalism. The ideational basis of the national state is even clearer. Consider, on this point, the following questions: Why do people give their allegiance to a state? Even more, why are people willing to give their lives for a state? The answer to both questions, most simply, is nationalism. Yet nationalism is an ideology, a *belief* that one belongs to a particular political community. This sense of belongingness, in turn, acts as a deep source of collective mobilization, collective responsibility, and—when necessary—collective violence. This is a very complex discussion, so suffice it to say that nationalism is a powerful ideological force in the world.

The dual development of capitalism and the national state enabled Western Europe to dominate the rest of the world, and eventually to impose that system on a global basis. Again, this was not a predetermined outcome, but was contingent on a host of material and ideational factors. Once this Eurocentric structure took hold, however, it became *the* picture of reality for much of the world, a picture that defines, but does not wholly determine, the parameters of our present existence. It is important to note that this Eurocentric system has itself changed significantly over time; indeed, it is no longer Eurocentric, but is instead U.S.-centric. The shift from a Euro- to U.S.-centric world economy, it is important to emphasize, brought with it more than just a change in leadership. In the U.S.-dominated system, we saw the ascendancy of a “hyper-liberal” form of capitalism (Cox 1995, p. 37) that had an almost messianic quality. Indeed, as Gill (1995) describes it, the “relentless thrust of capital on a global scale … has been accompanied by a neoliberal, *laissez-faire* discourse which accords the pursuit of profit something akin to the status of the quest for the holy grail” (p. 66). And, like a religious quest, any deviation from the orthodoxy “is viewed as a sign of either

madness or heresy, a view which acts to disarm criticism and to subvert the development of alternatives” (*ibid.*). This is the key point: ideas (values, culture, beliefs, etc.) become seen as natural or essential to our very way of life. The notion that ideas (including ideologies, values, culture, and intersubjective meanings) reflect/support the interests of the dominant class in global or national society is, of course, not unique to constructivist theories. Unlike most traditional views, however, constructivist theory sees the relationship among ideas and material forces, in a given historical structure, as invariably open-ended, no matter how entrenched they may appear to be.

### **Chapter 3: Conclusion**

I hope this brief survey of contemporary theories in IPE/GPE has inspired you to think differently about the world and about the factors and processes that influence and shape the world political economy. And even if you remain unconvinced about the validity of any of the perspectives we have discussed, I trust that you will not dismiss any of them out of hand. For, just as is the case with the three “grand narratives” (mercantilism, Marxism, and liberalism), I believe the contemporary narratives discussed in this chapter all have something of value to say. After all, each of them reflects the work of many very smart people who offer the benefit of their specialization and willingness to “trade” or share their knowledge with you. Still, we are left with the questions: Who is right? Which theory provides us the clearest route to the truth? As should be clear, I do not think that proponents of any one of the perspectives can make the claim that they speak *the* truth. Certainly, you might find one perspective more compelling than another. But be aware that your choice is not necessarily governed by your superior grasp of reality. Rather, your choice is governed by a host of personal, institutional, historical, and, yes, even structural biases. I am not saying this to confuse you, but to urge you to keep an open but critical mind. For if you really want to learn more about the world, you simply cannot afford to ignore the myriad strands of knowledge, thinking, and understanding available to anyone willing to listen, see, and absorb.

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<sup>3</sup> Cohn (1999) notes that, while a number of theorists take for granted the inevitable decline of hegemony, others (he calls them “renewalists”) argue that the United States in particular has not suffered a serious decline in its hegemonic position. Renewalists focus on three issues. First, while they agree that the U.S. is not as strong economically as in the past, its military and cultural power more than make up for any decline in economic power. Second, in a strongly related vein, renewalists emphasize the fact that the U.S. economic decline is only relative; in absolute terms, the United States remains the most important single economy with the widest range of resources. Third, some renewalists contend that divisive domestic politics in the United States is more responsible for the apparent decline in American hegemony than any actual weakening of American power (p. 441).

<sup>4</sup> In an interview in 2008, Krasner noted that, given the opportunity to rewrite his original definition, he would have modified it by offering three different versions. One would be a constructivist definition. The second would be a neoliberal definition, as follows: “regimes are principles, norms, rules and decision-making procedures that solve market-failure problems.” And the third would be a realist definition: “regimes are principles, norms and decision-making procedures reflecting the interests of the most powerful states in the system” (Schouten 2008, p. 6P).

<sup>5</sup> For additional discussion of voting power in the IMF, see Blomberg and Broz (2006). A downloadable version of their paper is available here:

[http://www.princeton.edu/~pcglobal/conferences/IPES/papers/broz\\_bloomberg\\_F1030\\_1.pdf](http://www.princeton.edu/~pcglobal/conferences/IPES/papers/broz_bloomberg_F1030_1.pdf)

<sup>6</sup> For further discussion on this point, see Jawara and Kwa (2004). This book can be previewed on Google Books at [http://books.google.com/books?id=d5PTbg9FLUQC&dq=wto&source=gbv\\_navlinks\\_s](http://books.google.com/books?id=d5PTbg9FLUQC&dq=wto&source=gbv_navlinks_s)

<sup>7</sup> The full story is much more complicated than presented here, and there are many criticisms of the protocol. The chief criticism is that the cuts outlined by the Kyoto agreement are insufficient to combat climate change, so even with full compliance the problem would not be solved. On this point, it is important to note that only a relative handful of countries—the Annex I Parties—were required to cut emissions; for the most part, developing countries, including China, were not required to implement any cuts.

<sup>8</sup> The full text of the Doha Amendment, as it is also known, is available on the UN Framework Convention on Climate change website at [http://unfccc.int/kyoto\\_protocol/doha\\_amendment/items/7362.php](http://unfccc.int/kyoto_protocol/doha_amendment/items/7362.php)

<sup>9</sup> Charles Tilly (1990), a prominent sociologist, provides an extremely useful analysis of the relationship between the development of the national state, capitalism, and war in his book, *Coercion, Capital, and European States, AD 990–1990*.

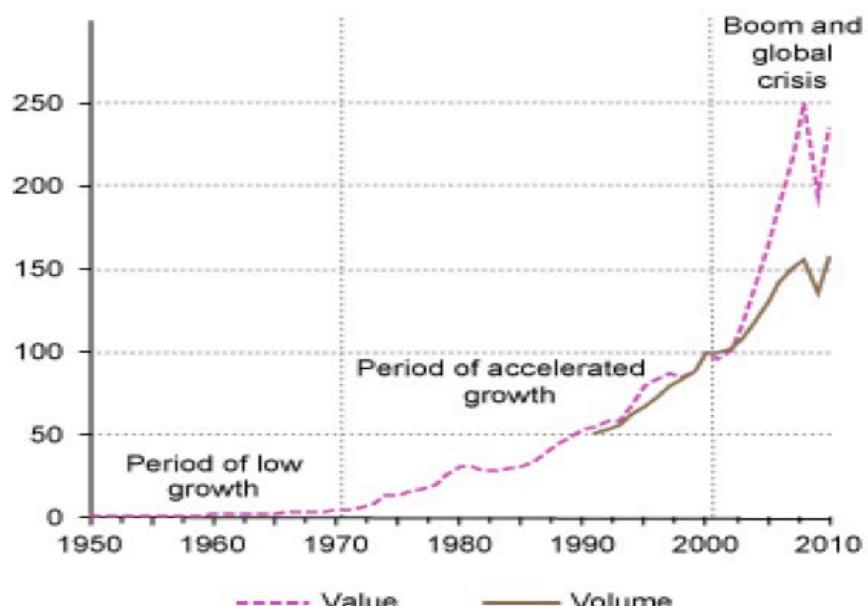
## Chapter 4

### Politics, Economics, and Cross-Border Trade

#### The Long History of Cross-Border Trade

Most people today, it is probably fair to say, take international trade for granted. That is, most of us consider international or cross-border trade to be a natural or an inevitable part of the world in which we live (for the purposes of this chapter, the terms *international trade* and *cross-border trade* will be used interchangeably). History seems to bear this out. We can, for example, find ample evidence of significant trade between and among many ancient and medieval powers. As Winham (2014) put it, “Trade lay at the centre of state revenue and state power in ancient Athens, Ptolemaic Egypt, the Italian city states of Venice, Florence, and Genoa, and the German Hanseatic League” (p. 110). In Asia, a vast and complex trading route called the **Silk Road**, which can be traced back to 2000 BCE, connected much of the old world through economic (and cultural) exchange. (The Silk Road was actually a network of routes, not a single road as the term implies.) From China, the Silk Road extended a total of 4,000 miles by land and sea through much of the rest of Asia (including India), to the

**Figure 4.1. Long-Term Trends in Value and Volume of Merchandise Exports, 1950–2010**



**Source:** UNCTAD secretariat calculations, based on *UNCTADstat* and CPB Netherlands Bureau of Economic Policy Analysis, *World trade database*.

Middle East, to North Africa, and to the Mediterranean and European regions.

Despite the long history of trade, it is important to recognize that the scope and scale of cross-border trade is, today, immensely greater than at any other time in human history. Consider, on this point, some basic statistics: before the global recession beginning in 2008, cross-border merchandise trade grew (in real terms) at an average annual rate of 6.2 percent a year between 1950 and 2007, compared to a much lower 3.8 percent a year between 1850 and 1913 (WTO 2008b). The growth in trade was an even more impressive 8.2 percent between 1950 and 1973. In dollar terms, this meant an increase in the value of trade from a relatively paltry \$84 billion in 1953 to \$13.6 *trillion* in 2007 (WTO 2008a). Equally significant, the growth of trade over the same period far outpaced the world GDP growth rate, which coincidentally also averaged 3.8 percent between 1950 and 2007. As a consequence of this disparity, the share of world GDP accounted for by merchandise trade (imports and exports combined) grew from only 18 percent in 1960 to more than 50 percent by 2008. This was a remarkable development, and one that has continued to the present time (2014), albeit with a significant, but short-lived decline in the first couple years of the global recession.

At the same time, for as long as there has been cross-border trade, there have been disputes and frequently serious tensions over trade. Especially over the past century or so, these disputes and tensions have ebbed and flowed, but never disappeared. Why this should be, at least on the surface, is perplexing. After all, the growth of trade has, in an important respect, brought unparalleled prosperity to the world. Of course, this is no surprise to liberal economists (and many other social scientists): they are almost universally united in their conviction that cross-border trade is beneficial, both for individual national economies and for the world as a whole. Even within the general public (especially in wealthy capitalist economies), most people acknowledge, although perhaps only tacitly, that the antithesis of trade—namely, **autarky** (i.e., a policy premised on complete economic independence or self-sufficiency)—is essentially impossible and self-defeating in the industrial and **postindustrial** eras. In this chapter, then, one of the main goals will be to try to make sense of the continuing debate over cross-border trade. As we will see, the debate revolves around both practical political issues—e.g., who benefits and who is harmed by trade—and also around deeper theoretical disagreements.

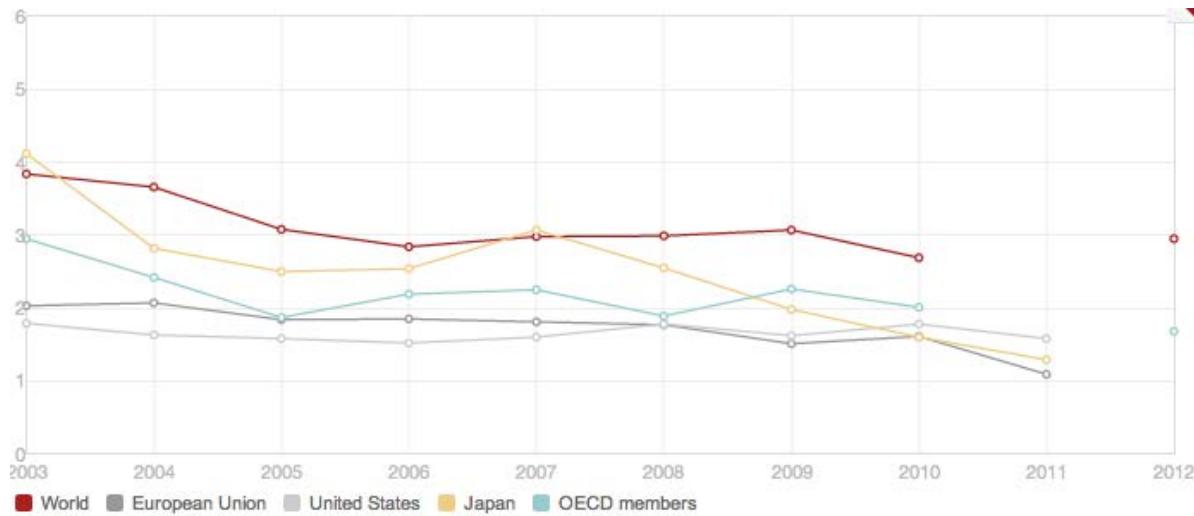
The debate over the desirability and utility of international trade, however, will be neither the only nor necessarily the main focus of this chapter. Instead, this chapter will also examine the intersection and inextricable linkage between politics and economics in the construction (and de-construction, as the case may be) of the political and institutional framework necessary for cross-border trade to thrive. There will be a strong emphasis on the period from the post–World War II era until the present, but a discussion of the early part of the 20<sup>th</sup> century is also important. The reason for emphasizing the last 70 years or so is simple: as already noted, the post–World War II era not only marks a period of unprecedented growth and expansion of cross-border trade, but is also the first era in history in which liberal trade rules became firmly and widely embedded in the international system. Understanding *how*, *why*, and *when* this happened, therefore, will go a long way toward developing our understanding of the study of international or global political economy. Before moving on to a substantive discussion of cross-border trade and international political economy (including the debate over trade), however, it will be useful to begin with an overview of basic—but essential—concepts.

## Basic Concepts and Data on Cross-Border Trade

Most readers already have a basic and basically sound understanding of trade. If I give you my laptop computer in exchange for your brand new iPad, we have engaged in trade. The exchange of a good or service for another illustrates a particular type of trade, referred to as *barter trade*. In the contemporary period, of course, the great preponderance of trade involves the exchange of money for goods and services. This type of trade can take place entirely within a domestic economy, and is, in principle, no different than cross-border or international trade. But there are a number of critical distinctions between domestic and cross-border trade. In particular, in cross-border trade the exchange of goods and services is, in the most minimal terms, mediated by at least two different national governments, each of which has its own set of interests and concerns, and each of which exercises (sovereign) authority and control over its national borders. In practice, this means that even “free” trade is never entirely free. Here, for example, is a standard definition of free trade: “The unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas” (from [investopedia.com](http://www.investopedia.com)). Yet, even today—in an era of unparalleled neoliberal globalization—all but a handful of countries or territories (i.e., Macao, Hong Kong, Singapore, and Switzerland<sup>10</sup>) continue to apply tariffs to a range of manufactured goods. In 2010, the (weighted) mean tariff rate for all countries and all manufactured products was 2.7 percent (see figure 4.2). While very low by historical standards, *any* tariff is still a government-imposed restriction on trade. Moreover, while tariffs on manufactured goods have declined dramatically over the last few decades, tariffs on *agricultural* products continue to be high: according to a report by the U.S. Department of Agriculture, at the turn of the 21<sup>st</sup> century, the global average tariff on agricultural products was 62 percent (Gibson et al., 2001, p. 34). Since then, the rate has come down, but it remains significant.

It would be useful to consider a concrete example: the North American Free Trade Agreement, or NAFTA, a trade agreement among the U.S., Canada, and Mexico (NAFTA is also a type of **regional trade agreement**, or RTA, which is discussed later in this chapter). Under the original terms of NAFTA, which came into force in 1994, Mexico was obligated to eliminate an **import licensing** system (a type of *nontariff barrier*, discussed below) for its agricultural sector; at the same time, NAFTA allowed Mexico to replace that system with **tariff-rate quotas** and ordinary tariffs. In other words, “free trade” under NAFTA initially meant a lesser degree of governmental constraints in cross-border trade, but not an elimination of government action. The tariffs were eliminated by mutual agreement in 2008; at the same time, both Mexico and the U.S. also agreed that “import-sensitive sectors”

**Figure 4.2. Tariff Rates (Weighted Mean), All Products**



Source: World Bank (graph created by author using tools provided by the World Bank online database, available at <http://data.worldbank.org/>)

could be protected with emergency safeguard measures in the event that “imports cause, or threatened to cause, serious injury to domestic producers” (USDA 2008). This same exception is embedded in trade regimes more generally, including in Article XIX of the General Agreement on Tariffs and Trade. In addition, under NAFTA, each country explicitly retains the right to determine, for itself, the standards and protections deemed necessary to protect local consumers from unsafe products, or to protect domestic crops and livestock from the introduction of dangerous pests and diseases. While many people would see this as a reasonable qualification, it is, again, a restriction on trade. The key point is simple: free trade remains as much an abstraction as an actual practice. This would be the case even if tariffs were completely eliminated tomorrow, since there would still be significant constraints on the flow of goods and services across borders.

It is important to add that the *terms* of “free trade” have always been, and, for the foreseeable future, will continue to be, set by the states that manage the extent to which markets are open (this point will be taken up again later in the chapter). From a broader historical perspective, in fact, the default position between sovereign states has been a mercantilist or protectionist position, whereby different kinds of barriers to trade have been intentionally erected to either minimize or control imports and sometimes even exports. Under mercantilism, maintaining a positive trade balance (i.e., a situation in which the value of exports exceeds the value of imports) has long been a primary goal of states. To achieve this, national governments have typically engaged in some form of *protectionism*.

As an economic policy, protectionism “protects” domestic producers from foreign goods and producers, typically by placing a tax on specific imported goods (*tariff*), prohibiting their importation (*import ban*), or imposing a quantitative restriction (*import quota*). The latter two policies are examples of *nontariff barriers*, or NTBs. Other types of NTBs include domestic health, safety, and environmental regulations; technical standards (i.e., a set of specifications for the production or operation of a good);

inspection requirements; and the like. NTBs, it is important to recognize, have, since the 1980s, become a more important source of domestic market protection than tariffs. One reason for this, which is discussed in more depth later in the chapter, is clear: by the 1980s, multilateral negotiation (through GATT) had significantly reduced tariffs, but many countries were still intent on protecting their markets. To do this, they turned to NTBs, which are less obvious and more subject to interpretation (that is, it is not immediately clear that an NTB is, in fact, meant to be a barrier to trade). On this point, it is useful to keep in mind that domestic regulations, practices, and standards are not always directly concerned with cross-border trade; other times, however, they are only thinly disguised efforts to inhibit foreign imports. One of the most famous examples of the latter situation is the Poitiers case, which involved France and Japan. In the early 1980s, French officials wanted to protect their market from imports of Japanese VCRs (see figure 4.3). The French government came up with an interesting strategy: it required that all customs inspections of Japanese VCRs be routed through a facility in a small town called Poitiers, in the center of France, that was staffed by only eight inspectors. The importation of Japanese VCRs into the French market slowed to a crawl. This policy, however, attracted such strong and immediate negative reaction that it was abandoned in less than a month (Jovanovic 2002, p. 248).

There is no need to feel sorry for the Japanese in this case, for Japan is well known for its extensive use of NTBs. In the automobile market, for example, Japan has not only required foreign automakers to meet very high safety standards, but has also required that the cars be submitted for a lengthy governmental inspection. According to Don Whitehouse, a retired Ford executive with long experience in Japan, these inspections were “brutal.” The inspectors, Whitehouse noted, “would check off every defect, even if it were well within generally accepted tolerance. They gun-sighted everything with magnifying glasses and flashlights to see if it had to be repaired” (cited in Hoffman 2009, n.p.). The result has been very low foreign car sales in Japan: in 2010, there were 4.2 million new vehicle registrations in Japan (for passenger cars), but of this total, imports by non-Japanese manufacturers were only 180,255—a scant 4.29 percent of total sales (figures Japan Automobile Manufacturers

**Figure 4.3. The VCR (Videocassette Recorder)**



The VCR was a ubiquitous, high-tech product from the 1980s to the 1990s. Ampex, an American company, originally developed the technology, but Japanese and European companies were the first to successfully commercialize the product for consumer markets. Competition was intense and began in earnest in the mid-1970s. By the early 1980s, however, Japanese companies—Sony, Panasonic, Toshiba, and JVC—were the industry leaders.

*Image: A Toshiba VCR. GNU Free Documentation License, Version 1.2*

Association 2012). Inspections on cars, however, seem reasonable and can be relatively easily justified. Other nontariff barriers, by contrast, bordered on absurdity. In one case, Japanese official barred the import of foreign skis, claiming that Japanese snow was different, and in another, restrictions on foreign beef were based on the contention that the intestines of Japanese *people* were not the same as intestines of Westerners (Reed 1993, p. 37).

Protectionism sometimes stands alone, but it is also part of a broader policy toward international trade (and domestic economic development) that involves the use of *subsidies*, *dumping*, and *industrial policy*. Subsidies are designed to give domestic exporters an edge in international market competition by, most commonly, lowering the effective price of domestically produced goods. Specific types of subsidies include an assortment of practices from tax credits (and tax holidays), to access to below-market rate loans, to in-kind subsidies (for example, government funded road, sewage, and electrical service for a single factory), to the purposeful **devaluation** of local currency (a devalued currency makes exports cheaper and imports more expensive). Dumping is the practice of selling an exported good at a price that is lower in the foreign market than the price charged in the domestic market; frequently, dumping involves selling a product in foreign markets for less than its cost of production. A primary motivation for dumping is to capture market share—this could lead to foreign competitors being driven out of business in their own markets. For this reason, dumping is also referred to as *predatory pricing*. Interestingly, dumping is legal under WTO rules, unless and until it causes or threatens to cause “material injury” to a domestic industry in the importing country. Dumping can be part of a larger industrial policy, the latter of which can be loosely defined as a coherent set of policies designed to *create* comparative advantage in trade, to increase the competitiveness of domestic industries (vis-à-vis foreign competitors), or to nurture and develop strategic industries (i.e., industries considered vital to future economic growth and development). Neo-mercantilists consider industrial policy key to the postwar economic success of Japan, South Korea, Taiwan, and China.

There are many other basic terms related to cross-border trade, but they will be introduced in later sections so that they can be discussed in context. With this in mind, let’s turn to the first substantive section of this chapter, the debate over international trade.

## Cross-Border Trade: A Still Contentious Debate

From chapter 2, you are already generally familiar with the theoretical debate over cross-border trade. You know, in particular, that the liberal argument centers on the principle of comparative advantage, while mercantilists and Marxists expound upon power differentials between national economies, or on class inequality and exploitation. In this section, elements of that debate will be extended and deepened, but with a focus on “making sense” of the debate. In other words, rather than rehashing the different sides of the debate, the focus will be on explaining why disagreements over trade have not gone away. As the following section will show, there are some obvious and not-so-obvious reasons for continuing concerns about trade, despite a basic consensus among scholars, policymakers, business people, and consumers that cross-border trade is preferable to alternatives, including autarky and a purely mercantilist trade policy. As will be shown, too, the most important disagreements are not about the costs and benefits of cross-border trade per se, but

are instead about the costs and benefits of *free* trade specifically. Let's begin with a quick review of the more obvious (or, more accurately, widely understood) reasons.

### *Domestic Politics and the Debate Over Cross-Border Trade*

Perhaps most obvious reasons for the continued debate over cross-border trade revolve around the inevitable fallout from international economic competition. By definition, competition produces “winners” and “losers.” Losers, of course, want and demand “protection” from market forces (i.e., competition), but even some winners have a vested interest in protecting their positions of advantage. That is, winners often want to turn their (temporary) positions of market dominance into permanent positions of advantage. (This point connects to the issue of infant-industry protection, discussed in the next section.) Both losers and winners—organizing themselves through coalitions or interest groups—may turn to the political system for protection. Put in different terms, cross-border trade almost always has significant domestic consequences that impact specific groups within a society in different ways. In particular, cross-border trade, as Alt and Gilligan (2010) explain it, “affects the distribution of wealth within domestic economies, which raises the question of who gets relatively more or less, and what they can do about it politically.” Thus, while the rising level of cross-border trade, it is fair to say, increases *overall* wealth within an economy, not everyone benefits equally, and some may not benefit at all (especially in the short and medium run). There is nothing at all surprising about this observation, and this is the main point: because cross-border trade invariably leads to unequal domestic outcomes, there will always be a debate about, or tension over, how free or unhindered trade should be. Some economists have provided very useful models for analyzing the political-economic dynamics of increasing cross-border trade at the domestic level, the best known of which is the Stolper-Samuelson model. (You can find additional discussion of the Stolper-Samuelson model or theorem in figure 4.4.)

**Figure 4.4. The Stolper-Samuelson Model of International Trade**

Wolfgang Stolper and Paul Samuelson “solved conclusively the old riddle of gains and losses from protection (or, for that matter, from free trade)” (Rogowski 2010, p. 365). Most simply, the Stolper-Samuelson theorem tells us that protectionism in the form of tariffs invariably produces both winners and losers. Significantly, the theorem tells us that free trade—i.e., the lack of protectionism—also invariably produces winners and losers. To understand why can get a little tricky, and for our purposes the details are not necessary. Suffice it to say that free trade acts to lower the real wage of the scarce factor of production, while protection from trade raises it. Consider two countries: China and the United States. China has an abundance of labor relative to the United States. In other words, labor is, relatively speaking, a scarce factor of production in the U.S. Thus, without any protectionist policies in place, cross-border trade between the two countries will tend to reduce the wages of American workers in import-competing industries. These American workers are the “losers.” At the same time, other American workers and American consumers will benefit from trade. Of course, if the losing workers can successfully convince the U.S. government to protect their industry through the imposition of tariffs, their wages will go up. But this will have a detrimental effect on other Americans. Again, no matter how you slice it, there



will be winners and losers due to any change in trade policy.

The Stolper-Samuelson theorem, however, is based on a number of simplifying assumptions, which have opened it up to criticism from a number of sources. Interestingly, some of the most voracious critics are other economists. Donald Davies and Prachi Mishra (2004), for example, argue that, while the Stolper-Samuelson theorem “has the hallmarks of great economic theory ... an enormous problem arises when we try to apply the Stolper-Samuelson theorem, unthinkingly, specifically to the question of the consequences of trade liberalization for the poorest or least skilled in poor countries.” The main problem is clear: the simplifying assumptions have very little relevance to real-world economies, which means that when it is actually applied to the real world it cannot provide reliable answers; but more than simply being wrong, “it is dangerous,” because those answers often end up as the basis for policies (p. 4).

*Image: Paul Samuelson, American economist and Nobel Prize winner (1970). The image is licensed under the Creative Commons Attribution 1.0 Generic license.*

It is worth re-emphasizing that the tension between winners and losers, and the effort by domestic actors more generally to influence trade policy, underscores the importance of two-level games, or the interconnectedness of the domestic and international levels. While this point has been made several times already, a short review is in order. In his classic study, “The Second Image Reversed: The International Sources of Domestic Politics” (1978), Gourevitch argued convincingly that international processes and structures almost certainly have a profound impact on domestic-level politics. At the same time, Gourevitch made it clear that internal political processes cannot be ignored. These processes shape (policy) outcomes in contingent and sometimes extremely significant ways. As he put it, “[t]his idea is captured in the old concept of logrolling: the need to make bargains changes the outcome. The importance of organizations, political parties, elections, ideologies, vision, propaganda, coercion and the like as well as the more obvious aspects of economic interest arise from this need. What must be illuminated is how specific interests use various weapons by fighting through certain institutions in order to achieve their goals. Each step in this chain can affect the final result” (p. 905).

Consider the dynamics of the Cold War. The overarching rivalry between the United States and the Soviet Union, it is easy to argue, had a profound impact not only on international relations, but also on individual countries around the world. Within individual countries, however, there was great leeway in dealing with the pressures of this international rivalry. In Japan, for example, conservative political and economic leaders used the rivalry to tremendous advantage: they purged leftists and labor leaders from positions of influence in the national economy (Gourevitch makes the same point about domestic politics in the United States [p. 905]), and they used the rivalry as justification to resurrect (albeit in a different form) the prewar, highly nationalistic ideology of achieving rapid industrialization at almost any cost. This, in turn, gave rise to a powerful economic bureaucracy with strong ties to large, market-dominating business groups (which, in the prewar period, were known as the **zaibatsu**) with tremendous political influence within Japan. The result, to oversimplify a complex story, was the very rapid, and mostly unexpected, economic ascendance of Japan to the position of third largest economy in the world by the 1960s—a development that has played an important role in shaping the global political economy ever

since. To understand and explain the debates over cross-border trade, then, it is essential that careful attention be paid to domestic-level political processes, and especially to the dynamics of inter- and intragroup bargaining.

### *Infant-Industry Protection*

Two other widely understood reasons for the continuing debate over cross-border trade focus on national-level interests. The first concerns so-called infant industries, and the second concerns national security. The infant-industry argument, which was alluded to in chapter 2, reflects core principles in the mercantilist or neo-mercantilist position. It is based on the idea that late-industrializing countries need to develop their own domestically based industrial capacity, lest they be permanently disadvantaged in the struggle for economic *and* political power internationally. The logic of the argument is clear-cut: in the real world, there are advanced and very powerful countries—with well-developed economies, competitive industries, and formidable military forces—and there are weak and industrially “backward” countries (as well as many

countries that fall in-between these two poles). The countries with the most advanced market economies have a decided advantage over everyone else. This is because their industries are more developed and economically competitive. As a result, they can easily dominate ostensibly free or open markets and international trade. Moreover, while the most powerful countries may preach free trade, they are not shy about engaging in protectionism when it suits their purposes. The United States is a case in point. In agriculture, the United States government heavily subsidizes American farmers: between 1995 and 2012, according to the Environmental Working Group (EWG 2013), the U.S. government provided \$292.5 billion in subsidies. Subsidies to some individual growers are immense. For example, nine corn farms received a total of \$2.7 billion in subsidies in 2012, an average of \$300.2 million per recipient. Ironically, the U.S. also subsidizes *Brazilian* agribusiness with a \$147.3 million yearly handout (Grunwald 2010). Why? Because this was the price the United States agreed to pay so that it could continue to subsidize U.S. cotton growers. (The backstory: Brazil brought a case against the United States in the WTO, which Brazil won; the U.S. had a choice to either end cotton subsidies altogether, allow Brazil to impose countervailing duties per the WTO decision, or make a deal with Brazil. The U.S. made a deal.<sup>11</sup>)

**Table 4.1. U.S. Agricultural Subsidies, 2012 (Selected Crops)**

| Crop     | Number of Recipients | Total Subsidy   |
|----------|----------------------|-----------------|
| Corn     | 9                    | \$2,702,462,268 |
| Soybeans | 7                    | \$1,469,484,005 |
| Wheat    | 12                   | \$1,109,821,903 |
| Cotton   | 53                   | \$560,924,418   |
| Dairy    | 42,229               | \$447,081,952   |
| Tobacco  | 58,506               | \$188,776,927   |
| Barley   | 4                    | \$51,815,935    |
| Sorghum  | N/A                  | \$141,933,892   |
| Peanut   | N/A                  | \$51,011,029    |

Source: EWG, “The United States Summary Information” for 2012. Reproduced from a table available online at

<http://farm.ewg.org/region.php?fips=00000&progcode=total&yr=2012>.

Most countries, of course, do not have the economic power of the United States. This was especially true in the early postwar period, when all of Western Europe and Japan were recovering from the devastation of the war. Their industries, in general, had a lot of catching up to do. More specifically, for those countries that hoped to break into key manufacturing sectors—e.g., steel, shipbuilding, aviation, and automobiles—their disadvantages were immense and seemingly insurmountable. Consider the case of automobiles, one of the most important early postwar industries. In the first few decades after the war, the major U.S. auto companies—Ford, General Motors, and Chrysler—held dominant and nearly unchallengeable positions, not just in the U.S. but also throughout the world. Japanese producers, in particular, had essentially no chance of competing head-to-head against U.S. car companies in the 1950s and 1960s: technologically, and in practically every measure of productive capacity, the Japanese were decades behind the Americans. Thus, if the Japanese had opened their domestic market fully to American automobiles, it is all but certain that the U.S. companies would have destroyed the still nascent domestic industry, which was just beginning to emerge behind the efforts of Toyota, Nissan, Isuzu, and Mitsubishi. Significantly, this is largely what happened in the 1920s, when Ford and GM first established operations *in* Japan (as will be discussed in more detail in chapter 6, U.S. car companies began engaging in overseas production—in both Europe and Japan—in the early part of the 20<sup>th</sup> century). It was crystal clear to everyone in Japan that the only way a domestic auto industry could develop and thrive was through infant-industry protection. And this is precisely what happened. In the early 1950s, the Japanese government essentially closed the domestic market to foreign producers through high tariffs and a strict quota. For a time, in fact, imports were limited to no more than 1 percent of the Japanese market (Cusamano 1988), although this ceiling was not strictly enforced. At the same time, Japanese companies—both final assemblers and auto parts producers—were provided numerous government-based incentives, including subsidized loans, which encouraged expansion and strong domestic competition.

Not surprisingly, the growth and development of Japan’s “infant” car industry took a fairly long time to mature. In the first few years following the end of the war, Japan produced no passenger cars at all: between 1945 and 1947, production was exactly zero. By 1950, the Japanese auto industry had taken a few baby steps, producing about 1,600

**Table 4.2. Japan’s Passenger Car Statistics (Total Production, Exports, Imports), Selected Years**

| Year | Total Production (Passenger Cars) | Exports (Passenger Cars) | Exports/Total Production** | Imports (Passenger Cars) | Imports/ Domestic Sales† |
|------|-----------------------------------|--------------------------|----------------------------|--------------------------|--------------------------|
| 1950 | 1,594                             | 7                        | 0.44%                      | 0                        | 0.00%                    |
| 1955 | 20,268                            | 2                        | 0.01%                      | 0                        | 0.00%                    |
| 1960 | 165,094                           | 7,013                    | 4.25%                      | 3,540                    | 2.24%                    |
| 1965 | 696,176                           | 100,716                  | 14.47%                     | 12,881                   | 2.16%                    |
| 1970 | 3,178,708                         | 725,586                  | 22.83%                     | 19,080                   | 0.78%                    |
| 1975 | 4,567,854                         | 1,827,286                | 40.00%                     | 45,480                   | 1.66%                    |

|      |           |           |        |          |       |
|------|-----------|-----------|--------|----------|-------|
| 1980 | 7,038,108 | 3,947,160 | 56.08% | 46,285   | 1.50% |
| 1985 | 7,646,816 | 4,426,762 | 57.89% | 52,225   | 1.62% |
| 1990 | 9,947,972 | 4,482,130 | 45.06% | 251,169  | 4.60% |
| 1995 | 7,610,533 | 2,896,217 | 38.06% | 401,836  | 8.52% |
| 2000 | 8,363,485 | 3,795,854 | 45.39% | 283,582  | 6.21% |
| 2004 | 8,720,385 | 4,214,027 | 48.32% | 281,526* | 6.25% |

\* For 2003 \*\* Author's estimates † Author's rough estimate (domestic sales determined by subtracting exports from total production)

Source: Japan Automobile Manufacturers Association (JAMA), <http://njk.com/statistics/index.htm>

cars. By 1960, however, the industry was clearly growing up: production stood at just over 165,000 that year. Still fully protected from foreign competition, the “teenage” years saw even more dramatic growth. In 1965, Japan was producing almost 700,000 cars, and by 1970, well over 3 million cars. In addition, moving into the 1970s, Japanese auto producers had achieved an important degree of international competitiveness, at least in the compact car segment—in part because U.S. producers were not particularly interested in manufacturing small, relatively low-profit automobiles. This allowed Japan to become a successful exporter; in 1970, almost 23 percent of total production was being sold outside of Japan (all figures cited in Japan Automobile Manufacturers Association 2012). Japan, of course, is not the only country to follow this strategy: South Korea, for example, implemented Japan’s infant-industry model almost exactly—and with very similar results (although it took South Korean automobile producers, the best-known of which is Hyundai, longer to break into major Western markets). China is also using classic infant-industry protection policies to nurture its domestic auto industry (and is doing the same in a number of other industries today, including commercial aviation and steel).

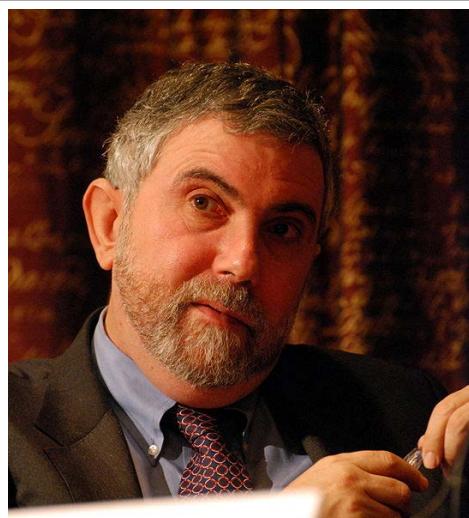
The neo-mercantilist argument is crystal clear: Japan and similarly situated countries could not have succeeded without infant-industry protection. For poorer, late-industrializing economies today, this means that state support is not an option, but an absolute requirement (for the most part, this has always been true). To repeat, neo-mercantilists argue that active, interventionist states are necessary to provide space for fledgling domestic firms to emerge, survive, and develop. These states can provide crucial assistance in a number of ways. One prominent advocate of the neo-mercantilist approach, Alice Amsden (1989), explains it this way:

Countries with low productivity require low interest rates to stimulate investment, and high interest rates to induce people to save. They need undervalued exchange rates to boost exports, and overvalued exchange rates to minimize the cost of foreign debt repayment and imports.... They must protect their new industries from foreign competition, but they require free trade to meet their import needs. They crave stability to grow, to keep their capital at home, and to direct their investment toward long-term ventures (p. 13).

Surprisingly, perhaps, not all mainstream economists wholly dismiss the neo-mercantilist argument. Thus, while liberal economic theory generally rejects any argument that subordinates the invisible hand of the market to the visible hand of the state, the verdict on the infant-industry argument is more open-ended. Indeed, as Baldwin (2001) notes, the “classical infant-industry argument for protection has long been regarded by economists as the major ‘theoretically valid’ exception to the case for worldwide free trade” (p. 295)—although we should note that Baldwin himself does not agree with many of his colleagues. Today, many liberal arguments about infant-industry protection draw from what is known as new trade theory (NTT), which is most closely associated with the work of Paul Krugman, a Nobel Prize-winning economist turned pundit. In a 1979 article, Krugman argued that the principle of comparative advantage could not adequately explain the level of trade that takes place between similarly situated economies. More specifically, the logic of comparative advantage suggests that the bulk of cross-border trade should occur between, say, a country with high *agricultural* productivity and a country with high *industrial* productivity (e.g., trading rice for cars instead of trading cars for computers).

Yet, this was (and is) not the case, and Krugman showed why. To put it in the simplest terms, he told us that consumers have a preference for variety or diversity of goods, while production favors economies of scale. These dueling preferences create situations in which countries specialize not only in the production of certain types of goods (as comparative advantage predicts), but in certain brands or styles (e.g., Mercedes, BMW, Lexus, and Volvo automobiles).

This insight did not, at first, connect directly to a rationale for infant-industry protection, except in a very general manner. To wit, in demonstrating that there was a clear theoretical counterpoint to comparative advantage (and more specifically to the mainstream Heckscher-Ohlin trade theory [see figure 4.6 for additional explanation]), Krugman and others opened the door to the idea that infant-industry protection could be justified from a liberal economic standpoint. Over time, this is exactly what has happened.



**Figure 4.5.** Paul Krugman, American economist and Nobel Prize winner (2008)

*Image source: Prolinserver. GNU Free Documentation License, Version 1.2.*

**Figure 4.6. The Heckscher-Ohlin Model**



The Heckscher-Ohlin model, or theory, explains why countries trade goods and services with one another. The model is based on the assumption that countries differ with respect to the availability of the factors of production (i.e., capital, labor, land). If one country, for instance, has abundant capital (in the form of machines), while another country has abundant labor (workers), both countries will benefit from trading if they specialize production based on the factor that they have in abundance. Of course, the theory is far more sophisticated than this, but sophisticated economic theories are often built from basic insights.

*Image. Eli Heckscher (left) and Bertil Ohlin (right). Both images are in the public domain.* [saylor.org](http://saylor.org)

“In fact,” as Maneschi (2000) puts it, “much of the new trade theory can be regarded as providing sophisticated arguments for some forms of protection to provide favorable initial conditions, such as subsidies for research and development activities” (p. 10). A main thrust of these arguments is that the initial costs associated with protection can be recovered once a country successfully develops its own specialization within a particular industry. The example of the automobile industry mentioned above is a good example: in Japan and South Korea, tariffs, quotas, and a host of NTBs prevented foreign competition for many years, which meant consumers in those countries paid a short- to medium-term premium for inferior products from domestic manufacturers. Over the long run, however, those initial costs became insignificant as the Japanese and South Korean auto industries developed into world-class competitors.

The upshot is simple: despite a good degree of continuing disagreement, the infant-industry argument does provide a fairly strong justification for protectionism, at least on a temporary basis. The same might be said for a third area of debate: national security.

### *The National-Security Argument*

The national-security argument, for many observers, makes the most intuitive sense. The logic is straightforward: war and conflict are facts of (international) life; thus, countries have to ensure that they do not unduly aid potential (still less actual) enemies by selling or transferring to them goods or technology that could be used in, or as, weapons. Achieving this objective clearly requires some restrictions on trade. In practice, however, it is often difficult to determine what, if any, restrictions are effective or reasonable. Thus, while most people would agree that a prohibition on selling materials to produce gas centrifuges that could be used to enrich uranium, which could then be used in nuclear weapons, to an actual or potential military-strategic rival is a threat to national security, other cases are less clear-cut. One particularly interesting case in this regard involved the French food giant (and yogurt maker), Danone. In 2005, it was rumored that PepsiCo of the United States was preparing a bid to take over Danone. The rumors were enough to cause an immediate uproar throughout France, and even prompted the French government to list Danone as a “strategic industry” to preempt any takeover bid. The case of Danone, it is important to note, was likely much more about French national pride than national security,<sup>12</sup> but for some countries food production is considered a genuine national-security issue. This is especially true for Japan, which argues that its restrictions on rice imports are part of an overall effort to achieve and maintain food, and national, security (Williams, Grant, and Fisher 1990).

Japan’s argument about food security is straightforward—namely, in case of an international crisis, having a secure source of domestic food production means that the country cannot be threatened with an embargo that could literally starve its population. This same argument is used for a variety of other industries or economic sectors—e.g., aerospace, petroleum, heavy equipment, steel, and armaments, among others. In addition, the shift from weapon-centric warfare to what has been labeled **network-centric warfare** has put a premium on countries having their own domestically based expertise in information (including cyberspace) and computer technology. More generally, many countries see the high-tech sector as an essential area with military-strategic, economic, and politico-social implications all rolled into one broad imperative. This is particularly apparent with regard to China (although China is certainly not alone), which in 2006 officially launched a set of policies dubbed “indigenous innovation.” At the core of China’s indigenous-innovation

initiative are 16 so-called megaprojects designed to make China a world leader in a full range of high-tech sectors, including core electronic components, high-end general use chips and software, large-scale integrated circuit manufacturing, broadband wireless and mobile communications networks, large advanced nuclear reactors, large aircraft, manned space-flight, and so on. Most of these sectors are designed to create dual-use technologies—that is, technologies that have both military and civilian applications. Significantly, three of China's 16 megaprojects are currently deemed classified (for further discussion, see McGregor, 2010), suggesting that they are considered national-security priorities. Tai Ming Cheung, a leading scholar on China's defense industries, believes that one of these classified projects is the Beidou Satellite Navigation System, a second-generation project that will provide global coverage in two modes: free or open services available to commercial customers with 10-meter location-tracking accuracy, and restricted or authorized services providing positioning, velocity, and timing communications estimated at 10-centimeter accuracy. Use of this technology would be limited to the Chinese government and military. The Beidou 2 satellites are also designed to withstand electromagnetic interference and attack. Presently, China still relies on the United States' GPS and Russia's GLONASS satellite navigation systems, which are subject to deactivation in times of conflict (cited in Raska 2013). Thus, from a national-security perspective, the development of Beidou 2 is crucial, as it will free the Chinese military from reliance on two potential adversaries, while providing essential space-age technological capability.

Another integrally related element of the national-security argument—but one that is worth discussing separately—revolves around the issue of defense procurement. Generally speaking, defense procurement refers to the process by which military-related equipment is purchased. Liberals would argue that, from a strictly economic (i.e., cost-effective) perspective, it would make sense for countries to buy their military equipment from companies that provide the best quality product at the lowest price, regardless of where those companies are located. In other words, buying from the open (global) market would allow countries to get the most bang for their buck (excuse the pun). For *some* defense-related procurements, this is the policy of the U.S. Department of Defense (DoD)—which, by some measures, is the largest single purchaser of contract goods and services in the world (GovWin Network 2010). In fact, the DoD purchases *all* its microchips for certain military equipment from overseas vendors. Significantly, though, some congressional representatives and senators deemed this sort of reliance on foreign technology unacceptable (McLean 2005). In response, the DoD issued a report that showed that building and maintaining a domestic base for producing the needed chips would have been extraordinarily costly: a facility would have cost \$2 billion to build, and a few hundred million dollars a year to maintain and upgrade. Ultimately, it was determined that the benefit of having more secure domestic production was not worth the cost of making the chips in the United States. Interestingly, McLean (a lieutenant colonel in the U.S. Air Force) asserts that the DoD generally prefers to source its military needs through the open market (p. 10), while the U.S. Congress prefers a “Buy American” policy.

The tension between Congress and DoD has resulted in a policy that is a little of both; yet, because Congress can write laws, it has been able to exercise greater influence over defense procurement practices. As far back as 1933, in fact, Congress passed the Buy American Act (BAA), which is still largely in force today. The BAA requires all government purchasers to validate that the products and services they buy are at least 50

percent American-made; it also gives a six percent advantage to domestic businesses when competing against a foreign company (McLean 2005, p. 14). Given the longevity of the BAA, it is fairly clear that most Americans (including policymakers) accept the notion that the military needs of the United States should, to a significant extent, be met by American companies and American workers producing goods on American soil. Of course, the U.S. is far from alone. Most countries, including European countries, have similar and sometimes far stricter defense procurement policies. It is important to emphasize, however, that the issue is not simply one of national security. Defense procurement policies are also extremely politicized and generally reflect a high degree of domestic-level politics that may have little to do with national security and defense.

### *Unequal Exchange and the Fallacy of Comparative Advantage*

So far, this chapter has dealt with the most widely understood or obvious strands of the debate over cross-border trade. As noted at the outset, however, there are also a number of less obvious arguments. Many of these come from within the Marxist tradition, and more specifically from theories concerning *unequal exchange*. Briefly put, unequal exchange refers to the phenomenon in which certain commodities or assets, including labor and primary goods, are *systematically* undervalued or overvalued. While there are several variants of unequal exchange, Arghiri Emmanuel first coined the term in 1962—although it was not popularized until 1972, when the English-language edition of his book, *Unequal Exchange*, came out—and developed a theory around it in which he asserted that (most) developing countries fail to benefit from cross-border trade because wages in poorer countries are kept artificially low. His argument was explicitly designed, at least in part, to challenge Ricardo's theory of comparative advantage, one key assumption of which is that *both* capital and labor are relatively immobile (Custers 2007). Emmanuel argued, however, that comparative advantage would not work as predicted if one or the other factor of production was mobile while the other remained immobile. Indeed, any examination of the real world tells us immediately that, especially since the mid-20<sup>th</sup> century, capital has become far more mobile than labor. That is, while capital can and does easily cross borders, for example, to take advantage of low-cost labor and resources, workers are stuck in place (not entirely, of course, but relative to capital, labor is highly immobile). The result is that international trade is at least partly driven by capital's unremitting efforts to find the lowest-cost wage-labor in the world. To be clear, according to the theory of unequal exchange, it is the immobility of labor that creates and sustains large wage differentials between and among countries. This process exacerbates inequality and perpetuates poverty (rather than making everyone better off), because the poorest workers in poor countries are not able to earn the real (or actual) value of their labor power.

Labor immobility is even a problem in regions of the world where, at least on paper, citizens have the right to move across borders and take up residence with relatively few restrictions. This is the case for legal residents of the European Union. Any person who holds the nationality of an EU country is automatically also an EU citizen, which confers the right to move freely around the European Union and settle anywhere within its territory (European Commission 2010). Despite having freedom of movement within the EU, labor mobility is still highly restricted. There are a host of reasons for this, one of which is simply cultural—especially language differences. However, most of the labor immobility in the EU has nothing to do with cultural factors, but instead is a product of government policy. Specifically, migrating from one country to another often means losing welfare and unemployment rights, pension assets, tax and housing benefits, and so on (Nonneman 2007, p. 5). These policies, in turn, reflect a profound division within the eurozone between so-called core and periphery states. David Marsh (2011) describes the eurozone as a “zone of semi-permanent economic divergence, corrosive political polarization and built-in financial imbalances, beset by a ‘perpetual penumbra of hope and pain’” (p. 3). The result is the reproduction of the same pattern of unequal exchange that afflicts the world in general.

Emmanuel's argument was taken up and revised by others, including Amir Samin, who argued that it is the larger structure and dynamics of the world economy (not just capital's mobility and labor's relative immobility) that creates and perpetuates unequal exchange. The global structure is based on a specific division of labor between countries, wherein poor (or peripheral) countries are relegated to the role of providing low-cost inputs (i.e., land, labor, and resources), while rich countries (the center or core) occupy a privileged position. The privileged position of the core is based on historical processes, especially

**Table 4.3. Summary Table on Main Economic Outcomes in Brazil, China, and India**

|                                     |                                 | Brazil           |                   | China            |                   | India            |                   | Latest year value |     |       |
|-------------------------------------|---------------------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|-------------------|-----|-------|
|                                     |                                 | Variables change | Latest year value | Variables change | Latest year value | Variables change | Latest year value |                   |     |       |
| Main variables                      |                                 | 1990s            | 2000s             | 1990s            | 2000s             | 1990s            | 2000s             |                   |     |       |
| Macroeconomic Outcomes              | GDP growth <sup>a</sup>         | -                | ++                | 5.1              | +++               | +++              | 9.0               | ++                | ++  | 6.1   |
|                                     | GDP per capita <sup>b</sup>     | →                | →                 | 9517             | →                 | ↑                | 5511              | →                 | →   | 2742  |
|                                     | FDI <sup>c</sup>                | ++               | ++                | 288              | +++               | +                | 378               | +++               | +++ | 123   |
|                                     | Trade to GDP ratio <sup>d</sup> | +                | ++                |                  | ++                | +++              |                   | +                 | ++  |       |
| Labour Market Outcomes <sup>e</sup> | Employment to population ratio  | →                | →                 | 68.2             | →                 | →                | 80.2              | →                 | →   | 58.2  |
|                                     | Unemployment rates              | →                | →                 | 7.4              | →                 | →                | 4.2               | →                 | →   | 3.4   |
|                                     | Informal employment             |                  | →                 |                  |                   |                  |                   |                   | →   |       |
| Living standards                    | Poverty incidence <sup>f</sup>  | ↓                | ↓                 | 10.6             | ↓                 | ↓                |                   | ↓                 | ↓   | 73.9  |
|                                     | Income inequality <sup>g</sup>  | →                | ↓                 | 0.55             | ↑                 | →                |                   | ↗                 | ↗   | 0.376 |

Notes: (a) For GDP growth, (-) indicates growth below OECD average; (+) indicates growth between 2 and 5%; (++) indicates growth between 5 and 8%; and (+++) indicates growth above 8%. (b) GDP per capita variation is measured with respect to the OECD average and the latest year value is in 2005 constant USD. (c) FDI corresponds to the inward stock: (+) indicates that FDI inward stock has increased on average above 5%, (++) above 10%, and (+++) above 20%. The latest year available value is in thousand million current USD. (d) Trade to GDP ratio measures the average trade openness during each period: (+) indicates the ratio is below 20%, (++) between 20 and 40% and (+++) above 40%. (e) 2008 data or the latest year available is given for reference. (f) Poverty incidence refers to the variation in the share of the population living on less than USD 2 per day. (g) Income inequality refers to the variation of the Gini coefficient of household income or consumption.

Table source: Copied from OECD Secretariat (n.d., p. 4)

colonialism, but also on the relatively recent emergence and development of *monopoly capitalism*, which is the term used by Marxian analysts to denote the (present) stage of capitalism characterized by (1) an extreme concentration of economic/productive power, and (2) the centralization of economic decision-making among a small number of major corporations (for further discussion see Sweezy 2004). It is the power of monopoly capitalism (or of monopoly capitalists) that maintains the unequal division of labor between rich and poor countries, and which ensures that cross-border trade disproportionately and systematically favors the core over the periphery. This does not necessarily imply some sort of conspiracy, but instead, simply reflects the overarching dynamics of an inherently exploitative and unequal system. To be sure, short-term gains are possible, but because poor countries tend to depend on only a few exportable products (especially agricultural products and cash crops—usually a vestige of colonial occupation), or because foreign capital controls industrial production and technology, long-term gains and dynamic economic growth are rare. (The few exceptions, we should note, are those cases in which the “rules” of free trade are purposely violated by poor countries with strong and interventionist governments. On this point, then, there is some common ground between Marxist and neo-mercantilist analysis.) There is, it is important to emphasize, a huge amount of quantitative research that has been done to demonstrate that increased trade via liberalization either results in large net gains for all countries (which contradicts the Marxian argument on unequal exchange), or fails to help developing countries grow their economies. Other chapters in this book cover some of the relevant data. For example, statistics on the significant decline in absolute poverty (chapter 1) indicate that trade liberalization is helping a range of poor countries overcome the worst conditions of poverty. On the other hand, chapter 5 shows that liberalization may be radically increasing the debt burden of many developing countries. Certainly there are other data that can be used, but for each set of statistics one side uses, the other side can usually find contradictory evidence. One point, however, is clear: there have been some significant success stories among developing countries. The most salient is China, which, partly through cross-border (but *not* free) trade, has been able to increase the standard of living among its people dramatically over the past two to three decades. Other major cases include India and Brazil. In these three success stories (at least by liberal standards), a significant increase in cross-border trade during the 1990s and 2000s has, according to the OECD, led to a decline in severe poverty (defined as living on less than \$2.00 a day in PPP terms): in China, over 600 million people have been lifted out of poverty since the late 1980s, while in Brazil, the number is 11 million. In India, by contrast, the decline is only in the percentage of the population living in poverty, while the actual number of poor increased by 40 million. Significantly, perhaps, while severe poverty declined in all three countries, inequality did not. Brazil did witness a small decline in inequality of 9 percent (measured in terms of the Gini coefficient), but it remains one of the most unequal countries in the world. China and India, by contrast, saw increases in inequality of 24 and 4.5 percent respectively. We are left with a somewhat mixed message (especially if we include all developing countries), which is another reason why the debate over the costs and benefits of cross-border trade remains unresolved.

### *Cross-Border Trade, Negative Externalities, and the Global Environment*

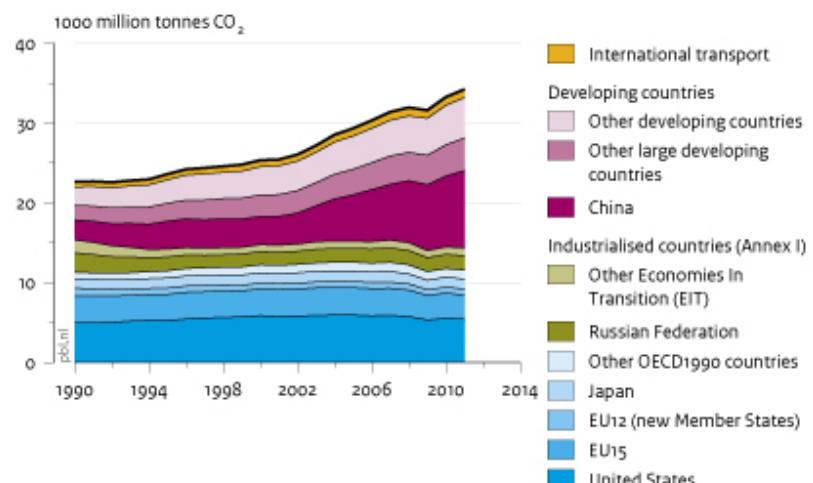
Even if the trading/economic success of China, India, and Brazil were unequivocal, the world would still be left with perhaps the most important, albeit long-term, cost of

increasing global trade *and* the intense economic competition (as well as increase in world economic growth) it creates: environmental degradation. This, too, is a less-than-obvious concern about cross-border trade and free (or unregulated) trade in particular. The basic problem can be expressed in economic terms: pollution and other economic practices that damage the environment are a type of *negative externality*. A negative externality, in the most general terms, is a cost that is suffered by a third party to an economic transaction. Externalities are most common in situations in which ownership of a particular asset or resource cannot be determined, or is uncertain. The most common examples come from the natural environment: the air or atmosphere, the oceans, rivers, the ozone layer, etc. The basic problem is clear: if the natural environment is not owned by anyone or anything, then economic actors can pollute or damage the environment without fear of incurring additional costs. Indeed, pollution and environmental destruction become fully *rational* actions under these circumstances. After all, why would any business owner incur additional expenses—expenses that might make his or her company less competitive—to prevent or mitigate pollution and environmental destruction if engaging in such practices is “free” to that company?

At the domestic level, negative externalities can be addressed through legislation or state action: economic actors can be compelled or forced to engage in environmentally sustainable activities. Of course, this is sometimes easier said than done, but it is clearly possible, especially when dealing with environmental issues that are tied directly to a local environment, such as pollution of a river or lake. However, when the environmental issues are tied to the global environment (e.g., global warming), the ability to develop effective legislation becomes significantly more difficult, since there is no *world* government that has binding, legal authority over all states (although, as we will see in the following section, the world does have legislative and juridical analogues to domestic governments).

An added problem is that cross-border trade makes it easier for the industrialized economies of the core to transfer their domestic environmental concerns to peripheral countries, the latter of which typically have governments either unwilling or unable to address environmental issues. That is, by outsourcing production of many (especially consumer) goods, most of which are sold back to and consumed by individuals in wealthy economies, the core effectively exports its environmental problems to the periphery. This has especially been the case in China, the “poster boy” for the transformative powers of international trade. China has indeed been transformed—into a world leader in environmental pollution and destruction. In 2007, for example, China overtook the U.S. in aggregate CO<sub>2</sub> emissions

**Figure 4.7. CO<sub>2</sub> Emissions by Region/Country, 1990–2012**



Source: Reproduced from Olivier, Janssens-Maenhout, and Peters (2012), “Trends in Global CO<sub>2</sub> Emissions; 2012 Report.” Available at [http://www.pbl.nl/en/publications/2012/trends-in-global-co<sub>2</sub>-emissions-2012-report](http://www.pbl.nl/en/publications/2012/trends-in-global-co2-emissions-2012-report)

(although, on a per capita basis, its emissions are still relatively low); in 2009, according to the International Energy Agency, China also overtook the United States in total energy use (2.252 billion tons of oil equivalent, compared to 2.17 billion tons in the U.S.); 16 of 20 of the most polluted cities in the world are in China; and, not surprisingly, China is the world's top emitter of sulfur dioxide (a noxious gas with a pungent, irritating smell). Even more, the average daily discharge of polluted water in China is comparable to that of the U.S., Japan, and India *combined*, which has resulted in the serious contamination of over 70 percent of China's rivers and lakes. This has exacerbated a water shortage in China to a critical threshold. Desertification is also accelerating, which is largely responsible for annual dust storms that spread toxic clouds of fine soil (called "yellow sand") throughout East Asia every spring. The toxicity is from industrial pollutants contained in the dust (all figures cited in Morton 2009, p. 3).

The problem, to repeat, is that China's environmental problems are all symptomatic of the larger economic system in which China operates, a system of global capitalism pushed forward by an acceleration of cross-border trade. To put the issue more generally, the commoditization of nature and the rejection of environmental preservation and protection as a hindrance to profit maximization are part and parcel of the capitalist process. China is simply the latest in a long line of capitalist economies that have already followed (and are still following) this path. China will start exporting its environmental problems to other, poorer countries, too, and as problems worsen in China, and as public outcry within China grows (a phenomenon that is already happening—see figure 4.8), it is likely that this process will accelerate. Of course, simply shifting environmental problems from one location to another is not a solution. More importantly, China's sheer size makes this an increasingly untenable solution, primarily because China's continued economic "development" will increasingly have more and more adverse global environmental implications: CO<sub>2</sub> emissions, to cite the most salient example, have no respect for national borders.

#### Figure 4.8. Social Networking and Environmental Problems in China

Despite the fact that China is still an authoritarian political system, the government has had to respond to increasingly strong public opinion on environmental problems. Much of this opinion is expressed through social media, especially [Weibo](#), China's micro-blogging version of Twitter. For example, public outcry on Weibo compelled the Chinese state to publicize the particulate count of air quality in major cities (e.g., <http://aqicn.org/city/beijing/>). In addition, China has seen a rapid increase of environmental NGOs: between 1994 and 2000, the number of registered environmental NGOs went from essentially zero to as many as 2,000, although there are widely varying estimates, due in part to the ambiguous manner in which NGOs are defined in China (Schwartz 2004). Most analysts concur that China's environmental NGOs presently exert very limited influence, but their rapid growth indicates growing domestic concern, both on the part of citizens and the Chinese state.



*Image description: Haze over China. The thickest of the grey-brown haze conforms to the low-lying contours of the Yellow River valley, and the western half of the North China Plain.*

*Source. NASA. The image is in the public domain because it was solely created by NASA, an agency of the U.S. government.*

Of course, not everyone agrees with this assessment. There have been a number of studies done that show, at best, an ambiguous relationship between expanding international trade and global environmental destruction. As with almost any political-economic issue, in other words, there is intense and ongoing debate fueled by competing claims and seemingly contradictory empirical analyses. It is well beyond the scope of this chapter to evaluate the competing claims. Nordström and Vaughan (1999), however, did a very good review and evaluation (albeit somewhat dated) of the literature on the relationship between cross-border trade and environment. Readers interested in exploring this issue in more depth are encouraged to read the Nordström and Vaughan study on their own.

#### *The Social Construction of Free Trade*

In the foregoing scenario, it is important to recognize that the freer the trade (that is, the less governmental regulation and management), the worse the situation is likely to be. Free trade, by definition, necessitates a lack of government (or nonmarket) oversight over economic processes and transactions. Genuinely free trade means, therefore, that some negative externalities might never be solved or addressed. The solution, some would argue, is not the elimination of trade, but instead, a continued regulation and perhaps re-regulation of cross-border trade. This might mean *fair trade* (see figure 4.9) as opposed to free trade, or it could mean something else. This suggests, in turn, that it would be necessary to begin constructing a very different type of trading and economic system, one based on principles and ideals that diverge, perhaps significantly, from what liberal economic theory or neoliberalism suggest.

The possibility of constructing a meaningfully different type of trading and economic system reflects

#### **Figure 4.9. What Is Fair Trade?**

Here is how the World Fair Trade Organization (<http://www.wfto.com/>) defines fair trade: “Fair Trade is a trading partnership, based on dialogue, transparency and respect, that seeks greater equity in international trade. It contributes to sustainable development by offering better trading conditions to, and securing the rights of, marginalized producers and workers—especially in the South.” In this view, fair trade is based on “just compensation” for *everyone* involved in the production, distribution, or sales of a product. This means that the small farmers and the unskilled workers, those who typically receive the smallest share of income, should be paid a living wage—that is, a wage that covers the basics of food, shelter, clothing, education, and medical care.



*Image is in the public domain.*

the basic principles behind the constructivist perspective, which was discussed in the previous chapter. Constructivist approaches, to repeat (once again), tell us that there are *always* different possibilities, but that these possibilities must be constructed through an interactive process involving a complex mix of material and nonmaterial factors and forces. Different possibilities, however, are not always easy to see or even imagine, especially when there are powerful structures already in place—e.g., the current neoliberal economic framework governing cross-border trade and international economic relations. Indeed, “free” trade as both an idea and an ideal has become deeply ingrained in the global system, even if free trade as an actual practice has never fully existed. This paradoxical situation is not difficult to understand: all social structures require an ideological (or ideational) basis that shapes not only what people *think* (and how they define themselves and their interests), but also what they *do*. Ideas and actions do not always match up. The key point, though, is this: the creation of a free-trade system, to the extent that it exists today, is a product of concerted and sustained collective action. The free-trade system is, therefore, a social construction. It is a real structure that exercises significant power in the world today, but it is also a normative framework for understanding and defining how cross-border trade *should* be conducted.

Asserting that the current system of cross-border trade is socially constructed may strike some readers as wrongheaded. Yet, if we examine the history of the international or global trading system we will see that there is nothing particularly controversial in that assertion. This is particularly evident in looking at the historical dynamics of cross-border trade throughout the 20<sup>th</sup> century, and especially since the end of World War II. For it was during the postwar period that a new international system of trade was quite consciously constructed through a variety of means. Hitherto nonexistent international regimes, rules, and institutions were created largely from scratch. Liberal principles were given renewed and even greater prominence; in those places resistant to liberalization (of which there were many), both sticks and carrots were used to ensure compliance. Very little of this occurred spontaneously, and very little of it *could* have occurred spontaneously. Indeed, underlying all these changes was a great deal of structural and material power, much of which was exercised specifically by the hegemonic power of the time, the United States. The construction of the postwar trading system, therefore, was also very much a profoundly political process. It is to this issue that we will turn next.

## The Rise of “Free” Trade in the 20<sup>th</sup> Century, Part I

Neither the idea nor the practice of free trade, as we have just seen, has always been readily or even mostly accepted, including in the major Western economies. In the United States, in particular, trade policy was generally protectionist until the mid-1930s—although, as we will see shortly, the U.S. began to pursue, in fits and starts, a policy of more open trade beginning in the last part of the 1890s. Still, the overall tone of America’s position on cross-border trade was solidly protectionist; this was clearly revealed in the general discourse of the time. Consider just one example: in 1895, shortly before he became president, Theodore Roosevelt wrote, “Thank God I am not a free-trader. In this country pernicious indulgence in the doctrine of free trade seems inevitably to produce fatty degeneration of the moral fiber” (cited in Irwin 2001, p. 61). To be sure, during that period, free trade was the subject of intense partisan bickering and posturing (at the time,

Republicans championed protectionism, while Democrats were supporters of free trade), but it is nonetheless true that protectionists often held the upper hand. This was well reflected in the passage of the Smoot-Hawley Tariff Act (formally, the United States Tariff Act of 1930), which increased import duties on top of already high tariff rates in the United States. Indeed, the Smoot-Hawley Act—along with other important trade legislation of that era, including the **Fordney-McCumber Tariff Act**—are generally held up as exemplars of unabashed American protectionism in the early part of the 20<sup>th</sup> century. Still, support for a more liberal trading policy, as already noted, was not absent. Indeed, by the mid-1930s, a new, more open trade policy began to emerge with the implementation of reciprocal trade agreements (discussed in more detail below). This tells us that we need to view U.S. protectionist policies in the first part of the 20<sup>th</sup> century in a wider perspective.

In this wider perspective, the United States could be understood (as many scholars have argued) as a *rising hegemon*: economically, politically, and militarily, the country was moving from a position of relative equality with the European powers, to one of preeminence. At the same time, Britain (which had occupied a hegemonic position beginning in the early to mid-19<sup>th</sup> century) was clearly on the decline. In such a period of hegemonic transition, advocates of hegemonic stability theory argue, instability and especially protectionism are very likely. David Lake (1983) explained the situation as follows:

When no hegemonic leader exists and only a single supporter is present, there are no constraints on protectionism within the supporter. Although it will continue to value export markets and may attempt to lead the international economy, a single supporter will lack the resources to stabilize the international economy successfully, or to create and maintain a liberal international economic regime. If the supporter believes that it cannot preserve its export markets, the protectionist fires at home will be fueled. The growing flames may precipitate the abdication of whatever leadership role had been held by the supporter (p. 523).

Lake argues that, in the early part of the 1900s, the U.S. largely fit the description above as a “supporter.” This can be seen, for example, in the U.S.-led effort to maintain the Open Door policy in China at the turn of the 20<sup>th</sup> century. The Open Door policy—which was based on a series of diplomatic notes written by Secretary of State John Hay—was directed at maintaining equal and nondiscriminatory privileges among the major countries trading with China at the time: the United States, Russia, Germany, France, Japan, and Britain. It was, in other words, a “free” trade policy, albeit for a geographically limited area. The principles of the Open Door, it is important to point out, long predicated the U.S. initiative. In fact, they were first articulated and enforced by the former hegemon, Great Britain, under the terms of the Anglo-Chinese treaties of Nanjing (1842) and Wangxia (1844). For half a century, the British maintained the open-door principles, but this started to break down in the 1890s as the major industrial powers began a scramble for spheres of influence in various parts of coastal China: within their respective spheres, they all claimed exclusive privileges. Importantly, Britain was not an exception: not only did the country abrogate its former (hegemonic) role, but the British also took part in staking out their own sphere of influence. The U.S., therefore, was essentially on its own in trying to maintain the open-door system. The U.S. did so, in large part, because it occupied a disadvantageous position in China (relative to the European countries and Japan), and had little to gain if China became a thoroughly closed market. The U.S., however, had a very limited capacity

to change the behavior of the other states; indeed, one can argue that the U.S. effort was an abject failure. Nonetheless, as Lake asserts, the Open Door policy marked a significant first step by the U.S. toward assuming the hegemonic mantle. (The pursuit of reciprocal trade agreements in the 1930s was another important, and far more successful step; again, this point will be discussed below.)

As a fledgling hegemon, the U.S. commitment to maintaining an open system was not entirely consistent. This helps explain why the U.S. continued to follow an ostensibly protectionist line in its trade policy more generally. As already noted, in 1922 and 1930, two major tariff bills were passed: the Fordney-McCumber Act, and the Smoot-Hawley Tariff Act. Interestingly, earlier in the century, two other tariff bills were passed that lowered tariffs. These were the Payne-Aldrich Act of 1909 (which was nonetheless a protectionist bill) and the Underwood Tariff Act of 1913 (a partly liberal bill, in that it significantly lowered tariffs). Except for the infamous Smoot-Hawley Tariff Act, it is important to note, the various tariff bills were at least partly used as “bargaining tariffs” designed to extend the Open Door policy abroad (Lake 1983, p. 534). More specifically, they contained a provision for “flexible” tariffs that would allow the U.S. to impose higher tariffs on countries that discriminated against American goods. For a variety of reasons—not the least of which is that using protectionism to reduce protectionism was viewed as hypocritical by America’s trading partners—the strategy did not work. But the U.S. had few other tools at its disposal. Partisan and interest-group politics within the U.S. also complicated the issue (Eichengreen 1986), and many Americans remained thoroughly unconvinced of the virtues of free trade. The situation, however, would soon change.

**Table 4.4. Duty Level by Tariff Act, 1897–1930**

| Tariff Act (Name), Date | Level of Duty on All Imports | Level of Duty on Dutiable Imports | Percentage of All Imports on Free List |
|-------------------------|------------------------------|-----------------------------------|--|
| Dingley, 1897           | 26.2                         | 47.6                              | 45.1                                   |
| Payne-Aldrich, 1909     | 20.0                         | 41.0                              | 51.3                                   |
| Underwood, 1913         | 8.8                          | 26.8                              | 67.5                                   |
| Fordney-McCumber, 1922  | 13.9                         | 38.2                              | 63.5                                   |
| Smoot-Hawley, 1930      | 19.0                         | 55.3                              | 65.5                                   |

Source: Lake (1983), p. 534. Original data are from the *Statistical Abstract of the United States*, selected years.

### *The Great Depression, the RTAA, and the Emergence of U.S. Hegemony*

In chapter 3 there was a brief discussion of the economic and political effects of the Great Depression. It was noted, in particular, that the decision by the U.S. to erect higher protectionist barriers through the passage of the Smoot-Hawley Tariff Act helped spur a significant worldwide rise in tariff rates and other discriminatory measures; not surprisingly, U.S. goods were a key target (Irwin 1998; also see table 4.5). While it is not at all clear that the Smoot-Hawley Act caused or even significantly contributed to the severity of the Great Depression,<sup>13</sup> it is nonetheless clear that it led to a serious rethinking within the United States about the efficacy of the tariff as the main instrument of trade policy. In this regard, the Great Depression played an important role in pushing the domestic political balance in favor of the democrats, who were then able to use their newfound voting advantage to

pursue reciprocal trade agreements (agreements that would reduce tariffs on a bilateral, as opposed to multilateral, basis). It is important to note here that the shift in thinking *and* action also represented a more profound change. That is, it reflected the process by which a new reality for international trade was being constructed. The extant worldview—one premised on neo-mercantilism and beggar-thy-neighbor policies—had defined the basic nature of the international trade regime for decades. The failure of those policies pushed countries around the world toward a different normative framework, one that would later lead to institutional innovations such as GATT, the WTO, and the idealization of “free” trade.

**Table 4.5. Average Tariff of Major U.S. Trade Partners, Selected Years**

| Country        | Share of U.S.<br>Exports | 1913 | 1928 | 1932 |
|----------------|--------------------------|------|------|------|
| Canada         | 18.2                     | 26.1 | 23.3 | 27.4 |
| United Kingdom | 16.5                     | 4.3  | 9.9  | 23.1 |
| Germany        | 9.1                      | 6.3  | 7.9  | 23.8 |
| France         | 5.6                      | 9.3  | 5.5  | 5.4  |
| Japan          | 4.7                      | 9.2  | 8.7  | 17.5 |
| Argentina      | 3.5                      | 17.6 | 18.8 | 28.8 |
| Italy          | 3.2                      | 7.4  | 6.7  | 23.5 |
| Netherlands    | 2.8                      | 0.4  | 2.1  | 4.7  |
| Australia      | 2.7                      | 17.9 | 22.4 | 41.2 |

Note: Figures are not comparable for all countries. For Canada, the listed tariff rate was for U.S. imports only; for other countries, the average tariff rate is based on the tariff revenue divided by total imports.

Source: Table reproduced from Irwin (1998), p. 339.

The basis for bilateral trade agreements came relatively quickly with the passage of the **Reciprocal Trade Agreements Act** (RTAA) of 1934. The successful passage and implementation of the RTAA has been intensively studied and debated by both economists and political scientists,<sup>14</sup> and for our purposes a detailed discussion is not necessary. Suffice it to say that the RTAA set in motion a largely virtuous cycle (as liberals would emphasize) that proved to be beneficial to the industrialized world, and especially to the United States. Because of this, the RTAA helped to cement a liberal trend in U.S. trade policy that had not previously existed. The path toward a liberal international trading system was, of course, interrupted by the outbreak of World War II. Significantly, though, World War II interrupted the process, but did not stop it. Indeed, in important ways, it may have ultimately accelerated the process of trade liberalization. As Hiscox (1999) argues, World War II had the effect of radically reducing—although only temporarily—import competition for U.S. manufacturers while simultaneously fueling a tremendous expansion in export demand for U.S.-made products (p. 685). The reason is easy to see: unlike most of the industrialized world, the United States homeland was essentially isolated from the devastation of the war. While other countries had to rebuild, the U.S. was able to build *up* from a still-intact, and very strong industrial foundation. Support of freer trade in the early postwar period, therefore,

became almost a no-brainer, even for formerly diehard protectionists in the Republican Party. This was a major reason why, in 1948, the Republican platform dropped its strong prewar opposition to the RATAA (p. 686). By the time the postwar export boom for the United States began to peter out in the early 1960s, opposition to “free” trade had become too fragmented for an easy return to protectionism.

Another strongly related effect of the war was to leave the United States with no viable rival in the *capitalist* world. The physical decimation of the European economies and Japan meant that U.S. economic, military, and political supremacy was well-nigh indisputable in the early postwar period. This was crystal clear to practically everyone, both inside and outside of the United States. It was, therefore, relatively easy—almost natural—for the U.S. to assume an unchallenged leadership role in world affairs, which is exactly what happened. In short, the *de facto* transition from British to U.S. hegemony had basically been accomplished as a result of World War II. Armed with a new liberal outlook, the United States was now in a position to pursue its open-door policy in a more vigorous and far more effective manner than before, and it wasted no time in doing so, as we will see in the following sections.

### *A Theoretical Caveat*

In the next section, we will examine important elements of the U.S.-led process of trade liberalization in the postwar period; before doing so, however, an important caveat is in order. The foregoing analysis offers an interpretation of events in the first half of the 20<sup>th</sup> century primarily from the standpoint of hegemonic stability theory (HST), although strong elements of the two-level game approach can be seen as well. And, in a general and loose way, the following discussion will continue along these lines. Yet, as should be quite clear by now, theoretical interpretations differ, sometimes in dramatic ways. That said, it is useful to employ the HST framework, not only because it is one of the more widely accepted interpretations of international trade during the 20<sup>th</sup> century, but also because it can fit with a variety of approaches. As noted in chapter 3, HST is a hybrid theory that can contain elements of mercantilism (realism), liberalism, and Marxism.

Since previous discussion of HST focused on the mercantilist view, it will be useful to say something about how HST fits with Marxist approaches. Classical Marxist analysis did not have much to say about hegemony. Contemporary versions of Marxism, however, recognize hegemony as an important element of global capitalism in general, and of free trade more specifically. Perhaps the most important of these contemporary views is **world systems theory (WST)**, which is primarily credited to the work of Immanuel Wallerstein. In Wallerstein’s view, hegemony “refers to those situations in which one state combines economic, political, and financial superiority over other strong states, and therefore has both military and cultural leadership as well. Hegemonic powers define the rules of the game” (Wallerstein 2004, n.p.). Given the dominant status of the hegemon, the state that occupies this position will generally use its power to support and maintain the system, and to ensure that any challenges to the system are eliminated or minimized. During the Cold War, for example, the efforts by the Soviet Union to create an alternative world system—one based on withdrawal from or nonintegration into the capitalist world system—compelled the United States to use its considerable resources to prevent the Soviet Union from expanding its sphere of influence, and to prevent other countries from “going communist.” U.S. policymakers at the time implicitly understood the need to expand the boundaries of

capitalism on a global basis, and therefore saw Soviet efforts as an *economic*—as opposed to military-strategic—threat. To achieve their goals, U.S. policymakers had to not only “contain” the Soviet Union, but also deepen and expand capitalism anywhere it was possible to do so. This explains, for example, why the United States decided to support Japan’s emergence as a center of capitalism in Asia in the late-1940s—despite having just completed a vicious and hate-filled war with that country. This meant providing Japan with one-way access to U.S. markets in the 1950s and 1960s (that is, the U.S. allowed Japan to sell as much as it could to the U.S., while not requiring that Japan open its markets to U.S. goods), but it also meant fighting a war on behalf of the Japanese, namely, the war in Vietnam (on this last point see figure 4.10, “Japan, Vietnam, and the Falling Domino Principle”).

