CHAPTER 1

International Political Economy

We live in a global economy. How many times have you heard or read that short sentence in the last month? If you watch the cable news networks or read the major newspapers, probably more than a couple of times. What does it mean? To paraphrase the famous British economist John Maynard Keynes, I think it means in part that, from my home in North Carolina, I can order an iPod designed by an American company, but manufactured by an East Asian company, order some polo shirts produced in Bangladesh, and buy and sell stocks in British and French companies all before I have finished my morning coffee (which, by the way, was grown in Sumatra). In part, therefore, living in a global economy means the products I regularly consume are as likely to come from a distant country as from the United States.

Living in a global economy also means that global economic forces play a large role in determining many of our career opportunities. Forty years ago, for example, people in my home state could find reasonably well-paying jobs in local textile mills. Today, most of these mills and the jobs they once provided are gone, and few young North Carolinians seek, much less find, employment in this industry. During the same period, however, high-technology firms moved to North Carolina. IBM, Lockheed, GlaxoSmithKline, and many other high-technology firms all operate within a few miles of my home. Charlotte, the state's largest city, has emerged as one of the country's largest financial centers, home to one of the nation's largest banks, Bank of America. High-technology companies and financial institutions today provide thousands of jobs for North Carolinians. Thus, the opportunities available to the typical North Carolinian are far different today than they were only 30 years ago. I'm sure that the state you live in has seen similar changes. The global economy has played a central role in bringing about these changes, shaped by global, rather than national (much less local), economic forces.

International political economy (IPE) studies how politics shape developments in the global economy and how the global economy shapes politics. It focuses most heavily on the enduring political battle between the winners and losers from global economic exchange. Although all societies benefit from participation in the global economy, these gains are not

distributed evenly among individuals. Global economic exchange raises the income of some people and lowers the income of others. The distributive consequences of global economic exchange generate political competition in national and international arenas. The winners seek deeper links with the global economy in order to extend and consolidate their gains, whereas the losers try to erect barriers between the global and national economies in order to minimize or even reverse their losses. International political economy studies how the enduring political battle between the winners and losers from global economic exchange shapes the evolution of the global economy.

This chapter introduces IPE as a field of study. It begins by providing a broad overview of the substantive issues that IPE examines and the kinds of questions scholars ask when studying these issues. The chapter then briefly surveys a few of the theoretical frameworks that scholars have developed in order to answer the questions they pose. The chapter concludes by looking at the emergence of a global economy in the late nineteenth century in order to provide a broader context for our subsequent focus on the contemporary global economy.

WHAT IS INTERNATIONAL POLITICAL ECONOMY?

International political economy studies the political battle between the winners and losers of global economic exchange. Consider, for example, the decision by the Bush administration to raise tariffs on imported steel in the spring of 2002. The decision to raise the steel tariff was prompted by lobbying by the owners of American steel firms and the United Steel Workers of America. The steel industry lobbied for higher tariffs because they were losing from trade. Imported steel was capturing a large share of the American market, resulting in a large number of plant closings and layoffs. Thirty-four American steel mills filed for bankruptcy between 1997 and 2002, forcing about 18,000 workers from their jobs. Steel producers and steel workers recognized that higher tariffs would protect them from this competition, thereby reducing the number of American steel mills in distress and slowing the rate at which steel workers were losing their jobs.

The higher steel tariff had negative consequences for other groups in society, however. The tariff hurt American industries that use steel to produce goods, such as auto manufacturers, because these firms had to pay more for steel. The tariff also harmed foreign steel producers, who could sell less steel in the American market than before the tariff was raised. Groups that suffered from the tariff turned to the political system to try to reverse the Bush administration's decision. In the United States, the Consuming Industries Trade Action Coalition (or CITAC), a business association that represents firms that use steel (and other imported inputs) to produce other goods, pressured the Bush administration and Congress to lower the steel tariff. Foreign steel producers lobbied their governments to pressure the United States to reverse the decision. In response, the European Union and Japan threatened to retaliate by raising tariffs on goods that the United States exports to their markets and initiated an investigation within the World Trade Organization (WTO)—the

international organization with responsibility for such disputes. The story of the steel tariff thus nicely illustrates the central focus of international political economy as a field of study: how the political battle between the winners and losers of global economic exchange shapes the economic policies that governments adopt.

The steel tariff also highlights the many distinct elements that international political economy must incorporate to make sense of the global economy. To fully understand the steel tariff, we need to know something about the economic interests of the businesses and workers who produce and consume steel. Understanding these interests requires us to know economic theory. Moreover, we need to know something about how political processes in the United States transform these economic interests into trade policy. This requires knowledge of the American political system and the American trade policy process. In addition, we need to know something about how a policy decision made by the United States affects businesses and workers based in other countries (more economic theory for this), and we need to know how the governments in those countries are likely to respond to these consequences (which requires knowledge about the political systems in the various countries). Finally, we need to know something about the role that international economic organizations like the WTO play in regulating the foreign economic policies that governments adopt. Thus, understanding developments in the global economy requires us to draw on economic theory, explore domestic politics, examine the dynamics of political interactions between governments, and familiarize ourselves with international economic organizations. Even though such an undertaking may seem daunting, this book introduces you to each of these elements and teaches you how to use them to deepen your understanding of the global economy.

