

The Future is OPEN



Open International Political Economy

OPEN INTERNATIONAL POLITICAL ECONOMY



The textbook provides overviews of three different kinds of economic integration: trade, production, and finance.

Clint Peinhardt

Clint Peinhardt
The University of Texas at Dallas



Open International Political Economy

Clint Peinhardt

The University of Texas at Dallas

This text is disseminated via the Open Education Resource (OER) LibreTexts Project (<https://LibreTexts.org>) and like the thousands of other texts available within this powerful platform, it is freely available for reading, printing, and "consuming."

The LibreTexts mission is to bring together students, faculty, and scholars in a collaborative effort to provide an accessible, and comprehensive platform that empowers our community to develop, curate, adapt, and adopt openly licensed resources and technologies; through these efforts we can reduce the financial burden born from traditional educational resource costs, ensuring education is more accessible for students and communities worldwide.

Most, but not all, pages in the library have licenses that may allow individuals to make changes, save, and print this book. Carefully consult the applicable license(s) before pursuing such effects. Instructors can adopt existing LibreTexts texts or Remix them to quickly build course-specific resources to meet the needs of their students. Unlike traditional textbooks, LibreTexts' web based origins allow powerful integration of advanced features and new technologies to support learning.



LibreTexts is the adaptable, user-friendly non-profit open education resource platform that educators trust for creating, customizing, and sharing accessible, interactive textbooks, adaptive homework, and ancillary materials. We collaborate with individuals and organizations to champion open education initiatives, support institutional publishing programs, drive curriculum development projects, and more.

The LibreTexts libraries are Powered by [NICE CXone Expert](#) and was supported by the Department of Education Open Textbook Pilot Project, the California Education Learning Lab, the UC Davis Office of the Provost, the UC Davis Library, the California State University Affordable Learning Solutions Program, and Merlot. This material is based upon work supported by the National Science Foundation under Grant No. 1246120, 1525057, and 1413739.

Any opinions, findings, and conclusions or recommendations expressed in this material are those of the author(s) and do not necessarily reflect the views of the National Science Foundation nor the US Department of Education.

Have questions or comments? For information about adoptions or adaptations contact info@LibreTexts.org or visit our main website at <https://LibreTexts.org>.

This text was compiled on 06/13/2026

TABLE OF CONTENTS

Licensing

1: Chapters

- 1.1: History of Globalization
- 1.2: Trade- International Institutions
- 1.3: Trade- Preferences and Interests Groups
- 1.4: Trade- Domestic Institutions and Policymaking
- 1.5: Trade- Development, Growth, and Inequality
- 1.6: Trade- Preferential Agreements
- 1.7: Production- Domestic Interests and Institutions
- 1.8: Production- International Institutions
- 1.9: Finance- Bretton Woods Monetary System
- 1.10: Finance- After Bretton Woods
- 1.11: Finance- Sovereign Debt
- 1.12: Finance- 1982 Debt Crisis
- 1.13: Finance- The Asian Financial Crisis
- 1.14: Finance- The Great Recession of 2007-08
- 1.15: Finance- International Institutions (International Monetary Fund)
- 1.16: Backlash against Globalization 3.0

Index

Glossary

Detailed Licensing

Detailed Licensing

Licensing LicensingEdit Update titlecancel

A detailed breakdown of this resource's licensing can be found in [Back Matter/Detailed Licensing](#).

CHAPTER OVERVIEW

1: Chapters

- 1.1: History of Globalization
- 1.2: Trade- International Institutions
- 1.3: Trade- Preferences and Interests Groups
- 1.4: Trade- Domestic Institutions and Policymaking
- 1.5: Trade- Development, Growth, and Inequality
- 1.6: Trade- Preferential Agreements
- 1.7: Production- Domestic Interests and Institutions
- 1.8: Production- International Institutions
- 1.9: Finance- Bretton Woods Monetary System
- 1.10: Finance- After Bretton Woods
- 1.11: Finance- Sovereign Debt
- 1.12: Finance- 1982 Debt Crisis
- 1.13: Finance- The Asian Financial Crisis
- 1.14: Finance- The Great Recession of 2007-08
- 1.15: Finance- International Institutions (International Monetary Fund)
- 1.16: Backlash against Globalization 3.0

This page titled [1: Chapters](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.1: History of Globalization 1.1: History of GlobalizationEdit Update titlecancel

Learning Objectives

Upon completing this chapter and activities, learners should be able to

1. Identify the origins of interrelation between international politics and economics.
2. Explain the rise and fall of three major historical periods of globalization.
3. Relate the historical roots of globalization to hegemonic stability theory.
4. Examine the three eras of globalization against the IMF's four dimensions.

The Rise and Fall of Economic Integration

Globalization has been a hot topic both culturally and politically for a number of years. It is a term that became popularized and more commonly used in the 1990s, following the collapse of the Soviet Union and the conclusion of the Cold War. But globalization's key feature, economic integration, existed in various forms over the past thousand years and has been an issue of tribal leaders, monarchs, and presidents (Vanham, 2019). The existence of globalization should not be taken for granted, as the period between World War I and World War II showed. With economic integration comes potential economic success, which is a big reason that East Asia went from being one of the poorest regions in the world to being a strong competitor against Western economies. They accomplished this through outward-oriented policies that continue to benefit them today (Globalization: Threat or opportunity? 2000).

Public opinion on globalization has fluctuated over the years. For example, in the U.K., some residents felt swept up in the wave of globalization and the ensuing economic pressure prior to the COVID-19 outbreak. Conversely, twin poll results focused on Americans “who voted against the seemingly inexorable tide of growing economic interdependence, cultural diversity and social connectivity that define a globalized world” (Silver et al., 2022). To better explain this fluctuation and difference in public opinion, we will examine the history and explain what led to the rise and fall of the periods of globalization in this chapter. The periods we will discuss in greater detail are referred to as Pax Mongolica, Pax Britannica, and Pax Americana. The Latin word, *Pax*, translates to peace and relates to categorizing the different eras of globalization in which a powerful empire or country supported a large increase in economic integration. In IPE the association of global peace and prosperity with hegemony, or the existence of an incredibly powerful political entity, is called hegemonic stability theory. Over the past thousand years, we argue the most impressive of these “hegemons” have been the Mongol Empire of the 13th century, the British Empire of the 19th century, and the modern-day United States. We examine each of these in turn.

Studying globalization as a historical phenomenon can show how current events shape international relations today. For example, the international organizations created to promote economic integration across countries such as the International Monetary Fund (IMF), the United Nations (UN), and the World Trade Organization (WTO) drew on the ideals of trade liberalization from the era of Pax Britannica (What is globalization? 2021). Besides trade, globalization has also impacted the movement of capital across borders through areas such as foreign direct investments, bonds, and stocks. Globalization may also refer to the diffusion of knowledge and ideas, such as the diffusion of Christianity from Great Britain to its colonies, such as India, but our focus in this book is on the economic dimensions of globalization. The IMF states that there are four dimensions of globalization: trade, movement of capital, movement of people, and movement of knowledge and technology (IMF). This chapter will discuss these four categories throughout Pax Mongolica, Pax Britannica, and Pax Americana.

Pax Mongolica (1206-1294)

Early in the 13th century, the world saw a new force appear in the Far East, as a Mongol leader named, Temüjin, began a twenty-year conquest that brought the majority of the world under his rule. In doing this, he had to unite nomadic tribes of the Eurasian Steppe, which spanned from present-day Hungary to northwestern China. His army was incredibly coordinated, fast, and devastating. Additionally, the labor roles within the empire were not always exclusively split between the sexes and often men and women would be found performing the same tasks and duties. Amidst the duration of his conquests, he gave himself the new, more commonly known, name of Genghis Khan. Despite its prosperous beginnings, the Mongol Empire would not last three generations. The reason for the fall of the empire occurred after the death of Genghis Khan, which resulted in a power struggle among his progeny and ultimately led to a division of land and resources that the empire was never able to recover from. Furthermore, his

descendants abandoned traditional practices of shamanism and instead turned to Tibetan Buddhism and Islam, and (separately) their armies became less effective. This all proved to be symptomatic of the fateful end of an empire (Cartwright, 2019).

Trade

During its time as a leading world power, the Mongol Empire was forced to address issues that threatened the stability of its economy, and by extension, its relationships with other prominent actors. The Silk Road, through which goods flowed between the empire from East Asia to the Middle East, North Africa, and Europe, was plagued by bandits who would target travelling merchants.^[1] Eliminating these bandits became vital to ensure resources got where they needed to go. Mongol hegemony also limited the number of powers involved in trade. Previously, goods moving from China to Eastern Europe had to pass through dozens of territories owned by kings and khans that posed a potential danger to the trade route. Traders could be subject to hefty taxes and unlawful inspections in these territories, but under the Mongols they instead only had to go through inspections and no extra taxes since the Khanate's conquest merged Asia into a few powers. From this historical example, we can identify two requirements for increased global trade: a decrease in barriers between trading partners and few external security threats. In other words, the easier and safer it is to get to and trade with a foreign merchant, the more trade both parties are willing to do. This was the case when the merchants of Genoa and Venice were willing to frequently trade with the Mongols on the Western edge of the empire once the threat of conquest was gone. Mongol trade appeared with the reinvigoration of the Silk Road, a global hegemon that created a tighter-knit world where "a man could walk from one end of The Mongol Empire to the other with a gold plate on his head without ever fearing being robbed." (Crash Course, 2012).

Movement of capital

Khan's method of acquiring capital was through repeated invasions of villages by his substantial army. After consolidating the empire, various streams of trade occurred. However, the Mongols were a nomadic tribe before their conquest, and their lifestyle formed a society that had no merchant class (Enkhbold, 2019). Once the empire emerged alongside the immense capacity for trade, a multitude of merchant classes needed to be created or hired. The *ortoq* were merchants that had previously engaged in some level of trade with the Mongols and other peoples in inner Asia, using caravans (Figure 1). Once the Khanate was established, the Mongol elite had money to spend and with this came more reasons to spend. Over the century of Mongol globalization, the partnership with the *ortoq* was a model of trade. Elites trusted merchants with capital to buy specific goods, or sometimes to spend freely, then return with the goods and all accrued interest (Enkhbold, 2019). Though this system and other systems like it, were already in existence before Pax Mongolica, the peace upheld by the Mongol Empire allowed the system to grow.

Movement of people

The actual Mongol people were relatively small in number prior to their conquest of Eurasia; the growth of the empire was due to tactics Genghis Khan implemented in his army, namely the integration of various individuals from an array of ethnic backgrounds into his forces. To continue the conquest, Genghis Khan had those he conquered join the army, not in segregated regiments, but assimilated directly into Mongol units. These foreigners were able to outrank ethnic Mongols with a merit-based system, meaning multiple different types of people were surrounding an officer at a time. The predominantly Mongol army was therefore a principal mover of people throughout the empire.

One of the late names to embrace globalization was the explorer Marco Polo, who went into Mongol China and worked for Kublai Khan as something resembling an *ortoq* for nearly twenty years. His story is not unusual; many people found themselves moving amongst the empire as Pax Mongolica enabled one of the first instances of widespread human migration in peacetime (Weatherford, 2004).

Movement of knowledge and technology

Pax Mongolica was an early form of globalization; many innovations and inventions were dispersed throughout the empire. The Khans saw the need to regulate and introduced the first taxes upon the empire in the 1230s. Genghis Khan also saw fit to standardize the size of silver throughout the empire to ease trade, something similar to the modern Euro. Later on in the history of the empire, Kublai Khan implemented paper money as a safer and easier way to facilitate banking. Paper money didn't sink as easily and was easier to protect in transit. Additionally, the empire concocted a new gunpowder formula which yielded a quicker and higher explosive force (Weatherford, 2004). Guns and cannons were also created. An important thing to note, is the fact that Mongol craftsmen were able to engineer these innovations with local materials, omitting the need to travel long distances for resources. With the creation of gunpowder, came hand grenades and other forms of weapons which eventually inspired the modern warfare that we know today.

Summary

The Mongol Empire provided protection from harm, increased trade, and opportunity for wealth on the Silk Road. Over the course of its empire, religious tolerance was implemented, and ideas were traded, as were goods and money. As time went on, the Empire was inching closer to succumbing to its fateful ending. With every Khan's death, a fight took place to be named the next Great Khan. The real empire was essentially a confederation composed of four Khanates: the Golden Horde, the Il-Khanate, the Yuan Dynasty, and the Chagatai Khanate. Eventually the differences between the Khanates grew too large, and the event that put the Mongol Empire over the edge had bled into its successors. The adaptation and diversity that the Mongols allowed in their empire, the reason it was able to exist, caused distance among the leaders. The trade that brought riches to all of them assisted in the spread of the bubonic plague. As a result, Pax Mongolica was ended after less than one hundred years of control, but the ideas had spread enough for history to know that once there was a world connected by a hegemon. Pax Mongolica was a medieval basis for what globalization could become, and parallels can be seen from Pax Mongolica to Pax Britannica and Pax Americana (Figure 2). Caught in the throes of the Black Death and hostility between Asian powers, the Mongol version of globalization ended.

Pax Britannica (1815-1914)

After defeating its European Rivals, Britain emerged as the financial commercial hegemon from 1815 to 1914, from Napoleon's defeat by the British military to the beginning of World War I. Britain was motivated by competition with France during the 17th century, leading to the formation of colonies in North America, the West Indies, and later, in India and Africa (Ashworth et al., 2017). At its height, the empire contained 25% of the world's land (British et al.). Most of these ventures came from companies and industry magnates instead of the English crown. Another key player during this time was the British Royal Army. The presence of the British Royal Army attributed to the spread of "Christianity, commerce, and civilization" to its colonies which in return defended its empire (Gough, 2014). Pax Britannica is thus a "systematic look at how Britain...molded Europe and the World between 1814-1914" (Gough, 2014).

Trade

In the 17th and 18th centuries, the British government exercised control over the colonies in trade and shipping under the mercantilist philosophy that reigned dominant during that time (British Empire, 2022). During this period, the principal trade law was the Navigation Act of 1651, which mandated that all colonies exclusively import and export with England. Britain had most of the share of the world trade market. They exported primarily manufactured goods. In turn, they imported raw materials such as tobacco, sugar, tea, and spices from their colonies, bolstered by developments in transportation technology, such as steamships and railroads (Watson, 2014). This era began in 1820 with the movement toward free trade when London merchants opposed the Corn Laws. The aristocracy created these laws in Great Britain to pin tariffs on all grain imports coming into the country (Beard, 2017). After its repeal, American wheat farmers were able to export grain to Great Britain, increasing Britain's dependence on imports while also forging trade relations with North America (Clark & Raper, 1936).

Another area where the British Empire developed intercontinental trade was with India, specifically the founding of the East India Company in 1600. The Company imported raw goods such as tea, cotton, jute, and rubber from India to the British Empire. As Britain's manufacturing capabilities improved, it produced manufactured goods made with Indian raw materials sold at a higher price point to Indian consumers (Nasta et al., 2017). Tea was one of the most significant commodities imported into Britain from India, beginning in the 1820s. Over time, it became a "quintessentially English custom..." and showed that cultural influence flowed both directions (Nasta et al., 2017).

Movement of capital

Britain is considered by many to be the world's first foreign investor on a large scale. They laid the foundation of modern-day foreign investment. As a world hegemon, Britain had a crucial role in the international financial system, including "direct investment ventures; licensing; and coordination in transnational webs of enterprise" (Shehadi, 2021). Before 1914, British foreign investment stood at £4 billion or 44% of the world's total foreign investment, with much of it going to British colonies in Africa, Latin America, and Asia (Clark, 2011).

The rise and success of joint-stock companies, such as the Russia Company and the more famous East India Company, meant that companies faced "international risks" (Shehadi, 2021). Multinational enterprises such as these laid the groundwork for modern foreign development practices in the British Empire in colonial holdings, such as "funding the construction of infrastructure (such as railways), or the extraction of natural resources" (Shehadi, 2021). With the laying of submarine cables in the 1860s, Britain was connected to the U.S. (New York), Europe, Asia, Australia (Melbourne), Latin America (Buenos Aires), and Russia. This

advancement “changed the informational environment of British investors” (Goetzmann & Ukhov, 2005). By the 1870s, with the development of telegraphs, British investors could “receive news concerning political events worldwide, economic and trade news, and even news regarding the weather and the storms affecting the crops in the colonies” (Goetzmann & Ukhov, 2005). Therefore, it is demonstrated that advancements significantly impacted the flow of capital in the technology sector.

Furthermore, Britain’s economic hegemony manifested as the widespread adoption of the gold and sterling standard. According to Robert Gilpin, an American political scientist, Britain organized the gold standard and, as the hegemon in “...commodity, money, and capital markets, ‘enforced the rules of the system’ upon the world economies” (Clark, 2011). As Britain rose to become the commercial and financial hegemon, it became more common for countries to have a part of their reserves in British Treasury Bills or bank deposits in London, Russia, Japan, Austria-Hungary, Holland, Scandinavia, and British Dominions together “held two-thirds of all foreign exchange reserves” (Eichengreen, 2019). As confidence in London as a financial center increased, countries also began holding large sterling reserves, which became just as, if not more important than, the gold standard in later years (Clark, 2011).

Movement of people

The movement of people during Pax Britannica can be classified into two groups: voluntary and involuntary (slavery). Within the voluntary classification, Britons moved to settler colonies such as Canada, Australia, New Zealand, and South Africa, primarily in the 18th century, and facilitated Anglicization by disseminating British values and customs (Free, 2018). Poorer Britons who wanted to move away from Britain’s “crowded and squalid cities” emigrated to Canada, and better-off Britons moved to other parts of the empire for employment opportunities to become governesses, builders, engineers, and farmers (Living in the British Empire: Migration). The Scots, Welsh, and Irish were another large demographic that voluntarily moved around the empire. These travelers moved around the world for the British Empire as military officials, engineers, and doctors (Living in the British Empire: Migration). Finally, in 1845, the Irish fled their country to the U.S., Canada, and Australia because of the Great Famine of 1845-1851, considered the first voluntary mass migration of people (O’Rourke & Williamson, 2001).

However, there was also a large flow of involuntary movement during this time. The British Empire was responsible for the most significant contributions to the slave trade market from 1640 to 1807, transporting 3.1 million Africans to British colonies in the Caribbean, North America, and South America during the transatlantic slave trade (Britain and the Slave Trade). Additionally, convicts were sent to Australia during the 1700s and 1800s. The British also shipped millions of Chinese all over the empire, such as in North America and South Africa, to build railways (Britain and the Slave Trade). Additionally, around 1.6 million Indians were shipped to North America and the Pacific Islands for “farming, mining, and other commercial enterprises” (Britain and the Slave Trade).

Movement of knowledge and technology

As mentioned previously, advancements in technology allowed for the integration and success of the British Empire into the world economy (see Figure 1). From 1760 to 1830, the British Empire underwent the first Industrial Revolution, giving it an edge in the global economy (Inikori, 2021). The development of steamships and railroads allowed goods to be transported over thousands of miles worldwide. The Industrial Revolution resulted in the creation of the factory system and the mechanization of manufacturing. Inventions such as the spinning jenny and power loom increased worker productivity. This was key to Britain’s export of its most important manufactured goods, cotton, to India at 20% of the price in 1700 (Inikori, 2021). In 1851, the English were the first to lay submarine telegraph cables under the English Channel successfully. These cables connected London to the European financial centers (O’Rourke & Williamson, 2001). Thus, these cables made it possible for those in New York, Paris, London, or Berlin to invest in international-scale joint stock companies and participate in more foreign direct investment (Vanham, 2019). Another innovation that was beneficial for investors was the electric telegraph. When a French company constructed the Suez Canal, transport time from Britain to India was further shortened, causing an increase in commercial activity (Vanham, 2019). Combined with the movement of people, religious ideas were created across borders. A prominent example was when British missionaries spread Protestant Christianity to areas in India and Africa. Due to all of these developments, “Britain was the country that benefited most from this globalization, as it had the most capital and technology” (Vanham, 2019).

Summary

The Pax Britannica era ended with the advent of World War I. The outbreak of European tensions signaled to the world that Britain was not strong enough to control up-and-coming powers such as Imperial Germany and the U.S. (Gough, 2014). By the end of the Pax Britannica in 1914, the groundwork for an interrelation globe had been well underway. It was rare to find a town or village whose prices were not influenced by a foreign market, whose infrastructure was not funded by foreign capital, and whose labor

markets were not impacted by immigration (O'Rourke & Williamson, 2001). Export industries flourished, and poor regions began chipping away at the wedge that separated them from more affluent areas. Still, not everyone was happy about this. Some capitalists argued that the increased interrelation of financial markets made them vulnerable to economic shocks that originated in foreign countries. Some laborers argued against the import of cheap goods made by cheap labor abroad.

During the Interwar Period (1918-1928), there were several attempts to reinstate British hegemony, but they all failed. Britain experienced 715,000 military deaths, the destruction of 10% of its domestic assets and 24% of its overseas assets (Crafts, 2014). World War I cost Britain over 25% of its GDP, which exhausted the empire (Crafts, 2014). Britain ushered in an era of liberalized trade, but World War I brought it to an “abrupt halt” as countries favored protectionism (Crafts, 2014). Japan and particularly the U.S. could fill in the vacuum left by the British in international markets during the war, such as for cotton textiles. Another attempt was made to reinstate the gold standard at the pre-war parity. However, this was unsuccessful because of the economists’ uncertainty about deflation. After World War I, Britain experienced lower income levels, higher unemployment, lower trade, and an increased public debt-to-GDP ratio (Crafts, 2014). Against this backdrop, the U.S. impacted less than Europe during World War I and emerged as the new hegemon. After World War II, the U.S. cemented its role as a world leader.

Pax Americana

Pax Americana was the new era of globalization that followed World War II and was spurred by the devastation of Europe post-war. Relative to Europe, the U.S. was comparatively unharmed by World War II. Thus, production did not have to recover and the economy was in much better shape than the rest of the world. As such, the U.S. began not only providing for itself, but also for the means of European recovery. Due to the economic success the states were experiencing, public policy under Franklin D. Roosevelt’s administration benefitted not only war veterans, but most Americans. This post-war glory would be short lived, however, due to the impending Cold War between the United States and the Soviet Union.

Trade

Globalization crashed after WWI, and what followed was a period of post-war protectionism and the Great Depression. After WWII, during the 1940s, the U.S. led several efforts to resuscitate the global economy via international trade and investment through international organization, trade treaties, and reductions to trade barriers. Between 1956 and 1957, quotas on dollar trade and other trade barriers were cut dramatically (Horowitz, 2004). It is interesting to note that conversely from the fact that the United States was leading efforts to revive the global economy, the decisions were made unilaterally. The U.S. helped to establish the General Agreement on Tariffs and Trade (GATT) in 1947, which “became the world’s most important multilateral trade arrangement” (Irwin, 2018). Through negotiating rounds, the GATT was successful at reducing tariff barriers on manufactured goods in industrial countries, helping to promote international trade after WWII. After 1995, the GATT became the World Trade Organization, which manages four international trade agreements: “the GATT, the General Agreement on Trade in Services (GATS), agreements on trade-related intellectual property rights and trade-related investment (TRIPS and TRIMS, respectively)” (Irwin, 2018).

Countries had also signed onto more bilateral or regional trade agreements (RTAs), such as the North American Trade Agreement (NAFTA). This agreement eliminates tariffs on merchandise and reduces barriers to trade in services and foreign investment between the U.S., Canada, and Mexico. The U.S. also entered into bilateral trade agreements with Israel, Singapore, Jordan, and Australia, among others. The interconnectedness of the world economy results in increased competition, spurring practices of off-shoring or outsourcing that allowed companies to benefit from the cheapest labor and lowest taxes (Irwin, 2018).

While this era provided cooperation between the United States and other countries, the Cold War alliance structure brought on a new wave of bipolarity between the world’s main powers, the Soviet Union and the United States. The decade of 1945 to 1955 is known as the “era of tight bipolarity” (Agashe, 2021).

Movement of Capital

After World War II, there were significant attempts to globalize finance. One such attempt was the Bretton Woods Agreement in 1944, which pegged other nations’ currencies to the U.S. dollar, creating an international monetary system. The vision that those at Bretton Woods had of this system was that it would be one that could provide exchange rate stability, prevent competitive devaluations, and promote economic growth. Eventually, under this new system, large domestic banks became internationalized, especially between 1964 and 1980 (Ghizoni, 2013).

Foreign assistance is another form of moving capital across borders given that it is the largest component of the international affairs budget, and makes up 1% of the entire federal budget. The U.S. has become the largest foreign aid donor in the world, “accounting

for nearly 23% of total official development assistance from major donor governments in 2019”, which was the last time data was collected on this topic (Morgenstern & Nick, 2022). The major foreign aid categories include multilateral and bilateral development assistance, humanitarian assistance, strategic economic assistance, and security assistance (Morgenstern & Nick, 2022). One of the most famous examples of the movement of capital during this time was the Marshall Plan, provisioned by the Economic Cooperation Act in 1948. The Plan disbursed more than 15 billion dollars by some estimates to Great Britain, France, and West Germany to spur production and international trade, along with spreading ideals of democracy to contain the spread of communism (Marshall Plan, 2009).

Since 2001, capital has been heavily allocated towards development aid (such as global health programs) and heightened security assistance (such as anti-terrorism measures) directed towards U.S. allies. In 2019, the main countries the U.S. donated to were Afghanistan, Israel, Jordan, Egypt, and Iraq. Thus, reflecting the strategic significance of Israel and Afghanistan, the humanitarian crisis in Jordan, and “long-standing commitments” to Egypt.

Other ways that capital can cross borders is through remittances, or payments made by immigrants in their host countries to their home countries. Remittances can constitute nearly 5% of the home country’s GDP in some cases, indicating how economic globalization is directly linked to the movement of people (Berridge, 2016).

Movement of People

Migration stalled with World War I, but resumed in the 1980s and remained historically high despite the various methods used to control it. Unlike in the eras preceding Pax Americana, the personal and financial costs of immigrating have substantially decreased. Currently, and perhaps due to this fact, the U.S. is the “most popular destination for international immigrants” (Wayne, 2015).

Personal costs decreased as developments in transportation technology made it faster and safer to travel. Financially, new immigrants have been able to benefit from the consequences of economic globalization, typically in the form of remittances, by older immigrants (Berridge, 2016). These substantially lowered costs have allowed for heavy “corridors” of human traffic between less wealthy countries and wealthier countries, such as Mexico and the U.S., or between Turkey and Germany. Migration increased from 446 per million world inhabitants in the 1980s to 603 per million world inhabitants in the 1990s. In the first decade of the 21st century alone, the rate of international migration “exceeded that of the 19th century” (Wayne, 2015). Corresponding to this increase in immigration, there are more formal barriers to migration than permits, passports, and visas than ever. The movement of people has created benefits, yet these benefits are unequal between home and host countries (the latter benefit more — see Figure 2; Wayne, 2015).

Movement of Technology and Knowledge

In 1956, the creation of the shipping container by Malcolm McLean revolutionized trade by reducing shipping and loading costs by nearly 90%, shortening port turnaround times, and lessening merchandise theft. Further developments in container ship technology allow for over 18,000 containers to be shipped overseas for commercial and military purposes (Hoover, 2021). As a result of this creation, 90% of global trade occurs through the sea currently (Ryssdal & Palacios, 2021).

The need for sharing best practices and knowledge across borders, increased as world economies globalized. One such example of this is the Basel I Accords, when banking officials from the three major banking powers, the United States, United Kingdom, and Japan, congregated and tried to harmonize their banking policies. This was attempted by implementing a risk-weighting system for banks. This was done without any formal treaty or state obligation, but by 1994, 92% of the 129 countries had some sort of system in place (Alessi, 2012).

Culture, especially American customs, music, and television has also crossed international borders. America exports culturally salient material such as music, movies, and other forms of media. Furthermore, these exports are seen as new which attracts younger generations. In comparison, older generations may view them with a potential disdain and may worry about the resilience of their own culture. Additionally, deeply-rooted historical traits are painted over to advertise the next superficial fad from America. As a result of this, according to the Pew Research Center, 37 of 46 countries surveyed (excluding the U.S.) cited “Americanization” as having negative effects on their own culture and traditions (Kohut & Wike, 2020).

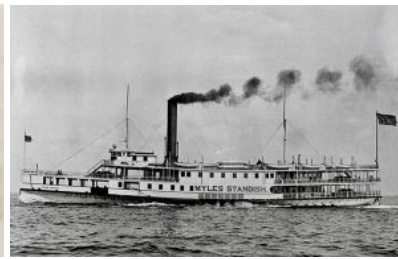
(Figure 1 here: Evolution of Methods of Trade Globalization)

Figure 1: Evolution of Methods of Trade Globalization

Pax Mongolica



Pax Britannica



Pax Americana



Summary

Pax Americana, or Globalization 3.0, was driven by its technological advancements and has brought a lot of benefits and backlash. It has facilitated global economic opportunities, enabling businesses to access larger markets, foster innovation, and lift millions out of poverty. Additionally, it has a widespread cultural exchange, helping societies with diverse perspectives and empowering people to address global challenges. However, globalization has also widened economic inequality, led to environmental degradation, and raised concerns about loss of sovereignty and cultural identity. The backlash against globalization has fueled calls for greater regulation to mitigate its effects and ensure a more equitable and sustainable total global economy. Despite its drawbacks, globalization 3.0 remains a powerful force for economic growth and cultural exchange. Efforts to address its challenges while taking its benefits are crucial for creating a more inclusive and sustainable global society.