On the surface, all of this sounds quite similar to the mercantilist view, and the similarities are admittedly strong. However, there is one key difference: in WST, hegemony reflects class dynamics and class power. In other words, it is not unitary states making decisions and acting in the national interest, but dominant class actors who are directly or indirectly calling the shots. Even more, in the world-systems view, hegemony reflects the inherently exploitative nature of the capitalist world system: the world is divided into unequal zones (i.e., the core, semiperiphery, and periphery), and the hegemon plays a key role in ensuring the integrity of this structure. In this structure, wealth is systematically extracted from the poorer and weaker zones (the periphery and semiperiphery) and brought to the core, and one of the most effective ways to do this is by imposing a “liberal” world order, one ostensibly premised on free markets and free trade. Of course, countries with weak, industrially backward economies cannot effectively compete in such a world, and in those areas where they might be able to compete, such as agriculture, the hegemon and other core economies conveniently ignore the principles of the free market and free trade. The main point is that the concept of hegemony is represented in a variety of theoretical approaches. In addition, it can be asserted that this is no accident; in other words, hegemony has been embraced by a variety of perspectives precisely because it provides a useful basis for understanding and explaining the *emergence* and *initial* dynamics of the U.S.-led, liberal international trade system in the postwar period. (Keep in mind that one of the primary criticisms of arguments focusing on hegemony is not that the concept is flawed, but that hegemony is a relatively short-term phenomenon.)

#### Figure 4.10. Japan, Vietnam, and the Falling Domino Principle

Asserting that the U.S. fought the war in Vietnam to benefit Japan may seem a huge stretch, but to see why it is not, consider the famous falling domino principle. The domino principle is based on the idea that, while Vietnam in its own right may have been unimportant to U.S. national security, if the U.S. had allowed Vietnam to fall to communist forces, this would have led to other countries in the region also falling to communism. Thus, the fall of Vietnam would have meant the collapse of several more pro-American allies in Asia, including Malaysia, Indonesia, Thailand, Burma, and the Philippines. The implication was that this would have seriously compromised the U.S. *military-strategic* position in the region and globally. Yet few people are aware of the original logic behind the falling domino principle, which was first enunciated by Dwight D. Eisenhower. In 1954, in response to a reporter’s question about the strategic importance of Indochina (the old name for

Vietnam, Laos, and Cambodia), Eisenhower said this:

You have, of course, both the specific and the general when you talk about such things. First of all, you have the specific value of a locality in its production of materials that the world needs. Then you have the possibility that many human beings pass under a dictatorship that is inimical to the free world. Finally, you have broader considerations that might follow what you would call the “falling domino” principle. You have a row of dominoes set up, you knock over the first one, and what will happen to the last one is the certainty that it will go over very quickly. So you could have a beginning of a disintegration that would have the most profound influences . . .

[W]hen we come to the possible sequence of events, the loss of Indochina, of Burma, of Thailand, of the Peninsula, and Indonesia following, now you begin to talk about areas that not only multiply the disadvantages that you would suffer through loss of materials, sources of materials, but now you are talking really about millions and millions and millions of people.

Finally, the geographical position achieved thereby does many things. It turns the so-called island defensive chain of Japan, Formosa, of the Philippines and to the southward; it moves in to threaten Australia and New Zealand. *It takes away, in its economic aspects, that region that Japan must have as a trading area or Japan, in turn, will have only one place in the world to go—that is, toward the Communist areas in order to live.* (2005 [1954], p. 383; emphasis added)

Think about the italicized part: Eisenhower justified intervening in Vietnam in order to protect Japan’s “trading area”! It’s hard to imagine why the United States would commit its own resources and people to defending another country’s trading area, except if we take into account the world-systems view on hegemony.

*Image. Dwight D. Eisenhower as general of the army (circa Dec. 31, 1943). The image is a work of a U.S. army soldier or employee taken as part of that person’s official duties. As a work of the U.S. federal government, the image is in the public domain.*



## The Rise of “Free” Trade in the 20<sup>th</sup> Century, Part II

It is fairly clear that there is almost nothing spontaneous or automatic about the emergence and development of a freer or liberal system of free trade internationally. In the prewar period (we can argue), it was a lack of a centralized authority with sufficient material, structural, and political power that prevented a stable, widespread system of free trade from developing. Without a solid political foundation and structure, in other words,

international or global markets could not fulfill their “potential.” Even more, without economic stability, the tensions inherent in the interstate system became increasingly difficult to contain, which made the outbreak of World War II—or, if not that war, then another conflagration between major states—almost inevitable. It is no surprise then that one of the first priorities of the United States in the postwar period was to create the framework for a more stable international economic system. In previous chapters, a key part of this framework was mentioned: the Bretton Woods system (BWS). As you learned, the Bretton Woods system is most closely associated with the creation of the international monetary or financial system. But another key (and strongly related) aspect of the BWS was the effort to liberalize international or cross-border trade on a sustained, multilateral basis. This effort was largely successful, as over several decades a new international trade regime was constructed. This almost assuredly could not have been achieved without the exercise of tremendous political will and power, and more specifically without the coordinating and stabilizing efforts of the United States.

Creating an international trade regime, then, was not a foregone conclusion. As noted in chapter 3, one of the very first attempts in the postwar period to do this failed. Specifically, after several years of both bilateral and multilateral negotiations, a draft agreement known as the Havana Charter (formally, the Final Act of the United Nations Conference on Trade and Employment) was announced on March 24, 1948. The charter’s main objective was the creation of the International Trade Organization (ITO). Although signed by 53 of the 56 countries participating in the final UN conference on this issue, the ITO failed to materialize. One big reason for this was the unwillingness of the U.S. Congress to ratify the charter, and without U.S. commitment, it was no surprise that other countries likewise refused to move forward. In retrospect, it is not difficult to see why the U.S. Congress refused to approve the charter. Specifically, the ITO was, at the time, an extraordinarily ambitious idea. As Narlikar (2005) explains it, “The ITO envisaged by the Havana Charter had a far-reaching mandate, and an elaborate organization to implement it.... [B]esides covering the obvious areas of commercial policy, the 106 articles of the ITO extended to areas of employment, economic development, restrictive business practices, and commodity agreements. It gave recognition to the importance of ensuring fair labour standards, and also incorporated provisions that allowed governments to address their development and humanitarian concerns” (p. 12). More simply, the ideas behind the ITO were too “radical” and too much to handle for many U.S. congressional free-trade-wary representatives. This points to a larger lesson as well: the failure of the ITO could very well have spelled the failure of the entire push toward trade liberalization in the early postwar period.

Fortunately (but not necessarily fortuitously), the ITO was only one prong of a multi-pronged strategy. Another prong was the General Agreement on Tariffs and Trade (GATT). Originally, the GATT was to be an interim arrangement until the ITO came into force, but it was also pursued by the Truman administration precisely because of fears that the U.S. Congress would oppose the more ambitious provisions of the ITO (Kaplan 1996, p. 53). Unlike the ITO, moreover, the GATT did not require ratification by the Congress (ironically, this was a result of the congressionally approved RTAA). As an interim agreement, the GATT was much less ambitious than the ITO; it focused on trade (or commercial) relations only and revolved around three basic principles: (1) nondiscrimination—i.e., the concept of **most-favored-nation** (MFN) status—in trade

relations among participating countries; (2) a commitment by all participants to observe the negotiated tariff concessions; and (3) a prohibition of quantitative restrictions (quotas) on exports and imports. Not only was the substantive coverage much narrower, but so too was its legal and institutional basis. The GATT was, in essence, little more than a negotiating forum; it was not an international organization, nor did it even have a membership per se—instead it had “contracting parties” (Narlikar 2005, p. 16). Despite these shortcomings, the GATT not only survived (for 47 years, after which it was formally replaced by the WTO), but it proved to be an effective—albeit far from perfect—means for establishing the necessary groundwork for a significant expansion of cross-border trade.

The effectiveness of the GATT was clearly premised on the support and leadership of the U.S. government; for just as the ITO failed without U.S. support, so too, it is fair to conclude, would have the GATT. This did not mean that support *within* the United States was undivided and consistent—it most certainly was not. Still, because sufficient trade-policy authority had been transferred to the executive branch, the GATT did not meet the same fate as the ITO. Thus, as each round of the GATT was negotiated, the agreements reached on tariffs were, without any “drama,” enacted. Until the Kennedy Round (1964–67), however, tariff negotiations had to take place on an item-by-item basis. Despite this cumbersome condition, the very first round of negotiations (the Geneva Round, in 1947) produced 45,000 tariff concessions. Subsequent rounds were less impressive, but significant tariff reductions were achieved overall—for example, the Torquay Round (1950) led to a cutting of the 1948 tariff levels by 25 percent. In the Kennedy Round, a new across-the-board method was used (to achieve this, the U.S. Congress had to give the president the power to abolish item-by-item negotiations, which was originally codified in the Reciprocal Trade Agreement Act of 1934). This resulted in average tariff reductions of 36 to 39 percent, worth about \$40 billion. Put in different terms, by the end of the Kennedy Round, the average tariff on manufactured goods was about 10 percent, compared to a 40 percent average in 1947. From the discussion at the beginning of the chapter, it is clear that these reductions in tariffs (along with nondiscrimination and the elimination of quantitative restrictions) helped lead to a significant—really, unprecedented—expansion of cross-border trade through the 1950s, 1960s, and beyond.

The details of each round, while important, are not the main concern. The main concern is how the GATT negotiations laid the groundwork for the establishment of a liberal international trading regime (or a new *socially constructed* order for international trade). In this regard the move from item-by-item negotiations to across-the-board negotiations—which was partly related to the growing economic power and influence of the European Economic Community (later the European Community, and finally the European Union)—was an important step. Specifically, it made it more difficult for parochial domestic interests (i.e., special interests) to influence negotiations (Kaplan 1996, p. 68). Also, the successive rounds of *multilateral* negotiations helped to establish a practical and normative framework for talks *and* disputes over trade issues in general, not just tariffs. Tariffs, as you know, are not the only barriers to trade. NTBs (nontariff barriers) are equally, and potentially more, corrosive to trade, since they are nontransparent (meaning that it is not always obvious what constitutes an NTB). As tariffs declined, many countries began turning to NTBs. But before this trend could completely undermine the progress made through tariff reductions, talks on nontariff barriers were added to the GATT agenda during the Tokyo Round (1973–79). To be sure, early negotiations could not and did not immediately resolve or effectively address

the issue, but they allowed for an ongoing dialogue among states. Subsequent rounds continued these discussions, and added other vexing issues, including intellectual property, agricultural subsidies, textiles, and dispute settlement. It is important to emphasize that as negotiations moved beyond tariffs—for manufactured as opposed to agricultural goods—agreements became harder and harder to come by (this was probably also the product of an expanding membership—from 23 participating countries in 1947, to 62 during the Kennedy Round, to 123 during the Uruguay Round). Yet, because a basic and sustained framework for trade negotiations had been created and institutionalized, the movement toward a more liberal trading order, while sometimes stalled, did not reverse itself or completely fall apart, as could have easily happened.

### *The Birth, Significance, and Troubles of the WTO*

Recognition of the increasingly unwieldy and ineffectual arrangements of the GATT reinvigorated interest in the creation of a full-fledged international trade organization—an organization that would fulfill, at least in very general terms, the original intentions behind the ITO. Significantly, the United States was not, at first, receptive to the idea of creating a trade organization. In particular, U.S. policymakers had a number of concerns about the scope and degree of authority that a new international trade organization might have. The United States had, for example, no interest in having labor standards, commodity agreements, or

monopolistic business practices included in the organization's charter (Narlikar 2005, p. 26). In addition, the U.S. demanded additional trade concessions from the European Union before it would drop its opposition; the U.S. even demanded a name change—from the proposed “Multilateral Trade Organization” to the “World Trade Organization” (Narlikar 2005, p. 25). Only when the United States got what it wanted was it possible for serious discussion on the establishment of the WTO to move forward; this discussion, not coincidentally, took place under the auspices of the final GATT round, the Uruguay Round, which lasted from 1986 to 1993.

A major reason why the GATT had become unwieldy and ineffectual was its ad hoc nature. The many overlapping negotiations of the GATT had produced a range of agreements and measures, not all of which were consistent with one another. Thus, some sort of coordinating mechanism was required for creating order out of an increasingly chaotic situation. Creating a coordinating mechanism, however, was (in practical terms) not possible within the existing GATT framework. As a forum rather than an organization, moreover, the GATT could not directly coordinate its activities with international organizations such as the IMF and the World Bank—a function that was becoming increasingly necessary as the global economy had become more complex and interconnected. Even more basically, it is important to understand that reducing tariffs on manufactured goods was a relatively easy part of trade liberalization—the rest was far more difficult, as the issue with NTBs demonstrated. Indeed, the increased use of NTBs gave rise to the phrase *new protectionism* in the 1980s to indicate that a significant and potentially destabilizing change was taking place in the world trading system. In sum, then, the GATT had served its purpose, but without a solid institutional basis it might not have been able to

**Figure 4.11. Official Logo of the WTO**



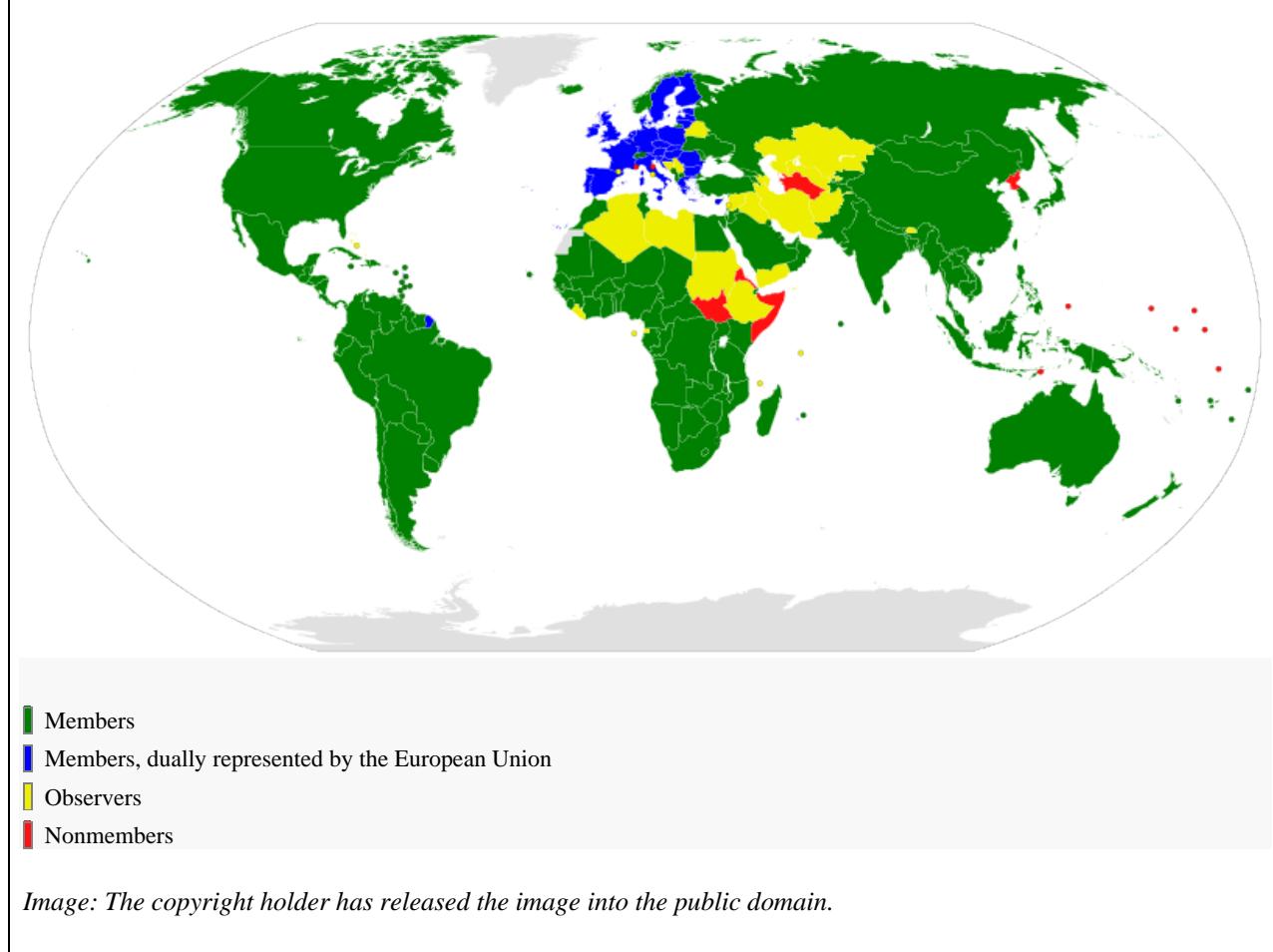
*Image: The image is in the public domain.*

sustain the progress that had been made. The significance of the WTO, therefore, would be found in its ability to reinforce the existing international trading system, but also to extend liberalization into the most politically sensitive and divisive areas.

On the first point, the WTO did, in fact, play a key role in reinforcing the existing system. One of the most important new features was the adoption of the *single-undertaking* principle. This principle required member countries to accept and implement *all* WTO agreements as a package rather than through a pick-and-choose method, which had been the practice under GATT. For the most part, this also meant that there would be no grandfathering of rights; that is, countries that had previously been exempted from certain agreements and articles because of existing (domestic) legislation were no longer allowed exempt status. This was a major change, in that it compromised the principle of state sovereignty by requiring member countries to change their domestic legislation if there was a conflict with WTO rules. Within the framework of the WTO, it is important to add, this was possible due to a Dispute Settlement Panel (DSP) that had been much strengthened via the Dispute Settlement Understanding (DSU). The new DSU made WTO rules easier to adjudicate, and easier to enforce through the principle of cross-issue retaliation (cross-issue retaliation allows a member country or countries to apply WTO-approved sanctions against a violator of an important area of trade in order to maximize the impact of the punishment).

More broadly, the DSU gave the WTO a power that few other international organizations had—a *compulsory*, legally binding process for resolving conflicts between member states. The compulsory element of the DSU was and is key: unlike the GATT (which had its own dispute-settlement procedures), or other international organizations that have a judicial process, the DSU did not require the consent of both parties to bring or hear a complaint. As you might guess, requiring consent from both parties to move a case forward can be a monumental obstacle. Under GATT rules, moreover, the (positive) consent of all parties—even the *losing* party—was required to make any decision legally binding. Under the new WTO rules, the “positive consent” principle was replaced with the “negative consent” principle. According to the latter, a ruling (or report) can only be rejected if all members decide by consensus *not* to adopt the report. Another important element of the DSU is the obligation of member countries to refrain from using unilateral measures to settle trade-related disputes; instead, they must bring their disputes to the WTO. All these and other rules raise an important question: Why would states voluntarily give up their (sovereign) rights and be bound by the rules and procedures of an international organization? The simple answer is this: the benefits of belonging to that organization outweigh the costs. On this point, recall the discussion of international institutions in chapter 3: international institutions allow states—operating in an environment of anarchy—to achieve cooperative goals that would be extremely difficult, if not impossible, to achieve on their own. Most generally, then, the rule-based framework of the WTO is widely seen as bringing economic benefits through cross-border trade that compensate for the diminution of autonomy and state sovereignty.

**Figure 4.12. Map of the WTO Members and Observers (2013)**



The WTO has been far less successful in extending liberalization into the most politically sensitive and divisive areas. This is clearly reflected in the current round of trade negotiations (under the WTO, high-level trade talks take place in ministerial conferences held every two years), known as the Doha Development Agenda, or the Doha Round for short. The Doha Round began in 2001, and was designed to take up a number of difficult issues, including agriculture, services, intellectual property regulation, environmental agreements, electronic commerce, regional trade agreements, transparency in government procurement, and trade facilitation, among others. The results have not been pretty: after the initial Doha meeting, the next ministerial conference in Cancún (2003) collapsed after just four days, and subsequent meetings in Hong Kong (2005) and Geneva (2009 and 2011) also failed to reach agreement. Things were so bad at one point that the biennial ministerial meeting in 2007 was cancelled (in addition to the ministerial conferences, there were also a number of lower-level, that is, nonministerial, meetings). The failure to reach an agreement

during the Doha Round has raised the obvious question: Is Doha dead? As this book was being written, however, the answer appeared: no. In December 2013, there finally was a breakthrough in negotiations; although not completely resolved, preliminary agreement was reached on some particularly sticky issues, although it still remains to be seen how far things will move (see chapter 7 for additional discussion).

As suggested above, however, the obstacles are not only related to difficult-to-negotiate issues, but also to (1) a dramatic expansion of membership (by the Doha Round, the WTO had 155 members); (2) a more pronounced division among “developed” and “developing” countries; (3) consensus decision-making; and (4) an all-or-nothing principle (based on the idea of a single undertaking wherein, in effect, “nothing is agreed until everything is agreed”). Critics, of which there are many, point to the recent difficulties faced by the WTO and argue that the organization—after less than two decades—has already become irrelevant. This argument could only be valid if the pre-existing and still-robust system of trade relations is ignored, which would be an absurd thing to do. Even if the focus is shifted entirely to current issues (and the current impasse), however, the argument for irrelevance does not carry much weight. After all, without an established institutional framework for multilateral negotiations, there likely would be no multilateral negotiations at all. Certainly, we could not expect agreements covering hard issues to automatically appear. This takes us back to the broader point: creating a framework for cross-border trade or international trade is a profoundly political process. More specifically, in a world of ostensibly sovereign states, free or liberalized trade *requires* a political-institutional framework. The creation of such a framework does not guarantee constant “progress,” but it makes progress—in this case, liberalization—possible and sustainable. This, again, tells us that studying the economic without the political (and vice versa) is a hollow practice.

### *Politics within the WTO: Bargaining Coalitions*

If we look inside the WTO, it becomes almost immediately apparent why the latest round of trade negotiations has been so painfully protracted: strong disagreements over particular trade policies and issues are exacerbated by profound divisions between “developed” and “developing” countries (also referred to as the North-South division). Keep in mind, on this point, that until the Kennedy Round in 1964, there were relatively few “contracting parties”: the total number of participating countries ranged from a low of 13 (Annecy Round 1949) to a high of 36 (Torquay Round 1950). More importantly, while there were developing countries represented in these early negotiations, they largely stood on the sidelines or were effectively co-opted by the developed countries. This has changed dramatically over time as developing countries have become more numerous (they now account for 75 percent of WTO membership), more assertive, and less beholden to the wealthier, developed countries. But standing alone, individual countries in the developing world had little capacity to exercise power, even with the decision-making-by-consensus rule in the WTO. To effectively exercise power, then, it was necessary for developing countries to adopt a unified and collective stand. This is more difficult than it sounds. After all, the so-called developing world is tremendously diverse, and does not always have a consistent set of interests and concerns.

In WTO negotiations, the primary means to overcome this diversity has been through the formation of **bargaining coalitions**—many of which predated the WTO and some of which originated outside the GATT/WTO framework—some targeted to specific issues and

others more broadly based. Among the many coalitions are the G77, the G90, the Like-Minded Group (LMG), the NAMA 11, Café au Lait (also known as the G20), the African Group, the Africa-Caribbean-Pacific (ACP) group, Caricom, the group of Small and Vulnerable Economies, the Cairns Group, the Cotton Initiative, and so on. There is not space to provide a detailed discussion of bargaining coalitions here, but suffice it to say that they have become a central feature of the negotiating process in the WTO, especially in the ongoing Doha Round. The impact of bargaining coalitions, however, is complex. As Narlikar (2003) and Rolland (2007) have noted, there are several types of coalitions: blocs, issue-based, and regionally based coalitions. Blocs are the largest and most diverse coalitions (e.g., the G77 and G90); they tend to play a negative role by stalling or blocking certain initiatives. Issue-based coalitions are smaller, and more focused, as the label suggests, on specific issues. The G20, or Group of 20, for example, was established to push for the liberalization of Western agricultural markets. In general, these have been the most effective coalitions. Regionally based coalitions typically come out of pre-existing regional trade agreements, such as ASEAN (Association of Southeast Asian Nations). These coalitions have had limited success, in part because their economic interests tend to conflict with one another, so group consensus is hard to maintain. (The one major exception, however, is the European Union—a point that is discussed below.) Overall, developing-country coalitions have changed the dynamics of WTO negotiations: they have proven to be a viable and influential vehicle for articulating the interests and demands of developing countries, and they have made the developing world a force to be reckoned with. Yet, it is precisely because of their effectiveness that negotiations in the WTO have stalled and remain in danger of complete collapse.

Developing countries, it should be stressed, are not necessarily *the* problem. After all, it takes two to tango. Consider the issue of agriculture: for their own, primarily domestic political reasons, many developed countries have steadfastly refused to liberalize their agricultural markets. The G20, which emerged primarily as a reaction to EU and U.S. intransigence on agricultural liberalization, played the lead role—in the Cancún meeting (2003)—in demanding that the European countries and the United States dramatically cut their domestic and export subsidies and provide greater market access. Although there were some signs that substantive negotiations over agriculture might take place, the overall trade talks collapsed over another set of issues, the so-called **Singapore issues**, which dealt with transparency in government procurement, trade facilitation, investment, and competition. Not surprisingly, the Singapore issues were a main concern of developed countries, especially the EU, Japan, and South Korea (over the years, South Korea had moved from developing-country status to developed-country status). In **green room** discussions, no consensus between the developed and developing countries could be reached on the Singapore issues (which happened to be the first agenda item), so the Mexican chairperson brought all negotiations to a close before the talks on agriculture and market access could even begin.

### *The WTO and Transnational Actors*

The discussion thus far has treated the WTO as if only countries or governments make decisions. Yet, as is clear from previous discussions of both the liberal and the Marxist perspectives, governments (or states) are almost assuredly not the only important actors: domestic political groups, social classes, and NGOs can be equally, perhaps even more,

important. In the case of the WTO, it is not difficult to see how these groups impact politics within the organization. For example, on the issue of trade-related aspects of intellectual property rights (referred to as TRIPS), which was *successfully* negotiated at the end of the Uruguay Round and is now enforced under WTO rules, pharmaceutical companies played a central role in pushing for an agreement that protected their rights—to the detriment, some critics argue, of developing (and especially the least developed) countries. Specifically, one important element of the TRIPS agreement gives pharmaceutical companies exclusive patent rights on drug innovations for a period of 20 years. While patent rights have long been protected, the controversy surrounding TRIPS is that it denies poorer countries access to drugs vital to maintaining public health. This particular issue was addressed in the TRIPS agreement through two exceptions: (1) compulsory licensing, and (2) parallel importing. The first exception gave member states the authority to grant a license to a third party to produce a patented invention without the consent of the patent holder under certain conditions, like, for example, a public health crisis. The second allows a developing country to take advantage of differential pricing between countries. For example, if a drug costs \$200 in Canada, but sells for \$300 in South Africa, a South African company or the government can import the drug from Canada and sell it at a lower price without the consent of the South African patent holder. Despite these exceptions, pharmaceutical companies in the U.S. and elsewhere pressured their governments to sanction developing countries that attempted to take advantage of these provisions (Subhan 2006).

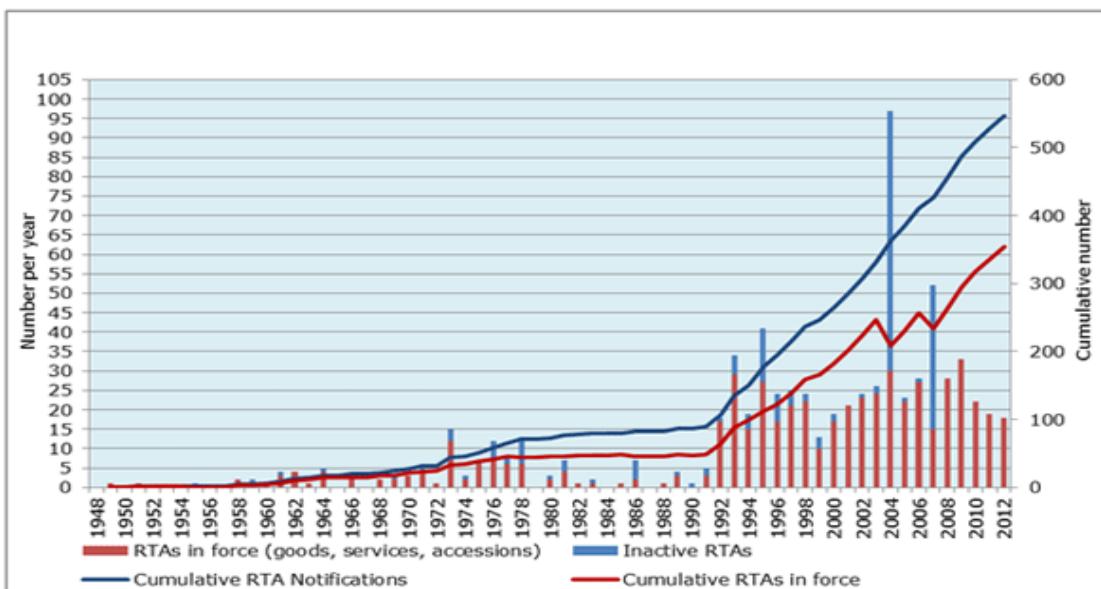
One of the most famous cases involved a 1998 suit brought against the South African government by the South African Pharmaceutical Manufacturers Association and 40 pharmaceutical manufacturers, most of them multinationals. The companies alleged that the South African government had violated TRIPS by authorizing the parallel importation of HIV/AIDS medication. At the start of the litigation, corporate interests lobbied their home governments to put pressure on South Africa. Corporate pressure at first worked quite well, as both the U.S. government and European Commission took up the cause of “Big Pharma,” and threatened to withhold trade benefits and impose trade sanctions against South Africa. Very soon, however, public outcry—led by NGOs and AIDS activists—changed the dynamics: then-presidential candidate Al Gore was accused of killing babies in Africa, and “[b]y the time the case finally reached the courtroom in May 2000, the drug companies could no longer count on the support of their home governments” (’t Hoen 2003, p. 44). Continuing public pressure eventually pushed the companies to drop their case. While much of this action took place outside the framework of the WTO, the controversy over TRIPS eventually found its way back into the Doha Round. Developed-country governments reverted back to pushing for changes on behalf of corporate interests, while developing countries—acting in part through coalitions, including the Africa Group—pushed for a larger public interest (for a more detailed discussion, see ’T Hoen 2003). The key point here is that the WTO does not just involve state actors. Indeed, any close examination of the WTO is bound to find a diversity of both state and nonstate actors influencing and shaping the organization in myriad ways.

## **Regional Trade Agreements**

As was noted early in the chapter, free trade is more an ideal than an actual practice. What the GATT and WTO have produced is a liberalized, but managed, system (or regime)

of international trade. The GATT and WTO, however, are not the only institutional or political frameworks for international trade. Another major source are regional trade agreements, or RTAs (also referred to as free-trade agreements), which are defined by the WTO as “reciprocal trade agreements between two or more countries”; they include free-trade arrangements and **customs unions**.<sup>15</sup> According to the WTO, there were 546 notifications of RTAs (counting goods, services, and accessions separately), and 354 in force as of January 2013.<sup>16</sup> Despite their name, not all RTAs are primarily focused on trade. Some are concerned with investment or capital liberalization; some provide the underpinnings to strategic alliances (and are therefore part of a security arrangement); some are meant for domestic economic restructuring; and some are centered on political, as opposed to economic, integration (Whalley 1998). Indeed, it might be fair to say that, for many RTAs, reciprocal trade arrangements are a secondary issue. Whatever the primary goal, however, it is clear that RTAs are an important, and increasingly pervasive, part of the international trading system. Thus, while RTAs have been around for a long time, their growth has accelerated over the past decade. In 1995, for example, there were 124 RTA notifications; by 2005 that number had jumped to 330, a more than two-and-a-half-fold increase in a decade. The current number represents an almost four-and-a-half-fold increase since 1995.

**Figure 4.13. The Growth of RTAs, 1948–2012**



Source: WTO Secretariat. Copied from WTO website and available at the following address:  
[http://www.wto.org/english/tratop\\_e/region\\_e/regfac\\_e.htm](http://www.wto.org/english/tratop_e/region_e/regfac_e.htm).

This rapid growth raises an obvious question: Why has there been a proliferation of RTAs following the establishment of the WTO? From an economic standpoint, one logical answer is that the rapid growth of RTAs reflects frustration with the WTO process: the stalemate in the Doha Round has weakened confidence in the WTO and in broad multilateral negotiations. The solution, therefore, is to pursue a smaller-scale, more

manageable approach to trade, which could then serve as the basis, or building block, for larger-scale, multilateral liberalization. In this view, the ideal model is to broaden or expand WTO trade rules within the RTA—this is referred to as a “WTO-plus” regional trade agreement. On the surface, the building-block explanation holds a lot of appeal, but few RTAs actually fit this model. Instead, as Sally (2006) bluntly puts it, a large majority involve “bogus” liberalization (p. 308). RTAs, in other words, tend to undermine multilateral liberalization—that is, they act as stumbling blocks—by creating more complicated trading arrangements between and among “regions” through the application of different rules for different products coming from different points of origin. Few are WTO-plus. (The issue of RTAs as building blocks or stumbling blocks is explored in much more depth by Robert Lawrence in his 1996 book, *Regionalism, Multilateralism, and Deeper Integration*). If the economic (and specifically liberalization) rationale is not the reason for the proliferation of RTAs, then what is? Some possible answers have already been suggested, but perhaps the simplest explanation is that the overarching motivation is political rather than economic. Of course, this does not tell us much. A slightly more specific explanation is that national governments have found RTAs to be useful and relatively effective economic tools for achieving political ends (Ravenhill 2005).

Consider the European Union, which began as the European Coal and Steel Community (ECSC), one of the first postwar RTAs. Certainly, there was an economic motivation for the ECSC, but there was arguably an even stronger political motivation—namely, to build a basis for lasting peace in Europe by consciously integrating the German economy, first into a regional economic arrangement, and ultimately into a regional political federation. To put it in more academic terms, underlying the ECSC was a security linkage. There were other political objectives, too, including creating a regional economic bloc that could negotiate on more even terms with the United States; in this regard, the RTA was used to increase multilateral bargaining power (this parallels the motivation behind bargaining coalitions within the WTO). The use of RTAs as a bargaining tool is, in fact, likely one of the more common reasons for their proliferation since 1996. In addition, for smaller-market countries, RTAs are an important method of guaranteeing access to larger markets. There is, of course, always a trade-off: to gain this access, the smaller-market economies must make numerous concessions to the larger-market countries. In a U.S.-Canada agreement, for example, Canada was able to secure an exemption from the use of anti-dumping and countervailing duties by U.S. producers, while the U.S. demanded that Canada maintain energy and investment policies favorable to the U.S.; Canada also made changes in pharmaceutical protection laws to parallel U.S. laws (Whalley 1998, p. 73).

There are other political motivations as well, but one of the key points is this: RTAs are not inherently vehicles for greater trade liberalization on a global scale. Instead, they are discriminatory (or preferential) trade arrangements that can easily contradict the nondiscrimination, or MFN, principle embedded in the WTO. This has created a great deal of tension, despite the fact that WTO rules explicitly allow for RTAs and can, at times, be applied in a manner that overrules certain RTA practices. Fiorentini, Verdeja, and Toqueboeuf (2006) put the problem this way:

The tension in the RTA-WTO relationship has extensive ramifications and may pose a threat to a balanced development of world trade through increased trade and investment diversion, particularly if liberalization on a preferential basis is not accompanied by concurrent MFN liberalization; it also poses a threat to the business

community and to the global production system on which it operates by raising costs through regulatory complexity and shifting production from comparative advantage to “competitive preferences.” (p. 26)

The RTA-WTO relationship raises important and interesting questions about the future of the system of international trade. Will liberalization at an international or global level continue to unfold—that is, will the world continue to move closer to a situation of international free trade? Or does the popularity of RTAs mean, instead, a balkanization of global trade? There is no clear evidence to show what the answer is.<sup>17</sup> However, a couple of things are fairly clear: continued liberalization in the international system of international trade is far from assured, and whatever the outcome, the process will be profoundly political.

## Chapter 4: A Quick Conclusion

The liberalization of international trade is a divisive issue. As we saw in the first part of the chapter, there is still a contentious debate on how “liberal” cross-border trade should be. This debate holds strong despite a general consensus that cross-border trade is itself good, or at least necessary. Thus, states (or economic actors within states) continue to trade, and cross-border trade has grown tremendously, especially in the postwar period. Nonetheless, we know from historical and contemporary experience that cross-border trade will continue to be defined, to a significant extent, by political boundaries, and that the existence of these boundaries means managed, rather than free, trade. *Managed trade*, however, is not necessarily a negative term: it reflects the outcome of complex processes and relations of power, all of which play out within domestic, international, and global structures. In IPE, the study of these processes and relations of power is critical to understanding the shape of the global economy. This does not, it is important to re-emphasize, necessarily imply state dominance; indeed, it means something quite different. “Relations of power” tell us that we need to be attuned to, for example, state-state interactions, state-firm interactions, and firm-firm interactions. Nor can we ignore the power and influence of a plethora of other actors, both inside and outside the state: international organizations, organized labor, NGOs, citizen movements, and the like. The interactions among all these actors produce results that are not generally predictable. The type of cross-border trade regime that exists today, therefore, was not inevitable, just as so-called free trade is not inevitable or natural.

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<sup>10</sup> The four listed countries are based on data and estimated from the World Bank’s WITS (World Integrated Trade Solution) program (<http://wits.worldbank.org/wits/>). Libya can also be included in this list, but the data are somewhat dated (from 2006). Altogether, WITS lists 178 countries and territories. The highest applied tariff rate for manufactured products is the Bahamas at 35.67 percent (2011), followed by Iran at 25.69 percent. The large majority of countries (n=119), however, have an average tariff rate of less than 10 percent.

<sup>11</sup> For a fuller discussion, see Schnepf (2010).

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<sup>12</sup> In the case of Danone, it can be argued that the French government never seriously considered the company important to the country's national security. France's prime minister at the time did, in fact, suggest that Danone was a strategic industry, but he later stated, “[Danone] does not figure within the category of so-called sensitive or strategic industries such as the defense industry” (cited in Rosenthal 2005). In addition, at the end of 2005, when France established a formal list of economic sectors that would shield a broad range of French companies from foreign takeovers, the yogurt industry was not on the list (Maxwell 2006, p. 7)

<sup>13</sup> As Eichengreen (1986) points out, there has been significant scholarly debate on the connection between the Smoot-Hawley tariff and the Great Depression. Some analysts argue that the tariff was a major contributor to the depression's “singular depth and long duration,” while others emphasize the “monetary aspects of the contraction … [and] argue that world trade was collapsing anyway” (in this view, Smoot-Hawley was a “sideshow”). Some scholars even argue that the tariff may have actually had a favorable impact on the U.S. economy, since it helped to offset the collapse of prices (pp. 1–2).

<sup>14</sup> See for example Bailey, Goldstein, and Weingast (2010); Haggard (1988); Hiscox (1999); Irwin (1998); and Schnietz (2000).

<sup>15</sup> This definition comes from the WTO website and can be found at the following URL:  
[http://www.wto.org/english/tratop\\_e/region\\_e/pta\\_pta\\_e.htm](http://www.wto.org/english/tratop_e/region_e/pta_pta_e.htm).

<sup>16</sup> The WTO keeps a list of all RTAs in force. This list is available at the following URL:  
<http://rtais.wto.org/UI/PublicAllRTAList.aspx>.

<sup>17</sup> Peter Katzenstein's notion of “porous regionalism” offers a strong argument against the balkanization view in his 2005 book, *A World of Regions: Asia and Europe in the American Imperium*.

# Chapter 5

## The Global Financial System

### Introduction

In the last chapter and through much of this book, the United States has been a major focus of attention. There is good reason for this. Beginning in the early part of the 20<sup>th</sup> century, the United States—not necessarily as a monolithic entity, but as a complex and diverse set of actors and institutions—gradually emerged as the predominant economic and political player in world affairs, especially in the capitalist world. The power of the United States, it is important to re-emphasize, was more structural than coercive. That is, U.S. power was based on its increasingly strong positions within the security, production, knowledge, and financial structures, positions that were considerably enhanced by the destructiveness of World War II. In the aftermath of World War II, U.S. dominance in the production structure in particular enabled the United States to dictate or shape—to a significant extent—the rules of the game for international or cross-border trade for a good part of the 20<sup>th</sup> century. Control of this process was, of course, never total, even in the early postwar years, but it is fairly clear that the major institutions of the international trade regime reflected and continue to reflect the interests and dominant position of the United States (and to a much lesser extent, Great Britain). In this view, it is not at all difficult to understand why a predominantly liberal set of trade rules developed around manufactured goods, while agriculture, to this day, is governed by a different set of largely protectionist principles. This double standard, to put it simply (and admittedly simplistically), reflected the interests of a hegemonic power, which pursued liberalization in those areas in which the benefits were clear, while it eschewed liberalization in those areas in which the benefits were less clear-cut. Such are the prerogatives of the hegemon.

In the global financial system (which is composed of two tightly connected elements, discussed shortly; for now, though, just think of currency issues as one element, and credit issues as the other element), the same basic dynamic was visible in the early postwar years. It is obvious that the United States—again, with Great Britain playing an important, but secondary role—took immediate charge of writing the rules for a new international monetary system (IMS), which is the part of the global financial system involving the exchange of national currencies. For the postwar IMS, the basic framework was explicitly

negotiated at Bretton Woods in 1944. One product of these negotiations was the creation of a modified gold standard, one in which the U.S. dollar was fixed to gold at the rate of \$35 to one ounce. There is nothing novel about the gold standard: it has been used and adopted many times throughout history. Importantly, though, it has *always* failed. The same was true for the postwar IMS, which abruptly collapsed in 1971 when President Nixon declared on national TV that the gold window was closed. The United States' inability, or steadily decreasing willingness, due to high costs, to maintain the gold-exchange system (GES), as it was also known, tells us that states—even ostensibly hegemonic states—do not have unlimited power in key structures of the global economy. This does not mean that the international monetary system, any more than the system for international trade, can somehow operate smoothly and efficiently without an overarching political framework or foundation. In the 1930s, there was no hegemonic power to maintain the international monetary system (one that also used a gold standard). As a result, the system collapsed, and was replaced by a series of relatively closed currency blocs (Helleiner 2005, p. 153), which exacerbated economic and financial problems around the world.

At the same time, a closer examination of the IMS (and the global credit system) tells us that there is a powerful economic logic at work, one that shapes and is shaped by the action and power of states and a variety of other key actors, especially transnational financial institutions (both public and private). Thus, understanding the global financial system quite predictably requires that careful attention be paid to the interdependent relationship between politics/power on the one hand, and monetary and financial forces on the other hand. It also requires that a number of key questions be addressed. Why have previous attempts to develop a stable international monetary system, especially through the establishment of gold standard, failed? What are the costs (and benefits) of a more flexible, but less stable system? What *should* the relationship between different national currencies be? Who or what controls the creation and allocation of credit in world financial markets? How is power distributed and exercised within the international or global financial system? These are all fundamental questions, the answers to which will shed considerable light on the dynamics of the global financial system.

With this in mind, the first part of this chapter will cover important background issues and key definitions.

## The Global Financial System: The Basics

The global financial system, as noted above, can be divided into two separate, but tightly inter-related systems: a monetary system and a credit system. The international *monetary* system, in the most general sense, is defined by the relationship between and among national currencies. More concretely, it revolves around the question of how the exchange rate among different national currencies is determined. The *credit* system refers to the framework of rules, agreements, institutions, and practices that facilitate the transnational flow of financial capital for the purposes of investment and trade financing. From these two very general definitions, it should be easy to see how the monetary and credit systems are inextricably related to one another. These rather dry definitions, however, do not tell us very much. It is important to delve more deeply into each in order to establish a firmer basis for understanding the dynamics of the global financial system as a whole (and, it is important to add, between the global financial system and the international trading

system). To begin, then, it will be useful to focus more sharply on the main components of the monetary and credit systems.

### *Exchange Rates and the Exchange-Rate System*

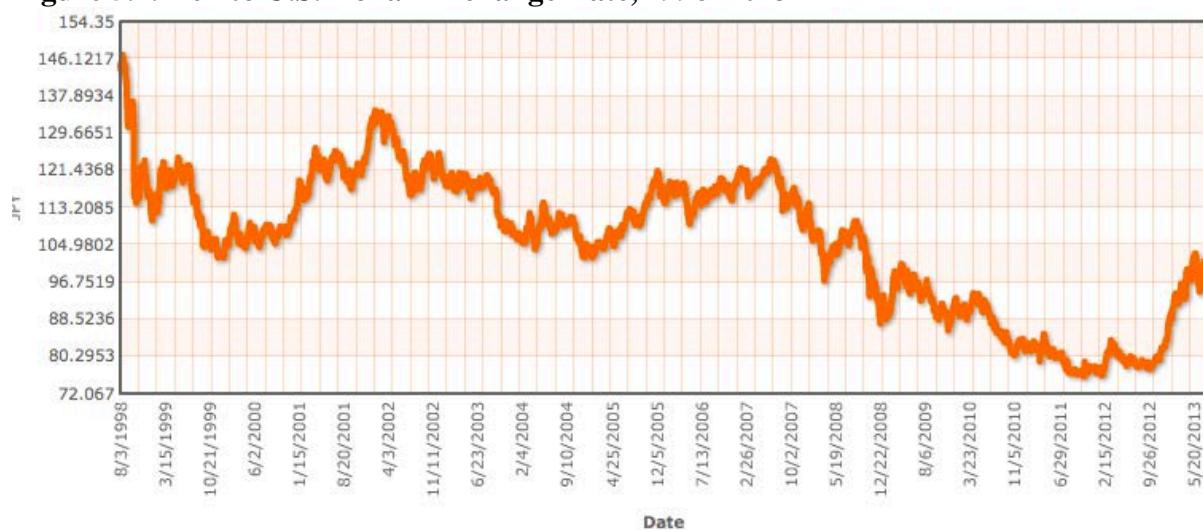
In a primer on exchange rates, Robert Bartley (2003), writing for the venerable *Wall Street Journal*, began with the following sentence, “The American political elite knows almost nothing about exchange rates. Worse, much of what it does know is wrong.” If Bartley is right, then there is no shame in being a bit befuddled about the exchange-rate system. At the same time, a basic and accurate understanding of this system is not difficult to achieve. The simplest point is this: an *exchange rate* is the price of one national currency in terms of another. For example, take

a look at table 5.1, which shows exchange rates for a few major currencies. The table tells us that, in July 2013, one U.S. dollar (\$1) was worth 98.1 Japanese yen (¥), while one British pound (£) was worth 1.54 U.S. dollars. Presently, however, exchange rates tend to vary over time. If you look at a graph of the exchange rate between the dollar and yen (see figure 5.1), to cite one specific relationship, significant variations can be observed: in August 1998, one U.S. dollar was worth 145.8 yen; compared to the rate in July 2013, that is a difference of almost 50 percent. In other words, in August 1998, the yen was substantially “weaker” (the quotation marks are used because a weak currency is not necessarily a disadvantage). What does this mean in concrete terms? Well, say you have \$2,000. In 1998, if you had traveled to Japan you could have exchanged that \$2,000 for 291,000 yen, but in 2013 that same \$2,000 (to keep things simple, disregard inflation) could be exchanged for only 196,000 yen. In short, you would have a lot less Japanese yen to spend in 2013. From a country perspective,

**Table 5.1. Exchange Rates, Major Currencies (July 2013)**

| Currency Pair             | Value (rounded) |
|---------------------------|-----------------|
| EURO (€)-U.S. Dollar (\$) | 1.3             |
| U.S.\$-Japanese Yen (¥)   | 98.1            |
| British Pound (£)-U.S.\$  | 1.5             |
| EURO-Japanese Yen         | 130.3           |

**Figure 5.1. Yen to U.S. Dollar Exchange Rate, 1998–2013**



Source: Data from U.S. Federal Reserve Bank of New York; image was generated by indexmundi.com at <http://www.indexmundi.com/xrates/graph.aspx?c1=JPY&c2=USD&days=5475>.

Japanese exports in 1998 were considerably less expensive than today. In fact, for a long time—from 1949 until 1971—the value of the Japanese yen was even weaker at ¥360 to \$1. Still more, the yen-dollar rate was *fixed* during this entire period. After 1971, the rate was readjusted as part of the **Smithsonian Agreement**, but in early 1973, the adjusted fixed rate was abandoned in favor of a *floating exchange rate*.

In the foregoing paragraph, several terms were introduced: the *exchange-rate system*, the *fixed exchange rate*, and the *floating exchange rate*. These are all basic terms. An exchange-rate system (or regime) refers, in general, to the set of rules that govern the relative value of national currencies. Fixed and floating exchange rates represent two major types of exchange-rate systems. While the notion of fixed and floating exchange-rate systems suggests a dichotomous separation, in practice, exchange-rate systems exist on a continuum (Stockman 1999, p. 1484): at one extreme is the pure floating (or flexible) exchange rate, while on the other end is the pure fixed (or pegged) rate system. The fixed and floating-rate systems, in this regard, might be better seen as *ideal types*—that is, purposeful simplifications or abstractions not meant to correspond to all the actual characteristics of a particular case. Scholars use ideal types for analytical purposes, to help us more clearly see and understand the essential characteristics and features of specific phenomena. With this in mind, in a pure floating-rate system, the value of a currency is determined solely by supply and demand; a pure floating-rate system, in other words, exists only when there is absolutely no intervention by governments or other actors capable of influencing exchange-rate values through nonmarket means. These conditions, it should be noted, have never been met; there has always been some degree of government intervention in the determination of currency values. A pure fixed-rate system, on the other hand, is one in which the value of a particular currency is fixed against the value of another single currency or against a basket of currencies, or against another measure of value, such as gold or silver (or some combination thereof). In practice, pure fixed-rate systems *can* exist, but only on a short-run basis; adjustments are, in practical terms, inevitable. The postwar gold-exchange system, for example, lasted until 1971, but prior to its collapse, there were exchange-rate realignments in 1958, 1961, and 1967 (Stockman 1999, p. 1485).

In between the pure fixed and floating exchange-rate systems, as already noted, are many variants. The IMF lists eight specific types or regimes, some with quite interesting names: (1) exchange arrangements with no separate legal tender, (2) currency board arrangements, (3) other conventional fixed peg arrangements, (4) pegged exchange rates with horizontal bands, (5) crawling pegs, (6) exchange rates within crawling bands, (7) managed floating with no predetermined path for the exchange rate, and (8) independently floating (there are also other variants). It is not necessary to go into a detailed explanation of each of these regimes (interested readers can find descriptions on the IMF website). The range of options, however, raises a question: is one type of exchange system better than others? The simple answer is no. The U.S. Treasury notes, on this point, that there is “probably no universally ‘optimal’ regime. Regime choices should reflect the individual properties and characteristics of an economy” (Appendix II, p. 1). Most scholars, including mainstream economists, agree.<sup>18</sup> But this takes us back to one of the key questions raised in the introduction—What should the relationship between different national currencies be? To answer this question, we need to recognize a truism in political economy: choices must be made, and typically getting more of something means giving up something else. This is called a *trade-off*. In the decision over whether to adopt a primarily fixed or floating

exchange-rate system, the basic trade-off is easy to discern: stability versus autonomy. Fixed exchange-rate systems generally offer greater exchange-rate stability. This is important, in that it reduces the risks in international trade (because the prices of imports and exports will not fluctuate based on unanticipated changes in the exchange rate), and, in principle, reduces the risk of currency speculation. The price of greater stability, however, is less flexibility or autonomy in dealing with domestic economic issues. With a fixed exchange-rate system, in particular, governments have less freedom to use monetary policy (e.g., adjusting interest rates, expanding or contracting the money supply) to manage the domestic economy. The basic problem is encapsulated in the Mundell-Fleming model (see figure 5.2).

### Figure 5.2. The Mundell-Fleming Model

Back in the 1960s, Robert Mundell (who won the 1999 Nobel Prize in Economics) and Marcus Fleming argued that, when a small country tries to maintain a fixed exchange rate in a world of perfect capital mobility (keep in mind that basic economic models often use simplifying assumptions to highlight key points of concern), money stock becomes exogenous. In other words, the stock of money is determined by other variables; in practical terms, this means that monetary policy is rendered completely ineffective as a stabilization policy instrument (Fan and Fan 2002). In addition, the two economists theorized that governments could not simultaneously have an independent monetary policy (i.e., control of the money supply and interest rates), a stable exchange rate (via a fixed or pegged system), and free capital movement. It is possible to achieve two of these objectives at the same time, but not all three; this has been labeled the “impossible trinity” (also known as the “trilemma”). O’Brien and Williams (2007) explain it this way:

Governments have to choose their priorities. For example, if a government favours capital mobility to attract investment, then it must choose between a fixed exchange rate which will facilitate trade and investment and an autonomous monetary policy which will support domestic economic conditions. If it chooses a fixed exchange rate, interest rates must support that policy by providing investors with returns which will keep their money in the country. If interest rates do not support the currency and instead target domestic concerns, such as unemployment, investors may move money out of the country, putting pressure on the exchange rate. The exchange rate comes under pressure because investors sell the currency as they move their money



*Image. Robert Mundell. Permission to use granted under the terms of the GNU Free Documentation License, Version 1.2.*

into other currencies and assets. This creates excess supply of the currency, lowering its value. (p. 213)

It is important to understand that the Mundell-Fleming model was proposed at a time when most countries had a fixed exchange-rate regime; thus, the model was prospective. By the 1980s, however, as more and more countries shifted to floating-rate regimes, the model's predictions were, by and large, confirmed. This is one reason for its widespread popularity and acceptance. At the same time, as with almost all economic models, there have been criticisms. Most of these center on the simplifying assumptions of the model; nonetheless, the Mundell-Fleming model has done a very good job of withstanding the test of time (and empirical evidence).

Beyond the basic trade-off between stability under a fixed-rate regime and autonomy under a floating-rate regime, a number of more specific advantages and disadvantages can be identified. For example, for a country heavily reliant on exports, such as China, a fixed exchange rate can be used to keep the value of the country's currency low relative to other currencies. This effectively increases the competitiveness of the country's exports on a generalized basis, and thus encourages stronger exports and stronger economic growth for the national economy. Fixed exchange rates also encourage greater and more consistent foreign investment: outside investors do not have to worry that the value of their investments will fluctuate based on the value of the local currency; thus, they are more likely to invest. In principle, a fixed or pegged currency can also help to lower inflation rates, again, because there are fewer concerns that the local currency will unexpectedly lose or gain value. For developing economies, in particular, fixed exchange-rate systems are, in a somewhat counterintuitive way, far easier to maintain than a floating exchange-rate system: floating systems generally require stronger financial institutions and more mature markets to properly maintain (Haekal 2012).

The disadvantages, however, can be quite severe. In particular, over time, fixed exchange-rate systems can lead to major distortions in the underlying value of the currency. If this happens, investors and others with financial interests in an economy may suddenly lose confidence, and begin to withdraw their investments en masse (as they try to convert local currency holdings into, say, dollars or euros at the fixed or pegged rate). In this situation, governments may try to prop up the local currency by using foreign reserves. Invariably, this strategy fails, and the currency's value collapses. The result is a massive financial meltdown, of which there are many real-world examples: Mexico (1995); Thailand, Indonesia, Malaysia, and South Korea (1997); and Russia (1998), to name just a few. In other words, the greatest advantage (i.e., stability) of a fixed exchange-rate system is, ironically, also its greatest weakness. (At the same time, one can argue that China's re-adoption of a fixed rate helped it to avoid the financial turmoil afflicting most other countries at the time.) In addition to the potential for economic catastrophe, a fixed-rate system generally requires countries to maintain higher-than-average currency reserves, but this can result in inflation because it increases the supply of currency (i.e., the monetary base) in the economy.<sup>19</sup>

One key advantage of a floating (or flexible) exchange-rate system is that it acts as an automatic stabilizer for the economy. For example, if external demand for a country's

exports decline, this will lead to a decline in overall output and an automatic depreciation in the value of the country's currency. This, in turn, makes the country's goods cheaper, which should (in principle) increase exports. In this regard, too, a floating system leads to an automatic adjustment in the balance of payments. As noted above, the floating-rate system gives countries more autonomy with regard to domestic monetary policy, especially in determining interest rates. In a fixed-rate system, domestic interest rates must be set at a level that will keep the exchange rate within a predetermined band; in a floating-rate system, this is not necessary. This allows a government, for example, to sharply cut interest rates during a recessionary period to spur domestic economic growth. The main disadvantages of the flexible exchange-rate system, according to Evrensel (2013), are three-fold. The first disadvantage is greater volatility (a point discussed several times already). The second disadvantage is the potential for too much use of expansionary monetary policy, and the third disadvantage of the floating exchange-rate system is that it does not, in the real world, live up to its reputation as an automatic stabilizer. The U.S. is a case in point: despite using a floating exchange-rate system, the U.S. has run large and persistent deficits in its current account.

### *Balance of Payments*

The selection of an exchange-rate system also has important implications for a country's *balance of payments*, a point that will be discussed below. But first, a few words about the balance of payments. The balance of payments (BOP) is another basic concept; it refers to the method countries use to account for all of their international monetary transactions (this includes transactions for goods and services, as well as purely financial ones by individuals, businesses, and governments) over a specified period of time. "Every international transaction", as the Federal Reserve Bank of New York (n.d.) explains it, "results in a credit and a debit. Transactions that cause money to flow into a country are credits, and transactions that cause money to leave a country are debits. For instance, if someone in England buys a South Korean stereo, the purchase is a debit to the British account and a credit to the South Korean account. If a Brazilian company sends an interest payment on a loan to a bank in the United States, the transaction represents a debit to the Brazilian BOP account and a credit to the U.S. BOP account" (n.p.). These transactions are further divided into two general categories: the current account, and the capital and financial account (the capital/financial account is sometimes divided into separate accounts). The *current account* is used primarily to mark the inflow and outflow of goods and services, but also includes earnings on investments, foreign aid, charitable giving, and wages paid to temporary (nonresident) workers. It is referred to as the current account because these transactions mark a short-term or one-time flow of payments or transfers. The capital and financial account is where all cross-border capital transfers are recorded. This includes the transfer of financial and nonfinancial assets such as stocks, bonds, securities (debt), foreign direct investment (FDI), official reserve transactions (e.g., financial assets denominated in foreign currencies or in **Special Drawing Rights**, also known as **SDRs**), land, factories, and mines. These are longer-term economic transactions.

In discussing the balance of payments, it is easy to become confused. One major point of confusion stems from the tendency to speak of a "balance-of-payments deficit (or surplus)." Technically, the balance of payments is always in balance, or zero; that is, if the current account has a deficit, the capital account has an exactly equal surplus. (This is a

basic accounting principle, although in practice, there is typically a statistical discrepancy.) Perhaps the easiest way to understand why this is the case is to consider what happens when a country runs a large current account deficit, which is typically the result of an imbalance between exports and imports. In this example, in order to pay for the imports it needs, a country (or economic actors within the country) may borrow money from a commercial bank or from an international financial institution; it could also receive foreign aid money or sell financial or nonfinancial assets. Or in the case of the United States, it could sell Treasury bonds or other government-based securities such as Treasury bills, known as T-bills, and notes (basically a Treasury bond is a type of long-term debt obligation; Treasury bills are short-term obligations; notes are medium-term obligations). These funds are recorded as a credit for the U.S. because other countries are effectively loaning money to the United States. In other words, what might otherwise be considered a liability or debt is a “credit” in the capital and financial account—which is another reason for confusion. It is important to note, too, that strong demand for U.S. securities (and U.S. securities are generally viewed as one of the safest, most secure investments available) may strengthen the relative value of the dollar, making U.S. exports less competitive (thereby worsening the U.S. current account deficit).

From the foregoing example, it should be apparent that the balance of payments is an important issue in international political economy generally, and for individual countries specifically. For the most part, countries see a capital and financial account surplus as a negative: to repeat, a surplus in the capital and financial account means that a country’s debits are more than its credits. More simply, this means that the country is a net debtor to the rest of the world. On the other hand, a country that runs consistent current account surpluses and capital and financial account deficits is a net creditor, which is viewed in very positive terms. China represents a good example of the latter case. For many years, China has been running huge current account surpluses—the figures for 2005 to 2011 are available in table 5.2. In 2008, to cite a particularly significant year, China’s current account surplus was a remarkable \$420.6 billion. Primarily as a result of these massive and consistent current account surpluses, China has been able to accumulate a balance-of-payments *reserve* of more than \$3.3 trillion in 2011 (in the balance of payments, the difference between the current account surplus and a capital/financial account deficit is made up for by an increase in reserves, which are foreign assets held by the central bank; reserves are considered a debit). To appreciate the significance of this figure, consider this: China’s reserves are almost three times that of Japan, which has the second largest reserves in the world at \$1.3 trillion. China’s immense holding of foreign assets, it is important to understand, significantly enhances China’s power in all the major structures of the global system, but especially in the financial and production structures. Reserves are essentially “money in the bank,” which can be used to purchase anything that the government or country needs, from the best commercial technology to the most advanced military weaponry, and anything in between. Foreign reserves also provide China leverage as *the* major creditor economy in the world today. China is not on the same level as the U.S. was at the end of World War II, when the United States controlled 70 percent of the world’s monetary gold (Mundell 2012, p. 526), but it is certainly a central player in the global financial system. What this means will be discussed in more detail later in this chapter. For now, it is time to move on to a more substantive examination of the development of the global financial system. This takes us back to the Bretton Woods conference (as well as other key elements of the early postwar

period).

**Table 5.2. China's Current Account Surplus and Total Reserves, 2005–2011 (in billions U.S.\$)**

|                 | 2005  | 2006    | 2007    | 2008    | 2009    | 2010    | 2011    |
|-----------------|-------|---------|---------|---------|---------|---------|---------|
| Current Account | 132.4 | 231.8   | 353.2   | 420.6   | 243.3   | 237.8   | 136.1   |
| Total Reserves  | 831.4 | 1,080.8 | 2,183.4 | 1,966.0 | 2,452.9 | 3,254.7 | 3,331.1 |

Source: World Bank, “World Development Indicators,” online database available at <http://wdi.worldbank.org/> (all figures are rounded).

## Constructing the U.S.-Led Postwar Global Financial System

By now, you are quite familiar with (and perhaps weary of reading about) the Bretton Woods conference. Still, any discussion of the global financial system requires a further examination of its significance, and especially of the larger context and underlying relations of power that shaped the negotiations and agreements reached at Bretton Woods. With respect to the global financial system, one of the key elements of the negotiations at Bretton Woods, as noted above, was the creation of the gold-exchange system, or GES (or, less commonly, the **par value system**). Two other key elements were the creation of the International Monetary Fund (IMF) and the World Bank (or the International Bank for Reconstruction and Development [IBRD], as it is formally known). To go along with this financial framework, it is important to understand, were frameworks for cross-border trade and for international security. The framework for trade was discussed in depth in chapter 4, so no more must be said here. As for the security framework, suffice it to say that it was important for creating a strong and enduring basis for political stability and order, and was part and parcel of the exercise of hegemonic power by the United States.

It is clear that all of these elements of the postwar order were consciously designed—largely by the United States—as part of an overarching whole. It should be very easy to discern why the United States would willingly, even eagerly, take on this role: in a word, hegemony. Remember that hegemony as an analytical concept and tool has resonance in most political-economy or IPE approaches. Even more, from a theoretical perspective it is very hard—and, arguably, unthinkable—to ignore the significance of hegemony in explaining the major economic and political dynamics of the *early* postwar period (I emphasize “early” because this is the period in which U.S. power was at its apex, and therefore, it is the period in which hegemony was likely most important). This does not mean that the conceptualization and implications of hegemony are the same in the various theoretical approaches. They are not. In addition to the concept of hegemony, it is crucial to keep in mind the notion of two-level games, for even in the early postwar period, it is clear that domestic political-economic considerations were an integral part of decision-making within the United States (as well as other countries).

That said, the primary topic in this chapter is the framework of the global financial system, and a good place to begin an examination of this topic is with the negotiations and agreements reached at the Bretton Woods conference of 1944.

### *American Power, Bretton Woods, and the Postwar Global Financial System*

Even before the end of World War II, plans were in the works to construct a specific postwar order premised primarily on American power and interests. One of the first orders of business was to re-establish economic and financial order, which was designed, at least in part, to avoid the mistakes of the past. Two contrasting mistakes were, first, the overly rigid gold standard of the 19<sup>th</sup> century, which did not allow governments to effectively manage domestic economic issues. The second was the disastrous experiment with floating exchange rates in the 1920s and 1930s: one of the problems with the 1930 system was that it encouraged countries to engage in “competitive devaluations” in order to gain a temporary advantage in international markets (Gilpin 2002). Part of the solution, then, was the gold-exchange system, which was designed to provide the best of both worlds. Specifically, the GES was meant to provide the stability of a fixed exchange system by establishing a set value for the U.S. dollar relative to gold (and other currencies relative to the U.S. dollar or gold), but also have the flexibility of a floating system via an “adjustable peg.” Under this exchange regime, participating countries were obliged to declare a specific value for their currency, known as a par value, or peg; they were also required to intervene in currency markets to limit exchange-rate fluctuations with a maximum margin, or band, of one percent above or below parity. (The par value concept, it is worth emphasizing, was originally used to define the Bretton Woods system, which is why it is common to hear people say that the Bretton Woods system collapsed in 1971.) At the same time, all countries retained the right to alter their par value to correct a “fundamental disequilibrium” in their balance of payments (Cohen 2001). In principle, this meant that governments could devalue their currency (beyond the one percent band), but quite unlike the prewar period, devaluations were subject to oversight by a third, supposedly disinterested or impartial, party—the IMF. The IMF, in other words, was given the authority, albeit not unlimited, to approve or reject requests for currency devaluation. This was, in an important respect, a remarkable development in the world of global finance, but it likely could only have happened with U.S. leadership. To see this, consider that, in practice, the IMF was often bypassed in favor of negotiations between the U.S. government and the affected government(s).

The IMF, which formally began operations on March 1, 1947, had much more to do than simply approve requests for currency adjustments. Indeed, it was meant to play a (even *the*) key role in the postwar global financial system. Thus, while set up as an ostensibly neutral international financial institution, the IMF was clearly meant to represent U.S. interests and power first and foremost, and the interests of the other major capitalist countries (the developed economies) secondarily. This can be seen, more concretely, in how decision-making power within the IMF was designed, a point discussed in chapter 3. Again, voting power is determined by what the IMF calls a quota. A quota (or capital subscription) is the amount of money that a member country pays to the IMF; it is the price of admission, so to speak, and a central component of the IMF’s financial resources. The quota is supposed to reflect the relative size of a country’s economy; in reality, however, this has never been the case (Bird and Rowlands 2006). China, for example, has the second largest economy in the world, but still has a smaller quota than France, Germany, Japan, and Great Britain. Even more interesting (or telling), China’s quota is only about 35 percent larger than Saudi Arabia’s quota, despite the fact that China’s economy is about 12 times (or 1,200

percent) larger (in terms of GDP). This is important, because quotas also determine the number of votes each member has. All members are automatically entitled to 250 basic votes, plus one for each SDR 100,000 of quota (an SDR is a special type of monetary currency reserve created by the IMF): in practical terms, the allocation of 250 basic votes means almost nothing. On this point, just consider that, in 2013, the U.S. quota (number of votes) was 421,961; compare this to, say, Chad's 1,403 votes (IMF 2013). When the IMF was first formed, the United States had almost 35 percent of all votes, while the other developed countries controlled more than 40 percent. To further ensure decision-making control, the countries with the five largest quotas were given permanent seats on the IMF's executive board (composed of 24 total members). In addition, important decisions require a supermajority of 85 percent, which means that the largest members effectively have veto power. None of this should be surprising, especially from a political-economy perspective, which tells us to pay close attention to the question of how power shapes the economic system, whether domestically or internationally.

Beyond the issue of voting power, the quota system within the IMF was primarily meant to provide a stabilization fund. The IMF's stabilization fund—which was partly, but not coincidentally, modeled on the **U.S. Exchange Stabilization Fund**, or ESF (established in 1934)—provided a pool of money available at the international level. This money was loaned, on a short-term basis, to countries suffering from *temporary* balance-of-payments problems (e.g., a current account deficit). The loans were meant to provide a type of safety valve so that governments would not be tempted to resort to unilateral devaluations of their currencies in an effort to reduce their current account deficits. The stabilization fund, to some extent, worked hand in hand with the IMF's authority to approve currency devaluation requests. Specifically, if the IMF opposed devaluation, it could not directly prevent a country from devaluating its currency. After all, the IMF had no enforcement arm, no IMF "police force." Instead, the IMF was authorized by the Articles of Agreement to bar that country from drawing from the stabilization fund. Unlike the par value system, the stabilization function of the IMF not only survived, but has also, over time, come to play a larger and quite significant role in the global financial system. In this regard, it is important to understand that the basic purpose behind the stabilization fund and IMF lending has changed. As the IMF itself explains it:

the purpose of the IMF's lending has changed dramatically since the organization was created. Over time, the IMF's financial assistance has evolved from helping countries deal with short-term trade fluctuations to supporting adjustment and addressing a wide range of balance-of-payments problems resulting from terms of trade shocks, natural disasters, postconflict situations, broad economic transition, poverty reduction and economic development, sovereign debt restructuring, and confidence-driven banking and currency crises (IMF n.d.).

### *The IMF and Conditionality*

Significantly, along with these general adjustments in the purpose of IMF loans have come other changes as well. One of these changes centers on the recipients. Originally, the IMF was designed to provide assistance to industrialized countries, and for the first two decades of its existence, more than half of IMF lending went to these richer economies. Since the 1970s, however, the vast majority of recipient countries have been from the

developing world (although with the global financial crisis beginning in 2008, the IMF again began providing loans to European countries). A related, but more important change has been a stricter and more expansive application of *conditionality*. Conditionality, in the broadest sense, refers to any condition or requirement attached to the receipt of a loan, as in, “In return for our willingness to extend this loan to you, you are required to meet the following conditions...” When the IMF was first established, there was no reference to conditionality; nor was it written into the Fund’s original Articles of Agreement. The concept, instead, was first introduced in 1952, but not formally incorporated into the Articles until 1969 as part of the First Amendment (Buira 2003, p. 3). One of the reasons for the lack of conditionality in the beginning was Britain’s very strong resistance to the idea. Britain’s negotiating team, led by John Maynard Keynes, was explicitly instructed not to accept any wording that would even suggest conditionality—the fear was that doing so would invite the “evils of the old automatic gold standard” (cited in Moggridge 1980, p. 143). The U.S. was willing at the time to accede to Britain’s position. Still, as soon as the opportunity arose, the U.S. used its position of advantage to push through its original desire to attach conditions to IMF loans. This original desire was summarized by Keynes, who pointed out that the U.S. wanted the IMF to have “wide discretionary powers” and the ability to exercise “influence and control over the central banks of member countries” (cited in Buira 2003, p. 2).

After conditionality was first incorporated into the IMF, it was generally limited to monetary, fiscal, and exchange policies—that is, conditions that were directly related to balance-of-payments issues. But beginning in the 1980s, conditionality began to extend well beyond balance-of-payments issues to “encompass structural change in the trade regime, pricing and marketing policy, public sector management, public safety nets, restructuring and privatization of public enterprises, the agricultural sector, the energy sector, the financial sector, and more recently to issues of governance and others in which the expertise of the Fund is limited” (Buira 2003, p. 19). The IMF, in short, began to encroach more deeply and significantly into issues of state sovereignty. Not surprisingly, this has made the practice of conditionality a deeply controversial and profoundly political practice, with many critics charging that the IMF has become little more than a tool—an extremely effective one—the United States uses primarily to enforce its will on the rest of world. The IMF, of course, steadfastly refutes the notion that it is primarily or even partly a political tool used by the U.S. or other powerful countries. There are certainly valid points made by all sides of this debate<sup>20</sup>; still, it is difficult to dismiss the argument that asymmetries in political and economic power play a central role in how the IMF deals with countries. As Paul Volcker, former chairman of the Federal Reserve, once put it, “When the Fund consults with a poor and weak country, the country gets in line. When it consults with a big and strong country, the Fund gets in line” (cited in Buira 2003, p. 4). Chapter 7 will provide a more in-depth discussion of conditionality and its impact on developing economies.

### *The Final Push: The Importance of Hegemony*

It should be fairly clear—almost beyond doubt—that the U.S. played a key role in constructing the postwar global financial system. However, building a system and ensuring that it actually works are two very different things. For the postwar global financial system and the GES/par value system specifically, it was immediately apparent that the U.S. needed to do more than forge an agreement on the framework and rules governing that system. In fact, the system created by the United States was not implemented until many years after the

final agreement was reached. The problem was clear: in the early postwar period, the major European economies did not have sufficient foreign exchange reserves to implement fully the gold-exchange or par value system. The system, to remind you, required participating countries not only to set a par value, but also to intervene in financial markets to prevent their currency from falling or rising one percent or more outside a preset band (based on the par value). Without sufficient foreign exchange reserves, this was a risky policy to adopt. Why? Because the war-decimated European economies needed to conserve as much foreign currency as possible for reconstruction and other basic needs of the domestic economy (Oatley 2012, p. 216). As a result, most of the European governments were unwilling to adopt the convertibility rules the system required; that is, they were not willing to allow to the free convertibility of domestic currency—francs, deutschmarks, lira, etc.—into dollars or gold. The British, it should be noted, did implement convertibility for a short period in 1947, primarily because it was a condition attached to the Anglo-American Loan Agreement of 1946: in return for a much-needed loan of \$3.75 billion (plus an additional \$1.2 from Canada), Britain was required to restore the convertibility of the pound sterling (this was an early form of conditionality, which is discussed below). Less than a month after restoring convertibility, however, Britain's foreign reserves were drained of \$1 billion; this forced the British government to suspend convertibility of the pound sterling.

The solution was quite simple, but politically very difficult (see figure 5.3, “Selling the Marshall Plan,” for further discussion): the U.S. would need to export U.S. dollars to Europe at a hitherto unprecedented level. Thus was born the Marshall Plan (or, as it was officially called, the European Recovery Program), which transferred \$13 billion to European allies between 1948 and 1951, on top of an equal sum already provided to Europe in the years following the end of the war. While \$13 billion does not sound like much today, at the time it constituted 5 percent of U.S. GDP (\$258 billion), albeit spread over several years. The Marshall Plan helped the European economies to rebuild, and also eventually stimulated a strong flow of private capital from the U.S. to Europe, such that European governments were able to accumulate large foreign reserves by the end of the 1950s. The primary vehicle for the disbursement of Marshall Plan money was the World Bank, which was originally set up to aid in the (immediate) reconstruction of Europe. The end result was exactly what the U.S. had hoped to achieve: a financially, economically, politically more stable and stronger Europe. With this stability and strength, the European governments were then willing to finally implement the Bretton Woods system in 1959—only for it to fail a little more than a decade later (discussed in the following section).

The key point: the Bretton Woods system was very much a product of American power, and more specifically, of America's hegemonic power. The system may not have ever been implemented were it not for the capacity and willingness of the U.S. government to use its vast resources to ensure implementation of the system by beholden, but constrained allies. The use of U.S. resources, moreover, was certainly not limited to the Marshall Plan and postwar reconstruction; the U.S. also built and funded an expensive security framework. Outside of Europe, too, the U.S. was very busy: Japan's postwar reconstruction was another “responsibility” taken on by the United States. At the same time, hegemony did not determine what the outcome(s) would be. Domestic politics, both within the United States and in countries throughout the world, played out according to their own logic (recall the discussion of two-level games). This is par for the course when discussing political-economic issues. It is also important to emphasize that the system was very much a

social construction. For the U.S., in particular, a new reality of **internationalism**, as opposed to **isolationism**, had to be defined. For the objective fact of American economic and military dominance does not necessarily translate into a globally oriented policy requiring major expenditures for the rebuilding and defense of other countries. In addition, this new reality required the elevation of ostensibly power-neutral international financial institutions (i.e., the IMF and the World Bank) to quasi-sovereign status. The IMF especially was made into *the* authoritative (albeit not unchallenged) voice for the entire international financial system. This privileged position allowed the IMF to translate its views—particularly on critical issues such as balance-of-payments problems—into reality. Barnett and Finnemore (2004) argue, for example, that, beginning in the 1950s, the IMF developed a monetary approach to balance of payments that essentially defined the “problem as one in which both the cause of and the solution to balance-of-payments problems lay in the deficit state” (n.p.); this became the justification for conditionality and for the IMF’s steadily increasing intervention in the domestic affairs of member states.

### Figure 5.3. Selling the Marshall Plan

The Marshall Plan played a critical role in ensuring the early success of the Bretton Woods system, and also in stabilizing America’s overall postwar framework. From the beginning, however, opposition to the plan was intense. As Barry Machado (2007), writing for the George C. Marshall Foundation, explains it, most of the opposition came from the Republican Party, which generally saw the Marshall Plan as unnecessary and wasteful, and certainly not necessary for America’s prosperity or long-term security. Howard Buffet (the father of Warren Buffet, the second richest person in the United States in 2013), who represented Nebraska’s Second Congressional District in 1948, was a particularly strident foe. He labeled the plan “Operation Rathole,” and condemned the “barrage of propaganda ... drench[ing] this country” as the Truman administration attempted to gain support for its passage (p. 15). It is important to understand that this was a time when the U.S. had yet to throw off its long-standing and deeply embedded preference for **isolationism**.