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

The international trade system is centered upon the WTO, to which some 153 countries belong and through which they have created a nondiscriminatory international trade system. In the international trade system, each country gains access to all other WTO members' markets on equal terms. In addition, the WTO and its predecessor, the General Agreements on Tariffs and Trade (GATT), have enabled governments to progressively eliminate tariffs and other barriers to the cross-border flow of goods and services. As these barriers have been dismantled, world trade has grown steadily. Today, goods and services worth about $7.6 trillion flow across national borders each year. During the last 10 years, however, regional trading arrangements have arisen to pose a potential challenge to the WTO–centered trade system. These regional trade arrangements, such as the North American Free Trade Agreement (NAFTA), are trading blocs composed of small number of countries who offer each other preferential access to their markets. Scholars who study the international trade system investigate how the political battle between the winners and losers of global economic exchange shapes the creation, operation, and consequences of the WTO–centered system and the emerging regional trading frameworks.

The international monetary system enables people living in different countries to conduct economic transactions with each other. People living in the United States who want to buy goods produced in Japan must be able to price these Japanese goods in dollars. In addition, Americans earn dollars, but Japanese spend yen, so somehow dollars must be converted into yen for such purchases to occur. The international monetary system facilitates international exchange by performing these functions. When it performs these functions well, international economic exchange flourishes. When it doesn't, the global economy can slow or even collapse. Scholars who study the international monetary system focus on how political battles between the winners and losers of global economic exchange shape the creation, operation, and consequences of this system.

Multinational corporations occupy a prominent and often controversial role in the global economy. A multinational corporation is a firm that controls production facilities in at least two countries. The largest of these firms are familiar names such as Ford Motor Company, General Electric, and General Motors. The United Nations estimates that there are more than 82,000 MNCs operating in the contemporary global economy. These firms collectively control about 810,000 production plants and employ about 77 million people across the globe. Together, they account for about one-quarter of the world's economic production and about one-third of the world's trade. MNCs shape politics because they extend managerial control across national borders. Corporate managers based in the United States, for example, make decisions that affect economic conditions in Mexico and other Latin American countries, in Western Europe, and in Asia. Scholars who study MNCs focus on a variety of economic issues, such as why these large firms exist and what economic impact they have on the countries that host their operations. Scholars also study how the political battle between the winners and losers of MNC activity shapes government efforts to attract and regulate MNC activities.

Finally, a large body of literature studies economic development. Throughout the postwar period, developing country governments have adopted explicit development strategies that they believed would raise incomes by promoting industrialization. The success of these strategies has varied. Some countries, such as the Newly Industrializing Countries (NICs) of East Asia (Taiwan, South Korea, Singapore, and Hong Kong) have been so successful in promoting industrialization and raising per capita incomes that they no longer can be considered developing countries. Other countries, particularly in sub-Saharan Africa and in parts of Latin America, have been less successful. Governments in these countries adopted different development strategies than the NICs throughout much of the postwar period and realized much smaller increases in per capita incomes. Students of the politics of economic development focus on the specific strategies that developing countries' governments adopt and attempt to explain why different governments adopt different strategies. In addition, these students are concerned about which development strategies have been relatively more successful than others (and why) and about whether participation in the international economy facilitates or frustrates development. In trying to make sense of these aspects of development, IPE scholars emphasize how the political battle generated by the distributive consequences of the global economy shapes the development strategies that governments adopt.

Those who study the global economy through the lens of IPE are typically interested in doing more than simply describing government policies and contemporary developments in these four issue areas. Most scholars aspire to make more general statements about how politics shape the policies that governments adopt in each of these issue areas. Moreover, most scholars want to draw more general conclusions about the consequences of these policies. As a result, two abstract and considerably broader questions typically shape IPE scholarship. First, how exactly does politics shape the decisions that societies make about how to use the resources that are available to them? Second, what are the consequences of these decisions? Because these two overarching questions are central to what we cover in this book, it is worth taking a closer look at each of them now.

How does politics shape societal decisions about how to allocate available resources? For example, how does a society decide whether to use available labor and capital to produce semiconductors or clothing? Although this question might appear quite remote from the issue areas just discussed, the connections are actually quite close. The foreign economic policies that a government adopts—its trade policies, its exchange rate policies, and its policies toward MNCs—affect how that society's resources are used. A decision to raise tariffs, for example, will encourage business owners to invest and workers to seek employment in the industry that is protected by the tariff. A decision to lower tariffs will encourage business owners and workers currently employed in the newly liberalized industry to seek employment in other industries. Decisions about tariffs, therefore, affect how society's resources are used. Foreign economic policies are, in turn, a product of politics, the process through which societies make collective decisions. Thus, the study

of international political economy is in many respects the study of how the political battle between the winners and losers of global economic exchange shapes the decisions that societies make about how to allocate the resources they have available to them.

These decisions are complicated by two considerations. On the one hand, all resources are finite. As a result, choices about how to allocate resources will always be made against a backdrop of scarcity. Any choice in favor of one use therefore necessarily implies a choice to forgo another possible use. On the other hand, in every society, groups will disagree about how available resources should be used. Some groups will want to use the available resources to produce cars and semiconductors, for example, whereas others will prefer to use these resources to produce clothing and agricultural products. Societies consequently will always confront competing demands for finite resources. One of the important goals of IPE as a field of study is to investigate how such competing demands are aggregated, reconciled, and transformed into foreign economic policies.

The second abstract question asks what are the *consequences* of the choices that societies make about resource allocation? These decisions have two very different consequences. Decisions about resource allocation have **welfare consequences**—that is, they determine the level of societal well-being. Some choices will maximize social welfare—that is, they will make society as a whole as well-off as possible given existing resources. Other choices will cause social welfare to fall below its potential, in which case different choices about how to use resources would make society better off. Decisions about resource allocation also have **distributional consequences**—that is, they influence how income is distributed between groups within countries and between nations in the international system.