Conclusion

Critics from a variety of disciplines such as economy, sociology, and cultural studies recognize that globalization leads to three principles: “increased connectivity, improved technology, and perceived convergence” (Pooch, 2016). These further lead to global interdependence, multidirectional migrations across the world, and the slow decline of national politics. This chapter covered the winners and losers of globalization over the course of its history, as shown in Figure 2.

During Pax Mongolica, those who won were Mongol empire officials and those who traded on and from the Silk Road. However, those who lost during this wave of globalization were people who were forcibly absorbed into the empire. During Pax Britannica, the winners were British empire officials and the British Royal Government as it acquired more colonies and subsequent wealth. To an extent, British citizens benefited from free trade when restrictive trade laws such as the Corn Laws were repealed. However, it may be argued that they too, were losers; benefits reaped from globalization weren't dispersed evenly, leading to many citizens remaining in poverty. Additionally, Indian, Chinese, and West African citizens who were exploited by the British, yet made up a significant component of globalization, were also harmed because of it. But is globalization popular in the most recent wave of globalization, Pax Americana?

First, it's important to note that globalization can be visible and invisible. Yet, globalization is more than a cultural melting pot. It occurs on a scale invisible to us such as the mutual connectivity of major world banks, international trade treaties, and foreign aid, among others. The last era of globalization examined is Pax Americana, but how accurate is it to describe this modern age as one of Pax? Foreign policy advisor to former President Obama, Jake Sullivan believes that "the fact that the major powers have not returned to war with one another since 1945 is a remarkable achievement of American statecraft", or proof of Pax Americana (Is the world getting more peaceful?, 2021). This is further evidenced by the fact that interstate conflict has decreased substantially in the 20th century and after World War II, and the number of interstate conflicts have also decreased from Cold War levels, but not as dramatically (Is the world getting more peaceful?, 2021). Factors that may explain this are characteristics of an era of Pax Americana: the globalization of economics and increased international trade, the globalization of capital, and the spread of democratic norms (Gartzke, 2007). Nevertheless, we are in an era where peace is not "continental" as it was under Pax Mongolica or Pax Britannica. Those eras laid the foundation for a globalized peace (Dizikes, 2017).

Figure 2: Winners and Losers across Waves of Globalization

	Pax Mongolica	Pax Britannica	Pax Americana
<i>Winners</i>	Mongols, Silk Road Traders, Western Europe	Europe, esp. UK; Colonialists	High skilled manufacturers in wealthy countries, low skilled manufacturers in poor countries
<i>Losers</i>	Rulers conquered by Mongols	Colonies, Slaves, Indian and Chinese laborers who worked in poor conditions	Low skilled workers in wealthy countries and high skilled workers in poor countries

According to the Pew Research Center, most believe that globalization is good for their country, but in practice, many believe "it's not good for them personally" (Stoker, 2020). This dualism presents a contradiction. Are more people not educated enough on globalization to develop a coherent opinion of it? Or does this nuanced response reflect the opposite, an increasing awareness of globalization and its relative benefits? This skepticism is prevalent among the advanced economies of the U.S., U.K., Japan, and some European nations. According to that survey, 81% of over 48,000 respondents from 44 countries believe that "international trade and global business ties are good for their country" (Stoker, 2020). However, the same survey indicates that only 56% of the respondents believe international trade creates job opportunities and only 26% of the respondents believe that trade lowers prices, despite that being the main arguments for why nations should globalize their economy. American citizens are especially skeptical, with only 17% of Americans believing that trade increases wages, and only 28% agreeing that foreign companies absorbing American companies is good for the country (Stokes, 2020). This suggests that as of late, Americans believe that globalization has turned the tide on them, and for the worse.

Ultimately, it would be fair to say that globalization is popular to everyone except those who directly lose from it, such as low skill manufacturers in highly developed countries and highly skilled manufacturers in less developed countries since their skills and goods are deemed too expensive. Thus, they get left out of the benefits of globalization; after all, what good is an out of season fruit when you can't afford it? Globalization's popularity is only as high as the people's belief that they are winning from it.

The last era of globalization examined is Pax Americana, but how accurate is it to describe this modern age as one of Pax? Foreign policy advisor to former President Obama, Jake Sullivan believes that "the fact that the major powers have not returned to war with one another since 1945 is a remarkable achievement of American statecraft", or proof of Pax Americana (*Is the world getting more peaceful?*, 2021). This is further evidenced by the fact that interstate conflict has decreased substantially in the 20th century and after World War II, and the number of interstate conflicts have also decreased from Cold War levels, but not as dramatically (*Is the world getting more peaceful?*, 2021). Factors that may explain this are characteristics of an era of Pax Americana: the globalization

of economics and increased international trade, the globalization of capital, and the spread of democratic norms (Gartzke, 2007). On the other hand, since the end of WWII, the world has still experienced catastrophic conflicts such as

Afghanistan, Korea, Vietnam, Iraq, amongst others. John Dower, Ford International Professor of History, Emeritus, and Pulitzer Prize winner, argues that “We’re in a perpetual cycle of violence in the name of preventing violence,” and that the dip in warfare is attributed to “hyperactive militarism”, such as increased involvement in proxy wars and risk of nuclear warfare (Dizikes, 2017). During the Cold War, between 1965 and 1973, the U.S. had deployed 40 times the tonnage of bombs it dropped on Japan onto Vietnam, Cambodia, and Laos. The War on Terror following the Sept. 11, 2001 terrorist attacks have led to protracted and costly conflicts in Afghanistan, Iraq, and other areas in the Middle East (Dizikes, 2017). In terms of recent events, the Russian invasion of Ukraine in February of 2022 is a symptom of the fact that the U.S. does not wield the same coercive power as it did during President John F. Kennedy’s administration. Still, many believe that the U.S. should play a leading role in addressing the conflict because of its unique economic, military, and geographic position in the world. Nevertheless, we are in an era where peace is not “continental” as it were under Pax Mongolica or Pax Britannica. Those eras laid the foundation for a globalized peace (Dizikes, 2017).

Questions for Reflection

1. How did globalization differ across each era on each of the IMF’s four dimensions and why? (*learning objectives 1,3,4*)
2. What factors contributed to the rise and fall of each era? (*learning objective 2*)
3. Compare the strengths and weaknesses of the three eras on the IMF’s four dimensions. (*learning objective 4*)
4. Discuss the progression of Pax Americana and its impact on the United States’ role in shaping international relations in the modern age. (*learning objective 1*)

Works Cited

Agahse, A. (2021, April). International Journal of Research Culture Society ISSN: 2456-6683 Volume 5, Issue 4, Apr 2021, from <https://ijrcs.org/wp-content/uploads/IJRCs202104006.pdf>.

Alessi, C. (2012, July 11). “The Basel Committee on Banking Supervision.” Council on Foreign Relations, Council on Foreign Relations, www.cfr.org/backgrounder/basel-committee-banking-supervision Accessed 18 Apr. 2024.

Ashworth, W., O’Brien, P., Inikori, J., Austin, G., & Lukasiewicz, (2017, November 2). British Imperialism and Globalization, 1650-1960. British Imperialism and Globalization, 1650-1960. Retrieved April 21, 2022, from <http://wehc2018.org/british-imperialism-and-globalization-1650-1960/>.

Beard, S. (2017, August 28). How the British Began a Free Trade

Bonanza. Trade Off: Stories of Globalization and Backlash. Retrieved April 21, 2022, from <https://www.marketplace.org/2017/08/28/how-the-british-began-free-trade-bonanza/>.

Berridge, S. (2016, January). International Migration Patterns Amid Globalization : Monthly labor review. Retrieved April 23, 2022, from <https://www.bls.gov/opub/mlr/2016/beyond-bls/international-migration-patterns-amid-globalization.htm>.

British Empire Overview. (n.d.). Retrieved April 24, 2022, from <https://www.nationalarchives.gov.uk/education/empire/intro/overview2.htm>.

Cartwright, Mark. “Mongol Empire.” World History Encyclopedia, <https://www.worldhistory.org/#organization>, 7 Aug. 2023, www.worldhistory.org/Mongol_Empire/

Clark, G., & Raper, R. (1936). The Oxford History of England. Clarendon.

Clark, I. (2011). Hegemony in international society. Oxford University Press.

Crafts, N. (2014, August 27). Walking Wounded: The British Economy in the Aftermath of World War I. Retrieved April 21, 2022, from <https://voxeu.org/article/walking-wounded-british-economy-aftermath-world-war-i>.

Crash Course. (2012, May 12). Wait For It...The Mongols!: Crash Course World History #17 [Video]. YouTube. <https://www.youtube.com/watch?v=szxPar0BcMo>.

Dizikes, P. (2017, June 27). Is the Pax Americana truly peaceful? Retrieved April 23, 2022, from <https://news.mit.edu/2017/john-dower-book-pax-americana-truly-peaceful-0627>.

- Eichengreen, B. J. (2019). *Globalizing Capital: A History of the International Monetary System* (2nd ed.). Princeton University Press.
- Encyclopædia Britannica, inc. (2022, March 13). British Empire. Retrieved April 21, 2022, from <https://www.britannica.com/place/British-Empire>.
- Enkhbold, E. (2019). "The Role of the Ortoq in the Mongol Empire in Forming Business Partnerships." *Central Asian Survey*, 38(4), 531–547.
- Free, M. (2018). Settler colonialism. *Victorian Literature and Culture*, 46(3-4), 876–882. <https://doi.org/10.1017/s1060150318001080>.
- Gartzke, E. (2007). The Capitalist Peace. *American Journal of Political Science*, 51(1), 166–191.
- Ghizoni, Sandra Kollen (2013). "Creation of the Bretton Woods System." *Federal Reserve History*, www.federalreservehistory.org/essays/bretton-woods-created
- Goetzmann, W., & Ukhov, A. (2005, April). British Investment Overseas 1870-1913: A Modern Portfolio Theory Approach. Retrieved April 21, 2022, from <https://www.nber.org/papers/w11266>.
- Gough, B. (2014). *Pax Britannica Ruling the Waves and Keeping the Peace before Armageddon*. Palgrave Macmillan UK.
- Hoover, G. (2021, January 21). Malcolm McLean: Unsung Innovator who changed the world. Retrieved April 23, 2022, from <https://americanbusinesshistory.org/malcolm-mclean-unsung-innovatorwho-changed-the-world/>.
- Horowitz, S. (2004). Restarting Globalization after World War II. *Comparative Political Studies*, 37(2), 127–151. <https://doi.org/10.1177/0010414003260980>.
- Inikori, J. E. (2021). The Industrial Revolution and Globalization: A discussion of Patrick O'Brien's contribution. *Journal of Global History*, 17(1), 165–171. <https://doi.org/10.1017/s174002282100036x>.
- International Monetary Fund. (2000, April 12). Globalization: Threat or opportunity? An IMF Issues Brief. Retrieved April 21, 2022, from <https://www.imf.org/external/np/exr/ib/2000/041200to.htm#II>.
- Irwin, D. (2018, August 29). International Trade Agreements. Retrieved April 23, 2022, from <https://www.econlib.org/library/Enc/InternationalTradeAgreements.html>.
- Is the world getting more peaceful? (2021, April 7). Retrieved April 23, 2022, from <https://oneearthfuture.org/news/2021-04-07-world-getting-more-peaceful>.
- Kohut, A., & Wike, R. (2020, July 28). Assessing Globalization: Benefits and Drawbacks of Trade and Integration. Retrieved April 23, 2022, from <https://www.pewresearch.org/global/2008/06/24/assessing-globalization/>.
- Marshall Plan. (2009, December 16). Retrieved April 23, 2022, from <https://www.history.com/topics/world-war-ii/marshall-plan-1>.
- Morgenstern, E., & Brown, N., R40213 Foreign Assistance: An Introduction to U.S. Programs and Policy (2022). Frisco, TX; Congressional Research Service.
- Nasta, S., Stadler, F., & Visram, R. (2017). Global trade and Empire. *South Asians in Britain*. Retrieved April 21, 2022, from <https://www.bl.uk/asians-in-britain/articles/global-trade-and-empire>.
- The National Archives. (n.d.). Britain and the Slave Trade. Retrieved April 21, 2022, from <https://www.nationalarchives.gov.uk/slavery/pdf/britain-and-the-trade.pdf>.
- The National Archives. (n.d.). Living in the British Empire: Migration. Case Study 6 Background. Retrieved April 21, 2022, from <https://www.nationalarchives.gov.uk/education/empire/g2/cs6/background.htm>.
- New World. "Mongol Empire." *New World Encyclopedia*, 18 Oct. 2018, Silver, L., Schumacher, S., Mordecai, M., Greenwood, S., & Keegan, M. (2022, April 7).
- O'Rourke, K. H., & Williamson, J. G. (2001). *Globalization and history: The evolution of a nineteenth-century Atlantic economy*. MIT Press.
- Peterson Institute For International Economics. (2021, August 26). What is globalization? What is Globalization? Retrieved April 21, 2022, from <https://www.piie.com/microsites/globalization/what-is-globalization>.
- Pooch, M. U. (2016). *Globalization and Its Effects* (Ser. Toronto,

New York, and Los Angeles in a Globalizing Age, pp. 15–26). Transcript Verlag. Retrieved April 24, 2022, from <http://www.jstor.org/stable/j.ctv1wxt87.5>.

Ryssdal, K., & Palacios, D. (2021, November 23). How the Shipping Container Revolutionized Freight and Trade. Retrieved April 23, 2022, from <https://www.marketplace.org/2021/11/23/how-the-shipping-container-revolutionized-freight-and-trade/>.

Shehadi, S. (2021, October 12). How the British Empire Created Foreign Investment. Retrieved April 21, 2022, from <https://www.investmentmonitor.ai/analysis/british-empire-created-foreign-investment>.

Silver, L., Schumacher, S., Mordecai, M., Greenwood, S., & Keegan, M. (2022, April 7). In U.S. and UK, globalization leaves some feeling ‘left behind’ or ‘swept up’. Pew Research Center’s Global Attitudes Project. Retrieved April 21, 2022, from <https://www.pewresearch.org/global/2020/10/05/in-u-s-and-uk-globalization-leaves-some-feeling-left-behind-or-swept-up/>.

Stokes, B. (2020, July 28). Most of the world supports globalization in theory, but many question it in practice. Retrieved April 23, 2022, from <https://www.pewresearch.org/fact-tank/2014/09/16/most-of-the-world-supports-globalization-in-theory-but-many-question-it-in-practice/>.

Vanham, P. (2019, January 17). A brief history of globalization. Retrieved April 21, 2022, from <https://www.weforum.org/agenda/2019/01/how-globalization-fits-into-the-history-of-globalization/>.

Watson, A. (2014, April 8). A quick exploration of ten nineteenth century British imports. A Quick Exploration of Ten Nineteenth Century British Imports. Retrieved April 21, 2022, from <https://tradingconsequences.blogs.edina.ac.uk/2014/04/08/a-quick-exploration-of-ten-nineteenth-century-british-imports/>.

Wayne, M. (2015). International Migration Remains the Last Frontier of Globalization. Federal Reserve of Dallas. Retrieved from <https://www.dallasfed.org~/media/documents/research/eclett/2015/el1502.pdf>.

Weatherford, J. (2004) Genghis Khan and the Making of the Modern World. Three Rivers Press.

1. For a nice interactive map of the Silk Road, see <https://en.unesco.org/silkroad/silkroad-interactive-map>. ↩

This page titled [1.1: History of Globalization](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.2: Trade- International Institutions 1.2: Trade- International InstitutionsEdit Update titlecancel

Upon completing this chapter and activities, learners should be able to

1. Comprehend the functions of trade as a building block for International Political Economy.
2. Gain greater insight into the functions of GATT and WTO in reference to the International Political Economy.
3. Recognize the importance of institutional design facilitating policy goals, especially internationally.
4. Utilize critical thinking to determine the significance of WTO and its efforts today on the international stage.

Introduction

As Chapter One mentioned, countries turned inward and increased trade barriers after World War I, especially in the late 1920s as financial crisis heightened the fears of spiraling domestic markets. Countries also tried but were unable to return to the classical gold standard that stabilized the international monetary system during Pax Britannica. Why did countries rethink their relationships with the global economy? One reason was the absence of international commitments to maintain openness, and by the end of World War II, efforts were underway to create international institutions that would help countries reduce trade barriers and keep their economies open to foreign products.

The U.S. would assume the leadership role of this endeavor working alongside with much of the Western World. In part this was due to its economy, which was undamaged from the war. American leaders were determined to create a foundation for postwar economic growth that would restore international trade and increase commercial incentives to maintain peace. Overall, they hoped that international institutions would further the goal of furthering the global economy by helping countries to commit to opening their economies to imports in exchange for reciprocal liberalization in other countries.

But first, it's important for us to revisit World War 2 and reckon with its destruction, which left states' economies utterly shattered. As countries began to scramble to rebuild their societies, they sought a new avenue in restoring their prominence. This led to the Bretton Woods Conference (1944), an attempt to create an international institution looking to revitalize Europe's economies and set the standards for international trade. Although the original plans of the Bretton Woods Conference regarding trade did not come to fruition, the General Agreement on Tariffs and Trade (GATT) would become the foundation for restoring international trade. Arising as a set of temporary guidelines with only 23 members, GATT would expand, adding more member countries and finding new challenges as time passed on. Numerous rounds of negotiations occurred to clarify rules and to make GATT adaptable to an ever-changing global economic environment. The Uruguay Round (1986-93) resulted in the creation of the World Trade Organization (WTO), the primary international organization for international trade. The WTO has tried to further set the rules of global trade, while it also implemented new rules to ensure smooth processes of trade in the world. Notably, the Doha Round (2002-2015) was another attempt to revitalize the rules and international trading system, but was not met with resounding success, and in general, the WTO's ability to increase international trade is now widely questioned.

The rest of the chapter examines all three of these experimental institutions in search of a trade liberalization model. We dive into the questionable aspects of each that led to their stagnation as well as the more admirable aspects that originally gave them legitimacy. It culminates to the WTO's current tenuous position in advancing global trade and what will need to happen to see a tipping of the scales once again toward trade liberalization.

The International Trade Organization (ITO)

At the close of 1944, as the war was coming to an end both the allied and axis nations were faced with incalculable damage. The obvious portion of this was done to the infrastructure of the respective nations, but even the health side took a substantial blow. Estimates proclaim that the standard of living was cut by 25 years for the winning side, with even lower numbers being shared by their opponents, reducing the standard of living. To restore international economic stability 44 of those allied states would meet at Bretton Woods, New Hampshire. There all parties would share ideas on how to supplant the ill-effects endowed to their countries leading to the notorious name of the Bretton Woods Conference.

Three institutions would stem from delegations at the conference: the International Banks for Reconstruction and Development (IBRD), International Monetary Fund (IMF), and the International Trade Organization (ITO) each with their own purpose. The IBRD aimed to provide credit to countries that needed to rebuild their economies. The IMF focused instead on the international

monetary system with the goal of stabilizing currencies. Finally, the ITO would be responsible for reducing trade tariffs and incentivizing economic cooperation among the world's states.

Although the IMF and the IBRD were established in 1945 and 1946 respectively, the ITO was delayed mainly due to domestic concerns in the United States, which received disproportionate voting power in the other two Bretton Woods institutions. The US Congress was displeased with the idea of having just one vote in the ITO, and so, consequently, the organization was never brought to a vote. Even more, protectionist ideals of American businesses proved hard to please, further striking the bid for the ITO charter. Without American support, the ITO never came into existence. However, all was not lost as GATT partially filled the ITO void.

The General Agreement on Tariffs and Trade (GATT)

Despite its failures, the ITO was an unprecedented venture to broaden the accessibility of goods to the global market. Its demise was preceded by the formation of the General Agreement Trade and Tariffs which took on the basic framework of the ITO charter. As countries were vying on how to reduce tariffs, a group of 15 members that stemmed from the original ITO charter met to tackle first the issue of custom tariffs. Long-held protectionist measures were specifically targeted so that goods could have broader access. In the end of deliberations, that number would grow to be 23 countries all poised to lead the charge for trade liberalization. GATT's main messaging was of course to limit trade tariffs to supply goods at a more affordable price, but the institution was similarly concerned in dismantling the unilateral influence that trade discussions were bound by. Two key features of the institution would allow that idea to stand: reciprocity and Most Favored Nation (MFN).

Reciprocity meant that countries simultaneously reduced trade barriers and was used as a tool in limiting the influence of externalities imposed on trade talks. Previously, countries could impose whatever restrictions they deemed beneficial to themselves in terms of trade. The introduction of reciprocal trade liberalization tied together the trade policies of member countries. Countries might hesitate to open their borders to foreign trade unilaterally, but would be more willing to do so when they knew that their exporters would gain from openness gained in other countries. By invoking reciprocity, GATT encouraged concessions from both parties to edge closer to moderations in negotiations (Bagwell and Staiger 1999). It is worth noting that this provision was not exactly exalted by the poorer nations of the institution. They lacked adequate bargaining power to convene with any country in providing goods that could be leveraged as a concession, leaving them with less room to advocate for trade measures.

The provision of nondiscrimination, or more formally known as MFN, would further reverse any tipping of the scale action during trade discussions by granting those poorer states with more insurance. By its definition, countries are not allowed to give preferential treatment to another member that is not applied to the organization. So, if a country were to enact a lowering of trade barriers to one of its trading partners, it would be expected to carry those same concessions with all trading partners.

Through reciprocity and MFN, GATT helped to increase trade substantially among GATT members in its first years. Such economic successes eventually led to more growth for member states' economies, and over time, other countries began to join GATT, as they became convinced of the benefits of international trade. As negotiations succeeded on tariffs, members eventually turned towards other, more complex trade barriers, such as antidumping duties, that became primary methods of trade protection as the use of tariffs waned. By 1993, 128 countries grew to be a part of GATT. Once again economic issues, global trends, and GATT's increasing size would lead to another round of trade negotiations.

Multilateral Trade Bargaining

Much of the progression throughout GATT's history took place during rounds of bargaining among member states. For instance, The Kennedy Round would focus on anti-dumping laws as well as development, while the Tokyo Round would home in on decreasing industrial tariffs. But perhaps the most successful round held under GATT was the Uruguay Round. Lasting from 1986 to 1993, the Uruguay Round of negotiations had two specific objectives; to bring overlooked areas of commerce to the GATT system and incorporate areas like agricultural sectors that had previously been ignored by the trade liberalization agenda. The Uruguay Round incorporated many aspects of the trade policy, including services and intellectual property, which were not previously part of the regime (Barton, et al., 2008 p.93). It was one of the most successful rounds by making agreements more applicable to all parties by implementing all elements of the state.

On the agricultural side the intended goal was to both lower trade tariffs for all member states as well as target other liberalization measures. Starting first with the tariff reductions we would see a concentrated effort on the part of both developed and developing nations in reducing the tax imposed on goods. The bulk of this action would be taken over by the bigger economies, but the move saw large reductions in tariffs relating to agriculture products and even spices. Subsidies were also a topic of concern during these discussions. The idea behind the position assumed that limiting the number of subsidies in both domestic and international markets

would free up space for imports. It was previously held that countries who engaged in dishing out subsidies would only embolden their own economies. This runs counter with the intent of liberalization so it would only make sense to see a reduction in subsidies so that countries should specialize in their most effective industries while importing from the least efficient sectors. We also saw a shift in international trade in terms of services. As the sector began to boom members felt a need to include it within the trade talks, so it too could be properly moderated in relation to other spheres. Its components included service dealing with hotels, consulting services, and financial services such as Citicorp (Fieleke 1995).

Another pre-GATT trade agreement was the intellectual property front. Much like the service sector, this industry would gain more prominence over the years, making its inclusion in this round an obligation. As expressed by some members” Governments have long endeavored to protect the ownership rights of inventors, writers, and other producers of intellectual property, but no multilateral system of principles and rules has existed to discipline international trade in counterfeit items.” From this conclusion, we would see a stress in offering proper protection for intellectual property through copyright claims, trademarks, and patents. These moves provided much needed affirmations on the safety of intellectual assets through mechanisms such as the MFN principle (treatment must be applied equally) and the transparency principle.

Yet, as always, there remained criticism of how the round played out. Some postulate that the deliberations were too one sided in favor of bigger nation states. It is implied that the smaller states had little purchasing power in some of the measures pertaining to agriculture tariff reductions as well as how sophisticated new entries such as intellectual property worked, which hindered their ability to defend some of its provisions. Many smaller organizations felt sore about the absence of human needs and the overhaul between the more powerful states in dealing with industrial tariffs as well.

Despite this, the Uruguay Round was still clearly the most crucial step taken to further trade liberalization since the 1940s. As a result, more tariffs were lowered in the world, and more nations became official members of the GATT organization. The Uruguay Development Round (or The Uruguay Round) was perhaps one of the largest sets of trade negotiations introduced in modern history and took “seven and a half years,” lasting from 1986 to 1993. (WTO n.d.). It was not only the most encompassing in terms of the issues it targeted (the round focused on issues like “services liberalization...intellectual property rights, and sanitary and phytosanitary standards...”), but was directly responsible for the creation of the WTO in 1995. It showed how effective trade deliberations could be when all sides are willing to make concessions to bolster the market in totality.

The World Trade Organization (WTO)

The World Trade Organization only came into existence after succeeding GATT in 1995 during the Uruguay Rounds. The goal of the WTO is to ensure that global trade happens smoothly, freely, and predictably. The WTO currently has 166 members, all of which have ratified the rules of the organization in their individual countries (WTO website, 1 September 2024). The WTO tends to support the removal of trade barriers, which allows international trade to follow its natural course without hindrances such as tariffs, quotas, or other restrictions.



Figure 2.1: WTO members are shown in green, members dually represented by the EU in blue, Observers negotiating accession in yellow, and non- members in red

Environmentalists have long had concerns that the WTO privileged trade would be prioritized over health and environmental concerns, and it is important to understand that this organization has systems in place in order “for the protection of human, animal or plant life and health, and natural resources” (WTO 2024), which was enforced in the case brought by India, Malaysia, Pakistan and Thailand against the US, like adopting trade-related measures that ensure the flow of it to be smooth and predictably to raise people’s living standards. The appellate and panel reports were adopted in 1998. The WTO has six objectives: (1) to create and enforce rules for international trade, (2) to provide a forum for negotiating and monitoring trade liberalization, (3) to create a space to resolve trade disputes, (4) to increase the transparency of countries decision-making process, (5) to cooperate with other major international economics management globally, and (6) to aid developing countries so they may benefit fully from the global trade system (Anderson 2021). By encompassing all goods, services, intellectual property, and investment property, the WTO pursues its objectives more comprehensively than GATT – which focuses exclusively on goods. Through these objectives, the WTO attempts to ensure stability in global trade.

The WTO prevents countries from discriminating between their trading partners through principles such as MFN and National Treatment. The MFN treatment helps ensure that there is no discrimination as well that each country treats the 140 fellow-members equally, then the national treatment coincides with this treatment by allowing that all the locally and imported goods are treated with the same treatment as one's own nationals — which ensures that no matter who or what is being taking into consideration when putting a tax on it there is an equilibrium all throughout the process.

The Most Favored Nation treatment requires countries to provide identical treatment to all other members of the WTO. For Example, if the United States were to apply a 2.6 percent tariff on an import from the European Union, then the United States must apply a roughly 2.5 percent tariff on imports from every other WTO member country. One reason that the WTO may not have allowed their members to have free trade agreements would be due to it showing unfair treatment to the other members of the WTO. However, free trade agreements can be if it is within its region like the USMCA for North America and the EEA for Europe are necessary because it would aid economic integration within their regional areas. Additionally, developing countries can gain special access to markets, and countries can choose to raise barriers against products, and in some instances services, which are unfairly traded from specific countries (WTO 2022). This means that nations may have their Most Favored Nations Status removed that ensures a country's promise to fairly treat another country no matter if it is local or foreign. Currently, the United States has suspended 30 total countries from their Most Favored Nation Status (Kenton 2021). For example, as of April 7, 2022, the United States Congress voted to strip Russia of its Most Favored Nation Status following the invasion of Ukraine, which signified that they were going to be held “accountable for this unjustified and unprovoked war that has already isolated Russia in the world” (Partington 2022).

The WTO uses national treatment as another nondiscrimination policy. The national treatment requires WTO members to treat foreign products no differently than the domestic product after it has cleared customs. Under national treatment, countries may still apply tariffs to foreign products that would otherwise not be applied to the domestic product with the caveat that the foreign product must be treated equally after it passes through customs.

Dispute Settlement Mechanism

Disputes may arise in the WTO if a member country adopts a trade policy or takes an action that a fellow-WTO member believes to be breaking a WTO rule or obligation. The Dispute Settlement Mechanism was introduced during the Uruguay Round agreement after GATT dispute settlement measures lacked fixed timetables which created a court backlog. The Uruguay Round introduced a structured process with clearly defined stages, and greater consideration for the length of time the case should take (WTO 2022). For example, should a case run its full course with an appeal, the case should take up to 15 months, which is important to note that these cases do frequently go on longer than is statutorily allowed.

The WTO dispute settlement process begins with a request for informal consultation between parties. If the consultation failed to resolve the dispute, the party may request the appointment of an investigating panel, which comprises three members. After receiving oral and written submissions from both parties, the panel issues a report along with the panel's recommendation. Should a party wish, they may seek an appellate review of the panel's report and recommendation. The appellate body may uphold, modify, or reverse the panel's report and recommendation. However, most cases do not reach the panel phase of the dispute settlement, meaning that disputes are often settled without legal proceedings. Even then, the WTO rules can influence states to abide by their commitments by removing illegal trade barriers.