Given the level and degree of opposition, passage of the plan was far from certain. Indeed, the Truman administration engaged in an “intensive five-month campaign of discussion, debate, and persuasion” that ultimately won broad public endorsement for the Marshall Plan. Of course, as Machado also notes, “the Truman administration’s willingness to concede a great deal to the concerns and biases of Congress in jointly crafting the final, compromise version of the ERP bill secured additional votes. Congress was always actively engaged in the process of revision, and the enabling legislation bore



numerous congressional fingerprints: the program would not be run out of the State Department, its director would be a respected businessman from the private sector, appropriations would be for one year only with annual reviews of how money was spent, guidelines and safeguards for disbursing funds would be imposed, aid would be denied to governments which went Communist, counterpart funds would be required, and American shipping would be employed” (p. 21).

*Image: One of a number of posters created by the Economic Cooperation Administration (ECA), an agency of the U.S. government, to sell the Marshall Plan. The image is in the public domain, since it was prepared by an officer or employee of the U.S. government as part of their official duties.*

### *Why Did the Bretton Woods System Fail?*

Given the discussion thus far, it may seem odd that a key element of the Bretton Woods system, the par value system (or the GES), collapsed after a relatively brief period of time. After all, the U.S. largely set up the system it wanted (including in the areas of trade and security), and as the hegemon, used its resources to considerable effect. The reason the system failed, however, is not difficult to discern. It was even predicted. As early as 1960, Robert Triffin argued that the gold-exchange system was inherently flawed since, for it to work, it depended on the U.S. being *reliably* able to convert dollars into gold. As long as dollars remained relatively scarce, as was the case in the 1950s, the problem was moot. This was because countries that had dollars would spend them on goods and services. As the European economies recovered, however, and as they began building their foreign reserves (composed mostly of U.S. dollars), the dollar gap turned into a dollar glut. This meant, in part, the supply of dollars had begun to exceed the supply of gold held by the United States: in fact, by 1959, U.S. gold holdings and foreign dollar holdings had already reached rough parity. As the situation deteriorated, with a larger and larger “dollar overhang” (the dollar overhang is simply the amount by which U.S. dollars held overseas exceeded U.S. reserves of gold), foreign countries and other holders of U.S. dollars began to lose confidence in the dollar itself, and specifically in their ability to freely convert dollars into gold.

The solution to the dollar overhang would have been for the U.S. to reduce the amount of dollars in circulation overseas. But this was problematic for two reasons. First, reducing the supply of dollars would have entailed a significant cutback in domestic spending and an increase in interest rates, neither of which the U.S. government was willing—or, as hegemon, able—to do. The U.S. would have also had to stop running a deficit in its current account. This led to the second, perhaps more significant, problem: by closing the current account deficit, the U.S. would have effectively reintroduced a shortage of the world’s de facto reserve currency; the result would have been a **liquidity shortage** and a contractionary spiral, perhaps resulting in a worldwide recession. The dilemma, to recap, was simple: Keep spending, and sending dollars to the rest of the world, and erode confidence in the dollar and the Bretton Woods system. Stop spending and eliminate the current account deficit, and risk a global recession and instability. Despite widespread recognition of the dilemma from an early stage—Triffin testified before the U.S. Congress on this very issue in 1960—a viable solution could not be found, although there were several efforts made. One of these was the creation of the London Gold Pool in 1961, in which the U.S. and seven European countries agreed to cooperate in defending a gold price of \$35 an ounce through coordinated interventions in the London gold market. The London Gold Pool

collapsed in 1968. Another effort, based on Triffin's suggestion, was the creation (in 1969) of an entirely new reserve unit—the SDR, or special drawing right. This effort, however, also failed to avert the U.S. decision to end the GES just two years later.

Richard Nixon pursued a third effort when he took office in 1969. His approach was to place the blame squarely on other governments, especially Germany and Japan, both of which had begun to run current account surpluses (specifically trade surpluses) and accumulate foreign reserves starting in the mid-1960s (see table 5.3). The Nixon administration pressured its West European allies and Japan to more actively support the dollar in the foreign exchange market, and to reduce their trade surpluses by importing more from the United States (Eichengreen 1996, p. 130). This policy, too, worked for a short time, but the American allies had their own domestic concerns and interests, and were unwilling to accept too much pain in order to appease the United States. Japan, in particular, was in the midst of its phenomenal postwar economic rise, and was ill-disposed towards slowing its export boom. Indeed, in 1971—the same year Nixon suspended convertibility of the dollar into gold—Japan achieved its largest trade surplus ever. That year, too, Japan's reserve holdings shot up by \$10.8 billion, an astronomical sum relative to the previous years (in 1970, for example, the increase was \$903 million). As the dollar overhang increased, confidence sank. This fueled speculative attacks against the dollar (speculators were betting on a major devaluation of the U.S. dollar), which made it even more difficult for foreign governments to support the United States. In May 1971—to cite the most egregious case, at least from the standpoint of the U.S.—Germany formally left the Bretton Woods system, because it was not willing to devalue the deutsche mark any further to support the dollar. The “Nixon shock” (as it was dubbed), therefore, was a surprise only in the sense that he failed to consult with any American allies before he suspended convertibility (Nixon also imposed a 10 percent tax on imports).

**Table 5.3. Trade Balance and Reserves for Germany and Japan, 1963–1969 (all figures in millions U.S.\$)**

|                           | 1963  | 1964  | 1965  | 1966  | 1967  | 1968  | 1969  |
|---------------------------|-------|-------|-------|-------|-------|-------|-------|
| Germany                   |       |       |       |       |       |       |       |
| <i>Trade Balance</i>      | 2,402 | 1,300 | 2,956 | 5,252 | 5,726 | 5,676 | 5,133 |
| <i>Change in Reserves</i> | --    | -133  | -617  | 418   | 329   | 1,332 | --    |
| Japan                     |       |       |       |       |       |       |       |
| <i>Trade Balance</i>      | -166  | 375   | 1,901 | 2,275 | 1,160 | 2,529 | 3,699 |
| <i>Change in Reserves</i> | 37    | 121   | 108   | -33   | -69   | 886   | 605   |

Source: *OECD Economic Surveys: Germany*, various years; *OECD Economic Surveys: Japan*, various years.

The collapse of the GES, or par value system, tells us that economic forces and processes cannot be ignored. It also tells us that hegemonic power has clear limits. The United States could not simply dictate the outcomes it wanted, although its influence was

certainly felt, and felt quite deeply. On this point, though, it bears repeating that the expansion and stability of international or global capitalism in the postwar period required new and strong frameworks—for finance, trade, and security. Without these frameworks it is not difficult to imagine that postwar economic recovery within the capitalist world would have taken much longer, been much more uneven, and remained dangerously unstable, just as it was for much of the first part of the 20<sup>th</sup> century. Creating these frameworks, even if imperfect, was therefore a critical task. But it was also a task that only a hegemonic power could effectively take on—although many scholars argue that the Nixon shock marked the end of American hegemony. This tells us, too, that an understanding of the postwar global financial system requires an examination of the intersection and interaction between politics and economics. Thus, just because the GES or the Bretton Woods system collapsed does not mean that, all of a sudden, politics and power no longer mattered. The shift to a floating or flexible exchange-rate regime (among the major economies), more specifically, did not mean that *pure* market forces had inserted themselves into and completely taken over the global financial system. This certainly was not the case, and even if it had been, it is important to remember that a free market rests on a political edifice. Indeed, the end of the GES did not even entail an immediate switch to a floating system; instead, for a couple more years, the global financial regime was based on an adjustable peg system. The floating exchange regime emerged in 1973.

Still, what exactly did the transition to a floating or flexible exchange-rate regime mean for the global financial system? What were the implications of this transition for the global economy and for individual countries? The next section will address these questions.

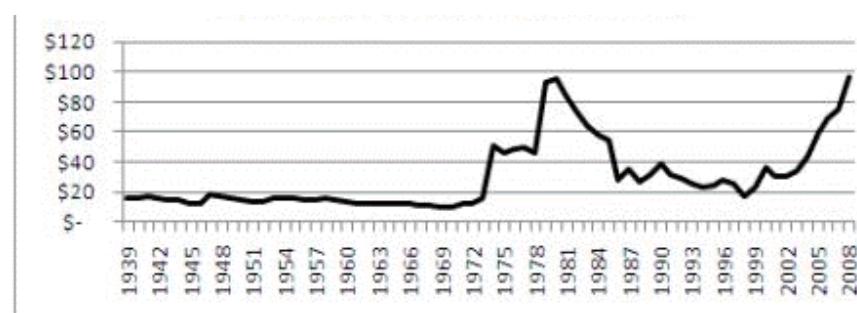
### *The Floating World*

Different exchange regimes, as you know, each have their advantages and disadvantages; there are always trade-offs. One of the most salient trade-offs, at the most general level, is between (relative) financial stability and instability, or volatility. In the 1970s, however, a significant degree of stability was maintained, in part because governments (and their central banks) continued to intervene in foreign currency markets to prevent overly large swings in the value of their currency. Moreover, there were no significant incidents of competitive devaluation, which might have sparked a trade war among the major economies. In fact, international trade continued to grow strongly throughout the 1970s, and cross-border investment began to take off since, without the need to maintain fixed rates, countries were more willing to loosen **capital control regulations**. Japan, for example, liberalized outward investment regulations for its banks in the early 1970s, which helped set the stage for an unprecedented expansion of outward or foreign investment beginning in the 1980s. In short, everything seemed to be going along smoothly. However, there was one contingent, but very important, development: the drastic increase in oil prices, the first of which took place in 1973–74, as a result of an embargo carried out by the Organization of Petroleum Exporting Countries (OPEC) against Western countries for their support of Israel during **Yom Kippur War**. (OPEC also reacted to the end of Bretton Woods by announcing that oil would be priced in terms of gold, rather than the U.S. dollar.) The details of this complex event are beyond the scope of this chapter. Suffice it to say that the embargo had a major impact worldwide, but also had the unintended effect of maintaining the status of the dollar as the world's top currency: because of the drastic increase in the price of oil, billions more dollars flowed into OPEC states—more than these

states could spend. This immense windfall of oil money—dubbed *petrodollars*—was deposited into Western banks, and then “recycled” largely in the form of loans to developing countries, which (ironically) were starved for hard currency as a result of the oil-price increases.

While the short-term effects of the switch to a floating or flexible exchange-rate regime seemed to cause little disruption, the longer-term effects have been much less innocuous. In some respects, the predictions of the fiercest pessimists

**Figure 5.4. Average Crude Oil Prices, 1939–2008 (in U.S.\$ at 2008 prices)**



Source: BP Statistical Review of World Energy. Permission is granted to copy, distribute and/or modify this document under the terms of the GNU Free Documentation License, Version 1.2 or any later version published by the Free Software Foundation.

have come to fruition. To wit, the global financial system has become extraordinarily volatile, unstable, and dangerous; it is increasingly fueled by speculation at a level that likely few people—even those familiar with the problems of the 1920s and 1930s—ever imagined was possible. Not everyone, of course, has been surprised by this. One scholar who has written extensively on the growing problems of the global financial system is Susan Strange, whose work was discussed in chapter 1. Strange (who passed away in 1998) wrote two fascinating books on the subject, *Casino Capitalism* (1986) and *Mad Money* (1998); although dated, both deserve careful reading by anyone interested in international political economy, and especially in the dynamics of the global financial system. In *Casino Capitalism*, Strange explained how a series of steps—decisions and nondecisions on the part of major state actors—laid the groundwork for a global financial system increasingly characterized by speculative activity; indeed, Strange asserted that global finance had become very similar to a game of chance, or gambling. Even more, Strange argued that the entire global financial system had become one huge casino, but unlike in regular gambling, the entire world is forced to play or at least bear the consequences of a losing bet.

One of the most important decisions leading to all this, according to Strange, was the “extreme withdrawal by the United States from any intervention in foreign exchange markets” after 1971 (Strange 1998, p. 6). In addition, at the domestic level, decisions by the U.S. government to begin a process of deregulation in the financial sector “freed” banks from their traditional activities of, well, banking (i.e., taking deposits and making loans); commercial banks became investment banks and increasingly started using their own capital in the global financial “casino.” In this regard, though, it might be better to call banks massive “institutional gamblers.” Strange, it is fair to say, was quite prescient, especially in light of the collapse of the U.S. housing bubble in the mid- to late 2000s, which was rife with all sorts of creative, but extremely risky investment vehicles. Still, not everyone would agree with Strange’s basic analysis, as Strange herself readily acknowledged: she devoted a whole chapter in *Casino Capitalism* on divergent views (chapter 3).<sup>21</sup> One thing, however, is

clear: speculative activity has increased significantly, a point that is partly evidenced by the radical increase in currency trading since the early 1970s: in 1973, daily foreign exchange trading averaged around \$15 billion; by 1998, this figure had grown to \$15 trillion. As Helleiner (2005) points out, the latter figure vastly exceeds the amount needed to service regular international trade and investment flows (p. 161), which strongly suggests that most currency trading since the 1990s has had little to do with basic or nonspeculative international economic activity.

### *Global Finance in the 1980s and 1990s: The Decline of Hegemony*

Recent developments in the global financial system are of obvious relevance to this chapter, but before covering these, it will be useful to go back to the 1980s and 1990s. This was a crucial period for a number of reasons. One particularly salient reason is this: the 1980s and 1990s marked a period of hegemonic decline, or at least erosion, in terms of the *economic* position of the United States. Japan and Germany, in particular, emerged as major economic competitors, and the formation and development of the European Union as a whole created a significant economic and political counterweight to the United States. In addition, this was a period in which significant parts of the hitherto marginalized developing world began to function more independently. OPEC is one prominent example, but there was also a more general (albeit far from radical) shift in the relations of power between the developed and developing world. As with OPEC, the shift was most evident in cases where developing countries were able to leverage their power through bargaining coalitions and other forms of collective action. In general, the decline or erosion of hegemony tells us that new modes of cooperation (e.g., a more significant role for multilateral institutions) would be necessary, but also that cooperation and coordination would be more difficult to achieve. The flipside to this would be the increasing likelihood of significant conflict between and among major state actors, but also among an increasing array of transnational and nonstate actors. To a significant extent, this is exactly what transpired.

The decline of U.S. economic dominance was clear. In a two-and-a-half-year period between 1980 and 1982, the U.S. experienced its deepest recession since the Great Depression, and despite a recovery beginning in 1983, the country began to run historically large current account deficits. In 1981, the U.S. had a current account surplus of \$6.3 billion, but in the following years the surplus turned into deficits of \$8.3 billion (1982), \$40.8 billion (1983), \$101.5 billion (1984), and \$124.3 billion (1985) (all figures cited in OECD 1986). This was after decades of a near balance in the current account for the U.S. Not coincidentally, as the U.S. current account *deficit* became larger and larger, the current account *surplus* for Japan and Germany grew dramatically, primarily because of growing trade imbalances. The trade imbalance, however, was not the only reason for the U.S. deficit. As the hegemon (even if in decline), the United States, from the very beginning of the postwar period, played and continues to play the role of “defender in chief” for the capitalist world (or in terms of the Cold War rhetoric still used today, the “Free World”). In other words, the U.S. not only built, but also continued to maintain, the postwar security framework at a very high cost throughout the 1980s and 1990s. Even at the end of the first decade of the 2000s, the United States pays for more than 22 percent of NATO’s budget, which was \$430.4 billion in 2010, and contributes another \$84.1 million (21.7 percent) to NATO’s civilian budget. In addition, the U.S. funds 22.2 percent of the NATO Security

Investment Program (NSIP) at highly variable amounts: in 2009, the figure was \$330.9 million and in 2010, \$197.4 million (Benitez 2011).

As long as foreign governments were willing to finance U.S. spending, however, there was nothing to prevent the overspending from continuing. In fact, in the first part of the 1980s, President Reagan encouraged greater domestic spending by increasing the military budget; Reagan also lowered taxes (thus putting more money into the pockets of ordinary U.S. citizens), which increased the national deficit. But to make sure that foreign governments and other investors would continue to buy U.S. debt, the Reagan administration had to maintain high interest rates—which, ironically, were originally put in place to slow domestic inflation and reduce demand. High interest rates attracted foreign investors because they offered an attractive return on investment. This policy worked: capital flowed into the U.S. Yet, this also caused the U.S. dollar to strengthen dramatically: between 1980 and 1985, the dollar appreciated 50 percent. But a stronger dollar meant less competitive exports, and, of course, a worsening trade balance. The ins and outs of this process can get confusing. The key point, though, is fairly clear: by the mid-1980s, the United States had lost its standing as the world's omnipotent economy. The U.S., instead, had become a debtor country with increasingly uncompetitive firms. Calls for protectionism began to ring out in the halls of Congress. American autoworkers—with their bosses' approval—began to smash Japanese cars, a symbolic act, but one that reflected American industrial decline rather than American power. (See figure 5.5, “Demons in the Parking Lot.”) A “Buy American” campaign gathered steam, and the domestic political situation within the U.S. was becoming untenable as a broad coalition of automobile and heavy equipment manufacturers, high-tech companies, grain exporters, labor unions, farmers, and others put pressure on the U.S. government. Things seemed very bad for the once unchallengeable hegemon. There was, however, a very bright spot for the U.S.—namely, the financial service sector. The 1980s saw the beginning of tremendous growth in this industry: between 1980 and 2006, the industry's share of total U.S. GDP went from 4.9 percent to 8.3 percent (Greenwood and Scharfstein 2013). Moreover, wages in the financial sector shot up: in 1980, the typical financial services employee earned approximately the same wage as workers in other industries; by 2006, however, financial services employees were earning an average of 70 percent more (cited in Greenwood and Scharfstein 2013, p. 4). The increasingly impactful financial services sector in the United States would come to play a very important role in the global financial crisis in the latter part of the 2000s.

### Figure 5.5. Demons in the Parking Lot

The following passage is an excerpt from the book *Buy American: The Untold Story of Economic Nationalism*, by Dana Frank (2000). It gives a palpable sense of the economic difficulties the United States began to experience in the 1980s:

The scene was like something out of a Batman cartoon. The first man lifted the sledgehammer, planted his feet wide apart, sighted over his left shoulder, and THWACK! sank it deep into the car with a grunt of pleasure. The crowd roared. The next man paid his dollar, swaggered up to the car, hefted the sledgehammer back and forth ... and suddenly WHAM! swung it into the car's front corner....

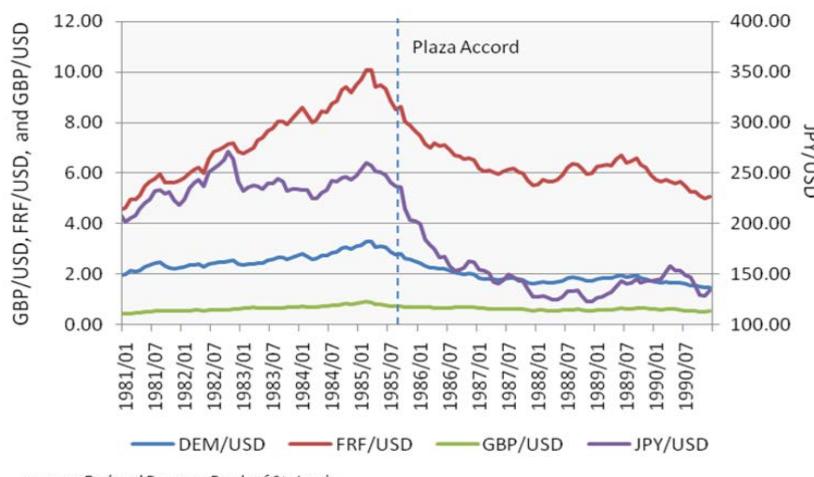
The object of their aggression was a Toyota, its assailants members of the United Auto Workers

at a union picnic in the 1980s. If the ILGWU's [International Ladies' Garment Workers' Union] "look for the union label" song burned itself into the memories of millions of TV watchers in the 1970s, even more emblematic of Buy American campaigns by the 1980s was the image of an unemployed auto worker in Detroit smashing a Japanese car. (p. 160)

While the difficulties faced by the United States in the 1980s were multifaceted, the switch to a floating exchange-rate regime certainly played a key role. Unlike in the interwar period, however, the United States did not follow the path of Smoot-Hawley; instead, the U.S. government opted for negotiations with the other G5 nations: the United Kingdom, France, West Germany, and Japan (see figure 5.7, "From the G5 to the G20," for a discussion of why only these countries initially met, and for a discussion of the evolution of the G5 into a larger "club"). In September 1985, ministers of finance and central-bank governors from the five countries met at the Plaza Hotel in New York City. The representatives all wanted to stifle the threat of protectionism, and therefore were able to reach an agreement that resulted in the gradual devaluation of the dollar against the yen, deutsche mark, and franc (see figure 5.6): over the following two years, the dollar depreciated by about 40 percent in relatively orderly fashion. The

agreement is known as the Plaza Accord. This did not turn the U.S. current account deficit into a surplus, but it did almost immediately lead to a rise in U.S. exports: in 1986, exports were up 8.2 percent; this was followed by increases of 13.8 percent, 18.3 percent, and 11.0 percent in 1987, 1988, and 1989 respectively (OECD 1991, p. 19). In 1987, the G5 (plus Canada and Italy) met again at the Louvre in Paris, France. This time, though, they wanted to put the brakes on the depreciation of the dollar. In addition, the seven industrial powers also wanted to improve coordination across a range of fiscal and macroeconomic policy areas beyond exchange rates, a task that was largely achieved, at least on paper. France agreed to reduce its budget deficits by one percent of GDP; Japan agreed to stimulus expenditures and tax cuts; Germany agreed to reduce public spending, cut taxes, and keep interest rates low; and the U.S. agreed to reduce its fiscal deficit and cut spending. There was also an attempt to rejigger the exchange-rate regime by introducing a target zone; this

**Figure 5.6. Foreign Exchange Rates, Major Currencies Before and After the Plaza Accord**



source: Federal Reserve Bank of St. Louis

Source: <http://www.research.stlouisfed.org/>. Permission is granted to copy, distribute, and/or modify this document under the terms of the GNU Free Documentation License, version 1.2, or any later version.

was a variant of the fixed-but-adjustable exchange-rate system (instead of the +/- one percent band of the par value system, this one used a +/- 10 percent band). Compared to the Plaza Accord, the Louvre Accord, as it is known, was far more ambitious. Unfortunately, but not surprisingly, the Louvre Accord did not work. A degree of stability was achieved for the first eight months, but after that the agreement was largely abandoned. Domestic economic and political concerns in the major countries, especially Germany, Japan, and the United States, trumped concerns for international cooperation (this helps underscore, once again, the value of two-level-game insights on the interconnectedness between international and domestic politics). Indeed, disagreements among the countries—particularly those between Germany and the U.S.—were, at times, quite intense. (At the same time, the value of the dollar did, for the most part, remain stable for a long period of time following the negotiations in Paris.)

### Figure 5.7. From the G5 to the G20

Why did the Plaza Accord originally include only five countries? While it is difficult to answer this question definitively, it is worth re-emphasizing a point made in chapter 2: in the early postwar years, the international system was thoroughly dominated by exclusive “clubs” of like-minded, economically powerful countries. The first of these clubs, according to Gordon Smith (2011), emerged in the aftermath of the collapse of the par value system. The first meeting occurred on March 25, 1973, when finance ministers from Britain, France, Germany, and the U.S. met and formed the Library Group, which was named after the venue of the initial meeting in the White House Library. A few months later, Japan was invited to join the club, and the Group of Five, or G5, was born. The G5 continued to meet on a periodic basis for the next decade or so, although Italy (in 1975) and Canada (in 1976) were invited to join the group, too, which led to the creation of the G7. (Canada, it should be noted, was added primarily to provide more geographic balance to the group—since Italy was added, the United States argued that Canada should be included as well.) The delayed inclusion of Italy and Canada, however, set them outside the core membership of the club. This is the most likely reason only five countries were included in the Plaza Accord meetings. Indeed, in the initial follow-up meeting at the Louvre, Italy and Canada were excluded; it was only after an agreement was reached among the five original members that the two latecomers were invited. This did not sit well with the Italian finance minister, who ended up leaving the meeting midway (Oba 2007). To avoid a recurrence of hurt feelings, subsequent meetings all included the expanded list of seven member countries. After the breakup of the Soviet Union, Russia was invited to participate, first on a selective basis and then as a full-fledged member in 1997. Thus, the G7 became the G8. Russia’s inclusion, it is useful to add, was something of a risk. The genesis of the club stipulated that all members, despite differences in policy, shared the same basic characteristics and values—i.e., they had to be market-based liberal democracies. The hope was that, by allowing Russia to join, it would eventually embrace the same set of values (Smith 2011).



As Smith (2011) notes, the exclusivity and elitist character of the club, however, became increasingly hard to justify over time, both for practical and ideological reasons. By the late 1990s, then, an effort—led by Canadian finance minister Paul Martin and U.S. Treasury secretary Lawrence Summers—was begun to expand the membership. One proposal called for increasing membership to 33, while another proposed expanding to 22 members. In the end, a slightly smaller number was selected; thus, in December 1999, the G20 was established. This did not mean, however, that the G8 would be disbanded; instead, the G20 was made into a separate (but not necessarily equal) club, while the G8 continued to hold its own, exclusive meetings. This, too, became less and less tenable, especially with the economic rise of China. Understanding that the unrepresentative nature of the G8 was becoming a burden, the chair of the 2005 G8 Summit, UK prime minister Tony Blair, invited five additional countries to the meeting: China, Brazil, India, Mexico, and South Africa. The 2007 summit regularized the relationship between the “G8+5,” but the new format was perceived as insulting. Paul Martin (the Canadian prime minister) nicely summed up the issue:

the image of Hu Jintao, the president of China, and Manmohan Singh, the prime minister of India —leaders of the two most populous countries on earth, quite possibly destined to be the largest economies on earth within our lifetimes—waiting outside while we held our G8 meetings, coming in for lunch, and then being ushered from the room so that we could resume our discussions among ourselves, is one that stayed with me.... Either the world will reform its institutions, including the G8, to embrace these new economic giants, or they will go ahead and establish their own institutions. (cited in Smith 2011)

In sum, the evolution of the G5/G7 is a microcosm of changes in the global political economy. It reflects the exercise of power in the global economy, and how changes in the distribution of power may compel, but do not always immediately lead to, institutional changes.  
*Image. A group photo of G7 finance ministers and central-bank governors during meetings at the U.S. Treasury Department on April 11, 2008.*

*Source: IMF Staff Photograph/Stephen Jaffe. The photo is in the public domain.*

### *The Rise of Neoliberalism: A New Social Reality*

Underlying the concrete problems with the foreign exchange regime was a significant shift in thinking about the nature of the relationship between the state and market. In chapter 1, the debate between Keynesians and followers of Hayek was discussed; up until the early 1970s, Keynesians were the clear winners (after Nixon took the U.S. off the gold standard, for example, he is reported to have said, “I am a Keynesian now” [*New York Times*, January 4, 1971]). But just a few years later, things had started to change, although a change had been in the works for some time: put most simply, neoliberalism was on the rise. The intellectual guru most closely associated with the rise of neoliberalism, however, was not Hayek (see figure 5.8, “Masters of the Universe and the Birth of Neoliberalism”) but instead was Milton Friedman, who was then teaching at the University of Chicago (the term *the Chicago boys* is sometimes used to refer to the neoliberal movement led by Friedman and a group of like-minded economists). No doubt, a big reason for the changes that were beginning to take place stemmed from a worsening economic environment. As David Harvey explains it, by the end of the 1960s, “[s]igns of a serious crisis of capital accumulation were everywhere apparent. Unemployment and inflation were both surging everywhere, ushering in a global phase of ‘stagflation’ that lasted throughout much of the 1970s. Fiscal crises of various states (Britain, for example, had to be bailed out by the IMF in 1975–76) resulted as tax revenues plunged and social expenditures soared. Keynesian policies were no longer working” (12). Actually, it is more accurate to say that the signs of serious crises were in many places, but not everywhere. Among the major economies, Japan and Germany were doing fine, while the U.S. and the United Kingdom were suffering from serious financial strains. Thus, it is no surprise that the shift in thinking was most evident in the latter two countries, with President Reagan and Prime Minister Margaret Thatcher leading the charge.

#### **Figure 5.8. Masters of the Universe and the Birth of Neoliberalism**

Daniel Stedman Jones (2012), in his book *Masters of the Universe*, points out that neoliberalism is an essentially transatlantic—as opposed to primarily American—phenomenon. Indeed, the origins of neoliberalism (which he defines as “the free market ideology based on individual liberty and limited government that connected human freedom to the actions of the rational, self-interested actor in the competitive marketplace” [p. 2]) can be traced to the 1920s, and the Austrian and German Freiburg (also known as ordoliberal) schools. The most prominent neoliberals in this early period were all Europeans: Friedrich Hayek, Alexander Rüstow, William Röpke, Jacques Rueff, Michael Polanyi, and, more prominently perhaps, Ludwig von Mises (p. 6). In this early period, however, the appeal of neoliberalism remained limited. After the end of World War II (which marks the beginning of the second phase of neoliberalism), the mantle of neoliberalism was taken up again, and the most stalwart advocate was Friedrich Hayek, part of the Austrian school, who founded the Mont Pelerin Society (MPS) in 1947. The society (which first met at Mont Pelerin, near Montreux, Switzerland) was devoted to the “exchange of ideas between like-minded scholars in the hope of strengthening the principles and practice of a free society and to study the workings, virtues, and defects of market-oriented economic systems” (<https://www.montpelerin.org/>).

The MPS became a hub for neoliberal thought, attracting, as it did, the leading neoliberal thinkers of the day, including the American economist Milton Friedman. Friedman, in fact, became an important

bridge between the first and second phases of neoliberalism and “between the concerns of the predominantly European founding figures ... and a subsequent generation of thinkers, mainly though by no means all American, located especially in Chicago and Virginia” (pp. 6–7).

From the 1950s to the early 1980s (until the rise of Thatcher in the UK and Reagan in the U.S.), the influence of the MPS and of neoliberalism slowly, but inexorably, grew. It was toward the last part of this period that neoliberalism developed into a recognizable group of ideas and a veritable movement (p. 7). The third and current phase, according to Jones, includes neoliberalism’s ascendancy during the Reagan and Thatcher period, during which time neoliberal ideas moved from the periphery to the center of the global political economy, as they became embedded in domestic national politics throughout the world, and into many global institutions, including the IMF, the World Bank, and the WTO (p. 8).

What happened, however, was more than a simple shift in thinking; instead, it was, at least to some analysts, a revolutionary change in understanding the common-sense relationship between the state and market, or among the state, market, and society. Following the ideas of Antonio Gramsci, Harvey (2005) tells us that common sense—defined as “the sense held in common”—is a social construction; it is the product of “cultural socialization often rooted deep in regional or national traditions” (p. 39). Common sense helps to define our social realities. Prior to the 1970s, the common sense was **embedded liberalism**, which was premised on an understanding that market processes and entrepreneurial and corporate activities should be grounded or embedded in a larger social context. In this view, the regulation and management of the market, and the active protection of society through, for example, social welfare programs, was taken for granted. That common sense has been replaced by neoliberalism, which tells us most generally that markets *need* to be liberated from state intervention and that society *needs* to be made more open to the logic of the market, rather than to be protected from markets. How this transition in common sense was achieved is a complicated story and too much to cover in this chapter.<sup>22</sup> For our purposes, it is enough to say that the ideological transition to neoliberalism was accompanied by a series of concrete policy changes: privatization, marketization (of areas not yet governed by market processes—see figure 5.9, “Marketization of the U.S. Military”), deregulation, tax cuts, the reduction of social welfare programs, and so on. In the global financial system, deregulation has been the most salient and far-reaching change: it has “freed” capital and led to significant financial innovations, which have not only produced denser and more sophisticated global interconnections than ever before, but also new kinds of financial markets based on **securitization, derivatives**, and all manner of futures trading: neoliberalization has meant, in short, the financialization of everything (Harvey 2005, p. 33).

### Figure 5.9. Marketization of the U.S. Military: An Example

Marketization, most simply, is the process of turning anything into a product that can be sold in markets. Consider the military. For a long time, the military was considered to be outside the domain of markets (even if the separation was never entirely complete). In the United States, however,

military functions have been increasingly marketized since the early 2000s. When the U.S. defeated the Iraqi army in 2003, for example, at least one out of every ten people deployed in the theater of conflict—doing work that traditionally had been done by soldiers—was an employee of a private

security company. In the occupation that followed, this number increased: by May 2004, there were more than 20,000 private security personnel in Iraq employed by some 25 different private security companies (Avant 2006), one of the best-known of which was Blackwater USA. Indeed, Blackwater employees even provided security for top U.S. officials in Iraq during the occupation: L. Paul Bremer, who served as the administrator of the Coalition Provisional Authority of Iraq following the 2003 invasion (until June 2004, when sovereignty was transferred from the U.S. government



back to the Iraqi government). Blackwater was paid \$21 million to guard Bremer over an 11-month period, but the company also had a five-year \$320 million contract with the U.S. State Department to provide security for U.S. officials in conflict zones around the world. In 2006, Blackwater won the contract to protect the U.S. embassy in Iraq, which is the largest American embassy in the world (<http://www.corpwatch.org/section.php?id=210>).

*Image: Iraqi Prime Minister Ayad Allawi (left), Ambassador L. Paul Bremer, and President Sheikh Ghazi Ajil al-Yawar make their farewells after a ceremony celebrating the transfer of full governmental authority to the Iraqi Interim Government, June 28, 2004, in Baghdad, Iraq. Although not indicated, it is likely the Blackwater personnel are trailing behind the three leaders.*

*Source: U.S. Air Force photo by Staff Sgt. Ashley Brokop. The image is the work of a U.S. government employee, taken as part of that person's official duties. As a work of the U.S. federal government, the image is in the public domain.*

Neoliberalism generally, and the deregulation of the financial sector (domestically and globally) more specifically, produced, in the views of many observers, breathtaking results. By the mid-1990s, all the economic problems of the 1970s were nothing but distant memories, especially in the United States and the United Kingdom. But one can argue that the positive effects were much more widely felt as well throughout much of the developing world, including, most prominently, in China. In the United States, almost all the credit was given to Reagan's neoliberal vision. Consider how Peter Ferrara, writing for *Forbes* magazine, described the success of neoliberalism:

[Reagan's] economic policies amounted to the most successful economic experiment in world history. The Reagan recovery started in official records in November 1982, and lasted 92 months without a recession until July 1990, when the tax increases of the 1990 budget deal killed it. This set a new record for the longest peacetime expansion ever, the previous high in peacetime being 58 months. During this seven-year recovery, the economy grew by almost one-third, the equivalent of adding the

entire economy of West Germany, the third largest in the world at the time, to the U.S. economy. In 1984 alone real economic growth boomed by 6.8%, the highest in 50 years. Nearly 20 million new jobs were created during the recovery, increasing U.S. civilian employment by almost 20%. Unemployment fell to 5.3% by 1989 (2011, n.p.).

## Crises and the Global Financial System

Not all was well, however. Particularly on the credit side of the global financial system, serious problems were beginning to emerge. The first hint of trouble began in the 1970s, but the real difficulties began in the early 1980s, with the Mexican debt crisis of 1982. This was shortly followed by a string of debt crises throughout Latin America, leading to what has been labeled the “Lost Decade” for the entire region. Moving into the 1990s, the bad news kept coming: Japan suffered from an **asset price bubble**, which collapsed in 1990, while Mexico experienced another crisis, this one centered on its currency, which was aptly called the Mexican peso crisis (1994–95). These were followed by the Asian financial crisis of 1997–98 (primarily affecting Thailand, Indonesia, Malaysia, and South Korea), the Russian financial crisis of 1998, and a string of crises in Brazil, Turkey, and Argentina at the end of the decade and into the first few years of the new millennium. Towards the end of the first decade of the 2000s, of course, the world was struck by a global financial crisis, but this time the principle victims were in the developed world, including the United States and much of Western Europe. Crises have become so common, in fact, that it might be said that the global financial system has been in a perpetual state of crisis since the early 1980s. All of this tends to support the analysis by Susan Strange, discussed earlier: the global financial system appears to have become extremely unstable and volatile. Whether it is a giant casino, or whether another metaphor provides a better description, it behooves us to take a closer look.

### *The Debt Crises of the 1980s*

Despite some success stories in the developing world, in the 1980s, a new type of problem emerged: an international debt crisis (more accurately, a series of debt crises striking a range of developing countries). The oil shocks of the 1970s, discussed earlier, helped to lay the groundwork for these crises by releasing vast sums of money into international financial markets—money that had to go somewhere in order for banks to earn profits. Much of this money found its way into the developing world, some of which was used to finance oil imports (although, contrary to conventional wisdom, only parts of the developing world were severely affected by this), and some of which was used to invest in industrialization. This sounds reasonable, but it was—at least according to some scholars—a recipe for disaster. First, a brief discussion of some details is in order. Between 1972 and 1981, external debt in the developing world increased six-fold to around \$500 billion. The most indebted countries—in terms of total external debt as a proportion of GDP—were primarily in Africa and Latin America. In 1982, for example, Brazil and Mexico had, respectively, external debt obligations of \$93 billion and \$86 billion with debt-to-export ratios of 447.3 percent and 311.5 percent. (The debt-to-export ratio is the total amount of debt in comparison to the total annual exports; it provides a rough measure of the capacity of a country to repay its external debt obligations; anything over a 100 percent is high.) The

extremely high debt-to-export ratios, as well as high **debt-service** ratios (see table 5.4) underscore an important and fairly obvious point: very much like in the housing bubble in the United States—also referred to as the subprime mortgage crisis—a lot of the loans made to developing countries in the 1970s were subprime (subprime loans are those given to borrowers with a tarnished or limited credit history).

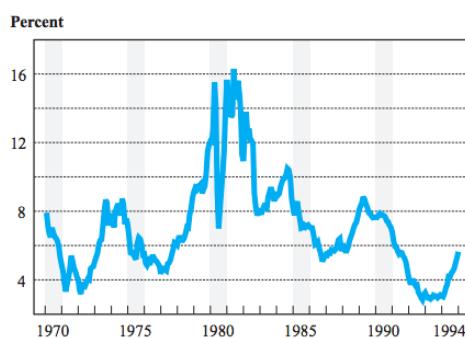
**Table 5.4. External Debt and Debt Ratios for Selected Countries in Latin America, 1982 (U.S.\$ billions)**

|           | Total Debt | Debt-Export Ratio (%) | Debt Service Ratio (%) |
|-----------|------------|-----------------------|------------------------|
| Argentina | \$43.63    | 447.3                 | 50.0                   |
| Brazil    | \$92.99    | 396.1                 | 81.3                   |
| Chile     | \$17.31    | 335.9                 | 71.3                   |
| Colombia  | \$10.30    | 204.3                 | 29.5                   |
| Mexico    | \$86.02    | 311.5                 | 56.8                   |
| Peru      | \$10.71    | 255.9                 | 48.7                   |
| Venezuela | \$32.15    | 159.8                 | 29.5                   |

Source: World Bank, *World Debt Tables, 1992–93, Vol. 2: Country Tables* (Washington, D.C., IRBD, 1992)

All this bad lending eventually led to situations in which a number of countries could not pay back their debts. The first big case was Mexico in 1982, but there were clear harbingers well before that: between 1976 and 1980, Zaire, Argentina, Peru, Sierra Leone, Sudan, and Togo all experienced serious difficulties. However, Mexico's announcement—on August 12<sup>th</sup>, 1982, Mexico's minister of finance told the U.S. government and the IMF that it would no longer be able to service its debt (i.e., pay the interest and principal on the scheduled due date)—opened the floodgates. By October 1983, another 26 countries, owing a total of \$239 billion, were forced to **reschedule** their debts (or were in the process of doing so), with many others to follow. Of the first 27 countries, 16 were located in Latin America, and the four largest—Mexico, Brazil, Venezuela, and Argentina—owed approximately \$176 billion to commercial banks, including \$37 billion to just eight U.S. banks. For these eight banks, it is useful to note, the \$37 billion in loans accounted for about 147 percent of the capital and

**Figure 5.10. Monthly Treasury Bill Rate (3-Month), 1970–1994**



Source: FDIC (1997), p. 205. Original source is Haver Analytics.

reserves at the time, meaning that they all faced the prospect of insolvency if the loans defaulted (all figures cited in FDIC 1997, v. 1, p. 191). The fact that the most serious problems began to appear in the early 1980s is tied to the manner in which the loans were structured: about two-thirds of outstanding developing-country debt was tied to a *floating LIBOR*, or the London Interbank Offering Rate (FDIC 1997, v. 1, p. 195). Thus, when interest rates shot up to record levels in the early 1980s (see figure 5.10)—a product of U.S. Federal Reserve efforts to curb oil-based inflation—debt-service costs to developing countries quickly became unmanageable.

So why were so many “bad” loans made? Needless to say, there are various competing answers, which largely parallel the arguments commonly heard about the subprime mortgage crisis in the United States. The main arguments can be neatly classified in the following manner: (1) irresponsible and greedy lenders; (2) irresponsible and corrupt borrowers; and (3) systemic problems (Cohn 2011, pp. 344–47). The first two arguments lay the blame on individual actors and strongly suggest that, without “bad actors,” there would have been no problem (which begs the question of whether deregulation of the global financial system was the main issue). These actor-centered arguments, however, are difficult to accept, at least as complete explanations, given the pervasiveness of the international debt crisis in the 1980s, and the fact that debt crises have become a lasting and recurring problem in the global financial system for the last three decades (more on this shortly). Thus, there are almost certainly systemic factors at play. In addition, we have to consider the issue of (structural) power and interests, and how political considerations more generally play a central role in the global political economy.

From a Marxist or neo-Marxist perspective, the explanation is fairly clear: the system is rigged to ensure that the developing world remains in a subservient and dependent position, and to maximize exploitative processes for capital accumulation among the core economies. The foreign debt regime, in particular, is designed so that the developing countries never get out of debt, and never develop significant economic autonomy. To see this, consider the fact that the commercial bankers knew well in advance that continued lending to the developing countries was unsustainable. In 1969, for example, the journal of the American Bankers Association warned, “Many poor nations have already incurred debts past the possibility of repayment.... International loans, even if made on ‘businesslike’ terms, have a way of getting lost *unless they are repaid out of the proceeds of additional loans*” (emphasis added; cited in Payer 1991, p. 69). The last part of the statement is quite telling—and prophetic—because this is precisely what happened. In Latin America, the region began exporting capital to the core economies in 1982, despite receiving a continuing inflow of capital from Western banks and other sources. This included loans from the eight largest U.S. banks, which were threatened with insolvency by the Mexican and related debt crises in the early 1980s: from 1983 to 1989, their lending to developing countries (not just Latin America) averaged \$52.9 billion a year for a total of \$370.5 billion (FDIC 1997, v. 1, p. 197; author’s calculations). Latin American countries received \$49.6 billion in loans in 1983, yet they ended up transferring \$66.3 billion (in interest and amortization) back to the West that same year. Payer (1991) estimates that, for Africa, the net transfer became negative in 1984, and for East Asia, 1986 (p. 14). If this were just a temporary or short-term phenomenon (or limited to a small set of countries), it would not necessarily mean much. But this has not been the case: it continued through the 1990s and into the 2000s. In 2007, a peak net transfer of financial resources from the developing world to the developed was

reached: approximately \$881 billion (UN DESA 2011, p. 69), although this figure did decline to “only” \$557 billion in 2010.

**Table 5.5. Net Transfer of Financial Resources to Developing Economies, 1998–2010 (billions U.S.\$)**

|                                   | 1998       | 1999        | 2000        | 2001        | 2002        | 2003        | 2004        | 2005        | 2006        | 2007        | 2008        | 2009        | 2010 <sup>†</sup> |
|-----------------------------------|------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------------|
| <b>Developing Economies (All)</b> | <b>-41</b> | <b>-128</b> | <b>-194</b> | <b>-164</b> | <b>-210</b> | <b>-302</b> | <b>-379</b> | <b>-597</b> | <b>-807</b> | <b>-881</b> | <b>-876</b> | <b>-545</b> | <b>-557</b>       |
| Africa                            | 2.9        | 1.6         | -31.7       | -16.4       | -4.2        | -16.1       | -34.5       | -79.4       | -108        | -101        | -99         | 2.9         | -35.3             |
| East and South Asia               | -130       | -140        | -123        | -121        | -149        | -176        | -183        | -265        | -386        | -530        | -481        | -427        | -533              |
| Western Asia                      | 34.5       | 2.7         | -35.3       | -29.7       | -23.2       | -46.4       | -76.3       | -144        | -175        | -144        | -222        | -48.4       | -112              |
| Latin America and Caribbean       | 41.5       | 7.7         | -4.2        | 2.5         | -33.6       | -64.3       | -85.4       | -111        | -138        | -106        | -73.5       | -72.1       | -56.1             |

\* Figures are rounded † Figures for 2010 are estimates

Source: UN DESA (2011, p. 71), based on IMF, World Economic Database, October 2010 and IMF, Balance-of-Payments Statistics

**Table 5.6. External Debt Stock of Developing Countries and Key Ratios, 2005–2010 (billions U.S.\$)**

|  | 2005           | 2006           | 2007           | 2008           | 2009           | 2010           |
|--|----------------|----------------|----------------|----------------|----------------|----------------|
| <b>Total External Debt Outstanding</b> | <b>2,514.1</b> | <b>2,675.3</b> | <b>3,220.5</b> | <b>3,499.2</b> | <b>3,639.6</b> | <b>4,076.3</b> |
| Ratios                                 |                |                |                |                |                |                |
| External Debt to GNI (%)               | 26.6           | 23.9           | 23.2           | 21.0           | 22.4           | 21.0           |
| External Debt to Exports (%)           | 75.9           | 66.1           | 65.6           | 9.3            | 77.0           | 68.7           |

Source: World Bank Debtor Reporting System and IMF; cited in World Bank (2012), p. 2.

These figures, combined with the statistics on total outstanding debt (see table 5.6), are astounding. They tell us that the developing world—barring truly radical changes in the global economy—will *never* be able to pay off or even pay down its outstanding debt. They also tell us, and even the harshest critics of Marxism might have to agree, that the developing world will likely forever remain unhealthily dependent on capital and markets in the developed world. Even more astounding, perhaps, is that the proposed solutions have only made the problem worse for the vast majority of developing economies (the figures in table 5.6 are clear testament to this). The most damaging “solution,” again from a neo-Marxist perspective, is obvious: liberalization, and more specifically the imposition of the neoliberal model on the developing world. This was manifested in the so-called **Washington Consensus**, which describes a set of neoliberal economic policy prescriptions that became the standard reform package used by the IMF and the World Bank in dealing with the debt crisis in the developing world. It was first applied to Latin American countries, and included trade liberalization, currency devaluation, liberalized capital markets,

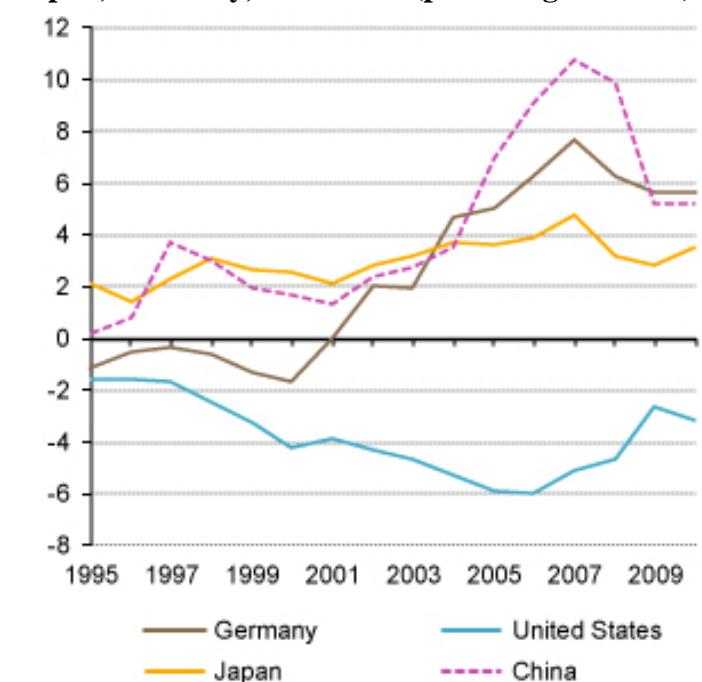
privatization, deregulation, fiscal austerity (i.e., a reduction in government spending), and tax reform. These policies also became the basis for IMF conditionality. The logic was simple: by liberalizing their economies and practicing greater fiscal discipline, developing countries would reduce their current account deficit, grow their economies faster, and be in a much better position to service and eventually pay off their external debt. This has clearly not been the case. Thus, while both critics and advocates of the Washington Consensus (or of conditionality) have plenty of examples they can trot out to support their respective positions, there is almost no doubt that the debt problem—and other indications of financial instability—are continuing to grow in the developing world.

Politically, however, the debt and currency crises in the developing world have proven to be quite successful: they have, according to critics, provided the IMF (and powerful actors within the U.S.) a useful pretext for expanding neoliberalism to most of the world. Thanks in part to conditionality, the promise of neoliberal *globalization* has come closer and closer to fruition, as virtually the entire world is now integrated into global markets for capital and trade. Of course, conditionality is only one mechanism used to advance neoliberal globalization—there are also emulation effects, as countries, such as China, see the voluntary embrace of some neoliberal policies as beneficial. Whether this is for good or bad, of course, is subject to intense and probably never-ending debate. Liberal economists tell us that liberalization—despite the inevitable ups and downs—maximizes the efficient use of resources, and therefore maximizes prosperity for the greatest number of people. Critics of the liberal view, neo-mercantilists and Marxists, tell us that liberalization is ultimately about the unequal distribution of power in the world, whether exercised by states-as-actors or by class actors, and is designed to maximize exploitation. Who is right? While the discussion here has admittedly been slanted toward the latter view, one thing is certain: power, politics, and economics always intersect in the global political economy.

#### *Trade Imbalances, the U.S. Housing Bubble, and the Global Financial Crisis*

For a long time, at least from the perspective of many people who live in core economies, the debt and currency crises in the developing world could be looked at with a fair degree of detachment. The developing world, after all, was different. Developing economies still had a lot to learn, and still had much to do to fully develop their markets. Their economic difficulties, in short, were symptomatic of immature market systems. To be sure, there have been plenty of significant financial crises in core economies in the postwar period—Black Monday in the UK (1987), the savings-and-loan crisis in the U.S. (1989–91), Black Wednesday in the eurozone (1992–93), the Long-Term Capital Management bailout (1998), and the dot-

**Figure 5.11. Current Account Balance: the U.S., Japan, Germany, and China (percentage of GDP)**



Source: UNCTADstat, <http://unctad.org/en/Pages/Statistics.aspx>

com collapse (2001), among others—but these have, to some extent, been viewed as anomalies. That is, they have been viewed as relatively isolated one-off events, different in character than the debt and currency crises afflicting the developing world in the 1980s and 1990s. To the extent that core countries suffered from long-term, debilitating problems—such as Japan experienced throughout the 1990s and into the 2000s—it was simply because, argued advocates of liberal economic theory, those countries had not embraced market principles strongly or closely enough. The global recession of 2008–2012 (including the **sovereign wealth** or **eurozone crisis**), however, has helped to dispel the notion that market liberalization offers a panacea. Indeed, the global recession has caused many analysts and observers (although certainly not all) to question the “common sense” of neoliberalism.

In retrospect, there were plenty of warning signs, not the least of which was the string of smaller, but still significant financial crises sweeping through the entire world (in developing and developed economies alike) for several decades. But there were more specific indicators, too. In the United States, the current account—which showed a surplus in 1991, but then quickly went back to a deficit—steadily worsened over the rest of the decade and into the mid-2000s, reaching a record high of 6 percent of GDP in 2006. For the U.S., large (even massive) current account deficits do not always lead to immediate problems. The basic reason, discussed several times already, is clear: the attractiveness of U.S.-issued securities (i.e., bonds, notes, and T-bills) means that the United States has easily been able to finance its current account deficits through foreign savings. This is a luxury few other countries have. There is, however, an important flip side to the large and persistent U.S. current account deficit: equally large current account surpluses in countries that are major trading partners of the U.S. These surpluses, in turn, typically lead to a significant amount of savings, which is partly indicated in the growth of foreign exchange reserves. This was quite evident in the case of China, which ran a current account surplus of \$353.2 billion in 2007, and increased its total reserves to \$2.1 trillion (as discussed below, there were other reasons why China’s foreign exchange reserves suddenly shot up after 2005). That same year, Japan had foreign exchange reserves of almost \$1 trillion, while Germany’s was just below \$900 billion. In other words, just as with the OPEC oil crisis (or oil-pricing boom, depending on your perspective), there was a lot of excess or surplus cash lying around in certain parts of the world. Much of this was, to repeat, used to finance the U.S. current account deficit. On the surface, this was a win-win situation: both the U.S. and its major trading partners clearly benefited from what appeared to be a completely reciprocal financial relationship. Still, the very large and persistent deficits in the U.S. were problematic, not just for the United States, but also for the global financial system as a whole.

Within the United States, the deficits of the 2000s led to renewed calls for protectionism. Unlike in the 1980s, though, the primary target of groups in the United States was China, which was most prominently labeled a **currency manipulator**, and was accused of recklessly violating the norms of international trade. Tensions between the two countries, as McKinnon (2012) describes it, increased significantly during the decade, with the U.S. senator Charles Schumer at one point threatening to impose punitive tariffs of 27.5 percent on all Chinese goods through a cosponsored bill (p. 38)—although this particular measure was later determined to be illegal under WTO standards (and, ironically, because China joined the WTO in 2001, the U.S. could not unilaterally impose protectionist measures against China). Nonetheless, the Chinese government finally relented in July 2005, and

began to allow a slow appreciation of renminbi (RMB) against the dollar at about 6 percent a year until July 2008 (p. 36). This policy shift led to a sudden influx of foreign capital into China as investors bet on a stronger RMB in the future (p. 37)—this was another reason for China’s huge increase in foreign exchange reserves. The stronger RMB, however, did not result in a decline in China’s current account surplus; instead, it continued to climb, reaching \$800 billion in 2010. It is apparent, then, that exchange-rate policy, by itself, does not necessarily correct for current account imbalances within the context of a globalized financial system (MacKinnon and Schnabl 2012). There is, in short, no easy fix to the trade and current account imbalances that have plagued the U.S. since the mid-1990s.

What does any of this have to do with the global financial crisis? Oatley (2012) provides a simple explanation: “The connection between imbalances and the financial crisis lay in the flow of cheap and plentiful credit from surplus countries to the United States at an unprecedented rate. The ability to borrow large volumes at low interest rates [after the dot-com bubble, the U.S. Federal Reserve cut short-term interest rates from about 6.5 percent to 1 percent] created credit conditions that typically generate asset bubbles” (p. 237). In the U.S., the bubble emerged in the real estate market, and first began to appear in the early 2000s. Table 5.7 provides some basic statistics, but the numbers are very clear: between 2001 and 2006, new mortgage originations totaled \$18 trillion, an average of \$3 trillion a year. In 1990, by contrast, new mortgage originations were only \$459 billion, and in 2000, \$1.14 trillion. The doubling, trebling, and (in 2003) quadrupling of mortgage lending over the space of a few years suggests that there was a vast and seemingly unlimited reservoir of “cheap” money available. But for mortgage lenders and others with access to those funds, there was a problem: the traditional customer base for home mortgages was much too small to absorb all that cheap money. Most simply, this is what led to a lowering of underwriting standards (as well as to a significant increase in refinancing). That is, to maximize profits, lenders had to dramatically expand their pool of customers; they did this by lending to homebuyers who had generally not had easy access—or any access at all—to the mortgage market. The lowering of underwriting standards is evidenced in the growth of subprime and Alt-A, or limited documentation, loans (see table 5.7 for a definition of Alt-A loans): from 2001 to 2003 nonprime (that is, subprime and Alt-A) loans constituted less than 16 percent of all mortgage originations, but in 2004, that figure more than doubled to 37 percent; in 2006, virtually half of all new loans were nonprime. In addition to lowering underwriting standards, the average difference in mortgage interest rates between nonprime and prime mortgages declined from 2.8 percent in 2001 to just 1.3 percent in 2003—this was almost completely contrary to past norms, since the decline in the gap between nonprime and prime loans coincided with increased risks in terms of the creditworthiness of borrowers (Bianco 2008, pp. 6–7).

**Table 5.7. U.S. Mortgage Originations, 2001–2006 and Selected Years (in billions)**

|      | Mortgage Originations<br>(Total) | Subprime | Alt-A | HELOC | % Nonprime |
|------|----------------------------------|----------|-------|-------|------------|
| 1990 | 459                              | N/A      | N/A   | N/A   | N/A        |
| 2000 | 1,139                            | N/A      | N/A   | N/A   | N/A        |

|      |       |     |     |     |    |
|------|-------|-----|-----|-----|----|
| 2001 | 2,215 | 120 | 60  | 130 | 14 |
| 2002 | 2,885 | 185 | 67  | 170 | 15 |
| 2003 | 3,945 | 310 | 85  | 220 | 16 |
| 2004 | 2,920 | 530 | 185 | 355 | 37 |
| 2005 | 3,120 | 625 | 380 | 365 | 44 |
| 2006 | 2,980 | 600 | 400 | 430 | 48 |

Notes: An Alt-A loan is a type of nonprime loan; it falls between the prime and subprime loan classifications. Borrowers typically have clean credit histories, but other risk factors are present, including (1) high loan-to-income ratio; (2) high loan-to-value ratio (e.g., these loans typically have minimal down payments), and (3) inadequate documentation of the borrowers income. HELOC stands for home equity line of credit.

Sources: Figures for 1990 and 2000 are from U.S. Census, “Table 1194. Mortgage Originations and Delinquency and Foreclosure Rates,” available at <http://www.census.gov/compendia/statab/2012/tables/12s1194.pdf>; figures for 2001–2006 are from *Inside Mortgage Finance*, cited in Acharya, Richardson, Neeuwerburgh, and White (2011), p. 36.

The lowering of underwriting standards was only part of the problem. After 2003, the market began to shift from “financing mortgages with regulated securitization to using unregulated securitization” (Levitin and Wachter 2012, p. 1182). Mortgage securitization—combining mortgages into one large pool and then marketing different tiers of this pool as separate securities backed by the cash flow from the original loans—has long been a common practice. Until 2003, though, the vast majority of mortgage securitization was done through the government-sponsored entities known as Fannie Mae, Freddie Mac, and Ginnie Mae.<sup>23</sup> This began to change as banks and other financial institutions invented new and “exotic” types of mortgage-backed securities; this, in turn, led to the creation of credit default swaps (or credit derivative contracts), which were designed to transfer the credit exposure of fixed income products (e.g., mortgage-backed securities) between parties. Ostensibly, credit default swaps reduced or insured risk—which is why they were sold by insurance/financial companies, such as AIG (American International Group)—by providing credit protection to the buyer. But this protection was only meaningful as long as the real estate bubble could be maintained. All bubbles, however, eventually burst, and when the housing bubble did, the consequences were not only immense for the United States, but also for the entire global financial system.

The most salient effects centered on the dramatic decline in housing prices in the U.S., which by mid-2009 had fallen 33 percent from the peak. But the decline in housing prices was only the tip of the iceberg. Not surprisingly, home foreclosures shot up, unemployment increased dramatically, and U.S. stock markets (e.g., the Dow Jones, NASDAQ, and the S&P 500) plunged. The decline in U.S. stock markets then led to significant declines in stock markets around the world. More importantly, because firms and investors in many other countries, especially in Europe, Japan, and China, were heavily invested in mortgage-backed securities and credit default swaps—international investors owned one-third of U.S. mortgages in some form (Cox, Faucette, and Lickstein 2010, p. 4)—the collapse of the U.S. housing bubble had a direct effect outside the United States. Even more, when the prices for mortgage-backed securities fell, investors could not, as Randall Dodd (2007), writing for the IMF’s *Finance and Development* magazine, explained

it, “trade out of their losing positions” (n.p.). This meant that they had to sell off other assets—especially those with large unrealized gains, such as emerging market equities—to meet margin calls or to offset losses. This further exacerbated stock market declines worldwide; it also led to a temporary decline of currency values in emerging markets. All this turmoil in the global financial system—which included the bankruptcy of several large financial firms, including Lehman Brothers—resulted in a free fall of global credit markets, which undermined economic growth on a global scale and made massive bailouts a “necessity.” Among the companies that were bailed out was AIG, which played a key role in creating the crisis: the U.S. government committed \$182 billion to AIG’s rescue, although the amount that AIG actually used was \$68 billion. Altogether, \$640 billion was disbursed through various rescue packages (see table 5.8); of that amount, bailed-out companies returned \$367 billion to the U.S. Treasury (Kiel and Nguyen 2013).

### *The Political Economy of the Global Financial Crisis*

The full story of the U.S. housing bubble and its fallout is far too complex to cover here in any depth, so the aim in this section is to highlight—largely in outline form—the *political-economic* aspects of the crisis. (For readers interested in a more detailed treatment of the housing bubble and subsequent financial crisis see, for example, Schwartz [2009] and Wachter and Smith [2011].) The first is the most general: the crisis clearly involved a complex interaction between political and economic forces and between state and nonstate actors. Power, moreover, was clearly and significantly *diffused* throughout the global financial system.

Thus, while the decisions of state actors mattered—e.g., the decision by the U.S. Federal Reserve to lower interest rates after the dot-com crisis was something that only the U.S. state had the power to do—so did decisions made by nonstate actors. The decisions of large banks and financial firms obviously were instrumental in the crisis; the privileged position they occupied in the global finance structure made it possible for them to have a fundamental impact on the dynamics of the system. It is important to recognize, however, that firms are made up of individuals, who also have the capacity to exercise power (especially in the knowledge structure), both as individuals and as part of larger organizations. The credit default swap, for instance, was the creation of a single person—Blythe Masters, who as an

**Table 5.8. Breakdown of Bailout Funds (Outflow and Inflow)**

|  | <i>Disbursed (in U.S.\$ billions)</i> |
|--|---------------------------------------|
| Banks and Other Financial Institutions | \$245                                 |
| Fannie Mae and Freddie Mac             | \$187                                 |
| Auto Companies                         | \$79.7                                |
| AIG                                    | \$67.8                                |
| Toxic Asset Purchases                  | \$18.6                                |
| State Housing Programs                 | \$2.68                                |
| Mortgage Modification Program          | \$2.35                                |
| Small Business Loan Aid                | \$0.368                               |
| FHA Refinance Program                  | \$0.050                               |
| <b>Total</b>                           | <b>\$640.3</b>                        |
|  |                                       |
|  | <i>Returned Funds</i>                 |
| Refunds                                | \$376                                 |
| Dividends                              | \$152                                 |
| Interest                               | \$1.81                                |
| Warrants                               | \$9.42                                |
| Other Proceeds                         | \$19.4                                |
| <b>Total</b>                           | <b>\$549.9</b>                        |

employee of J.P. Morgan, pitched the idea of selling credit risk to the European Bank of Reconstruction and Development in 1994 (Romm 2010).<sup>24</sup> While someone else may certainly have created a similar financial product sometime later, the fact remains that the credit default swap had to be created through individual action. Moreover, the initial timing and success of Masters's innovation was critical: it allowed for the credit default swap to become an important part of the global financial system before the housing bubble started to form. Borrowers, too, played a necessary role: the creation of mortgage-backed securities and credit default swaps would have had little impact if millions of individual borrowers did not actively seek out new mortgages. Agency, in short, clearly mattered in the process leading to the global financial crisis.

Added to this mix is the issue of *moral hazard*, which can be most simply defined as a situation in which one party in a transaction can make a decision about how much risk to take, while someone else bears the cost if things go badly (Krugman 2009). The housing market in the period leading up to the collapse was rife with moral hazard. AIG's use of credit default swaps (CDSs), in this regard, likely played a key role because, first, credit default swaps allowed the financial institutions making poor-quality loans to transfer risk to another party—i.e., those willing to buy the CDS. Second, the parties buying the CDS assumed that AIG was “too big to fail”; thus, they were able to transfer the risk of their investments to the American taxpayer (for further discussion see Dowd 2009). It is crucial, however, that agency (and the exercise of power) always be understood in context. This leads to the second point, which is that the U.S. housing bubble and subsequent global crisis was made possible by a specific type of financial regime, one that rested on a solidly political foundation and was the product of a profoundly political process. On this point, keep the earlier discussion of global neoliberalism in mind: to repeat, global neoliberalism did not arise automatically, but had to be painstakingly constructed by both state and nonstate actors. An important aspect of the neoliberal regime was deregulation, the freeing up of capital and nonstate financial actors from meaningful regulatory oversight and control. Thus, while the causes of the housing bubble and global financial crisis are manifold,<sup>25</sup> there is little doubt that the radical shift to *unregulated* securitization was a major factor. This shift, on one level, was simply a reflection of efforts by financial firms (important nonstate actors) to maintain their earning and profit levels. Significantly, another type of firm (or nonstate actor), the credit-rating agencies such as Standard & Poor's, Moody's, and Fitch Group, played a key role as well: without their say-so, which was represented by a triple-A (or similarly high) rating, a large percentage of the new types of securities used to finance subprime mortgages would likely not have been sold. The credit-rating agencies, in other words, had tremendous capacity to regulate risk (even though they do not possess formal regulatory powers), and their collective unwillingness to exercise this power responsibly almost certainly exacerbated the conditions that led to the bubble and its ultimate collapse. Of course, the credit-rating agencies were acting within the context of a regulatory environment that allowed them to profit directly from providing “generous” (that is, overly optimistic and even spurious) evaluations to the firms they were regulating. Thus, at another level, the housing bubble might not have happened (at least to the extent that it did) in a different domestic regulatory environment, nor would its effects have been as far-flung in a different global financial regime.

Granted, these are rather large generalizations, but it is easy enough to see that, for the last 30 to 40 years, deregulation and privatization have been virtual movements within

the United States, and through much of the world's financial markets. In the U.S. specifically, a key decision was the reinterpretation of the Glass-Steagall Act, put in place after the Great Depression. Glass-Steagall prevented institutions that were "engaged primarily" in banking activities from dealing in securities of any kind, and vice versa (Sherman 2009, p. 8). In 1986, the Federal Reserve qualified the original restriction and ruled that a bank could derive up to 5 percent of gross revenue in investment banking; a few months later, Alan Greenspan—an outspoken advocate of deregulation—was appointed chairman of the Federal Reserve. He used his three decades as chairman to render the Glass-Steagall Act effectively obsolete (Sherman 2009, p. 9). This was no accident: Greenspan held a strong belief in neoliberalism in general, and more specifically believed that the "inherent incentive structures" and self-regulating nature of free markets made the system "fireproof"; this belief, as Jones (2012) put it, "was based on the view that the self-interest of financial institutions would effectively substitute for the rigorous external regulation of financial markets because it would prevent banks from overexposure to high-risk strategies" (p. 339). Overweening faith in neoliberal principles, in this regard, played a key role in both deregulation and the housing bubble. Again, there is much more to the story of deregulation, but the gist is clear enough: deregulation was a purposeful, political process.

The fallout from the crisis helps underscore the third point, which is that states still must play a significant role, even, or especially, in the context of the global neoliberal order. While not a few analysts argue that doing nothing would have been the best response on the part of national governments, that was a near-impossible choice as the fallout from the crisis began to reverberate throughout the world. States or national governments could not afford to ignore the structural power (and political influence) of giant financial firms, nor could they risk the potentially calamitous damage to the global financial system by failing to act. Thus, while a handful of firms (e.g., Bear Sterns, Lehman Brothers, Countrywide Financial, IndyMac, Washington Mutual, and Wachovia, among others) could be allowed to go bankrupt, or more typically, acquired by other firms, the private financial sector as a whole—both domestically and globally—had to be rescued. Significantly, only states had the capacity *and* interest to carry out this rescue operation. And the state-led rescue effort was massive. Table 5.8, "Breakdown of Bailout Funds," gives a clear indication of the resources that were devoted by the U.S. government to stave off financial collapse: \$640 billion of actual disbursed financial assistance, and much more on paper. AIG was accorded extraordinarily special treatment because its involvement in credit default swaps was intimately connected to the financial viability of a host of other large financial firms—Goldman Sachs, Morgan Stanley, Bank of America, Merrill Lynch, and dozens of European banks (Greider 2010). Tellingly, in early efforts to rescue AIG, as William Greider (2010) explains it, the U.S. government attempted to coordinate with the private sector (i.e., the government wanted the private sector to cover most of the costs of saving AIG), but the banks rebuffed these efforts, naturally preferring a bailout using primarily public funds—a nice expression of their dominant positions in the financial structure even in the midst of a full-blown crisis that the industry, most everyone agrees, was primarily responsible for creating in the first place. Neo-Marxist analysts, it should be noted, would not be surprised at all by this situation, and would perhaps offer a sardonic smile. After all, they tell us, states and their agencies have always represented dominant class interests. Indeed, it is hard not to give some credence to this point of view. On the other hand, it is equally easy to argue that state actors were not simply doing the bidding of "big capital," but were instead acting in

their own interests by trying to save the system they created. The key point, to reiterate, is nonetheless clear: states played a critical role in ensuring that the crisis did not spiral out of control.

This leads to the fourth and final point. While, in the United States, the response to the collapse of the housing bubble and the ensuing financial crisis was a domestic affair, the global crisis that followed underscored the importance of international cooperation—even if limited and imperfect—and of the general framework for greater cooperation in the postwar period. To be sure, it was a relative lack of international cooperation (regarding current account imbalances) that helped to lay the groundwork; but unlike the Great Depression, the global financial crisis did not ultimately turn into a global conflagration. This was at least partly due to what John Lipsky (2010), First Deputy Managing Director for the IMF, described as the “unprecedented anti-crisis measures [implemented through enhanced international cooperation, which] included the largest ever coordinated counter-cyclical budgetary actions, rapid and massive rate cuts by major central banks and their provision of unprecedented sums through currency swap lines to support global market liquidity” (n.p.). In addition, according to Lipsky, the largest economies acted in concert to provide “large increases in the resources available to international financial institutions—including a tripling of the resources available to the IMF, among other effects helping to cushion the poorest countries from the brunt of the crisis.” International cooperation was facilitated through G20<sup>26</sup> summit meetings, the first of which was held in Washington, DC, in November 2008, followed by a second meeting in London in April 2009 (in addition, there was a great deal of less formal communication between government officials throughout the crisis). Importantly, the G20 was created in 1999 in response to the financial crisis of that decade, in recognition of the fact that the growing economic power of so-called emerging economies could no longer be ignored or marginalized in discussions of global economic issues. Since then, the G20 has been considered a major mechanism for international economic cooperation. The effectiveness of international cooperation during the global financial crisis can certainly be criticized, but the critical point is that a practical *and* normative framework for cooperation existed in the first place, and that it was used for coordinating policy responses and helping to prevent the crisis from getting out of control. (The topic of global governance will be discussed in more depth in chapter 8.)

## Chapter 5: Conclusion

This chapter has covered a lot of ground, but has also left a lot more ground essentially uncovered. This is unavoidable. The global financial system is immensely complex and far ranging; to cover it adequately would require several stand-alone volumes. The goal of the chapter, however, is simply to provide a basic and useful framework for understanding and interpreting the global financial system and major processes and events within that system from a political-economy standpoint. At a minimum, this means recognizing that the relationship between markets and states—in an increasingly globalized financial system—is complex and increasingly reciprocal. The complex and reciprocal relationship between states and markets also tells us that no one actor or set of actors is all-powerful. That is, power in a globalized financial system is also diffused among state and nonstate actors. This diffusion of power can be extremely messy, as different actors with divergent, oftentimes conflicting interests, endeavor to achieve their goals in concert with or

in opposition to others. But this is what the study of international or global political economy is all about.

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<sup>18</sup> Fahrettin Yagci, a lead economist for the World Bank, for example, writes that there is a growing consensus among economists that the selection of an exchange rate regime depends on a variety of factors, and that “... there is no single ideal exchange rate regime that is appropriate for all countries” (2001, p. 1).

<sup>19</sup> Generally speaking, economists argue that an expanding monetary base will lead to an increase in inflation. As Mankiw (2009) explains it, “The textbook story is that an increase in the monetary base will increase bank lending, which will increase the broad monetary aggregates such as M2, which in the long run leads to inflation.” Mankiw also argues that inflation does not always rise under such conditions, although Steiner (2009) demonstrates that inflation is much more likely in countries with rising reserves and a fixed-rate exchange.

<sup>20</sup> For a useful analysis of the debate over conditionality, see Dreher (2006).

<sup>21</sup> In *Mad Money* Strange covered contrasting arguments on pp. 10–18. The most salient opposing viewpoint came from what Strange referred to as “pro-marketeers,” such as Jeffrey Sachs, a Harvard economist. The basic argument from this viewpoint is one with which you should be familiar. That is, that left alone, markets will self-correct.

<sup>22</sup> Readers interested in an in-depth discussion of how the ideological transition from embedded liberalism to neoliberalism was brought about can refer to Harvey (2005, chapter 2, “The Construction of Consent.”

<sup>23</sup> The formal names for Fannie Mae, Freddie Mac, and Ginnie Mae are, respectively, the Federal National Mortgage Association, the Federal Home Mortgage Corporation, and the Government National Mortgage Association.

<sup>24</sup> The origination of the credit default swap had nothing to do with mortgage-backed securities, but was instead meant as a way for J.P. Morgan to loan money to ExxonMobil in the aftermath of the 1989 Exxon Valdez oil spill (Romm 2010).

<sup>25</sup> For a nice summary of some of the various explanations, see Levitin and Wachter (2012), pp. 1211–1227.

<sup>26</sup> The G20 includes the members of the G8, European Union, the IMF and the World Bank, plus major “emerging economies”: Argentina, Australia, Brazil, China, India, Indonesia, South Korea, Mexico, Russia, Saudi Arabia, South Africa, and Turkey.

## Chapter 6

# Transnational Production, Foreign Direct Investment, and Economic Development

### Introduction

The previous two chapters focused on two major elements of the international or global political economy: trade and finance. Both these areas have seen major developments during the 20<sup>th</sup> century, especially in the latter half of the century. There is a third, integrally related element that has undergone equally dramatic change and development since 1945—namely, the production or manufacturing system. More specifically, what was once a largely disconnected agglomeration of domestically based production systems has become increasingly linked on a globalized or transnational basis. To be sure, as with trade and finance, cross-border activity in manufacturing has taken place for a long time. The era of colonialism, which goes back many centuries, provides good examples of early endeavors to create transborder or transnational production networks. In particular, colonies were economically—typically, in a highly exploitative manner—with the imperial economies. Today, however, transnational production networks are immensely more complex and immensely larger in scale and scope than at any other time in history. They are arguably less exploitative, too, although many, if not most, Marxist and neo-Marxist analysts assert that the contemporary system of transnational production remains extremely and even necessarily exploitative. The question of whether transnational production is exploitative will be discussed later in this chapter (and in the following chapter). For now, suffice it to say that, as with the transnational production system as a whole, the issue of exploitation is complex and difficult to untangle.

In addition to the question of exploitation, any examination of the development of the contemporary transnational production system must deal with a range of issues and factors. One of the most important of these revolves around the basic building block of any such system—namely, the firm, and more specifically, the transnational corporation (TNC). TNCs, as noted in chapter 1, have become ubiquitous in the global economy, with as many as 82,000 such firms, along with more than 810,000 affiliates. To better appreciate the increasing significance of TNCs, consider the phenomenon of **intra-firm trade** (which, most simply, can be defined as the cross-border flow of goods and services between parent companies and their affiliates, or among affiliates). According to Lanz and Miroudot (2011), it is likely that intra-firm trade accounts for a significant share of total world trade.<sup>27</sup> In the

case of the United States specifically (the only country that keeps detailed statistics on intra-firm transactions), intra-firm trade accounted for 48 percent of imports and 30 percent of exports in 2009 (p. 12). Although the figures for the U.S. are likely higher than for most other countries—simply because the U.S. has a larger number of major TNCs—the level of intra-firm trade suggests that it has become a major part of the global economy.

The predominance of TNCs from the United States underscores another important issue, which is simply that major TNCs are concentrated in the developed world. Unsurprisingly, for most of the postwar period, the largest and most economically powerful TNCs came from, or were almost exclusively based in, the United States and a handful of mostly Western countries, including: the United Kingdom, France, Germany, Switzerland, the Netherlands, and Japan (the one major non-Western case). Significantly, though, while firms based in developed-world countries continue to dominate global networks of production, over the past several decades, firms from other regions have begun to emerge. In 2012, for example, among the 100 largest nonfinancial TNCs (based on foreign assets) were firms from Hong Kong SAR<sup>28</sup> (Hutchison Whampoa Limited), mainland China (CITIC Group and China Ocean Shipping), Taiwan (Hon Hai Precision Industry), Mexico (América Móvil and Cemex), Russia (VimpelCom Ltd.), and Brazil (Vale)—a total of eight (UNCTAD 2013, Annex Table 28). Five years earlier, in 2007, there were five TNCs from the so-called developing world in the top 100 (two of these were based in South Korea and one in Malaysia); and in 1995, there were only two (one company based in South Korea and one in Venezuela). The capacity of TNCs from the developing world to break into the upper echelons of global production is, to many analysts, a significant development. At the same time, there is little doubt that global production—as well as cross-border trade and investment—continues to be dominated by a fairly standard list of firms from a small number of advanced capitalist economies. From a political-economy perspective this raises important questions. Is this continuing dominance a product of market dynamics primarily, or does it reflect a highly unequal and thoroughly embedded distribution of power in the global political economy? If so, what are the implications of an entrenched “hierarchy of positions” (Philips 2013, p. 32) in the global production structure (and what have the consequences been for the past five or six decades)? It is also important to answer the question, why has so much production become transnational in the first place? There is a relatively obvious answer to this last question, but there are also less obvious answers that have to do with political-economic, rather than primarily economic dynamics. Finally, for the purposes of this chapter, there is one more question that needs to be addressed, one that has to do with a different, but closely related issue. The question is this: How do the structure and processes of transnational or global production affect the prospects for economic development in the developing world?