Welfare and distributional consequences are both evident in the American steel tariff. Because the tariff makes it more profitable to produce steel in the United States than it would be otherwise, some investment capital and workers, who might otherwise be employed in highly efficient American industries such as information technology or biotechnology, will be used in the less efficient American steel industry. The tariff thus causes the United States to use too many of its resources in economic activities that it does less well and too few resources in activities that it does better. As a consequence, the United States is poorer with a high tariff on steel than it would be without it.

The steel tariff also redistributes income. Because the tariff raises the price of steel in the United States, it redistributes income from the consumers of steel, such as American firms that use steel in the products they manufacture and the American consumers who purchase goods made out of steel, to the steel producers. In addition, because the tariff makes it more difficult for foreign steel firms to sell in the American market, it redistributes income from foreign steel producers to American steel producers. The steel tariff, like many economic policies, affects both the level and the distribution of income within a society.

These two abstract questions give rise to two very different research traditions within IPE. One tradition focuses on explanation, and the second focuses on evaluation. **Explanatory studies**, which relate most closely to our first

abstract question, are oriented toward explaining the foreign economic policy choices that governments make. Such studies most often attempt to answer "why" questions. For example, why does one government choose to lower tariffs and open its economy to trade, whereas another government continues to protect the domestic market from imports? Why did governments create the WTO? Why do some governments maintain fixed exchange rates whereas others allow their currencies to float? Why do some governments allow MNCs to operate in their economies with few restrictions, whereas other governments attempt to regulate MNC activity? Each of these questions asks us to explain a specific economic policy choice made by a government or to explain a pattern of choices within a group of governments. In answering such questions, we are most concerned with explaining the policy choices that governments make and pay less attention to the welfare consequences of these policy choices.

Evaluative studies, which are related most closely to our second abstract question, are oriented toward assessing policy outcomes, making judgments about them, and proposing alternatives when the judgment made about a particular policy is a negative one. A **welfare evaluation** is interested primarily in whether a particular policy choice raises or lowers social welfare. For example, does a decision to liberalize trade raise or lower national economic welfare? Does a decision to turn to the International Monetary Fund (IMF) and accept a package of economic reforms promote or retard economic growth? More broadly, do current policies encourage society to use available resources in ways that maximize economic welfare, or would alternative policies that encouraged a different allocation result in higher economic welfare? Because such evaluations are concerned with the economic welfare consequences of policy outcomes, they are typically based on economic criteria and rely heavily upon economic theories.

Scholars also sometimes evaluate outcomes in terms that extend beyond narrow considerations of economic welfare. In some instances, scholars evaluate outcomes in terms of their distributional consequences. For example, many nongovernmental organizations are highly critical of international trade because they believe that workers lose and business gains from trade liberalization. Implicit in this criticism is an evaluation of how global trade distributes income across groups within countries. Evaluations may also extend the frame of reference within which outcomes are evaluated beyond purely economic efficiency. For example, even those who agree that international trade raises world economic welfare might remain critical of globalization because they believe that it degrades the environment, disrupts traditional methods of production, or has other negative social consequences that outweigh the economic gains. Explanation and evaluation both play an important role in international political economy. This book, however, focuses primarily upon explanation and, secondarily, upon evaluating the welfare consequences of government policies.

STUDYING INTERNATIONAL POLITICAL ECONOMY

Scholars working within the field of IPE have developed a large number of theories to answer the two questions posed earlier. Three traditional schools of political economy—the mercantilist school, the liberal school, and the

Marxist school—have shaped the development of these theories over the last 100 years. Each of these three traditional schools offers distinctive answers to the two questions, and these differences have structured much of the scholarly and public debate about IPE.

Although the three traditional schools remain influential, more and more often students of IPE are developing theories to answer our two questions from outside the explicit confines of these traditional schools. One prominent approach, and the approach that is developed throughout this book, suggests that the foreign economic policies that governments adopt emerge from the interaction between societal actors' interests and political institutions. We begin our examination of how people study IPE with a broad overview of these alternative approaches. We look first at the three traditional schools, highlighting the answers they provide to our two questions and pointing to some of the weaknesses of these schools that have led students to move away from them. We then examine the logic of an approach based on interests and institutions in order to provide the background necessary for the more detailed theories that we develop throughout the book.

Traditional Schools of International Political Economy

Historically, theories of IPE have been developed in three broad schools of thought: mercantilism (or nationalism), liberalism, and Marxism. **Mercantilism** is rooted in seventeenth- and eighteenth-century theories about the relationship between economic activity and state power. The mercantilist literature is large and varied, yet mercantilists generally do adhere to three central propositions. (See, e.g., Viner 1960; Heckscher 1935.) First, the classical mercantilists argued that national power and wealth are tightly connected. National power in the international state system is derived in large part from wealth. Wealth, in turn, is required to accumulate power. Second, the classical mercantilists argued that trade provided one way for countries to acquire wealth from abroad. Wealth could be acquired through trade, however, only if the country ran a positive balance of trade, that is, if the country sold more goods to foreigners than it purchased from foreigners. Third, the classical mercantilists argued that some types of economic activity are more valuable than others. In particular, mercantilists argued that manufacturing activities should be promoted, whereas agriculture and other nonmanufacturing activities should be discouraged.

"Modern" mercantilism applies these three propositions to contemporary international economic policy:

1. Economic strength is a critical component of national power.
2. Trade is to be valued for exports, but governments should discourage imports whenever possible.
3. Some forms of economic activity are more valuable than others.

Manufacturing is preferred to the production of agricultural and other primary commodities, and high-technology manufacturing industries such as

computers and telecommunications are preferable to mature manufacturing industries such as steel or textiles and apparel.