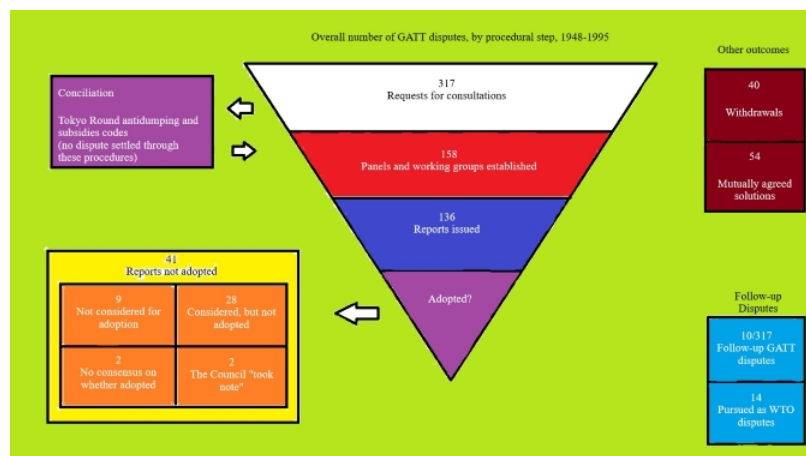


Figure 2.2: GATT Dispute Settlement Process (dated, needs updating to WTO)

The Doha Round

Despite Uruguay's Round's successes, it left several problems unresolved. Despite all that was achieved by Uruguay's Round, these trade negotiations ultimately failed to do one thing: provide a fair distribution of real and tangible benefits for developing countries. Uruguay's Round failed to provide developing countries with better access to rich countries' markets for the products they tended to produce, and it was the failure of the Uruguay Round that served as the impetus for the WTO to establish the new Doha Development Round during its fourth Ministerial Conference in Doha, Qatar, in November 2001. Additionally, it was meant to include the needs of developing as well as less-developed WTO member countries. The many issues that centered around the Doha Round: (1) Reduced tariffs on export of developing countries, (2) facilitating freer trade for agriculture and agricultural goods, and (3) revising rules surrounding trade in services. Unfortunately, the failure of Doha Round bargaining is a lost opportunity for the WTO. Though it was meant to boost the economic growth of developing countries, its continuous disagreements between China, India, Brazil, and other large economies with the rest of the developing world eventually led to downfall of the Doha Round.

Unlike the Uruguay Round, the Doha Round was never able to achieve the same number of successes. The Doha Round ultimately failed to achieve many of the issues on its initial agenda during its odd fourteen-year period. The subject of agricultural tariff reduction and more free access for developing countries in the realm of agricultural trade was an incredibly touchy subject regarding international trade. The importance of agriculture has been a big concern since no matter if you're the consumer or producer of these products the impact of the trade market affects everyone around them; additionally, the WTO concluded in 1995 that the agreement in agriculture that "initiated reductions in subsidies and trade barriers to make markets fairer and more competitive" (WTO 2024). Historically, agriculture is one area of international trade that the most developed countries came to be stricter on as agriculture is the foundation that helps cities and civilizations grow as well that without farming the world that is present would not have been possible. Producers in developed countries are protected by high tariffs and domestic government subsidies which, among other measures, have effectively barred developing countries from achieving any meaningful trade gains on this front.

So, the Doha Round's objectives became apparent: to fully get rid of "all forms of export subsidies, and substantial reductions in trade-distorting domestic support," (Verbiest et al. 2002, pg.4). Though the Doha Round did make some headway in this area, as we will soon discuss, there is some disagreement over the purported effectiveness of some of the solutions proposed in this round. Firstly, the participating member countries of the Doha Round all officially agreed to eventually abolish export subsidizing the year 2013, a decision that was fastened in the year 2005 by the Hong Kong Ministerial. Despite this consensus however, this agreement's "effectiveness might be somewhat less than suggested," given that export subsidies can essentially be "replaced by the same subsidy provided as a domestic subsidy," (Lester 2016, pg.1). What is more would be that in the more recent Nairobi Ministerial conference, domestic agricultural subsidies were not dealt with and "remain high and are proliferating," (Lester 2016, pg.1). While some progressions penning agricultural trade for the benefit of developing countries has been made, the issue remains largely unresolved due to the developed countries' refusal to budge on the issue of domestic subsidies and trade-distorting protections as well that some of the less developed countries are holding off in their support due to the system overwhelmingly distorting against them and having no agreement or treaty that will grant them growth as a country.

Another major area of concern for the Doha Round was the issue of increased Trade Liberalization and Trade Facilitation across the board, specifically for developing countries. Though the Doha Round, as mentioned above, failed to properly address some of the significant issues on its agenda, the development round did manage to produce some noteworthy, albeit modest, progress in the realm of Trade Facilitation with the ratification of the Trade Facilitation Agreement (TFA). The TFA was ratified in December 2013 at the Bali Ministerial Conference and is the "first new WTO multilateral agreement" since the actual creation of the WTO at the end of the Uruguay Round (Eliason 2015, pg. 643). The purpose of the TFA, and the Trade Facilitation in general, is to ensure the smooth, frictionless entry of goods into a country with as minimal cost and barriers to entry as possible. The TFA itself could reduce the cost of cross-border trading by \$1 trillion through its capacity to "improve transparency ...[reduce] institutional limitations, and [improve] access to information," (Eliason 2015, pg. 644-645). About efforts in promoting the removal of trade restrictions to facilitate the free exchange of goods between nations, the Doha Round produced the second iteration of the Information Technology Agreement. The (second) Information Technology Agreement is a trade agreement amongst 53 WTO member countries at the 2015 Nairobi Ministerial Conference aimed at significantly lowering tariffs on information technology products (Lester 2016, pg. 2).

The WTO Today

The Doha Round of negotiations encountered numerous obstacles in attempting to achieve many of the issues on its agenda, either due to external factors or internal, structural faults latent within the WTO. Developing nations did not receive any substantial

benefits from these negotiations in the way of increased market access for agricultural products or increased support for implementation of the objectives outlined in the TRIPS agreement. More importantly, the outcomes (or lack thereof) of the Doha Round may have broader implications for the WTO, questioning it as an efficacious institution in its attempts to promote frictionless international trade.

Even more detrimental to the WTO's mission has been the paralysis of the dispute settlement's Appellate Body, which is no longer functioning. Problems began in 2011 when the Obama administration prevented the reappointment of American Jennifer Hillman, who was already serving as a member, and then other members. The Trump administration continued to block all appointments and reappointments to the AB, and in 2019, it lost the ability to make quorum of three members. As a result, the WTO appeals process has now completely lost any ability to hear WTO disputes (see Schneider-Petsinger 2020).

Conclusion

In discussions about international trade, both the General Agreements on Trade and Tariffs (GATT) and the World Trade Organization (WTO) have played important roles. The postwar economic and political environment set the stage for the need for a rules-based system for international trade and the need for an institution to facilitate the flow of trade. Taken together, both GATT and the WTO have produced some of the most all-encompassing, internationally recognized, and politically important trade agreements in modern history whose outcomes have wide-reaching economic and political implications. From its inception in 1947 to 1995, GATT has undergone eight complete rounds of trade negotiations among increasing numbers of members with each round ultimately serving the goal of reducing international trade barriers and promoting a more open and more transparent system for global trade among countries. Among GATT's many achievements in promoting international trade, the eighth and final round of trade negotiations – known as the Uruguay Round – is perhaps the institution's crowning achievement. As discussed previously, the Uruguay Round was one of the most exhaustive sets of negotiations and trade agreements (ranging from agriculture to sanitary standards to intellectual property) ever constructed in modern history and, ultimately, epitomized the GATT's mission statement; in which this was the round of negotiations that created GATT's successor: The WTO.

The WTO's purpose was, like GATT, to reduce global trade barriers and facilitate freer trade between nations. The WTO now includes three times as many members as GATT and takes into consideration the interest of many more nations. But while the WTO might be GATT's successor, has it truly succeeded where GATT has otherwise stumbled? The outcomes, or lack thereof, of the latest round of trade negotiations under the WTO (the Doha Round) point to a more pessimistic answer. While the Doha Round was set to address issues that were important to developing nations, issues that were not properly addressed in the Uruguay Round, the negotiations met various internal and external roadblock and failed to achieve anything meaningful. As mentioned before, issues on market access for agricultural goods from developing nations, reductions in trade-distorting domestic, support for agricultural goods in developed nations, and other such problems persisted to some extent, so even after many negotiations over an extended period. So where does this leave the WTO? Is the Doha Round a unique case? Can the WTO move on and continue to push towards its primary objective in the way its predecessor had done? Or are the difficulties encountered in the Doha Round reflective of a larger, internal problem of the WTO? Should developing nations, whose interest have either been neglected, denied, or pushed back, seek out alternative means (i.e. regional trade agreements) of reducing trade barriers and realizing their economic pursuits? Or is the WTO simply no longer relevant in today's international stage? While these questions may not have an immediate answer, it is important to consider as the WTO pushes into a future of economic uncertainty and international instability. For the goals of the WTO to be realized, the institution itself, as well as its successes and failures, must constantly be reevaluated.

Worked Cited

Bagwell, Kyle, and Robert W. Staiger. 1999. "An Economic Theory of GATT." *American Economic Review* 89 (1): 215–48. <https://doi.org/10.1257/aer.89.1.215> .

Barton, J., Goldstein, J., Josling, T. and Steinberg, R. 1998. *The Evolution of the Trade Regime: Politics, Law, and Economics of the GATT and the WTO* . Princeton University Press, Princeton, NJ.

Eliason, A. (2015). The Trade Facilitation Agreement: A New Hope for The World Trade Organization. *World Trade Review* , 14 (4) : 643-670.

Fieleke , Norman S. 1995. "The Uruguay Round of Trade Negotiations: An Overview." *New England Economic Review* . Federal Reserve Bank of Boston. May – June , 3–14.

Keating, W. 2015. *The Doha Round and Globalization: A Failure of World Economic Development?* Thesis, The City University of New York, New York. <https://academicworks.cuny.edu/cgi/viewcontent.cgi?>

[article=1008&context=hc_sas_etds](#)

Lester, S. 2016. “ Is the Doha Round Over? The WTO’s Negotiating Agenda for 2016 and Beyond .” CATO Institute Free Trade Bulletin No. 64. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2784917

Partington, R. 2022, March 11. “G7 nations strip Russia of ‘most favoured nation’ status.” *The Guardian*. <https://www.theguardian.com/world/2022/mar/11/g7-nations-drawing-up-plans-impose-heavy-tariffs-russia-ukraine>

Schneider-Petsinger, M. 2020. “Reforming the World Trade Organization.” Chatham House. <https://www.chathamhouse.org/2020/09/reforming-world-trade-organization/04-dispute-settlement-crisis>

Solovy , E. M. 2022, December 14. “Policy brief: The TRIPS waiver for COVID-19 vaccines, and its potential expansion: Assessing the impact on Global IP protection and Public Health.” *Center for Intellectual Property x Innovation Policy*. <https://cip2.gmu.edu/2022/12/14/policy-brief-the-trips-waiver-for-covid-19-vaccines-and-its-potential-expansion-assessing-the-impact-on-global-ip-protection-and-public-health/>

Verbiest, J-P, Liang, J., and Sumulong, L. (2002). “The Doha Round: A Development Perspective.” ERD Policy Brief Series. Asian Development Bank.

World Trade Organization. 2000. “WTO | Understanding the WTO – the Uruguay Round.” *Wto.org*. 2000. Retrieved from https://www.wto.org/english/thewto_e/whatis_e/tif_e/fact5_e.htm .

World Trade Organization. n.d. “Understanding the WTO – Trade and Environment.” Retrieved April 15, 2024, from https://www.wto.org/english/tratop_e/envir_e/envt_rules_intro_e.htm

World Trade Organization. n.d. “Understanding the WTO – Uruguay’s Ground Agreement: Agreement on Agriculture.” Retrieved April 15, 2024, from https://www.wto.org/english/docs_e/legal_e/14-ag_01_e.htm

World Trade Organization. n.d. “Understanding the WTO – The Agreements: Intellectual Property – protection and enforcement.” Retrieved April 15, 2024, from https://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm7_e.htm

This page titled [1.2: Trade- International Institutions](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.3: Trade- Preferences and Interests Groups 1.3: Trade- Preferences and Interests Groups

Edit Update titlecancel

Learning Objectives

- Define interest groups in the context of international political economy and explain their role in shaping policy outcomes.
- Define the concept of trade preferences, and understand how they impacts the international political economy.
- Analyze the different types of interest groups, including business groups, labor unions, and environmental organizations, and understand how they represent and advocate for their members' preferences.
- Understand the concept of preference formation and how it relates to interest group influence in the policymaking process.

Introduction

Preferences and interest groups in trade are central topics in international political economy (IPE) and have gained increasing attention in recent years. This surge in interest can be attributed to the fact that trade has become a key driver of economic growth, prosperity, and development in the global economy. Free trade has in the past been seen as the optimal solution, but preferences and interest groups complicate the picture. Preferences and interest groups make it difficult to achieve a level playing field. Specifically, preferences and interest groups can create inefficiencies that can undermine the benefits of trade liberalization.

The potential for some industries or groups to gain an advantage over others is a fundamental issue in IPE. Such distributional conflicts can happen in a variety of ways, including through protectionism by the government, subsidies, or tariffs. These policies may occasionally be influenced by influential interest groups with the power to influence lawmakers and decision-makers. For instance, manufacturers may advocate for tariffs on imported goods while farmers may advocate for agricultural subsidies. These regulations may result in increased consumer costs, lower quality goods, and decreased domestic industry competition. The possibility for trade disputes between nations is another problem connected to trade preferences and interest groups. Trading partners may become tense and at odds when one nation's interest group is given preference over another. This may result in punitive actions like tariffs, which may then intensify into trade wars. The global economy, as well as businesses and communities that depend on international commerce, can be significantly harmed by such disputes. Today, these issues are being studied and addressed by researchers. It has been argued by many economists that free trade is the best way to promote economic growth and development. At the same time, they also acknowledge that there are situations where trade preferences and interest groups need to be considered. Many have begun to argue and support for temporary protections to help developing countries. These protections are seen as a guideline for these developing nations as they attempt to build their own industries. Others argue that certain industries may require subsidies to maintain competitiveness. Governments around the world have taken a variety of approaches to dealing with trade preferences and interest groups. Some have begun implementing protectionist policies to support domestic industries. Others have sought to reduce barriers to trade and increase market access. Over the years the support for the trend towards bilateral and regional trade agreements that attempts to balance interests has increased.

Interest groups play an incredibly important role in free markets; they are defined as a collective that either loses or gains from the distributional changes of trade policy and therefore have a strong interest in how legislation concludes both domestically and internationally. They use their preferences to help order outcomes within an interaction and analyze those in order to achieve best-case scenarios. Because there are both winners and losers, we'll examine how outcomes are tiered and why interest groups and their preferences are central to international relations and global trade.

The importance of these groups is evident in almost every piece of legislation passed domestically, and internationally. Tariffs, foreign policy, elections, and many more aspects of a governmental organization are defined by Interest groups and their preferences. Interest groups are a great way for citizens to organize and attempt to make their needs, views, and ideas known as a collective. In global trade, Interest groups and their preferences play a central role in deciding how tariffs and regulations are decided by governments. Often, the argument between liberalization and protection becomes a priority and leads to both winners and losers with policy changes. For example, a nation and relevant interest groups may prefer democratic partners instead of authoritarian regimes and state-owned entities, which may lead to tariffs on non-democratic nations and trade agreements between more politically aligned countries. For certain sectors, this is considered a loss as that trade partner could have been integral to their production needs. For some groups, this helps strengthen their position in a once tighter market or helps them push their political agenda further. This can also lead to large scale issues as trade preferences pushed by interest groups may isolate or anger another nation, leading to retaliatory tariffs and further polarization. Smaller nations with less negotiating capital to offer may find it hard to

compete globally as interest groups will have their preferences focused on more robust economies that offer higher volume and more potential as a preference-receiving nation. It's important to note that there are also issues related to the domestic production of items when preferences are given to foreign countries. If, for example, preferences are given to Haitian manufactured apparel, it results in a production adjustment domestically. In the long term, the sector may become vulnerable to supply disruptions, natural disasters, and geopolitical turmoil involving Haiti. Interest groups vary from corporations to loosely organized community groups, and have long been involved in international affairs, however as free markets have progressed, they have less room for leverage as regulations and tariffs have lessened overall.

It should now be apparent to the reader that trade preferences and special interest groups are enormously important when understanding both the way in which states engage in trade globally as well as internally, not to mention the longstanding effect both trade preferences and special interest groups have politically. These concepts will first be discussed at the macro level, before being broken down to their most fundamental theories; let us first take a look at the types of interest groups and how trade preferences appear in practice.

Later in the chapter, we'll dive into theories that help classify interest groups, like the factor and sector theories, and how these help predict winners in trade. To go further, we'll also touch on Adam Smith and both comparative and absolute advantages and how we use them to help define the modern economy.

Types of Interest Groups

Interest groups are organizations that represent the views and preferences of specific groups of actors, such as businesses, labor unions, and environmental organizations. These groups aim to influence government policies that affect their members' interests by lobbying policymakers and contributing to political campaigns. Interest groups often have significant financial resources, extensive networks, and specialized knowledge, which can enhance their influence in the policymaking process. However, interest groups may also face collective action problems, where coordinating and mobilizing members may be difficult. Moreover, interest group influence may be seen as undemocratic, as some groups may have more access and influence than others. It is, therefore, essential to analyze the different types of interest groups and understand how they represent and advocate for their members' preferences, as well as evaluate the advantages and disadvantages of their influence in the international political economy.

Trade Preference in IPE

When trade preferences and interests are manifested in the international political economy, they take on different forms. Interest groups are prevalent actors in the IPE, and when viewed in the context of international trade, such groups often possess a larger role than any one state on its own. Regional trade agreements, for example, are rather common agreements between two or more countries within a specific region that aim to liberalize trade and deepen economic integration among member countries. RTAs can take various forms, such as free trade agreements, customs unions, economic unions, and common markets. An example of a prominent RTA is the European Union, which is a regional trade agreement driven by trade preferences and interests, promoting intra-regional trade and protecting domestic markets. The implementation and enforcement of RTAs also reflect the trade preferences and interests of its member countries, as they interpret and implement these provisions based on their own domestic priorities and interests.

Moreover, the evolution of regional trade agreements over time also reflects the changing trade preferences of member countries. RTAs may undergo renegotiations or revisions to accommodate shifting priorities and dynamics while new trade rules, norms, and institutions may also emerge within regional trade agreements based on the evolving preferences and interests of member countries. For example, the Trans-Pacific Partnership (TPP) was a regional trade agreement that aimed to set high standards for trade and investment among Pacific Rim countries. However, the withdrawal of the United States from the agreement in 2017 led to its renegotiation and eventual transformation into the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which excluded some provisions that were previously favored by the United States.

Another way that one can consider trade preferences and interests is through the lens of developing nations versus developed nations. Each has distinct trade preferences in the scope of the international network, and these preferences are shaped by their unique challenges and position in the global economy. Developing countries often rely on international trade as a crucial source of jobs, economic growth, and poverty reduction; their trade preferences typically revolve around gaining access to new and profitable markets and promoting export-oriented industries so that they may take advantage of any natural resources they have access to.

At the same time, developing countries and their IGs may also have interests in protecting their domestic markets and industries from competition, safeguarding their agricultural sectors, and promoting domestic value-added activities. Developing countries

may use trade policy measures, such as tariffs, quotas, and export restrictions, to protect their domestic markets or industries from import competition and promote their domestic production. This is often driven by the need to safeguard domestic employment in order to protect small and medium-sized enterprises and preserve food security. For example, many developing countries impose tariffs or non-tariff barriers on agricultural products to protect their domestic farmers from competition with heavily subsidized agricultural products from developed countries.

Developed countries have their own distinct trade policy preferences, usually looking to drive economic competitiveness and prioritize political interests. This can entail aiming to secure access to new markets, reducing trade barriers, and optimizing regulations to secure the flow of investments. These countries will seek to gain preferential treatment in their trade agreements and are often able to do so due to their prominent position in the IPE.

Strategic considerations also play a large part in shaping the trade preferences of the interest groups of developed countries. They seek to strengthen their geopolitical influence and promote their values and norms, while countering the influence of other countries. They can use regional trade agreements as a tool for diplomatic engagement and alliance building. The EU has often done just this, as a part of its broader foreign policy objectives to promote stability, security, and prosperity in its neighborhood.

Despite their far-reaching goals and interests in global affairs, developed countries must maintain a respect for domestic political considerations. Governments and interest groups face pressure from internal stakeholders such as domestic industries, labor unions, and civil rights groups, which leads them to consider these preferences and seek to include provisions in trade agreements that address these political concerns. For example, labor and environmental standards, intellectual property rights, and investor-state dispute settlement mechanisms are often contentious issues in regional trade agreements involving developed countries.

While this discussion has outlined some of the optimal decision making for interest groups and countries in specific situations, it is important to note that not all act in their own best interests when faced with the global arena of trade; whether it be through inefficiencies, a lack of expertise in political decision making, or the distorting pressures of interest groups, many actors end up losing through trade. The following section will elaborate on these concepts and provide a framework for explaining the tiered outcomes of trade. To begin with, it is imperative to discuss some key terminology and theories that help us to understand why trade preferences and special interest groups are such a large and important voice within most if not all markets globally, both large and small. With that said, we will transition into discussing Adam Smith and Ricardo Viner and the issues of Absolute Advantage and Comparative Advantage.

Background Theories on Trade Preferences and Special Interest Groups

When discussing trade on a global scale, it is almost impossible to not include Adam Smith in the discussion. In this instance, Smith highlights correctly that the division and specialization of labor is how a modern economy grows as workers become more and more specialized and proficient in ever more detailed roles. This makes sense when one considers the time that Adam Smith lived in. Living during the age of Enlightenment in the United Kingdom, Smith saw the United Kingdom and western Europe as a whole, begin to industrialize at a rapid rate during the Scientific Revolution. As factories and fabrication of goods replaced the cottage and village industry which had been a constant of human society since the advent of agriculture, the need for specialized labor as opposed to the generalist labor roles of the dark ages such as carpenters or smiths soared to an all-time high, this was the truest in the most industrialized nation at the time, the United Kingdom. Adam Smith, looking at the fast-developing economy of his nation came up with a host of theories which have rightfully earned him the title of “Father of Modern Economics”, the most prevalent of his theories in our discussion of Trade Preferences and special interest groups is found within his Magnum Opus, *The Wealth of Nations*. In his book, Smith touches upon the division and more specifically, the specialization of Labor. He goes on to outline two types of advantages a country can have when engaging in international trade, these advantages being Comparative and Absolute. A comparative advantage is when a country can produce a good more cheaply and efficiently than it can produce other goods. On the other hand, an absolute advantage is when a country can produce goods for less of a cost than the country it is trading with. While both these ideas have been studied at length and deserve their own detailed discussion, the importance of comparative and absolute advantages towards trade preferences and special interest groups is that they are the most fundamental method of looking at what a country should specialize in producing, this in turn is what creates both trade preferences and special interest groups which seek to gain or further protections from their countries that align with the goods that they are producing. While absolute advantage has largely fallen out of favor as a driver for international trade, comparative advantage is the framework through which we understand free trade in the modern day.

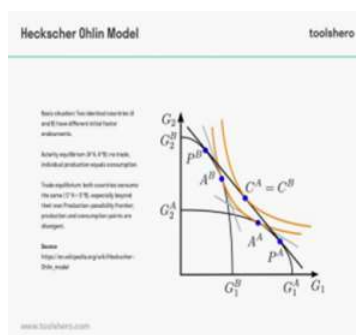


Competitive versus Comparative Advantage

In this vein of thought, another vastly influential Enlightenment Era scholar, David Ricardo, expanded upon the discussion of comparative advantage. Ricardo's theory of comparative advantage is often lauded as the logical backbone for the free trade argument from its inception over 200 years ago to the modern day. From Ricardo, we glean some key insights into how and more importantly when, countries should trade with each other as well as to what extent. Ricardo based his theory of comparative advantage in international trade in accordance with the relative difference amongst countries' opportunity costs, which he saw as the driving factor for efficient free trade as well as specialization within countries. Furthermore, Ricardo's model was based upon the Labor Theory of Value, which in essence counted Labor as the first and foremost means of production. Ricardo's theory of comparative advantage would go on to influence the economists Hecksher and Ohlin, who brought the discussion of comparative advantage to the modern day and provides us with the key framework of understanding the existence of Trade Preferences and Special Interest Groups and why they play a pivotal role in the makeup and trajectory of modern economies of scale.

H-O Model, Specific Factors Model, and the Development of Trade Preferences

The Heckscher-Ohlin Model (referred to as the H-O model from here on out) was developed by the Swedish Economist Eli Hecksher near the turn of the century and was expanded upon by his student at the Swedish School of Economics, Bertil Ohlin. Seeing the ever-changing socio-economic landscape of Europe at the time, Hecksher sought to reevaluate the works of Smith and Ricardo towards the now heavily capital-intensive markets of Europe at the turn of the century. It is from this outlook that the predictions and general principles of the H-O Model arise. Following Ricardo's thoughts on comparative advantage, the H-O model's basic principle is that all countries have finite resources of land, labor, and capital amongst others. In this vein of reasoning, as opposed to Ricardo's single, labor factor view, a country's comparative advantage is developed from creating products based on its most prevalent factor. In this two-factor system, when nations specialize, free trade should benefit all nations which take part in efficient trade. However, some paradoxes or seemingly irrational trade takes place against the H-O model's predictions. For example, the United States, an extremely capital-intensive market, more often exports labor-intensive products; in the same vein, only about half of capital-abundant nations export capital intensive products. While some of this can be accounted for by a lack of trade between global north and global south nations until recently, much of it can be explained by trade preferences between global north nations.



Graph Explaining the Heckscher-Ohlin Model

The Specific Factors model is best understood as a sort of synthesis between Ricardian Theory and the H-O model. The way the Specific Factors model works is like Ricardian Theory, this model assumes that a country that produces two or more goods can also adequately allocate labor between the production of these two different goods. However, unlike the Ricardian Theory, the Specific Factors Model incorporates other factors outside of labor, in line with the H-O model, if they are specific to one of two goods. The key assumptions or predictions drawn from the Specific Factors Model is that trade will occur when relative prices differ, countries will trade whatever goods they can produce the most cheaply, and most importantly to the discussion of trade preferences, specific factors in export sectors while those in import-competing sectors lose.

Both the H-O and the Specific factors model cannot be right. Neither model predicts trade flows very well, and the gravity model, which is a separate model that predicts how much states will trade based on their size, their proximity, and other characteristics, has shown the most success. Despite this success, it has been largely unknown why it works so well- until recently.

Michael Hiscox, a political scientist, looked at these models of trade in 2002 and found that perhaps both models are correct, asserting that the usage of the models depends on how mobile certain factors are in a given period. Therefore, if we were able to measure how mobile said factors are, we can know which trade theory to use to predict trade politics. This concept, combined with the model, could prove to be a useful tool in predicting the impact of trade on politics and vice versa. It is as if one is putting together the pieces of an equation; a formula where the missing variable can be determined if all other variables are known.

Trade Preferences and Special Interest Groups in Relation to International Trade

Understanding the H-O Model and the Specific Factors Model in the context of trade preferences and special interest groups is crucial to comprehending the complexities of international trade dynamics. These models provide and illustrate the foundation for understanding how trade preferences are formed between nations and how special interest groups influence trade policies at both national and international levels.

International trade creates trade preferences and alliances between nations for various reasons, such as maximizing profits or strengthening political ties. These preferences can often seem incongruent with the predictions of trade models, but they can be explained by the concept of trade preferences. For example, the United States may export more labor-intensive products to countries with similar preferences among global north nations, despite having abundant capital. Do note, however, that trade preferences are not static and can change over time.

Trade preferences are significant in building a useful model for understanding how countries interact economically and why there are hindrances to global free trade. Trade agreements are established based on trade preferences, and these agreements can shape the flow of goods and services between countries and impact trade patterns and economic relationships.

Special interest groups, particularly in capital-intensive markets, play a crucial role in shaping international trade policies. These groups, typically composed of powerful corporations, lobby for preferential legislation and trade policies to protect or expand the markets they are involved in. Their influence on trade policies can have far-reaching effects on a country's economy, including subnational impacts on dietary patterns, energy consumption, and labor markets.

For example, soy and corn farmers in Iowa have significant influence over energy consumption and food availability in North America through their lobbying efforts. Dairy farmers seek protections from the federal government in the pricing of milk, which can have implications for the availability and affordability of dairy products in the market.

Understanding the role of special interest groups is essential in comprehending the complexities of international trade dynamics. As these groups often have significant power and influence over trade policies, their interests and preferences shape trade patterns and economic relationships; it is such that trade preferences and special interest groups are inherently intertwined. These groups lobby for preferential treatment or protectionist policies to benefit their industries, and in reverse, trade preferences can shape the interests and strategies of special interest groups, as they seek to take advantage of preferential trade agreements or alliances. However, it should be noted that special interest groups may not always align with the broader national or global interests, and their influence can sometimes lead to distortions in trade patterns and hinder the benefits of free trade.