### Figure 6.1. A Profile: The Rise of Hon Hai Precision Industry

Although the name might not ring a bell for most readers, Hon Hai Precision Industry is perhaps *the* dominant player in the global electronics industry. Better known by its trade name, Foxconn, in 2013 the company was the largest electronics manufacturer in the world. It is best known as the main supplier for Apple products (including the iPad, iPhone, and iPod), but it also produces products for Amazon (Kindle), Sony (PlayStation), and Nintendo (Wii), as well as many other companies. Altogether, the company manufactures about 40

percent of all consumer-electronics products sold throughout the world (Duhigg and Bradsher 2012).



The company was founded in 1974 (in Taiwan), as a supplier of electronic components primarily to Western-based firms. (On this point, it is useful to note that, for companies in the developing world, their first connection with richer, brand-name firms is typically based on an unequal relationship in which the developing-country firm supplies products for the developed-country firm.) For

many companies in the developing world, the supplier relationship is tenuous, for as costs begin to rise domestically—which was certainly the case for Foxconn in Taiwan—the dominant firm or firms will often relocate to lower-cost locations. Foxconn, however, was able to avoid this problem by relocating its own production base from Taiwan to other countries, most prominently China. In 2013, Foxconn employed approximately 1.4 million workers in China in 13 factories. One of the company’s factory locations in China is a veritable city, with upwards of 450,000 employees. Foxconn also has factories in Brazil, Hungary, Slovakia, the Czech Republic, India, Japan, Malaysia, and Mexico. For a fuller and critical discussion of Foxconn global expansion, see Chan, Pun, and Selden (2013).

*Image: A Foxconn factory in the Czech Republic.*

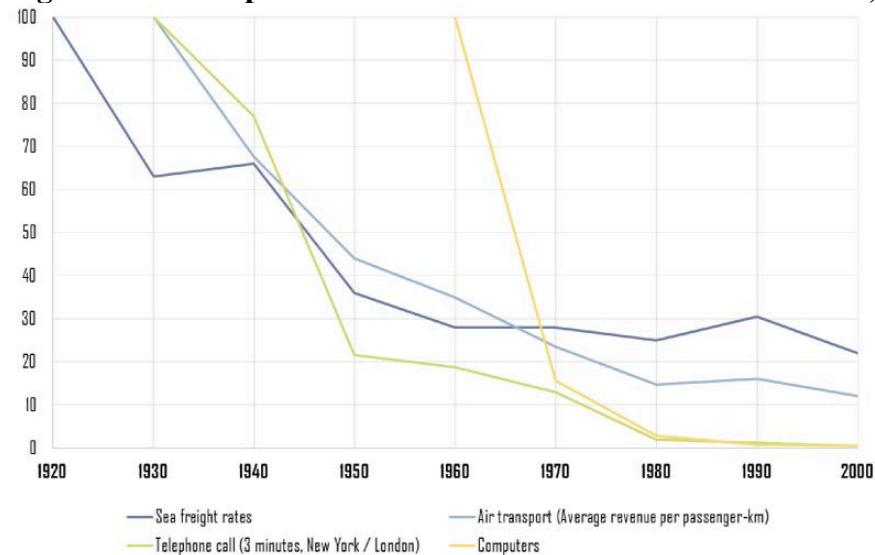
*Source: Nadkachna. Permission granted to copy, distribute and/or modify this document under the terms of the GNU Free Documentation License, Version 1.2.*

This chapter will address all of these questions. First, however, it is important to address a very basic question—namely, what is transnational, or global, production? This question will be answered in the following section. In the same section, too, a number of other basic terms and concepts will be introduced, as well as some important facts and figures.

## Transnational Production: Definitions, Concepts, and Basic Data

Transnational, or global, production is relatively easy to understand, at least in its basic form. Most simply, it is a type of production in which different parts of the overall production process for a particular product take place across different national territories. To

**Figure 6.2. Transportation and Communications Costs Indexes, 1920–2000**



Source: Copied from “The Geography of Transport Systems,” available at <http://people.hofstra.edu/geotrans/eng/ch1en/conc1en/priceevol.html>.

repeat an earlier point, this sort of production has been going on for a very long time, as even the simplest manufactured products often require inputs—especially raw materials or natural resources (Castro n.d.)—from other territories. Still, prior to huge advances in transportation (beginning in the late 1800s and continuing through the 20<sup>th</sup> century) and in communications, transnational production tended to be based on the necessity of sourcing a material that was only available from certain areas. One reason was fairly obvious: since transport and related costs were very high, it generally made more economic sense—given a choice—to source materials locally rather than globally.

Over the past century or so, however, the cost differential between producing locally and globally has not only equalized, but has begun to tilt in favor of transnational production. Consider, for example, the cost of air transport (expressed in constant U.S. dollars, using 2000 as the base year): the per-ton-kilometer price of transporting goods by air fell from \$3.87 in 1955 to under \$0.30 in 2004 (Hummels

**Figure 6.3. A Modern Container Ship**



The container ship seen above is the CMA Christophe Columb, an Explorer-class containership named after Christopher Columbus (but built by a South Korean company). When it was delivered in 2009, it was the largest passenger-carrying container ship in the world, measuring 365 meters long by 52 meters wide (about the size of four American football fields laid end to end). The ship can carry up to 13,300 twenty-foot equivalent containers. In 2013, however, there were even larger container ships in production. Indeed, the same Korean company that built the Christophe Columb, Daewoo Shipbuilding, planned to deliver ten 400-meter-long Triple-E-class ships in 2013 and 2014, with a capacity of 18,000 twenty-foot containers each. These ships will travel 184 kilometers using 1KWh of energy per ton of cargo.

Image Source: Huhu Uet. Permission is granted to copy, distribute and/or modify this document under the terms of the GNU Free Documentation License, Version 1.2.

2007, p. 138). Interestingly, there was no comparable decline in ocean shipping (during the postwar period), but as the World Bank (2008) notes, price trends for ocean shipping “do not factor in the total cost of door-to-door transportation” (p. 179). In this view, improvements in ocean shipping—most notably, the invention of containerized shipping—did lead to a dramatic decline in *overall* shipping costs. Thus, according to the World Bank, “[i]n 1956 the loading of loose cargo cost \$5.83 a ton. When containers were introduced in that year, the loading cost was less than \$0.16 a ton. So the main savings came from lower intermodal transfer costs. [That is, containerization] … allowed goods to be packed only once and shipped over long distance using maritime, rail, and road transport” (p. 179).<sup>29</sup>

Telecommunication costs decreased equally dramatically. In 1930, for example, a three-minute telephone call between London and New York cost \$245 (in 1990 U.S. dollars); the same call in 1990 was \$3 (UNDP 1999). By 2005, this had been reduced to \$0.25, but with the advent of VoIP (voice over Internet Protocol) around 2004, international calls, including streaming video calls, have been reduced to essentially nothing.

There is, it is important to emphasize, another very important side to the equation, which is the cost differential that exists between different parts of the world for labor, land, and other localized inputs. In her well-read book, *The Travels of a T-Shirt in the Global Economy* (2009), Pietra Rivoli shows how it is cheaper to grow cotton in the United States, ship it to China, have Chinese cutters, spinners, knitters, and stitchers manufacture millions of t-shirts, and ship them back to the United States, than it is to have U.S. workers make the same t-shirts using U.S.-produced cotton. Another somewhat minor, but still telling, example is the production of boxed lunches (called *bento* in Japanese) that are produced, cooked, and packaged in California using local ingredients, and then shipped to Japan for sale to commuters on Japan’s biggest railway, the JR line (which also runs Japan’s famed bullet trains). “This innovative concept,” California trade secretary Lon Hatamiya stated in May 2000, “will introduce a California-grown, -prepared and -packaged product to one of … [California’s] most lucrative foreign markets.” Despite the transport costs—the bento lunches must be transported 5,000 miles in refrigerated containers—the California-made lunches sell for about half the price of those made in Japan (Tempest 2000).

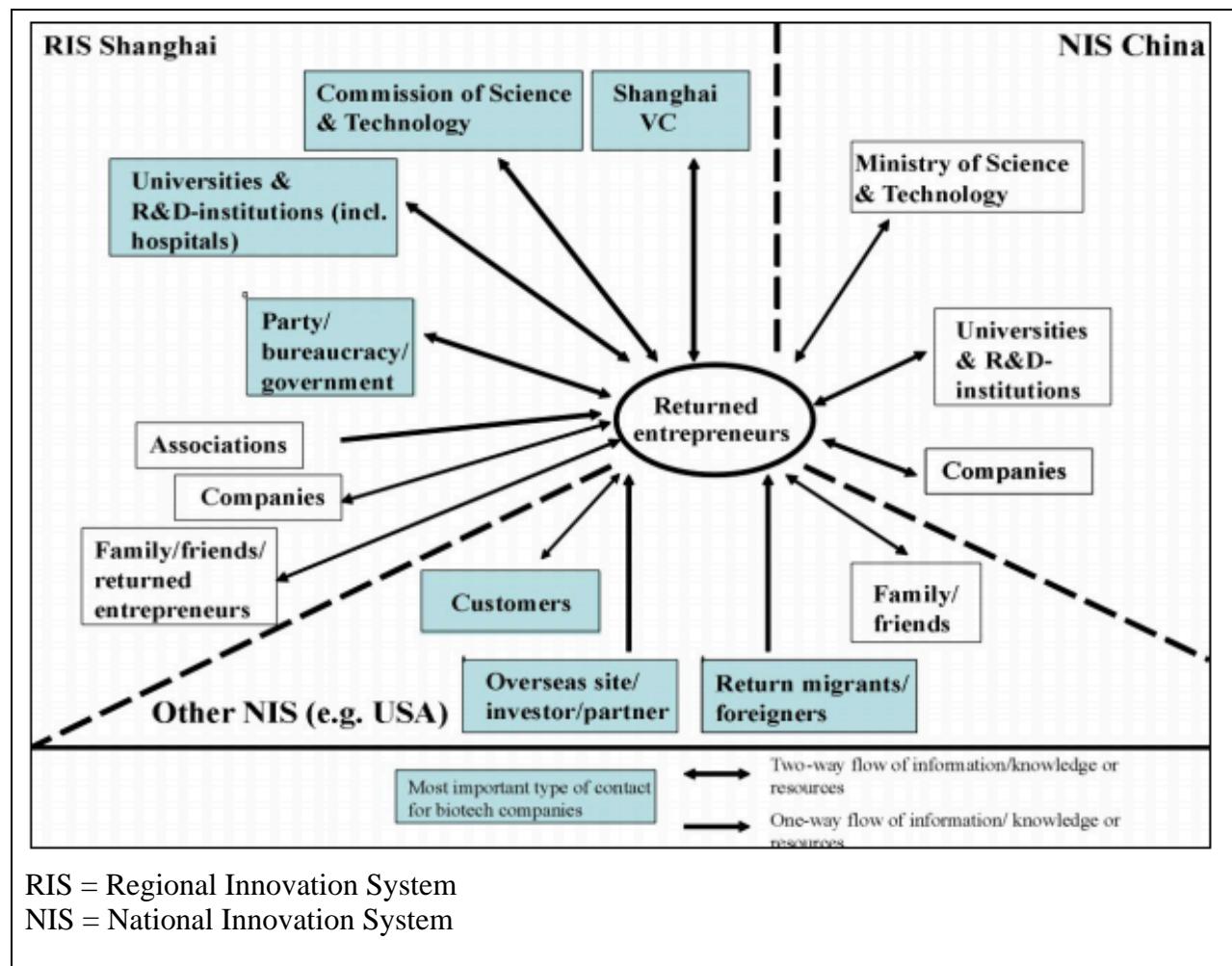
It is *not*, it is also important to understand, just cost differentials between and among different localities that drive transnational production: transnational corporations globalize their production processes for a variety of reasons. One of the main reasons that Japanese car companies—e.g., Toyota, Honda, Mazda, and Nissan—began to relocate plants to other parts of the world, and especially to North America, was to alleviate growing protectionist pressures. In the early 1980s, in particular, the U.S. government imposed voluntary export restraints (VERs) on Japanese-made cars: under this arrangement, Japanese automakers *as a group* were limited to exporting 1.68 million units to the United States from 1981 to 1983, and 1.85 million units for 1984 and 1985. Not coincidentally, Cornstubble (1998) argues, the major Japanese car manufacturers all began producing cars in the United States almost immediately. In fact, by 1994, the Japanese automakers were selling more U.S.-made cars than Japan-made cars in the United States (n.p.). There are other reasons as well for the shift to global production, especially for the production of capital intensive, durable goods. First, it reduces the risks of currency shifts, and second, it provides companies a better and more sophisticated understanding of local market conditions (Womack, Jones, and Roos 2007, pp. 211–212). Saxenian (2002) points to still another reason: the development of “transnational technical communities” and, more specifically, of transnational entrepreneurs who act as a

“mechanism for the international diffusion of knowledge and the creation and upgrading of local capabilities” (p. 1). These are technically skilled and well-educated individuals, in immigrant communities, who travel back-and-forth between their home countries (e.g., India, Taiwan, or China) and other, more advanced capitalist countries, such as the U.S., to take advantage of entrepreneurial opportunities. They are able to bring their knowledge, skills, and know-how back to their home countries, and create businesses that complement and fit into existing global-production networks. Embedded in this notion of transnational technical communities, it is useful to note, is a strong cultural element. Transnational entrepreneurs, in other words, are not just motivated by profit opportunities, but also by their personal, familial, and cultural connections to their home countries. (See figure 6.4 for further discussion.)

#### **Figure 6.4. Transnational Technical Communities: Silicon Valley and the Argonauts**

In Greek mythology, the Argonauts were a band of adventurers who sailed with Jason in search of the Golden Fleece. The new Argonauts come from Asia: they first ventured to the U.S. or other rich Western countries (where many studied engineering and/or other highly technical subjects) to escape from harsh economic and/or political conditions, but as economic and political conditions in their homelands improved over the decades, many have ventured back “to take advantage of their experience in and linkages with leading high-tech regions” (Sternberg and Müller (2007, p. 1). In so doing, they have forged concrete economic linkages between their new and old homelands, and (to some extent) have upended the traditional relationship between so-called core and peripheral economies. This has been made possible, in part, by the “fragmentation of production and the falling costs of transport and communication [which] allow even small firms to build partnerships with foreign producers to tap overseas expertise, cost savings, and markets” (Saxenian 2006, p. 103).

A key part of this process is the back-and-forth, or circulatory, movement of people between locations. The new Argonauts do not simply return to their homelands, but instead maintain strong connections between locations; at the same time, they may develop a whole new network of domestic and transnational connections. Thus, they may return to Taiwan or Shanghai to begin a new firm, but this new firm will immediately become part of a broader network with ties to investors in China and the U.S. (or other countries); with personal, professional, and governmental connections in both countries; with cross-border customer and vendor relationships; and so on. The figure below, reproduced from Sternberg and Müller (2007, p. 11), provides an illustration of the type of transnational network created around “returned entrepreneurs.”



One salient result of the general shift to global production has been the creation of the so-called global factory, which is set up to seamlessly exploit differential opportunities that arise in fabrication, assembly, quality control, R&D, design, technology, regulatory environments, marketing, and so on, in locations around the world. Firms that have this capacity, it is important to emphasize, generally are among the largest, most economically powerful firms in the world: among the top 25 TNCs (measured in terms of foreign assets), 20 are also among the top 100 largest firms in terms of total revenue (see table 6.1, “Rankings of the World’s Largest Firms by Foreign Assets and Total Revenues”). Their sheer economic size, in turn, allows global factories to, among other things, purchase potentially competitive firms in host countries, thereby extending their reach in key markets and dominance over key technologies. Their economic size, too, gives them immense purchasing power—often verging on monopsony (i.e., a market situation in which there is only one buyer)—such that they can almost dictate the prices they will pay (Buckley 2009, p. 137). The rise and development of global factories, therefore, is an extremely significant phenomenon, and one that necessarily impacts the dynamics of the global political economy. Before discussing the impact of global factories, it will be useful to discuss another essential element in the shift toward global production—namely, foreign direct investment, or FDI.

**Table 6.1. Rankings of the World's Largest Firms by Foreign Assets and Total Revenues**

| Ranking by:    |      |                         |                          |                |
|----------------|------|-------------------------|--------------------------|----------------|
| Foreign assets | TNI* | Global 500 <sup>†</sup> | Corporation              | Home economy   |
| 1              | 79   | 22                      | General Electric Co      | United States  |
| 2              | 32   | 1                       | Royal Dutch Shell PLC    | United Kingdom |
| 3              | 22   | 4                       | BP PLC                   | United Kingdom |
| 4              | 77   | 10                      | Toyota Motor Corporation | Japan          |
| 5              | 28   | 11                      | Total SA                 | France         |
| 6              | 45   | 2                       | Exxon Mobil Corporation  | United States  |
| 7              | 8    | **                      | Vodafone Group PLC       | United Kingdom |
| 8              | 62   | 33                      | GDF Suez                 | France         |
| 9              | 61   | 8                       | Chevron Corporation      | United States  |
| 10             | 64   | 12                      | Volkswagen Group         | Germany        |
| 11             | 51   | 17                      | Eni SpA                  | Italy          |
| 12             | 1    | 71                      | Nestlé SA                | Switzerland    |
| 13             | 71   | 52                      | Enel SpA                 | Italy          |
| 14             | 48   | 16                      | E.ON AG                  | Germany        |
| 15             | 4    | **                      | Anheuser-Busch InBev NV  | Belgium        |
| 16             | 6    | 70                      | ArcelorMittal            | Luxembourg     |
| 17             | 29   | 47                      | Siemens AG               | Germany        |
| 18             | 36   | 64                      | Honda Motor Co Ltd       | Japan          |
| 19             | 92   | **                      | Mitsubishi Corporation   | Japan          |
| 20             | 98   | **                      | EDF SA                   | France         |
| 21             | 73   | 21                      | Daimler AG               | Germany        |
| 22             | 67   | 89                      | Deutsche Telekom AG      | Germany        |
| 23             | 66   | **                      | Pfizer Inc               | United States  |
| 24             | 40   | 69                      | BMW AG                   | Germany        |
| 25             | 42   | 82                      | Telefonica SA            | Spain          |

\* TNI, the Transnationality Index, is calculated as the average of the following three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment.

\*\* Not in top 100 (but may be ranked in Global 500, positions 101 to 500)

<sup>†</sup> Global 500 is the annual rankings compiled by *Fortune* magazine of the 500 largest companies, by revenue, in the world. The list is available at

[http://money.cnn.com/magazines/fortune/global500/2012/full\\_list/index.html](http://money.cnn.com/magazines/fortune/global500/2012/full_list/index.html).

Source for foreign assets and TNI ranking: UNCTAD (2013).

FDI is, in the most general terms, investment made in a company or entity based in one country by a company or firm based in another country. A more specific definition is provided by the World Bank, which defines FDI as follows: “the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments” (n.p.). What makes FDI *direct* is the fact that firms (or investors) making such investments actively participate in managing the companies or factories in which they invest. This contrasts with portfolio investment (or indirect investment), which typically involves purchasing shares of a firm’s stock or corporate bonds, but does not entail any management interest or responsibility for operations. The key point for our purposes, however, is this: FDI serves as a useful proxy for measuring the level of transnational or global production because it tells us how much direct investment companies are making outside their home countries.

**Table 6.2. Trends in FDI, 1913–2004 (FDI as a Percentage of GDP)**

|                       | 1913/14 | 1930s   | 1950s | 1970/71 | 1980 | 1995 | 2003/04 |  |
|-----------------------|---------|---|-------|---------|------|------|---------|--|
| Developed Countries   |         | <i>Outward Stock of FDI (as percent of GDP)</i> |       |         |      |      |         |  |
| France                | 23      | 10  | --    | 5       | --   | 25   | 37      |  |
| Germany               | 11      | 5   | --    | 3       | 4    | 10   | 31      |  |
| Japan                 | 11      | 47  | --    | 2       | 2    | 5    | 8       |  |
| Netherlands           | 82      | 28  | --    | 35      | 25   | 47   | 94      |  |
| United Kingdom        | 49      | 18  | 9     | 17      | 15   | 28   | 65      |  |
| United States         | 7       | 8   | 4     | 8       | 8    | 18   | 17      |  |
| Developing Countries  |         | <i>Inward Stock of FDI (as percent of GDP)</i>  |       |         |      |      |         |  |
| Avg. for All Colonies | 42      | 61  | 35    | 14      | --   | 19   | --      |  |
| Postwar Averages      |         |   |       |         |      |      |         |  |
| Latin America         | --      | --  | --    | --      | 4    | 12   | 38      |  |
| Asia                  | --      | --  | --    | --      | 4    | 12   | 24      |  |
| Africa                | --      | --  | --    | --      | 8    | 15   | 32      |  |

Sources: Table reproduced from Velde (2006), p. 5

Interestingly, the relative level of FDI was higher in the early 1900s than for the rest of the 20<sup>th</sup> century; as late as 1995, outward FDI, as a percentage of GDP, was still below what it was at the beginning of the century (see table 6.2). This does not mean that production was especially globalized a century ago. It was not. Instead, it reflects the then-urgent need on the part of wealthier countries to develop sources of raw materials and natural resources for their rapidly industrializing economies. This type of FDI, by the way, is referred to as *resource-seeking FDI*. As Velde (2006) points out, in 1913, two-thirds of

world FDI was flowing to developing countries (p. 6)—mostly colonies—and almost all of that investment was for exploiting natural resources and building the railways needed to transport these commodities back to the West (p. 7). The situation is dramatically different today. Now most FDI “is amongst developed countries, and only a quarter of FDI is going to developing countries” (Velde 2006, p. 6); moreover, there has been a marked shift towards *efficiency-seeking* and *strategic asset-seeking FDI*. The aim of efficiency-seeking FDI is to increase competitiveness by lowering production costs (this is also referred to as **offshoring**). Strategic asset-seeking FDI aims at “advancing a company’s global or regional strategy into foreign networks of created assets like technology, organizational abilities and markets” (Wadhwa and Reddy 2011, p. 220; citing Faeth 2009). A fourth form of FDI is *market-seeking FDI*, which is based on gaining access to local or regional markets, whether for primarily economic or political reasons (e.g., Japanese automobile companies were motivated to invest in the United States because of VERs, while American auto-manufacturing investments in China are primarily based on the advantage of being located in a major and rapidly expanding consumer market for automobiles: both are examples of market-seeking FDI). While resource-seeking FDI has certainly not disappeared, efficiency-seeking and strategic asset-seeking FDI are particularly important for creating the global factory and, by extension, a complex transnational-production structure.

Over the past few decades, the total stock of FDI (which includes investment in both manufacturing and services) has grown dramatically. In 1990, the inward stock of FDI was \$2,078.3 billion, while outward stock was \$2,091.5 billion. By 2000, those figures had grown to \$7,511.3 billion and \$8,025.8 billion respectively, and by 2012, the respective figures were \$22,812.7 billion and \$23,592.7 billion.<sup>30</sup> In other words, over a period of a little more than two decades, the stock of both inward and outward FDI increased more than ten-fold, or 1,000 percent. By 2012, too, as a percentage of GDP, the outward stock for developed countries reached 42.8 percent (up from 11.9 percent in 1990), while the inward stock increased to 33.4 percent from 8.9 percent. For developing countries, the increase in inward stock went from 13.4 percent in 1990 to 30.4 percent in 2012 (all figures cited in UNCTAD 2013<sup>31</sup>). Combined with the equally rapid growth in the number of TNCs, these figures point to a significant reorganization of the global economy. In other words, the dramatic rise in FDI—lead by TNCs—is reorganizing the global economy by expanding and deepening the *integration* of national economies; this represents a very different phenomenon than simple or shallow cross-border exchange via trade (as discussed in chapter 4). TNCs are creating new and more complex linkages that have, more than ever before, tightly coupled the world economy.

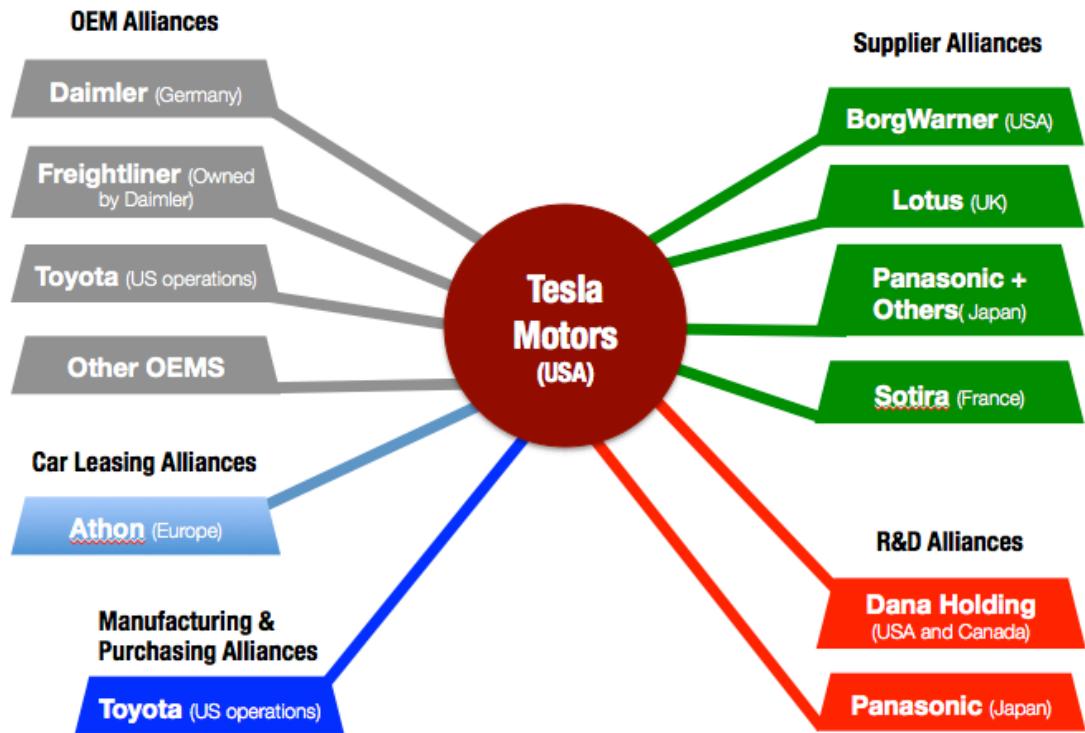
The term TNC was covered in chapter 1, and there is definition in the glossary, but let us look at another basic definition. UNCTAD (n.d.) provides a useful definition on its website: “Transnational corporations (TNCs) are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning a certain equity capital stake” ([http://unctad.org/en/Pages/DIAE/Transnational-corporations-\(TNC\).aspx](http://unctad.org/en/Pages/DIAE/Transnational-corporations-(TNC).aspx)). This is a fairly standard definition, and one that largely suffices (although there are some scholars who disagree).<sup>32</sup>

The rise of the TNC is also strongly connected to two related phenomena: *strategic alliances* between TNCs (or other enterprises) and full-scale fusions, usually through cross-border takeovers (Scholte 1997, p. 437). Strategic alliances comprise a range of cooperative

arrangements between legally separate (and occasionally competing) corporations; nonetheless, some of these arrangements involve a high degree of coordination and collaboration. Consider, for example, Samsung Corporation—a major Korean electronics manufacturer—which has had (or still has) strategic alliances with, among others, Apple, Nokia, Alcatel, Sony, IBM, Sun Microsystems, Matsushita, Qualcomm, NEC, and Microsoft. Samsung’s erstwhile alliance with Apple is particularly interesting, as the two global companies compete head-to-head in the markets for smart phones and tablets. Apple relied heavily on Samsung to produce proprietary chips (and high-resolution display screens) for the iPhone and iPad—proprietary chip making is an extremely expensive and difficult undertaking, which only a few corporations are capable of doing today (the other major players are Taiwan Semiconductor Manufacturing, Intel, and GlobalFoundries [Vance 2013]). When Samsung agreed to make the chips Apple needed, therefore, Apple readily agreed, although it required a level of cooperation that was unusual between two companies that were, in many respects, direct rivals. Not surprisingly, then, this alliance also led to a great deal of friction, as Apple accused Samsung of imitating its designs for smartphones and tablets; in 2011, Apple sued Samsung. Later, Samsung countersued Apple; all the while, however, Apple continued to use chips made by Samsung, and will continue to do so until at least 2015 (Lessin, Luk, and Osawa 2013).

Another useful example is Tesla Motors, which produces electric vehicles (EVs). The automobile industry is notoriously difficult for new companies to enter—largely because any new company must compete against huge global firms with a mature infrastructure, established supply and distribution systems, and strong ties to customers and political entities (Burroughs 2012). One way to overcome the “liability of newness” is to develop strategic alliances, which is exactly what Tesla Motors has done. Tesla’s alliances include suppliers, R&D experts, and original equipment manufacturers (or OEMs), including Daimler and Toyota—two automotive behemoths. The Daimler alliance, according to Stevan Holmberg, has been particularly important for Tesla, since it “represented an endorsement by a premier automotive manufacturer that further enhanced and verified for the broader market Tesla’s competencies, technologies, and ability to deliver results”; importantly, Tesla also produced battery packs and chargers for Daimler’s Smart fortwo car, or “Smart car” (quoted from Burroughs [2007], n.p.).

**Figure 6.5. Tesla's Strategic Alliances**



Source: Image created by author based on Burroughs (2012). Original image available at this link: <http://kogodnow.com/2012/09/how-tesla-used-strategic-alliances-to-power-green-products/>.

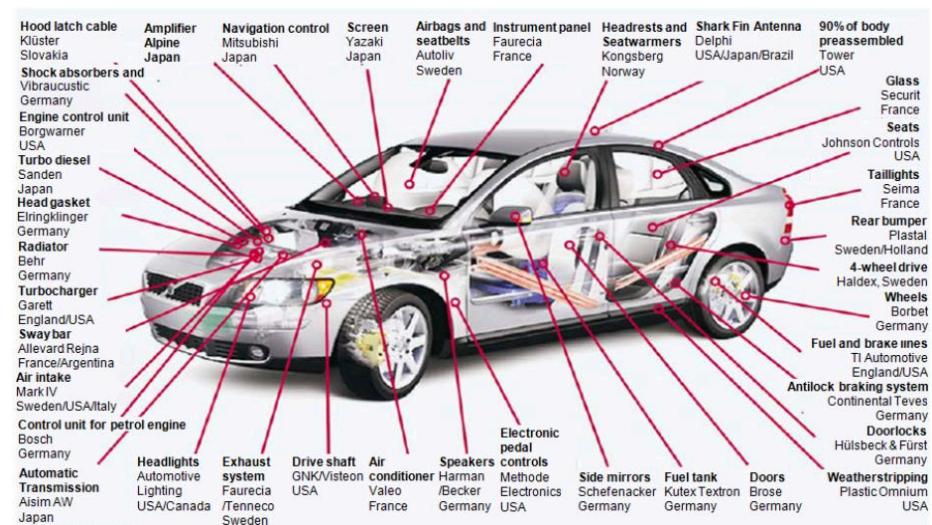
Full-scale fusions are most often reflected in **mergers and acquisitions (M&A)**, which are accounted for in FDI statistics. In the 1980s and 1990s, there was a flurry of M&A activity, although the large majority involved domestically based acquisitions: in 1998, only a quarter of total merger volume (about \$406.4 billion) involved a cross-border acquisition, but by 2007 that figure had grown to \$1.02 trillion, or 45 percent of total volume (Erel, Liao, and Weisbach 2012, p. 1045).<sup>33</sup> With the onset of the global financial crisis, M&A activity declined precipitously: in 2009, the volume of cross-border deals was a relatively small \$249.7 billion, much lower than the average annual amount over the previous 14 years. Still, compared to the early 1990s, not to mention the 1970s and 1980s, this was still a substantial amount. It is important to add, too, that every year there are a good number of megamergers—those involving at least \$1 billion in investment. In 2012, for example, there were exactly 200 M&A worth \$1 billion or more, the largest of which—the acquisition of GDF Suez SA, a French company, by the United Kingdom's International Power PLC (UNCTAD 2013, Annex Table no. 17)<sup>34</sup>—was worth \$12.9 billion. The scope and scale of cross-border M&A since the mid-1990s have, according to Kang and Johansson (2000/01), made them into one of the “fundamental mechanisms of industrial globalisation” (p. 6); indeed, the two economists assert that cross-border M&A have become even more important than **greenfield** FDI (*greenfield* refers to brand-new operations or factories).

The increasing fusion of firms across borders suggests that the basic definition of transnational production as “a type of production in which different parts of the overall production process for a particular product take place across different national territories” is, perhaps, a bit lacking. Hveem (2007) extends the definition by emphasizing the *systemic* aspect of transnational production. Thus, Hveem writes that transnational production systems [TPS] are comprised of “geographically distributed but integrated and more or less coordinated activities that include production, marketing and distribution functions organized across national boundaries. The TPS are usually institutionalized in long-term arrangements coordinated through active socialization or governed under some degree of centralized overall control (or both)” (p. 1). Consider, for example, the Swedish automobile manufacturer Volvo.

In a breakdown of one particular model—the Volvo S40—at least 38 major and minor components were manufactured in factories spread throughout the world: Slovakia, Japan, France, Norway, Brazil, Germany, the United States, Canada,

Holland, the United Kingdom, and, of course, Sweden. The hood latch cable, for instance, was manufactured by Klüster in Slovakia; the amplifier by Alpine (Japan); the engine control unit by Borgwarner (USA); the turbo diesel by Sanden (Japan); the drive shaft by GNK/Visteon (USA); the air conditioner by Valeo (France), the doors by Brose (Germany), and so on (Baldwin and Thorton 2008). In addition, it is likely that each of these manufacturers had their own transnational system of production. Figure 6.6, “The Volvo S40: A Product of a Transnational Production System,” provides a more detailed breakdown.

**Figure 6.6. The Volvo S40: A Product of a Transnational Production System**



**Table 6.3. Trends in Cross-Border Mergers and Acquisitions (By Value and Number)**

|   | 1990–<br>1996<br>Avg. | 1997–<br>2003<br>Avg. | 2004–<br>2008<br>Avg. | 2009      | 2010      | 2011      | 2012      |
|---|-----------------------|-----------------------|-----------------------|-----------|-----------|-----------|-----------|
| Value (by Sales) in Millions U.S.\$               | \$79,797              | \$426,270             | \$434,866             | \$249,732 | \$344,029 | \$555,173 | \$308,055 |
| Number of Cross-Border M&A (Sales)                | 2,542                 | 4,470                 | 5,575                 | 4,239     | 5,484     | 6,065     | 5,400     |
| Cross-Border M&A, Avg. Value (in millions U.S.\$) | \$31.4                | \$103.4               | \$78.0                | \$58.9    | \$62.7    | \$91.5    | \$57.0    |

Source: UNCTAD, “Annex Table 14 - Value of cross-border M&A purchases, by sector/industry, 1990–2012”; and “Annex Table 15 - Number of cross-border M&A sales, by sector/industry, 1990–2012.” Available online at <http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx>. The author calculated the averages.

## Explaining the Transnational Production Structure

With the foregoing discussion in mind, it is now time to move to a more substantive discussion of the transnational production structure (or system). On first glance, it may seem obvious why transnational production has become such a significant phenomenon. Indeed, in the previous section, a number of major factors were already identified, and one of these, the drastic decrease in transport and communications costs, would likely be fingered by most casual observers as the most important. After all, the drop in transport and communications costs has clearly made transnational production much more economically efficient—this is also reflected in the rise in efficiency-seeking FDI. Certainly, the search for greater economic efficiency is part of the answer; in this respect, too, it is important to underscore the development of new and better technologies, as well as improvements in global finance (Strange 1994). All of these changes have made it easier and more profitable to build integrated production systems across borders.

In keeping with this general theme, there are a number of other economically based theories that seek to explain the growth and deepening of transnational production. Dicken (2003) provides a very helpful overview. He begins with a macro-level Marxist approach that focuses on the concept, “circuits of capital.” Marx himself identified three circuits of capital: commodity capital, money capital, and productive capital. The term *circuit* is used to emphasize how money or capital invariably *circulates* through the three interconnected, but distinct processes, each of which *adds value* to the original amount. This idea—that capitalism is a spiral-like system designed to make money and commodities more valuable at the end of the productive process than at the beginning—is actually quite simple, and even self-evident. Still, it is an important insight that can be used to help explain the globalization of capitalism in general, and the globalization of production more specifically.

The basic circuit of capital works in the following manner: first, money (referred to as  $M$ ) is used to pay for factors of production, or basic commodities, such as raw materials and labor ( $C$ ). Second, through a productive process ( $P$ ), these basic commodities are then transformed into brand-new commodities ( $C'$ ), making them more valuable than the original cost. The new commodities are then sold; the profit or surplus value is turned back into money ( $M'$ ), and the process repeats itself, ad infinitum. The basic “equation” used to express this ongoing process is  $M—C \dots P \dots C'—M$ .

The reason this leads to globalization is equally simple. In the commodity-capital circuit, many raw materials need to be sourced internationally, which means that some level of cross-border activity must usually (albeit not necessarily) begin almost immediately. In addition, and more importantly, the sale of the newly produced commodities requires markets. Domestic or local markets are the obvious first choice, but these can become easily sated (especially as the productive process becomes more efficient). Thus, there is a strong and perhaps irresistible tendency toward cross-border trade. This is the first major phase in the internationalization of capitalism. Over time, as more surplus value is produced, new markets are also needed for investment capital; this leads to the globalization of the money-capital circuit (the second phase). The third phase is the globalization of the productive-capital circuit, which is the primary topic of this chapter. All three circuits, it is important to reemphasize, are part of an interconnected whole. This may all sound a bit arcane, but the main point is quite simple: capitalism is a constantly repeating process; as such, it has an inherent tendency to expand, first domestically, but then internationally or transnationally. In so doing, it inexorably connects and integrates national economies through trade, finance, and production. The globalization of productive capital (i.e., transnational production), more specifically, is a reflection of capitalism’s need to make the circuit operate at the highest possible velocity. “This requires”, as Murray (2006) explains it, “the development of space-shrinking and time-saving technologies which reduce the turnover time of capital. It is the development of such technologies, based on the capitalist imperative of maximizing profit, that ... has led to time-space compression and globalization as we know it” (p. 97; citing Harvey [1989]).

The advantage of the “circuits” approach, according to Dicken (2003) is that it emphasizes the interconnected and systemic character of trade, finance, and production (p. 210)—a very good lesson to keep in mind. At the same time, Dicken criticizes the Marxist approach for its inability to explain transnational production at a more specific level. Why are certain geographic areas chosen as sites for transnational production? After all, transnational production is not evenly distributed around the world; instead, it tends to concentrate in certain regions. Why are some kinds of organizational arrangements, or sector-specific decisions, made over others? What motivates firms to make the decision to engage in transnational production when they do? To answer these and similar questions, Dicken tells us that we must consider micro-level approaches. (By “micro-level,” Dicken means a *firm-specific* rather than a general system-level view.)

Dicken discusses a number of firm-specific arguments, the most comprehensive of which is John Dunning’s “eclectic paradigm,” which was first articulated in 1976 (see figure 6.7, “The Product Life Cycle and Transnational Production,” for a discussion of one other micro-level approach). Interestingly, Dunning did not consider his eclectic paradigm to be firm-specific: in a 1988 article, he asserted that it had “only limited power to explain or predict particular kinds of international production; and even less, the behavior of individual

enterprises” (p. 1). Nonetheless, the paradigm provided a general explanation for why firms begin to engage in international and transnational production. As Dunning explained it:

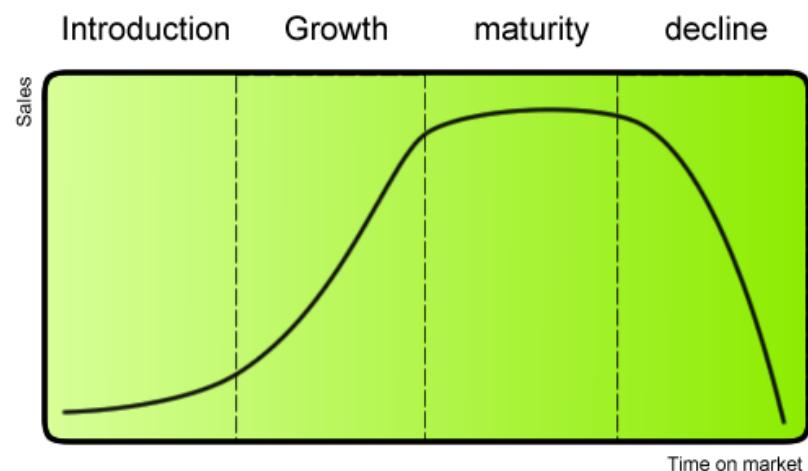
In its original form, the eclectic paradigm stated that the extent, form, and pattern of international production was [*sic*] determined by the configuration of three sets of advantages as perceived by enterprises. First, in order for firms of one nationality to compete with those of another by producing in the latter's own countries, they must possess certain advantages specific to the nature and/or nationality of their ownership. These advantages sometimes called competitive or monopolistic advantages must be sufficient to compensate for the costs of setting up and operating a foreign value-adding operation, in addition to those faced by indigenous producers or potential producers (1988, p. 2).

To put it in much simpler terms, before the decision to engage in transnational production is made by a specific firm, it must be reasonably clear that there is a sound economic basis for doing so. A second important and related condition, according to Dunning, is that there must be a compelling reason for a firm to not only locate production outside its home territory, but also outside the firm itself. Generally speaking, firms tend to internalize economic transactions in order to safeguard supplies of essential inputs, to ensure the quality of end products, to guarantee markets, to protect property rights, to spread the costs of shared overheads, and so on; thus, for a firm to transfer certain activities across national borders, there must be strong incentives (p. 3). On this last point, it is important to understand that Dunning’s model assumes that markets are imperfect—that is, that there are market failures. If there were not, then there would be no economically rational reason for firms to engage in transnational production. To understand the logic here, consider the issue of uncertainty. In real-world markets, firms cannot be sure that the intermediate supplies or other essential inputs they need for production will be available in the quantity and quality, and at the price, needed to ensure a consistent profit—especially if those goods are only available in certain foreign markets. It becomes rational, then, for firms to minimize or eliminate that uncertainty by taking control of the production of the goods they need by directly investing in the foreign markets in which those goods are located. Indeed, uncertainty is the major incentive for a firm to internalize factor or product markets (Dicken 2003, p. 205).

Finally, Dunning argues that there must be clear-cut locational advantages that make it profitable for the firm to use its assets in foreign as opposed to domestic locations. In other words, a location has to have something a firm needs that cannot be found in the firm's home country. This could be as simple as low-cost labor or resources; it could also be access to a country's consumer market. On this last point, it is important to emphasize that the choice of location may also be prompted by what Dunning refers to as "spatial market failure," by which he means barriers to trade. As Dunning puts it, "historically the imposition of trade barriers has led to a lot of foreign manufacturing investment by [TNCs]" (Dunning 1988, p. 4). This last point provides a nice segue into another type of explanation. While Dunning and others recognize that political and institutional factors can play a role in the development of transnational production, the emphasis is primarily on economic factors and questions of efficiency. But economic efficiency is not the only—or necessarily the most important—factor driving the emergence and development of transnational production. Another factor, also mentioned above, hinges on state policy: to repeat an earlier example, it is clear that the proximate cause of the shift by Japanese automakers from primarily domestically based production to transnational production in the mid-1980s was the imposition of VERs by the United States. This, of course, is the same point made by Dunning; still, it is important to consider the issue in broader and more systematic terms.

**Figure 6.7. The Product Life Cycle and Transnational Production**

*Product life cycle* refers to the period of time over which a particular product—e.g., a videocassette recorder (VCR)—is first developed, brought to the market (sold), and finally withdrawn from the market. In addition to development, introduction, and withdrawal, there are two other stages: growth and maturity. In the introductory stage, the product may experience little competition in the marketplace, but (assuming that the product is successful) eventually new competitors will enter the market, eroding the position of the leading firms. Over time, the product becomes standardized and widely available: this makes earning a profit on sales of the product more and more difficult. Makers of the product must find ways to reduce costs. At some point, the product goes into decline, eventually becoming obsolete.



The significance of the product-life-cycle concept to transnational production is simple: in the early phases of a product's life, production is typically centered in the originating country. Overseas demand for the product is met through exports. As the product matures, however, production tends to be (but is not necessarily) shifted across borders to lower-cost areas, or so that production can be closer to foreign markets. Dicken (2003) notes that the product-life-cycle concept explains only part of the process by which production is transnationalized (p. 204).

### *The Political Context of Transnational Production: A Focus on the Auto Industry*

Previous chapters have emphasized the importance of the political framework within which all economic activity necessarily takes place (this framework shapes, and is shaped by, economic activity). The lesson has become almost banal in the context of this book; yet, it is still one that needs to be highlighted. Recall, for instance, that *free trade*—to the extent that it exists—reflects the outcome of complex processes and relations of power, all of which play out within domestic, international, and global structures. With this in mind, one useful way of explaining the emergence and development of the transnational production system is to bring the focus down to a concrete level by examining a particular industry: automobile production. The auto industry is a good industry to focus on since it encapsulates many of the key issues involved in the process of transnational production. To be sure, the transnationalization of automobile production has its own distinctive aspects, which means that the experiences of the industry are not wholly generalizable.<sup>35</sup> Nonetheless, the industry’s experiences are broadly instructive and important, particularly since automobile production remains an area of major economic significance.

To begin, it is useful to note that the automobile industry, as Dicken (2003) writes, “is essentially an assembly industry. It brings together an immense number and variety of components, many of which are manufactured by independent firms in other industries. It is a prime example of a *producer-driven* production chain” (emphasis in original; p. 355).

Given the “immense number and variety of components” there has long been an important cross-border element to automobile production, in that certain materials—especially raw materials (e.g., rubber, glass, steel, and aluminum)—have always been sourced internationally. Still, production and assembly of the major (and high-value-added) components has tended to be located within the borders of a single country. Automobile production also has tended to be heavily concentrated in just a handful of major economies. In 1960, just six countries—the United States, Germany, the United Kingdom, France, Italy, and Canada (listed in order of production)—accounted for almost 92 percent of the total worldwide production of automobiles (OECD 1983). Significantly, Japan was not in the top six in 1960: it held the seventh spot, but was far behind Canada (that year, Canada produced 323,000 units, while Japan produced just 165,000). Canada’s inclusion on the list, it should be noted, reflects the limited degree of transnational production that had occurred prior to the 1960: both Ford Motor Company and General Motors (GM) began production operations in Canada in the early 1900s. Ford’s Canadian facility, however, was located just across the Detroit River in the city of Windsor, while GM acquired the Canadian company McLaughlin, which was located in Oshawa, Ontario (about 260 miles from Detroit). Both Ford and GM also established assembly operations in Europe, Latin America, Australia, and Japan in the 1920s. Not surprisingly, these early transnational operations were, according to

Dicken (2003), “triggered primarily by the existence of protective barriers around major

**Figure 6.8. Ford Motor Plant, Windsor Ontario (1920)**



Source: Canadian Postcard Company. The image is in the public domain in the United States because it was published before January 1, 1923.

national markets as well as by the high cost of transporting assembled automobiles from the United States” (p. 378).

Despite the early entry into transnational production by Ford and GM, little changed for more than half a century. The cross-border operations of the two American companies remained generally limited (World War II, in fact, forced a significant drawback in U.S. cross-border operations, while Japan’s mercantilist policies completely shut U.S. companies out of the Japanese market even before the war<sup>36</sup>); and, in Europe and Japan, automobile producers remained firmly rooted in their local landscapes. In Europe, the situation began to change in the 1970s. A major reason for this change, according to Dieter (2007), can be attributed to the European integration process—that is, the establishment of the European Union (which began with the creation of the European Coal and Steel Community in 1951). For transnational production, the key element of the integration process was the creation of a *single regulatory sphere*, which did two things. First, it enlarged the space of business (i.e., it created a larger market). Second, it enabled the enlargement of the area available for sourcing of components without having to consider local content requirements, which were common among the European economies at the time (Dieter 2007, pp. 17–18). The second factor came to play a particularly prominent role with the collapse of the socialist regimes in Eastern Europe after the fall of the Berlin Wall in 1989. Within a few years, the EU forged a regional trade agreement—the Central European Free Trade Agreement (CEFTA)—that originally included Poland, Hungary, and Czechoslovakia (after the breakup of Czechoslovakia, the Czech Republic and Slovakia joined separately). The CEFTA had two main components. First, it completely eliminated tariffs among the parties in the agreement, and, second, it *raised* tariffs between the CEFTA and the rest of the world (van Tulder 2004).

**Figure 6.9. Fiat Auto Factory in Poland**



Source: <http://www.kocjan.pl/> • This file is licensed under the Creative Commons Attribution-Share Alike 3.0 Unported license.

The new *political* framework led very quickly to a significant, albeit not huge, inflow of auto-related FDI to Eastern and Central Europe, led by Western European companies. Poland was, by far, the major recipient. In terms of *total* FDI, Poland’s inward FDI stock in 2000 was \$34 billion, compared to \$23 billion in Hungary (which was second to Poland). By

2009, inward FDI stock in Poland had grown to \$182 billion (cited in Zimny 2010, p. 9). The major European investors in Poland's auto industry are Fiat, Volkswagen, Volvo, and MAN Nutzfahrzeuge (a German truck company); more recently, Japanese and Korean automobile companies have invested in Poland. American car companies—Chevrolet and GM—also have operations located in the country. Indeed, except for one company (Solaris), the entire Polish car industry is based on foreign investments. Poland's initial appeal was likely the country's long experience producing cars during the socialist era: in 1989, the last year of socialist rule, the country produced about 289,000 units (during the socialist era, in fact, Poland was already producing cars for Fiat through a joint venture). After the CEFTA was implemented, but especially after Poland joined the EU, production in Poland ramped up. By 2004, Poland was producing over 600,000 units (passenger and commercial cars), and just four years later, in 2008, the country was nearing the one-million-unit production mark. (In more recent years, however, production in Poland has not only started to slump, but other Eastern European countries—the Czech Republic and Slovakia—have overtaken Poland.) In addition to finished automobiles, Poland also produces car engines, tires, and other parts. Significantly, almost all cars and auto parts produced in Poland are exported—about 98 percent—mostly to other European Union countries (Bulinski 2010, p. 3).

In other regions, similar processes unfolded. That is, major steps in the transnationalization of automobile production were preceded by political integration, usually in the form of a regional trade agreement. In Latin America, to cite another example, the creation of **Mercosur** (short for the Spanish phrase for “Common Market of the South”), a regional trade agreement among Argentina, Brazil, Paraguay, and Uruguay (which was a product of the 1991 **Treaty of Asunción**), created the basis for increased FDI in South America. The **Ouro Preto** agreement of 1994, which reinforced Mercosur by establishing a **customs union**, further spurred FDI by providing greater political credibility for economic integration in the region. Indeed, almost immediately after the Ouro Preto agreement was signed, Fiat decided to set up a new production complex in Argentina with an investment of \$600 million to produce 180,000 vehicles (Balcer and Enrietti n.d., p. 11). Balcer and Enrietti put this issue very bluntly: “Regional integration”, they write, “may be considered ... a necessary condition to

**Table 6.4. World's Leading Motor Vehicle Producers**

| Country/Region                                    | 2012       | 1990       | 1960      |
|---|------------|------------|-----------|
| China   | 19,271,800 | 509,242    | 22,574    |
| European Union                                    | 16,240,476 | n/a        | n/a       |
| United States                                     | 10,328,884 | 9,782,997  | 7,905,119 |
| Japan   | 9,942,711  | 13,486,796 | 481,551   |
| Germany   | 5,649,269  | 4,976,552  | 2,056,149 |
| South Korea                                       | 4,557,738  | 1,321,630  | --        |
| India   | 4,145,194  | 362,655    | 51,136    |
| Brazil  | 3,342,617  | 914,466    | 133,041   |
| Mexico  | 3,001,974  | 820,558    | 49,807    |
| Thailand  | 2,483,043  | 304,843    | --        |
| Canada  | 2,463,732  | 1,947,106  | 397,739   |
| <b>Other Selected Countries (World Rank 2012)</b> |            |            |           |
| Czech Republic (15)                               | 1,178,938  | 242,000    | 75,000    |
| Indonesia (16)                                    | 1,065,557  | --         | --        |
| Slovakia (19)                                     | 900,000    | --         | --        |
| Poland (22)                                       | 647,803    | 347,975    | 37,000    |

Source: Organisation Internationale des Constructeurs d'Automobiles (OICA), various years (<http://www.oica.net/category/production-statistics/>)

the development of an intra-firm division of labour on a regional level” (p. 12).

In North America, the adoption of NAFTA had a similar effect. To be sure, as noted earlier, U.S. companies were already engaged in transnational production prior to the mid-1990s (NAFTA was signed in 1994), but NAFTA helped to accelerate a regional reorientation of the North American auto industry, from one that traditionally stretched east to west, emanating from Detroit, to one that now stretches southward from Detroit to the Gulf of Mexico (Moavenzadeh 2006). This reorientation has turned Mexico into a major center of automobile production: in 2012, light-vehicle production reached a high of 3.57 million units, which made Mexico the eighth largest producer of light vehicles in the world, ahead of Canada (in 1989, Mexico produced just 439,000 vehicles to Canada’s 984,000); Mexico is also the world’s fifth largest producer of auto parts. Most of the cars produced in Mexico are exported, and most of Mexico’s car exports (more than 68 percent) go to the United States (U.S. Embassy—Mexico City 2013). Asia has been somewhat of an exception, in that there are no major regional FTAs involving both developed- and developing-world economies, but the transnationalization of automobile production is still premised on the construction of a political framework. Consider the case of Thailand.

In the early 1960s, the Thai government was primarily concerned with protecting the Thai auto industry, and imposed high tariffs on imports (up to 60 percent). At the same time, the country needed foreign technology and know-how, so it promoted FDI—but limited auto-related FDI to joint-ownership deals. There were a variety of other policies designed to promote local industrial development, but they generally failed to generate significant investment. Over time, this led to a shift toward a more open investment policy, which was most clearly reflected in the country’s adoption of the WTO agreement on Trade Related Investment Measures (TRIMS), which Thailand was the first developing-world economy to adopt. The government also eliminated local content requirements and most other restrictions on FDI, including the joint-ownership requirements (import tariffs, however, remained at fairly high levels). Thailand also signed a series of bilateral FTAs, including deals with Australia (2005), New Zealand (2005), and Japan (2007). Although not immediately apparent, the FTAs with Australia and New Zealand, as well as the existing ASEAN free-trade area (originally signed in 1992), were important parts of Thailand’s ascendance as a major regional center of auto production. Toyota, in particular, exports most of its Thai-produced vehicles to ASEAN member states, Australia, and New Zealand (all data cited in Athukorala and Kohpaiboon n.d.).

Importantly, Thailand’s neighbors in Southeast Asia—e.g., Malaysia, Indonesia, and Vietnam—largely failed to follow suit. That is, Thailand got a significant head start in liberalizing the investment and trade environment for automobile production, and therefore was able to create distance between itself and neighboring countries (which otherwise might also have been attractive locations for investment). The result for Thailand was a stunning rise in domestic automobile production: Thailand, which produced no cars in 1960, had become the 9<sup>th</sup> largest car producer in the world in 2012 (producing 2.45 million units), just behind Mexico, and the 7<sup>th</sup> largest auto exporter (about 1 million units). Not surprisingly, however, Thailand’s “big three” manufacturers are all foreign—specifically, Japanese—companies: Toyota, Isuzu, and Honda. (Ford, Daimler Chrysler, and GM also have operations in Thailand.)

The transnationalization of production in the automobile industry, in sum, provides a near-ideal window through which to view the globalization of the production process. On

the one hand, the economic imperatives (and benefits) behind the globalization (and regionalization) of production are quite clear. On the other hand, it is equally clear that the globalization and regionalization of automobile production invariably takes shape within a political framework. This political framework, to repeat a key point, is not merely a supplemental part of the process, but is instead an essential characteristic. In addition, while the transnationalization of automobile production has its own distinctive aspects, it is far from unique. To a significant extent, most manufacturing industries reflect the same basic dynamics.

### *The Auto Industry, Transnational Production, and Exploitation*

At the beginning of the chapter, I suggested that the increasing integration of the global economy, especially the linking of developed and developing world economies, may have made exploitation less serious today than in the past. On the surface, there seems to be some support for this view, as living standards in many of the more globally (or regionally) integrated developing economies—e.g., Mexico, China, Thailand, Poland, Brazil—seem to be rising. At the same time, some scholars argue that the expansion and deepening of transnational production is simply a repackaging of the same exploitative practices that have been going on for centuries under capitalism. Richard Vogel (2007), for example, asserts that the rise of transnational or global production reflects, at base, modern “capitalism’s relentless demand for cheap labor” (n.p.). In Vogel’s view, the globalization of production has created (or re-created) a hierarchical system of labor in which workers are divided, both domestically and internationally, into production tiers “that are paid grossly unequal wages and receive widely disparate employment benefits.” The ultimate goal or function of these global production chains “is to establish and maintain the lowest possible aggregate labor costs in order to maximize profits” (n.p.). This is not much different from previous eras, except that even workers in the core economies suffer from increasing exploitation. In the North American production system, for instance, midwestern autoworkers (a shrinking part of the overall workforce) in “Tier 1” jobs (these are jobs for the original equipment manufacturers [OEMs] in the main assembly plants) enjoy top wages, averaging about \$26 an hour in 2007. U.S. autoworkers in the southern

**Figure 6.10. A Maquiladora Factory in Mexico (2007)**



*Source: Guildhammer • The copyright holder has released this image into the public domain.*

states, however, receive only about half that amount—\$13.25 per hour on average. Tier 1 Mexican assembly workers, of course, are at the bottom of this scale, earning about \$3.25 an hour, a trifling 13 percent of the wages of their counterparts in the U.S. Midwest (all statistics cited in Vogel 2007).

Tier 2 employees—those working for subsidiaries or primary contractors—earn much less, and have fewer benefits. Again, wages are generally based on location, with U.S. Tier 2 employees, most located in southern states, earning about \$11 an hour, and Mexican workers earning an average of \$1.75. According to Vogel, however, there are relatively few U.S.-based Tier 2 employees, since the proximity of much cheaper—i.e., much more exploitable—labor in Mexico encourages locating the production of most parts and components across the border. Although Vogel does not provide figures for Tier 3 workers—these are the people who clean and maintain office and production facilities, work in cafeterias, laundries, etc.—their wages are typically set at the minimum-wage level: in 2013, the minimum wage in Mexico was approximately \$0.58 an hour. It is no accident, too, that many Tier 3 workers are undocumented immigrants who, because of their status, can be paid sub-minimum wages (with no benefits at all) in developed-country economies.

It is important to re-emphasize that this exploitative production system is part and parcel of a larger political process, one that is dominated by states and TNCs. The exploitation of Mexican workers, in particular, can be traced to the opening of the **maquiladora** program in 1964, which allowed foreign companies to set up and operate factories in Mexico free of duties, taxes, and other custom fees. NAFTA opened the door further to FDI, but made sure that workers' labor (and other) costs would remain extremely low. The Mexican government, in particular, "does all it can to ensure that workers don't unionize, or if they do that they join so-called 'protection unions' designed to assure the interests of plant owners and [to] keep wages low" (Johnson 2012, n.p.). As a result, many if not most maquiladora workers make just enough to survive—typically no more than \$7 to \$9 a day. It would, of course, benefit the Mexican economy if the workers were paid more. If they could earn middle-class wages, their consumption of goods would increase, which would provide a significant boost to the local economy. But if workers make too much trouble, replacement workers from Mexico's rural areas—where job prospects are even bleaker—can easily be brought in to replace them.

The Mexican government, however, is caught in a vise just as the workers are; if the government makes trouble by advocating for

**Figure 6.11. Median Annual Earnings for U.S. Males**



This graph shows a general decline in real wages for U.S. males; the upper line shows a relatively modest decline between 1964 and 2009 for full-time male workers. Significantly, though, only 66 percent of men held full-time jobs in 2009 compared to 80 percent in 1970. Taking both part-time and full-time jobs into account, the (median) real annual wage declined by \$13,000 (28 percent) over the four decades between 1969 (the peak year) and 2009.

*Source: Hamilton Project at the Brookings Institution. Original chart at [http://www.hamiltonproject.org/multimedia/charts/median\\_annual\\_earnings\\_since\\_1964/](http://www.hamiltonproject.org/multimedia/charts/median_annual_earnings_since_1964/)*

higher wages (for example, by imposing a minimum wage), demanding higher taxes and fees, or imposing regulations, the TNCs will threaten to move to another low-cost, less troublesome location. U.S. auto companies, in turn, have used their increasing reliance on the Mexican labor force to weaken, even “decimate” (as Vogel puts it), the unions in the United States. The United Auto Workers (UAW) union, in particular, is a shell of its former self: at its peak, it had 1.5 million members, but in 2012, membership stood at just 383,513 (UAW 2013). This has meant that wages even for Tier 1 employees in the Midwest have declined over the years. According to an analysis by Abby Ferla (2011), the entry-level wage (adjusted to 2011 dollars) for a UAW worker in 1961 was \$18.97; by 1970, this had increased to \$23.58. By 2007, however, the entry-level wage had dropped to \$15.25. For longer-term employees, the situation was the same: the “maximum attainable rate” dropped from a high of \$30.64 an hour in 1970 to \$19.28 in 2011 (for workers hired *after* 2007). The decline in manufacturing wages in the auto industry, it should also be noted, cannot be disconnected from wages more generally, both in manufacturing and service-sector jobs. Critics of globalization (and transnational production, more specifically), point out, that real wages—even in the United States—have been on a steady decline over the past four decades or so. In one study by the Hamilton Project at the Brookings Institution (2011), the median income for all male workers in the U.S. declined by 28 percent between 1969 and 2009—the equivalent of a \$13,000 drop in annual wages (see figure 6.11, “Median Annual Earnings for U.S. Males,” for more details).

The issue of whether transnational production exacerbates exploitation—about which there remains much vehement disagreement—raises a related and equally important question: has the globalization and increasing integration of the world economy created the basis for stronger, more dynamic economic growth in developing countries? Or is transnational production simply another mode of solidifying the division between the developed and developing world? It is to this question that we turn next.

## Transnational Production, FDI, and Economic Development

The relationship among transnational production, FDI, and economic development (in poor countries) is often oversimplified. On one side are advocates of neoliberal economic theory, who argue, quite assertively and unequivocally, that transnational production and FDI are almost entirely forces for economic progress. Consider the following statement by Anabel González, writing for the **World Economic Forum** and Global Agenda Council on Global Trade and FDI: “FDI is a powerful instrument for growth and development. Its relevance is enhanced today by its role as the crucial engine of growth, via global value chains, and by the critical need to increase investment flows to boost the global economy, create jobs, and promote knowledge and productivity enhancements” (p. 10). On the other side are writers such as Richard Vogel, whose work I discussed in the preceding section on exploitation and the globalization of the North American auto industry. Vogel, of course, is not alone. Critics of globalization and FDI argue, first, that the bulk of FDI does not flow to poor countries in the first place, but tends to concentrate in already wealthy economies. And, second, for poor or developing countries that do receive substantial FDI, their economies become seriously distorted—for example, they are made heavily reliant on external demand—and overly dependent on foreign companies that not only can leave at a moment’s notice, but that also tend to repatriate earnings back to their home countries. The result is

precious little development (for an example of this type of argument, see Hart-Landsberg 2006).

Looking around the world, it is almost assuredly the case that the truth lies somewhere in between these very general assessments. In Mexico, for example, the results are decidedly mixed: while FDI has created jobs and contributed to Mexico's overall growth, it has not led to a turnaround for the country's poor. This is reflected in the still extremely low wage levels in maquiladora factories and the largely unabated inflow of undocumented Mexican workers into the United States (which only slowed down after the collapse of the housing bubble in 2007—but only because there were fewer Tier 3-type jobs in the U.S.). Indeed, decades after the beginning of the maquiladora program and almost two decades after the implementation of NAFTA, Mexico continues to suffer from a very high level of poverty, with more than half the population (52.1 percent in 2012) living below the poverty line, a figure that is roughly the same as it was in 1992 (cited in Wilson and Silva 2013, p. 3). Similar stories can be found in other regions of the world. In Africa, a study by UNCTAD indicated that, with the exception of a few countries (Mauritius, Senegal, and Zimbabwe), the relationship between FDI and economic growth was either very weak or nonexistent (2005, p. 25). And while UNCTAD believes that FDI can play a constructive role on the continent, its overall conclusion is not favorable: “FDI seems to have reinforced a pattern of adjustment that privileges external integration [i.e., integration with world markets] at the expense of internal integration [i.e., development of strong linkages within domestic economies], typified by the establishment of **enclave economies**” (2005, p. 82). In Central and Eastern Europe and Asia, most studies have shown a generally positive relationship between FDI and economic growth, but there is clear evidence that the benefits from FDI, according to Hanson (2001) and others, tend “to be quite sensitive to host-country characteristics” (p. 23). The last part of the previous sentence is key. The effectiveness of FDI, to put it in slightly different terms, depends a great deal on the host country itself. However, it is not simply a matter of the host country having site-specific advantages, such as geographic proximity, cultural and linguistic affinity, a skilled and educated workforce, access to important natural resources, etc. These factors are certainly important in *attracting* FDI, but they have relatively little to do with the impact—positive or negative—that FDI will have on the host country as a whole.

In determining the impact FDI (and the concomitant integration into a transnational production system) will have on the host economy, the neo-mercantilist (or statist) position *may* offer the best answer: much depends on political factors. Does the host country have sufficient leverage to ensure that FDI is used to benefit the domestic economy? Does the host country have the capacity to effectively make and implement public policies? Equally, does it have the capacity to mediate effectively between domestic firms and TNCs—or sometimes, to deal directly with TNCs—to wring the maximum benefits out of FDI? The relationship between a host country's government and its own society is important as well. If state actors have little accountability and are generally unconstrained by domestic political arrangements—as often happens in authoritarian political systems—the benefits from FDI may accrue only narrowly to the economic and political elite. In short, when thinking about the impact of FDI it is important to keep firmly in mind that the goals and priorities of TNCs, governments, and societies are not only different, but also sometimes contradictory. In this view, the argument is straightforward: the only countries that will likely see a significant and broadly positive impact from FDI are those in which the state (1) has

adequate leverage and capacity vis-à-vis TNCs, and (2) is focused on promoting national economic development—in a strategic and systematic manner—and enhancing the general welfare of its citizens. In this regard, UNCTAD (2005) asserts that the East Asian countries, especially South Korea and Taiwan (China should also be added to this list), offer the best examples.

In East Asia, various policies were “employed to link FDI to a wider national development strategy, particularly in relation to upgrading and exporting; thus, in addition to clear ownership rights, guarantees against expropriation, EPZs (export processing zones) and fiscal incentives, such measures included **reverse engineering** of imported goods, technology screening, performance criteria, domestic content agreements, prohibited entry into infant sectors, and exchange controls” (UNCTAD 2005, pp. 55–56). Crucially, though, the UNCTAD report also acknowledges that “[s]trong and capable states are needed to bargain effectively with large firms” and with other interest groups, both domestic and foreign (p. 58). None of this is easy. Indeed, from the neo-mercantilist viewpoint, the primary problem is that most developing countries suffer from a serious lack of bargaining power vis-à-vis large TNCs. The reason is clear: in an era of globalized or transnational production, TNCs have an increasing capacity to exercise regulatory and labor arbitrage. Unless developing countries have something particularly valuable or unusual to offer, the ability of TNCs to locate production wherever the “best deal” is means that most developing countries have precious little leverage, much less power, of their own. (This can be partially mitigated through regional trade agreements, such as NAFTA or MERCOSUR, but even here state power is in play.) To better see the significance of state leverage and power, it would be useful to consider a specific case. One particularly good case to focus on, as suggested above, is China.

### *China’s Rapid Economic Rise and FDI*

The story of China’s economic rise, especially over the past two decades, is a complicated one—too complicated to cover in detail here. Thus, this section will examine, in a purposefully and extremely stylized manner, how China has dealt with FDI and transnational production, and why China has been successful in ensuring that FDI contributes significantly to the country’s economic growth and development. To begin, it is important to recall (from chapter 2) that China is still governed by the Chinese Communist Party (CCP), a highly organized, strongly interventionist political party that dominates all aspects of the Chinese state; the domination is so deep that China is said to be a *party-state*. Until 1978, the CCP presided over a centrally planned, command economy—the antithesis of a free market economy. Since then, however, the country has made a transition to a market economy, and the results have been stunning. In fact, since the transition, China has been one of the most dynamic and fastest-growing capitalist economies in

**Table 6.5. China's Average Annual Real GDP Growth Rates: 1960–2012**

| Time Period             | Annual Growth Rate (% per year) |
|-------------------------|---------------------------------|
| 1960–1978 (pre-reform)  | 5.3                             |
| 1979–2008 (post-reform) | 9.9                             |
| 1990                    | 3.8                             |
| 1991                    | 9.3                             |
| 1992                    | 14.2                            |
| 1993                    | 14.0                            |
| 1994                    | 13.1                            |
| 1995                    | 10.9                            |
| 1996                    | 10.0                            |
| 1997                    | 9.3                             |
| 1998                    | 7.8                             |
| 1999                    | 7.6                             |
| 2000                    | 8.4                             |
| 2001                    | 8.3                             |
| 2003                    | 9.1                             |
| 2004                    | 10.1                            |
| 2005                    | 9.9                             |
| 2006                    | 11.1                            |
| 2007                    | 13.0                            |
| 2008                    | 9.0                             |
| 2009                    | 9.1                             |
| 2010                    | 10.3                            |
| 2011                    | 9.2                             |
| 2012                    | 7.8                             |

Sources: For the years prior to 2009, Morrison (2009, pp. 3–4); for the years 2009–2012, *CIA World Factbook* (<https://www.cia.gov/library/publications/the-world-factbook/>)

the world. In 2012, China had the second largest economy in the world with a (nominal) GDP of \$8.2 trillion (in PPP terms, the CIA [2013] estimates China's GDP at \$12.6 trillion). Although still relatively poor in *per capita* GDP terms—China is ranked about 92<sup>nd</sup> in the world—the country's economic growth rates, combined with relatively low fertility rates, suggest that it will move up quickly. Since 1979, China has grown at an unprecedented pace, averaging 9.9 percent between 1979 and 2008. Even during the depths of the global recession, from 2009 to 2011, China continued with high growth rates at an average of 9.5 percent per year, although in 2012, growth slowed to 7.8 percent (see table 6.5, “China’s Average Annual Real GDP Growth Rates”). For much of the rest of the world, by contrast, the period between 2009 and 2012 was marked by either negative growth or very low growth, with 2009 being a particularly bad year.

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<sup>27</sup> The authors point out that it is difficult to make hard-and-fast conclusions, simply because there “are very few data available on intra-firm trade.” As noted in the text, only the U.S. collects detailed trade statistics distinguishing between trade with related parties (intra-firm trade), and trade with nonrelated parties. For a number of OECD countries, there are statistics available on the activities of TNCs, but the coverage is not comprehensive (Lanz and Miroudot 2011, p. 12).

<sup>28</sup> SAR stands for special administrative region, which is a designation that the government of the People’s Republic of China uses to classify certain regions of the country. Hong Kong is one of these regions. As an SAR, however, Hong Kong is formally considered to be a largely autonomous territory, with its own (elected) government, judicial system, police force, official language, etc. Macau is another Chinese SAR. Despite their autonomous status, SARs are ultimately under the sovereignty of the PRC, which is governed by the Chinese Communist Party.

<sup>29</sup> For a detailed discussion of the impact of containerized shipping on the world economy, see Levinson (2006).

<sup>30</sup> The inward and outward figures do not always balance because of normal accounting discrepancies. For example, FDI positions represent the value of the stock of direct investments held at the end of a fixed period (i.e., year, fiscal year, quarter, month), and the positions are affected not only by financial transactions recorded prior to and during the period, but also by other changes in price, exchange rates, and volume.

<sup>31</sup> The UNCTAD data are available online in the *World Investment Report 2013:Annex Tables* (<http://unctad.org/en/Pages/DIAE/World%20Investment%20Report/Annex-Tables.aspx>). The cited data are from Annex Tables 03, 04, 07 and 08.

<sup>32</sup> According to O’Brien and Williams, for example, the basic problem is that the UN definition does not differentiate the TNC from a related, but still distinct entity, the multinational company (MNC). Multinational companies, as with TNCs, have investments in other countries, but their primary focus is on selling goods to different markets based on local market conditions: in the past, for example, Japanese auto manufacturers did not produce any cars outside of Japan; they were MNCs. TNCs, by contrast, are typically involved in direct production activities abroad. Thus, an amended definition of a TNC is “a firm that owns and controls production (value-added) facilities in two or more countries” (O’Brien and Williams, 2007 p. 179). MNCs used to be the norm, but they have been largely replaced by TNCs. On this point, it is worth noting that many TNCs today were once multinational corporations. Again, automobile manufacturers are a good example: they used to produce all their cars in one country, invest in showrooms and maintenance facilities in another country, and then sell their products in the local market. (U.S. automobile manufacturers were a major exception, as they engaged in transnational production as early as the 1920s.) Today, as noted earlier, those same producers build cars throughout the world, usually as part of a globally integrated production system.

<sup>33</sup> Year-by-year figures for cross-border M&A activity fluctuate significantly. From 2010 to 2012, for example, the annual value of cross-border M&A activity went from \$344 billion to \$555 billion to \$308 billion. Between 2005 and 2007, by contrast, the average yearly value was \$703 billion (UNCTAD 2013, p. 24).

<sup>34</sup> This pales in comparison, however, to a proposal, first reported in September 2013, merger between Vodafone (a European company) and Verizon (an American company), which is said to be worth \$130 billion in cash and stock (Yu 2013).

<sup>35</sup> Surgeon, Memedovic, Bieseboek, and Gereffi (2009) point to four distinctive features of the automobile industry: (1) its highly concentrated firm structure; (2) its tendency to keep final assembly close to end markets; (3) its strong regional structure; and (4) its lack of generic parts or subsystems that can be used in a wide variety of end products without extensive customization (p. 9).

<sup>36</sup> Ford entered Japan in 1925, with GM following shortly thereafter. After about a decade, though, the Japanese government introduced the “Automobile Manufacturing Industry Law,” the primary impact of which was to force the two American companies to close their operations in Japan and leave the country entirely (van Tulder 2004, p. 207).

There is, it is important to re-emphasize, almost nothing laissez-faire about the Chinese party-state. It is deeply and pervasively interventionist. To the extent that China has freely operating markets, one can say with only slight exaggeration, it is because the state explicitly encourages and permits such activity. It is no surprise then that the party-state has played a key role managing FDI and China’s integration into global production systems. Particular attention

has been paid to ensuring that FDI improves the competitive capacity of Chinese firms in areas that Chinese leaders consider to be key industrial sectors—which typically include one or several state-owned enterprises (or SOEs), discussed in more detail below. For a long time, for example, the Chinese state has published an “investment catalogue,” which lists specific areas in which FDI is “encouraged,” “accepted,” and “discouraged.” Investments in the first category have access to a range of preferences: tax subsidies, preferential access to land and labor, a simplified regulatory process, and so on. The offer of preferences, however, is generally contingent on the foreign firm’s willingness to transfer technology to Chinese firms. In the high-speed rail sector, for example, foreign firms were restricted to joint ventures and, as a condition of their investment, required to transfer important technology to their Chinese partners. The result? Chinese firms quickly absorbed the technology and then proceeded to compete directly against American, European, and Japanese firms for contracts outside of China (Sally 2011, p. 13). Another salient example is the steel industry. The Chinese government imposes strict guidelines on acceptable foreign investment. China’s “Iron and Steel Industry Development Policy,” for instance, lists the following criteria for foreign investors: “[they] must possess iron and steel technology with independent property rights and should have produced at least 10 millions tons of carbon steel or a least 1 millions tons of high-alloyed special steel in the previous year” (cited in Heiden 2011, p. 20). As in the high-speed rail sector, the Chinese state (through the National Development and Reform Commission) requires joint ventures in which the Chinese partner maintains at least 50 percent ownership in the firm. The state’s involvement, it is important to note, goes well beyond the issue of foreign investment: it also manipulates the prices of vital inputs; imposes export restrictions on important raw materials (such as coke) and semi-finished products; selectively promotes exports of high-value-added, technology-intensive products; and subsidizes outward investment by Chinese firms (Heiden 2011). The goal, of course, is to make China into the largest and most profitable steel producer in the world. The first part of this goal was achieved in 1996, when China surpassed Japan as the world’s leading steel producer; ten years later, China also surpassed Japan as the largest exporter.

There are many other aspects of China’s policy toward FDI—again, too many to cover here. Suffice it to say, then, that the Chinese state has been very successful in not only encouraging technology transfer, but also technology absorption. In the process, many Chinese firms have moved from “junior partner” to “senior partner” status in relatively short order. Of course, this is not uniformly the case throughout the Chinese economy, but the success stories are fairly common. Another reason for this is China’s policy of developing “national champions”; that is, very large companies—often SOEs (see figure 6.12, “State-Owned Enterprises in China,” for further discussion)—that have preferential access to bank capital, as well as to FDI. China’s success raises an important question: Is China’s experience with FDI easily copied? That is, can other states do what China has done? The short answer is—it depends. China is unusual; that is, it is not like the vast majority of other developing countries. It has something that TNCs need: vast, still-underexploited, and extremely valuable markets, both for labor and consumption. China’s exceptionalism gives the country’s state leverage and power that most other developing countries lack. It is partly, perhaps largely, for this reason that China can extract maximum benefits from FDI, and, to some extent, even dictate terms to the largest, most economically powerful TNCs. On this point, it is useful to consider the neo-Marxist perspective.

### **Figure 6.12. State-Owned Enterprises in China**

State-owned enterprises, or SOEs, “are business entities established by central and local governments, and whose supervisory officials are from the government” (Szamosszegi and Kyle 2011, p. 6). SOEs, however, are only one of a number of types of state-controlled enterprises (SCEs). Thus, in addition to SOEs, there are joint-operation enterprises, limited-liability corporations, shareholding corporations (with the state owning the majority of shares), and public organizations. In 2010, there were 9,105 SOEs in China, and another 11,405 enterprises in which the state held a controlling share of the company (cited in Szamosszegi and Kyle 2011, p. 8). Despite the relatively small number of SOEs (and other state-controlled companies), their influence in the national economy remains significant. Accurate figures, unfortunately, are not available, but various analyses have put SOEs’ share of China’s GDP at between 30 percent and 50 percent. In addition, SOEs and SCEs account for as much as 48 percent of urban employment, and 54 percent of total wages paid to urban employees.