The emphasis on wealth as a critical component of national power, the insistence on maintaining a positive balance of trade, and the conviction that some types of economic activity are more valuable than others leads mercantilists to argue that the state should play a large role in determining how society's resources are allocated. Economic activity is too important to allow decisions about resource allocation to be made through an uncoordinated process such as the market. Uncoordinated decisions can result in an "inappropriate" economic structure. Industries and technologies that may be desirable from the perspective of national power might be neglected, whereas industries that do little to strengthen the nation in the international state system may flourish. In addition, the country could develop an unfavorable balance of trade and become dependent on foreign countries for critical technologies. The only way to ensure that society's resources are used appropriately is to have the state play a large role in the economy. Economic policy can be used to channel resources to those economic activities that promote and protect the national interest and away from those that fail to do so.

Liberalism, the second traditional school, emerged in Britain during the eighteenth century to challenge the dominance of mercantilism in government circles. Adam Smith and other liberal writers, such as David Ricardo (who first stated the modern concept of comparative advantage), were scholars who were attempting to alter government economic policy. The theory they developed to do so, liberalism, challenged all three central propositions of mercantilism. First, liberalism attempted to draw a strong line between politics and economics. In doing so, liberalism argued that the purpose of economic activity was to enrich individuals, not to enhance the state's power. Second, liberalism argued that countries do not enrich themselves by running trade surpluses. Instead, countries gain from trade regardless of whether the balance of trade is positive or negative. Finally, countries are not necessarily made wealthier by producing manufactured goods rather than primary commodities. Instead, liberalism argued, countries are made wealthier by making products that they can produce at a relatively low cost at home and trading them for goods that can be produced at home only at a relatively high cost. Thus, according to liberalism, governments should make little effort to influence the country's trade balance or to shape the types of goods the country produces. Government efforts to allocate resources will only reduce national welfare.

In addition to arguing against substantial state intervention as advocated by the mercantilists, liberalism argued in favor of a market-based system of resource allocation. Giving priority to the welfare of individuals, liberalism argues that social welfare will be highest when people are free to make their own decisions about how to use the resources they possess. Thus, rather than accepting the mercantilist argument that the state should guide the allocation of resources, liberals argue that resources should be allocated through voluntary market-based transactions between individuals. Such an exchange is mutually beneficial—as long as it is voluntary, both parties to any transaction will

benefit. Moreover, in a perfectly functioning market, individuals will continue to buy and sell resources until the resulting allocation offers no further opportunities for mutually beneficial exchange. The state plays an important, though limited, role in this process. The state must establish clear rights concerning ownership of property and resources. The judicial system must enforce these rights and the contracts that transfer ownership from one individual to another. Most liberals also recognize that governments can, and should, resolve **market failures**, which are instances in which voluntary market-based transactions between individuals fail to allocate resources to socially desirable activities.

Marxism, the third traditional school, originated in the work of Karl Marx as a critique of capitalism. It is impossible to characterize briefly the huge literature that has expanded on or been influenced by Marx's ideas. According to Marx, capitalism is characterized by two central conditions: the private ownership of the means of production (or capital) and wage labor. Marx argued that the value of manufactured goods was determined by the amount of labor used to produce them. However, capitalists did not pay labor the full amount of the value they imparted to the goods they produced. Instead, the capitalists who owned the factories paid workers only a subsistence wage and retained the rest as profits with which to finance additional investment. Marx predicted that the dynamics of capitalism would lead eventually to a revolution that would do away with private property and with the capitalist system that private property supported.

Three dynamics would interact to drive this revolution. First, Marx argued that there is a natural tendency toward the concentration of capital. Economic competition would force capitalists to increase their efficiency and increase their capital stock. As a consequence, capital would become increasingly concentrated in the hands of a small, wealthy elite. Second, Marx argued that capitalism is associated with a falling rate of profit. Investment leads to a growing abundance of productive capital, which in turn reduces the return to capital. As profits shrink, capitalists are forced to further reduce wages, worsening the plight of the already impoverished masses. Finally, capitalism is plagued by an imbalance between the ability to produce goods and the ability to purchase goods. Large capital investments continually augment the economy's ability to produce goods, whereas falling wages continually reduce the ability of consumers to purchase the goods being produced. As the three dynamics interact over time, society becomes increasingly characterized by growing inequality between a small wealthy capitalist elite and a growing number of impoverished workers. These social conditions eventually cause workers (the proletariat, in Marxist terminology) to rise up, overthrow the capitalist system, and replace it with socialism.

In contrast to liberalism's emphasis on the market as the principal mechanism of resource allocation, Marxists argue that capitalists make decisions about how society's resources are used. Moreover, because capitalist systems promote the concentration of capital, investment decisions are not typically driven by market-based competition, at least not in the classical liberal sense of this term. Instead, decisions about what to produce are made by the few firms that control the necessary investment capital. The state plays no autonomous

role in the capitalist system. Instead, Marxists argue that the state operates as an agent of the capitalist class. The state enacts policies that reinforce capitalism and therefore the capitalists' control of resource allocation. Thus, in contrast to the mercantilists who focus on the state and the liberals who focus on the market, Marxists focus on large corporations as the key actor determining how resources are used.

In the international economy, the concentration of capital and capitalists' control of the state are transformed into the systematic exploitation of the developing world by the large capitalist nations. In some instances, this exploitation takes the form of explicit colonial structures, as it did prior to World War II. In other instances, especially since World War II, exploitation is achieved through less intrusive structures of dominance and control. In all instances, however, exploitation is carried out by large firms based in the capitalist countries that operate, in part, in the developing world. This systematic exploitation of the poor by the rich implies that the global economy does not provide benefits to all countries; all gains accrue to the capitalist countries at the top of the international hierarchy.