Trade preferences and special interest groups play significant roles in shaping trade policies and influencing trade patterns and economic relationships between nations. By considering the interplay between these factors, we can gain a more comprehensive understanding of why international trade often deviates from the predictions of trade models and how trade preferences and special interest groups impact global trade dynamics.

Conclusion

With a better understanding of the broad categories of interest groups and their preferences, we can now explore areas where changes in geopolitics might lead to new developments. The changing political landscape of the 2020s and shifts in the position of workers may lead to a new wave of unionization efforts at large companies like Amazon and Starbucks, leading to new coalitions advocating for their preferences on trade policy. It will be important to observe how the increased organization of labor impacts their preferences and ability to advocate for them, as well as how multinational corporations react to this labor movement.

Another area that requires observation is the trade policy preferences resulting from the resurgence of NATO amid Russian aggression in neighboring countries. Significant actions like war lead to political costs for businesses, and in recent years,

consumers have increasingly looked towards businesses in the political sphere. As a result, these costs may change preferences regarding trade policy. For example, corporations may prefer reduced trade barriers with oil-rich countries to access resources without having to deal with Russia.

The continuing progression of globalization and the increase or decrease in connectivity will also lead to changes in preferences from every interest group. In studying trade preferences, it is important to note that outcomes are not indicative of individual actor preferences but rather the confluence of preferences from all involved actors. The factor theory and sector theory are particularly useful in classifying types of interest groups, as they predict different winners of trade, leading to different policy choices that different interest groups will advocate for.

It is certainly important to determine what interest groups are more likely to be effective in advocating for their preferred policies. Larger groups have more collective action issues, as organizing more competing interests requires overcoming more obstacles, but firms generally have fewer issues than consumers. Protectionist interests tend to be advocated for by specific domestic business interests because those businesses benefit from reduced international competition. Consumers tend to benefit from free trade, which results in lower prices from more competition. However, protectionist measures and policies tend to be advantaged or overrepresented in policy because firms are better at advocating than consumer groups.

One example of this is the Corn Laws enacted in Britain in 1815, which were protectionist tariffs on grain from outside Britain. Landowners supported the laws because they allowed them to charge higher prices for their grain, benefiting from reduced international competition. In contrast, non-landowners had to pay higher prices for grain products like bread and opposed the laws. Eventually, due to organizational efforts by opponents of the laws known as the Anti-Corn Law League, they were repealed in 1846. This example illustrates how economic situations and comparative advantages lead to preferences, which lead to policy that impacts preferences, leading to new policy.

In summary, this chapter has covered trade preferences and interest groups, reviewing Smith's and Ricardo's work and the models that influence trade preferences. We also explored real-world examples like the Corn Laws and modern American interest groups like dairy farmers. The discussion should provide readers with a fundamental understanding of what preferences are and why groups have them.

Works Cited

Carpenter, K. (n.d.). Petitions and the corn laws – committees – UK parliament. Retrieved from <https://committees.parliament.uk/committee/326/petitions-committee/news/99040/petitions-and-the-corn-laws/>

“Comparative Advantage and Adam Smith.” Comparative Advantage International Political Economy, https://mediawiki.middlebury.edu/IPE/Comparative_Advantage.

Gabel, M.. (2004). Hiscox, M. J.: International Trade and Political Conflict – Commerce, Coalitions, and Mobility.. Journal of Economics. 81. 281-283. 10.1007/s00712-003-0029-7.

Lake, D. A., & Powell, R. (1999). Strategic choice and international relations. Princeton Univ. Press. Interest groups, lobbying and polarization in the United ... (n.d.). Retrieved April 21, 2022, from <https://repository.upenn.edu/cgi/viewcontent.cgi?article=1000&context=edissertations>

Newnham, Randall E. “Georgia on My Mind? Russian Sanctions and the End of the ‘Rose Revolution.’” Journal of Eurasian Studies, vol. 6, no. 2, 2015, pp. 161–170., <https://doi.org/10.1016/j.euras.2015.03.008>.

Los Angeles Times (2015). IMF Agrees: Decline of Union Power Has Increased Income Inequality. Los Angeles Times, Los Angeles Times, 25 Mar. 2015, <http://www.latimes.com/business/hiltzik/la-fi-mh-imf-agrees-loss-of-union-power-20150325-column.html>.

This page titled [1.3: Trade- Preferences and Interests Groups](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.4: Trade- Domestic Institutions and Policymaking 1.4: Trade- Domestic Institutions and Policymaking

Learning Objectives

Upon completing this chapter and the activities involved, learners should be able to:

1. Identify how different regime types affect international policies and how it also affects domestic political institutions.
2. Understand how the Access Point Theory of Trade influences trade policy decision-making.
3. Understand how the electoral frameworks and interest groups contribute to trade policymaking decision.
4. Be able to explain the dynamics between domestics and international institutions in trade policymaking decision.

Introduction

A country's trade policy can be seen as a result of aggregated trade preferences of its domestic institutions. Domestic institutions typically refer to the officially established channels through which policy is formed. Most countries have economic institutions, political institutions, and interest groups. By analyzing the frameworks and priorities of each of these categories we can gain an understanding of how trade policy is proposed and implemented.

This chapter will discuss how economic and political regime type can impact the ability of the domestic institutions to contribute to trade policy. Regime type also influences the way a country negotiates trade policies with other countries. Though the world is filled with various economic and political regime types, an offer of trade relations can bring almost any country to the negotiating table. Historically, trade policy has also been used as a tool of foreign policy. Domestic economic and political institutions have rallied around trade policies that serve as deterrent or punishment for political regimes that have offended global norms.

This chapter will also discuss the role of interest groups in the formation of trade policy. An interest group is a group of people that form around a common policy goal and seek to advocate for this policy. The term interest groups often conjures an image of wealthy business representatives pressuring elected representatives to vote in their favor. While this is one version, interest groups range from nonprofit advocacy groups seeking civil rights improvements to political action committees (PACS) funding the campaign for candidates that align with their values.

This chapter will look at how domestic institutions interact with international institutions. When it comes to trade, domestic institutions focus on the control of importing and exporting. A domestic political institution may wish to appeal to constituents by promising a restriction on imports, thus protecting the constituents livelihoods. A domestic economic institution may wish to reduce volatile and complex supply chains. Accomplishing these goals would be easier said than done as domestic institutions must content with the norms of international institutions that oversee international trade. Finally, this chapter will examine three historical cases that illustrate how regime type can influence domestic institutions, and how those domestic institutions influence trade policy. These cases will specifically analyze the effect of interest groups being able to advocate for protectionist policies in a time of global economic downturn.

The Access Point Theory of Trade

One of the most influential dynamics in the making of trade policy is the relationship between interest groups and policymakers. A major factor in determining outcomes in trade policy is the domestic institutional framework in which these groups operate. The number of access points refers to the opportunities interest groups have to engage with the policymaking process. Access points are one of the most important institutional characteristics in determining trade policy, with greater access leading to the implementation of a more protectionist trade policy (Ehrlich, 2007). In addition, the collective action capabilities of groups are an important determinant of whether institutional opportunities can be leveraged to their advantage. Well funded interest groups are able to use these funds to organize and donate, creating more access points with each donation. For example, an interest group may fund a candidate with common trade policy preferences knowing that the election of that candidate will advance their policy goals. In other cases, the interest group may donate to a candidate in exchange for the politician answering the phone when the interest group calls.

Many interest groups working with and creating access points with many politicians compounds the impact that interest groups have on policymaking. This access point theory argues that aggregate protectionist lobbying power outweighs that of the free trade lobby. Combined with the ability to impact policymaking through numerous avenues, more protectionism on the whole (Ehrlich, 2007). Researchers also tested this theory by investigating the impacts of political parties and system type on these trade policy

dynamics. When there are a greater number of political parties involved in the system, researchers observed a positive relationship with the tariff amounts that were instituted—both in the short and long term of the policy horizon (Ehrlich, 2007). In addition, presidential systems tend to be associated with much lower tariffs, exhibiting a nearly ten percent decrease compared to countries governed by other types of domestic political institutions (Ehrlich, 2007). This is likely due to the fact that presidents typically deal with macro, state-wide economic concerns, and are also typically less beholden to individual interest groups than other policymaking actors such as individual legislators.

How Regime Types Affect Trade

Since the era of mercantilism, political economists and researchers have engaged in debates relative to the state's role in development and its international trade. In the post-World War era, but most especially after the Cold War, market economies proliferation was no longer limited to liberal democratic states. Therefore, this phenomenon draws the researchers' attention to the link between regime type and a nation-state's international trade policies.

The diversity of political systems (heterogeneity of regime type) in different countries, can have a significant impact on international trade. It is noteworthy to point out that the relationship between regime type and trade is complex and it has been explored by many scholars in the field of political economy (Simmons and Elkins, 2004). It is not accurate to say that autocracy encourages trade liberalization, or that democracy is against trade liberalization. In fact, the relationship between regime type and trade policy is more complex than a simple binary of autocracy versus democracy. While some scholars have argued that autocratic regimes may be more likely to pursue trade liberalization because they do not face the same pressures from domestic interest groups as democratic regimes, others have suggested that authoritarian regimes may also be more likely to engage in protectionism and limit trade.

Similarly, while democracies are often associated with free trade, this is not always the case. Democracies may face pressures from domestic interest groups or political opposition that can lead to protectionist policies or limits on trade. For example, in the United States, a democratic country, protectionist policies such as tariffs on steel and aluminum were implemented by the Trump administration in 2018, were seen as contrary to the principles of free trade. On the other hand, China, an authoritarian country, has pursued a policy of economic liberalization and trade openness since the 1990s, despite its autocratic regime.

One key argument relative to regime type is that democracies are more likely to engage in free trade because democratic regimes are more accountable to their citizens which makes it more responsive to public demands for economic growth and access to international markets. On the other hand, authoritarian regimes may prioritize political stability over economic liberalization, leading to protectionist policies and barriers to trade. Other scholars have challenged this view, arguing that regime type alone does not necessarily determine a country's trade policies. Rather, factors such as domestic interest groups, the distribution of economic power, and historical legacies may also play a role in shaping a country's trade policy (Simmons and Elkins, 2004).

For example, in their study of trade openness in China and India, Lee and Swenson (2018) found that although China is an authoritarian regime and India is a democracy, both countries pursued similar policies of economic liberalization and trade openness in the 1990s and 2000s. The authors suggest that this was due to a convergence of economic interests and ideas among elites in both countries, rather than a reflection of their regime types. Another study by Simmons and Elkins (2004) examined the impact of regime type on the adoption of international legal agreements. They found that democracies were more likely to ratify and implement international trade agreements, but the effect of regime type was mediated by other factors such as economic openness and the presence of international organizations.

Relative to regime types and their effects on trade, it is noteworthy to mention that states (governments) began to reduce barriers to trade in the mid-nineteenth century, whereby Britain was the first to repeal its "Corn Laws" in the 1840s, and opened its market to imported grains (Oatley, 2019 p.16). Additionally, in 1860, Britain and France eliminated significant trade barriers between them by executing the Cobden-Chevalier Treaty. This treaty subsequently triggered a wave of trade negotiations and immediately established a network of bilateral treaties which substantially reduced trade barriers in Europe. On the other hand, The United States refused to embrace the nineteenth-century trade liberalization, it remained staunchly protectionist up until the 1930s (Oatley, 2019).

Overall, the relationship between regime type and trade is complex and may be influenced by a range of factors beyond just the type of political system. The specific factors that shape a country's trade policy are likely to be shaped by a variety of factors, including domestic political pressures, economic interests, and global geopolitical trends (Frieden, 1991). Further research in this area could continue to explore these nuances and identify the specific mechanism through which regime type may impact a country's trade policies.

Electoral Frameworks and Trade

Additional research has touched on the relationship between electoral system type and interest group access to trade policymaking as well as the importance of the interplay between international trade negotiations and domestic political institutions. The differences between plurality rule and proportional representation systems have been a particular focus when determining the causes of where the trade policy lies on the continuum between free trade and protectionism. The plurality rule is more conducive to allowing very particular interest groups to exert substantial influence on trade policy, whereas the characteristics of proportional representation systems tend to make policymakers more responsive to a much broader set of less-organized interested parties (Betz, 2017). The smaller, single-member districts which typically occur in plurality electoral systems make individual legislators more beholden to local interests which tend to favor protectionist policies which work in their self-interests (Betz, 2017). In addition, the plurality rule tends to exhibit a wider overall range in the degree of protectionist trade policies that are instituted in a particular state. Figure 1 shows applied tariffs, Overall Trade Restrictiveness Index (Kee, Nicita, and Olarreaga 2009), for proportional representation and plurality rule. The figure displays the mean (as the bright horizontal line within boxes), upper and lower quartile (as the limits of the box), and upper and lower adjacent values (as the whiskers) for each group (Betz, 2017).



The Dynamics Between Domestic and International Institutions in Policymaking

The relationship between states and the coordination of international trade policy is a complex one that highlights the importance of domestic political institutions. Because international negotiations on trade are dependent upon reciprocal actions between states, exporters constitute an important interest group whose influence depends largely on the opportunity for involvement within the system of domestic political institutions in which they operate (Betz, 2017). These sorts of factors are important aspects of the strategies that are employed by international organizations. International trade institutions are likely to have more success at instituting their policy aims when member states have domestic political institutions that allow for more interest group influence in the policymaking system (Betz, 2017).

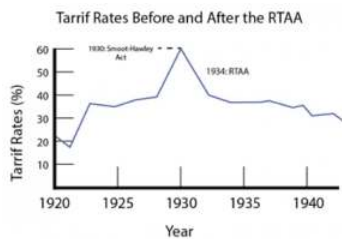
Lobbying and Policymaking

Political parties and interest groups occupy important, albeit awkward, places in the American political system. Neither parties nor interest groups are mentioned anywhere in the Constitution, and many of the founders distrusted “factions” of all kinds. Nonetheless, political parties and interest groups have emerged as the most important intermediaries between individuals and decision-makers in the federal and state governments (Lowry 2021). At the intersection between the political and the economic spheres lies the lobbying industry. Trillions of dollars of public policy intervention, government procurement, and budgetary items are constantly, thoroughly, scrutinized, advocated, or opposed by representatives of special interests (Bertrand et al., 2011).

Lobbyists’ connections to politicians are a significant determinant of what legislative issues they work on. Specifically, a lobby that works on trade policies and international relations, is systematically more likely to be connected (through campaign contributions) to legislators whose committee assignments include trade and relations. A large part of the theoretical literature on interest groups has painted the lobbying process as one of information transmission. Informed interest groups send cheap or costly signals to uninformed politicians. However, these stylized models of lobbying do not account for the presence of the lobbying industry as an intermediary. The role that the lobbyists themselves play in the lobbying process and how they use their specific skills and assets are some, if not all particularly valuable to the interest groups which hire them. According to one view, lobbyists are the experts who provide information to legislators and help guide their decision-making process. Their expertise might be particularly valuable when one considers that neither legislators nor the interest groups which hire lobbyists may have the technical background or the time to delve into the detailed implications of all the pieces of legislation that are under consideration (Bertrand et al., 2011).

There is deep skepticism about what exactly lobbyists do. There are two main views widely discussed by scholars and in the media. The first view considers lobbyists as issue experts who can contribute valuable information to the law- and rule-making process; the second considers them more as sources of access to lawmakers, because of their personal ties and knowledge of those

lawmakers. While both lobbyists' expertise and their connections might be at play in the lobbying process, the value analysis suggests that connections are the scarcer resource and therefore the one that commands the highest price (Bertrand et al., 2011).



Domestic Politics of Trade Policy

In 1989, Magee, Brock, and Young created a model of trade policy in which politicians chose trade policy strategically to gain campaign financing. They called this the endogenous tariff theory: in this theory, there are two presumptions that help define the endogenous approach to political economy. The first presumption is that final policy choices are systematically related to the economic effects of the chosen policy. The second presumption is that the relevant economic effects can be derived from standard, neoclassical, and or microeconomic models of the economy. (Nelson 1988). As a result of this process, tariffs arose – in other words, they finally had an explanation for trade protection.

Domestic politics matters for trade policy is now a well-established trope in both economics and political science. International trade and international relations more generally are not determined by a sole national executive, acting autonomously and isolated from the pressures of domestic political interests when choosing tariff levels, health and safety rules, and regulations, or other elements of trade policy. Instead, trade policy, like any other domain of public policy, is determined by the interplay of domestic economic interests, domestic political institutions, and the information that is available to all involved players. International trade theory offers a natural starting point for the political economy of protection. The classic Heckscher-Ohlin model of trade in which a country's factor endowments play a crucial role in determining the pattern of trade also allows clear predictions of the effect of trade on the relative incomes of factor owners. (Leeds 1999)

While identifying individual and firm preferences is the first step towards a complete model of trade policy, the next one is to specify how they influence policymaking. What can now be regarded as an endogenous process – lobby formation – was black-boxed until the seminal work by Grossman and Helpman (1994). The main idea behind Grossman and Helpman's (1994) theory of endogenous protection is best described by the paper's title: "Protection for Sale." It argues that special interest groups can use campaign contributions to incentivize politicians to adopt favorable trade policies. There is a contribution schedule as the announcement by a lobby of the number of campaign contributions it is willing to make in exchange for a given policy. The equilibrium is then defined as "a set of contribution schedules such that each lobby's schedule maximizes the aggregate utility of the lobby's members, taking as given the schedules of other lobby groups." It is industries' relative importing or exporting nature that will affect their decision to deviate from free trade. Grossman and Helpman (1994) take the existence of organized groups as a given, but Mitra (1999) endogenizes the lobby formation process.

Historical Cases

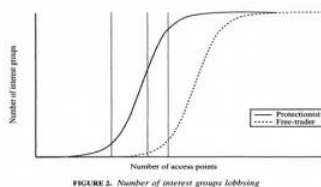
Domestic political institutions play a big role in trade policies so, in order to understand why countries decide to enact certain policies, we must discuss how their intuitions decide policies, historical trends, and similarities across regions. The first country we will discuss is the United States. The U.S. has not always had the same system to decide trade policies. Prior to 1934, trade policy was made and decided in both Houses of Congress: the House of Representatives and the Senate. Having the legislative branch make trade policies allowed interest groups to have greater access to the policy-making process and often ensured policies that would help protect industries were enacted. During this period of U.S. history, trade policy tended to be more protectionist which refers to having policies that protect domestic industries over foreign ones. Trade policies were protectionist because industries had more access points to the policy-making process which meant they had many opportunities to lobby for policies that would protect their industries. As expected, tariff rates remained high during this period with the average tariff rate of the United States being set at 60% in 1930 by the Smoot-Hawley Act.

The trend of protectionism and high tariff rates ended in 1934 when the Reciprocal Trade Agreement Act (RTAA) was passed. The RTAA moved the power to set tariffs from the legislative branch to the executive. This also tied tariff reduction to foreign concessions. Now, why would Congress agree to give up the power they had to set tariff rates? There are a few reasons that could

have led to the RTAA being passed. One reason is that it could have been done to help reduce the workload of Congress. Another reason could have been that Congress had decided that they were not the best branch to make trade policy. The third possible explanation is that Democrats wanted lower tariffs even when Republicans were in majority so to reduce the partisan issues, Congress decided to let the executive branch deal with trade policies. When Congress had the power to set tariff rates, the trend tended to be that when Democrats took, they would decide to lower tariffs while Republicans did the opposite. The RTAA had two primary rule changes for trade policymaking. The first was that it mandated reciprocal tariff reductions as opposed to the unilateral reductions like there was previously. The second change was that it required the ratification of trade agreements by simple majority votes instead of the supermajority. Since the RTAA was passed, protectionist groups like the ones that had greatly influenced trade policymaking, lost their influence and have not been as successful since.

The changes the RTAA brought are important because it shows how domestic political institutions can greatly influence policy making. By shifting trade policy-making powers to the executive, the RTAA not only made free trade a possibility in the U.S. but also eventually changed the optimal policy choices of elected officials. Now, we should discuss how trade policy-making of other countries is influenced by their domestic political institutions. As we have seen, legislators have been able to be influenced by protectionist lobbying but this is not the case in all countries. Unlike in the United States, where legislators were susceptible to protectionist demands due to their independence from their parties, in countries like Canada and Australia, party discipline is high. This means that legislators often stick to the policies favored by their party so they are less susceptible to protectionist lobbying that could lead to high tariff rates as the United States had prior to 1934.

Other countries, such as Chile following the Great Depression, began adopting a trade protectionist model instead. Using the Import Substitution Industrialization model, local producers were at an advantage as their products were prioritized in the market in comparison to exports priced with a higher tariff. As foreign competition charged consumers high prices due to tariffs, domestic manufacturers were able to significantly raise their own prices to gain a higher profit. This led to Chilean citizens paying astronomical prices for items that could've been lower in a non-protectionist economy.



As Chile attempted to be a self-supporting economy, manufacturers were forced to produce goods where they lack the skill of properly manufacturing in comparison to foreign competition, leading to lower quality products at high prices. Products of lower quality also tended to malfunction at a quicker pace compared to the imported goods from places that manufacture higher quality of a said product. For example, consumers had to pay up to 52% more for a pair of pants than if they were able to with an open international market (Edwards, 2009). These high prices made it difficult for the average working-class person to afford many goods.

Importers struggled with selling in Chile as they were heavily taxed for their products. However, they were subjected to make 10,000% deposit prior to selling in the Central Bank of Chile while said goods were held in customs (Edwards, 2009). The deposit combined with the country's ever-growing inflation rate of 30% per year also contributed to the high prices placed on imported goods.

Exporters also have difficulty making a profit selling abroad as the Chilean government strengthens the worth of the Escudo. This made the export profit worth less in local currency than with foreign currency. The effect of the overvaluation of the Escudo was equal to an export tax ranging from 24-32% of the value of the exported goods (Edwards, 2009).

It is a common belief that democratic regimes often produce policies encouraging trade liberalization and that autocrats will encourage trade protectionism. Nevertheless, not everyone fits this stereotype and decides to do the opposite. The following country we will discuss is Spain under the Franco dictatorship, where an autocracy encourages trade liberalization.

The dictatorship of Francisco Franco in Spain saw both trade protectionism and trade liberalization. When Franco stepped into power in 1939, Franco decided he wanted the economy of the nation to be separate from the rest of the world. To do this, he created many policies against the free trade market and alienated Spain from the global economy. However, this led to an economic downfall for the country as inflation rates multiplied, there was not much foreign investment coming in, and the emergence of black markets.

As Franco realized that the country would continue to suffer with its current economic policies, in the 1950s, he began implementing changes that would allow Spain to reenter the free market. The first major step taken was the Pact of Madrid, a military and economic agreement between Spain and the United States signed in 1953. In this pact, Spain allowed the United States to use its military bases in exchange for economic aid. During the first ten years of the pact, the United States sent different kinds of economic aid that totaled around \$1.5 billion (Solsten, Meditz, Library of Congress, 1990).

Following the Pact of Madrid, Franco spent the rest of the 1950s trying to liberalize Spain leading to the implementation of the Liberalization and Stabilization Plan (PSL) in 1959. This Plan focused on three main areas: reducing inflation, liberalizing domestic markets, and liberalizing foreign economic relations (Prados de la Escosura, Rosés, J.R., & Sanz-Villarroya, 2012). Economists figured out that the high inflation came from a lack of monetary discipline, leading them to create policies that controlled spending by the public and decreased the discount rate in the Bank of Spain. Most of the domestic market was inaccessible to the global economy, so the PSL began to suppress regulations regarding international trade and update policies to ease administrative procedures to allow trade to be more accessible. Along with liberalizing the market, the final area the PSL focused on is the liberalization of foreign economic relations. Strict tariffs and quotas were relaxed to complete this, and Spain increased its presence globally.

A prime example would be at the end of 1958 when Spain's peseta currency became integrated with the Bretton Woods system and convertible with the major European currencies. Before 1958, Spain had a robust black market for foreign currencies, as official exchange rates were outrageous. However, with the integration into the Bretton Woods system, official exchange rates became reasonable, dissolving the black market due to a lack of demand. Taking part in the Bretton Woods system also relaxed Spain's then-restrictions regarding foreign direct investment and international trade, leading to 80% of total trade liberalization and the near disappearance of quotas by 1973 (Prados de la Escosura, Rosés, J.R., & Sanz-Villarroya, 2012).

In the graph below, we see exports and imports as a percentage of Spain's GDP over time (Prados de la Escosura, Rosés, J.R., & Sanz-Villarroya, 2012). We see the graph reach an all-time low in 1942, three years after Franco took over. As years went by, we saw a slow increase until right before 1954, when the Pact of Madrid was signed. Afterwards, the levels of exports and imports began to reach the same levels prior to the Spanish Civil War. After 1959 and the implementation of the Liberalization and Stabilization Plan, we see that imports and exports continue to historically grow.

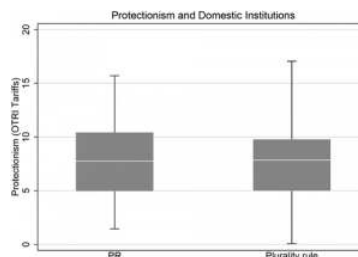


Figure 4 OPENNESS, 1850-2000 (EXPORTS AND IMPORTS AS % OF GDP)

Sources: Prados de la Escosura ([Reference Prados de la Escosura 2003](#)).

The change from protectionism to trade liberalization during the Franco dictatorship was significant to history as it became a case of institutional heterogeneity. After a failed attempt to keep Spain productive outside the global market, Franco decided it would be better for the country to open up to trade again. The economic growth following the implementation of the Liberalization and Stabilization Plan in 1959 up until the 1970s became known as the "Spanish Miracle."

Conclusion

The interactions between domestic political institutions and trade policy remain a dynamic domain of understanding, both in the literature as well as in the real-world policymaking process. Theory suggests that countries with democratic political institutions are more likely to have more collaboration and input from different actors in the trade policymaking process than in autocratic states which place decision-making authority in the hands of a small number of individuals. In addition, differences have been observed between states with strong democratic institutions. Research has found that differences in electoral processes can affect policy outcomes, with plurality systems tending to exhibit more trade protectionism than proportional systems. The presence of strong domestic political institutions is also a major determinant of whether or not international trade institutions are successful in fostering reciprocity between nations and healthier trading relationships. At the intersection between the political and the economic spheres lies the lobbying industry. The role that the lobbyists themselves play in the lobbying process and how they use their

specific skills and assets are some, if not all particularly valuable to the interest groups which hire them. Nonetheless, political parties and interest groups have emerged as the most important intermediaries between individuals and decision-makers in the federal and state governments (Lowry 2021). Trade policy, like any other domain of public policy, is determined by the interplay of domestic economic interests, domestic political institutions, and the information that is available to all involved players. As we have seen, this applies in many countries including the United States where interest groups played a large part in the process of making trade policies, especially before 1934. Lobbying led to strict protectionist policies that would not have been as extreme if it were not for the interest groups pushing for the policies. Having multiple players involved in the policymaking process is a characteristic of many democratic nations. This shows how the access point theory applies to American policymaking. When there were many different access points for influence before the RTAA, Congress implemented protectionist policies. After the RTAA, the number of access points decreased and trade liberalization began. A contradiction to this theory, however, is seen in the protectionism of countries such as Chile following the Great Depression. As the global economy fell into a depression, Chile began relying mainly on itself to produce the products that used to be imported following the Import Substitution Industrialization model. Throughout history we see many examples of autocracies promoting trade protectionism and democracies promoting trade liberalization to the point where we associate the trade policy with the type of institution. However, there are instances where a government goes out of the norm and displays an act of institutional heterogeneity. The Liberalization and Stabilization Plan of 1959 used in Spain under the Franco dictatorship is a prime example of institutional heterogeneity as we see an autocracy switch from promoting trade protectionism to encouraging trade liberalization.

Opportunities for Future Research

Continued investigation into the inner workings of the lobbying apparatus could provide a better understanding of how these powerful interests devise strategies for seeking the implementation of advantageous trade policy. On the empirical side, integration of the access point theory and the concept of veto players (political actors who must provide their approval in order to allow changes in policy) may provide additional insight into the actions necessary to succeed within particular institutional frameworks (Ehrlich, 2007) (Tsebelis, 1995). In addition, research into both the causes of individual attitudes toward trade, as well as the dynamics of collective action in policymaking may further this line of inquiry (Alkin et al., 2015).