Equally if not more important, the Chinese state has designated defense, electric power, petroleum and petrochemical, telecommunications, coal, civil aviation, and shipping to be strategic industries, and equipment manufacturing, automobiles, IT, construction, iron and steel, nonferrous metals, chemicals, and surveying to be pillar industries. In strategic industries, the state has declared that SOEs or SCEs must maintain either sole ownership or absolute control, while in pillar industries a “strong control position” is required. All SOEs, but particularly those in strategic and pillar industries, receive preferential treatment from state-owned banks. For example, they have access to capital and favorable interest rates, or, if they are unable to repay their loans, their debts may be forgiven. In addition, some uncreditworthy SOEs are extended loans. (The statistics and other information cited here come from Szamosszegi and Kyle [2011].)

The greatest benefits are provided to the so-called national champions—that is, firms that are among China’s largest SOEs. These include:

- China National Petroleum
- Sinopec
- China National Offshore Oil Company
- Aluminum Corporation of China
- China Minmetals
- China State Construction and Engineering Corp.
- China Ocean Shipping Group (COSCO)
- China Communications Construction
- ZTE Corp (telecommunications)

- Lenovo (IT)
- Haier (consumer goods)
- CITIC
- China Investment Corporation (a sovereign wealth fund)

In addition to their access to low-cost loans, the Chinese state helps to ensure the success of national champions by making sure they have access to cutting-edge, often proprietary technology. For instance, in return for access to the Chinese market, the Chinese government generally requires foreign firms not only to enter into joint ventures with Chinese manufacturers, but also to provide proprietary technology transfer—i.e., patents and trade secrets. For further discussion, see Hemphill and White III (2013).

In the neo-Marxist view, it is well understood that capitalism, to survive and prosper as a system, needs space for constant expansion. It is for this reason that China's 1.3-billion-person economy has long been looked upon as a necessary part of global capitalism. Under strict communist rule, however, Chinese markets were closed off to the capitalist world. Of course, this did not last. Thus, when China began its transition to a market economy, TNCs were more than ready to take advantage. In the first decade or so, not surprisingly, there was some trepidation, but by 1992, once it had become clear that the Chinese leadership were thoroughly committed to the reform process, inward FDI began to ramp up. This is evident in the statistics. From 1982 to 1991, the net annual inflow of FDI remained relatively low, growing from just \$430 million to \$4.366 billion. In 1992, by contrast, FDI shot up to \$11.15 billion, and then more than doubled to \$27.5 billion in 1993. Between 1993 and 2002, FDI averaged almost \$40 billion a year compared to the \$2.26 per year average between 1982 and 1991 (all figures cited at <http://data.worldbank.org/>). By the late 1990s, China had become the second largest destination for FDI in the world, behind only the United States; in 2002, China (temporarily) passed the U.S., and since then the two countries have been neck and neck. Among late-industrializing countries, though, China has been, by far, the largest recipient of FDI. The most impressive growth began in 2005: that year alone, China attracted \$117.2 billion in FDI, breaking the \$100-billion mark for the first time (OECD 2012). In 2011, China broke the \$200-billion mark with a total of \$280 billion—about \$23 billion more than the United States.<sup>37</sup>

The huge inflow of FDI to China reflects the importance of China to global capitalism. While it is certainly true that a great deal of FDI is meant to take advantage of low labor costs in China, it is also clear that TNCs are motivated by gaining a strong foothold inside China's growing consumer market. China's middle class plays a particularly important role in this regard, since it will be the main driver of increased and sustained consumption in the coming years. Consider, on this point, an analysis by Barton, Chen, and Jin (2013) of McKinsey and Company. They point out that China's middle class (which is defined as households with income between \$9,000 and \$34,000 a year) has grown from just 4 percent of the urban household population<sup>38</sup> in 2000 to 68 percent in 2012; they project that this will increase to 75 percent in 2022—this is equivalent to *630 million* consumers. Upper-middle-class households, in particular, are “poised to become the principal engine of consumer spending over the next decade,” both for China and, to a significant extent, the entire world. Barton (in a separate article) estimates that, in 2022,

China's middle class will be consuming goods and services valued at \$3.4 trillion. "This," he tells us, "will have enormous significance for U.S. businesses" and, by extension, for businesses from every core economy (2013, n.p.). Even now (in 2013), China is becoming a major market for relatively high-priced consumer goods: a case in point is Apple's iPhone 5S, which broke sales records when it was released in September 2013. A big reason for the success of the 5S, according to industry analysts, was the Chinese market (Greenfield 2013). TNCs cannot afford to *not* have a foothold in the Chinese economy, and this is what gives the Chinese party-state tremendous leverage and power: it remains, for the time being, the principal gatekeeper into (as well as out of) China. While the Chinese economy is a market-based capitalist economy, it is decidedly not a free market.

To sum up: in assessing the impact of FDI, it is critical to consider, first and foremost, the power of the host country state in the global economy. Not all states (especially in the developing world), of course, are equally empowered, nor is the source of power always the same. For this reason, China is not alone in exercising influence over TNCs and FDI. At the same time, there are few developing countries in the same position as China (possible candidates might include India and Brazil); nor are there many states that have the internal capacity of the Chinese party-state (a possible candidate is Russia). This explains why China has been able to use FDI to such great advantage, and even become an economic juggernaut.

China's economic ascendance, however, has not been all wine and roses. As in Mexico, integration into a global system of production has also meant integration into a highly exploitative global division of labor—a point also emphasized by neo-Marxist scholars. On this point, it is important to recognize that inequality in China has "increased steadily and inexorably" since the early 1980s (Naughton 2007, p. 217). The country's Gini coefficient—a scale on which zero is perfect equality and 1.0 is perfect inequality—increased from 0.28 in 1983 to 0.447 in 2001. This is an unprecedented deterioration, and one that has turned a country that was once one of the most equalitarian in the world into one that is "now similar to the most unequal Asian developing countries, such as Thailand, 0.43, or the Philippines, 0.46" (Naughton 2007, p. 218). Thus, while it is true that a new, relatively prosperous middle class in China has emerged and is growing—along with the rise of a class of economic elite—a huge and almost assuredly *permanent underclass* of hyperexploited, low-skilled workers has also been created. Other analysts argue, however, that the picture is not quite so neat. The World Bank (n.d.) notes that China has made remarkable progress in reducing severe poverty within the country: since 1978, more than 500 million Chinese citizens have been lifted out of poverty, and the poverty rate has fallen from 84 percent in 1971 to a scant 13 percent in 2008 (as measured by the percentage of people living on the equivalent of U.S. \$1.25 or less per day in PPP terms). Such results cannot be dismissed as unimportant; instead, they reflect a sea change, not only for China, but for the world as a whole, as half-a-billion people represents about 7.5 percent of the entire world population. Also, do not forget that China's burgeoning middle class will comprise at least 45 percent of China's population in 2022. The upshot is that there is no simple, black-and-white answer to the broader question: Does transnational production and FDI help the poor and less privileged segments of society? However, examining the question from a variety of theoretical perspectives will help you develop a better, more critical understanding of the issue.

## Transnational Production and State-Firm Interactions

The seeming strength of the Chinese state helps underscore a basic element of the global political economy: despite the increasing importance of TNCs and of the global production (and financial) structures, it is fairly evident that states still matter a great deal. This stands in sharp contrast with a common narrative of the past twenty plus years, which is that globalization has made the state increasingly irrelevant. The debate over the relevance of the state in an era of globalization, however, has not been terribly productive. This is true largely because the wrong question is being debated. That is, the question should not be, does the state still matter? Instead, the question should be, how has globalization (especially transnational production) changed the character of the state and the dynamics of its interactions with TNCs and other transnational actors? The discussion in the preceding sections also compels us to stop treating states as generic entities. There are, it is important to understand, a variety of states, with (1) widely varying degrees of internal capacity, competence, and coherence (political, economic, and military); (2) different policy interests, preferences, and choices; (3) divergent orientations and attitudes towards FDI, the market, and the world economy; (4) different political-regime types; (5) different levels of integration in the global economy and different levels of socioeconomic development; and so on. The list is quite long. All of these differences shape and even determine how states respond to globalization, and how effective their individual responses can be. To be sure, states share important characteristics, too, but their differences from each other can be, and often are, profound.

The case of China, for instance, represents a state with a high degree of internal capacity, competence, and coherence. But contrast this with the case of Somalia. In Somalia, a functioning national state barely exists, so it is no wonder that Somalia is not only one of the poorest countries on the planet, but also shows little hope of improving its economic condition any time soon. Of course, Somalia is an extreme example, but it underscores the vast differences that can and do exist between and among states. On a broader basis, Peter Evans (1995) examined the main differences between states and identified two basic categories (or ideal types): developmental and predatory states. Predatory states, as the name implies, prey on their citizenry, “terrorizing them, despoiling their common patrimony, and providing little in the way of services in return” (p. 45). Zaire was his archetypical case. Developmental states have a number of features, including a highly selective and meritocratic bureaucracy, a leadership committed to achieving national economic development (for a variety of reasons), and a strong connection to their societies. Japan, South Korea, Taiwan, Singapore, among a few others, fall clearly into this category. There also intermediate states “like Brazil and India that have enjoyed inconsistent by occasionally striking success in promoting industrial transformation” (p. 44).

So how has globalization changed the character of the state and the dynamics of state-TNC interactions? At the most general level, it has pushed most states to be much more cognizant of the interests and motivations of TNCs when making ostensibly domestic public-policy decisions. This is not necessarily new—Marxist analysts have always argued that what states do primarily reflects the interests of dominant class actors (although scholars from other schools of thought do not always agree). What is new, however, is that these dominant class actors may be foreign firms who are exercising power through transnational production (and finance) structures, rather than directly over or against particular states. In addition, unlike previous eras in which, say, an American firm had the implicit or explicit backing of the U.S. government in dominating foreign markets—for example, United Fruit Company in Guatemala

or ITT in Chile (see figure 6.13, “U.S.-Supported Coups and American Companies,” for further discussion)—TNCs no longer need the coercive capacity of their home state to back them up. The state-TNC relationship, in short, has become one between two sets of independent actors, each with their own sources of power. This does not mean, to repeat, that TNCs have power *over* states; rather, it means that states and TNCs have developed a type of reciprocal power relationship. States need TNCs for what they can do and offer (e.g., economic growth, employment, access to important skills and knowledge), while TNCs still need states to undertake those functions that create a necessary and stable framework of economic activity.

### Figure 6.13. U.S.-Supported Coups and American Companies

During the Cold War, many scholars argue, the U.S. government was implicated in a number of coups that overthrew governments considered to be inimical to U.S. *corporate* interests. One of these occurred in Guatemala in 1954, when the CIA (Central Intelligence Agency) helped to oust Guatemalan president Jacobo Árbenz from power. Árbenz, who was initially considered a U.S. ally, made the “mistake” of implementing land reforms that threatened the holdings of the U.S.-owned United Fruit Company. It is worth noting that both the director of the CIA and the secretary of state at the time, Allen and John Foster Dulles respectively (who happened to be brothers), had strong connections to the United Fruit Company: Allen Dulles was a former president of the company, while John Foster Dulles served as corporate council. Even more, after Jacobo Árbenz was successfully removed from office, the next president of United Fruit Company was Walter Bedell Smith—who happened to be a former CIA director (Hare 2009).



In Chile, a similar scenario unfolded when Salvador Allende, a socialist, was elected president in 1970. President Nixon told the CIA to “make the [Chilean] economy scream,” and authorized the CIA to use any means necessary to get rid of Allende. It is well known that a major American telecommunications company, ITT, collaborated with the CIA—first, to prevent Allende’s election, and then (when that effort failed) to overthrow Allende (Kornbluh 2004). Of course, there were other very important factors involved, but the Chile and Guatemala incidents help highlight the extraordinary level of cooperation between U.S. corporations and the U.S. government in foreign markets during the Cold War period.

*Image source: [Mágicas Ruinas](#) • This image (of Salvador Allende) is in the public domain because the copyright of this photograph, registered in Argentina, has expired.*

### The Rise of the Competition State

Some scholars have argued, more specifically, that the trend toward transnational production (and other aspects of globalization) has created a major shift, especially among the most developed countries, from the so-called **welfare state**—a concept of government in which

the state's key role is presumed to be the protection and promotion of the economic and social well-being of its citizens—to the *competition state*. The competition state may still pay heed to the well-being of citizens, but the method of providing for this well-being is very different. Instead of directly protecting society from the more destructive aspects of market forces (the premise of the welfare state), the competition state embraces “openness and marketization.” Competition states, as Cerny and Evans (n.d.) explain it, seek to make the domestic economy more prosperous and competitive in international terms while accepting the loss of key traditional social and economic state functions which were central to the development of the IWS [industrial welfare state]. Sometimes state actors even compel domestic private sector actors to abandon traditional cartel-like practices, to force them to be free and open to the winds of global market change; there was clearly a salient element of this in **Thatcherism** in Britain, not to mention the more authoritarian form of marketization in Pinochet's Chile. (p. 1)

Under Thatcher, it is worth noting, the state pursued a “Big Bang” approach, which is to say that financial markets (in particular) were deregulated in almost one fell swoop through the 1986 Financial Services Act. The act gave no special treatment to British banks, some of which were unable to survive the “onslaught of new competition” from abroad (Vogel 1996, p. 108). Arguably, though, the Big Bang strengthened the British banking system and helped to reestablish London as the financial center of the world.

As often happens with contrasting social-scientific terms, the concept of the competition state has tended to be portrayed as a binary opposite to the welfare state, although it is more accurate to think of the welfare and competition states as existing relatively close together on a continuum (moreover, as Cerny [2010] notes, the competition state is not about replacing markets, but making them more efficient). In any case, it is fair to say that some states have seemingly embraced the competition-state model to a significant extent, while others have

**Table 6.6. The Competition-State Index**

| Country         | Score  |
|-----------------|--------|
| Ireland         | 7.768  |
| Korea           | 6.694  |
| UK              | 5.065  |
| Australia       | 4.801  |
| New Zealand     | 3.459  |
| Switzerland     | 3.085  |
| Canada          | 3.072  |
| USA             | 2.789  |
| Slovak Republic | 2.616  |
| Czech Republic  | -0.123 |
| Japan           | -0.381 |
| Denmark         | -0.495 |
| Finland         | -0.600 |
| Sweden          | -0.606 |
| Norway          | -0.922 |
| The Netherlands | -1.353 |
| Italy           | -2.518 |
| Spain           | -2.550 |
| Portugal        | -2.718 |
| Greece          | -3.308 |
| France          | -3.922 |
| Germany         | -3.996 |
| Austria         | -4.065 |
| Belgium         | -4.115 |
| Poland          | -4.824 |

*Five dimensions were used to measure the degree to which countries conformed to the competition-state concept (overall welfare effort, postwelfare contracting state\*, traditional welfare responsibilities, government regulation of industry, and taxation). Countries that had the highest composite scores (the dimensions were weighted) most closely reflect the competition-state model.*

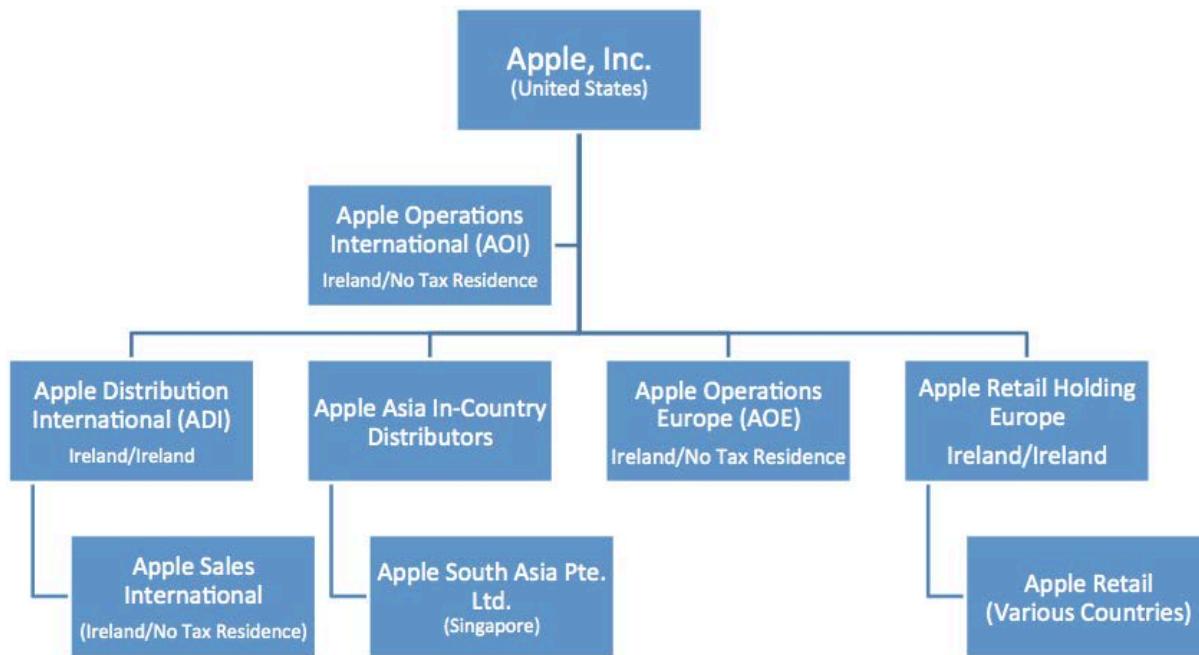
\* This refers to the replacement of welfare entitlements with schemes that favor integrating people into the private-sector workforce through, for example, subsidized employment or training programs.

not. To get a better sense of the divergence among states, Daniel Horsfall (2010) undertook an effort to measure the competition state (it must be emphasized that only 25 of 34 OECD countries were included). Based on his analysis, Horsfall concluded that Ireland, South Korea, the United Kingdom, Australia, and New Zealand were, in order, the closest to the competition-state model. Poland, Belgium, Austria, Germany and France, by contrast, were on the opposite end of the scale (see table 6.6, “The Competition-State Index,” for the complete list). Despite the apparently wide divergence between countries at the top and the bottom of the list, all of the countries subject to analysis could still be considered competition states (primarily because Horsfall explicitly measured each country’s “competition stateness” relative to other countries in the study). Unfortunately, comparable measurements for the vast majority of the world’s countries—especially for developing economies—are not available.

One can surmise, however, that effects of globalization—and, therefore, the pressure to become a competition state—are strengthening. The very notion of the competition state suggests that states must increasingly compete with other states to create the “best environment” for capital, and specifically for TNCs. As states compete against one another, moreover, this provides greater space for TNCs to exercise power, in part by playing one state off against another. This means, in turn, that states are increasingly forced to bargain not just with other states, but with TNCs as well, which are nonstate or transnational actors. Indeed, this is a primary basis for the changed dynamic between states and TNCs: in contrast to previous eras, there is much more bargaining between states and TNCs, both directly and indirectly. Scholte (1997) points to the basic reason: “Sovereign statehood depends on territorialism, that is, on a world where events occur at fixed locations either within a territorial jurisdiction or at designated points across tightly patrolled borders. Yet global processes like electronic money and transborder manufacturing chains cannot be fixed in a single territorial unit over which a state might exercise supreme and exclusive jurisdiction” (p. 442). The decreasing salience of territorialism means that TNCs have, in many (but not all) situations, the capacity to override sovereignty (Scholte 1997, p. 443).

A seemingly mundane, but very important, example is the ability of TNCs to avoid paying national taxes through **transfer pricing** and offshore corporate registration. A noteworthy case is Apple, Inc., which has set up three foreign subsidiaries (see figure 6.14) that, according to a U.S. Senate report, are not resident in any country for tax purposes: they are ghost companies (i.e., they exist, but have no physical, or more accurately, taxable presence). One of these subsidiaries, Apple Operations International (AOI), paid no corporate taxes to any nation for five years, although it reported \$30 billion in net income between 2009 and 2012. Another subsidiary has paid a tax rate to Ireland of one-tenth of one percent (0.001) or less for the years 2009 to 2011 (all information cited in Gross 2013). None of this, moreover, is illegal. Apple is simply taking advantage of a deterritorialized world over which even the most powerful states (in this case, the United States) exercise increasingly limited control. Corporate supporters of Apple, moreover, argue that the most rational course of action for the U.S. government to follow is clear: make the U.S. economy even “more competitive,” in large part by lowering the corporate tax rate, expanding the R&D tax credit, and enhancing government investment in research and technology development (ITIF 2013). Apple itself blames the U.S. government for building a tax system that makes bringing overseas earnings back to the U.S. “too costly.”

**Figure 6.14. Apple, Inc.’s Offshore Organizational Structure**



Source: Original chart prepared by the Permanent Subcommittee on Investigations (2013, p. 20), based on materials sent by Apple, Inc. (This chart was created by the author based on the aforementioned material.)

### *Sovereignty and the Regulation of TNCs*

At the same time, for countries such as the United States and China—and for regional entities such as the European Union—jurisdiction over a fixed geographic space remains an important source of power. Again, even the most powerful TNCs need access to certain types of markets—most importantly, consumer markets, but also markets for natural resources—that are still, for the most part, territorially based. On this point, it is important to emphasize that while production (and finance) have been globalized, political borders continue to constrain, quite profoundly, the free movement of people/consumers. But even without political constraints, populations tend to be relatively immobile, which means that territorialism will likely never be completely dead. Of course, not all countries have consumer or natural-resource markets that are large or valuable enough to be considered of vital importance or even of much significance to TNCs. For these countries, their bargaining power vis-à-vis TNCs is extremely limited, and will likely become even more limited as globalization continues to unfold.

The upshot is that sovereignty is not what it used to be, and it is the erosion of sovereignty that is seen as marking the demise of the state. Yet, as constructivists might tell us, state sovereignty has always been a social construction. To paraphrase Alexander Wendt (1992), “sovereignty is what states make of it.”<sup>39</sup> What this means, in part, is that sovereignty does not have an essential or necessary meaning or character. Until recently, sovereignty has been defined almost strictly in terms of the **Westphalian system**, which recognized the principle of territorial

integrity, and defined sovereignty as a quality of *individual* states. Sovereignty, in this view, is the power of the state to exercise *supreme*, comprehensive and exclusive authority over a given, delimited territorial space. This also means that there can be no higher or supranational authority capable of exercising power across national borders, and nor can there be shared sovereignty. And while Westphalian sovereignty has always been subject to contestation in practice—certainly the territorial integrity of most of the non-Western world during the era of colonialism was routinely ignored and violated by Western powers—the idea of sovereignty has remained extremely strong. More importantly, the idea that sovereignty can only be exercised by individual states over a fixed geographic space has, at least to some extent, prevented or at least blocked states from more effectively adapting to the circumstances of a more globalized world. Of course, this is not universally true: the formation of the EU, in particular, represents an important change in state behavior and an important attempt to redefine sovereignty, at least at a regional level. The effort to create a cross-border trading regime governed by the WTO is another salient example of states attempting to reshape sovereignty (consider, on this point, the evolution of the Dispute Settlement Understanding, discussed in chapter 4). There has been much less success with regard to the transnational production system, but this is not because states are inherently incapable of dealing with the deterritorialized character of the system. Rather, it is because states have thus far been unable to overcome the essentially self-imposed limits of Westphalian sovereignty. On this point, keep in mind that the constructivist perspective recognizes that social constructions, once created, have a great deal of power: social constructs, in other words, are *real* structures with objective effects that can and do severely constrain the action of agents. Sovereignty, in this regard, is a powerful force in the global political economy that cannot simply be wished away.

This has certainly been evident in early efforts to deal with the growing role of TNCs in the global political economy. R. Alan Hedley (1999) points out that international efforts to deal with TNCs began as early as the late 1960s; even then, however, the UN recognized that there was no effective international framework covering their activities (citing UNCTC 1990, p. 3). Thus, despite early recognition of the desirability, on the part of states, to regulate TNCs, little progress has been made over the decades. Not surprisingly, perhaps, the strongest progress has been made by the European Union, a regional organization that is premised, in large part, on the principle of pooled sovereignty (see figure 6.15, “The European Union and Pooled Sovereignty,” for further discussion). Pooled sovereignty, in general, means that members of an international organization, such as the EU, delegate some decision-making authority to shared supranational institutions. These institutions, in turn, make decisions that are binding on all member countries. For the EU specifically, Keohane (2002) writes, “Sovereignty is pooled, in the sense that, in many areas, states’ legal authority over internal and external affairs is transferred to the Community as a whole, authorizing action through procedures not involving state vetoes” (p. 748).

The advantage of a pooled sovereignty arrangement is that TNCs cannot play one (European) state off against another; in other words, it reduces the utility of regulatory (or labor) arbitrage. One disadvantage of pooled sovereignty arrangements, in general, is that they are still limited in terms of territorial scope; thus, TNCs retain the capacity to play one region off against another. Yet, in the case of the EU, because it encompasses a very large physical territory (which is capable of expanding even more through increased membership), and because it is a center of economic activity (the EU’s population exceeds 500 million people and has a combined GDP of approximately \$16 trillion in PPP terms), it has been able to achieve an important degree of

success. Writing in 1999, Hedley noted that the history of the EU process has not been tidy, “and is not yet complete, but from it has emerged a regulatory structure that more closely parallels transnational corporate activity than any devised to date” (p. 223). To repeat, pooled sovereignty made this possible. One other disadvantage, however, also needs to be highlighted: the loss of national autonomy in specific instances of coping with change or economic crisis—for example, the ability of individual countries to reregulate their domestic economies or conduct an independent monetary policy (for those states that are part of the **eurozone**). As I noted in chapter 5, there are always trade-offs.

### Figure 6.15. The European Union and Pooled Sovereignty

Implicit in the formation of the European Union was the principle that individual member states would inevitably cede at least some decision-making powers to the new supranational institutions that the EU created. However, this was not necessarily a point on which everyone initially agreed. Writing in 1991, Sir Peregrine Worsthorne, a British columnist, wrote, “Twenty years ago, when the process began, there was no question of losing sovereignty. That was a lie, or at any rate, a dishonest obfuscation” (cited in Jasper 2013). Worsthorne was reacting to the passage of the 1992 **Single European Act**, which he rightly recognized would necessarily infringe on the principle of Westphalian sovereignty. He was not happy, but others understood the necessity of this change. For example, the French finance minister Dominique Strauss-Kahn (who later became the IMF’s managing director, a position that he was forced to leave after being accused of sexual assault) wrote, at the same time, “The Euro is a conquest of sovereignty. It gives us a margin of manoeuvre. It’s a tool to help us master globalisation and help us resist irrational shifts in the market” (cited in Jasper 2013).

It would be more accurate to say that Westphalian sovereignty was conquered, but replaced with a new type of transnational—or a version of pooled—sovereignty. In this version, every member of the EU retains the right to revert back to the sovereignty of the individual state, but as long as each country maintains its membership it agrees to abide by decisions made by the EU as a whole. This version of sovereignty, as European Commission vice president Maros Sefcovic (pictured) put it, was “unthinkable a few years ago, and yet it is [now] likely to be the model for future development” (cited in Jasper 2013).

Significantly, William Jasper sees pooled sovereignty as a radical and dangerous process, one that has fundamentally transformed the relationship between the EU and its member states. Jasper writes, “The principal-agent relationship has been reversed, with the EU now assuming the principal position, and the



member nations becoming the agents, although many critics say the *master-servant description is now more apropos*. National sovereignty has been, in effect, defined out of existence in the EU. That is precisely what is also in store for Americans” (emphasis added). Jasper is expressing a common fear, especially on the part of some Americans, who view the loss of Westphalian sovereignty as a descent into slavery. This is their socially constructed reality, a reality that has a powerful hold on their attitudes, perceptions, and actions.

On the other hand, Keohane (2002) makes a forceful argument that pooled sovereignty could serve as a model for a future world order. As he puts it, “Europe can serve as a model for troubled societies, unable to create order on their own” (p. 762). At the same time, Keohane warns that the reluctance of other states—especially the United States—to move in the same direction is potentially dangerous: “different conceptions of sovereignty could make it even more difficult for Europeans and Americans to understand one another. Differences in geopolitical roles and interests, societal values, and the role of state security institutions, all pull the United States and Europe apart. The language of sovereignty has long been the language of diplomacy; but in this sense, the United States and Europe now speak different languages” (p. 762).

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In most of the rest of the world, by contrast, and on a number of vital issues, little headway has been made. Consider, again, the issue of taxation. The problem faced by the U.S. government is certainly not unique; nor is Apple, Inc. the only TNC engaged in the aforementioned behavior. Any company can engage in cross-border operations and manipulate transactions to significantly reduce its tax burden. This practice, moreover, has been going on for a long time. In 1992, for example, the U.S. Internal Revenue Service (IRS) expressed serious concerns about the ability of “multinational corporate groups” to “shift income, deductions, and other items among related entities to avoid paying a fair share of taxes in the United States” (cited in OECD 1993, p. 9). Further, according to the 1992 IRS Report, it was clear that foreign corporations operating in the United States were only paying about half as much income tax as similar U.S.-based corporations, suggesting that “income shifting” was at least partially, and likely mostly, responsible for the gap (OECD 1993, p. 9).

The continued expansion of transnational production (as well as cross-border trade and financial globalization) has made it much easier to shift profits around the world to achieve the lowest possible tax rates, a point made clear in a 2013 OECD report entitled *Addressing Base Erosion and Profit Shifting* (more on this report shortly). More importantly, this is an issue that no single country (or even a set of countries, such as the EU) can solve by itself: as long as the principle of Westphalian sovereignty holds, even in weakened terms, particularly among the major economies, TNCs will always be able to practice tax arbitrage. (Whether you think this is good or bad is beside the point; the point here is simply to understand the issue itself.) Only a broad-based transnational—as opposed to strictly international—strategy is likely to be effective. On this point, it is useful to note that the OECD has been working on the issue for quite some time.

The OECD report mentioned above clearly highlights how Westphalian sovereignty encourages TNCs to take advantage of differing national tax regimes. A perfect example of this is the use, by a wide range of TNCs, of something called a Special Purpose Entity (SPE). SPEs

(also known as Special Purpose Vehicles), in general, are legitimate tools used by corporations to isolate the main company from financial risk. SPEs are essentially stand-alone companies—but with no (or very few) employees, and little or no physical presence in the host country (just like Apple Operations International)—set up to fulfill a specific purposes (thus the name), such as the financing of a large project. If there are problems with the project, the parent company is not negatively impacted. In principle, SPEs can be set up in almost any country, but they are most common in tax-friendly venues, including Delaware<sup>40</sup> (in the United States), Luxembourg, the Netherlands, the Caymans, Ireland, Jersey, Guernsey, and Gibraltar (Tavakoli 2003, p. 3). (Note that a number of these countries are part of the EU, which tells us that tax arbitrage is a major issue even under conditions of pooled sovereignty.) SPEs have become a convenient and fully legal way for companies to engage in *profit shifting*—that is, shifting profits across borders to take advantage of lower tax rates (Love 2013). This helps to explain why the tiny country of Luxembourg, which has a population of just 500,000 people, attracted over \$2 *trillion* in inward stock investment in 2011, with \$1.9 trillion being made specifically through SPEs; outward stock investments from Luxembourg were just about the same (OECD 2013). As long as even a single country (and sometimes a single U.S. state—Delaware, for example) is willing to act as a tax haven, and as long as there is no unified cross-border tax regime, tax arbitrage will continue. The OECD is trying to address this issue, but it is a herculean task that requires, at a fundamental level, a rethinking of Westphalian sovereignty on a near-global basis.

## Chapter 6: Conclusion

This chapter, again, has only touched on the complexities of one part of the globalization process: transnational production. The basic lessons, however, are not necessarily complicated. First, it is clear that globalization in general and transnational production more specifically are, literally, reshaping the world economy. The world is becoming far more interconnected, at a far deeper level, than it has ever been. And this trend is likely to continue for the foreseeable future. Second, it is equally clear that these changes are affecting the power of states relative to not only other states, but to TNCs as well. This does not mean that states are becoming irrelevant or powerless; this is certainly *not* the case. In important respects, states will become even more important in protecting and promoting the strength and vitality of their societies (and citizens) in a more globalized, and more competitive, world economy. Unfortunately—and this has always been the case—not all states are equally prepared for or capable of carrying out that task. Third, even as states remain significant, TNCs and their activities will continue to rise in importance. This leads to a fourth point: what TNCs do, how and where they invest their capital, how they organize production, and so on, will have great bearing on the fate of individual countries and societies. This means, in turn, that questions about how TNCs can and should be regulated—or even if they can be effectively regulated—will remain central concerns for years to come. Finally, as the last section of this chapter emphasized, the effective regulation of TNCs and of the globalization process more generally will likely require a redefining of Westphalian sovereignty. The increasingly severe tension between the territorialism of Westphalian sovereignty and globalization will not go away. Both are exceedingly powerful forces (or structures), so something must give. What exactly this means is very much open to debate. As a student of international or global political economy, however, you now have the tools to try to figure out the meaning on your own.

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<sup>37</sup> Figures are from the World Bank's online databank for "Foreign direct investment, net inflows (BoP, current U.S.\$)," available at <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD>. The OECD (2012, p. 2) provides different figures, showing that China had \$228.8 billion of FDI in 2011, which was about \$5 billion less than the United States.

<sup>38</sup> Household population is slightly different from total population. The household population includes people who live in housing units such as single-family homes, townhouses, condominiums, apartments, and mobile homes. It excludes people in jail or prison, mental wards, and the like.

<sup>39</sup> Wendt, a well-known constructivist scholar who writes primarily within international relations theory, entitled his 1992 article, "Anarchy is what states make of it: The social construction of power politics." His basic argument is that anarchy—which is typically assumed to be an objective condition of the international system, and a condition that creates distrust, uncertainty, and conflict in international politics—is a social construct. As a social construct, anarchy can take many forms, some of which make conflict likely, and some of which make conflict much less likely. For example, the members of the European Union exist in an anarchy of "friends": they cooperate and collaborate on a wide range of economic, political, and security issues. As a result, the prospect of violent conflict among the members has been dramatically reduced. On the other hand, between and among other countries, an anarchy of enmity has been created, making violence much more likely.

<sup>40</sup> Delaware is one of the top tax havens in the world: more than half of all public corporations in the U.S. are incorporated in Delaware. Indeed, the state has more corporate tax entities than it does people—945,326 to 897,934. The state's tax laws allow companies to shift certain types of payments, such as royalties and similar revenues, to Delaware in order to avoid paying taxes. Over the last decade, the so-called Delaware loophole has enabled corporations to reduce the taxes paid to other states by an estimated \$9.5 billion (all information cited in Wayne 2012).

## Chapter 7

### Inequality, Poverty, and Exploitation in the Global Economy

#### Inequality, Poverty, and Exploitation: An Overview

The world is unequal. There is nothing surprising about the foregoing statement. Indeed, many people, especially in developed countries, take (economic) inequality for granted. That is, they assume that inequality is part of the human condition, essentially a natural or unavoidable byproduct of human and social interaction. After all, inequality has been around for ages, and seems to be embedded in virtually every society around the world. Yet while it is clear that inequality has been deeply entrenched in human societies, it is a highly variable condition. On a global basis, for example, inequality rose significantly between 1820 and 1980. Bourguignon and Morrison (2002) estimated that the gap in per capita income between the richest 5 percent and the poorest 20 percent of the world's population increased from a multiple of 6.8 in 1820 to a multiple of 17.5 in 1980. More specifically, in 1820, the bottom 20 percent of the world's population controlled 4.7 percent of income, while the top 5 percent controlled 31.2 percent; in 1980, by contrast, the respective figures were 2.0 percent and 35.0 percent (see table 7.1 for further detail). Perhaps even more telling is the trend in inequality within countries. In the same study by Bourguignon and Morrison, the authors showed that, in some places—e.g., the UK, Ireland, the Scandinavian countries, and Japan—income inequality actually *decreased* dramatically between 1820 and 1992, while in other countries income inequality rose over the same period (details are also contained in the table, "World Income Inequality Estimates"). The same basic pattern is reflected in more recent Gini statistics for the late 2000s: among OECD countries, Slovenia has the greatest degree of income equality with a Gini coefficient of 0.24, followed closely by Denmark, Norway, the Czech Republic, the Slovak Republic, Belgium, Sweden, Finland, and Belgium—all with a Gini score of between 0.25 and 0.26. On the other end of the scale are Chile (0.49), Mexico (0.48), Turkey (0.41), the United States (0.38), and Israel (0.37). (Figures cited in OECD 2011, p. 81.)

**Table 7.1. World Income Inequality Estimates (Globally and in Selected Countries), 1820–1992**

|  | 1820 | 1850 | 1870 | 1890  | 1910  | 1929  | 1950  | 1960  | 1970  | 1980 | 1992  |
|--|------|------|------|-------|-------|-------|-------|-------|-------|------|-------|
| World Gini*  | 0.5  | 0.53 | 0.56 | 0.59  | 0.61  | 0.62  | 0.64  | 0.635 | 0.65  | 0.66 | 0.66  |
| World Income Ratio, Top 5% to Bottom 20%   | 6.76 | 7.48 | 8.79 | 10.26 | 12.23 | 12.06 | 14.79 | 14.21 | 15.55 | 17.5 | 16.36 |
| <i>Inequality within Selected Countries, Ratio of Income of Top 5% to Bottom 10%</i> |      |      |      |       |       |       |       |       |       |      |       |
| United States  | 13   | 13   | 18   | 25    | 25    | 20    | 13    | 13    | 12    | 12   | 15    |
| UK, Ireland  | 40   | 40   | 35   | 30    | 30    | 16    | 10    | 10    | 7     | 7    | 10    |

|                             |    |    |    |    |    |    |    |    |    |    |    |
|-----------------------------|----|----|----|----|----|----|----|----|----|----|----|
| Scandinavian Countries      | 13 | 13 | 17 | 17 | 17 | 12 | 9  | 9  | 8  | 8  | 8  |
| Cote d'Ivoire, Ghana, Kenya | 6  | 6  | 6  | 6  | 6  | 8  | 16 | 16 | 15 | 22 | 23 |
| Egypt                       | 16 | 16 | 16 | 16 | 16 | 16 | 16 | 16 | 15 | 15 | 15 |
| China                       | 14 | 14 | 14 | 14 | 14 | 13 | 9  | 8  | 8  | 10 | 12 |
| India                       | 12 | 12 | 12 | 12 | 12 | 12 | 10 | 10 | 10 | 9  | 8  |
| Japan                       | 12 | 12 | 12 | 12 | 12 | 14 | 6  | 6  | 6  | 6  | 6  |
| Brazil                      | 21 | 21 | 21 | 21 | 21 | 21 | 21 | 21 | 24 | 24 | 24 |

Source for world inequality estimates, Bourguignon and Morrison (2002), table 1; source for inequality within selected countries, Jolly (2006), table 2 (citing Bourguignon and Morrison [2002]).

The Gini coefficient of inequality (or Gini) is the most common method to measure income inequality. The Gini coefficient varies between 0 and 1. A measurement of 0 represents perfect equality (i.e., everyone in an economy receives exactly the same amount of income), while a measurement of 1 represents perfect inequality (one person has all the income). The lowest Gini coefficient among countries is 0.25, while the highest is 0.632.

In the United States, specifically, table 7.1 shows that the level of income inequality has fluctuated fairly widely since 1820: through the second half of the 19<sup>th</sup> century, income inequality rose sharply, reaching a peak ratio of 25 to 1 (for the top 5 percent to the bottom 10 percent of income earners) in 1890—a figure that held steady until 1910. After 1910, however, the gap significantly narrowed, reaching a historical low of 12 to 1 in 1970. This figure held steady for a short time, but in 1980, income inequality began to creep up again. Data from the U.S. Census Bureau, which compares the ratio of the top 5 percent to the bottom 20 percent (a different set of statistics than used in the preceding table), indicate that the gap in income inequality continued to grow, albeit gradually, throughout the 1990s and the first decade of the 2000s. In 1990, the top 5 percent earned 18.5 percent of household income, while the bottom 20 percent of U.S. households earned 3.8 percent—a ratio of about 5 to 1. By 2011, the gap between the top 5 percent and the bottom 20 percent had grown to a ratio of 7 to 1 (the top 5 percent earned 22.3 percent of household income, while the bottom 20 percent earned 3.2 percent).

**Table 7.2. Distribution of U.S. Household Income, Bottom 20% and Top 5%, Selected Years**

|                             | 1968 | 1980 | 1990 | 2000 | 2005 | 2009 | 2010 | 2011 |
|-----------------------------|------|------|------|------|------|------|------|------|
| Income Share, Bottom 20%    | 4.2  | 4.2  | 3.8  | 3.6  | 3.4  | 3.4  | 3.3  | 3.2  |
| Income Share, Top 5%        | 16.3 | 16.5 | 18.5 | 22.1 | 22.2 | 21.7 | 21.3 | 22.3 |
| Ratio, Top 5% to Bottom 20% | 3.88 | 3.92 | 4.87 | 6.13 | 6.53 | 6.38 | 6.45 | 6.96 |

Source: U.S. Census Bureau, table A-2 of *Income, Poverty, and Health Insurance Coverage in the United States: 2011*; cited in Levine (2012), p. 4.

From a political-economy (and common-sense) perspective, it is reasonable to conclude that these fluctuations and variations among and within countries are not just random or “natural.” Instead, they are almost certainly a product of purposeful decisions and policies, and, more generally, are likely a reflection of power and specific relations of power, whether in the United States in particular or the world in general. Thus, part of this chapter will endeavor to explain the political economy of inequality. Before going any further, however, it is necessary to address the closely related issue of poverty. Indeed, many (albeit not all) observers argue that inequality and poverty are inextricably connected. Indeed, on the surface the relationship between inequality and poverty seems obvious. To wit, significant inequality leads to higher levels of poverty. And, generally speaking, the most unequal societies tend have the highest levels of poverty, and vice versa. Under the surface, however, the issue is more complicated. In particular, if the economic pie is growing rapidly—as has generally been the case for capitalist economies—increasing inequality and poverty do not necessarily go hand-in-hand. This point is nicely reflected in statistics compiled by the World Bank. In a 2013 press release, the bank announced that a significant decline in global poverty had taken place in the 30 years between 1981 and 2010. As the bank put it, “The number of people living on less than \$1.25 per day has decreased dramatically in the past three decades, from half the citizens in the developing world in 1981 to 21 percent in 2010, despite a 59 percent increase in the developing world population.” In some parts of the world the decline has been remarkable. East Asia, in particular, has seen a drop from 77.2 percent of the population living on less than \$1.25 a day in 1981, to 12.5 percent in 2011 (see table 7.3 for more details). Again, keep in mind that these declines took place during a period in which global inequality gradually increased. Even more, the East Asian country with the most rapid rise in inequality—i.e., China—saw the most dramatic decline in severe poverty, at least according to the World Bank.

The changes globally and in countries such as China underscore the complex relationship between poverty and inequality. Those changes also lead to a series of concrete and perhaps more pertinent questions: If a lessening of inequality is not the reason for declining global poverty, then what is responsible? In other words, what are the primary reasons for the decline in global poverty between 1981 and 2010? Is the decline, as liberals might argue, a reflection of the power of (free) markets and of liberal economic principles? Have free trade and open markets, to put it simply, made the world more prosperous for everyone? And in this regard, is it possible to argue that inequality is contributing, in a positive and even essential manner, to greater global prosperity? Or does the decline in absolute poverty, as others assert, simply mask an increasingly hard division between the “haves” and the “have-nots”? After all, while the number of people

**Table 7.3. Global Poverty (by Region), Percent of Population Living Below \$1.25/day**

| Region                          | \$1.25 Per Day |       |
|---------------------------------|----------------|-------|
|                                 | 1981           | 2011  |
| East Asia and the Pacific       | 77.2           | 12.48 |
| Europe and Central Asia         | 1.9            | 0.66  |
| Latin America and the Caribbean | 11.9           | 5.53  |
| Middle East and North Africa    | 9.6            | 2.41  |
| South Asia                      | 61.1           | 31.03 |
| Sub-Saharan Africa              | 51.5           | 48.47 |
| <i>Total</i>                    | 52.2           | 20.63 |

Source: World Bank, “Regional Aggregation Using 2005 PPP and \$1.25/day Poverty Line.” Available at [iresearch.worldbank.org/PovcalNet/index.htm?1](http://iresearch.worldbank.org/PovcalNet/index.htm?1)

living in desperate poverty may be decreasing, the number of people who live in less severe, but still serious conditions of poverty has hardly budged. Consider another set of statistics provided by the World Bank: in 2010, 2.59 billion people lived on less than \$2.00 a day, compared to 2.4 billion in 1981—a small increase, but an increase nonetheless. (These figures, though, are significantly mitigated by the fact that world population grew considerably between 1981 and 2010, from about 4.5 billion to 6.8 billion [UN Department of Economic and Social Affairs 2013].)

To make the issue a bit more complicated, consider (again) the case of China, which alone accounted for essentially all of the worldwide reduction in absolute poverty between 1981 and 2008: during that period, the number of people in China living on less than \$1.25 a day fell by a remarkable 662 million, while the figure for people living outside of China *increased* by 13 million (Broad and Cavanaugh 2012). Neo-mercantilists might tell us that China's capacity to reduce severe poverty within its own borders demonstrates that the reduction of "global poverty" is more mirage than reality. Even more, they might argue that, to the extent that global poverty can be significantly reduced, state power plays a central role. The Chinese state, in other words, has improved the standard of living for hundreds of millions of its own citizens because it has the power to intervene effectively in market processes, and has integrated into global markets on its own terms. Other, less powerful states and peoples, however, have had a far different experience: for them, liberal or, perhaps more accurately, neoliberal economic reform<sup>41</sup>—often forced upon them, primarily through conditionality, by the most powerful state actors through institutions such as the IMF—has meant a loss of control and deteriorating economic conditions.

(Conditionality has been mentioned several times in other chapters, and will also be discussed later in this chapter. The basic point here is that conditionality has, over time, impinged more and more on domestic sovereignty.) Marxist (at least contemporary Marxist) scholars would not completely disagree with the neo-mercantilist argument. For countries such as China, for example, the emerging capitalist class—a significant portion of which is composed of prominent members of the Chinese Communist Party—has naturally used the state as a primary vehicle by which to achieve its economic interests. For already established core countries, by contrast, the capitalist class also uses the major institutions of the global economy, including most saliently, the IMF, as tools to pry open the markets of those countries that still are not fully integrated into the global capitalist system. Conditionality, in this regard, should be viewed as simply another neo-imperialist policy. At the same time, Marxists would also argue that the overriding emphasis on state power by neo-mercantilists is misplaced. What matters most is the increasing power of a transnational capitalist class that presides over a now-globalized economic system, and which has fine-tuned exploitation and oppression. So while Marxists might agree that absolute poverty on a global scale has unequivocally declined because of China's economic ascendancy, everyday life is not necessarily improving for the vast majority of poor Chinese workers, still less for poor "workers"—many of whom are only children—in Bangladesh, Cote d'Ivoire, Honduras, Russia, Jamaica, or any one of dozens of other countries in the so-called developing world.

In sum, this chapter will tackle the intertwined issues of inequality, poverty, and exploitation. The primary focus, however, will be on poverty, and on the underlying question: Is it possible to end poverty? As usual, this question—as well as a number of closely related questions—will be addressed from multiple and competing perspectives, although the overwhelming focus will be on the liberal and Marxist perspectives, since it is between these two perspectives that the key issues are most clearly highlighted. The most serious disagreements between and among the perspectives, it should be noted at the outset, are deep and essentially

irreconcilable. Such “irreconcilable differences” can be a source of significant consternation among students who often are eager for definitive answers. While unfortunate, the lack of consensus on an issue as important as poverty, and on the issues of inequality and exploitation, is understandable. The disagreements suggest that poverty, inequality, and exploitation are complex, multidimensional issues that are not only the product of objective forces and processes, but also of subjective processes. Of course, the claim that poverty, inequality, and exploitation are a product of subjective processes is itself quite debatable. Yet, when considering the depth and longevity of disagreements between and among the various theoretical arguments, it is hard to dismiss the idea that analysts almost literally see different realities. It is on this last point that some common ground might be found. If a constructivist view is adopted, it might be possible to transcend the seemingly insurmountable differences between and among the *objectively* based theories of poverty, inequality, and exploitation. The key to transcending these differences, to repeat, is understanding that economic systems or structures are socially constructed. On this point, recall that liberal and Marxist explanations, in particular, assume markets can only work in certain ways. Is it possible, though, to profoundly reshape markets so they work differently? This is the question that constructivists ask, and their answer is clear: it is possible. And, if markets can work differently, then this possibility suggests a path toward resolving the hitherto intractable issues of poverty, inequality, and exploitation. The penultimate section of this chapter—“Capitalism Is What People Make It”—discusses the constructivist view in depth.

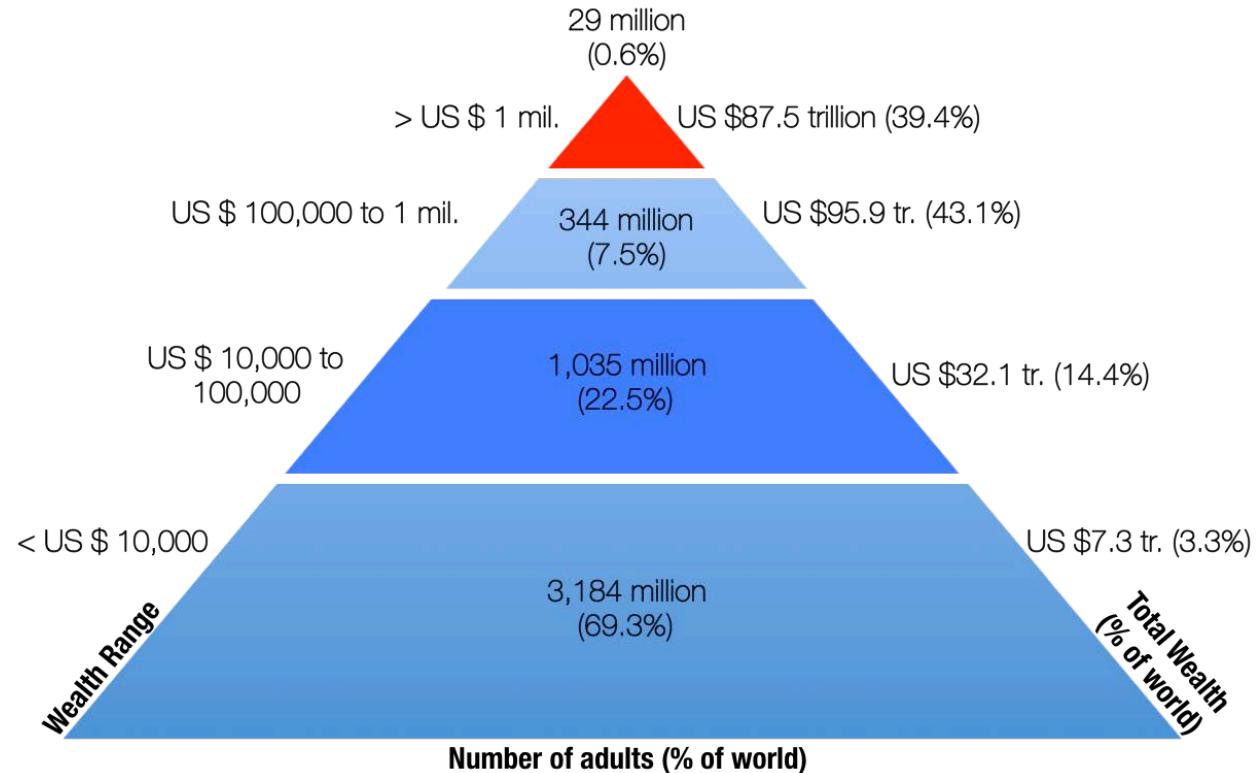
With all this in mind, the next section will discuss, in more detail, the basic concepts around which this chapter is organized, and will also revisit some basic data.

## Basic Concepts and Data on Inequality, Poverty, and Exploitation

Of the three core concepts discussed in this chapter, economic inequality is perhaps the most straightforward. It simply refers to the unequal distribution of economic resources, most typically in the form of income, which was the focus of the discussion above. Income inequality, however, is not the only type of inequality. Another equally important type is wealth inequality. (There is a third type of inequality tied to social mobility, which is discussed in relation to poverty.) Wealth inequality is the unequal distribution of (financial) assets within a given population. Financial assets include savings and investments, equity in a business or in real estate, durable goods and collectables, and pensions. Significantly, the level of wealth inequality on a global basis is much greater than the level of income inequality. According to Credit Suisse (2012), in fact, the top 0.6 percent of the world’s *adult* population (about 29 million) control 39.3 percent of total global wealth, while the bottom 69.3 percent of the world’s adults (about 3.2 billion people) control just 3.3 percent of global wealth (see figure 7.1, “The Global Wealth Pyramid”). Not surprisingly, membership within the various strata of the wealth pyramid is not randomly distributed across the world. As the Credit Suisse report explains it, while “members of the base level are spread widely across all regions [in part because of the life cycle phenomenon associated with youth, old age, or periods of unemployment] representation in India and Africa is disproportionately high, while Europe and North America are correspondingly underrepresented” (p. 18). Indeed, in India and Africa, more than 90 percent of the adult population is located in the poorest strata. An even more telling set of statistics was released by Oxfam<sup>42</sup> in early 2014. The Oxfam (2014) report noted, among other remarkable figures, that:

- A mere 85 individuals have more wealth than the bottom half of the world's population, or about 3.5 billion people.
- One percent of the world's population owns almost half of the world's total wealth; specifically, the top one percent have assets totaling \$110 trillion (this figure is also 65 times the total wealth of the bottom half of the world's population).
- In the U.S., the wealthiest one percent captured 95 percent of post-financial-crisis growth since 2009, while the bottom 90 percent became poorer.

**Figure 7.1. The Global Wealth Pyramid (not to scale)**



Source: Credit Suisse (2012), p. 18 (image was reproduced by the author)

Whereas inequality is a straightforward and relatively easy-to-measure concept, poverty is more complicated. The most common definitions of poverty center on its material aspects, and generally portray poverty as the lack of sufficient resources to meet the *basic* necessities of life.

Thus, a person without enough food and access to clean water, without shelter and clothing, is considered to be living in poverty. This notion of poverty—which is also referred to as severe or *absolute poverty*—is quite narrow, although it is amenable to relatively easy (but certainly not foolproof) measurement. As should be apparent, for example, the World Bank's use of the \$1.25-a-day standard is meant to measure absolute poverty. While undoubtedly useful, a strong and even exclusive focus on income-defined absolute poverty can be misleading. When the World Bank claims, for example, that global poverty has been cut by more than 50 percent over the past three decades, it implies that the problem of global poverty, in a more general sense, is being effectively resolved. Yet if poor people are merely moving from a situation of “extremely desperate” poverty to “desperate poverty,” why should that be considered a reduction in poverty at all? Moreover, as Laurence Chandy and Homi Kharas (2012) assert, reducing the measurement of absolute poverty to a single statistic is dangerous in that it can miss as much as it covers, especially if the statistic is based on incomplete data. For example, in its calculations, the World Bank must sometimes extrapolate from old data or, occasionally, from no (country-specific) data at all. This is because not all countries provide the information to make calculations. To say anything meaningful about poverty in a particular country, according Chandy and Kharas, it is necessary to have a household survey to show how income (or consumption) is actually distributed among its people. But not every country completes the required survey, and for some that do, they do so on an irregular basis. In sub-Saharan Africa (where there is a great deal of poverty), for example, only about 21 of 49 countries have undertaken a new household survey since 2005. For these countries, the World Bank extrapolates from the old data. A handful of other countries—i.e., North Korea, Burma, Zimbabwe, and Somalia—have never completed a survey. For these countries, the World Bank extrapolates from the region as a whole by assuming that any country with no survey has the same poverty rate as the average for the region (Chandy and Kharas 2012). Such extrapolation presents an obvious problem, since it is precisely the poorest countries that tend not to complete household surveys.

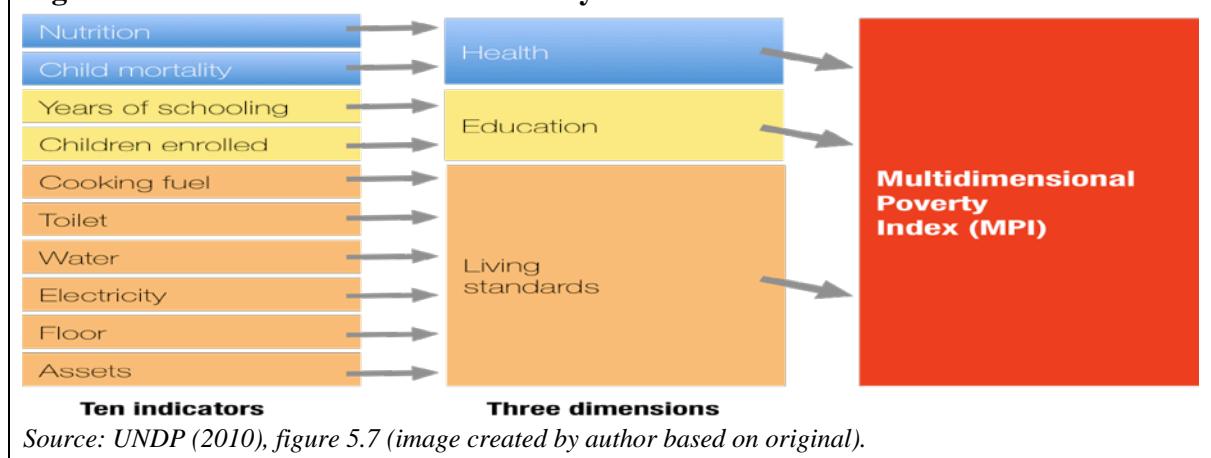
There are other issues with the concept of absolute poverty. Consider, on this point, an alternative definition proposed by the United Nations: fundamentally, poverty is a denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or a clinic to go to, not having the land on which to grow one's food or a job to earn one's living, nor having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence and it often implies living on marginal and fragile environments, not having access to clean water and sanitation (United Nations Administrative Committee on Coordination 1998, n.p.).

The UN's definition clearly includes the concept of absolute poverty, but goes well beyond it by emphasizing participation, education, and security, as well as access to medical care, credit, and opportunities to work either for oneself or for someone else. This more comprehensive definition of poverty suggests that merely meeting the most basic material needs of people is not necessarily sufficient to avoid poverty. It also tells us that a standard measure of poverty, such as the World Bank's \$1.25-a-day figure, is not only of limited value, but also does not measure some of the most important dimensions of poverty. In this regard, one alternative statistic is the multidimensional poverty index (MPI), developed by the United Nations. To be sure, the MPI is also an effort to establish a standard measure of poverty, but as the name implies, it is multidimensional. Specifically, the MPI is composed of three dimensions (health,

education, and living standards) divided into 10 specific indicators: nutrition, child mortality, years of schooling, school enrollment, and six separate indicators designed to measure living standards (see figure 7.2, “The Multidimensional Poverty Index”). Importantly, the use of this index, compared to a measurement based strictly on income, yields very different results both generally and for specific countries. Although covering far fewer countries than the World Bank (since the MPI is only applied when there is sufficient data), the UN estimates that about 1.75 billion people in 104 countries live in poverty (the World Bank’s number is 1.22 billion—but, again, this figure is an estimate for all countries). Within specific countries, the discrepancy between the two measures can be much larger. In Uzbekistan, for example, 46 million people lived on less than \$1.25 a day according to the World Bank (for the period from 2000 to 2008); by contrast, using the MPI, there were only 2 million people living in poverty in Uzbekistan during the same period. In Niger, the situation was largely reversed: the MPI headcount was 93 million, compared to 66 million using the \$1.25 figure (UNDP 2010, figure 5.8).

From the preceding discussion, it is apparent that how poverty is defined and measured has important implications. In particular, an overly narrow definition and measure—such as a definition that focuses strictly on daily income levels—tends to emphasize the symptoms of poverty, rather than its sources or deeper causes. To many analysts, such a definition is not necessarily a problem; to others, however, narrow definitions can have a dangerous effect by unintentionally suggesting equally narrow “solutions.” Thus, if very low daily income levels are the sole criterion for defining poverty, then boosting income through, for example, higher rates of economic growth is the obvious solution. A comprehensive definition (such as the UN definition above), by contrast, encourages analysts to examine poverty from different, less narrow perspectives. Thus, the UN definition strongly suggests that poverty is not merely the absence of economic growth, but instead, as the UNDP (2013) explains it, is a product of unjust governance; of inequitable access to land, water, and capital; of prevailing property structures that limit or restrict opportunities for people to benefit fully from their efforts (p. 37). This is the view of Nobel Prize-winning economist Amartya Sen (1981), who famously argued that people living in poverty are hungry (specifically, in times of famine) not simply because there is not enough food, but because of complex social, political, and economic factors arising from food prices and food distribution. In Sen’s view, in short, poverty is not primarily an economic condition, but a quintessentially political and social condition as well.

**Figure 7.2. The Multidimensional Poverty Index**



In the same vein, a comprehensive definition of poverty makes it clear that the relationship between inequality and poverty is more complex than liberal economics suggests. Indeed, in the neoliberal view (as alluded to earlier), increasing inequality is sometimes portrayed as a positive force for poverty reduction because a growing national economy generally means an increase in daily income for the poor. When other dimensions of poverty are factored in, however, the relationship between inequality and poverty is less benign. On this point, the UNDP (2010) has shown, for example, that “rising inequality, especially between groups, can lead to social instability, undermining long-term human development progress. Persistence of inequality often results in a lack of intergenerational social mobility, which can also lead to social unrest” (p. 31). Somewhat surprisingly, perhaps, this phenomenon of rising inequality between social groups and declining intergenerational social mobility has become particularly salient in the United States, which is typically mythologized as the “Land of Opportunity.” A number of recent studies have shown that there is less social mobility in the U.S. than in many other industrialized democracies, especially those in Western Europe. For example, a study by Markus Jantti, an economist at a Swedish university, found that 42 percent of American men raised in the bottom fifth of incomes stay there as adults. That shows a level of persistent disadvantage much higher than in Denmark (25 percent) and Britain (30 percent)—the latter of which is a country famous for its class constraints (cited in DeParle 2012).<sup>43</sup> This leads to one more concept of poverty known as *relative poverty*. Relative poverty, as Heywood (2011) explains it, is a primarily social phenomenon, and is based on people’s relative position in the social order. From this perspective, the poor are “less well off,” rather than destitute based on an absolute standard. “In other words,” writes Heywood, “people are considered to be ‘poor’ if their available income is substantially lower than that of a typical person in their country of residence” (pp. 353–54). An important implication of this definition of poverty, moreover, is that it reestablishes, in unequivocal terms, “a link between poverty and inequality, and in so doing suggests that reducing or eradicating poverty can only be achieved through the redistribution of wealth and the promotion of equality” (p. 354).

In sum, poverty remains a highly contested concept, although the controversy is less intense once it is understood that poverty can be conceived of in different ways (e.g., absolute, multidimensional, and relative).

The last concept that requires discussion is exploitation. In an important respect, the concept of exploitation is the most confounding of the three terms examined in this section. Some liberals see exploitation as a type of market failure, most common in situations in which a firm holds a monopolistic position in a labor market (Reynolds 2008). Under conditions of monopoly (or, more accurately, **monopsony**), the firm can pay much lower wages than would be the case in a competitive market, since workers have no other firms bidding for their labor. In this view, however, labor exploitation is an extremely rare phenomenon: it exists only when there is no functioning market, or when a market is not allowed to operate freely, which is typically the product of government action. For other liberals, the very idea of labor exploitation is laughable. The reason is clear: unless workers are *forced* to work—as under conditions of slavery or **debt-bondage**—workers are always free to *not* work. Thus, if a worker chooses to work for a specific wage, even a very low wage, it is a voluntary decision that necessarily benefits both the worker and the employer. In this scenario, therefore, there is a mutual exchange of labor services for wages, which means that exploitation cannot exist. Indeed, some liberal analysts suggest that to the extent that exploitation does exist in the labor market, it is workers who exploit employers. This is possible because unions, which are a type of monopoly

(sanctioned by the government), are able to prevent some companies from freely hiring nonunion workers. This allows unions to extract rents from the companies they are organized against (Reynolds 2008).

For Marxists (and mercantilists), however, there is an obvious and gaping hole in the liberal view of exploitation. Most simply, the liberal view fails to recognize the impact, or even acknowledge the existence, of power differentials in the market. Indeed, in the Marxist view, capitalist markets are in themselves a type of power structure. They are defined by a fundamental and unequal division between those who own or control the means of production and those who do not. The former group—i.e., the capitalist class—also controls capital, land, and technology. This control gives the capitalist class tremendous advantages and power vis-à-vis other market actors. Specifically, it gives capitalists the power to extract **surplus value** (i.e., profits) from workers, which, in turn, is the basis for exploitation. The argument is fairly simple. In Marxism, exploitation exists because capitalism *forces* workers to sell their labor-power. The reason is clear: essentially everything in a capitalist society is owned by someone. Refusing to work, therefore, is not an option, since not working means starving. Under these conditions, moreover, capitalist firms do not have to pay for the actual value produced by workers; instead, firms only need to pay for labor-power. While this may sound like hair-splitting, the distinction between paying for labor-power versus the value produced by labor is critical to understanding the exploitative nature of capitalism. Labor-power is a commodity; it is bought and sold, but under conditions in which there is almost always an excess supply of labor (consider how transnational production effectively and dramatically increases the number of workers available to capitalists). This allows capitalist firms to systematically bid down the cost of labor. Even more important, the wage offered by capitalist firms does not necessarily have anything to do with actual value (i.e., surplus value) produced by workers during the labor process. Consider a simple example: a worker is paid \$10 per workday. In two hours, the worker has produced enough value to cover her wages. Yet the worker, as a condition of employment, is required to work for another 10 hours that day. Everything the worker produces after two hours is surplus value. However, the worker gets none of the profit or surplus value. Instead, it “belongs” to the capitalist firm. Surplus value, in this regard, should be understood as *unpaid labor* (Lapon 2011).

In this view, then, when workers organize or form unions, they are not “exploiting” their employers by demanding and getting higher wages. Rather, they are simply claiming a small portion of the surplus value that their labor has produced. Collective action on the part of workers, in other words, helps to level the playing field between labor and capital by giving workers a marginal degree of power vis-à-vis capital. Alternatively, when workers lose the ability to effectively organize, or when their organizational power is undercut through transnational production or the opening of new labor markets, wages fall. In other words, as the labor market becomes “freer,” exploitation increases. This conclusion, to be clear, is exactly opposite the liberal view.

So, which perspective on exploitation is correct? While answering this question will likely invite only more debate, it is difficult to sustain the argument that capitalism does not entail any significant exploitation of workers, as liberals contend (this particular issue will also be discussed in more depth below). The liberal view is especially difficult to sustain when focusing on workers in poorer countries, where wages may barely reach subsistence level. To be sure, exploitation does not always have to lead to immiseration and misery, but the mere existence of wages—even “middle-class” wages—is not evidence that exploitation is not taking place. Indeed, from the Marxist view, middle-class wages are themselves a product of

exploitation: in richer countries, middle-class workers are paid more, in part, because of the hyper-exploitation of the poor workers in poor and rich countries alike (and, in part, because of effective collective action). Yet even this situation has proven to be untenable: the rising number of working poor, even in the wealthiest capitalist economies, demonstrates that the middle class is becoming smaller and less stable. At the very least, the Marxist definition of exploitation compels us to consider seriously the impact of power in markets, which is always a good practice for students of political economy.

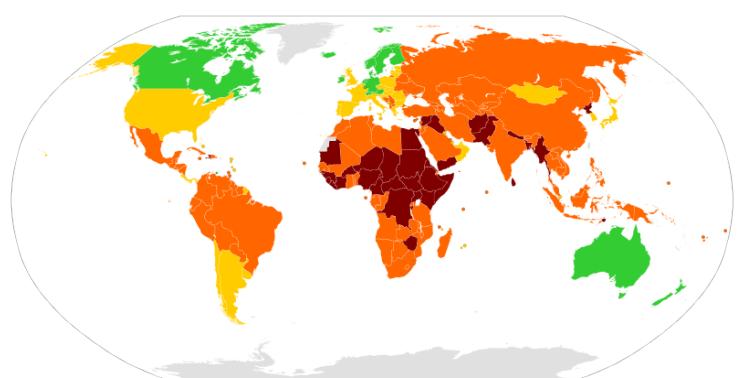
## Why Does Poverty Exist?

The discussion of poverty, inequality, and exploitation provides the groundwork for an examination of the most general question around which this chapter is organized: Why does poverty exist? As suggested earlier, the liberal view of poverty is straightforward. Poverty is, in the simplest terms, a product of economic and allocative inefficiency. Poor countries are simply not doing the “right things” to maximize the efficient allocation of resources. Poor countries, to be slightly more specific, are not allowing—or, perhaps, are unable to allow—free markets and open competition to flourish. There are many reasons for this, but the two most basic reasons are easy to identify. First, poor countries may simply lack an adequate legal-institutional framework for strong and vibrant markets to develop. Thus, while most liberal analysts are generally skeptical—and some are extremely skeptical—of state power, they recognize that states do have a minimal, yet crucial, role to play in market economies. Specifically, states must create and sustain a legal-institutional framework within which private property rights are protected and private contracts are respected and enforced. But if a state is weak or incapable, creating and maintaining such a framework is all but impossible.

Predictably, then, many of the poorest countries (based on the MPI)—e.g., Niger, Ethiopia, Burundi, Somalia, Central African Republic, Liberia, and Guinea—have what analysts refer to as “failed states” (see figure 7.3, “The Failed State,” for further discussion). A key feature of a failed state is an erosion or absence of law and order at the domestic level. Without domestic law and order, of course, protecting private property rights and ensuring that contracts are honored is problematic at best. The upshot is clear: in countries with failed states, poverty is the rule. Consider, for

**Figure 7.3. The Failed State**

The concept of the *failed state* is imprecise. As Daniel Thürer (1999) puts it, “the term ... does not denote a precisely defined and classifiable situation but serves as a broad label for a phenomena which can be interpreted in various ways” (n.p.). Thürer points to three basic legal elements. First, the term *failed state* refers to a domestic condition. Second, there is a political aspect, “namely the internal collapse of law and order. The emphasis here is on the total or near total breakdown of structures guaranteeing law and order.” Third, “there is the functional aspect, namely the absence of bodies capable, on the one hand, of representing the State at the international level and, on the other, of being influenced by the outside world.” In contrast to Thürer’s position, one organization, the Fund for Peace (FFP), suggests that there is a way to precisely define *and* measure the phenomenon of failed states. To this end, the FFP publishes an annual index of failed states, which is based on 12 primary social, economic, and political indicators, which are further broken down into more specific indicators (there are too many to list here). FFP’s indicators are available on the following web page: <http://ffp.statesindex.org/indicators>.



■ Alert ■ Warning ■ Stable ■ Sustainable

The image shows failed states according to the “Failed State Index 2013,” created by the Fund for Peace. The image file is licensed under Creative Commons Attribution-Share Alike 3.0 Unported license.

[saylor.org](http://saylor.org)

instance, the quintessential failed state: Somalia (Somalia ranks first on the “Failed State Index”). Somalia is also one of the poorest states in the world. On the MPI, Somalia is listed as the world’s sixth poorest country, with over 81 percent of its people living in poverty (according to MPI criteria). In terms of per capita GDP (based on **PPP**), Somalia is the third poorest country in the world. (**PPP** stands for **purchasing power parity**, and is used to compare income levels across countries; see glossary for further explanation.) Moreover, the two countries in front of Somalia—Zimbabwe and the Democratic Republic of Congo—also are considered to have failed states (the Failed State Index has Zimbabwe as tenth on its list, while the Democratic Republic of Congo is second).

From the liberal perspective, the second reason for the inability of free markets and open competition to flourish is the more common one: too much interference by the state. Thus, once the legal-institutional framework for a market economy is established, the state’s main role is to get out of the way of the private sector. To be fair, this statement is an exaggeration. Many liberal economists agree that states must continue to play a role in the economy by encouraging human capital formation (through, for example, education) or by creating a more inviting economic and political environment for trade, investment (both foreign and domestic), and competition. Still, the notion that many states do too much is a well-established liberal principle. Recall, on this point, the discussion of the Washington Consensus in chapter 5. The Washington Consensus was a set of economic policies that ostensibly offered a basic liberal roadmap to national prosperity for poorer countries. It called for, among other things, less government regulation, less government ownership of economic enterprises, and less government spending and taxation. The Washington Consensus also called for increased integration into global markets, which entailed less regulation of foreign capital and fewer restrictions on trade. For most liberal economists, cross-border trade is the linchpin of economic success: trade enables poor countries to take advantage of their comparative advantages, while exposing their markets and their domestic firms to open competition. Competition, in turn, ensures that only the most productive and most efficient firms survive, which maximizes the efficient allocation of scarce resources. In the liberal view, then, poverty exists simply because too many states fail to follow the liberal recipe for success.

In chapter 6, Marxist- and mercantilist-based criticisms of the liberal approach were discussed. Accordingly, it is not necessary to repeat those arguments in full in this chapter. It is useful, however, to revisit a few key points. First, from the perspective of Marxism and mercantilism, it is unequivocally clear that liberal prescriptions are not a panacea. To cite the primary neo-mercantilist example used in the previous chapter, China’s remarkable record of economic growth—and the country’s ability to bring millions of its own citizens out of absolute poverty—was certainly *not* the product of a hands-off, laissez-faire state. Quite the contrary: the Chinese state was and continues to be highly interventionist. Again, this critique reflects most strongly the neo-mercantilist position. Second, it is equally clear that the problem of poverty cannot be understood as an exclusively country-level phenomenon. For good and bad, the world’s economies are not only increasingly connected to one another through trade, investment, and production, but they are also increasingly in competition with one another for access to markets and capital. In a world characterized by vast inequalities between and among countries, this suggests that even countries that do all the right things (from a liberal perspective) may still end up as economic losers. Finally, to repeat the criticism made earlier in this chapter, the unwillingness of liberal analysts to consider the significance of power differentials—on this

point, do not forget the importance of structural power—in the global political economy is a huge flaw. Power, to put it simply, matters.

The three aforementioned reasons reflect the views of both the neo-mercantilist and Marxist approaches. So is it possible to reconcile the various arguments about poverty? The short answer is an emphatic no. The liberal, neo-mercantilist, and Marxist arguments are fundamentally at odds with one another over the question of why poverty exists. Rather than aiming at (theoretical) reconciliation, then, it is worthwhile to consider the issue of poverty at a more concrete and practical level. This means examining specific cases, policies, and initiatives to see what has worked, and what has not worked. Admittedly, in the limited space of this chapter, only a handful of situations can be examined, which means that no hard-and-fast conclusions can be drawn. Still, even accepting the limitations of examining a few cases, much can be learned.

### **How Can Poverty Be Defeated? Beyond Conditionality**

As is quite clear, the liberal (or neoliberal) solution to poverty revolves around allowing market principles to operate as freely as possible. In practice, this has involved a top-down approach. The IMF, for example, has played a central role in imposing liberal principles on dozens of poor countries. Critics, however, argue that the IMF's main interest is not and has never been poverty reduction. Instead, they see the IMF as a tool used by dominant states (or dominant class actors)—principally, the United States—to enforce a specific economic order on the world. This economic order is designed to ensure the continued dominance of the core economies. As discussed in chapter 5, the imposition of a neoliberal economic order has been primarily achieved through the principle of conditionality. The critics certainly have some support for their position: for the most part, in fact, conditionality has been shown to be largely ineffective in alleviating poverty in poor countries. If anything, conditionality has exacerbated poverty in many poor countries, a point that was tacitly, albeit only partially, acknowledged by the IMF in 1999 when it terminated the main vehicle of conditionality (known as the Enhanced Structural Adjustment Facility), and replaced it with the Poverty and Growth Facility. Despite the change in terminology, critics argue that little has changed. As Malaluan and Guttal (2003) bluntly put it, “‘Poverty’ is used as window dressing to peddle more or less the same Structural Adjustment Programmes (SAPs) to low-income countries that led them into a state of chronic economic crisis to begin with” (p. 1). Moreover, there is strong evidence that conditionality, in more general terms, has been ineffective. In an extensive review of the literature on IMF conditionality, for example, Axel Dreher (2008) concluded that there was little empirical evidence to show that conditionality helped to achieve any of the goals—including reducing the dependence of low-income countries on IMF funds, decreasing the debt burden of poor countries, and improving the quality of domestic economic policies in recipient countries—it was ostensibly designed to fulfill.