The three traditional schools of political economy thus offer three distinctive answers to our question of how politics shapes the allocation of society's resources. Mercantilists argue that the state guides resource allocation in line with objectives shaped by the quest for national power. Liberals argue that politics ought to play little role in the process, extolling instead the role of market-based transactions among autonomous individuals. Marxists argue that the most important decisions are made by large capitalist enterprises supported by a political system controlled by the capitalist class.

Each traditional school also offers a distinctive framework to evaluate the consequences of resource allocation. Mercantilists focus on the consequences of resource allocation for national power. The central question a mercantilist will ask is "Is there some alternative allocation of resources that would enhance the nation's power in the international system?" Liberals rely heavily upon economic theory to focus principally upon the welfare consequences of resource allocation. The central question a liberal will ask is "Is there some alternative allocation of resources that would enable the society to improve its standard of living?" Marxists rely heavily upon theories of class conflict to focus on the distributional consequences of resource allocation. The central question a Marxist will ask is "Is there an alternative political and economic system that will promote a more equitable distribution of income?" Thus, liberalism emphasizes the welfare consequences of resource allocation, whereas mercantilism and Marxism each emphasize a different aspect of the distributional consequences of these decisions.

These very different allocation mechanisms and unique evaluative frameworks generate three very different images of the central dynamic of IPE. (See Table 1.1.) Mercantilists argue that the IPE is characterized by distributional conflict when governments compete to attract and maintain desired industries. Liberals argue that international economic interactions are essentially harmonious. Because all countries benefit from international trade, power has little

TABLE 1.1

Three Traditional Schools of International Political Economy

	Mercantilism	Liberalism	Marxism
Most Important Actor	The State	Individuals	Classes, particularly the capitalist class
Role of the State	Intervene in the economy to allocate resources	Establish and enforce property rights to facilitate market-based exchange	Instrument of the capitalist class uses state power to sustain capitalist system
Image of the International Economic System	*Conflictual*: Countries compete for desirable industries and engage in trade conflicts as a result of this competition	*Harmonious*: The international economy offers benefits to all countries. The challenge is to create a political framework that enables countries to realize these benefits.	*Exploitative*: Capitalists exploit labor within countries; rich countries exploit poor countries in the international economy
Proper Objective of Economic Policy	Enhance power of the nation-state in international state system	Enhance aggregate social welfare	Promote an equitable distribution of wealth and income

impact on national welfare, and international economic conflicts are rare. The central problem, from a liberal perspective, is creating the international institutional framework that will enable governments to enter into agreements through which they can create an international system of free trade. Marxists argue that the international political economy is characterized by the distributional conflict between labor and capital within countries and by the distributional conflict between the advanced industrialized countries and developing countries within the international arena.

These three traditional schools have structured studies of and debate about the international political economy for a very long time. And although the presence of all three will be felt in many ways throughout the pages of this book, we will spend little more time examining them directly. In their place, we will emphasize an analytical framework developed during the last 15 years or so, which focuses on how the interaction between societal interests and political institutions determines the foreign economic policies that governments adopt.

Interests and Institutions in International Political Economy

To explain the policy choices made by governments, this book concentrates on the interaction between societal interests and political institutions. Such an approach suggests that to understand the foreign economic policy choices that governments make, we need to understand two aspects of politics. First, we need to understand where the interests, or economic policy preferences, of groups in society come from. Second, we need to examine how political institutions aggregate, reconcile, and ultimately transform competing interests into foreign economic policies and a particular international economic system.

Interests are the goals or policy objectives that the central actors in the political system and in the economy—individuals, firms, labor unions, other interest groups, and governments—want to use foreign economic policy to achieve. In focusing on interests, we will assume that individuals and the interest groups that represent them prefer foreign economic policies that raise their incomes to policies that reduce their incomes. Thus, whenever a group confronts a choice between one policy that raises its income and another that lowers its income, it will always prefer the policy that raises its income. We focus on two mechanisms to explain the formation of these policy interests.

First, people have **material interests** that arise from their position in the global economy. The essence of this approach can be summarized in a simple statement: Tell me what you do for work, and I'll tell you what your foreign economic policy preferences are. Consider once again the American steel tariff. Whether a particular individual supports or opposes this tariff depends on where he or she works. If you are an American steelworker, you favor the tariff because it reduces the likelihood that you will lose your job. If you own an American steel mill, you also will favor the tariff, because it helps ensure a market and a relatively high price for the steel you produce. If you are an American autoworker or you own a substantial share of General Motors (GM), however, you will oppose the steel tariff. Higher steel prices mean that it costs more to produce cars. As cars become more expensive, fewer are sold and, consequently, fewer are produced. The tariff thus increases the chances that autoworkers will be laid off and it causes GM to earn smaller profits. These are compelling reasons for autoworkers and their employers to oppose the higher steel tariff. In short, one's position in the economy powerfully shapes one's preferences regarding foreign economic policy. As we shall see, economic theory enables us to make some powerful statements about the foreign economic policy preferences of different groups in the economy.