Works Cited

- Aklin, Michael, Eric Arias, Emine Deniz, and B. Peter Rosendorff. "Domestic politics of trade policy." *Emerging Trends in the Social and Behavioral Sciences*, Wiley Online Library (2015).
- Bertrand, Marianne, Matilde Bombardini, and Francesco Trebbi. 2014. "Is It Whom You Know or What You Know? An Empirical Assessment of the Lobbying Process." *American Economic Review*, 104 (12): 3885-3920. DOI: 10.1257/aer.104.12.3885
- Betz, Timm. (2017). Trading Interests: Domestic Institutions, International Negotiations, and the Politics of Trade. *The Journal of Politics*, 79(4), 1237–1252. <https://doi.org/10.1086/692476>
- Dijkstra, A. G. (2000). Trade Liberalization and Industrial Development in Latin America. *World Development*, 28(9), 1567. [https://doi.org/10.1016/S0305-750X\(00\)00040-1](https://doi.org/10.1016/S0305-750X(00)00040-1)
- Edwards, Sebastian. "Protectionism and Latin America's Historical Economic Decline." *Journal of policy modeling* 31, no. 4 (2009): 573–584. <https://doi.org/10.1016/j.jpolmod.2009.05.011>
- Ehrlich, Sean D. (2007). Access to Protection: Domestic Institutions and Trade Policy in Democracies. *International Organization*, 61(3), 571–605. <http://www.jstor.org/stable/4498158>
- Ehrlich, S. D. (2008). The Tariff and the Lobbyist: Political Institutions, Interest Group Politics, and U.S. Trade Policy. *International Studies Quarterly*, 52(2), 427–445. <http://www.jstor.org/stable/29734242>
- Feinberg, R. (2008). Policymaking in Latin America: How Politics Shapes Policies/Civil Society and Social Movements: Building Sustainable Democracies in Latin America. *Foreign Affairs*, 87(5), 177.
- Fernandes, Ana Margarida, Klenow, P., Meleshchuk, S., Pierola, M., and Rodriguez-Clare, A. The Intensive Margin in Trade. (2018). *World Bank Policy Research Working Paper No. 8625*, Available at SSRN: <https://ssrn.com/abstract=3273672>

- Frieden, J. A. (1991). Invested interests: The politics of national economic policies in a world of global finance. *International Organization*, 45(4), 425-451.
- Hillman, A. L., & Ursprung, H. W. (1988). Domestic Politics, Foreign Interests, and International Trade Policy. *The American Economic Review*, 78(4), 729–745. <http://www.jstor.org/stable/1811171>
- Kim, In Song, Londregan, J., & Ratkovic, M. (2019). The Effects of Political Institutions on the Extensive and Intensive Margins of Trade. *International Organization*, 73(4), 755–792. <https://doi.org/10.1017/S0020818319000237>
- Lee, J. W., & Swenson, G. (2018). Heterogeneous autocrats: Trade policy in China and India.
- Leeds, B. A. (1999). Domestic political institutions, credible commitments, and international cooperation. *American Journal of Political Science*, 43(4), 979. <https://doi.org/10.2307/2991814>
- Lowry, Robert. “Political Parties and Interest Groups Syllabus.” University of Texas at Dallas, 2021. <https://personal.utdallas.edu/~rc1062000/Syll4326.pdf>.
- Nelson, D. (1988). Endogenous tariff theory: A critical survey. *American Journal of Political Science*, 32(3), 796. <https://doi.org/10.2307/2111247>
- Oatley, T. H., & EBSCOhost. (2019). *International political economy* (Sixth edition.). New York, NY: Routledge.
- Prados de la Escosura, Rosés, J. R., & Sanz-Villarroya, I. (2012). Economic reforms and growth in Franco’s Spain. *Revistade Historia Económica*, 30(1), 45–89. <https://doi.org/10.1017/S0212610911000152>
- Simmons, B. A., & Elkins, Z. (2004). The globalization of liberalization: Policy diffusion in the international political economy. *American Political Science Review*, 98(1), 171-189.
- Solsten, Eric, Sandra W Meditz, and Library Of Congress. Federal Research Division. Spain: A Country Study. Washington, D.C.: Federal Research Division, Library of Congress: For sale by the Supt. of Docs., U.S. G.P.O, 1990. Pdf. <https://www.loc.gov/item/90006127/>.
- Tsebelis, G. (1995). Decision Making in Political Systems: Veto Players in Presidentialism, Multicameralism, and Multipartyism. *British Journal of Political Science*, 25(3), 289-325.

- **Need sources and captions for all figures**

This page titled [1.4: Trade- Domestic Institutions and Policymaking](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.5: Trade- Development, Growth, and Inequality 1.5: Trade- Development, Growth, and Inequality

By the end of this chapter, students should be able to:

1. Identify and understand the leading trade theories of ISI and ELI and their effect on development.
2. Understand the history of how countries used these trade theories to grow their economies, specifically through integration with GVCs.
3. Identify other modes of development outside of ISI and ELI and how states use these.
4. Understand the scope of research still needed when it comes to trade policy and its effects on development and inequality.

Introduction

The leading theories among economists tend to show that most countries benefit from free trade. This movement towards free trade, meaning less barriers such as tariffs and other requirements on imports/exports is called trade liberalization. Organizations such as the IMF, WTO, and the World Bank are all organizations with the primary goal of increasing trade liberalization around the world, as well as encouraging policies that lead to free trade. Advocates of open trade policy argue that trade is essential as countries that engage in international trade experience rapid growth, innovation, and productivity. The theory of comparative advantage, which simply means that a nation should choose to produce what products it is best at producing. When nations start to specialize this usually leads to rapid economic growth which in turn generates more income, a variety of goods and services for consumers, and more opportunities for citizens and in developing countries. Essentially, efforts to integrate with the global economy through trade policy drives economic growth and reduces poverty locally as well as across the globe. While this widely supported argument for international trade presents it as an optimal policy especially for economic growth and development, it is far more complex than it is suggested to be.

Trade and development have had a variety of implications on countries and communities worldwide as it has contributed to the increase in the mobility of labor, capital, services, and goods across borders. It has fundamentally altered economies and societies by making them progressively interconnected.

However, the understanding of economic theory has evolved. Early on, the dominant theory was that a country's exports should exceed its imports with the trade plus being used to expand reserves of gold or silver. Then British economist, David Ricardo proposed the theory of comparative advantage which emphasizes efficiency in production. Ricardo argued that even if a country can produce goods more cheaply than other nations, it can still benefit from trade. And lastly, contradicting earlier theory, the American economist Frank William Taussig coined the concept "terms of trade" which defines the ratio between the number of exports needed to acquire a certain number of imports. The theory of terms of trade indicates that the fewer exports, the better as the terms of trade can change in ways that either benefit or harm the country through a reduction in welfare. Second, the nature of trade has also drastically evolved as it no longer occurs between small producers but among global or multinational corporations who produce and sell goods and services globally. Although this was the result of trade liberalization and advanced technology, international trade has expanded far more rapidly than global economic growth" (Kirst, The Wilson Center) impacting the types of strategies developing countries use to stimulate economic growth.

This chapter will first discuss two prominent trade theories, import substitution industrialization (ISI) and export led industrialization (ELI) exploring its emergence, importance, and limitations. The study of ISI and ELI will showcase whether developing countries may in fact, be disadvantaged if they liberalize their trade regimes. Next, as a direct application of these trade theories, this chapter provides a case study of South Korea and its use of ELI to promote economic growth as well as Brazil and its use of ISI. Section 2 expands upon the ISI and ELI strategies to consider other ways countries can develop by examining total factor productivity, GVC's, and terms of trade. To conclude, the final section explores the future of research as it remains obscure as to how trade policy contributes to growth, namely its effect on inequality. Additionally, new research has suggested that much of the original thinking behind how trade policy affects development may in fact be misunderstood.

Trade Theories: Import Substitution and Export Led Industrialization

Beginning in the 1930s and 1940s, some countries began to focus on manufacturing for the domestic market. The loss of traditional export markets because of the Great Depression required more domestically oriented economic policies. And following World War II, trade policies were influenced by the belief that the key to economic development was the creation of a strong manufacturing

sector. To do that, developing countries needed to protect their domestic manufacturers from international competition. This trend was prevalent and reflected in trade policies as domestic groups chose to consciously limit foreign competition, seeking to become more self-sufficient through the industrialization of their domestic market.

Import substitution industrialization (ISI) is a trade and economic policy that was established based on the idea that countries, specifically developing countries, should utilize the local production of industrialized products to reduce their dependence on foreign states (Manger and Shadlen, 2015). At its core, ISI seeks to replace imports with domestic production. Policies are enacted by developing countries to create an internal market, seeking economic development by nationalization. ISI policies include high barriers to trade, government subsidies and incentives to industry, and state ownership of much of the economy. Tariffs and nontariff measures worked to shield local producers from international competition. Investment in industry was encouraged by subsidies and tax incentives by the government. Countries that had high levels of state ownership in their key sectors were able to provide important inputs to local firms. Preferential treatment of domestic firms in government procurement was often used as a tool to promote local industry. By pursuing protectionist, domestically oriented trade policies, a country can shore up production channels for each stage of a product's development (Manger and Shadlen, 2015). Imposing local content requirements on foreign investors ensures transnational firms locally source their inputs, increasing domestic demand. This targets newly formed domestic industries to fully develop sectors so that production can be competitive with imported goods. At the same time, strategic sectors are reserved outright for domestic firms. Therefore, it is important to understand that ISI is not just about protecting domestic firms, but also about creating incentives for investment in new productive sectors.

While ISI policies have been successful in some cases, there are limitations to the concept. The attempts of ISI policies to promote domestic production often required large commitments of capital goods as well as advanced technology that had not been available domestically (Manger and Shadlen, 2015). These products would have to be imported, leading to balance-of-payment issues. This required more foreign borrowing or massive government spending. Even for the infant industries that ISI often focused on, development policies were not necessarily successful long term. For industries where policies were successful, there were issues when the infant industries needed to become subject to market forces but did not want to lose the government assistance. Generally, these issues meant that government finances deteriorated, external debts grew, and ISI generated inflationary pressure. That all meant that there was a shift in economic development and trade policies. The debt crises in the 1980s meant that protectionist strategies became unsustainable. Therefore, developing countries shifted towards new strategies of economic development in the 1980s and 1990s that were based on more liberalized trade and export orientation (Manger and Shadlen, 2015).

Export-led industrialization (ELI) focuses on the growth of manufacturing production aimed at the international market. By exporting goods that a nation has a comparative advantage in, developing countries can speed up their industrialization process. By reducing tariff barriers, establishing a fixed exchange rate, and increasing government support for exporting sectors, markets become open to foreign competition and gain market access to other countries (Karunaratne, 1980). Around 1970-1980 many nations began to adopt this model which gave them huge benefits and help to accelerate their economy. This type of economic policy is an excellent method to increase the exports of the country which improves the country's foreign currency, and a higher export growth can generate higher productivity, thus creating even more exports in a positive upward-spiraling cycle. A big example is the well-known East Asian Tigers (South Korea, Japan, Taiwan, Singapore, and Hong Kong). They utilized ELI policies and thus experienced rapid economic growth. While they never had free trade, they implemented many trade policies that were less mercantilist and were meant to promote exports (Manger and Shadlen, 2015).

The East Asian Tigers faced much less competition from other developing countries and therefore were able to achieve rapid growth for their export-oriented industries. Further, there were aspects common between all four countries that allowed for their development to be more successful while it may differ in other countries. For example, the success of a particular development strategy may depend on external conditions, such as the different forms of foreign aid and financing available to a country. Figure 1 shows the increase of the GDP per capita from 1945-2018. This explains very clearly the rapid growth in the economy of those countries because of the changes in their economic policies. The three East Asian Tigers being the first developing countries to pursue an export demand growth process at an early stage in the postwar era: this is especially significant as these countries were among the few that would eventually achieve a high level of manufacturing exports as a percentage of total exports, 134.5 percent for Hong Kong in 2010 and 37.9 percent for Korea.

The main difference between export-led industrialization and import substitution industrialization is the extent to which industrial production is targeted for export rather than domestic competition. ISI is about reducing trade and protectionist policies while ELI is about stimulating trade with policies that promote exporting. Countries that used infant industry protection initially, but then turned those industries into global competitors, were more successful in the long haul (Manger and Shadlen, 2015).

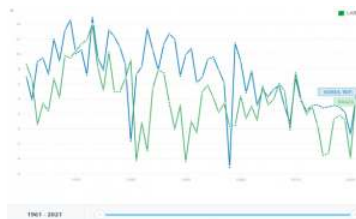


Figure 1: GDP per capita of Japan, North Korea, South Korea, and Taiwan, from 1945 to 2018.

ELI Case Study

South Korea

South Korea, one of the Asian Tigers, using ELI policies was able to promote rapid economic growth and therefore, serves as a comprehensive case study to examine the success of ELI discussed in the previous section. After experiencing a military coup in 1961, South Korea was one of several East Asian countries which began experimenting with the export-led industrialization (ELI) model of trade policies. This primarily included the restriction on imports into the country but combined with the focus on selling manufactured goods to its trade partners, including the United States and Japan, and the exploitation of cheap industrial labor due to a lack of regulation on labor, South Korea was able to boisterously expand their economy until the early 1980s. They are, however, quite a special case due to the amount of foreign loans received from its major trading partners, a benefit not shared with most other countries which utilized ELI.

To prioritize the exporting of goods in the national economy, South Korea was required to change the focus of its manufacturing industries, from their initial import-substitution position to the more outwardly focused ELI system (Haggard et al, 1991). This largely involved the direct regulation of these industries, including hefty tax credits and institutional support for exporting industries. While investment in the domestic market was still common during this period, protections for companies which chose to focus on exports were prioritized by the regime, to signal their attempt to change to an export-oriented market (Haggard et al, 1991). South Korea also began limiting its imports, chiefly focusing on the importation of raw materials and capital goods (Krishnan, 1985). This was a major shift from the import-intensive economy of South Korea during the mid-to-late-1950s (Haggard et al, 1991). Limiting imports to only the necessary materials for industrialization allowed South Korea to optimize their industrialization, often exporting consumer goods to the same countries the raw materials were acquired from.

South Korea's success using export-led industrialization policies stemmed largely from its relationship with much larger economies, most notably the United States and Japan (Krishnan, 1985). After establishing a permanent military presence in South Korea, to protect its own interests, the United States and Japan quickly became the largest purchasers of South Korean exports, with an average of over 35% of all exports from South Korea being purchased by the United States between 1961-1982 (Krishnan, 1985). This was also reciprocated by South Korea, with Japan and the United States accounting for the first- and second-highest share of their limited imports (Krishnan, 1985). These relationships between the United States, Japan and South Korea catalyzed the steady growth of South Korea's economy during the industrialization period. Both the U.S. and Japan are also responsible for providing direct aid to South Korea, with over \$5 billion in both public and private loans over this time period provided by the United States alone (Krishnan, 1985). Japan, which did not provide any major assistance until 1965, was able to account for almost 20% of South Korea's private loans, providing \$3 billion of the \$13.79 billion in commercial loans between 1959-1978 (Krishnan, 1985). Without the trade and loans generated by South Korea's largest trading partners, it likely would not have been able to see the rapid rate of growth it enjoyed until the 1980s.

Investments from large corporation helped the growth of the economy of the country. Those corporations took advantage of the commercial opening to diversify exports to have more manufacturing exports or natural resources, with greater incorporation of technologies and knowledge. Arguably the most important factor in the success of the export-led industrialization system in South Korea was the abundance of cheap labor. Following the Korean War, workers' rights legislation such as the Labor Standards Act, Labor Union Act, and Labor Disputes Adjustment Act (Minns, 2001). This legislation gave laborers the guarantee of an eight-hour workday and the ability to form workers' unions. Under the military regime established with the coup in 1961, these labor unions were antagonized, which included banning said unions from political action and collaboration with other unions (Minns, 2001). No further developments were made in the realm of workers' rights legislation until the passage of the Minimum Wage Act in 1986. Due to these conditions, South Korean manufacturers were able to take advantage of the low-cost labor, rapidly increasing their rate of industrialization (Krishnan, 1985). This abundance of labor was optimal for the manufacturing of consumer goods, such as electronics and footwear, as well as textiles and metal, goods which

are further manufactured by the importing country to create finished products (Krishnan, 1985). Countries with higher labor costs, such as the United States, were keen to take advantage of trade with South Korea for their cheap labor. This allowed South Korea to rapidly expand their exports after adopting the ELI model, contributing to the steady economic growth seen by the country using this model.

While South Korea's economy was able to flourish by using the ELI model, it was assisted heavily by both foreign loans and trade with its major partners in the United States and Japan. Despite this, South Korea was able to develop a large economy due to its primary focus on international trade. Use of the ELI model allowed South Korea to expand from a small, postcolonial economy with a focus on industrialization for the domestic market, into one more export-oriented, able to fare well on the stage of global trade.

Supplemental Development Strategies

Numerous countries such as South Korea, analyzed in the previous section, have utilized ELI and ISI strategies to successfully engage in international trade. However, there are other strategies that countries employ to stimulate economic development including but not limited to total factor productivity, global value chain integration, national savings, terms of trade, and immiserizing growth.

Global Value Chains

Global Value Chains and the integration of more and more countries into them started to dominate global trade in the 1990s. Global Value Chains simply refers to the idea that one product may be produced with products that come from all around the world. For example, an American made car might also have parts from Japan, Taiwan, and the Netherlands despite being made in the United States. According to Dunhaupt and Herr, GVCs involve “a product crosses borders several times until it is finished, or a finished product is assembled in one country using many intermediate products produced in different countries (Dunhaupt et. al 2021). Intermediate goods are an especially important component of GVCs. It essentially is any good that is used to produce other goods, and this could be parts, knowledge, training and more. Many developing countries took advantage of specializing in these intermediate goods and gearing trade policy towards greater integration into GVCs and the global economy.

The theory of comparative advantage is essential to understanding how and why countries are striving for greater GVC integration. Comparative advantage means that a country will specialize in what it “is best at”. For example, if a Chinese factory worker can produce a greater number of goods in a more efficient way, then say their counterpart in South Korea, China would gear its policy towards exporting that product rather than wasting resources on a product that can be made more efficiently elsewhere. Many MNEs started to take advantage of low labor costs in developing countries and split their production process to ensure efficient production across multiple countries. By doing this, companies increase their profit margin and developing countries begin to industrialize. There is ample evidence that higher participation in GVCs leads to hastening industrialization in developing countries.

According to Dunhaupt, “market mechanisms in vertical GVCs support industrialization and also product and process upgrading under certain conditions.” (Dunhaupt and Herr 2021) Countries such as the Asian tigers have been especially successful in using ISI/ELI strategies to integrate into GVCs. While the literature has suggested that GVC integration leads to better pay-levels and labor conditions, recently these ideas have been called into question. Research has shown that a country must have a strong labor union movement coupled with strong political institutions to enforce labor law. Just because a country is producing what its best at producing doesn't necessarily mean that the conditions of employment improve.

Countries that have been successful in using GVCs to promote economic growth all used “conclusion of this is that for catching-up, countries need comprehensive horizontal and vertical industrial policy” (Dunhaupt and Herr 2021). Horizontal integration simply means domestic firms acquiring other firms or merging with each other. Vertical integration occurs when a domestic firm acquires a firm for it to gain an advantage in the production process, hence giving it more say in the full GVC. These two strategies must be used at the same time for GVCs to really have an impact on development. This is usually coupled with massive investment of the government in certain firms or industries to gain more control within the GVC. If a state uses these strategies to fuel economic growth, rapid industrialization usually ensues (Dunhaupt and Herr 2021).

Total Factor Productivity

One of the most important things in development is called *Total Factor Productivity*, or TFP. TFP is residual, or everything that is not capital (materials) or labor. It includes education, technology, infrastructure, healthcare systems, political institutions, policing, property rights, and more. While TFP encompasses many factors, a single number cannot be measured but only derived. A low

TFP means the society is less productive — after all, sick people do not work well, nor do those who cannot get to work because of poor transportation networks. When examining the gap between the richest and poorest countries and accounting for labor, differences in capital account are responsible for about $\frac{1}{3}$ of the disparity while the other $\frac{2}{3}$ is due to TFP.

ISI Case Study

Brazil

Brazil had implemented an industrialization strategy of import substitution from 1930 to 1980. There were numerous industrial policy tools being used, and the central state had a considerable width to control a wide range of economic factors and prices. It actively invested in basic industry and infrastructure, making up more than 40% of all investments made in the economy. Total factor productivity allowed for the development and creation of a compounded industrial structure. More specifically, sufficient institutions, and infrastructure Within the terms of this accepted economic theory was the key to this development.

When it comes to ISI- The economic theory of import substitution industrialization- its typically one that most developing nations utilize- especially when there's a goal to become more independent and less reliant on rich nations. To completely develop new sectors and make domestically produced goods competitive with imports, ISI focuses on the preservation and fostering of newly developed local industries. With Brazil, the role of immigrants was fundamental for the expansion of the coffee industry, but perhaps even more so for the development of Brazilian industry overall. From the end of the nineteenth century and the beginning of the twentieth, immigrants were brought in and 'provided' by the government for the manufacturing industry and for the establishment of free laborers. Understanding the growth of Brazilian industry depends on how coffee production has changed in terms of accumulating and the emergence of a wage-earning class as opposed to slaves or small-scale farmers. The influx of immigrants from Europe, particularly Italy, had a considerable impact on the growth of production-as well as Brazilians who started earning a living. Wages would have been greater if the growth of the coffee business had been entirely dependent on European immigrants. Exports were the main engine of economic growth in Brazil, increasing by 214% between 1840 and 1890. The five-fold growth in coffee production suggested that the coffee industry was the main economic driver despite sugar expanding by 33% and cotton by 43%.

Between 1928 and 1955, the manufacturing industry expanded at an average annual rate of 6.3%, increasing from 12.5 to 20% of GDP. The establishment of new financial institutions created during the ISI era was a significant development in Brazil. The increase of American investment during the 1920s marked a significant change, which persisted throughout the 1930s with the manufacturing plants and factories in Brazil. Brazil didn't have many export costs because the US was the country to which most of its products, including coffee, were sent. This was simply the period of transition from Brazilian proprietors of coffee plantations to more industrialized economies.

The expansion and level of political intervention in the following decades was greater, thus corresponding to the name of the process of Import Substitution Industrialization (ISI), representing significant progress for industrial development and both countries.



Figure 2 Cacao tree



Figure 3: Cacao Seeds



Figure 4: Photo of a Coffee Plant.

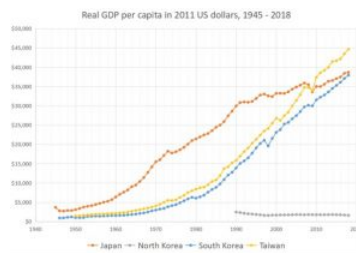


Figure 5: World Bank national accounts data, and OECD National Accounts data files.

Figure 5 shows real GDP growth between South Korea and Brazil to highlight the differences in ISI/ELI over the long term. Brazil while initially successful as not been as successful as Korea in the long run.

Effects of Trade: Global Inequality

Evidently, the effects and success of trade policy are not as obvious as economists would suggest. While some countries such as South Korea, were able to transform their economies using ELI policies and emerge as competitive powers on the international stage, others using ISI policies, such as Brazil were not as successful in the long run. Nonetheless, economists argue that in the aggregate international trade is beneficial as it results in more output, a variety of goods and services, and increased efficiency, and generally leads to industrialization. There is evidence to suggest however that some of these strategies have disproportionate negative effects on certain industries.

As countries increase production and investment, and depending on the development trade strategy expose themselves to the volatility of international markets they face challenges with the distribution of resources. One of the most widely agreed upon observations from trade theory and policy is that a country's exposure to international markets influences the allocation of resources within that country and potentially results in "distributional conflict" (Goldberg & Pavcnik, 2007, p. 39). Although research has yet to find a general trend in inequality, current trends in developing countries show an increase.

Furthermore, scholars have determined that the increase in exposure due to international trade impacts countries through three mechanisms: changes to labor income, relative prices (consumption), and household production decisions. A common theme that has emerged in literature suggests that globalization influences inequality by altering the demand for skilled workers. The rise in skill premium or the wage gap between high and low skilled workers is the primary contributing factor to rising inequality, particularly wage inequality.

While it appears that based on the few measures of inequality and globalization that as the global economy has become more interconnected it has also become increasingly unequal, establishing a causal link between globalization and inequality remains challenging as the “mechanisms through which globalization [affects] inequality are country, time, and case specific” (Goldberg & Pavcnik, 2007, p. 78). Existing conclusions on the impacts of trade policy are based on models that are more focused on the costs and benefits to specific sectors rather than how trade policy affects the gap between low and high skilled workers. The relationship between trade policy and inequality, specifically how trade policy may contribute to inequality is an area that needs further research.

Transitional Unemployment

Among the most widely expressed concerns about globalization, the notion that trade liberalization is accompanied by an increase in transitional unemployment as the economy adapts to the volatility of the international markets, is the most common. Unemployment does have important implications for income inequality as it largely affects low-skilled and poor workers. However, yearly total unemployment statistics show that macroeconomic recessions have a larger impact on unemployment than tariff reductions (Goldberg & Pavcnik, 2007, p. 69). Although it is crucial to note that these predictions do not specify which workers or sectors are impacted, hence they can be misleading (Goldberg & Pavcnik, 2007, p. 69). More broadly, there is a limited amount of empirical research that aims to identify the relationship between transitional unemployment, trade, and inequality, largely due to a lack of data sources; a trend that will be observed in the following sections and more generally applies to research about inequality and its causes.

Industry Wages

Industry wage premiums can be defined as the aspects of workers’ wages that are attributable to the workers’ industry affiliation rather than characteristics such as age, experience, and education (Goldberg & Pavcnik, 2007, p.70). Trade policies affect industry wage premiums in various ways but due to trade liberalization, wages in sectors composed of mostly unskilled workers decreased relative to the corresponding average wage, contributing to the rise in wage inequality. Nevertheless, there is evidence that the effect of trade liberalization on industry wage premiums was small, thus, it is not clear whether the decrease in these wages is a driving force of wage inequality (Goldberg & Pavcnik, 2007, p. 70).

Economic Uncertainty and Employment

Unlike other areas of research examining the effects of globalization on inequality, there is an existing body of research that has investigated how workers are exposed to greater economic uncertainty via “less secure employment” and “volatile income” due to globalization (Goldberg & Pavcnik, 2007, p. 71). More specifically, trade liberalization exposes both domestic consumers and producers to the unpredictable nature of international markets which results in more price volatility and productivity shocks, subsequently making wages and employment more volatile as well (Goldberg & Pavcnik, 2007, p. 71).

Labor Market Standards

Opponents of globalization insist that it affects inequality because it increases the number of workers employed in the informal labor market which is characterized by low wages and poor working conditions. They argue that trade liberalization increases the level of informality within the labor market because it heightens competition, leading firms to minimize costs by employing more informal workers and ultimately complying less to the labor market standards (Goldberg & Pavcnik, 2007, p. 73). Again, there is little data and research about the relationship between informality and trade reform, and the few studies that have examined it yielded mixed results, making these claims controversial.

It becomes increasingly clear that the difficulties in acquiring data sources and developing a framework to measure inequality have posed many problems for researchers as demonstrated in the examination of the various impacts of international trade on transitional unemployment, industry wages, economic uncertainty, and labor market standards. Existing research draws many conclusions and can be contradictory, primarily because measuring globalization and inequality is difficult and ambiguous.

Based on the few and limited measures of globalization and inequality, it appears there is an increase in inequality. However, there is not enough empirical research and evidence to establish a formal causal relationship between the two. Despite these difficulties, research has attempted to document the evolution of inequality by utilizing new and more thorough sources of data from which two trends emerge: developing countries have been more exposed to international markets, especially in recent years and while measuring inequality remains complex, existing measures of inequality in the developing world show an increase in inequality with some countries experiencing severe increases (Goldberg & Pavcnik, 2007, p. 39).

Conclusion

It is quite clear that trade policy and what type of strategy a state decides to employ to grow its economy has a massive effect on development or lack thereof. As mentioned much of the research dealing with trade policy and its effect on development can be contradictory. In practice, most countries have moved away from both ISI and ELI. These days, many countries employ elements of both with massive state intervention/investment. Research in this area needs to be expanded upon to truly measure the full scope of how trade policy affects domestic industries, namely income inequality and unemployment. States are no longer using the traditional practices of integrating into the global economy, and there is very little research available concerning these strategies. Ultimately, this line of research will continue to grow as more and more states are engaging in trade wars and joining the integrated global economy. As more countries develop, inequality will become important to understand and how it can be managed through government trade policy if at all. If there is research to indicate a direct relationship between a certain type of trade policy and rising income inequality, this will become important to the future of trade development. As more and more countries become competitive in the global trade market, we will see more and more different techniques regarding trade policy and tariffs to stimulate economic growth and most likely more research to confirm which strategies work well and which ones have not worked as well.