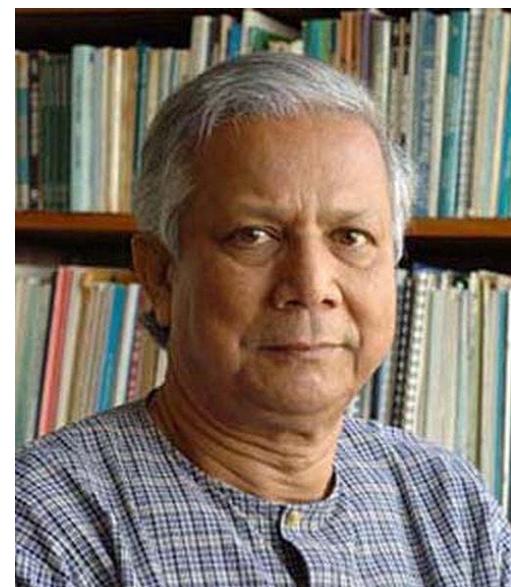
To be fair, the IMF has never been the primary focus of liberal efforts to eradicate poverty. That role, instead, has been fulfilled by the IMF's sister institution, the World Bank. Indeed, for more than two decades, the primary purpose of the World Bank has ostensibly been the elimination of world poverty. The World Bank makes its commitment to addressing global poverty crystal clear; on its website, the stated mission of the World Bank Group is twofold: to “end extreme poverty within a generation” and to “boost shared prosperity” (<http://www.worldbank.org/en/about>). While many critics of the World Bank make almost no distinction between it and the IMF, it is fairly clear that there are some important distinctions

between the two (although, because the two institutions work so closely together, it is hard to draw a clear-cut line). One of the most important initiatives by the World Bank centers on what is known as the poverty reduction strategy paper (PRSP). A PRSP is not merely a paper: it is the starting point for what is meant to be a comprehensive approach to poverty reduction in *individual* countries. Even more, it is an approach that has been largely developed by poor countries themselves. In an important way, then, PRSPs are the opposite of the one-size-fits-all approach behind SAPs. Tellingly, PRSPs do not focus on poverty reduction per se. Rather, a great deal of emphasis is put on good governance as a prerequisite for economic and social development (Grindle 2002). *Good governance* means a lot of things, including combatting corruption, building strong domestic institutions (especially the judiciary), reforming the legal code, improving public safety and law enforcement, improving social services, and so on. The core idea behind the PRSP is that individual countries be active participants and “take ownership” of comprehensive poverty reduction strategies, an element that SAPs, in particular, entirely lacked. To a significant extent, the PRSP has been successful precisely because it has encouraged some poor countries to implement crucial political reforms (Mallaby 2004). Ironically, though, the logic of the PRSP means that the worst-off countries—i.e., those that lack the capacity to pursue significant political reforms—are excluded from the program (Mallaby and Myers 2005).

#### *The Rise of Microcredit: A Bottom-Up (Liberal) Solution*

The debate over the goals of the IMF, the World Bank, and other international financial institutions is an important one, but it is not necessarily a good case to focus on in terms of evaluating the impact of liberal principles on poverty. After all, despite their obvious financial power and influence, international institutions are limited in what they can do, particularly since they act in a top-down manner (notwithstanding the more participatory approach of the PRSP). Perhaps a much better example of (neo)liberalism in practice, then, is a program known as microcredit, or microfinance. It is useful to note at the outset that microcredit is not typically associated with liberalism, still less neoliberalism. Thus, an explanation of why microcredit is an exemplar of the liberal approach is necessary, although it makes more sense to save this discussion until after the basics of microcredit are laid out. For now, then, suffice it to say that the basic logic of microcredit is premised on unleashing the entrepreneurial capacities of the very poor.

**Figure 7.4. Muhammad Yunus: Creator of Modern Microcredit**



Source: Tanveer Islam. The photo is licensed under the Creative Commons Attribution 3.0 Unported license.

So what exactly is microcredit? To begin, it is a bottom-up approach to poverty reduction. Although the general concept of microcredit has, arguably, been around for centuries, its beginnings as an explicit poverty reduction program can be traced back to the 1970s. This is when an economics professor in Bangladesh, Muhammad Yunus (who later founded the **Grameen Bank**), stumbled on to what has since become a global strategy. The basics of microcredit are simple. As the term implies, microcredit involves a very small amount of money (a few dollars to a few hundred dollars), which is loaned to very poor people. In contrast to regular bank loans, moreover, microcredit loans do not require collateral or any other legal guarantee. Indeed, because microcredit is premised on lending to those who have the least—i.e., those who have virtually no possessions or assets—people who have collateral originally did not qualify for microcredit loans (although, over time, microcredit has been extended to small enterprises, referred to as microenterprise loans; in addition, those who successfully pay their original loans usually qualify for subsequent loans). The loans, it is worth noting, are also premised on the borrower's intention to begin some sort of business—a microenterprise—so that the borrowed money can be paid back. On this point, it is important to emphasize that microcredit loans are, in fact, loans. They are not meant to be grants or unreimbursed aid. Those who receive microcredit financing must pay interest. Indeed, the interest rate charged for microcredit loans is typically quite high—the worldwide average is about 35 percent per annum (Kneiding and Rosenberg 2008). To help ensure that loans are paid back, borrowers are required to form or join a group of other borrowers, where the whole group becomes responsible for ensuring that each member's loan is paid back. This method has worked well, as microcredit institutions, including the Grameen Bank, report a repayment rate of between 95 and 97 percent.

In many respects, microcredit has been a tremendously successful program (see figure

7.5, “Microcredit Success Stories,” for a couple of individual cases). Beginning in a single country—and with just \$27 (the amount of money Yunus supposedly had in his pocket when the idea first came to him)—microcredit programs have spread to more than 85 countries, and have lent out between \$60 and \$100 billion on a cumulative basis (International Finance Corporation 2012). Most significantly, the number of people—mostly women—who have access to microcredit loans, according to the Microcredit Summit Campaign (Maes and Reed 2013), reached a peak of 205 million individual clients at the end of 2010. Of this number, 137.5 million were the poorest of the poor. This meant that as

### Figure 7.5. Microcredit Success Stories

Individual success stories abound. Consider Fatima Hassan, from Yemen, the sole breadwinner for a family of seven. For years, she toiled making a small number of handicrafts with rudimentary tools. Her level of production was very low, and she was never able to earn enough to do more than provide her family with the bare essentials. After taking out a \$120 microloan, however, she was able to invest in better tools and open a still-small but more productive center for producing handicrafts. First she sold to her neighbors and adjacent shops, but later she was able to get her products into the biggest commercial mall in her city. Her success encouraged her to open another business, a beauty salon, for which she borrowed another \$100. Although far from rich, Hassan has significantly improved her life and the lives her family members (cited in Al-Yarisi 2012).

Madhavi is another case. Illiterate and widowed—her husband died from tuberculosis—Madhavi and her three children were close to starvation. In desperation, she took up fish vending. Unfortunately, since she had no money, she was forced to borrow 90 rupees every morning, but then repay 100 rupees the same evening to a moneylender. She and her children survived, but just barely. In 1996, she was able to bypass the moneylender, and get a microloan for 2000 rupees (about \$32). The loan made a world of difference. Not having to pay back the money every single evening (at a usurious interest rate), she was able to do more business and earn a comfortable margin (cited in Villareal and Upare 2003).

many as 687 million of the world's poorest people were aided by microcredit loans, since the average client family consists of five members (Maes and Reed 2013; see table, "Basic Statistics on Microcredit Clients and Their Families," for details). In 2010, there were an estimated 3,652 microcredit institutions—i.e., organizations that provide microloans and other services to the poor. In 1997, by contrast, there were only 618 such organizations. The large plurality of microcredit institutions (1,746), it should be noted, are located in the Asia-Pacific region, but in 2010 there were more than 1,000 microcredit institutions in sub-Saharan Africa, 647 in Latin America and the Caribbean, 73 in Eastern Europe and Central Asia, and 86 in North America and Western Europe (all figures cited in Maes and Reed 2013). The rapid growth of microcredit is one clear indication of its success, but the more useful indicator is how it has helped poor people improve their economic situations. On this point, it is almost certain that microcredit has helped tens of millions of people improve their lives. In one study conducted in India, for example, Shubhashis Gangopadhyay of the India Development Foundation concluded that microcredit had helped nearly 9 million households (approximately 45 million people) rise above the \$1.25-a-day threshold between 1990 and 2010 (cited in Maes and Reed 2012).

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**Table 7.4. Basic Statistics on Microcredit Clients and Their Families (2010)**

|   |             |
|---|-------------|
| Total Number of Clients (Dec. 31, 1997 to Dec. 31, 2010)    | 205,314,502 |
| Total Number of Women                                       | 153,306,542 |
| Total Number of Poorest Clients                             | 137,547,441 |
| Total Number of Poorest Women                               | 113,138,652 |
| Est. Total Number of Poorest People Impacted by Microcredit | 687,737,205 |

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*Note: The numbers are based on reports from microcredit/microfinance institutions. Not all the figures have been verified.*

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Source: Maes and Reed (2013)

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### *Critiques of Microcredit*

The rapid and impressive growth of microcredit has led many policymakers, philanthropists, business leaders, international organizations, activists, and academics alike to see it as a solution, and perhaps *the* solution, to eradicating global poverty. It is no surprise, then, that the UN declared 2005 the International Year of Microcredit. Nor is it a surprise that, in 2006, Yunus was awarded the Nobel Peace Prize for his efforts. There are, however, more than a few critics of microcredit. Many of these critics, while acknowledging the concrete benefits that microcredit has brought to the lives of millions of extremely poor people, argue that its effects are, at best, palliative. At worst, microcredit also has the potential to exacerbate the lives of most of the world's poor over the long run. As a palliative measure, critics charge that microcredit focuses primarily on reducing *severe* poverty—i.e., allowing people to move from the category of earning less than \$1.25 a day to earning slightly more—while ignoring the problem of inequality, which allows still-serious poverty to persist. In this regard, critics assert that microcredit is fundamentally premised—as are all liberal and neoliberal approaches to poverty—on increasing economic growth as the solution to poverty. Yet if the mechanisms that create

massive inequality in the first place are left untouched, it is doubtful that the vast majority of the world's poorest people will be able to do much more than slightly improve their economic situations.

To be fair, few if any advocates of microcredit argue that microcredit by itself can eliminate global poverty. Muhammad Yunus has certainly acknowledged this. As he put it, "Micro-credit is not a miracle cure that can eliminate poverty in one fell swoop. But it can end poverty for many and reduce its severity for others. Combined with other innovative programs that unleash people's potential, micro-credit is an essential tool in our search for a poverty-free world" (1999, p. 171). So what is the real problem with microcredit? The answer, for critics, is simple: microcredit programs bring the logic of profit-based, market relations to very poor communities. Consider, again, the basics of microcredit: First, clients, or recipients of microcredit loans, are required to start a business, or a microenterprise. Second, they are also required to earn relatively high profits in order to pay back the principal and generally very high interest. This is not a problem when only a small proportion of a community receives loans, but what happens when dozens or hundreds of micro-entrepreneurs begin operating within the same limited space? The inevitable result is "market saturation" and a hypercompetitive situation, which also means "very low, and declining rewards for such simple micro-enterprise activities" (Chowdhury 2009, p. 3). In this sort of hypercompetitive situation, there are bound to be many "losers"—losers who could end up worse off than before they took out their loans.

The evidence of market saturation and hypercompetition is still far from complete, but consider the following description of Jobra, Bangladesh, the birthplace of modern-day microcredit:

In spite of an unparalleled availability of microcredit since the late 1970s, Jobra and its neighbouring villages remain mired in deep poverty, unemployment and underdevelopment. Moreover, a new social problem haunts the region thanks to the ubiquity of microcredit—growing levels of personal over-indebtedness. Not only does microcredit encourage more competition among micro-entrepreneurs, but it also encourages competition among microfinance institutions (Bateman 2011, n.p.).

A more systematic study by Bateman and Chang (2012) concluded that microfinance institutions have, in general, generated an artificially inflated supply of informal microenterprises, leading to market saturation at the local level, "which in turn precipitated reduced turnover in existing individual microenterprise units and downward pressure on local prices and incomes in general (thus negatively affecting both new and incumbent microenterprises)" (p. 22). The result, the authors found, was "that from the 1990s onwards, incomes, wages, profits and work-life conditions for those struggling in the informal microenterprise sector began to deteriorate quite markedly across the globe" (pp. 22–23). This deterioration, unfortunately, means that many poor borrowers end up, according to Bateman and Chang (2012), in "much deeper, and possibly, irreversible poverty." The reason, according to the authors, is clear: "a failed microenterprise often means the poor lose not just their already minimal income flow, but also any additional assets, savings and land they might have invested into their microenterprise, or else are forced to sell off (often at 'fire-sale prices') in order to repay the microloan" (p. 23).

The upshot is that microcredit works for some, but not all or even most poor people. The unevenness of the microcredit solution, for Marxist analysts and other critics, is predictable. For just as liberal principles have not solved poverty at a global level, the application of those same

principles cannot be expected to solve poverty at a local level. Instead, the application of those principles will likely only deepen inequality and poverty over the long run; there may be slightly more haves, but the have-nots will continue to number in the hundreds of millions, at the very least. Even worse, from a critical perspective, the palliative success of microcredit may be used as a justification by advocates of liberal and neoliberal approaches to declare that everything that can be done for the poor has been done. Those who continue to live in poverty, therefore, are irredeemably poor: they simply cannot be helped, and perhaps should not be helped.

## Poverty and Capitalism: An Unbreakable Bond?

To Marxist critics of liberalism, to reinforce a point made several times already, the solution to poverty lies not solely or primarily in pumping up economic growth, or in unleashing the market. Instead, the solution lies in attacking the root cause of poverty, which is the exploitation and inequality inherent in capitalism itself. Unfortunately, to many Marxist scholars and activists, the root cause of poverty is deeply embedded in the capitalist system as a whole. Thus, the only meaningful solution to global poverty is to essentially root out capitalism altogether. Not surprisingly, many analysts—even some who are sympathetic to Marxist principles—consider this view extreme. People, in general, want workable solutions to serious problems. One major fault in the Marxist approach, then, is the general inability to offer prescriptions for reducing or eliminating global poverty (more on this point below). That said, the exploitative and unequal characteristics of capitalism, it should be further emphasized, are strengthened and reproduced by a globalized superstructure composed of a supposedly anarchic, but actually hierarchic, interstate system; international regimes and institutions (controlled by the most powerful states) governing trade, finance, and investment; and a global and increasingly hegemonic market culture, which portrays liberalism or neoliberalism as the answer to all the world's problems. On the surface, the Marxist view may seem to be simplistic and ideologically biased, but it is worth noting that, despite decades of assurances that the rising tide of (market-based) economic growth would lift all boats, the reality is growing global inequality and continuing exploitation. And while it is true, as even Marxist scholars (perhaps grudgingly) acknowledge, that there has been some progress in reducing absolute poverty—at least using the extremely restricted conceptualization of poverty as a single statistic (e.g., \$1.25 or \$2.00 a day)—it is clear that the “boats” in which hundreds of millions of severely poor, and billions of very poor, people reside have hardly risen at all. Meanwhile, over the decades, relative poverty has been increasing within many richer countries. This suggests that, while economic growth may be a necessary condition to reduce poverty, it is certainly not sufficient. Indeed, as long as exploitation and inequality remain part and parcel of the overarching economic system, the problem of poverty cannot be effectively resolved.

### *The High Costs of Cheap Clothes: A Concrete Example of Exploitation*

The last point raises an obvious question: Is it possible to dramatically reduce or even eliminate exploitation and inequality in the current global economic system? To Marxists, the simple answer is no. If exploitation is *inherent* in capitalism, this means that it is a necessary feature of capitalism. As Lapon (2011) explains it:

Marx's theory of exploitation reveals that because the source of capitalists' wealth is the unpaid labor of workers, the interests of workers and capitalists—like slave and master or serf and lord before them—are diametrically opposed and are impossible to reconcile. The two will always come into conflict since capitalists can only increase their share of the wealth at the expense of workers, and vice versa. Workers have to struggle to decrease the severity of the exploitation they face under capitalism. *But as long as the capitalist system exists*, workers will be exploited, and their unpaid labor will remain the source of the profits that are the lifeblood of the system (emphasis added).

Again, it is easy to reject such analysis out of hand. But a quick look around the world suggests that Marxist analysis should, perhaps, be seriously considered. The indications of unfettered exploitation are all around us. Take, for example, the collapse of the Rana Plaza garment factory building (also known as the Savar building) in Bangladesh in April 2013. The collapse of the building made global headlines largely because of the large number of people—mostly poor garment workers—killed in a single tragedy. According to news reports, at least 1,129 died in the collapse, and over 2,500 people were seriously injured.<sup>44</sup> Admittedly, a tragedy such as the collapse of the Rana Plaza garment factory building does not happen every day, but it is not an uncommon phenomenon. Indeed, in Bangladesh alone, as many as 1,000 workers died in factory fires between 2006 and 2013 (Akter 2013), and 79 others perished, during the same period, when smaller factories

**Figure 7.6. The Rana Plaza (Savar) Factory Collapse, Bangladesh**



Source: This image, which was originally posted to Flickr.com, was uploaded to Commons using Flickr upload bot on 19:05, 12 May 2013 (UTC) by Rijans007. The image is licensed under the Creative Commons Attribution-Share Alike 2.0 Generic license.

**Figure 7.7. Map of Bangladesh**



Source: CIA. This image is in the public domain because it contains materials that originally came from the United States Central Intelligence Agency's World Factbook.

collapsed (Ratnayake 2013). Just six months after the Rana Plaza tragedy, moreover, another seven people were killed, and dozens more injured, in a large fire that broke out in a knitwear factory on the outskirts of Dhaka (Hussein 2013). Of course, it is not just Bangladeshi workers who are at risk. In Pakistan, 300 workers perished in a textile factory fire in September 2012, and in China it is estimated that there are as many as 147,000 factory deaths every year from accidents and other mishaps, and perhaps hundreds of thousands more (Kaye 2010).<sup>45</sup> These and thousands of other similar incidents—from those that make the headlines to those that no one but close friends and family notice—suggest that the relentless drive for profits trumps the health, safety, and very lives of those who play a significant role in making immense profits possible.

On this last point, it is important to add that the Rana Plaza tragedy not only helped to highlight the dangerous conditions faced by poor workers in poor countries, but also served to shine a very bright light on the exploitative nature of a highly globalized industry. Follow-up coverage by news outlets and activist organizations, in particular, revealed that workers in the Rana Plaza factory building were making as little \$36.50 a month (Walsh 2013),<sup>46</sup> while working up to 14.5 hours a day, six and seven days a week (Institute for Global Labour and Human Rights 2013). This means that some workers were earning just a few pennies an hour, as little as 13 cents. It is important to understand that these wages were being paid, albeit indirectly, by some of the largest transnational companies in the world: indeed, one of the primary clients for the garment companies in the Rana Plaza factory building was Walmart (other companies included Benetton, Primark [a British company], Joe Fresh, JC Penny, and The Children's Place). While the garments produced at the Rana Plaza factory building were just a small fraction of Walmart's total business, it is worth noting that the company earned \$15.7 billion in profits in 2012, based on \$446.9 billion in total revenue (Walmart 2012). Even more, Walmart's president and CEO (chief executive officer), Michael Duke, received total compensation of \$17.6 million in 2012, which meant that he “earned” \$48,219

every *day* of the year: to put this figure in perspective, bear in mind that it would take a Bangladeshi worker earning \$36.50 a month *110 years* to earn what Duke earned in a single day (Duke stepped down as president and CEO of Walmart Stores, Inc. in 2014). Given these statistics, as well as the on-the-ground situations faced by workers in Bangladesh, it becomes even harder to argue against the Marxist assertion that Walmart and its executives thrive, in large part, because of the “unpaid labor” of those who make the products Walmart sells.

Admittedly, the situation faced by workers in Bangladesh is extreme. In other relatively poor countries, such as Colombia, some workers doing basically the same work—i.e., sewing garments—earn four or five times more than their Bangladeshi counterparts (McCune 2013). The discrepancy in labor costs between Bangladesh and Colombia raises an obvious question: Why would major manufacturers and retailers choose relatively high-

**Figure 7.8. Map of Colombia**



Source: <https://www.cia.gov/library/publications/the-world-factbook/geos/co.htm>. This image is in the public domain because it contains materials that originally came from the United States Central Intelligence Agency's World Factbook.

cost Colombia over Bangladesh (or another very low-cost country)? The answer, on one level, is quite simple. In Colombia, the apparel industry has much better technology. This means that Colombian garment workers can make clothes much faster than Bangladeshi workers can. In other words, higher productivity in Colombia makes the costs of producing garments in the two countries roughly equivalent, despite significantly higher wages and generally much better working conditions in Colombia. According to National Public Radio's *Planet Money* program, in fact, eight Colombian workers on one sewing line can produce about 140 T-shirts in 60 minutes; it would take 32 Bangladeshi workers 105 minutes to produce the same number of T-shirts (McCune 2013).<sup>47</sup> Other factors also played a role in Colombia's success as a major source of textile manufacturing. One of the most important of these has been the Andean Trade Promotion and Drug Eradication Act (enacted in 2002), which gave Colombia (and other South American countries) duty- and quota-free access to the U.S. market for certain apparel products. In addition, the broader multilateral Agreement on Textiles and Clothing, which governed world trade in textiles and clothing from 1974 to 2004, established quotas for textile exports from developing countries to developed markets; this agreement had the effect of limiting competition from lower-cost manufacturers.

Despite their differences, the key to the survival of the garment industry in both countries is the same: lower *overall* costs. Thus, if overall production or other associated costs were to increase in either country, it is likely that the apparel industry would very quickly leave in search of "cheaper pastures." This point was made quite clearly by Luis Restrepo, the CEO of a garment manufacturing company in Colombia. In an interview with *Planet Money*, Restrepo put the issue bluntly: "Our industry follows poverty." No matter how good his company is, Restrepo also admitted, he is only "one phone call away" from going out of business. In fact, shortly after the interview, Jockey (the U.S. company for which Restrepo's company was sewing clothes) announced that it would cease operations in Colombia. The reason? Rising costs and wages. Jockey indicated that it would move production to several other countries, where the cost per shirt would be 20 to 30 percent lower (cited in McCune 2013, n.p.). Jockey's decision, it should be noted, is part of a larger trend. For several years Colombia had been losing to lower cost competitors, primarily from Asia. Consider, for example, the case of Enka, which was Colombia's largest thread manufacturer and the leading producer of nylon and other polyester threads in the Andean region in the 1990s. After the expiration of the Agreement on Textiles and Clothing, Colombia was "flooded with polyester threads and fabrics from Southeast Asia that sold for one third of Enka's cost . . . Some of the materials came in illegally; some with all the required customs documentation. The nadir was in 2008 when Enka suffered a 40% loss of sales and was forced to discontinue several polyester lines. By the end of that year, the company had shed 1,000 employees, or 15% of its work force" (Wharton School of Business 2011). Enka's decline was a product of China's emergence as a major producer of low-cost textiles. Yet while China was still the largest exporter of textiles in 2013, its position began to be challenged by even lower-cost countries, such as Bangladesh (Anbarasan 2012). Bangladesh is now the second largest exporter of clothes in the world, behind only China.

It is important to reemphasize that, in the Marxist view, the situation described above does not just happen because of greedy and unfeeling factory owners. Instead, it reflects the dynamics and imperatives of capitalism as a *system*. Increasing competition (whether local or global), in particular, compels factory owners and other owners of capital to keep searching for lower-cost production sites. If the owners refuse to engage in this process, they will not survive: competition and the impersonal dictates of market forces will sweep them away. Their

participation, however, both perpetuates and increases the intensity of exploitation and inequality, and ensures that the poor will remain poor.

### *Reprise: Power and Poverty in the Global Economy*

Importantly, when production was more localized (or less transnational), workers had a greater capacity to challenge the exploitative pressures of capitalism through collective action, a point mentioned earlier in the chapter. The expansion of transnational production, however, has made it more and more difficult for workers to increase their wages, create more employment stability, and exercise greater control over their work lives. To put the issue in slightly different terms, globalization and transnational production specifically have dramatically enhanced the structural power of capital (vis-à-vis both workers and states). To be sure, workers might be able to win relatively small victories here and there, but even these tend to be ephemeral. For example, in the aftermath of the tragedy in Bangladesh,

factory owners agreed to increase the minimum wage for garment workers by 77 percent—but this was only after workers engaged in strikes, protests, and street violence (Burke 2013). But as is unequivocally clear from the preceding discussion, if labor costs rise too much in Bangladesh, the Western companies that source their clothes from Bangladesh will simply move somewhere else, and when they do, hundreds of thousands of workers will lose their jobs, and many of those workers will be forced back into absolute poverty. This situation, moreover, reflects almost perfectly the nature of structural power. Western firms are not using coercion or any visible means of force to exercise power; indeed, they do not even interact directly with the poor workers in Bangladesh, or in most other poor countries where they site production. Instead, they are simply taking advantage of their privileged position in the global economy, while pursuing their *raison d'être*: profits. It bears repeating, too, that there is generally very little that the states in these poor countries can do to change the situation—even those that are motivated to do so—for their workers. The reason poor states can do very little, again, has to do primarily with expansion of transnational production. If a poor state attempts to negotiate a better deal for its workers, TNCs will simply go elsewhere. There are, to put the issue in slight different terms, high **opportunity costs** associated with pro-labor policies: all things being equal, better wages and stronger worker protections means less FDI.

**Figure 7.9. A Protest by Garment Workers in Bangladesh, March 2006**



On March 2, Bangladeshi workers observed a national one-day strike to protest the deaths of over 100 fellow workers in a recent factory fire.

*Source: Derek Blackadder. This file is licensed under the Creative Commons Attribution-Share Alike 2.0 Generic license.*

In sum, in the Marxist perspective, exploitation, inequality, and poverty are all necessary products of a system both premised on and dependent on the incessant generation of surplus value. To repeat, this is the reason why—from a Marxist perspective—market-based solutions cannot eliminate or significantly reduce poverty on a global scale. There is, on this last point, one more useful example to consider, which demonstrates how the logic of the market invariably leads to greater exploitation and inequality—namely, modern-day slavery. Slavery, which one scholar defines very simply as “unpaid forced labor” (Manzo 2009, p. 248),<sup>48</sup> is admittedly another extreme example, but still a relevant and important one upon which to focus.

### Hyper-Exploitation: The Resurgence of Slavery in Africa

In chapter 2, the problem of slavery was briefly mentioned. More specifically, the chapter mentioned the growth of slave labor, and particularly child slave labor, in Ghana and Côte d’Ivoire, two relatively small countries in West Africa. The experiences of these countries, especially Côte d’Ivoire, are instructive for a number of reasons. First, their experiences again highlight how market forces operate, with brutal efficiency, on small and structurally weak economies—and especially those economies that rely heavily on their so-called comparative advantage in producing cash crops. Second, their experiences further highlight the role that the superstructural elements of the global economy—especially international financial institutions such as the IMF—play in reinforcing and reproducing poverty. Third, and finally, the experience of Côte d’Ivoire in particular reinforces the earlier point that economic growth alone, no matter how promising, is not a guarantee that poverty, in the long run, can be defeated.

With these general points in mind, it should be noted, to begin, that slavery, as unpaid forced labor, has never fully disappeared from the world. Unlike in the past, however, it is now considered to be an abomination by essentially all states and societies (or at least no state or society would publicly defend or condone slavery). From the standpoint of international law, moreover, slavery has long been banned as an unequivocally illegal practice, although it was not until the 1953 Slavery Convention that any organization—in this case, the United Nations—was authorized to exercise a regulatory role (Bell 2008). While the 1953 convention did not succeed in eradicating slavery, it was a further step in firmly embedding the normative principle that slavery constitutes a violation of fundamental human

**Figure 7.10. Map of West Africa**



Source: Peter Fitzgerald. The image is licensed under the Creative Commons Attribution-Share Alike 3.0 Unported license.

rights (Bales and Robbins 2001). There was, however, a downside to making slavery both morally repugnant and illegal—namely, it drove slavery deeper underground. One consequence of this is that it is difficult to estimate the number of people held as slaves today. The most commonly cited number is 27 million, but this is far higher than an estimate by the International Labor Organization, which puts the number at 12 million. If the higher estimate is accurate, though, it means that there are many more people being held as slaves today than at any point in human history (Hogenboom 2012). Even the lower estimate would be roughly equivalent to the total number of slaves during the height of the Atlantic slave trade (between the 16<sup>th</sup> and 19<sup>th</sup> centuries). Thus, whatever the actual number, it is clear that slavery is alive and well. The important question for our purposes, then, is why and even how this is the case.

### *Côte d'Ivoire, Cocoa, and Child Slavery*

Kate Manzo (2009), while not offering a comprehensive answer to the last question, argues that the resurgence of slavery in parts of Africa, and in Côte d'Ivoire specifically, is due to a process called “deproletarianization,” which is when “forced labor is reintroduced as a method of worker discipline and a way to cut costs under capitalism” (p. 258). In Côte d'Ivoire, this process unfolded primarily in the cocoa industry, which is the country’s most important industry. On this last point, it is useful to note that even in the early 2000s—after strong efforts to diversify agricultural production—cocoa still accounted for 70 percent of the country’s exports of primary products, more than 30 percent of exports overall, and 15 percent of GDP (International Monetary Fund 2013b). Indeed, despite having a relatively small national economy—with a GDP of about \$25 billion in 2012—Côte d'Ivoire is the world’s preeminent source of cocoa production: in 2011, Côte d'Ivoire alone was responsible for 35 percent of the global supply of cocoa, while Ghana, the world’s second largest supplier, produced another 23.7 percent of global supply (International Cocoa Organization 2013). Significantly, the region’s dominance in cocoa production is a direct result of colonialism: after acquiring a taste for cocoa (and the chocolate that comes from cocoa seeds), European imperial powers brought the cocoa seed to Africa (from South America) in an effort to increase production and reduce costs. The first cocoa seeds were planted in Nigeria in 1874, and in Ghana in 1879. West Africa proved to have an especially hospitable climate for the cocoa tree—the tree grows best within a narrow belt between 10 degrees north and 10 degrees south of the equator—so it did not take long for the region to become the center of cocoa production worldwide.

Côte d'Ivoire’s climate and fertile land, more generally, were also quite conducive to the production of coffee, cotton, and timber—all highly sought-after cash crops. Not surprisingly, then, Côte d'Ivoire relied heavily on these agricultural products for its economic growth after France granted the country its independence in 1960 (after almost seven decades of colonial rule). For two decades after independence, this seemed to be a successful strategy, as Côte d'Ivoire’s economy thrived—from 1960 to 1981, the Ivorian economy grew at an average annual rate of between seven and eight percent. The economy was doing so well that many analysts referred to Côte d'Ivoire’s economic success as the “Ivorian miracle”—an obvious reference to the equally explosive economic growth that was taking place in Japan, Taiwan, South Korea, and Singapore during the same period, which was referred to as the “Asian miracle.” On top of strong economic growth, outside observers praised the Ivorian government (in the period of high economic growth) for its low taxes, limited regulation, effective integration into world markets, reliance on the country’s comparative advantage in agricultural commodities, and sound economic management (Watkins n.d.). Côte d'Ivoire, in short, seemed to be doing all the right

things, at least from a liberal economic perspective. It should be noted, however, that, contrary to liberal prescriptions, the government did retain a strong hand in the cocoa industry: during the period of French rule, the industry was regulated by a state institution called the Caisse de Stabilisation, referred to as the CAISTAB. The CAISTAB was retained by the Ivorian government following independence. Among its primary functions, the CAISTAB set an official export price, released exports negotiated by private exporters, sold a proportion of the crop, set the pricing structure, and ensured the quality of the beans at the point of export. The CAISTAB, importantly, also provided a safety net for the cocoa farmers by guaranteeing a minimum price for the season, no matter what the price of cocoa beans was in the world market (International Labor Rights Fund 2004). The role of the CAISTAB, which might be viewed in very positive terms by mercantilists, problematizes the liberal argument that a hands-off or laissez-faire approach produces superior economic results—i.e., a stronger and more stable cocoa industry.

Throughout the 1960s, cocoa (and other commodity) prices were relatively low, but also fairly stable (see figure 7.11). Beginning in the 1970s, however, cocoa prices rose sharply, reaching a high point of \$5,368 per metric ton in July of 1977; in 1965, by contrast, cocoa was selling for just \$211 per metric ton. The sharp increase in prices encouraged heavy government and private-sector borrowing, particularly for infrastructural improvements and investments in public enterprises (many meant to help diversify the economy). These investments, it should be noted, made good economic sense: the Ivorian government and the private sector understood very well that overreliance on agricultural commodities (such as cocoa and coffee) left the entire economy extremely vulnerable to market forces over which the country had no control. Commodity prices, in particular, are subject to periods of boom and bust. Diversification, therefore, was needed to provide a more stable economic foundation. Unluckily, the timing was extremely bad, as the bulk of the increased investment—financed primarily through foreign borrowing—took place just before a dramatic drop in commodity prices in the late 1970s. To make matters worse, according to Manzo (2009), the Ivorian economy was also negatively impacted by a decline in the value of the U.S. dollar (the currency in which commercial loans were denominated), and a rise in prices for imported oil. “The cumulative effect”, as Manzo (2009) succinctly puts it, “was a dramatic increase in national indebtedness. By 1981, Ivory Coast’s external debt was ten times higher than it had been only three years earlier” (pp. 253–254).

**Figure 7.11. International Cocoa Prices, 1959–1990 (U.S.\$ Per Metric Ton)**



Source: *Tradingeconomics.com*. User-generated chart. <http://www.tradingeconomics.com/commodity/cocoa>

The country's large external debt and its deteriorating terms of trade almost forced the government to turn to the IMF and World Bank, although the first loan—a World Bank Structural Adjustment Loan—was not disbursed until 1989. Prior to receiving any loans, Côte d'Ivoire was required to submit to a structural adjustment program (SAP), the first of which was introduced in 1981 (Ridler 1981). The IMF- and World Bank-imposed SAP required the standard list of one-size-fits-all reforms: currency devaluation, liberalization of prices and interest rates, fiscal restraint, and trade liberalization. Unfortunately, the reforms did not work (more on this very shortly). Commodity prices remained jittery, and while still much higher (on average) than the 1960s, they remained too low for the country to service its foreign debt. Every drop in price, moreover, exacerbated Côte d'Ivoire's financial situation, which put the country deeper and deeper into a debt hole. Yet the more serious problem—at least from a Marxist perspective—was not the debt per se, but the neoliberal policies imposed upon Côte d'Ivoire by the IMF and World Bank. One of the most important of these policies was the forced privatization of the CAISTAB. From the IMF and World Bank's perspective, the process of privatization was designed to guarantee transparency in the cocoa industry and encourage fairer trade by creating a freer market (International Labor Rights Fund 2004). As an aside, it is useful to point out that countries such as the U.S.—occupying, as they do, a privileged position in the world economy—provide very strong protections, or safety nets, to their farmers.

The cocoa market was, in fact, made freer, but it was also made more hazardous for key market participants. This is because privatization also effectively transferred the risk of commodity price changes entirely to the farmers. In the old system, as noted above, the Ivorian government, through CAISTAB, guaranteed a minimum price for farmers, which helped to

ensure at least subsistence-level wages for the workers who harvested the cocoa beans. In the new system, whenever the international price of cocoa dropped, farmers (the landowners) were squeezed, which meant that wages had to drop too. When prices plummeted in 1999, farmers were squeezed to the breaking point. The problem they faced was that wages were already extremely low. To survive, then, the farmers were essentially forced to stop paying wages altogether. Of course, almost no one would volunteer to do the difficult work of harvesting cocoa beans for no compensation. Thus, the basis for slavery, and particularly child slavery, was set: the only way farmers could harvest their crops under conditions of very low commodity prices—set by the free market—was to force children to do the work. But why children? The answer is fairly simple: compelling adults to do unpaid forced labor is far more difficult and costly than compelling children. Children, in other words, are far more manageable and compliant than adults. This is especially the case when children are taken from their homes and sent to faraway and isolated locations where they may not even speak the local language. Thus, it is no surprise that most of the children doing forced labor in Côte d'Ivoire have been trafficked from neighboring countries such as Ghana, Mali, and Burkina Faso. The numbers, moreover, are significant: according to a U.S. Department of Labor (2012) report, in 2010 there were as many as 30,000 children in Côte d'Ivoire working under conditions of forced labor in rural areas (a much larger number—around 800,000 children—were working as paid labor in the country).

Meanwhile, as noted in chapter 2, the global candy and chocolate industry has generally thrived: in 2012, revenues were about \$118 billion. That same year, the largest candy and chocolate company (and the third largest private company) in the world, Mars, Inc., had sales of \$33 billion (not all from chocolate) (Murphy and DeCarlo 2013). Because Mars is a privately held and family-owned company, there is no information on profits, or on the salaries of top executives, but David Kaplan (2013), writing for *Fortune* magazine, points out that the three owners are multibillionaires, with each reportedly among the 20 or so richest Americans. Interestingly, Mars is known for treating U.S.-based employees exceedingly well: turnover in the U.S., according to Kaplan (2013) is very low (5 percent or so), and some families have been employed by Mars for multiple generations. By all accounts, it is a great company for which to work. At the same time, for decades, the company sourced a significant proportion of its cocoa from Côte d'Ivoire, which means, at least according to one critic, that some of the company's products “are almost certainly produced in part by [child] slavery” (Robbins 2010, n.p.).

The Marxist perspective, it is important to emphasize, asserts that it is the combination of two factors—i.e., sharply lower commodity prices set by a free market *and* the structural adjustment policies of the IMF and World Bank—that produced child slavery in Côte d'Ivoire. This is not to excuse the decisions of the farmers who force children into slavery, but rather to underscore the claim that capitalism as a system, which includes its superstructural elements (e.g., the IMF and World Bank), creates a dynamic that leads to exploitation, and, in some cases, hyper-exploitation in the form of slavery (unpaid forced labor). In this view, child slavery certainly is not a common form of exploitation, but it is very much part of the logic of capitalism. For many Marxist analysts, this logic is hardwired into capitalism. Thus, exploitation and poverty will not only persist, but will likely get worse as the logic of the market is introduced and more firmly embedded—often forcefully—throughout the globe.

## Summing Up: Marxist and Liberal Views of Capitalism, Exploitation, and Poverty

The contrast between the Marxist and the liberal views could not be starker. To review: the former sees capitalism itself as the problem, while the latter sees capitalism as the only viable solution to poverty. For Marxist analysts, poverty is a direct product of the exploitative and unequal nature of the necessarily unending search for profits, a search that requires greater exploitation over time rather than less. Liberal analysts, of course, reject this view. Some argue that exploitation, to the extent that it exists, is a product of imperfect markets in which nonmarket actors (e.g., governments and unions)—rather than market forces—are the primary culprits. When serious exploitation of workers does occur—as is obvious in Côte d'Ivoire—it is precisely because the market is not functioning correctly. For other liberal analysts, as noted above, the very idea of labor exploitation is laughable, since market exchanges are, by their very nature, voluntary and mutually beneficial. And, finally, while liberals agree that inequality is clearly part of the capitalist process, they argue that inequality is largely irrelevant to the question of poverty: in a growing economy, all boats can and do rise, even if some rise faster and higher than others. Inequality also creates incentives for poor individuals to do the things—such as learning new skills or acquiring a better education—that will allow them to not only improve their own financial situations, but also improve the quality of human capital within their societies. Society-wide improvements in human capital lead to stronger economic growth, which leads to less poverty.

In sum, the gap—or, perhaps more accurately, the chasm—between the Marxist and liberal views cannot be bridged, at least from the standpoint of hardcore proponents of either approach. Does this mean that one must choose sides? Or is it possible to find some common ground? On one level, the answer to the latter question is no. Both the Marxist and liberal perspectives, it bears repeating, imply that markets operate according to principles that are figuratively set in stone. To Marxists, capitalism *must* be exploitative and unequal; thus, to overcome poverty, capitalism as a system must be destroyed. To liberals, on the other hand, markets *must* be completely free to produce optimum economic and social results: overcoming poverty means freeing markets to the maximum extent. Admittedly and importantly, the foregoing statements reflect the views of purists on both sides of the theoretical chasm. Many, even most, other analysts adopt far less fundamentalist positions. Thus, as was suggested in the introduction to this chapter, common ground can be found if fundamentalist views are rejected; this means, too, challenging the usually unstated assumption that the world is composed purely of objectively defined forces and processes.

### *A Few Words on the Neo-Mercantilist Perspective*

The neo-mercantilist view on poverty is very simple. For instance, with regard to international efforts to solve global poverty, neo-mercantilist analysts, for the most part, agree that all such efforts are doomed to fail because states are fundamentally self-interested actors. More specifically, because rich states generally have little or nothing to gain from helping other countries overcome their conditions of poverty, they have no motivation to do anything. To be sure, richer states may pay lip service to eradicating global poverty, but they are unwilling to commit the resources or make the sacrifices necessary to effect meaningful change. When richer countries do act to bring about positive economic development in poorer countries, it is only because of an overriding national interest on their part. In the early years of the Cold War, for example, the United States was intent on building a strategic network that could effectively

contain the Soviet Union and China, both of which, according to neo-mercantilists (and their theoretical counterparts in international relations—realists) posed serious geopolitical threats to the United States. The U.S., in short, needed strong, reliable allies. Thus, American policymakers devoted considerable resources to rebuilding Western Europe and Japan as primary allies, but soon discovered that it was equally important to extend their strategic network to smaller countries. In Asia, two especially important recipients of American largesse were South Korea and Taiwan. In the 1950s, both these countries were dirt poor; in fact, they were among the poorest countries in the world at the time. The U.S. helped both countries overcome their poverty through the extension of a huge amount of economic and military aid, and, perhaps more importantly, by providing essentially one-way access to U.S. markets, a privilege that was first extended to Japan (remember, too, that the U.S. encouraged Japan to use an undervalued exchange rate of ¥360:\$1 for many years; this made Japanese export goods very cheap). One-way access meant that all three Asian countries could sell as much as they wanted to the United States, yet not have to open their markets to either American goods or FDI. It was a very sweet deal, and one that allowed Japan, South Korea, and Taiwan to accelerate their economic development and climb out of poverty relatively quickly (for more detailed discussion, see Lim 2014).

The Cold War context, however, was special, as was the geopolitical position of the East Asian countries: South Korea and Taiwan became central bulwarks against communist expansion due to their especially hostile and extremely tense relations with North Korea and China respectively. At the same time, neo-mercantilists would no doubt emphasize the internal characteristics of the East Asian countries. All had strong states committed to achieving rapid industrialization and economic growth by whatever means possible. They were not concerned with laissez-faire or free-market principles; indeed, they employed the whole panoply of classic mercantilist practices: import-substitution industrialization, infant industry protection, the use of high tariffs and NTBs; capital controls; restrictions on FDI; and so on. Their use of these practices, to repeat, was contingent—to a significant degree—on “permission” from the United States. As the East Asian economies developed into potential and actual economic rivals, it is important to add, the U.S. became less and less willing to allow for special treatment. Recall, from chapter 5, the 1985 Plaza Accord, which resulted in a drastic strengthening of the Japanese yen relative to the dollar. Later that decade, the U.S. also demanded that Japan eliminate unfair trading practices through the **Structural Impediment Initiative**, or SII. Similar pressures were brought to bear on South Korea and Taiwan. Fortunately, for these countries, they had already made enough economic progress to hold their own economically; thus, they did not descend back into poverty.

Another major case illustrating the neo-mercantilist perspective, which was mentioned a number of times earlier in this chapter, is China. China has made tremendous economic strides since 1979, when it abandoned central planning and turned to a market economy. Yet this does not mean that the liberals are right: it is not the free market that led China out of poverty, but a highly managed and guided market. China, to a large extent, has followed the mercantilist (or neo-mercantilist) path of its East Asian brethren. China, too, is a special case, but not exactly for the same reasons as Japan, South Korea, and Taiwan were. China’s sheer size *and* strong political leadership gave the country leverage and power that no other poor country could (or can) hope to match. In this respect, China’s capacity to significantly reduce poverty within its borders reflects perfectly another aspect of the neo-mercantilist approach: to the extent that poverty can be overcome, it will be the product of strictly national-level efforts. These national-

level efforts, however, cannot be based on adherence to free-market or laissez-faire principles; instead, only those countries that are able to follow a mercantilist path can achieve economic success. Unfortunately, there are precious few poor countries that have this capacity.

## Capitalism Is What People Make It

Constructivism provides a useful way of examining and reframing the debates over poverty, inequality, and exploitation. Constructivists, to reiterate a key point, do not claim that there are no objective forces, processes, or structures. They do not, in particular, claim that reality is a mere figment of our collective imaginations. Poverty, inequality, and exploitation are certainly real, as are the processes that lead to those outcomes. Constructivists, however, also strongly emphasize the subjective or, more accurately, intersubjective elements of all structures. In this regard, to paraphrase Alexander Wendt (1995), constructivists assert that the structure of capitalism is what people make it. On the surface, that may seem to be a nonsensical statement. After all, both Marxists and liberals agree that capitalist markets, once set in motion, operate according to fundamental and intrinsic principles that cannot be ignored, dismissed, or wished away: simply put, capitalism is what it is. Marxists are particularly adamant that capitalism is inescapably exploitative. Importantly, constructivists do not disagree with the premise that capitalism can be and often is a brutally exploitative system (or structure) that creates and sustains poverty and vast inequality on a global scale. But, constructivists are quick to add, this brutally exploitative and unequal structure cannot exist apart from the people that both made it and sustain it. To put the issue in slightly different terms, markets are not, according to Wendt (1995), acts of God; instead, “they are effects of practices” (p. 77).

The logic underlying the idea that markets are effects of practice is simple: markets are ultimately the product of what people do. At the same time, what people do is the result of their shared understanding, or shared knowledge. More specifically, constructivism asserts that market actors—whether the CEO of Walmart, a factory owner in Bangladesh or Colombia, or slave-owning farmers in Côte d’Ivoire—all share the same basic understanding of the logic and dynamic of the market process. This logic tells them that profit-maximization is their *raison d'être* (i.e., the reason for their existence). Moreover, it tells them that the most efficient ways to accumulate profit is to cut costs by reducing wages to the bare minimum (or by cutting wages completely), by building substandard factories, by “following poverty,” or by constantly pressuring their workers to produce more and more in less and less time. Thus, they act—or put into practice—their understanding of how the market system works; and it is precisely their actions that keep the system as it is. As purposeful agents, however, they have the capacity to make different choices, or to engage in a different set of practices. In the constructivist view, the capacity for choice, or agency, is critical.

One objection to the constructivist idea is immediately apparent: market actors do not really have a choice. They do what they have to do to survive. Again, constructivists do not dispute this “hard” reality. All market actors—especially those in poorer countries—are subject to the intense and unremitting pressures of market forces; escaping the market system, especially in an era of globalization (where the market is virtually everywhere), may not be possible for many actors. In this regard, poverty, inequality, and exploitation may be, for all intents and purposes, unavoidable facts of life for most of the world’s people. The present reality, however, is not the only possible reality. This understanding of the malleability of reality (or social structures), to repeat a key point, is what sets constructivism apart from the other approaches.

Thus, constructivists argue that severe poverty, inequality, and exploitation, while apparently deeply embedded elements of capitalist markets today (notwithstanding the arguments of some liberal analysts), are neither necessary nor permanent. Uprooting them, however, is likely to be a slow, extremely arduous process—a process that will begin with the development of alternative understandings of how markets are supposed to work. Shared understanding, in turn, needs to be the basis for collective and persistent action that ultimately reshapes the reality of the market structure.

It is important to add that the shared knowledge of how capitalism is supposed to work does not exist in a vacuum. Power and politics, in particular, play a central role in defining dominant discourses or interpretations of capitalism. Over the past several decades there has been an intense struggle over defining what capitalism is (or is supposed to be); this struggle has been, to a significant extent, but not entirely, dominated by advocates of neoliberalism, a point that was discussed at some length in chapter 5 with regard to the global financial system. While neoliberalism still defines the shape of the global financial system, in the realm of development (which encompasses the issues of poverty, inequality, and exploitation), neoliberal ideas have faced an increasing, albeit still limited, challenge from alternative perspectives. Consider, for example, the emergence of new corporate codes of conduct, especially for corporations engaged in transnational production. A corporate code of conduct (or ethics) is, in the most general sense, a statement that outlines the mission and values, including the professional ethics, of the business organization; these have been around for a long time. Since the 1990s, however, corporate codes of conduct have become more focused on a corporation's role in conducting operations in foreign locations, especially in poorer countries. Many codes of conduct now emphasize the corporation's social responsibility to workers (and the responsibility to protect the natural environment). Tellingly, the recent wave of codes of conduct based on social responsibility toward workers tend to be concentrated in certain sectors, such as garments, footwear, sporting goods, and toys—the same areas in which worker exploitation has tended to be greatest (environmental codes, on the other hand, are more likely to be found in the chemical, forestry, oil, and mining industries) (Jenkins 2001).

The shift towards codes of conduct focused on a corporation's responsibility to workers did not appear out of nowhere.

### Figure 7.12. Nike—Code of Conduct

According to Nike, its current code of conduct is designed to clarify and elevate the expectations the company has of its factory suppliers; the code “lays out the minimum standards we expect each factory to meet.”



These minimum standards include: (1) voluntary employment (i.e., no forced employment); (2) no child labor (minimum age for workers is 16 years old); (3) respect for freedom of association and collective bargaining rights among workers; (4) timely compensation; (5) no harassment or abuse of workers; (6) nonexcessive working hours (no more than 60 hours a week); (7) regular employment (no home-based work); (8) a healthy and safe workplace; and (9) full implementation of the code.

Nike's Code of Conduct is available online at [http://nikeinc.com/system/assets/2806/Nike\\_Code\\_of\\_Conduct\\_original.pdf?1317156854](http://nikeinc.com/system/assets/2806/Nike_Code_of_Conduct_original.pdf?1317156854).

Instead, the shift was primarily the product of grassroots movements and media campaigns, especially the anti-sweatshop movement waged by activists, including many students, who called for fairer treatment of garment workers around the world. The movement began in the late 1980s, and was primarily directed at major American companies such as Nike, Gap, Levi-Strauss, Adidas, Reebok, Walmart, and others. Nike was a particularly prominent target, and thus it is no surprise that the company was, in 1992, one of the first to establish a code of conduct in which it promised to establish living wages and improve working conditions for workers in Nike vendor factories—at the time, Nike had major operations in Indonesia (see figure 7.12, “Nike—Code of Conduct,” for more detail on the company’s current policy). Since then, most major U.S. and European companies that source their products overseas have established codes of conduct. Again, there is an obvious objection to the significance of such codes. The objection is simply that codes of conduct are mere window dressing; they do little to meaningfully alter the depth and scope of exploitation. There is likely a lot of truth to the last statement, but it is instructive to note that, in one empirical study of the effects of codes of conduct, Harrison and Scorse (2010) found that, in Indonesia, Nike’s code of conduct in particular did have a positive impact. Wages increased significantly in factories that Nike (and other companies) used, while employment (at least during the time period studied) did not see a major or even minor decline. In other words, Nike and other companies were not fleeing from Indonesia because of higher labor costs. Even with the wage increase, however, Marxists scholars would argue that workers are still being severely exploited around the world. In this regard, they might argue that corporate codes of conduct are, at the very best, a palliative measure. Constructivists would not necessarily disagree. But the larger point is this: codes of conduct have started to redefine—albeit in a marginal way—the reality of capitalism. Social responsibility, to put it more concretely, has become a salient and difficult-to-dismiss element of transnational production and global capitalism.

On the last point, it is useful to note that the idea of corporate responsibility (which is embedded in the movement behind corporate codes of conduct) has also been picked up at the intergovernmental level. In 1999, then UN General Secretary Kofi Annan called upon business leaders, at the World Economic Forum, to become involved in “setting up social and ecological cornerstones to support a new global economy” (Respect Austria 2006, p. 1). Annan’s announcement was the genesis for the UN Global Compact, which is a wholly voluntary governance framework designed to encourage business on a worldwide basis to adhere to ten principles in the area of

### Figure 7.13. The Global Compact: Ten Principles

#### Human Rights

*Principle 1:* Businesses should support and respect the protection of internationally proclaimed human rights; and

*Principle 2:* make sure that they are not complicit in human rights abuses.

#### Labor

*Principle 3:* Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

*Principle 4:* the elimination of all forms of forced and compulsory labour;

*Principle 5:* the effective abolition of child labour; and

*Principle 6:* the elimination of discrimination in respect of employment and occupation.

#### Environment

*Principle 7:* Businesses should support a precautionary approach to environmental challenges;

*Principle 8:* undertake initiatives to promote greater environmental responsibility; and

*Principle 9:* encourage the development and diffusion of environmentally friendly technologies.

#### Anti-Corruption

*Principle 10:* Businesses should work against corruption in all its forms, including extortion and bribery.

Source: United Nations Global Compact (n.d.),

<http://www.unglobalcompact.org/AboutTheGC/TheTenPrincipleS/index.html>

human rights, labor, the environment, and anti-corruption (see figure 7.13, “The Global Compact: Ten Principles,” for details). As a voluntary framework, companies must proactively seek membership in the Global Compact by sending a letter to the UN secretary general. Once accepted, the company is expected not only to integrate the ten principles into its business operations, but also into the company’s culture; member companies are also expected to publicly advocate for the Global Compact and its principles through press releases, speeches, and other forms of communication (Respect Austria 2006). The effectiveness of the Global Compact is certainly subject to debate, with many critics arguing that the compact is meaningless without any effective monitoring or enforcement provisions. Even worse, some critics charge, the Global Compact allows companies to engage in “bluelwashing”—that is, giving their activities legitimacy, whether earned or not, merely by being associated with the United Nations (Bruno and Karliner 2000). These criticisms, though, tend to miss the larger point, which is that initiatives such as the Global Compact help to reframe the definition of self-interest. The profit motive becomes enmeshed with social responsibility, since social responsibility enhances a firm’s reputation and status. Firms care because it is profitable to care. In this context, too, tragic events such as the Rana Plaza factory collapse take on added significance, since they highlight the destructive character of a form of capitalism in which social responsibility is largely or entirely ignored.

That concrete changes have been marginal, to repeat, does not mean constructivists believe that corporate codes of conduct or global compacts are a panacea or even a major remedy for the ills of capitalism. They understand quite well that codes of conduct or global compacts, *by themselves*, are only one small step toward redefining the reality of capitalism. The prospect of fundamental change is still a long way—a very long way—off. Nonetheless, small steps are often a critical part of the process of changing firmly entrenched, extremely powerful social structures. At the same time, it is certainly understandable that skeptics want to see more evidence that capitalism, as a social structure, can be reshaped in a way that largely eliminates—or at least significantly reduces—poverty, inequality, and exploitation. Significantly, over the past several decades, more and more—albeit still limited—evidence is emerging. Indeed, in conjunction with the rise of the anti-sweatshop movement, there has been a growing worldwide anti-poverty movement—crusade, even—which has not only been vehemently challenging taken-for-granted practices of global capitalism (and of neoliberalism more specifically), but also the key institutions of global neoliberalism—i.e., the IMF, the World Bank, and the WTO. The next section discusses the global anti-poverty movement in more detail.

### *The Global Anti-Poverty Movement*

Marxist scholars contend that international institutions of the global economy such as the IMF, World Bank, and WTO play a central role in spreading

**Figure 7.14. Protestors at the 2000 Annual Meeting of the IMF and World Bank in Prague**



Source: Jaroslav Kučera. This file is licensed under the Creative Commons Attribution-Share Alike 3.0 Unported license. [saylor.org](http://saylor.org)

and deepening neoliberalism as both an ideology and a practice around the globe. Marxist analysis also makes clear, as was discussed in the previous section, that these institutions have the capacity to seriously exacerbate poverty, inequality, and exploitation by imposing, for example, one-size-fits-all structural adjustment programs on poor countries, or by enforcing the rule of “free” trade in way that primarily benefits core economies. Yet with only minimal reflection, it is clear that these institutions cannot simply be responding unthinkingly or automatically to invisible market forces and pressures. Instead, they (or rather, the decision-makers within the institutions) are taking purposeful actions, which are guided by a core set of beliefs about how markets are supposed to work. Of course, they are also representing the interests of core economies (although this is, perhaps, less true of the WTO). It stands to reason, then, that if the guiding principles of the major international institutions change, that will bring about broader changes in global capitalism. Accordingly, political activists, transnational advocacy groups, NGOs, international organizations (including the United Nations), and poor states themselves have, over the past several decades, brought increasing pressure to bear, either directly or indirectly, on the IMF and World Bank.

The history of the global anti-poverty movement is far too complex and multifaceted to cover adequately in this chapter (one detailed discussion of the movement can be found in Amory Starr’s *Global Revolt: A Guide to the Movements Against Globalization* [2005]). Suffice it to say, then, that the global anti-poverty movement began as a series of often-separate movements (protests, campaigns, demonstrations, and the like)—not all necessarily focusing on poverty—that took place in different parts of the world. Those movements that most directly connected to the issue of poverty, however, tended to focus on SAPs and international debt more broadly. One noteworthy early example, according to Amory Starr (2005) occurred in 1990, when the African Council of Churches (ACC) called for a year of “Old Testament Jubilee”; more specifically, the ACC called for the forgiveness of African debt (Starr 2005). (In the Bible, a Jubilee year takes place once every 50 years; it is a special year during which time slaves and prisoners are supposed to be set free, and all debts forgiven.) The call for a Jubilee by the ACC, it is important to note, led to a much broader transnational Jubilee movement dubbed Jubilee 2000, which, like the ACC campaign, focused on debt cancellation, but was meant for all countries suffering from serious debt burdens, not just those in Africa. As a movement, Jubilee 2000 attracted hundreds of thousands of active supporters around the world. A petition-signing campaign gathered 24.3 million signatures from 161 countries, and the petition was delivered to the IMF and World Bank at their annual meetings in the year 2000, held in Prague, Czech Republic (Friesen 2012). But the Jubilee 2000 campaigners did much more than circulate a petition. They organized and carried out myriad protests, including a major one involving at least 70,000 protestors at the 1998 G8 Summit in Birmingham, England, as well as many smaller-scale campaigns (Friesen 2012). They were, in an important respect, extremely successful at getting their voices heard by core states, the IMF, and the World Bank. In March 1999, for example, G7 finance ministers, as well as officials of the IMF, the World Bank, and the Paris Club, attended an all-day meeting in London with representatives of 10 national Jubilee campaigns to discuss the critique of extant debt-relief efforts (Friesen 2012). More importantly, perhaps, the Jubilee 2000 campaign was instrumental in pressuring G8 leaders, at the 1999 summit in Cologne, Germany, to agree to cancel \$100 billion in debt owed by the poorest countries. It is important to emphasize that Jubilee 2000’s debt campaign was not just about debt cancellation. That was the immediate goal, but for many in the Jubilee 2000 campaign, according to Elizabeth Friesen (2012), “debt cancellation was part of a larger strategy aimed at the

underlying structural causes of inequity and exploitation in the global economic system and international finance in particular” (p. 72).

Beyond Jubilee 2000, there have been an incalculable number of anti-poverty protests around the world, some remarkably large, others quite small. The cumulative effect of these protests has been to slowly build a “global anti-poverty consensus” (Kolk and Van Tulder 2006). As Noël (2006) describes it, “On all sides, discourses and debates have shifted, to make poverty a foremost issue . . . A global poll covering 68 countries and conducted in May and July 2005 . . . found that poverty, or the gap between rich and poor, was considered ‘the main problem facing the world’s citizens’” (p. 305). This sentiment towards the importance of poverty is not limited to ordinary citizens; it has also been placed near the top of the global agenda by most of the major international economic actors. The first official recognition that poverty had reached the top of the agenda came in 2000 with the UN Millennium Declaration, which made “eradicating extreme poverty and hunger” the first priority among eight Millennium Development Goals (MDGs) (see figure 7.15, “UN Millennium Development Goals”). But it is equally noteworthy that poverty eradication has become part and parcel of the formal missions of both the IMF and the World Bank. One change, for example, has been the introduction of the Poverty Reduction Strategy Papers (PRSP) approach, which was initiated in 1999. In sharp contrast to SAPs, the PRSP approach is supposed to be country-driven, result-oriented, comprehensive, partnership-oriented, and based on a long-term perspective (see figure 7.16, “Core Principles of the PRSP Approach,” for additional details).

**Figure 7.16. Core Principles of the PRSP Approach**

According to the IMF, five core principles underlie the PRSP approach. All poverty reduction strategies should be:

1. *Country-driven*, which means that they promote national ownership of strategies through broad-based participation of civil society;
2. *Result-oriented* and focused on outcomes that will specifically benefit the poor;
3. *Comprehensive* in recognizing the multidimensional nature of poverty;
4. *Partnership-oriented*, which means involving the coordinated participation of development partners (government, domestic stakeholders, and external donors); and
5. *Based on a long-term perspective* for poverty reduction.

Source: IMF (2013b), “Factsheet: Poverty Reduction Strategy Papers (PRSP),” September 24, 2013, <http://www.imf.org/external/np/exr/facts/prsp.htm>

noted, though, that the volume of this debate is much lower in the United States than in most

**Figure 7.15. UN Millennium Development Goals**



Source: United Nations. The official icons of the eight MDGs can be freely edited and used for information about the MDGs. The image is licensed under the Creative Commons Attribution-Share Alike 3.0 Unported license.

It is difficult to say with any certainty what all these changes will mean at a concrete level. From a constructivist perspective, however, one thing is fairly clear: the global anti-poverty movement has produced a new debate and discourse about how capitalism should work on both a national and global basis (it should be

other parts of the world). A new debate and discourse, to repeat a key point in this section, does not mean that dramatic changes will suddenly appear; it does not even mean that any significant change will occur. It does mean, however, that there is now a very real possibility for such changes. Noël (2006) provides a nice perspective on the issue. As he explains it, “the new global politics of poverty could provide an opening, a new frame of reference to challenge neoliberalism and move policy debates ahead. The theme could also be interpreted more narrowly, however, as a call for modest adjustments within the current policy framework. In one way or another, the new global politics of poverty will have consequences, and it will matter for a wide array of social and political forces, at various scales” (p. 325).

## Chapter 7: Conclusion

The foregoing discussion of inequality, poverty, and exploitation is admittedly far from complete; that said, it has been framed to help readers think more critically and analytically about these interrelated issues. The bulk of this chapter focused on the different interpretations provided by the Marxist and liberal perspectives. These two perspectives represent, in a number of important ways, diametrically opposed positions, and thus leave almost no space for middle ground. Indeed, in the Marxist view, capitalism is the fundamental problem, since it necessarily engenders inequality and severe exploitation. In the liberal view, by contrast, capitalism (or freely operating markets) is the only solution to poverty. Importantly, both the Marxist and liberal views are, at least tacitly, premised on an objectivist ontology (which is a scholarly way of saying that both believe in an objective reality that exists independently of human knowledge and perceptions). It is this commitment to an objectivist ontology that makes it difficult to find any middle ground between the two perspectives—basically, both assert that only one position can be right, since there is only one objectively defined reality. In the constructivist approach, however, the emphasis on the social construction of reality leaves room to maneuver, so to speak. The constructivist approach compels us to see market structures and processes as malleable, as subject to both minor and fundamental revision depending on how those structures and processes are commonly understood, and depending on what people, institutions, and organizations do.

Capitalist markets may never be free of exploitation. Some form of poverty may always exist. There may also always be a significant level of inequality in the world. But these outcomes are subject to agency, and therefore subject to amelioration. To accept the latter conclusion—i.e., that exploitation, poverty, and inequality can be reduced through agency—is not Pollyannaish. Again, to see this, just look around the world: different market-based societies have dealt very differently with the issues of inequality, poverty, and exploitation. Levels of inequality and poverty, as discussed in the introduction, vary considerably from country to country. Those variations are not random or accidental. They are the product of purposive decisions, albeit decisions that are made within the context of a still significantly exploitative system (at least according to many analysts). This last point underscores the importance of systemic change. Debt cancellation, for example, can only be a short-term palliative if everything else in the global economic system remains the same; that is, if the conditions that gave rise to unsustainable debt among the world’s poorest countries remain the same, the debt problem will simply resurface later. Signs of systemic change, however, are emerging—the global anti-poverty movement, in particular, has produced a new debate and discourse about how capitalism should work. This, in turn, has changed the focus and practices of central international players, including the IMF and

the World Bank. Rather than simply saying that there are “signs of systemic change,” it is more accurate to say that these emerging signs have been created and implanted in societies around the world through an intense political process involving millions of people struggling to redefine global capitalism.

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<sup>41</sup> It is useful to make a distinction between liberal and neoliberal principles. The former is a broad label—and one that includes neoliberalism—but it also refers to other market-friendly or primarily market-oriented policies and approaches. Neoliberal principles, in contrast, put an extremely strong emphasis on the elimination of almost *any* restrictions on market transactions and processes.

<sup>42</sup> Oxfam comes from the original name of the organization, which was the Oxford Committee for Famine Relief. Oxfam was formed in Britain in 1942 to help relieve famine in Greece during the Nazi occupation in the 1940s. Since then the organization has become a major anti-poverty and social justice NGO. In 1995, Oxfam International was formed, and it has become a confederation of 17 organizations working with over 3,000 partners in about 90 countries.

<sup>43</sup> A 2011 PBS *Newshour* story provides a useful discussion of rising inequality and declining social mobility in the United States. Available through the following link:

<http://www.youtube.com/watch?v=YnQwTS-K6jI>

<sup>44</sup> The estimates of deaths and injuries resulting from the building collapses are inconsistent. The earliest reports generally listed only a few hundred deaths, while reports several months after the disaster listed at least 1,000 deaths. The figure of 1,129, for example, comes from an article in the *Guardian* newspaper (Butler 2013), published on June 22. The Institute for Global Labour and Human Rights provides a slightly higher figure of 1,132; this same source also provided the figure of 2,500 people “seriously injured.”

<sup>45</sup> Johann Hari (2010), writing for the *Independent*, points to a story in the *China Daily*, which estimated that as many as 600,000 people are killed every year in China from “overwork,” primarily working in factories for long stretches at a time. One worker Hari discusses in his article supposedly worked in a Foxconn factory for as long as 35 hours straight. One day, he simply “dropped dead.”

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<sup>46</sup> Several sources cited similar monthly wages of around \$35; however, other sources noted that workers' daily wages were around \$3, which would indicate a much higher monthly wage—as much as \$90 if workers worked seven days a week.

<sup>47</sup> In comparing labor costs between the two countries, it is important to keep in mind that workers in Bangladesh work very long days—much longer than their counterparts in Colombia. Many sources indicate that Bangladeshi workers work up to 14 hours a day. If the figure of 14 hours is used, then the typical production of 32 Bangladeshi workers will be 1,120 T-shirts per day (80 shirts per hour x 14 hours). According to the *Planet Money* report, garment workers in Colombia make about \$13 a day without overtime, which suggests that their workdays are 8 or 9 hours (Colombia's "Substantive Work Code," in fact, provides a maximum of 48 hours of work per week). If the 8-hour-a-day figure is used, the daily production by 8 workers in Colombia would, perhaps coincidentally, be exactly the same: 1,120 shirts (140 shirts per hour x 8 hours). Thus, despite a much higher level of productivity, it is still generally cheaper to produce garments, such as T-shirts, in Bangladesh.

<sup>48</sup> There are, of course, other definitions of slavery, most of which tend to be either fairly broad in scope or overly vague. One oft-cited definition, for example, is offered by Kevin Bales (1999), who defines slavery as "the complete control of a person, for economic exploitation, by violence, or the threat of violence" (p. 6). In Bales's definition, each criterion is subject to wide interpretation, which could render the definition meaningless. Consider the phrase "complete control." One would be hard put to argue that any human being has complete control of another human being, so on its face, the phrase suggests that there is very little or no slavery in the world. (To be fair to Bales, the phrase "complete control" comes from the 1926 Slavery Convention.) On the other hand, the phrase "economic exploitation" is problematic because it could, from a Marxist perspective, include almost all workers. Even the phrases "by violence" and "the threat of violence," while seemingly less fuzzy, can cause difficulties. Some scholars, for example, argue that one of the most insidious forms of violence is

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structural violence, which can be defined as a form of violence in which a social structure or social institution harms people by preventing them from meeting basic needs (Galtung 1969).

# **Chapter 8**

## **Governance in the Global Economy**

### **The Need for Governance**

The global economy is exceedingly complex. Part of this complexity is due to the sheer number of players: not only are there innumerable market actors, from ordinary workers to multibillion-dollar transnational corporations, but there are also states and state-based actors (i.e., international organizations and institutions), as well as other nonmarket actors such as churches, civic organizations, social movements, and the like. The existence of states, in particular, means that the global economy is rife with political and jurisdictional divisions and vast power differentials, structural and otherwise; jurisdictional division and power differentials, in turn, tend to exacerbate the often-competing interests and concerns of states (and their societies). In this state of affairs, the potential for discord or serious conflict is ever present. At the same time, virtually all state actors share a range of common interests and concerns, not the least of which is avoiding serious conflicts that might lead to economic crises and political instability. These common interests and concerns, moreover, invariably grow stronger and more significant as cross-border interdependence and globalization increases. One reason for this is clear: since interdependence means “your business is my business” and vice versa, more cross-border collaboration becomes a practical and even necessary part of resolving an increasingly wide range of issues. It is important to add that the chain of causation can move in the other direction as well; that is, economic crises or political instability can lead to serious conflict between and among states. This is because economic crises tend to spread—the so-called contagion effect. The contagion effect is particularly pernicious in the absence of a hegemonic leader, as states, in an effort to protect themselves, typically impose beggar-thy-neighbor policies, thereby deepening the crisis. The classic example is the 1930s, when economic turmoil led to, among other things, the rise of Adolf Hitler and one of the most destructive interstate conflicts in history—i.e., World War II. Clearly, such an outcome is not in the interest of any state.

States’ shared interest in an era of globalization, in sum, suggests that states not only have a reason for cooperating or collaborating on a variety of issues, but also have an interest in building a strong framework for mutually beneficial economic activity at the regional, international, or global levels. Accomplishing this latter task, however, has become potentially more difficult over the decades, as the growth and deepening of cross-border trade, inter-economy competition, globalized financial flows, transnational production, and globalization more generally, have created extremely dense and complicated linkages. These linkages, from a concrete perspective, make cross-border collaboration more difficult, in part because the topics of negotiation are increasingly more sensitive to questions of sovereignty and are more subject to politicization. Consider, on this point, an example discussed in chapter 4: agricultural subsidies for the U.S. farm industry. Agricultural subsidies are deeply embedded in domestic political processes; more specifically, they reflect the dynamics and pressures of local electoral politics, of lobbying by agribusiness, of partisan politics, and a host of other primarily domestic factors.

Yet, to use a trite phrase, “local is global”: U.S. agricultural policy is inextricably linked to global agricultural markets, and to other domestic markets around the world. For the most part, however, U.S. congressional representatives, in particular, are loath to change their positions on what they view as an essentially domestic policy issue. And what is true in the U.S. is generally true for other countries as well.

Returning to the main point, the dense and complicated linkages created by increasing cross-border interdependence make virtually all the world’s economies more interdependent and arguably more productive and efficient, but they also make them more sensitive and vulnerable to economic instabilities anywhere in the world. The upshot is fairly clear: to address this growing complexity, there must be some sort of mechanism for managing the processes and dynamics of globalization to minimize instabilities, both great and small, that could damage—and even devastate—every state, society, and market. The type of mechanism that is needed is, not surprisingly, subject to a great deal of debate. Some liberals—or perhaps more accurately, some neoliberals—believe that the market mechanism is sufficient, since, in their view, freely operating markets are not only self-correcting, but also produce socially optimal results, or at least results that are *always* superior to a nonmarket mechanism. (Remember a key lesson from chapter 2: not all liberal economists are sanguine about the self-correcting power of markets; Keynesians, for instance, believe that government intervention is sometimes necessary to restore markets to equilibrium.) Most other analysts, however, argue that such a view is naive, even utopian, especially in a world comprised of sovereign states. After all, as long as the world remains politically divided, a market-only solution would effectively require all states to give up their sovereignty to “the market.” And while most states are willing to cede a part of their sovereignty to markets, very few, if any, are willing to cede all their sovereignty. In fact, no state thus far—including the most ostensibly liberal ones, such as the United States—has been willing to allow market forces to completely determine its economic fate. It is clear, then, that any mechanism for organizing and governing the global economy must continue to include a role, and likely a central role, for states. But this suggests that governance of the global economy might simply be an extension of state governance and power—that is, a type of governance in which state actors make and enforce all the rules. Yet, as previous chapters have shown, in the global economy today, states are not the only important (or necessarily the most powerful) actors. The increasing diffusion of power through the closer and more complex intersection of the security, finance, production, and knowledge structures in a globalizing world has helped to ensure that no single actor, or set of actors, is capable of controlling the global economy. It is in this context that the concept of global governance has emerged. Global governance, in the most general sense, reflects both the fact that the global economy has grown too complex for any one set of actors to manage, and the fact that the global economy cannot simply be “left alone.”

This closing chapter, then, focuses on global governance. Previous chapters, it should be noted, already discussed global governance, although often in a tacit and indirect manner. One purpose of this chapter is to make those discussions more explicit by focusing directly on the meaning and ramifications of global governance. This chapter is also meant to serve as a general conclusion for the book, and thus, an effort will be made to tie together the major themes of the various chapters. In this respect, a focus on global governance is particularly appropriate, since the concept of global governance encapsulates, on one level, the unavoidable and inextricable nexus between the economic and the political, while on another level, as will become evident shortly, it compels us to adopt a comprehensive and nuanced view of the actors, dynamics, and processes at work in the global political economy.

One last point: this chapter will be fairly brief. A major reason for this is to avoid repetition: since this chapter covers much of the same ground as other chapters (albeit from a different perspective and with a different emphasis), there is less need to provide detailed discussion of examples and evidence. A second reason is pragmatic: as a concluding chapter, the primary aim is simply to wrap things up. With all this in mind, in the next section we will address the following question: What is global governance?

## What Is Global Governance?

Although there is still considerable debate on what the term *global governance* means (Dingwerth and Pattberg 2006), there is growing acceptance of its theoretical and analytical utility. Theoretically, global governance is understood as a necessary corrective to traditional theories of international relations (i.e., realism and neorealism) that focus almost exclusively on state power. Again, while states are clearly important, they are just as clearly not all-important. For this reason, it is important to find an approach that can account for the power and influence of both state and nonstate actors in the global economy. Analytically, the concept of global governance provides a very useful way of understanding the processes, particularly since the end of World War II, through which major concerns and issues are being concretely addressed within the global economy. On this point, consider how Heywood (2011) conceptualizes the term. He begins with a very broad definition: global governance, as he puts it, is “the management of global polices in the absence of a central government” (p. 458). Again, this suggests that global governance might be nothing more than state governance. However, Heywood’s definition goes much further, as he identifies five key features of global governance:

- *Polycentrism.* This means that there are multiple centers of authority governing the world economy and world affairs more generally, with different institutional frameworks (which include international regimes) and decision-making mechanisms in different issue areas. An important characteristic of polycentrism is the notion that the multiple centers of authority are horizontally, as opposed to hierarchically, organized; that is, in polycentrism, a clear-cut hierarchy of power is difficult, if not impossible to discern (Dingwerth and Pattberg 2006).
- *Intergovernmentalism.* Recognizes that states and state-based, or international, organizations, such as the United Nations and the WTO, continue to play an important role in making, implementing, and overseeing the rules that govern economic, political, and social relations at the international level.

- *Mixed-Actor Involvement.* Recognizes that the system of rules that govern economic, political, and social relations are not just the product of state action, but also the product of action and activities by nongovernmental organizations, transnational corporations, transnational advocacy networks, and other elements of a **global civil society**.
- *Multilevel Processes.* Unlike traditional conceptions of international relations, where decision making is limited to the national and international levels, global governance recognizes that decision-making processes operate through the interactions between and among individual actors, groups, and organizations at various levels, from the municipal to the global (this conceptualization is akin to two-level games, but arguably includes more than two levels).
- *Deformalization.* Refers to the increasing importance of norms and informal rules of conduct in governing economic, political, and social relations.

The five features identified above, it is important to emphasize, also tell us what global governance *is not*. Most obviously, according to Heywood (2011), it is not “world government”; that is, global governance is not and does not connote a situation in which a single, overarching political authority is permanently vested with the power to make and enforce rules for the entire world. The prospect of such a political authority emerging remains, at best, an extremely distant and unlikely possibility (although, in keeping with the principles of social constructivism, it is not necessarily impossible). Perhaps the closest real-world analogue to a world government is the European Union (*not* the United Nations<sup>49</sup>), but the EU is, and will almost assuredly remain, a strictly regionally based organization. While global governance through a world government is exceedingly unlikely, the world has seen something not completely dissimilar: global hegemony. Scholars of many (theoretical) stripes, as discussed in previous chapters, agree that hegemony has played an important role in establishing, institutionalizing, and enforcing rules for the world economy; this is evident in the postwar international financial and monetary order, and to a lesser extent, in the regime for cross-border or international trade. Still, those same scholars also agree that hegemony invariably breaks down, and can do so relatively quickly (e.g., over a two- or three-decade period). Thus, while the United States may have used its overwhelming power to lay the groundwork for a liberal postwar order in the few decades following the end of World War II, that power has gradually and necessarily diminished, meaning that something must replace it. Moreover, even during the height of its dominance, the idea that the U.S. state single-handedly and unilaterally governed all aspects of the (capitalist) global economy is, at best,

exaggerated. So even while there is wide agreement that global hegemony has played an important governing role in the world economy, there is equally wide agreement that hegemony has never operated as a sole governing force.

While having a basic definition of what global governance is, as well as understanding what it is not, is clearly important, a few more basic questions emerge: Does global governance actually describe what is happening in the global economy today? If so, to what extent does global governance matter? These questions are briefly examined in the next section.

## The Significance and Relevance of Global Governance

Heywood's definition presumes that global governance is, in fact, a real and significant phenomenon in the global economy. Certainly, one does not have to search very long or hard to find evidence of polycentrism, intergovernmentalism, mixed-actor involvement, multilevel processes, or deformatization at work in the global economy (it is important to note that each of these elements is, by itself, an indication of global governance). The discussion in chapter 7, for example, focused on the emergence of corporate codes of conduct, which is not only an example of deformatization, but also of mixed-actor involvement and a multilevel process. Granted, the impact of corporate codes of conduct is still rather limited, but it nonetheless represents a potentially significant trend. A much more substantial example revolves around the long-lived and yet still increasing importance of international regimes, which might be regarded as the prototype of global governance.

In this book, much has already been written about the roles of, for example, the regimes for international trade and the global finance and monetary systems (the Bretton Woods system). An international regime, you should recall, is a set of explicit or implicit "principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue-area (Krasner 1983, p. 1). Regimes, it is important to reemphasize, do not just magically appear. Typically, they are the product of multilateral state-to-state negotiations, which themselves take place primarily within international organizations such as the United Nations and the World Trade Organization (WTO). Indeed, international organizations function, in large part, as the main apparatus of global governance: they provide the concrete forum for state-to-state negotiations, and are key "mechanisms for monitoring and enforcing rules" (O'Brien and Williams 2007, p. 385). States engage in international negotiations and create regimes because they understand that, on many issues and in many areas, noncooperative or unilateral action is either counterproductive or inimical to their own interests. Even states that feel disadvantaged by a particular regime may largely abide by its rules because the cost of *not* doing so are higher than the costs of participation. This is especially true for poor or developing states, or those that have traditionally had less power to shape negotiations in their favor. This suggests that the fruits of global governance are not always, or even mostly, fair or just. Indeed, it is reasonable to say that, for the regimes established in the early postwar years, they almost assuredly were unfair or unjust to poor or developing states. Most poor countries today did not even participate in the formation of the Bretton Woods regimes because they were colonies of major Western powers, and therefore not independent countries. (In more recent years, however, the formation and use of bargaining coalitions, discussed in chapter 4, have helped poorer countries at least begin to exert more leverage in international negotiations.)