Second, interests are often based on ideas. **Ideas** are mental models that provide a coherent set of beliefs about cause-and-effect relationships. In the context of economic policy, these mental models typically focus on the relationship between government policies and economic outcomes. Not surprisingly, therefore, economic theory is a very important source of ideas that influence how actors perceive and formulate their interests. By providing clear statements about cause-and-effect economic relationships, economic theories can create an interest in a particular economic policy. The theory of comparative advantage, for example, claims that reducing tariffs raises aggregate social

welfare. A government that believes this theory might be inclined to lower tariffs to realize these welfare gains. Alternatively, a government might adopt high tariffs because a different economic theory (the infant industry argument, for example) suggests that under the right conditions, tariffs can raise national income. What matters, therefore, is not whether a particular idea is true or not, but whether people in power, or people with influence over people with power, believe the idea to be true. Thus, ideas about how the economy operates can be a source of the preferences that groups have for particular economic policies.

Understanding where interests come from will enable us to specify with some precision the competing demands that politicians confront when making foreign economic policy decisions. It does not tell us anything about how these competing interests are transformed into foreign economic policies. To understand how interests are transformed into policies, we need to examine political institutions. **Political institutions** establish the rules governing the political process. By establishing rules, they enable groups within countries, and groups of countries in the international state system, to reach and enforce collective decisions.

Political institutions determine which groups are empowered to make choices and establish the rules these "choosers" will use when doing so. In domestic political systems, for example, democratic institutions promote mass participation in collective choices, whereas authoritarian systems restrict participation to a narrow set of individuals. In international economic affairs, governments from the advanced industrialized countries often make decisions with little participation by developing countries.

Political institutions also provide the rules that these groups use to make decisions. In democratic systems, the usual choice rule is majority rule, and policies are supposed to reflect the preferences of a majority of voters or legislators. In international economic organizations, the choice rule is often relative bargaining power, and decisions typically reflect the preferences of the more powerful nations. Political institutions thus allow groups to make collective decisions and, in doing so, determine who gets to make these decisions and how they are to be made.

Political institutions also help enforce these collective decisions. In many instances, individuals, groups, and governments have little incentive to comply with the decisions that are produced by the political process. This is particularly the case for those groups whose preferences diverge from those embodied in the collective choice. And even in cases where a group or a country as a whole does benefit from a particular decision, it may believe it could do even better if it cheated a little bit. If such instances of noncompliance are widespread, then the political process is substantially weakened.

This problem is particularly acute in the international state system. In domestic political systems, the police and the judicial system are charged with enforcing individual compliance with collective decisions. The international system has neither a police force nor a judicial system through which to enforce compliance, however. Consequently, it can be very tempting for governments to attempt to "cheat" on the international economic agreements they conclude with other governments. International institutions like the WTO and the IMF can help governments enforce the international agreements that they conclude.

A focus on interests and institutions will allow us to develop a set of reasonably comprehensive answers to our first question: How does politics shape societal decisions about how to allocate resources? The explanations we construct almost always will begin by investigating the source of competing societal demands for income and then explore how political institutions aggregate, reconcile, and ultimately transform these competing demands into foreign economic policies and a particular international economic system. This approach may not always provide a full explanation of the interactions we observe in the international political economy, but it does provide a solid point of departure.

THE GLOBAL ECONOMY IN HISTORICAL CONTEXT

Although we will focus on how the interaction between interests and institutions shapes government behavior in the post–World War II global economy, the contemporary global economy embodies a deeper historical continuity. Even though the contemporary global economy is distinctive in many ways, this system continues a trend toward deeper international economic integration that began in the nineteenth century. Because the contemporary system has deep roots in the nineteenth century, it is useful to examine the rise, fall, and reconstruction of the global economy in the years before World War II.

People have conducted long-distance trade for hundreds of years, but the first true "global" economy emerged only in the nineteenth century. This "first wave" of globalization was driven by the interaction between technological change and politics. Technological innovation, in particular the invention of the steam engine and the telegraph, made it profitable to trade heavy commodities across long distances. Steam engines dramatically reduced the cost and time involved in long-distance trade. The railroad made it possible to ship large volumes of heavy commodities across long distances—grain from the American plains states to the Atlantic coast, for example—quickly and at low cost. In 1830, it cost more than $30 to ship a ton of grain (or any other commodity) 300 miles; by 1900 the cost had fallen to about $5 (Frieden 2006, 5). The use of steam to power ocean-going vessels further reduced the cost of long-distance trade. Whereas in the early nineteenth century it took a month and cost $10 to ship a ton of grain from the United States to Europe, by 1900 the Atlantic crossing took only a week and cost about $3. Consequently, whereas throughout history high shipping costs discouraged trade of all but the lightest and highest-value commodities, technology had reduced shipping costs so sharply by the late nineteenth century that such trade became very profitable.

Although new technologies made long-distance trade possible, political structures made it a reality. Capitalizing on the new possibilities required governments to establish an infrastructure that facilitated global exchange. This infrastructure was based on a network of bilateral trade agreements and a stable international monetary system. Governments began to reduce barriers to trade in the mid-nineteenth century. Britain was the first to adopt a free-trade policy in the 1840s when it repealed its "Corn Laws" and opened its market to imported grain. The shift to free trade gained momentum in 1860,

when Britain and France eliminated most tariffs on trade between them with the Cobden–Chevalier Treaty. The treaty triggered a wave of negotiations that quickly established a network of bilateral treaties that substantially reduced trade barriers throughout Europe and the still-colonized developing world (see Irwin 1993, 97). The United States remained an important exception to nineteenth-century trade liberalization, remaining staunchly protectionist until the 1930s.