Works Cited

- Cooney, Paul (2022). *Paths of Development in the Southern Cone: Deindustrialization and Reprimarization and... Their Social and Environmental Consequences*. SPRINGER NATURE.
- Cooney, Paul. (2021) "Import Substitution Industrialization (ISI) in Argentina and Brazil." Springer International Publishing AG, Switzerland,
- Dünhaupt, & Herr, H. (2021). Global value chains – a ladder for development? *International Review of Applied Economics*, 35(3-4), 456–474. <https://doi.org/10.1080/02692171.2020.1815665>
- Goldberg, P.K. and Pavcnik, N., (2007). Distributional effects of globalization in developing countries. *Journal of economic Literature*, 45(1), pp. 39-82.
- Guimaraes, A. Q. "State Capacity and Economic Development: The Advances and Limits of Import Substitution Industrialization in Brazil." *Luso-Brazilian review* 47.2 (2010): 49–73. Web.
- Haggard, S., Kim, B., & Moon, C. (1991). The Transition to Export-led Growth in South Korea: 1954-1966. *The Journal of Asian Studies*, 50(4), 850–873. <https://doi.org/10.2307/2058544>
- Karunaratne, N.D. (1980): Export oriented industrialization strategies. *Intereconomics*, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, 15(5), pp. 217-223. <http://dx.doi.org/10.1007/BF02924575>
- Krishnan, R. R. (1985). South Korean Export Oriented Regime: Context and Characteristics. *Social Scientist*, 13(7/8), 90–111. <https://doi.org/10.2307/3520299>
- Krist, W. *Chapter 3: Trade Agreements and Economic Theory*. The Wilson Center. <https://www.wilsoncenter.org/chapter...conomic-theory>
- Manger, M.S. and Shadlen, K.C. (2015). Trade and Development. *The oxford handbook of the political economy of international trade*, pp. 444-451.
- Minns, J. (2001). The Labour Movement in South Korea. *LabourHistory*, 81, 175–195. <https://doi.org/10.2307/27516810>
- Stronger open trade policies enable economic growth for all*. World Bank. <https://www.worldbank.org/en/results...cies-enables-economic-growth-for-all>

This page titled [1.5: Trade- Development, Growth, and Inequality](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.6: Trade- Preferential Agreements

Overview

Preferential Trade Agreements (PTAs) are a major cornerstone of international trade policies in the 21st century. PTAs are agreements between two or more countries that grant preferential treatment to each other's goods and services by reducing tariffs and other barriers to trade. With the introduction of the World Trade Organization (WTO), PTAs were initially regarded as a thing of the past, but PTAs are more prevalent now than ever. More than two-fifths of world trade takes place within PTAs (Bagwell 2011, 7). There are currently 796 trade agreements on file, of which 557 are active, and 354 are in force at this time. As shown in Figure 1, this number has jumped significantly after the end of the Cold War and the 1994 General Agreements on Tariffs and Trade (GATT) Uruguay Round.



The Growth of PTAs

In this chapter, we argue that the current world order of Preferential Trade Agreements (PTAs) prevalence and necessity is based on the Hegemonic Stability Theory (HST). HST posits that a stable global economic system requires the presence or necessity of a dominant economic power, or hegemon, that can enforce the rules and norms of the system.

From the perspective of Hegemonic Stability Theory, PTAs can be seen as a threat to the stability of the global trading system. If countries begin to focus on regional trade agreements, they may start to neglect the broader global economic system, leading to the fragmentation of the framework of the current system. This could ultimately challenge the existing hegemon's control and threaten the stability of the global economic system.

Therefore, it is important to consider the implications of PTAs in terms of their impact on the global economic order. While PTAs may provide benefits to the involved countries, they should not be seen as a substitute for the existing global trade system. Instead, they should be seen as a supplement to the global system and a way to further strengthen it. Organizations like the WTO provide a useful, **global**, framework for trade, but preferential trade agreements allow

In the following sections we look at past examples, namely, The Council for Mutual Economic Assistance (CMEA) aka COMECON, which was the Soviet Union's trade agreement amongst eastern bloc and communist friendly states. We also look at the European Union, its predecessors, and the goals for which they were created. We delve into the political and economic ramifications of both the past through case studies in addition to the current reality facing us now. namely with the Trans-Pacific Partnership and the outlook it entails for the near-term future of trade.

Global Hegemon Theory

The current "American Empire" is in a downward trajectory- despite the best efforts of many actors, no successor has fully filled this void. There is not currently a single sphere of influence, thus explaining the reemergence and importance of PTAs today. Arguably the peak of current American order was in the 1990s when the Soviet Union dissolved. The competing spheres of influence dissipated allowing the commencement of the 1994 GATT Uruguay round to shape how trade will function in this new world. After the September 11th attacks in 2001 the absolute supremacy of the United States was shown. This has not been a swift affair and American willingness to act on the foreign stage has waned significantly. The tax on resources and morale of the citizenry has triggered somewhat of an isolationist desire to be self-sufficient and not interfere in the qualms of others.

In today's world there are multiple overlapping spheres of influence, including the United States, China, the European Union, and India. This overlap is unique and unprecedented in the last few centuries. Before the Second World War, trade was limited to your own sphere and those around you. After the Second World War there were two global spheres of influence that states belonged to, the West, led by the United States, and what lay behind the "Iron Curtain", centered around the Soviet Union. Now, there are two main transcontinental spheres: the receding American influence sphere, and the increasingly large Chinese sphere. The unique

factor is the states which play both sides along with the new regional powers emerging. Though initially viewed as sharing similarities to The Non-Aligned Movement (NAM) of the Cold War, the realities are much more profound. Specifically, countries like Turkey and India are becoming a regional powerhouse with strong relationships with both Russia/China and the United States. They are effectively playing both sides to achieve the best possible outcome for themselves. Other emerging powers like Brazil, Mexico and Indonesia are gaining regional influence and the ability to set the course of their respective regions. Within these new dynamics between states, preferential trade agreements between those with common interests are emerging. For example, in 2009 Australia and New Zealand struck a deal with the 10 countries that make up the Association of Southeast Asian Nations (ASEAN) in a new agreement dubbed the ASEAN Australia-New Zealand Free Trade Area (AANZFTA) in order to decrease tariffs between all nations involved. Because of this agreement, trade creation between members has increased significantly and trade diversion to non-members has increased at a lesser rate (Gharleghi, 2020). With emerging powers bearing no loyalty to a hegemon, the current landscape is one of PTAs continuing to flourish.

GATT, Integration, and Sovereignty

PTAs formed before 1995 were primarily concerned with trade in goods and took the form of free-trade areas (FTAs) or, more rarely, customs unions (CUs), involving mainly tariff liberalization. The General Agreement on Tariffs and Trade (GATT) was created after the second World War as a framework on trading in the new post-war era and has since been built upon numerous times. Most worthy of note in relation to PTAs is the framework laid out for trade relations between states outside of normal GATT rules. Specifically, Article XXIV of the 1994 Uruguay round which includes a developing country exception agreed to in 1979. Article XXIV provides the parameters under which FTAs and CUs can be created. FTAs are permitted “provided that trade barriers between members are eliminated on substantially all trade”. The Enabling Clause “permits developing countries to grant each other whatever preferences to which they may agree.” In addition, the Generalized System of Preferences “allows developed countries to grant preferential access to developing countries” (Krishna 11-12).

There are various levels of integration countries can achieve in PTAs. The most intertwined and complex of these is a customs union (CU). In such trade agreements the parties have a unified policy for trade with non-members of the agreement. This at its essence surrendering some aspects of its sovereignty to another body. This may eventually lead to even further integration through common institutions such as with the European Union (EU). The surrender of sovereignty is a hard pill to swallow, thus leading to the current gridlock in the further integration of Europe.

The European Union is the most prominent example of a customs union today. It was originally conceived as the European Coal and Steel Community (ECSC) at the end of the Second World War. One of the initial ideas behind its formation was that if two countries, like France and Germany had integrated economies, it would be very difficult for them to go to war with each other again. To add further pressure to this, coal and steel were two of the most important industries affecting the economies of the war and its immediate aftermath. It was initially targeted as it only conceded a very specific and limited amount of autonomy while furthering the goal of European peace.



Figure 2: 3-D Map of European Union

In 1957, the members of the ECSC met in Rome and signed The Treaty of Rome. This created the European Economic Community (EEC). The treaty laid out the main principles of the EU today, one of which is the common market. To achieve a common market required the implementation of a customs union. The six countries were surrendering an unprecedented amount of sovereignty and intertwining their fates in a way few countries have done while maintaining independence.

Many other European countries at this time were either unable or unwilling to join the EEC. A huge factor for many was the amount of sovereignty being surrendered in a customs union. Seven of these other European states met in Stockholm in 1960 signing the Stockholm Convention creating the European Free Trade Association (EFTA). The EFTA removed many trade barriers within member states but did not create a common market or impose a customs union. This left the sovereignty of its members’

foreign policies intact. Most EFTA members left the association to join the EEC and other European community treaties with time. There are still four members today who have chosen not to join the EU: Iceland, Liechtenstein, Norway, and Switzerland. These countries operate independently of the EU and have decided their sovereignty is more important than the potential benefits of joining the EU.

The EEC evolved with the creation of other European Community treaties leading to the creation of the European Union in 1993. The market has been further integrated through the use of a common currency, the Euro. This is managed by the European Central Bank, and constricted members' abilities to use currency to help exports. There are numerous institutions in place now as well which make the trade decisions for the whole of the block. Since the inclusion of treaties like the Schengen agreement of 1985 which eliminated law enforcement controls at the borders between members of the treaty, countries' trade policies are largely now decided in Brussels.

PTAs can open the door to further integration between members which can diminish sovereignty. However, this is rarely the initial intent and many countries remain fiercely independent and resist. In the next section we look at The Council for Mutual Economic Assistance (CMEA) and the ill-fated TransPacific Partnership (TPP) and the role hegemony and sovereignty played in their creation and implementation.

Case studies of CMEA and TPP

The first major PTA created in the post-war order was surprisingly on the eastern side of the iron curtain: The Council for Mutual Economic Assistance (CMEA) aka COMECON (acronym bears no relation to communism). This was created by the Soviet Union as a reaction to the plans laid out by the 1947 Committee of European Economic Cooperation (CEEC). This committee ultimately laid preparations for the implementation of The Marshall Plan to rebuild Western Europe. The sudden prospect of an integrated Europe cooperating and acting in unison caused the Soviet Union to get ahead of the curve of the anticipated Marshall Plan. Thus, the CMEA was initially created in 1948 as a customs union between its satellite states in Eastern Europe. What is most notable about the CMEA is that it preceded the Warsaw Pact defensive alliance. The purpose of these two agreements was to provide the legal means for the Soviet Union to reduce the sovereignty of the nations of the eastern bloc so they could more easily impose power in Eastern Europe.

The CMEA is a fantastic case study since it's the only major PTA which ceased force and was not replaced by a true successor in the modern era. As the eastern bloc satellites were liberated from communism their status as Soviet tributaries ended. This left the CMEA without a common binding force and thus ceased effect on June 28, 1991. The principles of economic cooperation between the former members had an attempted revival in the planned Organization of International Economic Cooperation Transition. However, due to the collapse of the Soviet Union into 13 republics, the process terminated. The closest successor to the CMEA would be the Commonwealth of Independent States (CIS) however this agreement was a last-ditch attempt to preserve the trade links between the new republics of the Former Soviet Union (FSU), not the eastern bloc and communist allies of the past.

The most notable example of a brand-new PTA created in the last twenty years is the ill-fated TransPacific Partnership (TPP). This agreement was spearheaded by the United States to single handedly cutoff China from its region, in hopes of igniting a decline and decimation of their growing sphere of influence. Arguably, the CMEA was used as a framework for the anti-China measures in the agreement. As stated above the United States' ability to steward this continued world order is currently hampered by domestic distractions and calls for isolation. Thus, in an ironic twist of fate, the United States pulled out of the very agreement it had written and lobbied other nations to join. The remaining members went ahead and signed the agreement, ratifying it as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

The American void in agreement has left an opportunity for China to join, although they would still be subject to the restrictions placed by the U.S. However, they would have gained access to countries that are highly unlikely to ever sign bilateral or Chinese-led multilateral agreements. Japan, with some assistance from Australia, has ensured the opportunity for the United States to return remains available, however they will not be able to do so indefinitely.

Political Rationale

Most of the political rationale for the creation of Preferential Trade Agreements are defensive in nature. Whether that be to protect and maintain established trade linkages or divert existing ones to politically advantageous locations. Sometimes the trade agreements are offensively minded with the intention of gaining influence or creating new supply chains within politically advantageous locations. Whether offensively or defensively minded the overall idea remains the same: enrich your friends while impoverishing your enemies.

Many of the PTAs that were made were created with the intention of directing trade to a more politically advantageous location. There are two ways in which trade agreements can be crafted in order to achieve this. A trade agreement can protect established industries within the PTAs member nations or seek to divert trade from nations outside of the PTA to nations in the PTA. Nations that seek to protect trade invoke a Rules of Origin clause. Typically, Rules of Origin dictate what goods-producing countries are eligible for preferential treatment within an FTA. NAFTA, for example, has an origin clause that dictates that a certain percentage of production must occur within North America for the good to trade freely. Overall, PTAs seek to create and promote trade with relatively few limits among member countries.

PTAs that seek to divert trade often will raise the cost to trade with nations outside of the PTA and lower the costs of trade within the PTA. When geopolitics are factored in, a country might choose to negotiate a PTA with a country or countries with the primary goal of exercising influence or gaining favor. A modern example of the U.S. negotiating a PTA with the goal of exercising influence would be the Trans-Pacific Partnership, or TPP. Created in 2016, “The TPP could help to address these grievances by diverting trade away from China and directing trade toward other countries, such as Australia, that enjoy more friendly relations with the U.S.” (Chow). The trade agreement was made with the containment and exclusion of the People’s Republic of China as its chief motive. While it is very hard to create a trade agreement that creates trade when previously non-existent, if certain circumstances are met trade can be created rather than diverted. However, these are mostly when PTAs follow free trade principles and rarely occur by design.

Many PTAs were also made with alliance structures in mind. Given the omnipresence of geopolitics, many nations use economics to leverage allies and enemies alike. As stated by Mansfield, “the gains from trade accrue to states with common security goals. Allies therefore have little reason to view as threatening increases in the power of members that are generated by trade. In fact, the gains in efficiency that are fostered by the expansion of trade among allies should increase the aggregate income of the alliance partners and hence, their collective military power.” (Anderson and Blackhurst 208). States tend to economically support political allies with preferential trade, rather than political adversaries. Nations are more comfortable with other powers making gains from trade if the partner powers have the same policy goals; however, hesitancy would be present when hostile powers benefit from trade. If two powers with the same policy goals mutually benefit from trade, then the two nations would use their surplus resources in cooperation. However, should two hostile nations mutually benefit from trade, then they would use their surplus resources in competition. This can be seen in Stalin’s creation of COMECON. Stalin created the organization not to promote trade, he wanted to prevent trade. “Following what he perceived to be an American drive for control of the whole of Europe, outside the Soviet Union, particularly through the establishment of the Marshall Plan in 1947, he clearly wanted to establish a distinct and defensible Soviet-East European economic system.” (Wallace and Clarke 1). Stalin saw American influence in Europe increase, and wanted to carve his satellite states far out of America’s reach.

Many great powers also use trade agreements to influence smaller nations. The great powers use their leverage within the trade bloc to get whatever concessions they desire. One such example was within the COMECON, trade bloc. The Soviet Union would utilize its dominant position within the Socialist world to exert influence on other Socialist nations. As stated in COMECON, Trade and the West, “It is an interesting theory that most East European problems stem from the efforts of monocentric governments to control their pluralistic societies. The theory could be extended to the USSR and, in a doubly complex fashion, to the CMEA—the Soviet Party attempting to run all the other communist pirates, and each in turn trying to run its own country” (Wallace, W., V., & Clarke 64). The Soviet Union viewed COMECON as that mechanism of influence to promote whatever version of Socialism they envisioned. The United States also viewed PTAs as a mechanism to promote their influence. Unlike the Soviet Union, which used a multilateral trade deal to influence multiple nations, the United States instead exerts their influence using many bilateral deals. “For the United States, entering bilateral rather than multilateral agreements enhanced its influence over the other participating countries” (Mansfield, E. D., & Pevehouse, J. C. W. 594). This was because the United States sought to build multinational institutions using consensus and cooperation, while the Soviet Union used coercion and force.

Economics of PTAs

Now that we understand the political implications and the history of Preferential Trade Agreements, we can transition into the overall economic impacts of PTAs in terms of trade creation and trade diversion. What do we mean by trade creation and trade diversion? In basic terms “PTAs that create trade increase welfare; PTAs that divert trade may reduce welfare” (Krishna 18). PTAs create trade by removing obstacles of trade, such as tariffs, quotas, and nontariff barriers. Competition created by the PTA between foreign and domestic producers creates new opportunities to sell abroad and obtain cost savings from greater economies of scale. This demonstrates the perceived cause and effect of trade which encourages a more efficient allocation of resources in the economy raising the average productivity of businesses and industries in states. Through this increase in productivity, trade can boost the

overall economic output and workers' average real wage. Consumers and businesses profit because trade lowers prices for some goods and services as explained, increasing the variety of products available for purchase. These agreements can enable states to harmonize laws and regulations which, among other effects, make the costs of operating businesses in other countries similar to those costs in their own state. Easing regulations on foreign investment and providing improved legal protections for foreign investors facilitates greater investment by states. An example of this would be NAFTA which caused significant increase in trade and investment mostly stemming from the U.S.-Mexico trade totaling \$481.5 billion in 2015, and U.S.-Canada trade, which totaled \$518.2 billion. Trade between Mexico and Canada meanwhile was the fastest-growing channel of trade between 1993 and 2015 even though the overall total was much lower at \$34.3 billion. The combination of these totals sum up to over a trillion dollars in trilateral trade which has increased by 258.5% in nominal terms and a real increase of 125.2% since 1993. In terms of GDP the United States' increased by 39.3% to \$51,638, Canada's increased by 40.3% to \$50,001, and Mexico's increased by 24.1% to \$9,511.

Trade diversion is an economic behavior separate from trade creation, which diverts trade from countries that produce goods efficiently to countries that produce the same goods relatively inefficiently. This, likewise, occurs through the formation of a PTA, and preferential treatment is given towards partners. An example of this would be the Tequila Crisis which occurred in 1994. During this crisis the Mexican government imposed tariffs on imports entering Mexico, except imports under NAFTA, which included a clause that eliminated this charge on imports from participating countries. In 1998, the government increased tariffs on imports after experiencing revenue loss when the worldwide price of oil plummeted. This discriminatory practice against non-NAFTA members caused trade diversion from those exporters to the benefit of NAFTA members (Kreuger 1999). Another example of this is how the European Union's application of common agricultural policy leads to increasing tariff discrimination towards outsiders. This is shown by the rate of discrimination and extra area imports having a negative correlation. Other important footnotes regarding trade diversion in term of PTA's are that "PTA membership lowers trade outside the bloc by 6 per cent" (Ghosh and Yamarik 2004) and "Intra-PTA trade diversion has been found in 3 out of 22 PTAs analyzed; 5 PTAs lower the extra-PTA exports from member to non-member countries as referenced by Acharya et al.2011. While trade diversion does have an impact as a consequence of a PTA it is not seen as a central outcome of an agreement. There is support on both sides if PTA's do indeed create trade or divert trade exemplified by various studies into the matter with overall mixed conclusions looking at the net welfare of PTA's overall. An example of this in favor of trade creation would be the Canada-United States free trade agreement (CUSFTA). A study conducted by Clausing (2001) found data "that the agreement increased US imports from Canada, but did not divert US imports away from other US trading partners. Similarly, the CUSFTA study by Trefler (2004) confirms the finding that trade creation outweighs the trade diversion effect" (pg. 105 WTO report). Conversely a study by Romalis in 2007 of NAFTA deduces that the PTA is trade diverting overall in comparison to trade creation. In this study "Romalis uses changes in EU trade over the period to capture the counterfactual (i.e., what would have happened in the absence of the agreement) but finds that the welfare costs of NAFTA are small" (WTO report pg. 105). Some other studies of importance that corroborate these findings would be Magee's study in 2008 using gravity models and Carrere's study in 2006 using the same model. Magee's study used "panel data for 133 countries in the 1980-1998 period and includes several fixed effects to capture the counterfactual: what would happen to trade if there were no PTAs. He finds that the average impact of PTAs on trade flows is small – only 3 percent – and that, on average, trade creation exceeds trade diversion" (WTO report 105). In comparison Carrere's study on PTAs found that "130 countries from 1962 to 1996 have generated a significant increase in trade between members, often at the expense of the rest of the world, suggesting evidence of trade diversion" (WTO report 105) displaying further the debate if PTA's really do create trade or divert trade with their being no clear answer due to so many different findings in support of both arguments.

PTAs and the WTO

Now that we have an understanding of the concepts of trade creation and trade diversion in PTAs, we can move on to our next critical topic: the relationship of PTAs with the World Trade Organization. Preferential trade agreements are an exception to the bedrock principle MFN, a provision of the WTO which states that countries must treat all their trade partners equally, and one country should not be favored over another, in other words no country should give another preferential treatment in regards to their imports. The two main exceptions to this provision exist: aiding in poorer countries' economic development and comprehensive trade agreements that foster economic integration (i.e., EU, NAFTA, PTAs in general). Significantly, all WTO members are parties to at least one PTA. PTAs are an innovation of the WTO, and the way in which they function makes them comparable to the WTO and may be considered to be "multiplied WTOs" in different parts of the world. Interest in creating PTAs has skyrocketed due to global economic crises with the purpose of preserving existing openness in spite of political pressure to reduce access. The WTO's transparency mechanism should be used to develop "best practice" guidelines on various aspects, traditional and new, of PTAs (new including environmental protections, labor rights, intellectual property related preferences). This would place a non-binding

pressure on WTO members to not deviate from the established guidelines and would much more effectively aid in achieving the goals of trade liberalization and development than the old binding obligations that do not keep up with the fast-paced evolution of PTAs.

Just as the role of PTAs is evolving, so is the role of the WTO. While the U.S. has been a member of the WTO since 1995, and its predecessor GATT since 1948, it has since taken a somewhat controversial stance that has negatively affected routine WTO functions. The WTO's dispute settlement mechanism includes an appellate court, which decides how to implement a resolution. However, since 2011, the U.S. has blocked the appointments of appellate judges, rendering the WTO's accountability measures useless (Hufbauer 2011). Without this functioning mechanism, it is clear that the role of the WTO is forever changed, and PTAs may become even more important.

Conclusion

In conclusion, PTAs are a powerful tool policymakers can use in order to craft trade policy in a way that is beneficial for their respective country. During the Bretton Woods era, the world was in a place where the United States was taking an active leadership position. Becoming one of two global hegemon, the United States didn't need to rely on regional trade agreements, but looked at trade through a global lens. Trade was conducted within the confines of global institutions. Upon the collapse of the Soviet Union, the United States was also arguably no longer in the same active leadership role with preferential trade agreements becoming more commonplace. Without a singular global hegemon, some regional leaders have carved spheres of influence in which important trade relationships are fostered and PTAs and RTAs are formed. A PTA can serve as much more than an economic tool. A developed country may consider a PTA as a means to exercise influence over less-developed countries. The TPP, for example, was seen as an opportunity for the U.S. to establish itself as a leader in the Pacific, in hopes that member countries would not turn to China for economic support. Sometimes this creates trade if the partners operate as if they were operating under liberal trade terms with each other but more often than not these trade agreements take trade from distant or hostile nations, diverting them towards nearby or friendly nations.

Works Cited

- Anderson, K., & Blackhurst, R. (1993). *Regional Integration and the Global Trading System* (502pp. ISBN 0745014755. ed.). Pearson Higher Education.
- Axline, W. A. (1994). *The Political Economy of Regional Cooperation*. Macmillan Publishers.
- Baber, G. (2021). *Preferential Trade Agreements and International Law (Routledge Research in International Economic Law)*. Routledge.
- Bagwell, Kyle. 2011. *Preferential Trade Agreements: A Law and Economics Analysis*. Edited by Kyle Bagwell and Petros C. Mavroidis. N.p.: Cambridge University Press.
- Balassa, B. (1967). Trade Creation and Trade Diversion in the European Common Market. *The Economic Journal*, 77(305), 1–21. <https://doi.org/10.2307/2229344>
- Baldwin, R., & Low, P. (2009). *Multilateralizing Regionalism: Challenges for the Global Trading System* (Illustrated ed.). Cambridge University Press.
- C. Causes and Effects of Ptas : Is It All about Preferences? https://www.wto.org/english/res_e/booksp_e/anrep_e/wtr11-2c_e.pdf.
- Chow, D. (2016). *How the United States Uses the Trans-Pacific Partnership to Contain*. Chicago Journal of International Law. Retrieved April 18, 2022, from <https://cjl.uchicago.edu/publication/how-unitedstates-uses-trans-pacific-partnership-contain-china-international-trade>
- Clausing, K. A. (2001). Trade Creation and Trade Diversion in the Canada – United States Free Trade Agreement. *The Canadian Journal of Economics / Revue Canadienne d'Economie*, 34(3), 677–696. <http://www.jstor.org/stable/3131890>
- Corbet, H., & Robertson, D. W. (1970). *Europe's Free Trade Area Experiment: EFTA and Economic Integration (C.I.L.)* (First ed.). Pergamon.
- Delener, N. (1999). *Strategic Planning and Multinational Trading Blocs* (First Edition). Praeger.

Evolution of Regional Trade Agreements in the world, 1948–2022. (2022, March). [Graph]. World Trade Organization. https://www.wto.org/images/img_tratop/evolution_of_rtas_1948_2018.png

Gharleghi, & Shafighi, N. (2020). Do regional trade agreements increase trade? Empirical evidence from the Asia–Pacific region. *Economic Affairs* (Harlow), 40(3), 419–435. <https://doi.org/10.1111/ecaf.12435>

Ghosh, Sucharita & Yamarik, Steven. (2004). Are Regional Trading Arrangements Trade Creating?: An Application of Extreme Bounds Analysis. *Journal of International Economics*. 63. 369–395.

“How Preferential Trade Agreements Affect the U.S. Economy.” *Congressional Budget Office*, 29 Sept. 2016, <https://www.cbo.gov/publication/51924>.

Hufbauer, Gary Clyde. “WTO Judicial Appointments: Bad Omen for the Trading System.” PIIE. Peterson Institute for International Economics, August 31, 2018. <https://www.piie.com/blogs/realtime-economic-issues-watch/wto-judicial-appointments-bad-omen-trading-system>.

Krueger, Anne. (1999). “Trade Creation and Trade Diversion under NAFTA.” *National Bureau of Economic Research*, December. <https://doi.org/10.3386/w7429>.

Krishna, P., Horiuchi, A., Krugman, P., Sato, R., Subrahmanyam, M., & Zeckhauser, R. (2005). *Trade Blocs*. Cambridge University Press.

Lehne, Jens. (2019). *Crisis at the WTO*. Berlin; Bern: Carl Grossmann Verlag.

Mansfield, E. D. (1998). The proliferation of preferential trading arrangements. *Journal of Conflict resolution*, 42(5), 523–543.334

Mansfield, E. D., & Pevehouse, J. C. W. (2013). The Expansion of Preferential Trading Arrangements. *International Studies Quarterly*, 57(3), 592–604. <https://www.jstor.org/stable/24017927?seq=1>

Romalis, J. (2007). NAFTA’s and CUSFTA’s Impact on International Trade. *The Review of Economics and Statistics*, 89(3), 416–435. <http://www.jstor.org/stable/40043039>

SEN, A. (2010). The World Trade Organization and Preferential Agreements. *Economic and Political Weekly*, 45(28), 24–26. <http://www.jstor.org/stable/40736723>

Trefler, D. (2004). The Long and Short of the Canada-U.S. Free Trade Agreement. *The American Economic Review*, 94(4), 870–895. <http://www.jstor.org/stable/3592797>

Wallace, W., V., & Clarke, R. A. (1987). *Comecon, Trade and the West*. Palgrave

Beyond the WTO? an Anatomy of EU and US ... – Wiley Online Library. <https://onlinelibrary.wiley.com/doi/full/10.1111/j.1467-9701.2010.01273.x>.

This page titled [1.6: Trade- Preferential Agreements](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.7: Production- Domestic Interests and Institutions 1.7: Production- Domestic Interests and Institutions

Edit Update titlecancel

Learning Objectives

Students will be able to:

- Understand the history of FDI politicization
- Explain the political power of MNCs
- Examine the regulation and liberalization of FDI
- Compare the financial mechanisms used to regulate and liberalize FDI

FDI Politicization: The History

The politics of foreign direct investment (FDI) and the battle between domestic institutions and multinational corporations (MNCs) is a storied history that, at its core, challenges the very nature of the governing bodies and the enterprises they seek to regulate. American economist Raymond Vernon highlights these innate differences by asserting that “the regime of [states] is built on the principle that the people in any national jurisdiction have a right to try and maximize their well being...within that jurisdiction” while the MNC “...is bent on maximizing the well being of its stakeholders from global operation, without accepting any responsibility for the consequences of its actions in individual national jurisdictions”. It is this intrinsic conflict that motivates the ever shifting winds of FDI regulatory policy.

The history of FDI politicization has gone through many iterations of increased restrictions, open liberalization, and relative stagnation since its inception. Various scholars note the relative novelty of the concept foreign investment regulation as a result of the industrial revolution. Prior to that, capital flows generally went from that of rich Western European countries to the cash-poor periphery, most of which were under colonial control. Countries very rarely restricted foreign direct investment as much of it came in the form of large-scale infrastructure projects. But as the world entered the twentieth century, the approach towards FDI policy began to change.

By the early 1900s, private firms began to direct investments towards research and development and other projects based on intellectual property. These investments lead the way to develop firm-specific assets, or assets that are exclusive to a firm for private use. Additionally, firms saw an increase in market demand for consumer products, not just domestically, but internationally. Together, this led to an increase in FDI for the production of goods and services, allowing firms to expand the scale of economies that their intellectual properties created. The increase in FDI pathed the way for the global economy, but with it came the first instances of politicization that would linger for years to come.