Even if global governance has frequently failed to produce fair and just results, there is little doubt that international regimes are an integral and extremely important part of the global

economy. Imagine, on this point, if the world had proceeded without the frameworks for cross-border trade, finance, and monetary relations established by the Bretton Woods negotiations. Minimally, there would have been a much higher degree of both economic and political instability in the international realm; moreover, it is not unlikely that any one of a number of postwar financial crises could have created the conditions for large-scale, internecine warfare à la World War II. In this regard, the role of the IMF should be highlighted. Although subject to a great deal of criticism—some of which is very likely deserved—the IMF’s increasing power in the global economy is all but impossible to dispute. On this point, it is important to emphasize that, over the years, the IMF has gradually moved from being a lender of last resort to playing a central role as a global crisis manager (Momani 2014). This transition was in full swing by the mid-1980s, as the IMF played a particularly prominent role in promoting policy coordination among developed countries’ currency and exchange-rate systems, especially in negotiations for the Plaza Accord (1985), the Louvre Accord (1987), and the **Brady Plan** (1989) (Momani 2014). The IMF’s crisis-management role was further tested in the 1990s with the Asian financial crisis, and the financial crises in Russia, Brazil, Argentina, and Turkey. The biggest test, perhaps, was with the global financial crises that began in 2007–2008. As Momani (2014) puts it, the global financial crisis of the late 2000s “re-energized the IMF as the provider of ideas, policy coordination, surveillance, and catalytic financing” (p. 543). Moreover, the IMF was given an expanded mandate by the G20 as it was asked to “facilitate and support the coordination of the macro-economic policies of the world’s pre-eminent economies, and the accountability of these countries to agree upon norms and policy commitments” (p. 544). The IMF’s role in Europe was particularly important: during the height of a financial crisis that threatened to break up the eurozone (the eurozone is the group of 18 European Union member states that have adopted the euro as their common currency and sole legal tender), the IMF pledged €34 billion (about \$44 billion) to Greece in 2010, as well as another €28 billion in 2012 (IMF 2012). In addition, the IMF also approved bailout loans to Ireland (2010) and Portugal (2011). All these loans, it should be pointed out, were part of a much larger loan package involving a “troika” of institutions; the other two were the European Central Bank and the European Commission. Still, many consider the IMF’s role to have been crucial, in part because the IMF “has more say over crisis management than many euro zone members”, and the managing director of the IMF, Christine Lagarde, is considered a quasi head of state, “whose views carry more weight than those of elected leaders” (Ewing 2013). Significantly, IMF intervention in Greece, Ireland, and Portugal also highlighted the institution’s role in shaping the discourse on how to deal with financial crises. Originally, and not surprisingly, a great deal of emphasis was put on austerity. But, three years after the loan to Greece, the IMF admitted that austerity might not have been the best policy choice for Greece (Stevis and Talley 2013). The main lesson is clear: managing international financial crises is obviously a critical task, and without institutions of global governance, such as the IMF, it could very well be an unmanageable task.

Crisis management, however, is not the only area in which international organizations and regimes have played a crucial role. The GATT/WTO, discussed in chapter 4, was instrumental in building a framework that allowed for a major and generally smooth expansion of cross-border trade for the entire postwar period. There is no need to repeat the statistics on the growth of cross-border trade here, but it is worth reiterating that the expansion of trade was part and parcel of a political process in which trade barriers were gradually reduced, and new rules, norms, and procedures governing international trade were created and institutionalized, first through GATT, and then through the WTO. One of the most important creations was the dispute

settlement mechanism, which was used to adjudicate over 450 disputes between the establishment of the WTO in 1995 and 2013 (Hoekman 2014). The long-standing deadlock in WTO negotiations (on the Doha Development Agenda)—which finally saw a breakthrough in December 2013 after more than a decade (see figure 8.1, “The Doha Round: Breaking the Deadlock”—suggests that future agreements will be extremely hard to come by. Still, even without the recent breakthrough, it is fair to say that a great deal has already been accomplished, and that those past accomplishments are not likely to unravel any time soon. In sum, then, the global trade regime that was created through GATT and the WTO has provided a strong framework for countries to exchange trade policy

commitments; it has also served an important role in establishing an effective mechanism through which those commitments can be enforced (Hoekman 2014). In this regard, the international trade regime has clearly contributed to the dramatic and unprecedented expansion of wealth and prosperity on a global scale.

As is perfectly clear from the previous chapter, however, more wealth, even immense wealth, does not necessarily translate into optimal outcomes for everyone, or even for the majority of the world’s population. There are still many countries and more than one billion people living in abject poverty—

and billions more living in less severe but still serious poverty, and in relative poverty. There are still hundreds of millions of hyper-exploited workers, and severe inequities between the haves and the have-nots. There is still child slavery and forced labor. There are still growing environmental problems, primarily the product of economic activity, some of which could have catastrophic effects. More broadly, too, “development” remains a brightly burning issue.

### *Global Governance: Beyond the State*

Arguably, all the aforementioned issues (as well as others) cry out for action and resolution, so a key question is, can they be resolved? There is no simple answer. But any resolution will minimally, and perhaps necessarily, require broad-based collective state action. In a world that is divided by political boundaries and characterized by the absence of an overarching central government, states (and state-based organizations) remain—for good or bad—the locus of rule-making and rule-enforcing power. At least for the foreseeable future, then, there is simply no alternative or substitute for states. At the same time, states are often an obstacle, and sometimes the primary obstacle, to effective action on problems or issues that cross national boundaries. This is especially the case for the most powerful states, such as the United States, which are in the best position to ignore or challenge international agreements that do not

### **Figure 8.1. The Doha Round: Breaking the Deadlock**

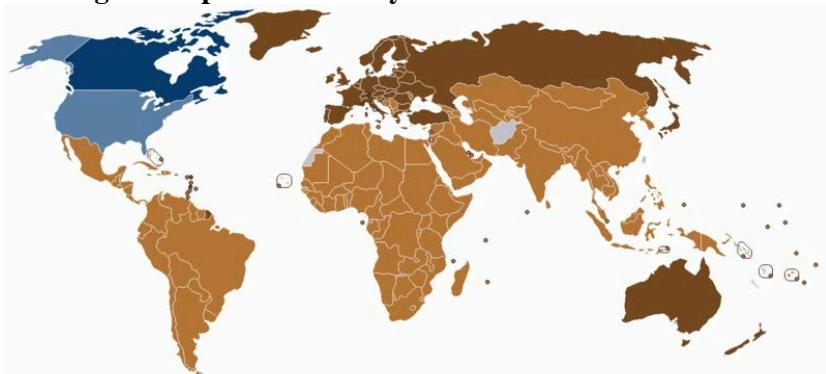
During the Ninth WTO Ministerial Conference, held in Bali, Indonesia, from December 3 to 7, 2013, an agreement was reached on a range of hitherto intractable issues. The Bali deal is made up of three basic parts: the Agreement on Trade Facilitation, an agreement on specific agricultural issues, and an agreement on development issues. Of the three parts, the biggest element is the trade facilitation agreement, which will make it easier and cheaper for countries to move goods around the world by cutting red tape and improving and streamlining customs and port procedures.

Despite the breakthrough, many issues still remain to be decided. As the WTO director-general, Roberto Azevedo, put it, the decisions made in Bali are “important stepping stones towards the completion of the Doha Round.” Thus, the Bali package (as it was dubbed) “is not an end, it is a beginning” (cited in “WTO Chief Hails Significant Advance at Bali Summit” 2013).

fully represent their national interests and concerns. (It should be noted that, from the Marxist viewpoint, the notion of a state having a national interest is highly debatable. In Marxist analysis, scholars assert that a state's interest is primarily a reflection of the interests of dominant class actors, especially transnational corporations.)

Consider, for example, the U.S. policy on global warming: the United States was the only major country that never ratified the Kyoto Protocol on climate change (although one country, Canada, formally withdrew from the agreement in December 2012 after it had ratified the treaty in 2002; significantly, the Canadian government based its decision, in part, on the fact that the U.S. had not agreed to abide by the terms of the treaty [“Canada to Withdraw from Kyoto Protocol” 2011]). The U.S. refusal to ratify the Kyoto Protocol, it is important to note, was primarily justified on economic grounds: because China was not obligated, under the terms of the agreement, to reduce greenhouse emissions to the same extent as the United States, U.S. politicians argued that American industry would be put at a serious competitive disadvantage. Indeed, even before the protocol was signed, the U.S. Senate pledged not to ratify the agreement if it did not include commensurate mandates for large developing countries (China being the main target). And though President Clinton did sign the agreement, the Senate held fast to its promise; when George W. Bush took office, the U.S. withdrew its signature (Hoffman 2014). Bush, too, consistently reiterated, even parroted, the concerns of the U.S. Senate. In a speech he made in April 2008, for example, he justified his administration’s position by asserting, in part, that “the Kyoto Protocol would have required the United States to drastically reduce greenhouse gas emissions. The impact of this agreement, however, would have been to limit our economic growth and to shift American jobs to other countries—while allowing major developing nations to increase their emissions” (Bush 2008). All of this suggests that U.S. policy was not just driven by the state, but by corporate actors as well (a point that Marxist analysts would certainly highlight).

**Figure 8.2. Map Showing Participation in the Kyoto Protocol**



Participation in the Kyoto Protocol, as of December 2011: Brown = Countries that have signed and ratified the treaty (Annex I & II countries in dark brown); Blue = No intention to ratify at this stage. Dark blue = Canada, which withdrew from the protocol in December 2011, effective December 2012; Grey = no position taken, or position unknown.

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For other global problems, such as poverty, labor exploitation and child slavery, human rights abuse, and the like, many states simply do not have a compelling reason—i.e., a national interest—to act at all, in the absence

of significant exogenous pressure. (*Exogenous pressure* refers to pressure from outside the state itself, but not necessarily from outside a country. Thus, pressure from domestic groups within a particular country is exogenous to the state, just as pressure from nondomestic groups or organizations can be considered exogenous.) Global governance, in this regard, becomes an even more relevant process, as exogenous pressure, or more specifically, the impetus for state action, must often come from the nonstate level and from nonstate actors. Most frequently, the nonstate actors are transnational organizations, a somewhat nebulous catch-all category that is comprised of nonstate and nonmarket (e.g., corporate) actors. Included under the label of transnational organizations are churches (the Roman Catholic Church is a particularly prominent example<sup>50</sup>), other NGOs (nongovernmental organizations), transnational social movements, some think tanks (e.g., the Heritage Foundation and the Brookings Institution), and large charitable foundations (such as the Ford, Bill and Melinda Gates, and Rockefeller foundations). “Today”, as Marshall (2014) puts it, “there are many thousand transnational organizations . . . that operate in every sector and virtually every country worldwide” (p. 573). Given their growing presence, it is important to consider the impact of transnational organizations on global governance.

In addition to their sheer numbers, though, examining the impact of transnational organizations (TNOs) is useful for a less obvious reason: unlike state and market-based actors, TNOs typically pursue objectives that cannot be described as essentially self-interested. Whether their focus is on poverty, human rights, the global environment, gender equality, disease prevention, education, or democracy, these actors generally advocate for broad-based social transformation and the global good. It should be emphasized, though, that definitions of “the global good” vary widely. On economic issues, in particular, there are huge variations. For instance, some nongovernmental organizations, such as the Cato Institute, might be categorized as laissez-faire liberalizers (Armijo 2005). Laissez-faire liberalizers, as the name implies, advocate for free global capital markets as way to maximize efficiency, which in turn brings the greatest benefit to the greatest number of people. On the other end of the spectrum are antiglobalizers, some of whom oppose capitalism in general, but are primarily focused on reining in the free market. “All antiglobalizers”, according to Armijo (2005), “are suspicious of free trade, multinational corporations, and international financial flows” (p. 282). Thus, for these two groups, their definition of the global good is exactly opposite: laissez-faire liberalizers see the global good as a world in which markets are completely free, while antiglobalizers see the global good as a world in which capitalist markets are tightly constrained, or even eliminated.

The key point, to repeat, is that due to the character and motivation of TNOs, they are, in general, likely to have a different impact on the global governance process than “self-interested” state and market-based actors.

## Transnational Organizations and Global Governance

At first glance, it is easy to dismiss the power of “do-gooder” organizations, whether they operate at a primarily domestic or global level. After all, these organizations typically, although not universally, have little in the way of financial resources (compared to TNCs), and obviously do not possess the coercive and rule-making capacity of states and international organizations. Despite clear disadvantages in the main structures of power, transnational organizations have proven to be extremely resourceful, and have operated on a number of levels to influence global governance (O’Brien and Williams 2007). They do this in a number of general ways: by creating and activating global networks, by participating in multilateral arenas, by facilitating interstate cooperation, and by acting within individual states to influence policy and enhance public participation (for further discussion of each of these activities, see Alger 1997). As suggested above, perhaps the greatest attribute of TNOs is their ability to act as *advocates* for different causes, communities, and even whole countries and regions. As advocates, TNOs seek, at the broadest level, to reshape the discourse on global issues. Put in slightly different terms, according to Keck and Sikkink (2014), TNOs “change the way the game is played in international politics.”<sup>51</sup> More specifically, “[t]hey reshape the terms of international debate. They redefine and sometimes create the issues that gain international attention. They work to realign alliances and coalitions of powerful players. In short, they change fundamentally the way that international policy and practice occurs” (Keck and Sikkink 2014, n.p.).

The important role that TNOs can play is clearly evident in the global anti-poverty movement. TNOs were able, first, to convince individual states to take the issue seriously (primarily through their campaigns on debt cancellation), and, second, to compel international institutions—the IMF and the World Bank in particular—to make anti-poverty measures an integral part of their missions. Of course, this has not necessarily resulted in a dramatic change on the ground. Indeed, skeptics argue that very little, and perhaps nothing, has changed: some argue that the concern for poverty among the richest countries, as Hume and Turner (2014) explain it, is little more than a “confidence trick, with rich nations, powerful organizations, and global elites retaining the existing structures of power and resource access while maintaining their legitimacy, and at next to no cost for themselves” (p. 635). There may be more than a little truth to the foregoing criticism, but the key point is this: TNOs, at a minimum, provide a strong and persistent alternative voice in the global political economy. As an alternative voice, they provide a source of pressure, through their advocacy, that would otherwise not exist. TNOs are not always immediately successful in their efforts, but without them it is almost certain that many issues would never have become an integral part of the global agenda. Global poverty is a case in point. For much of the early postwar period (still less the first half of the 20<sup>th</sup> century and before), global poverty was largely ignored by major states and state-based organizations. Over the past several decades, however, global poverty has become a front-burner issue; doing something about poverty has become a requirement, not an option, for the world community. Consider, on this point, that it is not just the IMF and World Bank that have shifted their attention to poverty reduction, but also an alphabet soup of UN-affiliated and other international

organizations: the UNDP, FAO, WHO, UNESCO, UNAIDS, the OECD, the EU, the G8 and G20, and so on.<sup>52</sup>

The fact that global poverty continues to be a serious, seemingly intractable problem does not mean that the efforts of TNOs have been wasted: the issue is such a huge, complex, and deeply embedded problem that, even with full commitment by the global community, any resolution is likely to take many decades. Even more, while the overall results (at least from the TNO perspective) have been disappointing, it is important to understand that there has been demonstrable progress. Thus, “besides partial success through the MDGs [Millennium Development Goals],” according to Hume and Turner (2014), “debt cancellation has been unprecedented; aid flows have stabilized; the EU has ensured that new members commit to foreign aid; and countries such as Ghana, Rwanda, Mozambique, and Tanzania have improved their capacity to plan and program poverty reduction” (p. 636).

#### *TNOs and the Multilateral Agreement on Investments*

In addition to very limited but nonetheless notable progress in combatting global poverty, it is important to

understand that, on more specific and manageable issues, TNOs have occasionally been able to exercise a much higher degree of influence, or “power,” to shape outcomes. Importantly, this power is not always exercised to establish new frameworks for governance, but sometimes to prevent specific frameworks or regimes from being imposed on the world by a small group of self-interested actors. One good example is the involved negotiations over the Multilateral Agreement on

Investment (MAI), an agreement that was designed to establish a new framework for governing international investment flows (see figure 8.3, “The Multilateral Agreement on Investment,” for further information). Negotiations over the MAI began in the OECD—critics argue that this was meant to forestall undue interference by poor countries—in 1995. According to Walter (2001), the choice of the OECD as a negotiating forum was deliberate and quite strategic: those originally pushing for the MAI, especially governmental and corporate actors in the United States, believed that it would be easier to develop a “strong regime” within the OECD, which could then be extended, in top-down fashion, to “recalcitrant developing country nonmembers” (p. 159). “The alternative forum, the WTO,” as Walter notes (2001), “was ruled out as unlikely to

#### **Figure 8.3. The Multilateral Agreement on Investment**

According to the OECD, the objective of the MAI was “to provide a broad multilateral framework for international investment with high standards for the liberalisation of investment regimes and investment protection and with effective dispute settlement procedures, open to non-OECD countries” (OECD 2014, n.p.). While the broad objective was not particularly controversial, there were several controversial provisions in the MAI draft agreement, including:

- the opening of a wide range of economic sectors, including natural resources, to foreign ownership;
- a requirement for the “fair and equal treatment” of foreign firms;
- the further removal of restrictions on the free movement of capital across borders;
- the right for foreign firms to sue foreign governments before an international mediation panel; and
- “full and proper” compensation for expropriation.

The full text of the draft agreement is available online at <http://www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf> (Negotiating Group on the Multilateral Agreement on Investment 1998).

deliver a regime that U.S. business could support and help to ratify domestically” (p. 159). Interestingly, the choice of the OECD was not universally supported by the original participants: both European and Japanese business actors felt that the WTO would have been the better forum, precisely because it would have included broader participation by developing countries (Walter 2001).

The key players in the original negotiations were OECD member states (whose negotiating teams largely consisted of investment experts) and the business community, which includes major corporate players. Organized labor was also informed about the MAI from the beginning, through the Trade Union Advisory Committee, although labor groups were not included at the negotiating table (Tieleman 1999). TNOs (or NGOs) were noticeably missing. In fact, for the first two years of negotiations, TNOs had no effective input, largely because there was no formal or sustained effort on the part of the OECD to ensure public knowledge of the negotiations. In 1997, however, a draft text of negotiations appeared in Canada, and was quickly disseminated throughout the TNO/NGO community (Tieleman 1999). Almost immediately, a global campaign was launched, with public-interest NGOs in the United States (Public Citizen Global Watch), Malaysia (Third World Network), and Canada (Polaris Institute) taking the lead (Tieleman 1999). The impact of the campaign was felt almost immediately. Individual governments bore the brunt of this pressure, as NGOs were able to galvanize domestic opposition to many of the proposed provisions. In the United States, Canada, and France political support of the MAI largely collapsed; France even withdrew from the negotiations altogether in October 1998 (which effectively ended the talks). Before that, however, TNO/NGO pressure had forced the OECD negotiation group to meet directly with NGO representatives. The first large-scale official meeting between the OECD negotiating group and NGOs was called on October 27, 1997; not surprisingly, no resolution was reached. Instead, the NGO community questioned the openness and motives of the negotiating group; many members of the community also believed that the OECD simply wished to use NGO participation as a way to restore credibility and legitimacy to the original principles of the MAI (Tieleman 1999). In the end, the NGOs, for the most part, simply turned down the OECD invitations for consultations (Tieleman 1999).

The case of the MAI suggests quite strongly that TNOs can be significant actors in the global economy generally, and in global governance more specifically. Their effectiveness, to be sure, will vary considerably based on the specific issue or concern that is being addressed. On this point, it is important to keep in mind that, in thinking about the shape and dynamics of the global economy, there is not just one overarching metaprocess taking place. Instead, there are thousands of smaller processes, decisions, and events (such as the effort to create a new investment regime)—though they are all interconnected either directly or indirectly—that make the global economy what it is, or that make globalization what it is. Understanding that globalization, in other words, is not just “one big thing” gives a better perspective on the role of TNOs. That said, if “global governance is to push ahead,” as O’Brien and Williams (2007) posit, “one would imagine that some form of accommodation is required between [or among] the three different types of key actors (state, corporate and civic)” (p. 396).

## The Main Points of Contention in the Global Political Economy

Accommodation will not be easy. Nor is it guaranteed. The divergence in interests and the varying sources and degrees of power between and among the key actors means that moving forward to a coherent and effective, still less fair and just, system of global governance for the

world economy will be a tremendously difficult, even herculean task. Still, just as people and their organizations and institutions constructed the global economy as it exists today—and keep it together based on shared understanding and practices—they can potentially reshape and reconstitute it in myriad ways (or, at least, this is what constructivists argue). It is also important to understand that, in thinking about the shape and dynamics of the world economy, there is a constant, albeit not always obvious, political struggle taking place for control over virtually every aspect of the global political economy: from a struggle for control of material resources and wealth to a struggle over dominant ideas and discourses; from a struggle over the primary modes of regulation to a struggle over the primary modes of governance; and so on. To end this chapter and book, then, it will be useful to refocus on two of the main points of conflict and contention in the global economy.

### *Free Markets (or Global Neoliberalism) versus Managed Markets*

Capitalism won the war against socialism, but the war between neoliberal capitalism and managed markets continues to be waged, albeit in much less dramatic fashion. There are many aspects to this conflict, some of which are playing out primarily between states, and others that revolve around the principles and practices of capitalism more generally. China's remarkable economic ascendance, for example, has once again demonstrated the power of an interventionist, hands-on state in building a strong, dynamic, and market-based economy. Neoliberal economists, libertarians, and others committed to the free market remain unconvinced that the Chinese state—led by the Chinese Communist Party—played a central role in the country's economic rise, but the evidence, at least from a neo-mercantilist perspective, is well-nigh incontrovertible. On the surface, it may be difficult to understand why neoliberals reject evidence that shows the efficacy of state intervention, but there are a number of fairly basic reasons (which, admittedly, reflect the view of analysts at odds with the neoliberal view) to which one can point to explain the neoliberal position. The first, and perhaps most obvious, is that while there may be “incontrovertible” evidence to show that state intervention works, there is also ample evidence to show the utter failings of state intervention. The history of central planning is a testament to this, as are efforts by some developing countries—e.g., India and Brazil in the 1960s and 1970s—to follow a course of **import-substitution industrialization (ISI)**, which, in the most simple terms, was a policy designed to replace foreign imports with domestic production (in this regard, ISI rejected comparative advantage and free trade, the two mainstays of market capitalism). Neoliberal analysts focus on the failures, although one might argue that looking only at the failures of state intervention without looking at its successes is myopic. The second, and more controversial, reason is that the theoretical commitment to highly deductive liberal economic principles runs very, very deep: for many neoliberal analysts, those principles are considered axiomatically true, so contradictory evidence simply cannot be accepted. The third, and perhaps most controversial, is that the commitment by neoliberals to their theoretical principles may be mostly political rather than analytical. In other words, they understand quite well that neoliberalism creates lopsided and unfair outcomes, but as long as neoliberal principles work to their benefit, they will continue to defend neoliberalism as a neutral, essentially objective (or scientific) theory of how economies work. In this regard, a quote by Robert Cox, a well-known critical theorist,<sup>53</sup> seems particularly apropos. As Cox (1981) famously put it, “Theory is always *for someone, for some purpose*” (emphasis in original; p. 128). Cox’s quote can be used to highlight the political-economic motivation of neoliberalism quite nicely. At the risk of

oversimplification, one can say: neoliberalism is a theory *for* those in power, *for* the purpose of staying in power.

To be clear, Cox and other critical theorists argue that all social science theories are for someone and for some purpose. Neo-mercantilism, for its part, can be said to be a theory for weaker states for the purpose of challenging the economic dominance of the strongest states. Thus, it is no accident that neo-mercantilism found a home in countries such as Germany, Japan, South Korea, and China as they attempted to catch up with the leading capitalist powers of their day. Marxism and constructivism, of course, have strong political-economic biases, too. Both are anti-establishment. Marxism, in general, is a theory meant to be in the interest of the working class; its overarching purpose (albeit not a purpose shared by all Marxists) is to overthrow the capitalist system altogether. Within constructivism (and critical theory specifically), a primary goal is the emancipation of humankind from all forms of domination and oppression. Constructivists, it should be noted, are generally the most willing to acknowledge the bias of their theoretical views. They also directly challenge the supposedly objective foundations of neoliberalism, neo-mercantilism, and Marxism, but are especially critical of neoliberalism, since it is the dominant paradigm.

In endeavoring to expose the political-economic bias of social science theory in general, and of neoliberalism in particular, constructivists hope to push individuals, their societies, and their countries toward a dramatically different path. More specifically, if constructivists can demonstrate that neoliberalism is designed to preserve existing power relations, deepen inequality, and exacerbate poverty, they can create an alternative ideational-theoretical framework, one which would be necessary for achieving major change in the global political economy. To put the issue very simply, if markets do not have to be “free” to be efficient or effective, then it becomes possible to argue that major capitalist economies have an obligation, for example, to build politically governed trade and financial regimes designed to give developing countries a real opportunity to catch up with the strongest, most productive economies. This is the idea behind the fair trade movement (discussed in chapter 4), which is premised on providing producers in developing countries higher, or fairer, prices for their goods, as well as promoting higher social and environmental standards. Not surprisingly, fair trade goods constitute only a tiny percentage of global trade, but this is largely because the idea of fair trade is not widely accepted. At the same time, fair trade has had an impact, even if only tiny, in those industries where exploitation and oppression are greatest. In the cocoa industry, for instance, fair trade standards have been introduced to a small segment of the industry. A key provision of these standards is to set a minimum price of \$2,000 a ton for fair-trade certified cocoa beans (or the market price, if higher); the standards also prohibit child and forced labor (Fairtrade Foundation 2011). In addition, in 2010 a new international cocoa agreement was signed, which made achieving “fair prices leading to equitable economic returns to both producers and consumers in the value-added chain” a key objective (UNCTAD 2010, p. 10). In 2012, however, fair-trade certified cocoa constituted only 0.5 percent of the cocoa market (International Cocoa Organization 2013).

Given the foregoing discussion, it is important to reemphasize that the global economy is already a heavily managed system, even if that management is designed to create freer markets and lopsided economic outcomes. The key point of contention, then, is not whether the global economy will be managed, but *how* it will be managed in the future, and this will be determined by a primarily political process, a point that nicely leads to the next issue: power politics versus global governance.

### *Power Politics versus Global Governance*

The mercantilist view underlines the centrality of power politics: the strong rule (or govern), while the weak are ruled (or governed). For much of history, this has been an axiom in world politics, but, as has been suggested throughout much of this book, the era of power politics could be coming to an end. The overarching reasons, to repeat, are globalization and the diffusion of power. Yet those actors who occupy positions of power and privilege in the global system—as it is presently constituted—are not only unlikely, but also extremely loath to voluntarily relinquish their positions. In the first part of this chapter, of course, the focus was on examining the need for and significance of global governance in the world economy. The conclusion was that global governance is both significant and needed, but this conclusion does not guarantee that global governance will supplant power politics, or that it will become a primary mode of governance. There is plenty of evidence to show that the most powerful states will continue to exert tremendous influence over the global system, including over the various regimes that shape the global political economy. Moreover, if and when those regimes are perceived to be too burdensome, too much in conflict with their vital national interests, the largest and most powerful states may simply usurp painstakingly established global rules and norms.

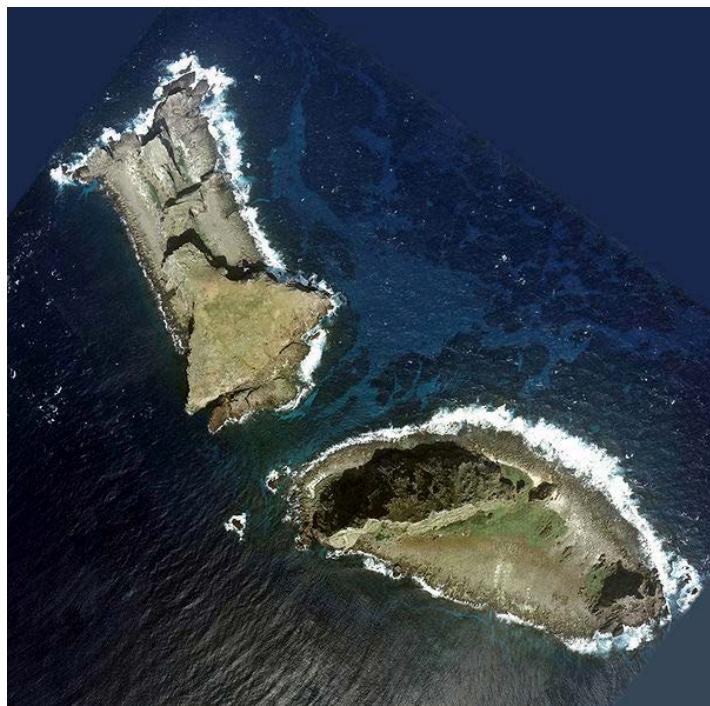
Consider the ongoing conflict between the U.S. and India (as well as other countries) playing out in the WTO over the use of agricultural subsidies—developing countries are demanding that the U.S. and other major developed countries slash their subsidies for commodities such as cotton, sugar, and corn; the developed countries, however, have been unwilling to make major concessions. The dispute over subsidies was a major impediment to the Doha Round of trade talks, which were launched in Qatar in 2001. The deadlock encouraged the U.S. to seek deals outside of the WTO framework, including a deal with the EU (the **Transatlantic Trade and Investment Partnership**, or TTIP), and a multilateral deal among Australia, Brunei, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, Vietnam, and the U.S. (known as the **Trans-Pacific Partnership**, or TPP). One scholar, Zaki Laïda (2013), asserts, “If the TPP or TTIP come into being, they will kill the WTO. For better or for worse, the organisation will cease to be the place where trade standards are negotiated” (n.p.). To Laïda, the move to work outside the WTO framework represents a return to power politics: he argues that the underlying motivation on the part of the United States, in particular, “is to contain China’s rise by setting a high bar for regulatory standards” (2013, n.p.). As noted above, in December 2013 an important breakthrough was made in the negotiations in Bali, Indonesia. Nonetheless, it remains to be seen how effective WTO negotiations will be.

The prospect of a breakdown of extant international regimes, at least in some areas, should not be lightly dismissed. The trends—e.g., a return to bilateral or limited multilateral agreements and regionalism—are certainly there. A key question, therefore, is how far these trends might go. To answer this question, one must consider current events, issues, and trends that both undermine the basis for international cooperation and strengthen it. With regard to the former, there are two salient concerns. One is the so-called democratic deficit in international institutions and organizations, and the second is the resurgence of right-wing nationalism. Briefly put, the *democratic deficit* refers to the undemocratic, or only partly democratic, character of most international institutions and organizations. In the IMF, for example, voting power is determined primarily by quota share. But even in the UN—which is sometimes considered to be the exemplar of democratic decision-making at the international level—there are serious issues.

First, while the General Assembly is based on “one vote, one country,” this means that the smallest member states have the same voting power as the largest states. Consider, on this point, the tiny country of San Marino, which has a population of about 31,000, and compare this to China, which has a population of 1.35 billion people. Is it democratic that San Marino has the same voting power in the General Assembly as China? Second, in the UN the most important decisions are made by the Security Council, which is composed of 10 rotating members and five permanent members (the U.S., China, France, Russia, and the UK). Each permanent member has *veto power* over any Security Council decision; giving veto power to a handful of countries is unequivocally nondemocratic. The lack of democracy within international institutions and organizations is a serious and longstanding issue, and one not amenable to an easy fix. More importantly, the lack of democracy undermines the authority and legitimacy of decisions made by international organizations and institutions, especially since it is developed countries, for the most part, that hold disproportionate voting power. The WTO, it should be emphasized, is an exception.

Another worrisome sign is the resurgence of right-wing nationalism in different parts of the world, including what has otherwise been a bastion of liberal cosmopolitanism: Western Europe. Writing for the *New York Times*, Andrew Higgins (2013) summed up the situation in Europe as follows: “All over, established political forces are losing ground to politicians whom they scorn as fear-mongering populists. In France, according to a recent opinion poll, the far-right National Front has become the country’s most popular party. In other countries—Austria, Britain, Bulgaria, the Czech Republic, Finland and the Netherlands—disruptive upstart groups are on a roll” (n.p.). Europe, moreover, is certainly not the only trouble spot: even in Japan, the extreme right wing has been making strong political inroads. In early 2014, an ultraconservative candidate for Tokyo governor won 611,000 votes—about 12 percent of all votes cast. While he did not win the election, the sheer number of votes indicates that there are many Japanese citizens who feel that their country needs to adopt a more aggressive stance towards the outside world. This sentiment is also reflected in the popularity of the current government, led by Prime Minister Shinzo Abe (who assumed office in 2012). Under Abe, tensions with

**Figure 8.4. Disputed Islands: Senkaku/Daiyou**



An image of the Senkaku, or Daiyou, Islands. Both China and Japan claim sovereignty over this set of eight uninhabited islands, which cover an area of just about seven square kilometers. Although tiny, the islands are considered economically and strategically important, since they are close to important shipping lanes, offer rich fishing grounds, and lie close to unexploited oil and gas reserves. Currently, Japan controls the islands.

*Image source: Made based on [http://w3land.mlit.go.jp/WebGIS/National Land Image Information (Color Aerial Photographs)], Ministry of Land, Infrastructure, Transport and Tourism.*

China—particularly over competing claims on a set of islands in the East China Sea, known as Senkaku in Japan and Daiyu in China—have grown. It is not inconceivable that the dispute could lead to a violent conflict between the two countries. More generally, right-wing nationalism can be an extraordinarily powerful and dangerous phenomenon: to an important degree, it almost always plays a role in violent interstate conflict and in power politics. Back in Europe, at least for now, the rise of right-wing nationalism does not necessarily “signal the return of fascist demons from the 1930s, except in Greece, where the neo-Nazi party Golden Dawn has promoted openly racist beliefs, and perhaps in Hungary, where the far-right Jobbik party backs a brand of ethnic nationalism suffused with anti-Semitism” (Higgins 2013, n.p.). Still, once the genie of right-wing nationalism is released from the bottle, so to speak, it can be extremely difficult to control.

In the face of the still-strong—and perhaps strengthening—appeal of right-wing nationalism, an obvious question is this: Are countervailing tendencies toward global governance strong enough to resist a complete resurgence of power politics? Clearly no definitive answer is possible at this point. Nonetheless, for the reasons discussed above, it is reasonable to conclude that global governance is likely to continue growing in significance over the coming years. To understand the reasoning behind this conclusion, it is important to return to the discussion of structural power in chapter 1. In the global political economy, power is multidimensional, which means that the exercise of power is complex. In the past, the use of violence and coercion (i.e., military power) was far less problematic: if Country A had the military capacity to defeat Country B, and to prevent other countries from intervening, it had very little else to worry about. Thus, while the use of military power is obviously still relevant—consider the decision by Russia to send troops into Crimea (in Ukraine) in March 2014—its benefits are harder to calculate. For example, the Russian incursion in Crimea, while still in the very early stages as this chapter is being written, will almost certainly have negative, perhaps profoundly negative, implications for the Russian economy, which is far more connected to the global economy now than it was during the Cold War. Among the many possible consequences, the Russian stock market may plunge (shortly after the incursion, the Russian stock market dropped 12 percent in value), and, more generally, the Russian financial system could become dangerously unstable. The Russian ruble may slide, which could spark inflation in Russia (in fact, to a small extent, this has already happened too). In addition, capital flight could increase, while FDI decreases. The conclusion is clear: the benefits of naked aggression have become increasingly problematic for states. In addition, it is equally clear that state power is not what it used to be. Again, in the past states had a much greater capacity to exercise power in all structures, but that power has significantly diminished in an era of globalization. At the least, TNCs have become major actors in the global economy because of their dominance in the finance and production structures. But the fourth major structure, the knowledge structure, has given nonstate and nonmarket actors—i.e., transnational organizations, or NGOs—increasing space and opportunity to exercise power too. The diffusion of structural power creates a more complex political landscape, one in which brute force must increasingly give way to accommodation.

## Chapter 8: A Very Brief Conclusion

This book has covered a lot of ground, but much more ground has been left uncovered. IPE is a vast domain. There are new, potentially important developments almost every day, and no book on the subject would ever be able to keep up. Thus, in this book, one goal has been to

provide you with the basic conceptual tools and frameworks of analysis (i.e., the various theoretical approaches) with which you can begin fruitfully analyzing, understanding, and explaining events, processes, and issues in the international (or global) political economy on your own. Having command of these principles and frameworks of analysis, in other words, allows you to keep up independently. That said, the dominant principles and frameworks of analysis are themselves subject to change; back in the 1970s, there would have been no mention of social constructivism in any textbook, and many other approaches were just being introduced. The three foundational theories—liberalism, mercantilism, and Marxism—are still important, but they have been subject to a great deal of refinement and revision over the years. Change, in short, is constant—a trite statement, to be sure, but an important one to keep in mind when thinking about the global political economy.

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<sup>49</sup> In the United States especially, the UN is often portrayed as a potential world government, operating independently of states, with the power to impose its will on every country. Consider, for example, the following headlines: “United Nations’ Threat to All Nations’ Sovereignty” (<http://www.renewamerica.com/columns/alba/060727>); “Another UN Convention That Poses Threats to U.S. Sovereignty” (<http://blog.heritage.org/2012/07/13/another-u-n-convention-that-poses-threats-to-u-s-sovereignty/>); and “Empowering the UN, Destroying U.S. Sovereignty” (<http://www.antiwar.com/paul/?articleid=7500>). Most of these types of stories are based on fearmongering; at present, there is absolutely no prospect of the UN challenging U.S. sovereignty in particular (although, for weaker states, the principle of absolute state sovereignty is clearly no longer sacrosanct within the United Nations when it comes to, for example, questions of human rights and genocide). With respect to the U.S., however, just keep in mind that a part of the UN’s institutional structure is the Security Council, through which the most important decisions of the organization are funneled. Each permanent member of the Security Council (the United States, Russia, China, the UK, and France) has veto power: that is, each individual member has the single-handed ability to prevent the Security Council from making any decision contrary to its interests.

<sup>50</sup> For a useful discussion of the Catholic Church as a transnational organization or actor, see Ryall (2001).

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<sup>51</sup> The quotation comes from an online article; however, the original source is Keck and Sikkink's influential book, *Activists Beyond Borders* (1998). It should be noted that Keck and Sikkink differentiate between transnational organizations and what they refer to as transnational advocacy networks, the latter of which they define as "forms of organization characterized by voluntary, reciprocal, and horizontal patterns of communication and exchange" that operate across borders (1998, p. 8). TNOs, though, are a major actor within transnational advocacy networks.

<sup>52</sup> Many of the acronyms listed have been referred to elsewhere in the book. For the sake of simplicity, and to keep the main text from becoming overly cluttered, here are the full names for each acronyms listed: UNDP, United Nations Development Programme; FAO, Food and Agriculture Organization; WHO, World Health Organization; UNESCO, United Nations Educational Scientific and Cultural Organization; UNAIDS, United Nations Programme on HIV/AIDS; the OECD, Organisation for Economic Cooperation and Development; and the EU, European Union; the G8 and G20, Group of 8 and Group of 20, respectively.

<sup>53</sup> "Critical," in this term, refers to scholars whose work is premised on critical theory, a neo-Marxist school of thought associated with the work of scholars in the Frankfurt school (for present purposes, a detailed discussion of the Frankfurt school is not necessary). According to scholars in the Frankfurt school, as Bohman (2013) puts it, "a 'critical' theory may be distinguished from a 'traditional' theory according to a specific practical purpose: a theory is critical to the extent that it seeks human emancipation, 'to liberate human beings from the circumstances that enslave them'" (citing Horkheimer 1982, 244). In this regard, critical theorists question how existing orders or structures came into being (Cox 1995), and how they are sustained. On this point, critical theorists pay particular attention to ideology, theories, major discourses, and other subjective processes. As might be apparent, there is strong correlation between constructivism and critical theory.

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## Glossary

*The entries included here correspond to words that appear in **boldface** in the main text. Items in SMALL CAPITALS in the glossary are cross-references to other glossary entries. Please note, too, that this glossary is not meant to be comprehensive; nor is it meant to include all or even most of the significant terms discussed in the book. Most of the omitted terms are discussed at length in the main text.*

\* \* \*

**actor(s).** A typical definition of *actor* is “someone who performs on stage, in movies, or on television.” This is *not* the definition used in the social sciences and in the context of this book. Instead, *actor* refers to a person or a collective entity (e.g., a corporation, a trade union, a nongovernmental organization, a state) that has the capacity to act in a “purposeful manner.” This means behaving in a manner that expresses the actor’s intention to achieve a specific goal. Determining who the key actors are—and what degree of power they have—is a basic step social scientists must take as they develop their explanations of political, economic, or social phenomena.

**agency.** Often contrasted with the concept of STRUCTURE, agency implies that actors, whether acting individually or in groups, have the capacity for independent action (that is, action that is not determined by forces outside the individual), and the capacity to affect or shape the larger (social) environment in which they live. Although this may seem to be a commonsensical notion, many social scientists argue that all human action is, to at least some degree, constrained or

otherwise shaped by exogenous factors and forces such as institutions, SOCIAL CLASS, culture, or overarching structures (e.g., capitalism).

**anarchy.** Anarchy is a central concept in REALISM and mercantilism. It does mean not “chaos,” but instead refers to the absence of a supreme political authority. The international system is anarchic because each individual unit (i.e., state) in the system is sovereign; in other words, there is no political authority that exists above states.

**Anglo-American capitalism.** As the term implies, *Anglo-American capitalism* refers to the type of capitalism practiced in Britain and the United States. At the most general level, this suggests a version of capitalism closer to LAISSEZ-FAIRE than in other capitalist economies. A second definition centers on the prominent role of shareholders, especially in the American system. In “shareholder capitalism” primary emphasis is placed on short-term profits and shareholder interests.

**Arab Spring.** A wave of anti-government movements, demonstrations, and conflicts that took place in the Middle East and North Africa beginning in December 2010. The Arab Spring started in Tunisia, but quickly spread to Algeria, Jordan, Egypt, and Yemen. Subsequently, protests—of widely varying sizes and intensities—emerged in Oman, Bahrain, Libya, Kuwait, Morocco, Lebanon, Saudi Arabia, Syria, and Palestine. In four countries—Tunisia, Egypt, Libya, and Yemen— popular protests led to long-lived dictators being ousted from power.

**autarky.** Autarky means self-sufficiency, and typically refers to the idea that countries can and should be economically self-sufficient. This means producing everything a country needs internally, without the need to engage in international trade.

**bargaining coalition.** A group of countries that band together for negotiating purposes. As Narlikar (2005) explains it, there are two basic types of bargaining coalitions: bloc-type

coalitions and issue-based coalitions. The former are held together by a set of ideas and an identity that is more than instrumental, while the latter are bound together by shared interests on a particular issue.

**beggar-thy-neighbor (policy).** In economics, the term *beggar-thy-neighbor* is used to describe a type of policy in which a country imposes trade restrictions or other measures (e.g., currency manipulation and devaluation) to increase its own exports or improve its own economic conditions at the expense of other countries.

**BIS (Bank for International Settlements).** The BIS is an organization composed of central banks. It was established in 1930 in Basel, Switzerland. Originally, the BIS was designed to administer reparation payments imposed on Germany at the end of World War I, but since then its main functions have been to foster monetary cooperation among the major economies, to collect and analyze financial data, and to perform more traditional banking functions for central banks (such as gold- and foreign-exchange transactions).

**Brady Plan.** The Brady Plan—named after U.S. Treasury Secretary Nicholas F. Brady—was designed to address the debt crisis afflicting developing countries, especially those in Latin America, in the 1980s. The plan was premised on providing limited debt relief in exchange for market reform and liberalization. A detailed discussion of the Brady Plan can be found in Vásquez (1996).

**Bretton Woods system.** Bretton Woods is the name of a resort area in New Hampshire, but it was also the site of an important set of meetings that took place in July 1944 among 730 delegates from 44 allied countries. The meeting, however, was thoroughly dominated by the views of the United States and Great Britain. It was during these meetings that the framework for a new international financial system was developed and agreed upon. The main objective was to

develop an international monetary regime, whereby participating states bound themselves to an exchange-rate mechanism with all major currencies tradable for U.S. dollars, which, in turn, were convertible to gold at a fixed rate. This system broke down in 1971 when President Richard Nixon unilaterally abrogated the U.S. commitment. Nonetheless, key elements of the Bretton Woods system remained: the INTERNATIONAL MONETARY FUND and the WORLD BANK.

**Buchanan, Pat (b. 1938).** Buchanan is a columnist, TV pundit, and chairman of The American Cause, as well as editor of *The American Conservative*. He is best known for challenging George Bush for the Republican nomination in 1992, and also for his roles as an assistant to President Nixon and director of communications for Ronald Reagan.

**bureaucratic politics.** Bureaucratic politics refers to an analytical model in public policy that focuses on bargaining that goes on *within* states. In general, the model asserts that policy decisions are the product of bargaining and negotiations that take place between and among governmental actors, which include influential leaders and their agencies or organizations. A key element of this approach is the assumption that different governmental actors represent a range of different interests and ideas, and possess varying degrees of influence depending on the policy issues.

**capital control regulations.** As the phrase suggests, *capital control regulations* refers to any measure taken by government (or government entities, such as a central bank) to limit or regulate the flow of foreign capital into and out of the domestic economy.

**capital goods.** Capital goods are goods used in production; that is, they are goods used to produce other goods. The machines that a factory uses to produce automobile parts, for example, are capital goods, while the finished automobile is a consumer good (or a durable good).

**central planning.** Central planning refers to an economic strategy in which the state makes the most important decisions about how to allocate economic resources within a national economy. This includes decisions on what to produce, how much to produce, what prices to charge, and so on. Central planning began in the 1920s with Soviet Russia.

**Chinese Communist Party.** The CCP (also known as the Communist Party of China) was founded in 1921, and has been the sole ruling party of China since 1949. Before coming to power, the CCP fought a long war against the Kuomintang (KMT), and was also engaged in a struggle against the Japanese. The CCP is the world's largest political party, with a membership of more than 76 million.

**class-based analysis.** Most common in MARXIST analysis, class-based analysis hinges on explaining economic, social, and political phenomena by focusing first on the interests, power, and role of social classes. Class-based analysis assumes, for example, that state policy is primarily a product of the interests and power of the dominant class. Class-based analysis also pays careful attention to the interaction—or the struggle—between dominant and subordinate classes.

**Cold War.** The term Cold War has two distinct meanings. The first meaning refers to a specific period of time, roughly 1947 and 1991, which was a period of intense antagonism between the United States and the Soviet Union. The war was “cold” because there was never direct and open military violence between the two countries, although the two countries often fought indirectly through proxy states. The dates of the Cold War are a bit fuzzy, since between 1947 and 1991 there were at least three warming periods, or periods of detente (1953–1960, 1969–1975, and 1985–1989). The second meaning “has to do with the structure rather than the behavior of East-West relations. To the extent that key elements of the structure remained continuous throughout

the postwar period, then cold war refers to the whole period from the late 1940s to the late 1980s” (Crokatt 2001, pp. 93–94).

**command economy.** A command economy uses CENTRAL PLANNING, but is not entirely synonymous with central planning. A key distinction revolves around the level of state intervention in the economy. Under central planning, the state may set production goals or targets, allocate resources to specific sectors, and so on, but does not necessarily directly control enterprises. In a command economy there is necessarily a high degree of public ownership of industry.

**comparative advantage.** The concept of comparative advantage was first introduced by David Ricardo in *On the Principles of Political Economy and Taxation*. The basic idea is this: when people, firms, and whole economies engage in trade based on specializing in certain tasks, total output will be greater than with no trade. In other words, everyone is better off by specializing and trading.

**conditionality.** *Conditionality*, in general, refers to the conditions a bank or lending institution places on the borrower in exchange for a loan. More commonly, however, it refers specifically to the conditions placed by the IMF or WORLD BANK on individual countries in return for a loan provided or approved by the IMF. The IMF defines conditionality as follows: “When a country borrows from the IMF, its government agrees to adjust its economic policies to overcome the problems that led it to seek financial aid from the international community. These loan conditions also serve to ensure that the country will be able to repay the Fund so that the resources can be made available to other members in need. In recent years, the IMF has streamlined conditionality in order to promote national ownership of strong and effective policies” (<http://www.imf.org/external/np/exr/facts/conditio.htm>). IMF conditionality is

extremely controversial, as many developing countries view the IMF as an institution controlled by the major Western economies, especially the U.S., which uses conditionality as a way to gain control over their domestic economies.

**contradiction.** In MARXISM, all existing economic structures contain inherently oppositional forces that lead to instability, and ultimately to the collapse of the structure itself. Marx argued that there were two primary contradictions in capitalism. The first derived from the competitive nature of capitalism, which necessarily creates winners and losers. Over time, the winners would become progressively larger and more powerful, leading to a concentration of capital in the form of monopolies and oligopolies. The second contradiction arises from the first. As capital becomes more concentrated, so too does wealth and income: to put it simplistic terms, the rich get richer and the poor get poorer. As wealth becomes more concentrated, however, the gap between the productive capacity of capitalism as a system and the consumptive capacity of markets increases. This leads to further concentration and greater polarization in the system. The end result is a collapse of the system, which may be accelerated through social revolution. (This entry borrows from Athabasca University and the International Consortium for the Advancement of Academic Publication (ICAAP), *Online Dictionary of the Social Sciences*, available at <http://bitbucket.icaap.org/dict.pl>.)

**convention.** In international law, a convention begins as a meeting of representatives from many countries and ends as a general agreement about *procedures* or *actions* that they will take on specific topics, such as global climate change. In this regard, a convention is typically the first step toward a PROTOCOL or treaty.

**crony capitalism.** A crony is a close friend, a pal, or a buddy. The term *crony*, then, implies a close relationship between individuals. Crony capitalism is not necessarily based on friendship,

but emphasizes the importance of close relationships between business people and state or government officials. These close relationships, in turn, are the basis for many economic transactions; indeed, under crony capitalism, business success is largely dependent on favoritism and special access to resources controlled by the state.

**currency convertibility.** Except for the euro, currencies are generally issued on a national basis, which means, in principle, that a currency only has value in the country that issued it. However, to facilitate international trade, it is vital that at least some currencies be easily convertible—that is, easily exchanged for gold or another hard currency.

**customs union.** A customs union is a specific type of trade agreement under which a group of countries agree to apply a common set of tariffs to the rest of the world, while eliminating tariffs among all members of the union.

**Davos Forum (also referred to as the WORLD ECONOMIC FORUM).** Davos is a city in Switzerland, and the Davos Forum—which is hosted by the World Economic Forum (a Swiss nonprofit foundation)—is the invitation-only annual meeting held in the city and attended by heads of state and high-ranking officials, corporate leaders, high-profile celebrities, academics, NGO representatives, journalists, and others, to discuss major economic issues.

**debt-bondage.** Debt-bondage (also referred to as bonded labor) occurs when a person is forced to pay off a loan with direct labor. In this situation, the worker is not free to leave his or her job until the debt is paid in full. Debt-bondage has been described by the United Nations and many NGOs as a form of modern-day slavery; it is prohibited by international law.

**debt-service.** Most simply, the debt service is the amount of money that needs to be repaid over a particular period of time to cover the interest *and* principal on a debt. Any time an individual or company takes out a loan, a debt service is created. For countries, the same definition applies. A

debt service is neither good nor bad, but a high debt service ratio may indicate financial problems. The debt service ratio for an individual is that individual's total annual debt payments divided by gross income. If, for example, you have annual debt payments of \$10,000 and an income of \$30,000, your debt service ratio is 0.33 (also expressed as 33.3%), a manageable level. If you have annual debt payments of \$100,000, by contrast, your debt service ratio would be 3.33 (or 330%), which would be extraordinarily high and likely completely unmanageable. The debt service ratio for a country is the ratio of debt service payments to export earnings.

**derivatives.** Derivatives are a type of financial instrument—or more simply, a contract between two or more parties—designed, in principle, to insure against risks. Consider, for example, a wheat farmer. The farmer depends on a certain price for wheat at the time of harvest; if the price drops, however, he could easily go bankrupt. To minimize, or hedge against, this risk, the wheat farmer buys a derivative (an insurance contract) from a financial company that essentially guarantees a fixed price. If the price drops, the financial company bears the costs; however, if there is no price drop (or if the price increases), the company makes money. Derivatives, therefore, are very useful financial tools, but they can also be misused. Some companies use derivatives for speculative purposes, and because derivatives were not regulated, there was no limit on how many derivative contracts financial firms could buy and sell. Before the 2008 global financial crisis, some large firms simply held too many contracts (which had a total value that vastly exceeded world GDP). In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act was passed, part of which dealt explicitly with the regulation of derivatives.

**devaluation.** Devaluation is a monetary policy tool used to make a country's exports less expensive in international markets, and therefore more (price) competitive. At the same time,

devaluation causes imports—such as oil and food—for that same country to become more expensive for domestic consumers.

**diasporic (community).** The general definition of *diaspora* is “the movement, migration, or scattering of people away from an established or ancestral homeland.” Among scholars, usage of the term is largely the same, but there is also an understanding that a diasporic *community*, which is generally defined on the basis of ethnicity or national identity, maintains a meaningful and significant attachment to the ancestral homeland.

**Dispute Settlement Panel (DSP).** The “Understanding on Rules and Procedures for the Settlement of Disputes” of the WORLD TRADE ORGANIZATION contains a number of provisions for resolving disputes among or between WTO members. The most frequently used of these methods is a process of adjudication by ad hoc panels. These panels are informally known as dispute settlement panels. The process of dispute settlement is fairly complicated, with the panels playing an important but limited role. For further information on how disputes are resolved in the WTO, see UNCTAD, *Dispute Settlement: World Trade Organizations, 3.2 Panels*, available at [http://unctad.org/es/Docs/edmmisc232add12\\_en.pdf](http://unctad.org/es/Docs/edmmisc232add12_en.pdf).

**Doha Climate Conference.** The Doha Climate Conference was the 18<sup>th</sup> session in a series of annual meetings based on the United Nations Framework Convention on Climate Change. The meetings, in general, are meant to assess progress in dealing with climate change. The main achievement of the Doha Climate Conference was an agreement to continue the terms and commitments of the Kyoto Protocol for another eight years; perhaps even more significantly, it confirmed an earlier agreement that, in 2020, the distinction between “developed” and “developing” countries would be eliminated, which means that all countries will be required to make commitments commensurate with their level of development.

**duty (duties).** A duty is basically synonymous with a TARIFF. Both *duty* and *tariff* refer to taxes imposed on imported goods. The main difference between the two terms is in usage. When referring to a specific taxation rate, *duty* is typically used; when referring to a government or economic policy, *tariff* is used.

**Earth Summit.** The Earth Summit is the informal name given to the United Nations Conference on Environment and Development, which was held in Rio de Janeiro (Brazil) from June 3 to 14, 1992. The conference included 172 national governments, and some 2,400 representatives of nongovernmental organizations. The primary result of the Earth Summit was Agenda 21, which was a nonbinding action plan designed to encourage sustainable development. Other results were the Rio Declaration on Environment and Development, the Statement of Forest Principles, the United Nations Framework Convention on Climate Change, and the United Nations Convention on Biological Diversity.

**embedded liberalism.** *Embedded liberalism* refers to a compromise between the economic nationalism of the 1930s, in which states pursued mercantilist policies, and the unregulated nature of the free market. In embedded liberalism, the basic idea was to create a liberal economic order at the international level through cooperative multilateral efforts, while allowing states to practice domestic interventionism designed to tame the most socially disruptive effects of the market. In other words, a liberal market system was embedded into a social and political web, as well as a regulatory environment that both restrained and enabled market processes (Harvey 1989).

**enclave economies.** *Enclave* refers to portion of the economy devoted to the manufacturing or assembly of products for export. In addition, within an enclave foreign firms usually control all or most production in order to take advantage of low labor and resource costs. An enclave

economy, therefore, is an economy that is heavily dependent on an export sector dominated by foreign firms.

**Engels, Friedrich (1820–1895).** Engels was a German philosopher and close collaborator of Karl MARX. Along with Marx, Engels is most famous for his work, *The Communist Manifesto* (1848); Engels also edited the second and third volumes of Marx's *Das Kapital*.

**epistemic community.** In most dictionaries, the definition of *epistemic* is “of or relating to knowledge.” This general definition provides a useful starting point for defining *epistemic community*, which refers to a network of experts (especially scientists) who have specialized knowledge of a particular issue or concern. In addition, epistemic communities generally are concerned with framing issues for policymakers and the public, as well as offering solutions and assessing outcomes. As a community, the experts in the network typically share a set of beliefs and values and see themselves as working toward a societal (as opposed to self-interested) goal. Typically, epistemic communities are transnational. Scientists working on global climate change are often pointed to as an exemplar of an epistemic community.

**European Coal and Steel Community (ECSC).** The ECSC was a precursor of the EUROPEAN UNION. It was first proposed in 1950 as a way to create a more stable and peaceful relationship between France and Germany: the declared aim was “to make war not only unthinkable but materially impossible.” In 1951, the Treaty of Paris established the ECSC, and included not just France and (West) Germany, but also Belgium, the Netherlands, Luxembourg, and Italy. The ECSC was joined by two similar, but still separate, organizations in 1957—the European Economic Community (EEC) and EURATOM (European Atomic Energy Community). Eventually, all three organizations merged as the EEC. The EEC later became the European Union.

**European Union (EU).** A description from the European Union's official website, Europa.eu (English language version is available at [http://europa.eu/index\\_en.htm](http://europa.eu/index_en.htm)): "The EU is a unique economic and political partnership between 27 [there are now 28 members, with the addition of Croatia in 2013] European countries that together cover much of the continent. It was created in the aftermath of the Second World War. The first steps were to foster economic cooperation: the idea being that countries that trade with one another become economically interdependent and so more likely to avoid conflict. The result was the European Economic Community, created in 1958, and initially increasing economic cooperation between six countries: Belgium, Germany, France, Italy, Luxembourg and the Netherlands. Since then, a huge single market has been created and continues to develop toward its full potential. But what began as a purely economic union has also evolved into an organisation spanning all policy areas, from development aid to environment. A name change from the EEC to the European Union (the EU) in 1993 reflected this change."

**eurozone.** The eurozone, also known as the euro area, consists of the EUROPEAN UNION (EU) countries that have adopted the euro, which was introduced in 1999, as their currency. The eurozone has 18 member states: Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, the Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland, Estonia, and Latvia.

**eurozone crisis.** See sovereign wealth crisis.

**export processing zone (EPZ).** An export processing zone, or EPZ, is known by a number of names, including free-trade zone (FTZ), special economic zone (SEZ), free ports, or economic development zone. A MAQUILADORA is a type of EPZ. It is a location, typically within a developing country, that is set up specifically to assemble—or to process—imported materials so

that they can be re-exported as a finished product. Foreign companies operating in EPZs are usually exempt from normal customs, trade, and other business regulations of the country in which the zone is located, and typically are offered a range of financial incentives, such as tax exemptions and subsidies.

**feudalism (feudal).** The meaning of *feudalism* is subject to a great deal of debate, but in general terms it refers to the type of social system prevalent in medieval Europe, wherein control of land constituted the primary source of power. In the feudal system, there were a multiplicity of powers and authorities with concomitant allegiance patterns (as in local lord, king, and the church).

**Fordney-McCumber Tariff Act (1922).** The Fordney-McCumber Tariff Act followed on the heels of the Emergency Tariff Act of 1921, the latter of which was designed to be a temporary measure until a more comprehensive bill could be passed. The Fordney-McCumber Tariff Act was that more comprehensive measure. The act raised tariffs to historically high levels, gave the president broad powers to adjust tariff rates (by as much as 50 percent), and introduced the use of the “American selling price” (which was a measure designed to increase tariff protections without having to actually raise the tariff rate).

**foreign exchange reserves.** Strictly defined, a foreign exchange reserve is the total of a country’s foreign currency deposits and bonds (liquid assets), which are typically held by the central bank. More loosely, though, foreign exchange reserves also include a country’s gold holdings, as well as other assets. Foreign exchange reserves are used by monetary authorities to keep their domestic currencies stable and reduce the effects of economic shocks.

**free-ride (free-rider, free-riding, the free-rider problem).** Most generally, a free-rider is an individual who benefits from the actions or contributions of others “for free.” This means that the

free-rider does not share in the cost of producing a particular good, because it is nonexcludable and nonrivalrous (i.e., a public good). Consider clean air, domestic peace and order, national security, or a highway system: once these goods are created, anyone can consume or benefit from them, even if they did not help pay for their creation. Free-riding, it is important to emphasize, is a rational and predictable action if there are no sanctions attached to failing to contribute. In many societies, a free-rider *problem* arises when there is no political authority—usually the state or government—capable of compelling citizens to contribute to the creation of public goods.

**gender.** The words *gender* and *sex* are often used interchangeably, but for social scientists there is a clear distinction. *Sex* refers to the biological and physiological characteristics that distinguish men from women. *Gender* refers to the socially constructed roles, behaviors, activities, and attributes that a given society assigns to, or considers appropriate for, men and women. In IPE, some scholars argue that inequities between men and women are usually legitimized and even naturalized through gendered constructions.

**General Agreement on Tariffs and Trade (GATT).** A multilateral agreement on international trade that was negotiated over several decades through a series of trade rounds. The GATT was signed in 1947, and was expressly intended to bring about a “substantial reduction of tariffs and other trade barriers and the elimination of preferences, on a reciprocal and mutually advantageous basis” (Preamble). Although not an organization *per se*, the series of ongoing trade rounds, which culminated in the seven-year Uruguay Round, made the GATT a *de facto* organization. One of the major issues in the Uruguay Round, however, was the creation of a standing organization devoted to international trade—the WORLD TRADE ORGANIZATION, or WTO.

**global civil society.** *Civil society* generally refers to the vast expanse of nongovernmental organizations, institutions, and social movements that reflect the interests of ordinary citizens within a given country. Although nongovernmental organizations, institutions, and social movements can certainly include business or commercial enterprises, civil society is typically considered to be separate from both business and the state. It is the so-called third sector. Based on this conceptualization, *global civil society* refers to nongovernmental organizations, institutions, and social movements that operate, or are linked, across borders. For a more detailed discussion, see Taylor (2002).

**global warming.** The definition of *global warming* is quite simple—it is a situation in which heat generated by sunlight is somehow trapped in the earth's atmosphere, thus making the planet warmer than it would otherwise be. While the definition is simple, there has been a long-standing debate (1) on whether global warming is actually occurring, and (2) if it is occurring, whether the cause is natural or the product of human activities. In general, the scientific evidence is fairly clear on both questions—that is, there is consensus that global warming is taking place and that it is largely the product of human activity. Nonetheless, the debate over global warming remains intense.

**gold-exchange standard (GES).** The gold-exchange standard (also known as the gold-exchange system) was a product of the postwar BRETON WOODS system. The main requirement of the GES was for all participating countries to peg their currencies to a certain amount of gold. At the same time, the United States pegged the price of the U.S. dollar at \$35 per ounce—a value the U.S. maintained by buying and selling gold as needed. In practice, then, the postwar GES was a “dollar exchange system,” as most currencies were directly pegged to the dollar and indirectly pegged to gold. Unlike currency, however, gold is a finite resource; and as the world’s

economies began to grow and prosper, the gold stock was insufficient to finance the growth of the output and trade. This led to the “Nixon shock” of 1971, when President Nixon closed the gold window—that is, announced that the U.S. would no longer convert dollars for gold. The result was the “collapse of the Bretton Woods system” (as many analysts put it). Nonetheless, other key institutions—i.e., the IMF and WORLD BANK—continued to play crucial roles in the world economy.

**Grameen Bank.** The Grameen Bank was founded in 1976 in Dhaka, Bangladesh, by Muhammad Yunus. Unlike traditional banks, the Grameen Bank is committed to providing small loans—known as microcredit—to poor people without collateral. Borrowers are expected to use their loans to start or improve a “micro-enterprise.” Between its founding and 2014, the bank provided more than 7 million individual loans, at an average amount of \$100. Over 95 percent of the loans were made to women, and almost all the loans were paid back. In 2006, the Grameen Bank, along with Muhammad Yunus, was awarded the Nobel Peace Prize.

**Great Depression.** The Great Depression was a period of severe economic difficulties in the decade preceding World War II. In the United States, the official beginning of the Great Depression was October 29, 1929, the day the stock market crashed. The Great Depression, however, was not limited to the United States: countries around the world, but especially Western European countries, were also hit very hard. Germany, which was already suffering from serious inflation (really hyperinflation as result of the large debts it was required to pay back after losing World War I), was in a particularly precarious position, since it had borrowed large sums of money from the U.S. in order to repay its European debts. After the U.S. stock market crash, the United States gave Germany 90 days to start repaying those loans—a burden

that the country simply could not bear. Germany's economic difficulties almost certainly played a central role in the rise of Adolf Hitler.

**greenfield.** *Green field* connotes a natural grass-covered area, one that has never been used or exploited for commercial purposes. Not surprisingly, then, the term *greenfield* was originally used in the construction industry to refer to an area of land on which there was no need to demolish or rebuild any existing structures. Over time, however, the term was adopted in other industries. When referring to FDI, in particular, greenfield projects are those in which the foreign investors build a brand new plant or factory.

**green room.** The term *green room* refers to informal negotiations among a relatively small set of representative countries on difficult-to-negotiate issues. The WTO describes the green room as follows: “The term ‘Green Room’ has its origins in British theatre and refers to the room where performers would wait when they were not needed on stage. Green Room meetings serve a useful purpose in that their informal nature allows negotiators to explore new approaches to settling difficult issues. Ministerial Green Room consultations deal with the most sensitive political issues—including tariff or subsidy cuts, or the degree of flexibility regarding those cuts. Green Room meetings often run until the early hours of the morning and can stretch out for days. They can also be tense and dramatic settings in which nerves are taut and tempers evident” (WTO 2008).

**G8 (Group of Eight).** The Group of Eight is a forum for most of the world’s largest economies. It began in 1975 as the Group of Six with representatives from six states: France, Germany, Italy, Japan, the United Kingdom, and the United States. Canada was included in 1976, and Russia was added as a full member in 1997. At the G8’s annual summit meetings, the heads of state (e.g., presidents or prime ministers) convene to discuss the major economic and political issues

affecting their economies and societies; these issues include macroeconomic management, international trade, and relations with developing countries. In conjunction with the summit meeting among heads of state, the G8 has also developed a network of supporting ministerial meetings, which allow ministers to meet regularly throughout the year.

**G8+5.** As the name implies, the G8+5 consists of the eight members of the G8 (Canada, France, Germany, Italy, Japan, Russia, the UK, and the U.S.), plus five additional states: Brazil, China, India, Mexico, and South Africa. The G8+5 was formed in 2005, when Tony Blair (the prime minister of the UK) invited the five “emerging” countries to join the original Group of Eight.

**Hamilton, Alexander (1755–1804).** One of the Founding Fathers, Hamilton was also the first U.S. Secretary of the Treasury. Hamilton is generally considered to have been an ardent believer in mercantilism, a belief that was expressed in his support of a national bank and protectionist policies.

**hard currency.** A freely convertible currency, which usually means a currency that is traded regularly on a global basis, and is expected to serve as a reliable and stable store of value (i.e., is not expected to lose value). The U.S. dollar, the British pound, the euro, and the Japanese yen are all hard currencies.

**Hayek, Friedrich A. (1899–1992).** Hayek is considered to be one of the leading economists of the 20<sup>th</sup> century. He is best known, perhaps, for his vigorous defense of classical economics (and the free market), and for his polemical writings on the dangers of fascism, socialism, and central planning. His best-known popular work is *The Road to Serfdom*. Intellectually, Hayek is most closely associated with what is known as the Austrian school (which is distinguished from neoclassical economics, at a general level, by its rejection of economic models and statistical methods). Hayek and JOHN MAYNARD KEYNES were contemporaries, and they engaged in a

vigorous debate, from which neither backed down. For more information, go to [Friedrich August Hayek in the Concise Encyclopedia of Economics](#).

**historical materialism.** The concept of historical materialism is a core tenet in MARXIST theory, one that regards material (economic) forces as the primary basis for human society.

**IMF (International Monetary Fund).** The IMF and its sister institution, the WORLD BANK, were established in 1944; together, they are known as the BRETON WOODS Institutions. The IMF was designed to promote international monetary cooperation. The IMF also engages in lending, but on a short-term basis only. IMF loans (and loan guarantees) are meant to solve temporary balance-of-payment problems faced by member countries that cannot otherwise obtain sufficient financing. In this sense, the IMF is an international lender of last resort. The IMF has been subject to intense criticism. Critics are mainly concerned with the CONDITIONALITIES imposed on borrower countries. These conditions typically require borrowers to liberalize their economies and cut government spending. The problem, critics charge, is that liberalization and austerity often make economic conditions worse.

**import licensing.** *Import licensing* refers to an administrative procedure that requires a country or corporation to submit an application or other documentation to an administrative body as a prior condition for importation of goods.

**import-substitution industrialization (ISI).** An economic strategy premised on reducing the need for imports by expanding and increasing production of domestically produced goods. Typically, an ISI strategy involves heavy state involvement in the national economy. For example, to create the minimal foundation for ISI, the state must prohibit certain imports and provide financial assistance (e.g., a subsidy) to import-substituting firms and industries.

**infant-industry protection.** In an already-established and internationally competitive industrial sector, an infant industry is one that emerges relatively late in a particular country. For example, in the 1970s, South Korea built its first steel mill, while a range of other countries already had large and extremely efficient steel industries. As a newcomer, the infant industry normally cannot operate on the same scale and, therefore, at the same level of competitiveness and efficiency as its more established international competitors. Thus, some argue that states should be allowed to protect and nurture their infant industries until they have time to “grow up.” This argument is referred to as infant-industry protection.

**International Monetary Fund.** See IMF.

**Internationalism.** *Internationalism* is an ambiguous term, but it generally refers to a foreign-policy position that advocates strong international cooperation and the recognition that countries have a range of shared interests, including the prevention of war. Internationalists are also advocates of a central role for international organizations.

**institutions.** Traditionally, institutions are equated with concrete public and private organizations and agencies, such as the legislature, the presidency, corporations, and so on. The traditional definition is still relevant and frequently used, but the term has a more expansive and arguably more important meaning as well. One of these more expansive definitions defines *institutions* as “systems of established and embedded social rules that structure social interactions,” where rules are understood as “socially transmitted and customary normative injunctions” (i.e., rules tell us what is right or wrong) (Hodgson 2006, pp. 17–18).

**intra-firm trade.** Intra-firm trade is trade that takes place between and among related or affiliated companies that are located in different countries. Intra-firm trade may consist of trade in parts and components that go into the production of a final product. In the automobile

industry, for example, Toyota may send an engine produced by a Toyota factory in Japan, a windshield made by a Toyota affiliate in the United States, and other components/parts from different Toyota subsidiaries around world to an assembly factory in Mexico. All these products are being traded on an intra-firm basis.

**invisible hand.** A metaphor coined by Adam Smith to describe the self-regulating behavior of free markets. Smith assumed that individuals try to maximize their own good through self-interested behavior, and in so doing, make society as a whole better off. To Smith, the invisible hand represented the antithesis of the visible hand of state or government intervention.

**Isolationism.** Isolationism, which is most commonly associated with U.S. foreign policy for much of the country's history (until World War II), is a policy based on avoiding entanglements with other countries, particularly countries that are geographically distant. Advocates of isolationism argue that limiting involvement with foreign countries is the best method for ensuring security and prosperity in their home countries.

**Keynes, John Maynard (1883–1946).** Keynes was an extremely influential British economist who spearheaded a revolutionary, albeit controversial, rethinking of neoclassical economic thought. His best-known arguments centered on the issue of unemployment. Keynes argued that the normal operations of free markets would not always restore full employment to an economy suffering from significant unemployment. He linked this to his equally important ideas about aggregate demand (that is, the sum of consumption, investment, and government spending in a national economy). In the neoclassical view, unemployment is resolved when wages fall to a low enough level to encourage businesses to begin hiring again. The problem, however, is that the general fall in wages reduces aggregate demand (workers have less to spend), which in turn reduces the demand for labor. The solution is for the government to step up its spending to keep

aggregate demand high. For more information, go to [John Maynard Keynes in the Concise Encyclopedia of Economics](#).

**Kyoto Protocol.** The Kyoto Protocol is an international agreement based on the United Nations Framework Convention on Climate Change. The key agreement in the protocol was the commitment by 37 industrialized countries and the European community to reduce greenhouse gas (CHG) emissions by an average of five percent compared to 1990 levels. These reductions were supposed to occur over a five-year period, from 2008 to 2012. The agreement was negotiated in Kyoto, Japan, and adopted on December 11, 1997.

**laissez-faire (economics).** The loose translation of the French term *laissez-faire* is “leave it alone,” where *it* refers to the market. Laissez-faire economics, then, is based on the idea that markets should be free from government intervention.

**lender of last resort.** As the term implies, the lender of last resort is a financial institution that provides loans when no other institution is willing or able to do so. At the international level, the lender of last resort may be a specific country, especially the hegemon, or a multilateral financial institution. The IMF has, in practice, functioned as an international lender of last resort, although it does not accept this role on a formal or official basis.

**libertarianism.** Libertarianism is a philosophy that is premised on classical liberal principles. In general, libertarian values emphasize the right of individuals to live their lives free from the interference of political authorities, such as the state. According to David Boas (1998), “libertarianism is the view that each person has the right to live his life in any way he chooses so long as he respects the equal rights of others. Libertarians defend each person's right to life, liberty, and property—rights that people have naturally, before governments are created.”

**LIBOR.** LIBOR stands for the London Interbank Offered Rate, which is a key interest rate at which banks borrow funds from other banks in the London interbank market. It is the most widely used benchmark for short-term interest rates.

**liquidity shortage.** *Liquidity* refers to the level of ease with which assets can be either converted into cash or bought and sold in a market without adversely affecting the asset's price. A shortage of liquidity, therefore, is a situation in which assets cannot be sold at their "full" price, or a situation in which assets cannot be easily converted into cash. A liquidity shortage often leads to a liquidity crisis.

**List, Friedrich (1789–1846).** List was a German economist and leading proponent of mercantilism. His most famous work is *The National System of Political Economy*, which was originally published in 1841 (in German).

**Mao Zedong (1893–1976).** Also written as **Mao Tse-Tung**. Mao was the near-absolute leader of the People's Republic of China from the founding of the country in 1949 to his death in 1976. He governed the country as chairman of the Communist Party of China (CCP), leading China through a number of tumultuous and frequently disastrous decades.

**maquiladora.** A specific type of assembly plant that originated in Mexico; they were primarily located near the United States–Mexico border. The first maquiladora plants appeared in the 1960s. Typically, in the maquiladora (the word *maquila* in Spanish means "processing fee"), materials and parts from outside Mexico are shipped in and assembled in Mexico, and then the finished product is returned to the original market (usually in the United States). This allows U.S. and other non-Mexican firms to take advantage of lower production costs in Mexico while avoiding duties and other taxes.

**Marshall Plan (also known as the European Recovery Plan).** The Marshall Plan, which ran from April 1948 to December 1951, was a U.S. foreign aid program designed primarily to aid in European reconstruction following the end of World War II. The plan disbursed about \$13 billion—an extraordinarily large amount at the time—to 16 European countries, including Germany, but excluding European countries then under military occupation by the Soviet Union (the Soviet Union and its satellite countries were eligible to receive aid, but when the Soviet Union refused to participate, the eastern European countries under its influence also withdrew). By most accounts, the Marshall Plan was considered quite successful, as Western Europe was able to recover relatively quickly from the war; moreover, because “vanquished countries” (especially Germany) were also included, the economic problems that developed after World War I, when Germany was forced to pay massive reparations, were completely avoided.

**Marxism (Marxist, Marx).** Most generally, Marxism is the economic philosophy of Karl Marx (1818–1883). While often caricatured, more than a few basic principles of Marxism have, many argue, withstood the test of time. In particular, Marx argued that economic production (or material forces) is the foundation (the base) of any society. Thus, material forces largely dictate the shape and organization of society, not the other way around. This means that the main elements of a society—e.g., the politico-legal system, the educational system, the culture, religious institutions—are reflections of economic forces; they exist largely to maintain or help reproduce the dominant mode of economic production. In the Marxist view, too, different economic systems produce different types of class relations. In capitalism, the main division is between capitalists—those who own the means of production—and workers. Marx argued that this relationship is fundamentally exploitative, as capitalists (occupying an advantageous position in the economic system) use their control of the means of production to extract “surplus

value” from labor. There is, of course, much more to the Marxist perspective than these two basic points. Chapters 2 and 7 contain fuller discussions.

**means of production.** Most simply, the means of production are the resources, materials, tools, and facilities used by workers to make products. Examples include raw materials, land, machinery, tools, plants, and equipment. The means of production are part of the mode of production, which refers to the specific organization of economic production within a society. Capitalism is a mode of production that uses machinery, tools, and factories (for example) to produce a range of economic goods.

**Mercosur.** Mercosur, which is an acronym from the Spanish *Mercado Común del Sur*, is known as the Common Market of the South. It is an economic and political agreement among Argentina, Brazil, Paraguay, Uruguay, and Venezuela designed to promote the free movement of goods, services, and people among member states. It was established in 1991 by the TREATY OF ASUNCIÓN, and later amended by the 1994 OURO PRETO PROTOCOL. Mercosur is now a full CUSTOMS UNION.