Most governments also adopted gold-backed currencies. In this gold standard, each government pledged to exchange its national currency for gold at a permanently fixed rate of exchange. From the late nineteenth century until 1933, for example, the U.S. government exchanged dollars for gold at the fixed price of $20.67 per ounce. Great Britain was the first to adopt the gold standard, shifting from a bimetallic system in which the pound was backed by silver and gold to a pure gold standard in the eighteenth century. Other nations embraced the gold standard during the 1870s. Germany shifted to gold in 1872, and many other governments followed. By the end of the decade most industrialized countries, and quite a few developing countries, had adopted the gold standard. By stabilizing international price relationships, the gold standard encouraged international trade and investment.

Technological innovation and the creation of an international political infrastructure combined to produce a dramatic expansion of global economic exchange in the nineteenth century. Trade grew at an average rate of 3.5 percent per year between 1815 and 1914, three and a half times more rapidly than the previous 300 years. People crossed borders in historic numbers as well. Each year between 1880 and 1900, 600,000 people left Europe to find new lives in the United States, Canada, Australia, and Argentina; the number of such migrants continued to rise, reaching one million per year in the first decade of the twentieth century (Chiswick and Hatton 2003). In all, close to 14 million people left Western Europe in this period (Maddison 2001). Although the absolute numbers are large, one gains a deeper appreciation of the scale of late nineteenth-century migration by recognizing that these migrants represented 2 to 5 percent of the total population of the home countries (Baldwin and Martin 1999, 19). Financial capital also poured across borders. In the late nineteenth century British residents invested almost 10 percent of their incomes in foreign markets, and the French, German, and Dutch invested only slightly smaller shares of their incomes. These capital flows constructed railroads and other infrastructure in the lands of recent settlement (Bordo 2002, 23).

By the late nineteenth century, therefore, it was no exaggeration to talk of a global economy. In the passage I paraphrased at the beginning of this chapter, John Maynard Keynes remarked on the extraordinary nature of the global economy in the early twentieth century. "The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery on his doorstep; he could at the same moment and by the same means adventure his wealth in the natural resources and new enterprise of any quarter of the world. He could secure forthwith, if he wished it, cheap and

comfortable means of transport to any country or climate without passport or other formality. . . . He regarded this state of affairs as normal, certain, and permanent" (Keynes 1919, 9–10).

Globalization was not permanent, however. In the first half of the twentieth century governments dismantled the dense international economic networks they had created and retreated into sheltered national economies. The First World War triggered the retreat. European governments abandoned the gold standard in order to finance the war. They tightly controlled trade and financial flows in order to marshal resources for the war. Following the war, governments tried to reconstruct the global economy, but were not successful. This failure was a consequence of many factors, a full accounting of which would require more space than we can dedicate here. One of the most critical factors, however, lay in dramatic changes in the global political structure that supported the global economy.

Throughout the nineteenth century Britain stood at the center of the world economy. British manufacturing dominated world trade, and London served as the world's financial center. As the dominant economic power—what many political economists call the hegemon—Britain provided much of the infrastructure of the global economy. By the turn of the century Britain was ceding ground to the United States and Germany. These two rising nations industrialized rapidly in the late nineteenth century, taking advantage of science and new forms of corporate organization. By the end of the century both countries were challenging Britain's dominance. World War I accelerated this trend. American manufacturing output expanded during the war as the United States supplied the European nations. American financial power grew as the belligerents turned to the United States to finance their war expenditures. In contrast, 5 years of fighting weakened the British industrial capacity. Britain borrowed heavily and sold many of its foreign assets to finance its war expenditures, and thus exited the war saddled with a heavy foreign debt. At the war's end, the United States stood as the world's dominant economic power—the world's largest manufacturing economy and its largest creditor.

This power shift meant that postwar global economic reconstruction hinged on American leadership. Yet, the United States refused to accept the responsibilities that hegemonic status carried, preferring instead to retreat into a traditional policy of isolationism. Nowhere was the lack of American leadership more evident than on the war debt question. France and Britain (along with smaller European nations fighting against the Triple Alliance) had borrowed from the United States to finance part of their war expenditures. At the war's end, they asked the United States to forgive these debts. Britain and France had paid a heavy price, measured in terms of human suffering and economic damage, in the war. Was it not reasonable, they argued, for the United States to forgive the war debt as part of its contribution to the common effort? The United States refused, insisting that European governments repay the debt. To further compound the problem, the United States raised tariffs in 1922, making it difficult for Europe to sell products in the American market in order to earn dollars needed to repay the debt.

American war-debt policy held the key to the pace of European economic recovery, and thus had real consequences for the interwar global economy. War debt was linked (at least in the eyes of European governments) to German reparations payments. France insisted that Germany pay for war damages by paying reparations to the Allied powers. The amount of reparations the French sought was, in part, a function of the total demands on French financial resources. The American refusal to forgive French debt, therefore, encouraged France to demand more from Germany. Larger reparations payments in turn delayed economic recovery in Germany. And the delay in German recovery in turn delayed recovery throughout Europe. Had the United States forgiven the war debt, France might have demanded less from Germany. A smaller reparations burden would in turn have enabled Germany to recover more quickly, and German economic recovery would have driven European recovery. No less important, an early settlement would have enabled European governments to move past wartime animosities. Instead, the war debt–reparations mess dominated diplomacy and soured inter-European relations throughout the 1920s.

The failure to resolve these financial issues meant that governments never placed the international economy on a firm foundation. Although governments had reestablished a gold standard and had revived international trade by the mid-1920s, lingering war debts and reparations problems rendered the system quite fragile and unable to withstand the shock of the crash of the American stock market in October 1929. The financial collapse depressed economic activity. Consumer demand fell sharply, and as people stopped buying goods, factories stopped production and released their workers. Output fell and unemployment rose. The resulting Great Depression represented the largest collapse of production and employment the industrial world had ever experienced. American production fell by 30 percent between 1929 and 1933; unemployment rose to 25 percent in the United States and as high as 44 percent in Germany.