FDI first faced politicization during the interwar period, or the period of time between the end of WWI and the beginning of WWII. Cases arose from the perceived threat to national security posed by foreign ownership of production assets. One example of this was the seizure of all foreign-based assets by the U.S. government during WWI, the likes of which included chemical and pharmaceutical patents owned by U.S. subsidiaries of German companies. Simultaneously, the removal of foreign-based firms helped advance the interests of local producers who could finally compete with the larger, more productive MNCs.³

The era of FDI regulation brought about changes to the organization of political and labor efforts that solidified the position of the U.S. in terms of deflecting foreign investment. Political coalitions created by state-led development strategies dissolved resistance of locally operating firms under foreign control while local firms profited off of high tariffs rates. Additionally, workers gained higher wages in protected industries where labor was organized effectively. Through this, politicians and bureaucratic agents who helped shape FDI policy reaped the benefits from their regulatory decisions.²

Towards the end of the twentieth century, countries markedly adopted an increasingly open stance towards FDI. During the 1970s, up to 35 percent of industries within a given country were protected from foreign-ownership of local firms; thirty years later, that number had dropped to 10 percent. Additionally, MNCs faced more favorable attitudes from host countries. For example, beginning in 1975, there were over eighty acts of expropriation directed at MNCs, levied across thirty countries internationally. Expropriations are actions taken by host countries that seek to redistribute income generated by the MNC to domestic groups, through the use of tax increases and sometimes seizure of property. Nearly a decade later, not only were these acts becoming increasingly scarce, but many governments revised national investment laws to specifically guarantee property rights for foreign-owned MNCs.³

Regulation of FDI

One of the difficult aspects of studying FDI is the complexity of enforcement and regulation mechanisms that govern FDI policy around the globe. Due to the expansive nature of multinational participation and various regulatory issues at play (i.e. business licensing, finance, labor, etc.), there is no single regulatory agency that strictly handles FDI policy. For this reason, this can make the regulatory environment to which FDI policy exists confusing, complex, and at times, contradictory. One concern for scholars on the subject is the differences in location of regulatory authority over FDI within the government. By and large, investment policy first originates from the national legal code, which is expressed through the government's legislative body. In turn, investment and company laws provide the legal basis on which the regulatory authority of the government exists. Despite this, these laws often set aside huge amounts of autonomy relating to policy implementation for regulatory agencies in the executive branch. At times, these laws can create investment boards, which are regulatory bodies designed to review and approve foreign investment schemes and additionally, provide guidance on entry and operational procedures for MNCs. Alternatively, the legal code may vest regulatory authority in preexisting agencies with the relevant jurisdiction, much like Japan's Ministry of Trade and Industry, which coordinates FDI regulation with other macroeconomic policy points.² In the United States, the interagency committee that is responsible for reviewing and approving foreign investment in U.S. companies is called the Committee on Foreign Investment in the United States (CFIUS). While CFIUS is not considered an investment board or an independent agency as previously mentioned, CFIUS was established by an executive order in 1975, and its jurisdiction and authority have been expanded over the years by subsequent legislation and executive orders, most recently in 2018 when Congress and the Trump administration passed the Foreign Investment Risk Review Modernization Act which sought to adjust to the "shifting" national security landscape and the nature of investments that follow. Its primary mandate is to review and evaluate proposed foreign investments in U.S. businesses to determine whether they could result in a threat to U.S. national security. The committee is composed of representatives from various U.S. government agencies, including the Departments of Defense, Treasury, Justice, Commerce, State, Homeland Security, and Energy, as well as other federal agencies and departments as appropriate, and it operates under the auspices of the Department of the Treasury. CFIUS has the power to block or modify proposed foreign investments in U.S. companies, as well as to impose conditions on those investments in order to mitigate any potential national security risks. Its decisions are confidential, and it does not generally disclose the details of its reviews or investigations.

The Political Power of MNCs

While some scholars have chosen to study the various government institutions around the world and the mechanisms they use to administer and govern FDI regulation, others have chosen to analyze the multinational corporations themselves as political actors that play a significant role in shaping the global economy. For example, just looking at the United States, MNCs represent less than 1% of American firms but comprise more than 24% of private sector GDP and 26% of private sector compensation. Similarly, the OECD (2018) estimates that MNCs constitute half of global exports, account for almost a third of world GDP (28%), and nearly a fourth of global employment. The transnational activities such as outsourcing and offshoring by MNCs have driven the transformation of international trade, investment, and technology transfers in the globalized economy. Additionally, their decisions have massive implications for a variety of policy issues including taxation, investment protection and immigration across a wide range of political and economic institutions. It is for this reason that scholars have chosen to assess how and why MNCs function as political actors.

As researchers have found, there exist unique economic and political characteristics compared to other (domestic) firms that MNCs utilize to shape policy preferences. The first distinct characteristic that separates MNCs from other firms is their size and capacity for production. In general, MNCs tend to be larger and more productive than domestic firms. Additionally, they tend to be the largest exporters, the most integrated in global value chains (GVCs), employ the most high-skilled laborers, and are the largest spenders on research and development. This variation in size and scale of firms leads to a "pecking order" by which only the most productive firms invest in numerous foreign locations while the least productive firms invest in only the most productive locations. Another distinct characteristic of MNCs that allows them to shape policy preferences is their influence in foreign policy. Because of their size and scope, MNCs hold great influence over areas such as trade, foreign investment, exchange rates, and immigration. With regards to trade, it has long been understood that firms will have different preferences based on their ties to the international economy. Furthermore, domestic firms that face competition with imports will advocate for greater protections, whereas big exporters and MNCs will opt for freer trade. Finally, the last distinctive quality is that MNCs are the main advocates of preferential trade agreements and bilateral investment treaties. Additionally, MNCs have been the primary leaders on the inclusion of provisions protecting investment and intellectual property rights and liberalizing services in preferential trade agreements, as means to gain an edge over MNCs from other countries, which are excluded from the trade agreements.

All in all, these policy preferences and distinct characteristics lead to MNCs exerting their political influence in three primary ways: direct lobbying, indirect influence as a component of the state, unintended influence as an agenda-setter. First, MNCs may directly enlist in political activities such as lobbying and contributing to campaigns to affect the policy making process or to pressure political leaders to address their demands. In doing so, they can also partner with industry associations and political action committees to advance similar interests. Firms can leverage their bargaining power by offering both “inducements” or promises of brand-new investment and “deprivations” or threats of withdrawal of investment. Second, many have argued that MNCs hold an inadvertent role in foreign policy as a component of the state. In this point of view, governments have utilized MNCs to further their national interest by bolstering the effects of sanctions through the production networks of MNCs, fostering capital transfers through firms to enhance monetary policy, or permitting MNC’s foreign affiliates to assist in the gathering of intelligence.¹² Finally, MNCs can hold extensive agenda-setting power from their simple presence abroad. The view of governments towards MNCs is that of a “privileged position” that assists political leaders in defining problems, devising policies, and prioritizing objectives. Taken together, multinational corporations exert significant influence over domestic institutions through a variety of methods that ultimately work in favor of advancing their interests on a global economic level.

FDI Liberalizing Factors

FDI has various direct and indirect advantages for the host country, including contributing to capital formation, economic growth and development, increasing the transfer of managerial skills, organizational capabilities, know-how, market access, and technology. Additionally, it can enlarge domestic firms’ competitiveness and productivity. As mentioned earlier, to benefit from the advantages FDI brings to a country, governments, domestic institutions, and interest groups engage in creating policies that liberalize FDI. There are multiple factors behind FDI liberalization, such as democratization, increased effect on economic growth, shift towards neoliberal reform, increased cost of closure, trade openness, and reaction to other economic policies.

In autocratic countries, policymakers serve the interests of domestic firms by implementing strict regulations on MNCs.³ Democratization is the change in the ways organizations, institutions, and countries practices to democratic principles and it can partake in reforming FDI policies. Democratization is one of the primary causes of FDI liberalization globally.³ Democratization contributes to the deregulation of FDI by propelling policymakers to favor policies that align with the interests of labor.³ Reforms in domestic institutions may cause the empowerment of laborers over capital.² Increased political participation of labor groups leads to the monitoring of politicians to keep them accountable to voters.³ As a result, voters’ need for higher wages, jobs, and economic growth causes economic restrictions to be more demanding, causing the relaxation of protectionist policies towards FDI.² Moreover, domestic political institutions may be motivated to engage in policy liberalization because of pressures from outside forces. Policymakers’ interests could be amended due to other competitors’ or countries’ activity. Countries heavily dependent on foreign direct investment may compete with each other and become responsive to each other’s FDI policies by relaxing their restrictions and offering legal and tax incentives.² Another explanation for greater openness to FDI is policymakers’ “rational” decision in understanding “an opportunity cost of closure”.¹⁶ The opportunity cost of closure includes the level of development, country size, market size, human resource capabilities, and trade openness.¹⁶ These opportunities of costs help determine whether a country is losing advantage and efficiency when liberalizing FDI. When the benefits outweigh the costs for FDI, policymakers are more likely to attract FDI. Furthermore, a country’s openness towards other policies, such as trade, reflects its openness towards FDI because it can display policymakers’ preferences on the positive correlation of economic openness, development, and growth to a connected global economy.¹⁶



Figure 1: Global Neoliberalism

Financial Mechanisms

Similar to how domestic interests and institutions affect policies and regulations, they also regulate FDI openness and closure using financial mechanisms. Domestic political institutions have access to financial privileges that allows them to make decisions for credit distribution through personal and political networks instead of market discipline.² Financial privileges grant these

institutions financial benefits at a lower cost. When there is banking reform that limits locals' privileged access, elites will seek alternative sources of finance. MNCs provide greater access to international investment banking. The lack of access to financial privileges drives domestic businesses to back policies and lobby to support FDI liberalization.² Lack of access to financial sources for domestic companies because of circumstances at the local and global scale can influence FDI liberalization.² Costly financing constraints force local firms to support liberal FDI policies in order to benefit from MNCs' capital. Financial constraints faced by domestic firms can encourage FDI openness in order to gain increased access to MNCs' investment financing and increase economic growth by benefiting domestic economies.²

On the other hand, governments can use financial instruments to attract FDI by implementing incentive policies such as fiscal and financial incentives. Financial incentives can appeal to MNCs to engage in operations by helping reduce the cost of establishment and operation. Financial incentives can be indirect or direct subsidies, including loans, subsidies, grants, expatriation costs, and others.¹⁷ The government supplies direct subsidies to assist the MNC by renting operation areas, funding job training, and covering other operations costs for greenfield projects.¹⁷ Additionally, the government can provide funding to build infrastructure, including power, road, healthcare, and education facilities.¹⁷ Comparatively, fiscal incentives involve preferential tax treatment through deductions, exemptions, grants, or other strategies. It comprises tax allowances, tax holidays, lower tax rates, credits, allowances, and decreased import tariffs. Unlike financial incentives, fiscal incentives are more beneficial to FDI in the latter phases of investment because they help decrease future costs of operation for the MNC.¹⁷

Financial mechanisms can also be used to restrict FDI. One of the most common methods of engaging in FDI is mergers and acquisitions (M&A), when two companies join together to form one company or when one company takes over another. The government's response towards M&As is usually driven by competition or the "nationality" of the MNC involved in the M&A. Economic nationalism is the partiality for domestics instead of foreigners in economic interests. The level of economic nationalism within a country determines the extent domestic institutions will go to support or oppose FDI. Governments advocate for firms not to be owned by foreign corporations and instead remain domestically owned.¹⁹ Nationalist governments are able to achieve economic nationalism by intervening in economic activities, promoting, and implementing different policies that would be in favor of domestic corporations.

Some common methods used to implement nationalism in M&A are moral persuasion, public interests, prudential rules for financial companies, golden shares in privatized companies, providing financing to domestic bidders, playing for time, and creating national champions.¹⁹ Moral persuasion can be used by a government by blocking the merger initially and using implicit threats toward the MNC.¹⁹ Governments can impose restrictions to safeguard public interests.¹⁹ Governments often fund local bidders to acquire companies through government-owned banks, public pension funds, or investing directly in the company.¹⁹ Additionally, the domestic government can create national champions, which are large companies with vital positions in a country's economy and promote the interests of a political group to prevent M&A. This encompasses developing a new big firm by aiding the merger of local firms and making it difficult for it to be acquired by foreign companies.¹⁹ If the company's size is too big, it becomes demanding for MNCs to acquire, discouraging FDI. Governments can also buy time to obtain or finance a domestic bidder by implementing prudential rules or creating requirements for regulator approvals from different commissions.¹⁹ A "white knight" or a favorable acquirer in order to obstruct MNCs from acquiring the firm can be used.¹⁹ The "white knight" may receive financing from financial institutions that the government backs. Another strategy for implementing nationalism to block FDI is using golden shares, which are shares that grant veto power to shareholders over changes in the company's operation, rules, and regulations. Having golden shares in a company allows governments to make the decision for the company not to be acquired.¹⁹ Similar to these techniques, domestic institutions can implement many other policies to discourage MNCs from engaging in FDI.

Case Study: Ireland and the Celtic Tiger

The relationship between domestic institutions, multinational corporations, and foreign direct investment is complex and interconnected. One intriguing historical example of this multifaceted relationship is Ireland during its Celtic Tiger period. From the 1990s to the early 2000s, Ireland witnessed unparalleled economic growth, largely thanks to foreign direct investment (FDI), which saw multinational corporations establish operations in Ireland and create jobs for local workers. This phenomenon of success did not appear suddenly. Rather, it was a series of policy changes that arose over a period of multiple decades. Therefore, understanding the causes of Ireland's economic success during the Celtic Tiger period can provide useful insights into the relationship between domestic institutions, MNCs, and FDI, and influence discussions on how to promote economic growth and development in other countries.

Beginning in the 1920s, Ireland held a staunchly protectionist stance that aimed to protect local industries and promote a self-sufficient economy. However, this policy was counterproductive and led to high unemployment rates and emigration.²⁰ Like other

protectionist countries, the Irish government gradually began to realize the opportunities that came with allowing foreign direct investment in the 1960s, and as a result, began taking down their trade barriers to draw in foreign investors. These actions led to an inflow of FDI into the country, which prompted Ireland's explosive economic growth beginning in the 1990s.²⁰ In 1994, one of the most rapid years of growth, Irish gross domestic product (GDP) growth rates increased to 5.8%.²⁰ Despite the benefits of FDI, managing tensions between domestic institutions and multinational corporations remained a persistent challenge. Critics argued that the Irish government prioritized the interests of foreign corporations over those of local businesses and workers. For example, some multinational corporations allegedly were not paying their fair share of taxes or underpaying their workers.²¹ Other critics were worried about the effect of FDI on Ireland's society and culture. The influx of foreign corporations caused the inflation of property prices and rent, making it difficult for locals to afford housing, widening the social gap.²⁰ Nonetheless, Ireland's strategic location in the European Union, its well-educated workforce, and English-speaking population made it an enticing place for multinational corporations looking to enter the European market.²² The government continued to develop policies that were favorable to FDI, such as low corporate tax rates, which strengthened the country's appeal to multinationals.

As previously mentioned, the benefits of FDI during the Celtic Tiger period brought along challenges. Ireland's dependence on MNCs for economic growth led to concerns about the impact of foreign investment on local businesses and workers.²² The government addressed these concerns by implementing policies promoting local entrepreneurship and investment alongside FDI. These initiatives were designed to balance promoting foreign investment with support for domestic businesses and industries. For instance, it established Enterprise Ireland, a state agency tasked with promoting the development of Irish-owned businesses. This agency gave support and funding to Irish businesses to help them compete with the more resource-rich multinationals. In addition to promoting local entrepreneurship, the Irish government invested in education and training programs to help local workers acquire the skills to compete in the global economy.²⁴ This investment into human capital ensured that Irish employees benefitted from jobs created by the foreign firms operating in Ireland. While there were many, one example of this program was Skillnets, which funded training programs for the workers of small and medium-sized corporations.

Despite these efforts to balance the competing interests of foreign investment and domestic businesses and industries, some expressed concerns about the longevity and fairness of the tax incentives afforded to multinational corporations.²⁸ Low corporate tax rates did enable foreign investment and economic growth, but concerned parties believed this could lead to a "race to the bottom," with countries competing to provide corporations the most favorable tax environment.²⁹ The 2008 global financial crisis had a significant impact on Ireland's economy, leading to a period of instability and slowed growth. Some critics suggested that the country's reliance on FDI had left it vulnerable to economic shocks, as foreign corporations chose to relocate or downsize operations in response to the shaky economic conditions.³⁰ As a result, the Irish government introduced a range of measures aimed at promoting local businesses and industries, including a 500-million-euro innovation fund for high-growth startups.³¹



Figure 2: Lost Celtic Tiger

One of the critical lessons learned from Ireland's experience is the need to develop a comprehensive strategy for promoting FDI while supporting local businesses and industries.²² In particular, governments must ensure they are not sacrificing long-term economic growth for short-term gains by offering excessive tax incentives to foreign corporations.²⁸ Moreover, they must ensure that MNCs are doing their part to support local communities and create high-quality jobs.²⁸ Additionally, governments must invest in education and training programs to help local workers acquire the skills to compete in the global economy.³²

Ireland's experience during the Celtic Tiger period illustrates the complexities of FDI and the tensions that can arise between domestic institutions and MNCs.²² While the government's decision to liberalize the economy to foreign investment played a crucial role in stimulating economic growth, it also created challenges that policymakers must navigate carefully.²⁵

Conclusion

Domestic institutions exert a significant amount of political influence when it comes to the regulation of foreign direct investment. Since the twentieth century, foreign direct investment has been used to expand industry while the world engages in repeated cycles of increasing and decreasing levels of trade liberalization. The measures taken by each country to regulate foreign direct investment changes based on regime type and domestic politics, but in cases such as the United States, where organized interests play a powerful role in legislative and oversight processes, multinational corporations occupy an influential role in dictating FDI policy for the nation. Various factors contribute to domestic Institutions and interest groups creating policies that liberalize FDI including democratization, increased effect on economic growth, shift towards neoliberal reform, and increased cost of closure, trade openness, and reaction to other economic policies. Financial mechanisms are also used to regulate FDI closure and openness. Fiscal and financial incentives are used by governments to attract FDI. Moreover, financial constraints faced by domestic firms can influence FDI liberalization. On the other hand, governments can use moral persuasion, public interests, prudential rules for financial companies, golden shares in privatized companies, providing financing to domestic bidders, playing for time, and creating national champions to restrict FDI. The case study discusses the complex relationship between domestic institutions, multinational corporations (MNCs), and foreign direct investment (FDI) using the example of Ireland's Celtic Tiger period. The policy changes made by the Irish government over multiple decades to attract FDI led to explosive economic growth, but also raised concerns about the impact of foreign investment on local businesses and workers. The government addressed these concerns by implementing policies to promote local entrepreneurship and investment alongside FDI. One of the critical lessons learned is the need to develop a comprehensive strategy for promoting FDI while supporting local businesses and industries, investing in education and training programs, and ensuring MNCs are creating high-quality jobs and supporting local communities.

Works Cited

- "Activities of U.S. Multinational Enterprises: 2016." New Releases. U.S. Bureau of Economic Analysis (August 24, 2018). <https://www.bea.gov/news/2018/activities-us-multinational-enterprises-2016>.
- Autor, David, David Dorn, Lawrence F. Katz, Christina Patterson, and John Van Reenen. "The Fall of the Labor Share and the Rise of Superstar Firms." NBER Working Papers Series. National Bureau of Economic Research (May 2017). https://www.nber.org/system/files/working_papers/w23396/w23396.pdf.
- Baccini, Leonardo. "The Economics and Politics of Preferential Trade Agreements." Annual Review of Political Science. Annual Reviews (November 28, 2018). <https://www.annualreviews.org/doi/abs/10.1146/annurev-polisci-050317-070708>.
- Barry, Frank, Linda Barry, and Aisling Menton. "Tariff-jumping foreign direct investment in protectionist era Ireland." Economic History Review 69 (2016): 1285-1308. <https://doi.org/10.1111/ehr.12329>.
- Barry, Frank, and John Bradley. "Economic imperialism and the tyranny of experts: Ireland in the crucible of the international financial crisis." Journal of Contemporary European Research 9, no. 4 (2013): 560-579.
- Barry, Frank, and John Bradley. FDI and the labour market: Lessons from Ireland's inward investment experience. Oxford University Press (2013).
- Barry, Frank, and John Bradley. "The Irish model of corporate development, 1945-2005." Business History 55, no. 5 (2013): 754-771.
- Bernard, Andrew B., J. Bradford Jensen, and Peter K. Schott. "Importers, Exporters and Multinationals: A Portrait of Firms in the U.S. That Trade Goods." Producer Dynamics: New Evidence From Micro Data. National Bureau of Economic Research (January 16, 2009). <https://www.nber.org/books-and-chapters/producer-dynamics-new-evidence-micro-data/importers-exporters-and-multinationals-portrait-firms-us-trade-goods>.
- "The Committee on Foreign Investment in the United States (CFIUS)." Policy Issues. U.S. Department of the Treasury (April 5, 2023). <https://home.treasury.gov/policy-issues/international/the-committee-on-foreign-investment-in-the-united-states-cfius>.
- Cimino-Isaacs, Cathleen D. "The Committee on Foreign Investment in the United States (CFIUS) – Congress." CRS Reports. Congressional Research Service, February 26, 2020. <https://crsreports.congress.gov/prod.../RL/RL33388/91>.
- Coulter, Colin, and Steve Coleman. The End of Irish History?: Reflections on the Celtic Tiger. Manchester University Press (2003).
- Cuervo-Cazurra, Alvaro, Bernardo Silva-Rêgo, and Ariane Figueira. "Financial and Fiscal Incentives and Inward Foreign Direct Investment: When Quality Institutions Substitute Incentives." Journal of International Business Policy 5, no. 4 (2022): 417–443.

- Danzman, Sarah Baurle. *Merging Interests: When Domestic Firms Shape FDI Policy*. Cambridge: Cambridge University Press (2019).
- Dinc, I. Serdar, and Isil Erel. "Economic Nationalism in Mergers and Acquisitions." *The Journal of Finance* 68, no. 6 (2013): 2471–2514. <http://www.jstor.org/stable/42002573>.
- Department of Jobs, Enterprise and Innovations. "Ireland's National Development Plan 2018-2027." (2018).
- Enterprise Ireland. "About Us." (2021). Retrieved from <https://www.enterprise-ireland.com/en/about-us/>.
- Erel, Isil, Yeejin Jang, and Michael Weisbach. "The Corporate Finance of Multinational Firms," (February 2020). <https://doi.org/10.3386/w26762>.
- Gilpin, Robert. *U.S. Power and the Multinational Corporation: The Political Economy of Foreign Direct Investment*. London: MacMillan Press (1975).
- Forfas. "FDI in Ireland: Performance and policy." (2010).
- Henderson, David. "The Celtic Tiger and its lessons for globalization." *Journal of International Affairs* 61, no. 2 (2008): 59-76.
- Hunt, Jennifer, and Andrea L. Wheeler. "Foreign direct investment in Ireland: policy implications for emerging economies." *Journal of International Business and Economy* 18, no. 1 (2017): 31-44.
- Kim, In Song, and Helen V. Milner. "Multinational Corporations and Their Influence Though Lobbying on Foreign Policy." Brookings Institute. Princeton University (January 2019). https://www.brookings.edu/wp-content/uploads/2019/12/Kim_Milner_Brookings19-final.pdf.
- Kim, In Song, and Iain Osgood. "Firms in Trade and Trade Politics." *Annual Review of Political Science*. Annual Reviews (February 1, 2019). <https://www.annualreviews.org/doi/ab...-050317-063728>.
- Kobrin, Stephen J. "The Determinants of Liberalization of FDI Policy in Developing Countries: a Cross-Sectional Analysis, 1992-2001." *Transnational corporations* 14, no. 1 (2005): 67–.
- Lavelle, John and Kenny, O. "Irish entrepreneurship policy: Progress made and lessons learned." *International Journal of Entrepreneurship and Innovation Management*, 20 (2016): 223-244.
- Lindblom, C. E. *Politics and Markets: The World's Political Economic Systems*. New York: Basic Book, Inc. (1977).
- Martin, Lisa L., and Soo Yeon Kim. "Deep Integration and Regional Trade Agreements." Essay. In *The Oxford Handbook of the Political Economy of International Trade*. Oxford: Oxford University Press (2015).
- "Multinational Enterprises in the Global Economy." OECD (May 2018). <https://search.oecd.org/industry/ind/MNEs-in-the-global-economy-policy-note.pdf>.
- Nye, Joseph S. "Multinational Corporations in World Politics." JSTOR. *Foreign Affairs* (October 1974). <https://www.jstor.org/stable/20039497>.
- Skillnets. "About Us." (2021). Retrieved from <https://www.skillnets.ie/about-us/what-we-do>
- O'Rourke, Kevin H., and Alan M. Walsh. "The Irish economy since 1987: from crisis to boom to bust." *Journal of Economic Perspectives* 24, no. 3 (2010): 67-85.
- Pandya, Sonal S. "Democratization and Cross-National FDI Liberalization." In *Trading Spaces* (2013):88–108
- Pandya, Sonal S. *Trading Spaces: Foreign Direct Investment Regulation, 1970-2000*. Cambridge: Cambridge University Press (2013).
- Vernon, Raymond. *In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises*. Harvard University Press, 2000.
- Yeaple, Stephen Ross. "Firm Heterogeneity and the Structure of U.S. Multinational Activity." Science Direct. *Journal of International Economics* (March 18, 2009).

This page titled [1.7: Production- Domestic Interests and Institutions](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.8: Production- International Institutions

1.8: Production- International Institutions

Edit Update titlecancel

What happens when a government or state actor commits a treaty violation toward a foreign investor? Do the states handle it on their own? Are foreign investors responsible for fixing the problem themselves? When disputes arise, parties agree to go to arbitration. This is used as a way to solve legal disputes impartially. In the United States, this is why they have a judicial system and due process in the courtroom. However, on an international level there are a lot more factors that come into play regarding legal disputes, not to mention there isn't a common constitution or shared legal document that can be applied on an international level. Everyone from individual community members to powerful nations can be affected by a dispute between a foreign investor and a state. Leveling the playing field is important for the smaller participants who need legal protections to ensure their voices are heard. It's also important for countries that are going up against successful billion-dollar companies with vast amounts of resources. International investment treaties were made so countries could set a standard for treatment of foreign investors from other states (Colombia, 2022). If there is a breach of an international investment treaty, the involved parties can bring their grievances to a courtroom. This is the process of investor-state dispute settlement, hereafter referred to as ISDS, which allows private investors and states to settle their disputes on legal matters through arbitration (Colombia, 2022). Courts that handle ISDS claims are responsible for awarding the correct party their remedy usually a financial award – by the violating party (USTR, 2014). Most ISDS claims are brought up by the investors involved and out of those claims filed, a majority were brought in by private investors from developed countries (Colombia, 2022).

Bilateral investment treaties (BITs) and the International Centre for Settlement of Investment Disputes (ICSID) are both parts of the process of investment treaties. BITs ensure that foreign investors in a different country receive fair treatment in regard to private investments that they make in a host country (Cornell, 1992). The ICSID is designed specifically for international disputes (Colombia, 2022). Overall, ISDS including BITs and ICSID are useful systems that create a fair and legal method of settling disputes. They give states the option of what kinds of protection they want to offer to investors. It allows them the opportunity to oversee foreign investors' grievances in a fair light and builds on the legal system created domestically, encouraging continuity when settling disputes.

The ISDS process is extremely important to international relations. Before, foreign investors would have to risk solving legal disputes with the host country they were in, which meant facing their courts and their laws. These disputes could become disputes between states making them much more politicized. There arose a need for disputes to be handled that would offer protections to investors in host states.

In this chapter, we'll be discussing how ISDS addresses the problem of legal disputes between state actors and foreign investors. We'll be looking at the historical background, examples and how we can compare ISDS claims to how the World Trade Organization settles disputes. We'll also be observing what ISDS accomplishes, notable criticisms of the process, and its relation to multinational companies.

Key Design Features

ICSID

Like most governmental processes, ISDS requires a bureaucratic process of accomplishing its purpose. The International Centre for Settlement of Investment Disputes (ICSID) is where countries can resolve investor-state disputes (Alle & Peinhardt, 2010). It was created in 1965 in Washington, D.C. where it currently hosts its headquarters. As a member of the World Bank Group, it exists to solve arbitration problems between investors and states (Alle & Peinhardt, 2010). So far, more than 150 states have signed and ratified their membership in the agreement. There are four stages to the process of settling these disputes in the ICSID. The first step is the registration and tribunal appointment. Then there is the hearing on the jurisdiction. After that, there is the hearing on merit which can lead to an awarded amount, and lastly, there can be an annulment processed if it is requested. (Alle & Peinhardt, 2010) State consent to arbitration is a key design feature in the functions of the ICSID. In international law, there are legal frameworks that are bypassed through states' consent. (Alle & Peinhardt, 2010) That way it won't be necessary to exhaust local remedies and other functions done through international law. Consent can be given through several different methods. It can be given in a government contract, an interstate treaty, or through domestic arbitration law. (Alle & Peinhardt, 2010) Another key design feature of the ICSID is the process of enforcement. Members need to consent or agree to awarding the correct amount within their domestic courts. This means the court can decide in favor of the state, the investor, the suit can be discontinued, or

there can be no damages awarded. (UNCTAD, 2021) Whichever direction the case goes, the appropriate party must enforce the court's decision.