**mergers and acquisitions (M&A).** Although grouped together, mergers and acquisitions are separate actions. A merger occurs when two firms agree to bring their operations together into a single new company. This happened, for example, when the German company Daimler-Benz merged with the American company Chrysler to become a new company, DaimlerChrysler (Daimler-Benz itself was the product of a merger that took place in 1926; as part of the merger, the new company agreed to use the brand name Mercedes Benz on all their automobiles). An acquisition occurs when one company takes over another and establishes itself as the new owner. Acquisitions can be either hostile (i.e., the target company does not wish to be acquired, but is unable to prevent the buyer from taking it over) or friendly (i.e., the target company agrees, on a

voluntary and negotiated basis, to be acquired). Facebook, in two examples of friendly acquisitions, famously acquired Instagram for \$1 billion in 2012, and WhatsApp for \$19 billion in 2014 (between 2005 and February 2014, Facebook acquired 45 companies). Yet while a merger and an acquisition are distinct actions, the end result is the same: formerly separate companies are made into a single company.

**method.** Refers to the procedures used by researchers (in the social and natural sciences) for testing an argument, a claim, or a theory. There are a wide variety of methods, including the scientific method, the comparative method, the statistical method (or quantitative analysis), and so on.

**monopsony.** A monopsony is a situation in which a single buyer controls a very large proportion of a given market. A true monopsony is rare, although situations approximating a monopsony can be found in certain labor markets. For example, a coal-mining operation might be the primary source of employment for a town, and even those workers who do not work for the coal-mining operation are dependent on the employment of coal miners.

**most-favored-nation.** Under the WTO agreements, member countries cannot normally discriminate among their trading partners. Thus, if a country decides to grant another country a special favor (such as a lower customs duty rate for one of their products), it must extend that favor to all other members of the WTO. This nondiscriminatory principle is referred to as most-favored-nation treatment.

**multilateral institution.** *Multilateral*, in this case, refers to any international institution with three or more participating states.

**NAFTA (North American Free Trade Agreement).** NAFTA is an international agreement signed by the governments of the United States, Canada, and Mexico. The agreement entered

into force on January 1, 1994. The agreement was designed to remove most barriers to trade and investment among the three countries.

**national state.** The national state and nation-state are closely related. Although subject to debate, the latter is a state whose citizens or subjects are virtually all members of a single nation, that is, a homogenous community connected by a common (ethnic) descent, culture, or language. Few modern countries, however, fit this description. A national state, by contrast, is one in which a shared identity is consciously constructed so that citizens, regardless of their ethnicity, culture, or language, perceive themselves as members of the same group. States that are multiethnic or multicultural can generally be considered national states.

**NATO (North Atlantic Treaty Organization).** NATO is a military alliance based on the North Atlantic Treaty, which was signed on April 4, 1949. The primary purpose of the organization is collective defense and the maintenance of democratic peace. There are currently 28 members, all European except for the United States and Canada. More information is available on the NATO website: <http://www.nato.int/cps/en/natolive/index.htm>.

**neoclassical economics.** The *classical* in neoclassical economics refers to foundational economic ideas first laid down by 18<sup>th</sup>-century scholars, most notably Adam Smith (1723–1790) and David Ricardo (1772–1823), and later refined by Alfred Marshall (1842–1924), Vilfredo Pareto (1848–1923), John Clark (1847–1938), and Irving Fisher (1867–1947). The classical ideas focus on the importance of competition as the primary disciplinary mechanism leading to an efficient allocation of (scarce) economic resources. In this view, competition acts as an invisible hand that effectively regulates or guides economic activity in more or less automatic fashion, so that a balance or equilibrium between supply and demand is always achieved. The

*neo* in neoclassical economics refers to further refinements that focused on incorporating mathematical techniques into the study of economics.

**neo-corporatism.** Neo-corporatism is an updated version of corporatism. The concept of corporatism was first used to describe a type of authoritarian political framework in which different interest groups (e.g., labor and business) are integrated, or incorporated, into a hierarchically ordered and state-dominated system. In this framework, the different groups are granted a representational monopoly by the state in exchange for observing certain controls (Schmitter 1979). Neo-corporatism, by contrast, posits a similar incorporation of interest groups, but does not presume state domination. Instead, neo-corporatist arrangements are polycentric, and the relations between and among groups can be based on consensus and cooperation. The best examples of neo-corporatism can be found in Scandinavia, Germany, Austria, and Switzerland.

**neoliberal economic order (also neoliberalism).** *Neoliberal economic order* refers to a particular type of capitalism wherein the market (or capital) is given clear and almost unchallenged prominence, both domestically and internationally. Generally, the neoliberal economic order is based on extreme privatization and deregulation, which allows capital the greatest “freedom”; a defunding of state and government functions (another term for defunding is *austerity*); and a concomitant dismantling of redistributive mechanisms (such as tax regimes and policies). To advocates of the free market, all of these changes represent unalloyed benefits to society at large, whereas to critics, the neoliberal order represents an almost existential danger to societies and peoples around the world.

**neo-mercantilism (neo-mercantilist).** Originally, *mercantilism* referred to the practice of defining national wealth strictly in terms of the amount of precious metals (e.g., gold or silver)

owned by a country; later versions focused on maintaining a favorable trade balance. Neo-mercantilism, however, does not focus on ownership of precious metals or a favorable trade balance per se, but on developing a country's industrial and technological capacity. This generally means protecting infant industries from foreign competition, as well as targeting strategic industries.

**network-centric warfare (NCW).** Most generally, network-centric warfare is about the effective integration of multiple and geographically dispersed sources of information (e.g., reconnaissance detection systems, communication systems, command and control systems, weapon systems, and so forth) into a coherent network than can bring battlefield advantages and increase mission effectiveness. The idea was first introduced by the U.S. Department of Defense.

**nongovernmental organization (NGO).** NGOs are nonprofit organizations that operate independently of state, intergovernmental, or corporate influence (although they often receive government and/or corporate funding). These organizations are typically associated with progressive causes, such as environmentalism, human rights, democracy, and so on. However, this need not be the case.

**normative judgment.** A normative judgment, or statement, can be contrasted with a positive, or objective, statement. Something that is objective is supposedly value-free; it is a statement of fact. Normative statements, by contrast, reflect the values, beliefs, or other subjective assessments of the speaker: they are what the speaker thinks is appropriate, good, or best. For a long time, social scientists assumed that the distinction between the two was clear-cut and easy to maintain; even more, they generally asserted that scholars should stick to objective analysis. Over the past few decades, however, a growing number of scholars—some known as postpositivists, reflectivists, or constructivists—have argued that the line between objective and

normative analysis cannot be maintained, because human beings do not have the capacity to see the world as it (objectively) is.

**OECD (Organization for Economic Cooperation and Development).** Headquartered in Paris, France, the OECD was established in 1961, with a membership of 18 European countries plus the United States and Canada. Since then, membership has expanded to 34 countries, including several non-European and non-North American countries: Chile, Japan, South Korea, and Turkey. The OECD restricts membership to democratic countries with market-based economies. The mission of the OECD, as defined by the organization itself, is to provide a “forum in which governments can work together to share experiences and seek solutions to common problems” (<http://www.oecd.org/about/>).

**offshoring.** In general, offshoring is moving employees or certain business activities to a different country or territory (i.e., offshore) in order to take advantage of lower labor costs or more favorable economic conditions, such as lower tax rates or limited regulations on business activities. The term *offshoring* is sometimes used synonymously with the term *outsourcing*, although the latter term, according to the OECD, means “acquiring services from an outside (unaffiliated) company or an offshore supplier”

(<http://stats.oecd.org/glossary/detail.asp?ID=6271>).

**opportunity costs.** When an individual or organization chooses one course of action, an alternative course of action must be given up. If an individual or organization, for example, decides to spend \$100,000 for a plot of land in Brazil, that same \$100,000 cannot be used to buy a plot of land in, say, Canada—which was the next best alternative. In economic theory, the opportunity cost is always based on the next best alternative. Thus, the opportunity cost is the value of the best foregone alternative; it is the value of a missed opportunity.

**Ouro Preto (Protocol).** The Protocol of Ouro Preto (which is a city in Brazil) was signed in 1994. The protocol established the present organizational structure of MERCOSUR, and gave Mercosur a legal personality under international law. This meant that Mercosur could negotiate agreements with countries and other international organizations.

**par value system.** In general usage, a par value is the stated or face value of a particular asset, such as a stock or bond. In reference to the foreign exchange system, par value refers to the stated value of national currencies. During the Bretton Woods negotiations, it was decided that a par value system for national currencies would be created. As Cohen (2001) explains it, this system represented a compromise between the polar alternatives of a freely floating exchange-rate system, and one based on irrevocably fixed rates. Under the par value system, “members were obligated to declare a par value (a ‘peg’) for their national money and to intervene in currency markets to limit exchange-rate fluctuations within maximum margins (a ‘band’) one per cent above or below parity; but they also retained the right, whenever necessary and in accordance with agreed procedures, to alter their par value to correct a ‘fundamental disequilibrium’ in their balance of payments. Regrettably the notion of fundamental disequilibrium, though key to the operation of the par value system, was never spelled out in any detail—a notorious omission that would eventually come back to haunt the regime in later years” (n.p.).

**pegged rate.** *Pegged rate* refers to a method of valuing a national currency. In this method, a country will attempt to fix the value of its currency to the value of another—usually hard—currency, such as the U.S. dollar. Pegging an exchange rate is typically done through a country’s central bank. The central bank (or its equivalent) will set and maintain an official exchange rate. To keep the domestic currency rate tied to the pegged currency, the bank will buy and sell its

own currency on the foreign exchange market in an effort to balance the supply and demand. In practice, this is easier said than done, particularly since many smaller countries do not have sufficiently high levels of currency reserves.

**Perot, Ross (b. 1930).** In 1992, Perot ran as an independent candidate for president of the United States. He received 18.9 percent of the popular vote. In 1996, he ran again as the Reform Party candidate (Perot founded the Reform Party in 1995). Before running for president, Perot founded Electronic Data Systems (EDS), which was responsible for a number of important innovations, including the first automatic code generator ([http://www.hp.com/retiree/eds/eds\\_history.html](http://www.hp.com/retiree/eds/eds_history.html)).

**pluralism.** The term *pluralism* has a variety of meanings in the social sciences. The usage in this book refers to the idea that a multitude of groups—not a single all-powerful entity—fluence and shape policies within a polity. In a democracy, these groups include political parties, unions, trade and industry associations, nongovernmental organizations, corporations, special interest groups (e.g., the National Rifle Association), informal coalitions of like-minded citizens, and so on. The influence of specific groups depends, in large measure, on specific policy areas.

Embedded in the notion of pluralism is a multidimensional understanding of power. Thus, it is not only the wealthy that have power, but also any group that can exercise control over resources, both tangible and intangible. Intangible sources of power include legitimacy, knowledge, celebrity, prestige, legal authority, charisma, and so on.

**Polanyi, Karl (1886–1964).** Polanyi was born in Hungary, but he eventually found his way to the United States, where he was a resident scholar at Bennington College (1940–1943) and a visiting professor at Columbia University (1947–1958). He is best known for his work, *The Great Transformation: The Political and Economic Origins of Our Time*, published in 1944. In this book, Polanyi analyzed the evolution of the market in 19<sup>th</sup>-century Europe, and argued that

truly “free” markets would inevitably lead to political and social collapse. The [entire text](#) of *The Great Transformation* is available online.

**positive-sum (game).** In contrast to a ZERO-SUM GAME, a positive-sum game is a win-win situation. Participants in a positive-sum game, in other words, can simultaneously benefit from participating in the “game” because the sum of winnings and losses is greater than zero. Liberal economists argue that international trade based on specialization and comparative advantage is a positive-sum game. This does not mean that the gains are equal, only that each party is better off than before they “played the game.”

**postindustrial.** Describes the stage in which a country’s economy is dominated by the service sector rather than the manufacturing sector. The term, popularized by the sociologist Daniel Bell, is a bit of misnomer, since a complete transition from a manufacturing economy to a service (or knowledge-intensive) economy is unlikely. The key point, however, is that a postindustrial society is characterized by a major emphasis on knowledge and ideas as the motive force of economic growth.

**PPP (purchasing power parity).** Most simply, PPP is a method for comparing income levels in different countries by adjusting exchange rates. As the OECD explains it, “Calculating PPPs is the first step in the process of converting the level of GDP and its major aggregates, expressed in national currencies, into a common currency to enable ... comparisons to be made” (<http://www.oecd.org/std/prices-ppp/purchasingpowerparities-frequentlyaskedquestionsfaqs.htm>).

**protocol.** A protocol is an international agreement that is meant to serve as the basis for a final CONVENTION, or treaty. A protocol is, in most respects, the same as an international treaty, except

that a number of countries that participate in negotiations—while signing the protocol—may fail to ratify it.

**public goods.** In economics, a public good is a good that is both nonexcludable and nonrivalrous. In simpler language, this means that once a good is created, it is available to everyone, but also that the use, or consumption, of that good by one individual does not reduce its availability to others. Examples include clean air, financial stability, and international peace. Public goods are important, but because they are nonexcludable and nonrivalrous, private actors (via the market) will generally not produce these goods.

**Putin, Vladimir (born in 1952).** Putin is a former officer in the KGB (the national security agency of the Soviet Union), who rose to prominence as a politician after the collapse of the Soviet Union. He was first elected president of Russia in 2000, and then re-elected in 2004. In 2008, his term expired and he was ineligible to run a third time. However, his protégé, Dmitry Medvedev, was elected president, and Putin was appointed as prime minister, a position that allowed him to continue exercising political power. Putin, in fact, was able to engineer a change in the Russian constitution while serving as prime minister, which allowed him to run a third time. He did so and was re-elected in 2012 for a six-year term. Putin has been widely credited with turning Russia around, both politically and economically.

**quantitative easing (QE).** Quantitative easing—which is generally orchestrated by independent central banks to prevent deflation—increases the supply of money in an economy in an effort to bring down interest rates and thereby stimulate economic activity: lower interest rates encourage more borrowing and more spending. One of the first major attempts at quantitative easing was by the Bank of Japan in the early 2000s; later in the decade, the United States also employed

quantitative easing (beginning in 2008). [Investopedia](#) has a [short video explaining quantitative easing](#).

**rationality.** In economic analysis, rationality is viewed as the basis of virtually *all* individual action. That is, individuals are assumed to be self-interested actors who seek to maximize benefits for themselves from the decisions they make. Rationality, in other words, leads individuals to make choices that they believe will make them better off. This very simple concept has been used by economists and other social scientists to build sophisticated models designed to better explain and predict what people will do given certain circumstances.

**realists, realism.** Realists, in international relations theory, are advocates of a school of thought known as realism. Realism posits that relations between and among states are governed, first and foremost, by a constant struggle for power. This struggle for power dominates because the international system is characterized by ANARCHY, since there is no central political authority for the international system as a whole. With no central authority, individual states are left to themselves to resolve conflicts and ensure their own security: the realist world is based on self-help. These same assumptions and principles underlie mercantilist and neo-mercantilist thought.

**Reciprocal Trade Agreements Act (1934).** The RTAA represented a significant change in U.S. trade policy. For the first time in U.S. history, Congress authorized the president to levy or reduce tariffs without congressional approval. The RTAA also gave the president the power to negotiate bilateral trade agreements, again without receiving prior congressional approval. The idea behind the RTAA was, it is important to note, to *reduce* tariffs by providing more negotiating flexibility. Under the RTAA, the president could negotiate directly with foreign countries to reduce their tariffs in return for reciprocal reductions by the United States. The

success of the RTAA framework led to an important element of the GATT in the postwar period—namely, the most-favored-nation (MFN) principle.

**regional trade agreements (a.k.a. preferential trade agreements, or PTAs).** According to the WTO, regional trade agreements (RTAs) are reciprocal trade agreements between two or more partners (typically countries, but they can also involve regional organizations, such as the EUROPEAN UNION, and individual countries). They include free-trade agreements and CUSTOMS UNIONS. NAFTA is an example of a regional trade agreement.

**regulatory arbitrage.** A general definition of *arbitrage* is “profiting from differences in prices (or yields) in different markets.” Arbitrageurs will typically buy a commodity, currency, security, or some other financial instrument in one place and then immediately sell it at a slightly higher price to a buyer in another place. *Regulatory arbitrage*, therefore, refers to profiting from differences in regulations (instead of price) between different regulatory markets, but in the case of IPE, *markets* generally refers to whole countries. Examples of regulatory arbitrage include companies that move operations to countries with lax environmental regulations, or with very low corporate tax rates.

**relative autonomy.** In classical Marxist theory, the state is seen as representing and acting entirely on behalf of the dominant class in society. In this view, the state has no autonomy or independence: it does what it is directed to do by the dominant capitalist class (or rather, the leaders of the state do what they are directed to do). Over time, however, this rigid view of the state changed. Today, most contemporary Marxists concede that, while the state continues to represent the interests of the dominant class most of the time, it also has the capacity to act independently of those interests. This capacity to act independently some of the time is referred to as relative autonomy.

**reschedule (debt rescheduling).** If a country cannot pay back the money it owes on its international debt, it may be rescheduled. This means restructuring the terms of the debt, which may involve extending the payment terms, delaying the payment dates, reducing the interest, and similar tactics designed to make repayment possible. Debt rescheduling should not be confused with *debt cancellation*, which refers to an agreement that the original debt (in full or in part) does not have to be repaid at all.

**reverse engineering.** Reverse engineering is a process by which a more complex device, machine, program, or product is disassembled, or otherwise deconstructed, in order to determine how it was made. The basic motive behind reverse engineering is to reproduce the finished product when the technology embedded in the original product is otherwise unavailable. In the 1970s, to cite one example, South Korea successfully built its own two-stage, solid-fuel missile by reverse engineering a U.S. Nike Hercules surface-to-air missile.

**Security Council (of the United Nations).** The Security Council is the most powerful decision-making authority within the United Nations. Under the UN Charter, the Security Council has “primary responsibility for the maintenance of international peace and security,” and (unlike the General Assembly), resolutions made by the Security Council are binding on all member states. Significantly, the Security Council has five permanent members, all of which have veto power (that is, each of the five members can override, through its single vote, any resolution of the council). The five permanent members are the United States, Great Britain, Russia, China, and France.

**securitization.** Most basically, securitization is the process of turning a financial asset that is otherwise difficult to buy or sell (an illiquid asset) into another type of financial asset that is easy to trade. The most salient example of securitization occurred in the U.S. housing industry in the

2000s. During this period, a large number of individual mortgages were bundled into one large pool. The pool was then divided into smaller pieces, which were then “sold” to investors. (Technically, securitized assets are not sold; instead, investors loan funds to the party that issues the security. The loan is secured against the underlying value of the securitized assets, and the cash flow—e.g., monthly mortgage payments—associated with those assets.)

**Silk Road.** The Silk Road is an ancient trade route, or more accurately, a network of trading routes, that connected China, other parts of Asia, the Middle East, North Africa, the Mediterranean, and Europe. It was the route followed by Marco Polo in the 13<sup>th</sup> century to reach Cathay (modern-day China).

**Singapore issues.** The term *Singapore issues* refers to four groups that were set up during the WTO Ministerial Conference in 1996 (the conference met in Singapore). Each group was assigned a specific issue on which to focus negotiations: transparency in government procurement, trade facilitation (on customs), trade and investment, and trade and competition.

**Single European Act.** The Single European Act of 1986 (SEA) was the first major revision of the Treaty of Rome (the Treaty of Rome, signed in March 1957, was the agreement that led to the founding of the European Economic Community). The main objective of the SEA was to establish a “single market” by December 31, 1992.

**Smith, Adam (1723–1790).** Smith is generally considered the father of classical economic thought. He is best known as the author of *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published in 1776. Smith challenged the principles of mercantilism, which was the dominant economic practice of his time. He argued that the free exchange of goods would lead to mutual benefit, and that society as a whole would be better off if individuals were allowed to pursue self-interested economic goals.

**Smithsonian Agreement.** A multilateral agreement involving ten countries (the G10), which led to a devaluation of the U.S. dollar in 1971 relative to other major currencies. The agreement implemented a PAR VALUE exchange-rate system (i.e., a system that allows for currency fluctuations within preset boundaries) that was no longer backed by gold (recall the so-called Nixon shock, in which President Nixon unilaterally declared an end to the GOLD-EXCHANGE STANDARD).

**Smoot-Hawley Tariff.** Also known as the United States Tariff Act of 1930, the Smoot-Hawley Tariff was named after its two chief sponsors, Senator Reed Smoot of Utah, and Representative Willis Hawley of Oregon. The act raised already-high tariff rates in the United States by as much as 50 percent; equally important, the new tariff rates applied to over 900 industrial products. The enactment of Smoot-Hawley led to a round of reprisals by other countries, which led to a significant decline in world trade: between 1929 and 1934, world trade decreased by 66 percent.

**social class(es).** In general, *social class* refers to economic stratifications in society, whereby members of certain economic groups tend to share a number of important characteristics—both objective and subjective—that distinguish them from other groups or classes. One of the most common conceptualizations of class today is based on a three-stratum model: the upper class, the middle class, and the lower class. Marx, however, talked of two main classes: the working class and the capitalist class (i.e., those who owned the means of production).

**social movement.** A social movement is a type of sustained collective action that takes place outside the confines of a specific organization. The goal of a social movement is to bring about political or social change that reflects the interests of those participating in the movement. A good recent example of a social movement is the Occupy Wall Street (OWS) movement, which

emerged in 2011 from a protest begun in Zuccotti Park in New York City. The movement quickly spread throughout the United States and to many other countries.

**sovereign state.** A *state* is typically defined as “a political entity with a permanent population, a defined territory, and a national government capable of maintaining effective control over its territory.” *Sovereignty* means that the state also exercises legitimate and unchallenged authority over its citizens and others who reside inside its borders. In general usage, there is no distinction between the terms *state* and *sovereign state*, so they can be considered interchangeable.

**sovereign wealth crisis (better known as the eurozone sovereign debt crisis).** Refers to a period of time, beginning in the late 2000s, when a number of European countries—members of the eurozone—faced the threat of financial collapse due to high government debt and related financial problems. The crisis began in 2008 with the collapse of Iceland’s banking system, and quickly spread to other countries, including Greece, Ireland, and Portugal in 2009.

**special drawing rights (SDRs).** The SDR is a special type of international reserve asset created by the IMF in 1969. SDRs were originally meant to supplement the official reserves of member countries (i.e., central bank holdings of gold and widely accepted foreign currencies, such as the U.S. dollar), because the supply of the two most important official reserves—U.S. dollars and gold—was deemed inadequate. Today, the SDR continues to serve as a supplementary reserve asset, but is also used as a unit of account for the IMF and other international organizations.

Private entities cannot hold an SDR.

**stimulus spending.** *Stimulus spending* (or *economic stimulus*) is a term used to describe an element of a government’s fiscal policy (i.e., policy that relates to a government’s expenditures, revenues, and debt) designed to increase or maintain aggregate demand within a national

economy. Government stimulus spending is meant to revive an economy that is experiencing a short-term economic decline, such as a recession.

**Structural Impediments Initiative (SII).** The SII was a negotiation between the United States and Japan designed to reduce their bilateral trade imbalance. U.S. negotiators demanded “structural changes” rather than simple tariff reductions, because it was believed that the imbalance was due, in part, to the manner in which the Japanese economy was organized. An agreement was reached in 1990 that revolved around changes in Japan’s retailing practices (e.g., its prohibitions on large retailers), land use, and investment in public works. The U.S., for its part, promised to increase domestic saving and reduce its budget deficit.

**structure.** The everyday meaning of *structure* is akin to the framework of a building or some other artifact. Structure also refers to the interrelations or arrangements of parts in a complex entity. In the social sciences, both meanings are reflected in the concept of *social structure*, which might be most easily defined as “any relatively enduring pattern of social relationships.” The existence of a social structure implies that human action (or AGENCY) is at least partly influenced by the structure within which that action takes place.

**subsidy.** A subsidy can take many forms, but the general goal is for the government to provide economic support to a particular industry, or even an individual business firm. Examples of subsidies include tax breaks, cash payments, trade barriers, and preferential loans.

**superstructure (and base).** In MARXISM, all societies can be defined in terms of their material, or economic, base (i.e., the manner in which production is organized and carried out), and their superstructure, which is a product of the base. The superstructure of a society includes political institutions, specific ideologies, religious institutions, the educational system, the legal system, and so on. In simple terms, the superstructure exists to protect and strengthen the base; however,

once created, a partly reciprocal (or mutually constitutive) relationship between the base and superstructure develops.

**surplus value.** Surplus value is a MARXIST concept that refers to the value created by workers in excess of their own labor-cost. The labor-cost is the wage paid to the worker. Thus, if a worker is paid \$1 an hour, yet is able to produce \$10 worth of goods in one hour of work, the surplus value is \$9 minus the cost of materials and other costs of production.

**tariff.** A tariff is a type of tax (referred to as a customs DUTY) usually imposed on imported goods. As a form of protectionist policy, tariffs are meant to give domestic producers a competitive advantage vis-à-vis foreign competitors.

**tariff-rate quota.** The tariff-rate quota is a product of the Uruguay Round (and specifically the Agreement on Agriculture). Under the tariff-rate quota, countries agree to provide minimum import opportunities for products previously protected by nontariff barriers.

**Thatcherism.** As the term implies, Thatcherism reflects the principles and policies espoused by Margaret Thatcher, prime minister of the United Kingdom from 1979 to 1990. There was nothing novel about Thatcher's principles; at bottom, she was an advocate of NEOLIBERALISM, believing, as she did, in the power of free markets and the importance of small government. During her time as prime minister, Thatcher put her principles into practice: she succeeded in lowering taxes across the board, but was particularly effective at lowering the higher rate from 83 percent to 40 percent. She was also successful in privatizing previously state-owned enterprises—including British Gas, British Airways, and British Telecom—and in eliminating the government's commitment to full employment. Thatcher's views and policies also led her to a strong anti-union position domestically, and to a hostile attitude towards the EUROPEAN UNION.

**Third World.** A term coined during the Cold War to differentiate three categories of countries:

(1) the first world included those that were aligned with the United States and other Western countries, (2) the second world included those that were aligned with the Soviet Union, and (3) the third world included those that were “nonaligned.” Over time, however, the term began to be used almost exclusively to refer to poor and under-industrialized countries. In this sense, “Third World” took on a pejorative meaning. It is partly for this reason that other terms have been proposed as replacements. These include the South (or the Global South), Less Developed Countries (or LDCs), developing countries, and a few others. Of these alternatives, the most common are the (Global) South and developing countries.

**Trans-Pacific Partnership (TPP).** The TPP is a major trade and investment agreement (still under negotiations in 2014) involving the United States, Canada, and ten other countries in the Asia-Pacific region: Australia, Brunei, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. The TPP has a broad mandate that extends well beyond trade; it includes rules on service-sector regulation, investment, patents and copyrights, government procurement, financial regulation, and labor and environmental standards. Trade negotiations cover both industrial and agricultural goods. The TPP, it should be noted, is an extension of the 2005 Trans-Pacific Strategic Economic Partnership Agreement (TPSEP), which originally involved Brunei, Chile, New Zealand, and Singapore.

**Transatlantic Trade and Investment Partnership (TTIP).** The TTIP is a trade agreement between the EUROPEAN UNION and the United States. (As of March 2014, the agreement was still under negotiation.) The primary goal of the TTIP is to remove still-existing trade barriers between the EU and the U.S. in a wide range of sectors, the most important of which is agriculture—a sector in which duties remain relatively high. Trade barriers include both tariffs

and nontariff barriers, such as technical regulations, standards, and approval procedures. The TTIP is also meant to give private firms a right of litigation against the laws and regulations of various states.

**transfer pricing.** A transfer price is an accounting tool that is used to value transactions between affiliated enterprises—between two divisions of the same large company, for example. Increasingly, transnational corporations use transfer pricing to minimize their overall tax liability. They do this, for example, by pricing a service as low as possible when the supplying unit is in a high-tax country. Some companies go a step further and transfer intangible property—e.g., patents, trademarks, and licenses—to offshore subsidiaries located in lower-tax countries.

**transnational actor (TNA).** A transnational actor is a nongovernmental actor whose activities cross borders, and/or who has a relationship with or connection to any actor from another country, or with an international organization. Transnational corporations are the most salient example of a type of transnational actor, but there are many others, including NGOs, many criminal and terrorist organizations, and social movements.

**transnational corporation (TNC).** Most basically, a TNC is an enterprise composed of a parent company and one or more foreign affiliates. The parent company is an enterprise that controls the assets of entities in countries other than its home country. For example, General Motors, which is based in the United States, is one of the world's largest transnational corporations. In 2011, the company held over \$500 billion in assets outside the United States, with the majority located in Europe. Chapter 6 has a more detailed discussion of TNCs.

**Treaty of Asunción.** Signed in Asunción (the capital of Paraguay) on March 26, 1991, the treaty originally established a common market among the countries of Argentina, Brazil, Paraguay, and Uruguay. The Treaty of Asunción is more commonly known as MERCOSUR.

**Treaty of Versailles.** The Treaty of Versailles ended the war between Germany and the Allies, but it was primarily written by Britain, France, and the United States. The most controversial aspect of the treaty was the terms imposed against Germany, which had little choice but to accept them. The population and territory of Germany were reduced by about 10 percent, and all of Germany's overseas colonies in China, the Pacific, and Africa were parceled out to Britain, France, Japan, and other Allies. Most importantly, Germany was required to pay reparations to the Allied countries: when the treaty was drafted, a commission assessed the losses and came up with a payment of \$33 billion—an almost impossibly large sum at the time. This particular requirement in the treaty is often pointed to as an important factor behind World War II.

**U.S. Exchange Stabilization Fund.** The Exchange Stabilization Fund, or ESF, which was created in 1934 through a provision in the Gold Reserve Act, is designed to allow the U.S. government to intervene in foreign exchange markets to influence exchange rates. The ESF is also used to finance foreign governments: in 1994, for example, President Clinton provided Mexico, during a period of economic crisis in that country, \$20 billion in currency swaps and loan guarantees from the ESF. The fund consists of three types of assets: U.S. dollars, foreign currencies, and SPECIAL DRAWING RIGHTS (SDRs).

**Washington Consensus.** Refers to a set of free market—or neoliberal—economic principles and policies supported by Western policymakers and key international financial institutions, especially the IMF and the World Bank. The Washington Consensus served as the basis for IMF conditionality, and therefore, has been the subject of significant controversy.

**welfare state.** In the United States, *welfare* has a negative connotation: in common usage, it is strictly associated with government assistance to the poor. Welfare, however, has a broader meaning, and is more properly associated with a number of concepts, including general well-being, comfort, safety, and protection; the term *welfare state* is most closely connected with these concepts. A welfare state, therefore, refers to a system in which the government plays an important role in the protection and promotion of the economic and social well-being of its citizens. This protection extends to the poor, but can include any socioeconomic segment of society. The United States is a welfare state, although this has only been the case since President Franklin D. Roosevelt's New Deal was enacted in the 1930s. Quintessential welfare states include the Nordic countries (Sweden, Norway, Denmark, and Finland), as well as all Western European countries. By and large, all industrialized democracies today have adopted the basic principles of the welfare state.

**Westphalian system.** Most simply, the Westphalian system is the modern system of sovereign states that exists today. It is so named because it originated with the Peace of Westphalia, signed in 1648. The Peace of Westphalia not only signaled the end of the Thirty Years War, but it also introduced the principle of territorial integrity and national sovereignty. Under the Peace of Westphalia, states became the primary institutional agents in world affairs.

**World Economic Forum.** Another name for the DAVOS FORUM.

**World Bank.** The World Bank, which is formally known as the International Bank for Reconstruction and Development (IBRD), is responsible for financing economic development, which means that it provides long-term funding for large-scale, usually infrastructural projects. The World Bank's first loans were extended to the war-ravaged economies of Western Europe,

although in recent decades almost all its lending has gone to developing economies and to poverty reduction.

**World Trade Organization (WTO).** The WTO is an international organization composed of 159 member states (as of March 2013), and based in Geneva, Switzerland. The organization is, according to the WTO's website, "the only international organization dealing with global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible" ([http://www.wto.org/english/thewto\\_e/whatis\\_e/inbrief\\_e/inbr00\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/inbrief_e/inbr00_e.htm)).

The WTO was formally established in 1995 as the successor to the GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT). In addition to serving as a rule-making organization, the WTO monitors trade agreements, adjudicates trade disputes between member states, and facilitates trade talks.

**world-systems theory (WST).** World-systems theory is a neo-MARXIST, structural approach most closely associated with the work of Immanuel Wallerstein. In Wallerstein's view, there have been many different world systems throughout history, of which the (present) capitalist world system is the most prominent. As a now-globalized system, capitalism has divided the world into three interconnected zones: the core, the semiperiphery, and the periphery. Each zone has a specific role or function, and the zones are hierarchically organized. The core, composed of strong states, concentrates on higher-skill, capital-intensive production; the core also appropriates much of the surplus of the whole world economy. Peripheral areas focus on low-skill, labor-intensive production and extraction of raw materials; the periphery has weak states. Semiperipheral areas are less dependent on the core than peripheral ones, and have more diversified economies and stronger states. The semiperiphery also plays an important political role: it helps to disguise the polarization inherent in the system of world capitalism.

**Yom Kippur War.** This was a relatively brief war (waged between October 6 and October 29, 1973) fought between Israel, on one side, and Egypt and Syria—with broad-based support by other Arab countries—on the other side (the war is also known as the 1973 Arab-Israeli War, the Ramadan War, and the October War). The U.S. also became involved, as it supplied Israel with arms and ammunition. Because of U.S. and Western involvement, the war also led to the imposition of an oil embargo by the Organization of Arab Petroleum Exporting Countries (not to be confused with the Organization of Petroleum Exporting Countries, or OPEC, which is the better known of the two organizations). The oil embargo resulted in significantly higher oil prices worldwide, and had serious economic repercussions throughout the world.

**zaibatsu.** A Japanese term meaning “financial clique.” More concretely, the term *zaibatsu* refers to large, family-controlled conglomerates. The *zaibatsu* were networks of hierarchically organized firms that generally consisted of a holding company on top (a holding company owns shares of other companies), a banking subsidiary (which provided financing), a trading company, and several industrial subsidiaries. Technically, the *zaibatsu* were all dissolved in the early postwar period during the American occupation; however, they were largely reconstituted in slightly different form as the *keiretsu*.

**zero-sum (game).** A situation in which one participant’s gains necessarily means an equivalent loss from another participant. Mercantilists are generally accused of seeing international trade as a zero-sum game wherein, for example, an increase in exports by China to the United States necessarily means a decrease in exports by the U.S. to China. In this scenario, trade between the two countries does not lead to an increase in total trade. Liberal economists argue that international trade is not zero-sum, but instead is POSITIVE-SUM. Another way to describe a zero-sum game is as a “win-lose” game: my win is your loss.



## Chapter Questions

### Chapter 1 Questions

1. Why are there strong disagreements among scholars studying international political economy? In other words, isn't there a single, unified theory on which all or even most scholars agree?

**Guide to Responding.** *In answering this question, there are several elements on which to focus. Consider, first, what is being studied in the international or global political economy—i.e., what or who are the primary subjects of study and why does that matter? Second, consider the concept of contingency, which suggests that outcomes in the social world can vary depending on both a host of specific factors and also on the unique interaction of factors. Third, consider the differences between a closed and an open system.*

2. One definition from a popular textbook tells us that political economy “is the study of the tension between the market, where individuals engage in self-interested activities, and the state, where those same individuals undertake collective action” (Balaam and Veseth 1996, p. 6). What are some issues with this definition?

**Guide to Responding.** *Remember that definitions play an important, but often hidden, role in determining how an issue or even a whole field is understood and ultimately studied. How definitions are constructed will have an impact on what people consider important or relevant in terms of key actors, processes, and dynamics. Definitions can also determine the type of explanations people develop.*

3. Why is the word *international* problematic when studying the world or global economy today? Why might the word *global* be a better alternative?

**Guide to Responding.** *International* has a specific and fairly narrow meaning that suggests that only certain types of actors play an important role in shaping the world economy. *Global*, on the other hand, is a more inclusive term and includes a much broader range of actors, processes, and issues. An important question to consider is whether the actors included in the meaning of international are necessarily and always more important than other actors.

4. In globalization, who wins and who loses? Explain.

**Guide to Responding.** *There is no easy answer to this question. The general point to remember, though, is that globalization is a multidimensional, highly complex, and often contradictory process—or series of processes—that affects a range of actors in different ways. Consider, for example, how economic globalization is changing relations between states and transnational corporations, or how the globalization of ideas is reshaping understandings of human and political rights, and social, economic, and environmental justice. Consider, too, the impact of developments in information technology that simultaneously make it easier to disseminate ideas across and within borders, and easier and more efficient for powerful political and economic actors to keep tabs on more and more people. Also think about the new institutions of global governance, and how these institutions exercise power and make decisions.*

5. This chapter asserts that the tendency to see states and markets as separate and antagonistic entities is mistaken. How *should* the relationship be conceptualized, and why?

**Guide to Responding.** *This is a purposely subjective question meant to underscore the tendency to take for granted the liberal understanding of state-market relations. The liberal understanding is not necessarily wrong, but in the study of IPE or GPE, a more open-ended understanding of state-market relations is called for. Understanding why requires that the notion of the state-market dichotomy be questioned. On this last point, it is very important to consider Polanyi's view of the relationships among the state, the market, and society.*

6. How does the chapter ultimately define international or global political economy? What are the advantages of the definition provided in the chapter?

**Guide to Responding.** *In contrast to the other chapter questions thus far, the answer to this question is fairly straightforward. The chapter relies primarily on a definition offered by Susan Strange, a prominent IPE scholar. The advantages of Strange's definition have to do primarily with its inclusiveness.*

7. One of Mao Zedong's famous quotes is, "Political power grows out of the barrel of a gun." In this quote, Mao was suggesting that military power is the only type of power that matters in the world. Is this really the case? How might you argue that other forms of power are equally important, especially in the contemporary period of globalization?

**Guide to Responding.** *This question does not require that you dispense entirely with the notion that coercive or military power is important; instead, it requires, first, that you consider what other sources—or dimensions—of power exist in the world. Second, it requires*

*you to consider the limits and drawbacks of coercion or force in the context of an increasingly interconnected global economy.*

8. What is structural power? Why is it important to understand structural power when analyzing the international or global political economy?

**Guide to Responding.** *To answer the first part of the question, think about how people and institutions are empowered by the positions they occupy or the roles they play in the global economy, rather than by their individual attributes. One of the examples—albeit a very basic one—used in the text is the power a teacher has in virtue of being a teacher. Think carefully about this example and why a teacher has power vis-à-vis students. To answer the second part of the question, consider the four structures of power discussed in the chapter. In addition, think carefully about the discussion of Jamie Dimond (CEO of JPMorgan Chase) and HSBC. These two examples were designed to illustrate the power of the banks in one of the four structures—namely, the financial structure. Is it possible to adequately understand and explain the global political economy if the financial structure—and other structures—are ignored?*

9. It is relatively easy to argue that corporations have power in the global economy, but what about ordinary citizens working together in grassroots organizations, unions, social movements, et cetera? Do they have power? Explain.

**Guide to Responding.** *There is no set answer to the main question. However, in thinking about a response, it is important, again, to consider the different dimensions of power. It is particularly important to think about the significance of ideational power (part of the*

*knowledge structure). How much do ideas, beliefs, and values matter? While this latter question may be difficult to answer, one way to get a better sense of the importance of ideas is to consider a counterfactual situation. For example, if the vast majority of Americans decided, in unequivocal terms, that the “free” market was no longer a viable economic system, what effects might that have? Could the loss of faith in the free market lead to a complete restructuring of the U.S. economy and the global economic system more generally?*

10. In what way is capitalism a belief system?

**Guide to Responding.** *This question is related to the preceding question. To answer, focus on the discussion of Antonio Gramsci and his ideas about cultural hegemony. It would also be useful to think about whether you agree with Gramsci’s idea. Why do you think the way you do?*

## **Chapter 2 Questions**

1. Mercantilism is the oldest of the foundational theories in IPE. For the most part, however, it has been replaced by an updated variant referred to as neo-mercantilism. In what ways are mercantilism and neo-mercantilism different?

**Guide to Responding.** *First off, it is important to note the core similarity that ties mercantilism and neo-mercantilism together—namely, the understanding that maximizing national economic development requires an interventionist state. In other words, both mercantilism and neo-mercantilism are premised on the view that states play a central role protecting the domestic economy (this point was implied in the text, but not explicitly spelled out). The differences between the older and newer versions of mercantilism, then, revolve around the question of what the state needs to do to maximize national economic development. In mercantilism, the state's role was fairly limited, but in neo-mercantilism, the state's role is much more expansive.*

2. What is wrong with the statement “Marxism is dead”?

**Guide to Responding.** *To answer this question it is important to differentiate between the real-world examples of supposed communism—e.g., the former Soviet Union, and the People’s Republic of China (PRC) prior to 1979—and what Marx originally wrote. Thus, while it is true that many Marxist scholars praised the Soviet Union and the PRC as exemplars of Marxist-Leninist principles, it is equally true that Marx himself did not believe communism could exist until a society had passed through the capitalist stage. Make sure you think carefully about this last point. In addition, it is important to consider what Marx*

*said—and what contemporary Marxists say—about the issues of exploitation, inequality, and the inherent instability of the capitalist system. How serious are these phenomena today? Are they fundamental problems?*

3. Despite some disagreements, advocates of economic liberalism agree on several fundamental tenets, or core features. What are these core features?

**Guide to Responding.** *The answer to this question is spelled out very clearly in the text. The main issue to keep in mind is the central importance that all liberals put on the free market.*

4. Why do proponents of both liberalism and neo-mercantilism point to China as a case that reflects the explanatory power of their principles?

**Guide to Responding.** *To be fair, this question cannot be fully answered based on the information available in chapter 1. However, on the surface, it should be fairly easy to see why both liberals and neo-mercantilists point to China to help support their positions. On the liberal side, the important point is that, prior to 1979, China was an economic basket case. However, something major happened in 1979 that began to turn things around for China's economy. Identifying what happened goes a long way towards explaining the liberal position. Neo-mercantilists would not disagree that 1979 represented a turning point; at the same time, they would emphasize what didn't happen in China. This last point is addressed late in the chapter—consider who or what continues to run things, including the economy, in China.*

5. In the theoretical conversation, Friedrich talks about the dog-eat-dog nature of the world, and about the importance of self-help in the international system. Why are these two things

important from the standpoint of mercantilism?

**Guide to Responding.** To answer this question, put yourself in the shoes of a political leader.

As a political leader, can you really depend on other countries (or any other entity, such as an international organization) to help you out in times of dire need? Or do you understand that other countries act only in their own interests? If you cannot depend on others, what does this mean you need to do, whether militarily or economically, to protect your country's interest?

6. What is the logic of the mercantilist criticism of free trade?

**Guide to Responding.** The mercantilist view hinges on the assumption that the international world is characterized by vast inequalities in power and wealth. This is the starting point for explaining the logic of the mercantilist criticism of free trade. So, to answer this question, you must first consider the implications of unequal power and wealth. Second, consider the following question: If free trade is the route to economic success for all countries, why is there still so much inequality in power and wealth today? With just a few exceptions, why do the same set of countries that have dominated the world for at least the past century continue to dominate the world and the world economy today? It would also be useful to consider why ostensibly neutral international institutions, especially the IMF, have expended so much effort on liberalizing as much of the world as possible. Is it because market liberalization is to the benefit of the already rich and powerful?

7. Liberals clearly do not agree with the mercantilist view on the benefits of free trade. Explain why, in the liberal view, the mercantilists are wrong about free trade.

**Guide to Responding.** Answering this question requires that you consider a number of important liberal principles and ideas. One of the most important of these is the idea of comparative advantage. In what way does comparative advantage undermine the mercantilist claim that free trade only benefits the wealthiest and most powerful countries?

Liberals also challenge the mercantilist assumption that the economic world is zero-sum. Instead, liberals argue that we live in a positive-sum world. How does the assumption that the economic world is positive-sum undermine the mercantilist view?

8. What does the term *historical materialism* mean?

**Guide to Responding.** To answer this question, begin by breaking down the term *historical materialism* into its two component parts. First, explain what Marxists mean by the term *historical*. Second, explain what Marxists mean by the term *materialism*. Third, explain how the two terms are connected to one another. Some hints: (1) *Historical* is based on the notion that there are different and distinct stages in the evolution of human society; each stage operates according to different principles and a different logic. (2) In thinking about *materialism*, do not confuse it with *materialistic*. Instead, think of *materialism* as a synonym for *economic conditions*. (3) The connection between the two terms is based on the claim that historical stages are defined by the dominant mode of economic production.

9. Using the class-based analytic focus of Marxism, how would you answer the question, “Why do states go to war?”

**Guide to Responding.** This question is only addressed in passing in the chapter; however, it provides an opportunity to assess the utility of the Marxist perspective. To answer this

*question, first think about typical explanations for war. Some people might focus on the role a particular political leader—such as Adolf Hitler—plays. Others might consider questions of national interest, as in, “Countries go to war to protect their national interest.” Class-based analysis, however, asks you to begin with the premise that wars reflect the interests of the class that dominates the economy, society, and political system of a country. Why did the U.S. invade Iraq in 2003? Was it because Iraq was threatening the U.S.? Was it because Saddam Hussein was a threat to world peace? Or was it because the war served the interests of certain class interests in the U.S.?*

10. After reading about all three traditional perspectives, which do you find most compelling?

You should be able to defend and support your response.

***Guide to Responding.*** *There is, of course, no set response to this question. It is important, however, to take some time to reflect on the strengths and weaknesses of each perspective. It is very easy to dismiss one or another of the perspectives out of hand. Many people, for example, are extremely hostile to the Marxist view (and, conversely, many people are extremely hostile to the liberal view), but it behooves you to approach each with an open mind. After all, all three perspectives have been around for a very long time, and it is likely that all three have something important to tell us.*

## Chapter 3 Questions

1. Using the principles of hegemonic stability theory, explain how and why the worldwide economic depression of the 1930s happened.

**Guide to Responding.** *In general, your response should be fairly easy to put together, although it would be useful to consider a number of counterfactual questions: What if there were a country willing and able to play a hegemonic role in the 1930s? What would the hegemon have done in the 1930s? Even more, with twenty-twenty hindsight, what international institutions and safeguards would the hegemon have created and helped to sustain prior to the 1930s? Also consider what actually did happen in the absence of a hegemonic actor.*

2. To what extent was the Bretton Woods system a product of hegemonic action?

**Guide to Responding.** *Although there is certainly room for debate, most analysts agree that the U.S. was a dominant actor in the early postwar period, and did, to a large extent, occupy a hegemonic position. Thus, to answer this question, consider carefully the actions taken by the United States to help construct the Bretton Woods system. Did the U.S. play an absolutely essential role? Did the system both reflect the interests of the United States and bring benefits in general to a range of other countries? Could the Bretton Woods system have been created in the absence of the hegemonic actor?*

3. What is *post* about post-hegemonic theories? Do post-hegemonic theories accurately describe the condition of the world economy in the 21<sup>st</sup> century? Explain.

**Guide to Responding.** On the first question, consider a generally agreed upon point:

hegemony is a transitory phenomenon. That is, any situation of hegemony is bound to erode over time. Thus, the question arises, what comes next? Answering this question means identifying what has succeeded the era of U.S. hegemony. At the same time, it is important to not simply focus on what might be the easiest response—i.e., a return to a system in which multiple states, as opposed to a single hegemonic state, now call the shots. The *post* in post-hegemonic theories has a broader implication both in terms of actors and issues. On the second question, the answer is purposely open-ended and subject to much debate. Just consider and try to answer the question, who or what governs the world economy?

4. What are some of the key international institutions in the global political economy? What happens when international institutions lack legitimacy, or are too weak to be effective? On this last question, consider how a lack of legitimacy and effectiveness may have allowed the aggressive economic nationalism in the 1930s to lead to World War II.

**Guide to Responding.** *The first question is straightforward. Consider institutions that deal directly with economic issues—such as finance and trade—and those that deal with related issues, such as the global environment. The second question calls for another open-ended answer. It is important, however, to think carefully about the roles that institutions play in the world economy today. Could these roles be fulfilled strictly by states acting independently of one another? Is broad-based international cooperation on important economic (and related) issues possible without institutions? Is international cooperation important to the health and stability of the world?*

5. What are the problems with a state-centric approach in IPE?

**Guide to Responding.** There are several parts to the answer for this question. In the first part you should focus on the role of nonstate actors or transnational actors. Who are these actors? What is their source of power? Can nonstate actors act independently of states? Can nonstate actors shape or even determine the decisions made by states? In the second part you should consider the often-unquestioned assumption that states are unitary or holistic entities. In the third part you should consider the vast differences among states themselves—some are extremely powerful and wealthy, some are just the opposite. Yet, despite these differences, the state-centric view assumes that even the weakest of states is more important than the strongest transnational actor. Is this a reasonable or even defensible assumption?

6. Who is Mohamed Bouazizi, and how do his actions in 2010 support the need for a transnational theory?

**Guide to Responding.** This was a case in which the actions of single, very poor individual, in a country isolated from the centers of global power, arguably set off one of the most important series of political events in 2010–2011, the reverberations of which are still being felt in 2014. To answer this question, then, consider how, for example, state-centric theories would not even allow for an analysis of Bouazizi's influence.

7. What are two-level games, and how can they help us better explain outcomes and decisions in the global economy?

**Guide to Responding.** Answering this question requires you, first, to distinguish between the two levels. What actors and processes constitute the first level? What actors and processes constitute the second level? (Note, too, using the terms *first* and *second* is not

meant to imply that the first level is more important than the second.) Once you have identified the characteristics of the two levels, ask yourself, how well does the concept of two-level games reflect real-world decision-making?

8. In constructivist theory, what is wrong with the conventional distinction between objectivity and subjectivity, and how does this relate to the concept of a self-fulfilling prophecy?

**Guide to Responding.** On the first part of the question, it is very important to understand the philosophical meaning of the term *subjective*. Here is one definition: “relating to or of the nature of an object as it is known in the mind as distinct from a thing in itself”

(<http://dictionary.reference.com/browse/subjective?s=t>). In the philosophical view, therefore, essentially every object we observe has an unavoidably subjective element. This may not matter much if, say, you are looking at a rock. However, if the object of study is the global economy, it might matter a great deal. Why? One answer is that the global economy is a lot more complex; as you know, too, people’s understanding of the global economy varies tremendously. The question then arises, can different understandings lead to different outcomes? This is the starting point for understanding the concept of self-fulfilling prophecy as it relates to the global economy. On this point, consider the example used in the chapter—i.e., understanding the world as Darwinian. If you think we live in a world defined by the “survival of the fittest,” and you act on that belief, do your beliefs and actions help to construct a particular type of reality?

9. How would a constructivist critique the following statement: “Capitalism is an inherently exploitative and unequal system”?

**Guide to Responding.** A basic answer is provided in the textbook, but the key point is that constructivist approaches tell us that there are always different possibilities: what we currently have is not necessarily what we must have. At the same time, constructivists also recognize that capitalism has very real, very serious consequences; they also recognize that capitalism is a deeply embedded, extremely powerful structure.

#### 10. Which is the best theory of IPE?

**Guide to Responding.** This is a trick question. The chapter makes it very clear that no single approach necessarily offers the clearest route to the truth. Still, it is important to consider the strengths and weaknesses of the various perspectives discussed in this chapter, as well as in chapter 2. Each perspective offers important, perhaps even indispensable insights, and each should be taken seriously. At the same time, each should also be subject to constant critical assessment.

## Chapter 4 Questions

1. What does it mean to say that “free trade remains as much an abstraction as an actual practice”?

**Guide to Responding.** To answer this question, just consider, first, how barriers to trade—whether in the form of tariffs or NTBs—have been reduced over time. Have they ever been completely eliminated? Second, consider what has to happen for cross-border trade to take place in a world populated by sovereign states. Is it possible for trade to take place in a manner that is completely free from any nonmarket intervention? It would also be useful to think about questions of power, and whether differentials of power among states necessarily impacts how cross-border trade is conducted.

2. How can the concept of two-level games be used to explain the persistent resistance to free trade among most countries today, including those—such as the United States—that are the staunchest advocates of free trade?

**Guide to Responding.** Remember that two-level games examine the interaction between the international and domestic levels. At the international level, the benefits of free trade, at least among the wealthiest and most productive countries, is generally well recognized. Thus, there is a strong tendency to promote more inclusive free-trade measures. But can the same be said at the domestic level? What factors push against free-trade policies within a particular country? Why are domestic-level factors (and actors) difficult to ignore?

3. Does infant-industry protection work? Does it provide a reasonable justification for protectionism?

**Guide to Responding.** This is a somewhat loaded question, as among mainstream economists there is still an intense debate over the utility of infant-industry protection. From the mercantilist view, however, the answers to both questions are crystal clear. You should be able to summarize the basic points fairly easily from the discussion in the chapter. Consider, too, real-world examples. It is also important to incorporate the views of those liberal economists who see infant-industry protection as one of the few theoretically valid exceptions to the otherwise ironclad principle of free trade. One of the most influential liberal views derives from new trade theory.

4. Why are the negative externalities from increasing cross-border trade extremely difficult to resolve?

**Guide to Responding.** This question requires you to consider the differences between the domestic and international realms. How are negative externalities—such as pollution and environmental destruction—dealt with in a country such as the United States or Japan? Can the same process that works at the domestic level work at the international level? Why? Do the vast inequalities that exist among countries contribute to the problem of resolving negative externalities? Why?

5. While many people might be uncomfortable with some of the fallout from free trade, they might also argue that it is better than any possible alternative. Thus, it's either free trade or no trade. How would a constructivist respond to this view?

**Guide to Responding.** Remember, to a constructivist, free trade is one of many possible structures. There are always other possibilities, one of which is discussed in the chapter. In

*addition, a constructivist would be quick to point out that the world, to date, has still not achieved a reality based on the (abstract) ideals of free trade. In responding to this question, it would also be useful to consider the evolution of cross-border trade from the early part of the 20<sup>th</sup> century until today.*

6. In poor countries, the price of labor is systematically undervalued. Why does this matter in a discussion of the benefits and costs of free trade?

**Guide to Responding.** *To answer this question, begin with a review of the Marxist theory of unequal exchange—an admittedly difficult theory to grasp. More simply, then, consider the question: If the price of labor in poor countries is kept artificially low, how does this prevent those countries from benefitting from cross-border trade?*

7. The chapter asserts that the successful effort to liberalize international trade in the early postwar period would not have happened “without the exercise of tremendous political will and power, and more specifically without the coordinating and stabilizing efforts of the United States.” What did the United States do? What theoretical approach best explains the role the U.S. played?

**Guide to Responding.** *The chapter covers a number of major tasks begun and pushed through by the United States. The most important starting point is the Bretton Woods system: as discussed in the chapter, the BWS is most closely associated with the creation of the international monetary or financial system, but there were also important initiatives with regard to trade. What were these initiatives and what were the most important institutional developments? As for the theoretical approach that best explains the role the U.S. played, the*

*answer should be easy enough to discern. Just keep in mind that, following the war, the U.S. emerged as an unrivaled power in the capitalist world.*

8. The WTO has been criticized by some as an instrument used primarily by powerful Western countries to impose a liberal economic order on the rest of the world. Over time, however, this criticism has lost a lot of its weight. Why?

***Guide to Responding.*** *To answer this question, consider the emergence of bargaining coalitions within the WTO, and also consider the long deadlock (only recently broken) over the Doha Round of WTO negotiations.*

9. International trade is truly international—that is, it is primarily about trade relations and negotiations between and among states, whether directly or through negotiating forums such as the WTO. What is wrong with the foregoing statement? Explain.

***Guide to Responding.*** *For this question, it is important to consider the role of transnational actors, including corporations and nongovernmental organizations. Several examples were discussed in the chapter, including the issue of trade-related aspects of intellectual property rights (referred to as TRIPS).*

10. Is the emergence of regional trade agreements (RTAs) a reflection of increasing free trade, or does it signify a challenge to free trade? Explain.

***Guide to Responding.*** *There are a number of ways to answer this question. It is important to keep in mind, though, that a regional trade agreement, even one premised on free trade among the parties involved, also means discriminatory treatment of others. That is, RTAs are*

*exclusive arrangements, and parties that are excluded are not entitled to the benefits of membership. At the same time, RTAs could reflect frustration with the slow progress of broader-based efforts to liberalize global markets. It is important to consider the various aspects of the question.*

## Chapter 5 Questions

1. What are the implications of a weaker currency for a country?

**Guide to Responding.** *This is a very simple question, but one that often causes confusion. A weaker currency sounds negative, and it often is. Still, whether a strong or weak currency has positive or negative implications for a country depends on a number of factors. It is important to consider, for example, if a country has significant exports, and whether those exports would increase if the relative price of its export goods decreased (which is the result of a weak currency). On the other hand, if a country exports very little, and needs to import certain products—say oil—a weak currency will make those imported goods relatively more expensive.*

2. Which is better, a fixed exchange-rate system or a floating exchange-rate system? Explain.

**Guide to Responding.** *This is another trick question, as there is no right or wrong answer. Each type of exchange-rate system has advantages and disadvantages—in other words, there are trade-offs if a country chooses one or the other. You should be able to describe the basic trade-offs; consider, on this point, the Mundell-Fleming model.*

3. What is wrong with the phrase, “balance-of-payments deficit (or surplus)”? Why is so much attention paid to the BoP?

**Guide to Responding.** *Balance of payments* is another term that causes confusion, in part because it is often conflated with one of its key components—namely, the current account. The *current account*, you should recall, basically refers to the balance between exports and imports over a given period of time. The current account can show a deficit or a surplus.

However, the other component of the BoP is the capital account. Thus, to understand what is wrong with the phrase, “balance-of-payments deficit (or surplus),” one has to consider the relationship between the current account and the capital account. As for the second question, the answer revolves around the question of whether it is good or bad for countries to be net debtors or creditors.

4. Two important elements of the postwar international financial order were the gold-exchange system (also known as the par value system), and the International Monetary Fund. The gold-exchange system collapsed in 1971, but the IMF has continued to play an important role in helping to stabilize the international financial system. Most everyone agrees that the IMF has fulfilled this stabilization function, but there are many critics of the IMF. What is the basis for their criticisms? Do the criticisms have merit?

*Guide to Responding. The answer to this question is fairly straightforward. Some factors to focus on are, first, the decision-making procedures within the IMF, which raise questions about whose interest the IMF serves. A second important focal point is conditionality.*

*Consider how conditionality has evolved over the years, and how it has been used in the recent past. The second part of the question is open ended, but it is important to think carefully about the validity of the criticisms. In particular, think about the criticisms as a student of international political economy—that is, with an emphasis on political factors.*

5. In the chapter, one of the sections is entitled “Why Did the Bretton Woods System Fail?” Of course, the whole system did not fail, but an important part did: the gold-exchange system.

What was the fundamental problem, and what does this problem tell us about the limits of hegemony?

**Guide to Responding.** For the first part of this question focus on the Triffin dilemma. For the second part of the question, consider not only how difficult it is to maintain a system that has a near-global scope, but also one in which the interests of key actors (i.e., other powerful states) are bound, at some point and on some issues, to diverge from the interests of the hegemon.

6. What factors and processes led to the Plaza Accord in 1985?

**Guide to Responding.** There are many factors and processes that played a role, but one of the most important, albeit very general, factors was the decline of American economic dominance. Consider how this general decline made it more and more difficult for the U.S. to maintain a current account surplus, and for the U.S. to play the role of “defender in chief” for the capitalist world (i.e., taking on primary responsibility for ensuring the security of countries allied or aligned with the U.S.). Consider how overspending in the U.S. impacted the strength of the U.S. dollar. Taken together, you should have a fairly good explanation for the Plaza Accord.

7. In the 1980s, neoliberalism became a dominant mode of thinking, not only about the economy, but also about the “proper” relationship between the market and the state. How did this happen?

**Guide to Responding.** This is not an easy question to answer, but it would be very useful to adopt a constructivist framework to explain the ascendance of neoliberal ideas and principles. Keep in mind that neoliberal ideas did not just magically appear one day, but instead were the product of human agency. More simply, the emergence of neoliberalism has to be tied to the interests and actions of specific actors. At the same time, the larger context within which these ideas took hold must be considered. Think about what neoliberalism largely replaced, and consider why this “substitution” took hold.

8. The chapter discusses the debt crisis of the 1980s, as well as the continuing problem of indebtedness among developing countries. Why has the debt crisis never been completely resolved for the developing world in general?

**Guide to Responding.** To answer this question, begin by looking at what happened in Latin America, but make sure you extend your analysis to the present time. This will clearly show that indebtedness among developing countries has gotten much worse over time (consider the statistics in table 5.5, “Net Transfer of Financial Resources to Developing Economies”). The worsening of indebtedness suggests that the problem is structural or systemic in nature.

Marxism provides a useful take from a structural perspective.

9. What parallels are there between the debt crises in the developing world and the collapse of the U.S. housing bubble?

**Guide to Responding.** This is a big question, but one useful place to start is with the ideas of Susan Strange (see the discussion of her books, Casino Capitalism and Mad Money). A key lesson is that the focus of analysis should be the system of capitalism in general, and more

*specifically, the lenders rather than the borrowers. Why do lenders lend so much money when the risks of default are relatively high?*

10. The global financial crisis of the late 2000s underscores a number of important points in the political-economy approach. What are these points?

*Guide to Responding. The main elements required to answer this question are spelled out fairly clearly in the chapter, so there is not much need to provide specific guidance here. Suffice it to say that the global financial crisis demonstrates, very clearly, that the economic and the political are inextricably tied together.*

## Chapter 6 Questions

1. What are some of the *basic*, or general, reasons for the increase in transnational production?

**Guide to Responding.** This is meant to be a basic question. The answer should highlight the economic, political, and social reasons for the expansion of transnational production.

Economically, one important factor is the drastic reduction in transport costs; the huge amount of variation in labor costs is another important economic factor. Politically, focus on efforts by governments to protect domestic jobs. Socially, consider the example of “transnational technical communities.”

2. Specific theoretical explanations—such as the “circuits of capital” approach—may do a very good job of accounting for the growth of transnational production as a general, system-level process, but they also have important limitations. Identify and discuss some of these limitations.

**Guide to Responding.** For this question, first review the discussion on the circuits of capital.

Using that approach, you should be able to explain why capitalist production tends to expand across borders or geographic spaces in general. Second, consider some of the other questions raised in the chapter: Why are certain geographic areas chosen (over others) as sites for transnational production? What motivates firms to make the decision to engage in transnational production when they do? To answer the foregoing questions, it is necessary to delve deeper into the economic and political rationales for transnational production. On the economic side, consider the “eclectic paradigm” introduced by Dunning; in particular, think about the notion of “spatial market failure.” On the political side, consider how the construction of specific types of regimes—such as the Central European Free Trade

*Agreement or NAFTA—can have a profound impact on the directional flow of FDI.*

3. Discuss how and why certain countries and regions—e.g., Central Europe, Mexico, and Thailand—became centers of automobile production.

**Guide to Responding.** *This is basically an extension of question 2, but it is nonetheless useful to think again, and perhaps more deeply, about the factors that direct FDI into certain geographic areas. A sharper focus on a particular industry, too, should help you highlight the intersection between economic and political processes, as well as the intersection between the domestic and international levels. Pay attention, for example, to regional trade agreements and to domestic-level efforts to increase FDI. Consider the political dynamics that allow for the establishment of regional trade agreements (on this point, remember the significance of two-level games). At the same time, do not forget the broader dynamics of capitalism, and how, as a system-level process, it provides a constant imperative to push transnational production forward.*

4. Consider the following statement: “Transnational production is simply another way to more effectively exploit labor.” Do you agree or disagree with this statement? Explain.

**Guide to Responding.** *There is no clear-cut answer to this question. How one answers depends to a great extent on the theoretical predisposition one holds (which raises the question: what is your theoretical predisposition?). With this in mind, it is important to consider the contrasting theoretical positions. The chapter, for the most part, provides a Marxist argument. Make sure you review this argument, and that you understand the basic points, one of which is that transnational production in the automobile sector has led to a*

*general and marked decline in overall wages for autoworkers everywhere. Thus, while it might be the case that Mexican workers, for example, are earning higher than average wages (which is still not very high) relative to other Mexican workers, U.S. autoworkers have seen a significant decline in their wages. The liberal and mercantilist arguments, while not discussed explicitly, should be easy enough to discern based on your general understanding of both perspectives.*

5. Here is another statement from the chapter to consider: “FDI is a powerful instrument for growth and development. Its relevance is enhanced today by its role as the crucial engine of growth, via global value chains, and by the critical need to increase investment flows to boost the global economy, create jobs, and promote knowledge and productivity enhancements” (González 2013, p. 10). Do you agree or disagree with this statement? Explain.

*Guide to Responding. The guidelines for this question are basically the same as those for question 4. Understanding that you likely have your own theoretical predisposition, consider this question from the standpoint of the various theoretical perspectives. Marxist scholars would focus on the uneven distribution of FDI (some countries are major recipients, while others receive very little), and on the unequal results (within a country, some parts of the population will benefit greatly, and other parts not at all). Liberals will focus on how the growth of FDI fuels economic growth in general. As for the unevenness and inequality, liberal scholars could argue that both have a positive function (consider what this positive function is). Mercantilists are concerned with the capacity of individual governments, and whether they have the power and leverage to ensure that FDI benefits their economies.*

6. How has China been able to take advantage of FDI and transnational production to build the world's second largest economy?

**Guide to Responding.** *Empirically, it is very important to emphasize that China's rapid economic ascent has likely had a great deal to do with the rapid expansion of FDI in the country, and the concomitant buildup of manufacturing tied to transnational production. The critical question is whether all this has happened within the context of a laissez-faire environment, or one that has been dominated by an interventionist state. The evidence clearly points to the latter, although it is certainly debatable how positive state intervention has been. The effectiveness of Chinese state intervention is the critical issue in answering this question.*

7. From a Marxist perspective, how might the economic rise of China be best explained? Why has China become such an attractive destination for FDI and for transnational production?

**Guide to Responding.** *For this question, it is important to adopt a system-level, or structural, perspective, which means that you must begin by considering the position China occupies within the system of global capitalism. Why is China important to the health, vitality, and expansion of global capitalism? Is any other country in a position to play the role China now plays?*

8. How has globalization changed the character of the state and the dynamics of its interactions with TNCs and other transnational actors?

**Guide to Responding.** *The main point to consider is the way in which globalization has made the struggle for control over territory and raw materials less and less relevant (which is not*

*(to say that such control is irrelevant). The globalization of finance and production, in particular, means that states have become increasingly concerned with attracting capital and firms (or TNCs). What happens when states have to compete with each other to attract capital and firms? Consider, for example, the rise of the so-called competition state.*

*Remember, though, that control over geographic space or territory (and the populations contained therein) is still an important source of power, and this means that TNCs continue to rely on states, which suggests a highly reciprocal relationship.*

9. How has the principle of state sovereignty changed in the era of globalization? More specifically, what concrete policy innovations have resulted from the erosion of Westphalian sovereignty?

**Guide to Responding.** While strongly related to the foregoing question, this question asks you to consider concrete state strategies for dealing with a more “deterritorialized” world. There are a number of strategies that can be highlighted. Consider, for example, the approach of the European Union (and consider the formation of the European Union itself). The growth and development of international regimes and organizations, such as the WTO, is also an important example.

10. Will transnational production continue to expand and deepen around the world, or has it largely reached its limits?

**Guide to Responding.** This question is not directly addressed in the chapter, but you should still be able to provide an informed response. In responding, there are several points to consider. First, beyond the simple issue of geography (i.e., whether there is space for

*expansion), consider the basic dynamics of capitalism. As a system, does capitalism necessitate continued, unremitting expansion and deepening of transnational production? Second, consider the political dynamics of transnational production. Does the process create unbearable political tensions (e.g., in state-TNC relations), or does it lead to net benefits and thereby reduce political tension? Is the unevenness of the process sustainable? Is there any viable alternative?*

## Chapter 7 Questions

1. What are the advantages and disadvantages of measuring poverty based on a single statistic, such as the \$1.25-a-day standard used by the World Bank and adopted by many poverty analysts?

**Guide to Responding.** *It is important to think carefully about this question. Consider the practical utility of using the World Bank's very simple and easy to understand statistic. Even if imperfect, is the statistic meaningful? That is, does it tell us something important about the quality of life for people who earn no more than \$1.25 a day? At the same time, think carefully about the criticisms. What does the statistic leave out? Is it an accurate measurement? Is the use of a single statistic dangerous in the sense that it encourages us to ignore deeper causes of poverty? Perhaps even worse, does it encourage us to think that if, somehow, everyone in the world can be brought above the benchmark of \$1.25 a day, poverty will have been defeated?*

2. Is absolute poverty more important than relative poverty? Explain.

**Guide to Responding.** *To answer this question, first make sure you have a clear understanding of the meaning of the terms, both of which are defined in the chapter. Second, consider the two terms in their appropriate contexts. Absolute poverty is, quite clearly, associated with the poorest countries—those countries that not only have weak economies, but also generally have ineffective or extremely corrupt states as well. Absolute poverty is an unequivocally serious problem. But consider the social and political tensions that can and do arise in conditions of relative poverty. What sort of problems might develop as result of these tensions? Is it possible for severe social tensions to lead to, for example, widespread violence*

*and political instability? Are these problems any less serious simply because people are relatively poor as opposed to absolutely poor?*

3. Is exploitation of workers a fundamental problem, as Marxists argue, or is exploitation essentially a nonissue in capitalist markets, as most liberal analysts argue?

**Guide to Responding.** *This is an open-ended question. To respond adequately, though, you need to understand the arguments on both sides. The logic of the liberal argument should be fairly easy to discern, and is encapsulated in the notion that, within a labor market, employers and workers engage in voluntary exchanges of labor for wages. Think carefully about the assumptions that underlie this view. The Marxist position is more complicated, but it is still relatively easy to understand. It relies on the assumption that the relationship between employers and workers is not primarily, or even mostly, voluntary. To see why, one has to keep in mind the structural character of capitalism. Once you have clarified the logic of both positions, consider concrete situations. On this point, though, it is important to not just look within wealthy capitalist economies, but also at poorer countries, where, after all, the large majority of workers exist.*

4. A main question in the chapter is “Why does poverty exist?” In your own words, answer this question from a liberal perspective.

**Guide to Responding.** *The answer to this question is spelled out clearly in the chapter. Make sure you focus on the two contrasting elements of the liberal position. Both elements of the liberal argument focus on the role states play in creating the conditions for poverty.*

5. Microcredit, or microfinance, has been portrayed as an important innovation in efforts to combat severe poverty. In many respects, in fact, it has been a tremendously successful program; nonetheless, there are harsh critics of microcredit. What are the main criticisms of this anti-poverty initiative? Do you agree with them?

**Guide to Responding.** *The primary criticisms, which are laid out clearly in the chapter, revolve around the tacit neoliberal logic of microcredit programs. Make sure you understand the neoliberal logic of microcredit. In addition, to properly assess the criticisms, it is important to move beyond anecdotal success stories, and ask this question: What happens when microcredit programs are dramatically scaled up within a particular community? Once you have a solid grasp of the criticisms, you'll be in a good position to evaluate critically the strength of the argument against microcredit.*

6. Using a Marxist framework, can you explain why the growth of transnational production intensifies exploitation?

**Guide to Responding.** *It would be very useful to frame this question in the context of the emergence of Bangladesh as a major source of textile production for global markets. Keep in mind, though, that the Marxist perspective focuses on dynamics of capitalism as a system. Thus, as you consider the Bangladeshi case, think about the following questions: Where does Bangladesh fit into the capitalist system? Why has it become a major transnational center for textile manufacturing? What happens if wages begin to rise in that country—and what determines when wages rise “too much”?*

7. What were the main factors behind the emergence of child slavery in Côte d'Ivoire and other West African countries? Do you think it is an anomaly or a predictable outcome of market capitalism?

**Guide to Responding.** *The chapter's discussion of child slavery in Côte d'Ivoire is framed primarily from a Marxist perspective, but for this question it would be useful to consider other theoretical explanations. Can you develop your own liberal explanation for the emergence of child slavery in the cocoa industry? Does it reflect, for example, the basic argument about failed states? Would mercantilists agree that a weak, ineffective state is the real problem? It would be useful to consider a counterfactual question: Would child slavery have emerged in Côte d'Ivoire if the government were stronger and more competent?*

8. In the mercantilist view, *global* poverty is a nonissue for individual states. What is the logic of the mercantilist position?

**Guide to Responding.** *This question calls for a straightforward answer. The main point to remember is that mercantilists believe the international system to be fundamentally and inescapably anarchic. The anarchic system compels states to behave in a thoroughly self-interested manner and to rely on themselves (i.e., self-help) to achieve their goals, whether the goal is national security or national prosperity. Use these principles to frame your response.*

9. What does it mean to say that markets are “effects of practice,” and what are the implications of that principle for the issue of global poverty?

**Guide to Responding.** *This question asks you to apply the constructivist perspective. To*

*answer the first part of the question, make sure you understand the idea that the structure of the global economy—as it is presently constituted—is a social construction. Since this concept is discussed at length in the chapter (and earlier in the book), no additional discussion is necessary here. Just remember that constructivists are not naïve: they understand the hard reality of poverty, inequality, and exploitation, and they understand that changing that hard reality is no easy task. But they also understand that the present reality is not the only possible reality. Understanding this last point provides the basis for identifying the implications of the constructivist approach to global poverty.*

10. Consider the following statement: “The global anti-poverty movement is bound to fail. People protesting against an ‘unfair’ economic system, or attempting to challenge powerful states and international institutions, are just wasting their time. Nothing substantial can ever come of their actions.” Do you agree or disagree? Explain.

***Guide to Responding.*** *To adequately address this question, you need to consider the various theoretical positions. Clearly, the approach that would offer the strongest challenge to the statement is constructivism. Marxism and mercantilism, on the other hand, would provide the strongest support. The liberal position is a bit more ambiguous, but would likely not give much credit to the global anti-poverty movement unless it were able to coalesce into a more organized institutional force. Make sure you can adequately summarize the logic of each position. Once you’ve done that, you will be in a better position to offer your own analysis. As you do so, however, also make sure you think about power in broader, structural terms.*

## Chapter 8 Questions

1. Is *global governance* simply another term for *state governance*? Explain.

**Guide to Responding.** This is a fairly simple question, but it is important to be able to differentiate between the two terms, or concepts. The key points are as follows. First, *global governance* is a more inclusive term, one that includes states but is not limited to what states do. Second, global governance is multidimensional—make sure to review the five features, or elements, of global governance discussed in the chapter. Consider how these features differ from governance exercised strictly by states.

2. Does global governance imply world government? Explain.

**Guide to Responding.** This is another straightforward, primarily definitional, question, but one that merits special attention. The idea of world government is often tied to any form of governance beyond the national level, so it is important to recognize what global governance is and what it is not.

3. Does global governance actually describe what is happening in the global economy today?

**Guide to Responding.** This is the exact same question raised in the chapter, so the answer is largely given to you. Still, it is important to think critically about the question and the examples discussed in the chapter. How important or significant are international regimes? Are international regimes the sole evidence of global governance? Can you think of any examples?

4. In what ways is the IMF an important institution of global governance?

**Guide to Responding.** *On a general level, one way to answer this question is to refer back to the five features, or elements, of global governance discussed in the chapter. To what extent does the IMF reflect, for example, polycentrism, intergovernmentalism, and mixed-actor involvement? On a more specific level, consider the various roles that IMF plays in the world economy and in national economies. Is the role of the IMF significant? Is it indispensable? What might things look like if there were no IMF?*

5. What is a key distinction, especially in terms of motivation and interests, between transnational organizations and states?

**Guide to Responding.** *This is meant to be a simple question. Keep in mind, though, that TNOs are diverse; yet, at a very basic level, one can argue that all TNOs share a basic concern with the “global good.” Focus on the concept of the global good to distinguish between TNOs and states.*

6. Generally speaking, what do TNOs do? What is their greatest attribute? To what extent do you think this attribute is important?

**Guide to Responding.** *The first two questions are strongly related, and fairly easy to answer (the answers are given directly in the chapter). The third question is, by contrast, purposely open-ended. To answer the question, it is important to reconsider basic principles in the constructivist perspective. In particular, think about the importance of shared knowledge and practice.*

7. While global governance is clearly not a panacea, some of the most compelling global problems—e.g., poverty, child slavery, and the abuse of human rights—cannot be resolved in its absence. Why?

**Guide to Responding.** *For this question, it is critical to think about the limitations of strictly state-based governance. Why do states act on certain issues and not others? What defines a state's interests? Answering these questions will provide the basis for explaining why global governance may be necessary before certain issues and problems can be addressed seriously, or addressed at all.*

8. What lessons about global governance can we derive from negotiations over the MAI (Multilateral Agreement on Investment)?

**Guide to Responding.** *It is important to consider the negotiating process from a comprehensive perspective. Who were the key actors in favor of the MAI? Were state actors the primary movers and shakers, or did they largely respond to the interests of nonstate actors? Who were the key actors opposed to the MAI? How did their actions impact the negotiating process? Also be sure to consider, again, the five features of global governance discussed in the chapter.*

9. Why does the conflict between advocates of free markets (or global neoliberalism) and advocates of managed markets persist? Why hasn't there been a resolution?

**Guide to Responding.** *The main point in answering this question is to recognize that the debate is not just over the facts; nor is it just about theoretical bragging rights. Instead, the*

*debate reflects a deeper political struggle. Identifying the basis for this political struggle, and understanding the implications of the struggle, are key to answering the question.*

10. Consider the following statement: “In the global economy, power politics is dead.” Do you agree? Explain.

**Guide to Responding.** *To answer this question, it is important to frame the issue properly. Consider, as the chapter emphasizes, the impact of globalization and the diffusion of power. Consider, too, the deepening significance of transnational (economic) issues and processes—that is, issues that unavoidably transcend, or cross, national borders. On the other hand, consider the obstacles to developing alternatives to power politics. What will it take to get the most powerful states to eschew using their power for narrowly defined national interests? Is this likely, or even possible?*