Governments responded to collapsing output and rising unemployment by raising tariffs in a desperate attempt to protect the home market. The United States led the way, sharply raising tariffs in the 1930 Smoot-Hawley Tariff Act. Countries with colonial possessions created trade blocs that linked the colonial power and its possessions. Great Britain established the Imperial Preference System in 1933 to insulate its trade and investment relationships with its colonies from the rest of the world. France established similar arrangements with its colonial possessions. Powerful countries that lacked colonies began using force to acquire them. Japan invaded Manchuria in the early 1930s and sought to bring much of East Asia into a Japan-dominated Asian Co-prosperity Sphere. Germany exploited its power and position in Central Europe to establish a network of bilateral trade relations with the region. By the mid-1930s, the world economy had disintegrated into relatively insulated regional trading blocs, and governments were moving toward the Second World War.

The failure to reconstruct the global economy after World War I and the subsequent depression and war had a dramatic impact on American policy. American policymakers drew two lessons from the interwar period. First, they concluded that World War II was caused in part by the failure to reconstruct a stable global economy after the First World War. As a result, the construction

of a stable and liberal international economy would have to be a centerpiece of post–World War II planning in order to establish a lasting peace. Second, American policymakers concluded that the United States alone controlled sufficient power to establish a stable global economy. America's European allies had been further weakened by World War II, and the Japanese and German economies had been destroyed. The United States, in contrast, emerged in a stronger position. These conclusions encouraged the United States to embrace an internationalist orientation. Working alongside British policymakers in the early 1940s, the United States designed international institutions to provide the infrastructure for the postwar global economy.

The resulting Bretton Woods system—so named because many of its final details were negotiated at an intergovernmental conference held in Bretton Woods, New Hampshire, in late summer of 1944—continues to provide the institutional structure at the center of the global economy. The WTO, the IMF, and the World Bank all have their origins in this concerted period of postwar planning. The contemporary global economy, therefore, was established as an explicit attempt to return to the "golden years" of the late nineteenth century to prevent a recurrence of the economic and political disasters of the interwar period. The post–World War II global economy differed from the classical liberal system of the nineteenth century in important ways. At the broadest level, the difference reflected changed public attitudes about the government's proper economic role. In the nineteenth-century liberal system, governments eliminated trade barriers and made little effort to manage domestic economic activity. The Great Depression encouraged governments to play a more active role in the economy. Governments used macroeconomic policy to promote growth and limit unemployment, and they established safety nets to protect society's most vulnerable from the full force of the market. This more active government role in turn required some insulation between the domestic and the international economies. The rules embodied in the Bretton Woods system provided this insulation. This important difference notwithstanding, the postwar global economy was, in effect, a restoration of the nineteenth-century global economy.

In short, the contemporary global economy continues a global trend toward deeper international economic integration that first emerged in the nineteenth century. So, although we are often inclined to view our contemporary system as fundamentally new, it is not so unique. The first wave of globalization also highlights another lesson. One often hears that globalization is inevitable, but the first wave of globalization suggests that it is not. Economic globalization is not a disembodied spirit; it is the product of multiple decisions made by governments throughout the world. Sometimes these decisions result in policies that encourage globalization, and sometimes they result in policies that discourage cross-border exchange. These decisions, in turn, are shaped by politics; that is, they are shaped by the pressures brought to bear by those who gain and those who lose in the process of international economic integration. In the remainder of this book we will explore how this political dynamic has shaped the evolution of the global economy after World War II and how it continues to shape the contemporary global economy.

CONCLUSION

IPE studies the political battle between the winners and losers of global economic exchange. It examines how this political competition shapes the evolution of the international trade and monetary systems, affects the ability of MNCs to conduct their operations, and influences the development strategies governments adopt. Thus, IPE suggests that it is hard to understand anything about the global economy without understanding how political competition unfolds.

IPE scholars traditionally have studied the global economy through the lens of three schools of thought. Each school offers a distinctive window on the global economy, and each emphasizes one aspect of global economic exchange—cooperation, competition between governments, and competition between labor and capital—as the central defining element of politics in the global economy.

This book relies on an approach that emphasizes the interaction between societal interests and political institutions. Such an approach will enable us to develop models that provide insights into how the global economy generates winners and losers, how these groups compete to influence the policies that governments adopt, and how the policies that governments adopt affect the evolution of the global economy.

KEY TERMS

Distributional Consequences
Evaluative Studies
Explanatory Studies
Ideas
Interests
Liberalism
Market Failures
Marxism
Material Interests
Mercantilism
Political Institutions
Welfare Consequences
Welfare Evaluation

SUGGESTIONS FOR FURTHER READING

For an excellent discussion of the historical development of the global economy since the late nineteenth century, see Jeffry A. Frieden's *Global Capitalism: Its Rise and Fall in the Twentieth Century* (New York: W.W. Norton & Company, 2006). The two best treatments of mercantilism can be found in Jacob Viner's *Studies in the Theory of International Trade* (London: Allen & Unwin, 1960) and Eli Heckscher's *Mercantilism* (London: Allen & Unwin, 1935). Adam Smith's *The Wealth of Nations* (New York: Bantam Classics, 2003) remains the most authoritative statement of liberalism. Vladimir Il'ich Lenin's *Imperialism: The Highest Stage of Capitalism* (New York: International Publishers, 1933) provides the seminal Marxist approach to international political economy. For a more general treatment of the three traditional schools, see Robert Gilpin's *The Political Economy of International Relations* (Princeton, NJ: Princeton University Press, 1987).