BITs

Bilateral investment treaties are agreements that are signed to establish terms and conditions on an international level for private investments between nations and companies of one state in a different state. (Cornell, 2022) BITs are related to ISDS claims because ISDS suits are filed when BITs have been violated. Countries sign BITs for many reasons. They can sign them to get around weak domestic institutions, or because countries they're in economic competition with sign BITs. They can also sign them to be perceived as open to foreign investors or to raise the costs of expropriation, inevitably making private investor protections more necessary. (Allee & Peinhardt, 2010) In most cases, countries that sign BITs will get more foreign direct investment (FDI). It can seem like FDI increases when more BITs are signed, which is generally the case. However, the behavior of states can play a bigger role in that they show BITs follow FDI. (Allee & Peinhardt, 2010) There is a demand by foreign investors to get into markets and proximity to markets in nearby regions. (Allee & Peinhardt, 2010) Over 2,000 BITs have been signed and there are certain circumstances in which BIT organizers decide to delegate disputes over to the ICSID. This is seen when the private investor's home country is much more powerful than the host country they were in, or if the home country has a large number of multinational corporations. Also if the host country participated in expropriation within the last decade or if they receive world bank assistance. Disputes can also be delegated if the host country has been independent in the last decade. That is all to say that, BITs are different and unique to the countries they are being applied to. This uniqueness means the effects of the treaties will be different depending on the circumstances. The effects of BITs can also be dependent on the behaviors of those signing. States that end up in international arbitration end up getting fewer FDI, and if they lose their arbitration dispute they receive even less FDI.

Background, Example Scenario, and Comparisons

Historical Background

Before ICSID, various governments made attempts to create a system to encourage and protect foreign direct investments. This was difficult given the variety of views governments had when it came to how to handle legal issues that would arise, including who would be best to arbitrate such issues and who would be financially responsible when conflict such as this arose. As mentioned, ICSID was created in 1965 via what is colloquially known as the Washington Convention. Available online, the historical record describes the purpose of the organization as one "to promote the resolution of disputes" through "facilitating recourse to international conciliation and arbitration" (ICSID, n.d.). As a member of the World Bank Group, ICSID was created as part of an international financial institution, becoming a part of a global infrastructure for developing prosperity, especially in developing nations, and reaching a shared understanding with member states. It is currently ratified by 156 states.

Example Scenario

To understand ISDS, let's take a hypothetical foreign investor – Example Inc. Example Inc. is located in Country A, but is interested in business in Country B, specifically mining, using the ample resources available in Country B that have yet to be developed. When Country A and Country B develop and agree to an investment treaty, they agree to ISDS provisions that provide corporations like Example Inc. standing to sue Country B in the event that Country B takes actions that affect their business and foreign investment. Country A would be Example Inc.'s home state and Country B would be their host state. In theory, this agreement provides Example Inc. opportunities to develop their mining industry and financially prosper, while simultaneously bringing economic development and job opportunities to the people of Country B.

In this scenario, we can understand the FDI into the mining company in Country B to be an investment in the primary sector; that is to say, industries involved in the extraction of raw resources. If it helps your understanding, we could easily imagine the company to be something in the agricultural industry, for instance. However, FDI can be in a variety of industries, such as manufacturing, the service industry, or even banking (Columbia, 2022).

What is investor-state dispute settlement (ISDS)?
Part 1: The Power

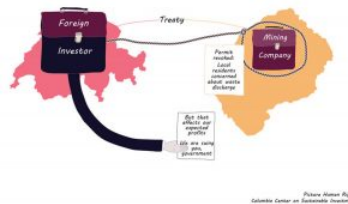


Figure 1: ISDS and Power

When disputes arise, Example Inc. is allowed to directly arbitrate with Country B instead of needing to rely on their home state, Country A, to act on their behalf. Country B's citizens may be concerned with environmental conditions worsening because of the development Example Inc. has done in their country. Country B might even have passed environmental legislation at the behest of domestic popular support. However, those environmental protections negatively affect Example Inc. investment in Country B and their business; because Country A and Country B have an investment treaty that includes ISDS provisions, Example Inc. is able to bring a case against Country B, their host state. Although an agreed-upon tribunal to arbitrate the case is involved, this dispute settlement process does not include third parties: Example Inc. and Country B are both directly involved with the arbitration. Unlike other common legal proceedings, third parties have little ability to directly participate or intervene in ISDS (Columbia, 2022). This may be of frustration to citizens and environmental protection groups in Country B, who because of the agreed-upon ISDS provisions in the investment treaty between Country A and Country B, do not have a seat at the table, even if the end result directly impacts their health and livelihoods.

These concerns about environmental protection and human rights violations can be seen in the real world. Ethiopia, a country that receives foreign direct investments in the agricultural sector, has had rising concerns about foreign investors' use of the country's water resources. There are also concerns over foreign investors' efforts (or lack thereof) on environmental protection as well as enforcement of these protections by the government of Ethiopia (Bossio et al., 2012). Blanton and Blanton (2006) found that greater respect for human rights is linked to countries being better hosts for FDIs. However, there are a variety of potential conflicts between economic development and respect for human rights, even if there are reasons to respect human rights as human capital develops (Blanton & Blanton, 2006). For these reasons, more recent investment treaties may specifically include provisions related to the United Nations' Sustainable Development Goals, like Goal 6 – Clean Water and Sanitation (United Nations, n.d.). Beyond that, cases brought forth for arbitration can include topics such as tax evasion and money laundering, addressing climate change, government regulation of health care, and more (Columbia, 2022).



Figure 2: ISDS Process and People

After the arbitrators reach their decision, awards are given out to the winner with no right of appeal. In our scenario, let's imagine that Example Inc. wins its dispute. Country B would then directly pay Example Inc. in damages as part of their award. Country B could then continue its business as usual in the host state. Notably, this process did not involve Country A having to act on behalf of Example Inc. It is also important to consider that the damages awarded to Example Inc. by Country B would come out of taxpayer dollars; as noted above, these same taxpayers are unlikely to have had a seat at the table when the case was arbitrated. These are also resources that could have been used by the host state in areas such as health and education (Columbia, 2022). How might the citizens of County B react to this arbitration process if they knew their money was being paid out to foreign investors?

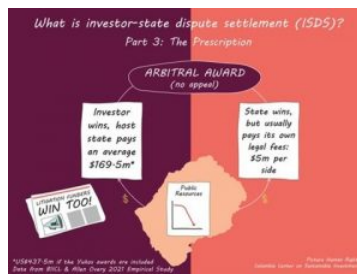


Figure 3: ISDS The Prescription

In this scenario, we can see that there are concerns about the role in which the people affected by the decisions reached through arbitration often do not have a seat at the table. Additionally, as mentioned previously, home states and to an extent the foreign investors involved can be more powerful than the host countries; this imbalance of power can make it difficult for developing countries to adequately arbitrate against such disputes with large corporations while simultaneously protecting the interests of their citizens. What recourse do developing countries have? Think about the implications that may arise because of this – criticisms of ISDS are explored later in the chapter.

ISDS vs. WTO Dispute Settlement

To better understand the investor-state dispute settlement procedure, it would help to understand it as compared to the dispute settlement procedure of the World Trade Organization, shortened as the WTO, which is another important institution in the study of international political economy. These differences extend beyond the surface level understanding that trade and investment differ. One fundamental difference is that while WTO disputes occur between states, ISDS involves dispute settlements between foreign corporations and states; foreign corporations cannot sue the country they have business with through the WTO, but they can if the investment treaty between their home state and the host state includes ISDS provisions. When disputes arise because of WTO violations, it becomes an international legal process through the WTO, arbitrated between states. Through that, we can understand that elements of power politics, both on an international scale and domestic interests, come into play when these types of disputes are arbitrated; examples of this can be seen with India and Brazil as emerging powers (see Mahrenbach, 2016). By comparison, ISDS involves arbitration between states and corporations. While ICSID provides a legal framework for agreed-upon rules and arbitration processes, a variety of international tribunals may come into play throughout the dispute settlement process. Importantly, this means that the home state does not have to get involved on the corporation's behalf, which could raise a variety of international political implications and politicization. The politicization of investment treaty disputes is an area of research that warrants further study (see Gertz and Poulsen, 2018).

Further comparing ISDS with the WTO dispute settlement process, we can explore how often each method is used. Since its inception in 1995, the WTO generally has seen a decline in requests for the establishment of a panel to arbitrate disputes (Mavroidis & Johannesson, 2017). The number of treaty-based ISDS cases has continued to rise over the same time period (UNCTAD, 2021). ISDS cases have also accumulated rapidly over the past 10 years (Columbia, 2022). It is important to remind readers that WTO's dispute settlement process and the ISDS process must be carefully compared given the differences in scope and jurisdiction. There are also simply more corporations able to bring forth cases for arbitration than there are countries bringing forth WTO violations. However, noticing trends for both helps us to better understand the ever-changing international financial institutions and political climate. Investment and trade go hand in hand when it comes to the global economy.

ISDS Implications

Purpose and Critics

The purpose of ISDS is to peacefully resolve trade conflicts between host states and multinational corporations. ISDS permits international investors to resolve differences with the government of a host state in which their investment was made in a neutral venue through a binding international tribunal. Without ISDS foreign investors would have to rely on local or state courts of the host country to resolve conflicts. Investors would face obstacles such as a lack of legal safeguards and of judicial independence because courts would make biased decisions in favor of the host country. On the other hand, ISDS has had to face criticism in regards to how it's being applied. Though the goal of ISDS is to stay neutral, many critics have expressed their concerns that private investors have exploited the ISDS clause. Critics believe that successful investors with over 1 billion in annual revenue or high-income countries tend to file for claims (Columbia, 2022). Hence countries that have lower incomes aren't financially able to file claims or even defend themselves because the loss of a case can have a significant impact on their economy. With that being said, developing countries tend to be victims of ISDS because they are an easy target for exploitation from multinational

companies. Another criticism that ISDS faces is that most of the case hearings happen behind closed doors and third parties are not taken into consideration (Allee & Peinhardt, 2010). ISDS cases are decided by three-judge panels nominated and compensated by the investor and responding state, things such as human rights, workers' rights, and community rights are not considered while deciding these cases. Treaties mostly impose binding obligations only on states, not investors; states generally cannot initiate or bring counterclaims in ISDS. So an investor may win a case even if it has violated domestic law, international human rights, or environmental norms in connection with the operation of the investment. With that being said, the most important thing that is considered while deciding an ISDS case is if principles of the appropriate investment treaty are used.

Who is Affected by ISDS?

ISDS has a lot of leverage and can have negative implications because environmental and human rights aren't considered when passing judgments. All things considered, the general public tends to be collateral damage. An example of this is the case that occurred in 2009 between Chevron v. Ecuador. Chevron filed a case against Ecuador under a BIT in order to avoid the payment of a multi-billion dollar court decision against the firm for the massive degradation of the Amazon rainforest. The Ecuadorian government discovered that their investor Chevron had been dumping toxic waste in the water, as well as digging hundreds of open-air oil sludge pits in Ecuador's Amazon, leading to contaminating the communities of approximately 30,000 residents. Rather than complying with the orders of the Ecuadorian government, Chevron requested that the investor-state court review the decision that was made. Chevron also requested the court to force Ecuador's taxpayers to pay billions of dollars in damages it may be required to pay to clean up the still-devastated Amazon, as well as all legal bills paid by the corporation in its investor-state dispute settlement. Chevron's investor-state action seeks to re-litigate crucial points of the protracted domestic court case, including whether the affected communities had the right to challenge the firm in the first place (Public Citizen's Global Trade Watch, 2015). Considering the environmental damage that Chevron had caused in the Ecuadorian community, Chevron is still able to file a case under the ISDS because the trade treaties have been "violated", disregarding the fact that the company has caused a lot of environmental damage. Furthermore, because of the company's actions, indigenous communities living in that region of the Amazon virtually went extinct (Public Citizen's Global Trade Watch, 2015). This case shows that even though the treaty was made with good intentions, multinational companies have used ISDS to assist themselves resulting in the victimization of common people.

COVID-19 has heavily impacted ISDS as most states may not be able to comply with investment treaties that were made before COVID-19. Investors can easily sue host states as they are bound by their investment treaty. New rules and regulations would have to be placed in order to preserve public health and ensure economic recovery. There have been multiple attempts to suspend treaty-based investor-state litigation for all COVID-19-related measures or establish the use of international law defenses in these rare circumstances because the primary goal should be to focus on the global crisis we are facing as a world rather than focus on investment treaties. There have also been many instances in the past where ISDS has had a negative impact because it puts countries in a difficult position where they have to decide whether they use their resources to defend themselves against a lawsuit or to help their civilians in a time of crisis. With this in consideration, and also understanding the severity of the situation around COVID-19, some measures have been taken in order to prevent the spread of COVID-19. The International Institute for Sustainable Development (IISD) drafted the proposed agreement for the coordinated suspension of ISDS in April 2020 with respect to COVID-19-related actions and disputes. The agreement is a provision of any investment treaty in effect between two or more signatories to this agreement providing for the resolution of disputes between an investor and a state is thus suspended with regard to claims that the responding signatory state believes to be concerning COVID-19-related measures (Bernasconi-Osterwalder & Maina, 2020). The treaty also mentions that "any indicator preventing or detection of virus transmission; ensuring the availability of tangible and intangible goods, services, materials, or technology; or national economic recovery, stability, or development during or following the spread of the virus and the international response; as well as any other objective relevant to the COVID-19 pandemic and its consequences" (Bernasconi-Osterwalder & Maina, 2020). Though certain measures have been taken to prevent the spread of COVID-19 and to help states during hard times, there are still many states that are struggling with ISDS cases from the past that are yet to be resolved.

Conclusion

In conclusion, ISDS is a system of protection for private investors and states. Its primary goal is to provide a legal system for settling disputes between foreign investors and states. Bilateral investment treaties are the primary way in which investors and states agree to terms on foreign investment. ICSID, as a part of the World Bank Group, helps facilitate these investment treaties and provides a framework for arbitration and enforcement. Overall, this system has the intention to develop prosperity, especially for developing nations which often act as host states for foreign investment.

Though ISDS was made with good intentions and provides protection for both parties, throughout the years there have been concerns raised about the balance of power between large corporations and the developing countries they're investing in. With developing countries being limited in legal resources and recourse to uplift the interests of their citizens on issues like environmental protection and human rights even if it risks arbitration with the foreign investors in the country who claim to be negatively impacted by such interests. Because of these considerations, ISDS has received criticism as a system that benefits private investors at the expense of developing countries and their citizens. Additionally, damages being paid out from the host state to the foreign investors in the event the host state loses the arbitration process is one aspect of ISDS that has the potential to be politicized.

Countries that host foreign investment and agree to ISDS provisions must carefully balance domestic interests and foreign investors' interests. COVID-19 especially has shown how investment agreements are complicated as situations in the host countries evolve and the state balances domestic concerns with foreign interests; states navigating domestic concerns of public health may be doing so at the risk of challenging agreed-upon terms for foreign investments. States agree to the enforcement of ISDS provisions when signing investment treaties while understanding that the domestic situation may change outside of their control but will nonetheless impact foreign investment and the agreed-upon terms. There are questions raised as to the role of global institutions in intervening in situations like this, even if the agreement is between a corporation and a state and not a state-to-state agreement.

Future research might explore how ISDS provisions between states continue to evolve. Although this chapter focused primarily on FDI between a developed home state and a developing host state, investment treaties also exist between developed states. As the global economy develops and developing countries continue to industrialize and move past primary sectors, there are additional considerations for the kinds of foreign investments received and how that may impact the host state's citizens. This chapter has mentioned concerns about environmental impact and human rights as a part of foreign investment; future research into the treaties themselves and the effectiveness of including specific provisions around the UN's Sustainable Development Goals might yield interesting insights into this area. Generally speaking, the effectiveness of BITs and the arbitration methods provided by ISDS is an area of research that could use more study, exploring the effectiveness of ISDS and how it affects relationships between states when provisions are broken.

ISDS is a novelty amongst international institutions that generally involves disputes between states. As such, as international financial institutions evolve with shifting international politics, so too will the scope and specific provisions of ISDS evolve as countries become more experienced with this type of dispute settlement process and citizens continue to raise concerns about the ways in which countries agree to foreign investments.

Works Cited

- Allee, T., & Peinhardt, C. (2010). Delegating differences: Bilateral investment treaties and bargaining over dispute resolution provisions. OUP Academic. Retrieved April 21, 2022, from <https://academic.oup.com/isq/article/54/1/1/1789480?login=true>
- Bernasconi-Osterwalder, N., Brewin, S., & Maina, N. (2020). Protecting Against Investor-State Claims Amidst COVID-19: A call to action for governments. International Institute for Sustainable Development (IISD). Retrieved April 21, 2022, from <https://www.iisd.org/system/files/publications/investor-state-claims-covid-19.pdf>
- Beunder, A., & Mast, J. (2019). As the world meets to discuss ISDS, many fear meaningless reforms. Longreads. Retrieved April 24, 2022, from <https://longreads.tni.org/isdsmany-fear-meaningless-reforms>
- Blanton, & Blanton, R. G. (2006). Human Rights and Foreign Direct Investment: A Two-Stage Analysis. *Business & Society*, 45(4), 464–485. <https://doi.org/10.1177/0007650306293392>
- Bossio, D., Erkossa, T., Dile, Y., McCartney, M., Killiches, F., & Hoff, H. (2012). Water Implications of Foreign Direct Investment in Ethiopia's Agricultural Sector. *Water Alternatives*, 5(2), 223–242.
- FitzGerald, A. G., & Valasek, M. J., (2017). Frequently asked questions about investor-state dispute settlement. Norton Rose Fulbright. Retrieved April 19, 2022, from <https://www.nortonrosefulbright.com/en/knowledge/publications/8014c6b7/frequently-asked-questions-about-investor-state-dispute-settlement>
- Gertz, G., Jandhyala, S., & Poulsen, L. N. S. (2018). Legalization, diplomacy, and development: Do investment treaties de-politicize investment disputes? *World Development*, 107, 239–252. <https://doi.org/10.1016/j.worlddev.2018.02.023>

Investor-state dispute settlement (ISDS). (n.d.) Picture Human Rights. Retrieved April 16, 2022, from <https://www.picturehumanrights.org/isds>

ISDS: Important questions and answers. United States Trade Representative. (n.d.). Retrieved April 21, 2022, from <https://ustr.gov/about-us/policy-offices/press-office/blog/2014/March/Facts-Investor-State%20Dispute-Settlement-Safeguarding-Public-Interest-Protecting-Investors>

Legal Information Institute. (n.d.). Bilateral Investment Treaty. Cornell Law School. Retrieved April 19, 2022, from https://www.law.cornell.edu/wex/bilateral_investment_treaty

Mahrenbach, L., C. (2016). Emerging Powers, Domestic Politics, and WTO Dispute Settlement Reform. *International Negotiation*, 21(2), 233–266. <https://doi.org/10.1163/15718069-12341332>

Mavroidis, P. C., & Johannesson, L. (2017). The WTO Dispute Settlement System 1995-2016: A Data Set and its Descriptive Statistics. *Journal of World Trade*, 51 (Issue 3), 357–408. <https://doi.org/10.54648/trad2017015>

Primer on International Investment Treaties and Investor-State Dispute Settlement. (2022). Columbia Center on Sustainable Investment. Retrieved April 19, 2022, from <https://ccsi.columbia.edu/content/primer-international-investment-treaties-and-investor-state-dispute-settlement>

Public Citizen's Global Trade Watch. (2015) Case studies: Investor-state attacks on ... – public citizen. Case Studies: Investor-State Attacks on Public Interest Policies. Public Citizen. Retrieved April 22, 2022, from https://www.citizen.org/wp-content/uploads/egregious-investor-state-attacks-casestudies_4.pdf

The facts on Investor-State Dispute Settlement. (2014) United States Trade Representative. Retrieved April 19, 2022, from <https://ustr.gov/about-us/policy-offices/press-office/blog/2014/March/Facts-Investor-State%20Dispute-Settlement-Safeguarding-Public-Interest-Protecting-Investors>

The History of the ICSID Convention. (n.d.). International Centre for Settlement of Investment Disputes (ICSID). Retrieved April 16, 2022, from <https://icsid.worldbank.org/resources/publications/the-history-of-the-icsid-convention>

UNCTAD. (2021) Investment flows to developed economies slumped by 58% in 2020. United Nations Conference on Trade and Development (UNCTAD). (2021). Retrieved April 21, 2022, from <https://unctad.org/press-material/investment-flows-developed-economieslumped-58-2020>

UNCTAD. (2021) Investor-State Dispute Settlement Cases: Facts and Figures 2020. United Nations Conference on Trade and Development (UNCTAD). Retrieved April 19, 2022, from https://unctad.org/system/files/official-document/diaepcbinf2021d7_en.pdf

United Nations. (n.d.). The 17 goals | sustainable development. United Nations. Retrieved April 21, 2022, from <https://sdgs.un.org/goals>

This page titled [1.8: Production- International Institutions](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.9: Finance- Bretton Woods Monetary System

1.9: Finance- Bretton Woods Monetary System

Learning Objectives

- Become familiar with the Mundell-Fleming economic theory and how it affects international political economy
- Understand the context for the Bretton Woods Conference of 1944
- Learn about the reasons behind the failure of the Bretton Woods system

At the turn of the twentieth century, gold played a key role in anchoring the value of many countries' currencies. In what has come to be known as the classical gold standard, nearly all countries held the value of their currencies in connection to a fixed quantity of gold. This was the basis of the international monetary system which became dominant in the 1870s and lasted until World War I. Between World Wars I and II, disorder and volatility marked the financial realm. The interwar period (1918-1939) was characterized by harsh economic outcomes of the great depression and financial competitiveness which resulted in countries wanting to keep their currency at a low value compared to other currencies, benefitting exports and reducing imports. The devaluations of currency during the interwar period created instability internationally. This called for revision which resulted in a conference of 44 allied nations to conjure an improved international monetary system that is tailored to international needs and boosts unity amongst states.



Pictured above are U.S. President Franklin D. Roosevelt, British Prime Minister Winston Churchill, and Soviet Premier Joseph Stalin during the Yalta Conference held in 1945, which discussed post-war options for peace.

The Bretton Woods Conference

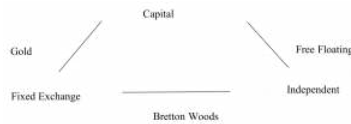
The Bretton Woods Conference was held in 1944 in Bretton Woods, New Hampshire. The goal of the conference was to establish a new international monetary system to promote greater international trade through creating a standardized exchange rate as well as assisting less developed countries and those which were ravaged by the events of World War II, which was in its closing stages at the time of this meeting. A conference of 44 allied nations gathered to establish a new international monetary system, which used the experience of The Great Depression and The Gold Standard to create a new international monetary system with a focus on Post-War reconstruction.

The two largest groups present at these talks each had differing schools of thought on how this new system would function. One group was led by British representative John Maynard Keynes while the other was led by American representative Harry Dexter White. Both sides of this debate had the common goal of attempting to promote greater international trade by doing away with the rampant protectionism which was particularly unsatisfactory during the years preceding the Second World War. Keynes and White agreed that the unregulated capital flow which had been occurring between nations in the past was a destabilizing influence that promoted predatory trade practices and had to be solved, they also believed that it was vital for there to be some type of system for assisting countries which were running payment deficits so as to shore up the potential weak points in the international market.

After much deliberation, White's school of thought gained the popular vote, and consequently, the International Monetary Fund (IMF) received much less funding than Keynes had anticipated. The United Kingdom along with every other nation which signed onto the agreement had their currencies pegged to the value of the Dollar while the dollar was attached to gold. Even so, the IMF continues to operate and has even grown its reserves a great deal since its inception. The rigid exchange rate between currencies which White tried to introduce, has fallen by the wayside over the years in favor of much more flexible rates of exchange. From

this process, it can be said that although the American ideal may have won during the initial debate, over time, the Keynes position seems to have proved itself to be the more sustainable of the two systems.

The difference between the new Bretton Woods System and the previous Gold Standard can be illustrated by the Mundell-Fleming trilemma which argues that there is a certain extent of mutual exclusivity between the so-called “Impossible Trinity.”



The Mundell-Fleming trilemma argues that any country can simultaneously achieve at most two of the following three economic goals:

1. Exchange Rate Stability, achieved by maintaining fixed exchange rates between the national currencies of different states;
2. Autonomous Monetary Policy, or the ability of states to control their monetary policy;
3. Capital Mobility, or the free movement of capital across borders.

The classical gold standard paired exchange rate stability with capital mobility, meaning that states were required to forfeit control over their domestic monetary policies. In the time of the Great Depression, when people were more concerned about rampant unemployment rates than less immediate matters such as currency stability, states were forced to abandon the old system in order to meet the needs of their people.

Those present at the Bretton Woods Conference knew that the new system would have to be tailored to the needs of the present time. Thus, while the Bretton Woods System incorporated fixed exchange rates as its predecessor did, it was willing to sacrifice capital mobility so that states could retain autonomy over their domestic monetary policies.

Creation of the International Monetary Fund

The IMF was created in 1944 in the Bretton Woods meetings. Some parties such as Keynes wished for it to have a good amount of influence, but White and the Americans did not. It had some action in its first year, however, it fell to the wayside during most of the time under the Bretton Woods system as the Americans’ plan had won out. It was more of a show of collective action and commitment than an enforcing agency. It would find new influence in the time that followed the Bretton Woods system, so we will mostly ignore it in this chapter.

Evaluating the Bretton Woods System

The Bretton Woods system that White argued for solidified the style of both domestic monetary policy autonomy and international exchange rate stability that countries around the world would follow for some time. Countries were required to peg their currencies to the dollar at \$35 dollars an ounce. They also could change the par values to correct any minor imbalances in their balance of payments. These two aspects of the triangle offered both a flexibility to make some changes while having a rigid backbone to keep things steady. One large cause of the success was the low number of countries in the initial agreement allowed for much easier collective action within the ideas in the system and the similarity of the countries made it simpler for them to follow the system collectively. The other large aspect that success can be attributed to is the closed nature of domestic economies and that actual change was made by these countries within. The system helped to facilitate economic growth and stability in many countries during the post-World War II period. One example of a country using the Bretton Woods system for success during the time period of its operation is West Germany. The Bretton Woods system also allowed West Germany to benefit from a stable international financial system to support its post-war economic recovery. The country experienced significant economic growth during the 1950s and 1960s, becoming one of the world’s leading economies by the end of the Bretton Woods system in 1971.

The US held so much power in this system not only because it was White’s idea, but also because during the postwar period they had a very large share of the global economy. This allowed them to support the system and provide a backbone. Winning the war led to a group of allied countries that would eventually work with this system and hold the dollar. In these ways the US was the global “hegemon” that oversaw this global system and majorly assisted in it working.

Bretton Woods over Time

The Dollar Shortage Period

During the time from 1947-1958 the world experienced something known as the Dollar Shortage Period. There was a large demand for dollars as implied in the name from countries and a limited supply. Trade imbalances were being experienced in the US and it was worsening over time. The US began taking on dollar deficits for stability and assisting other countries so the want for gold would be reduced. An example is the Marshall plan that supported much of Europe in their postwar economic recovery.

Dollar Glut Period

This was a time from 1958-1971 where the world had an overflow of dollars. One of the causes for this was an increase in speculation on gold which in response the US sold some reserve gold and took measures to discourage this practice. Another cause was from direct government action that discouraged individual Americans and banks/firms from buying foreign securities and sought to reduce the outflow of US dollars. The increased amount of dollars did help bring economic growth for a while, however it would slow down eventually.

Case Study: France

Now let's apply this knowledge and take a look at what France was doing during this period of time in history. It is widely argued that France and its monetary policy had a very large influence on the decline and the overall collapse of the Bretton Woods monetary system. French contention with the Bretton Woods system began very early in the system's inception and continued up until the final nail in its coffin. In this case study, we will examine the French history, relationships, and responses to Bretton Woods policies and the system itself.

France, like many other Western and allied nations, sent delegates to the original Bretton Woods conference to present ideas and plans about the future infrastructure of the international monetary system. However, unlike the US who was economically spared from World War II, France was economically and industrially decimated. So even though historically France was seen as a great power in international affairs, their input in the new monetary system was mostly sidelined in favor of American and British plans. This lack of influence extended into the early years of the Bretton Woods system (Bordo et al, 1994).

One of the first real conflicts between France and The Bretton Woods System came in 1948 when France decided to devalue its currency to take advantage of the weak currency situation throughout Western Europe, as well as creating a multiple exchange rate system. These monetary actions went against the agreements laid out in Bretton Woods, so in response, France was denied funds from the International Monetary Fund for 4 years until 1952. (Bordo et al, 1994).

The French economy began to expand greatly with considerable help from the American Marshall plan. Also, in response to withheld funds, France also singularly pegged their currency at 350 francs to the dollar. However, after a few years, economic growth in France slowed and inflation began to climb. They also faced an ever-increasing budget deficit as well as balance of payment issues. The French had no real solution for this until the newly elected president, Charles de Gaulle, took power. Under his rule, France reduced expenditures and raised taxes to address the budget deficit. But again, contrary to the goals of Bretton Woods, they devalued the franc to 493.7 on the dollar (Bordo et al, 1994).

As well as altering monetary and fiscal policies, French economists began to envision a future of the monetary system which shifted away from the hegemony of the US dollar. One economist of note, Jacques Rueff, was very influential in the De Gaulle government, pushing France to enact policies that conflicted with The Bretton Woods System. Rueff was very skeptical of the domination of the US dollar as a reserve currency and the staggering deficit the US was taking in its balance of payments. To avoid issues with these balance of payments issues, Rueff proposed to move away from the asymmetric Bretton Woods system to a symmetric system in which countries would not be able to constantly increase their deficits. In order to move closer to a system like this, Rueff thought that the US should pay all of its outstanding dollar debts to central banks in gold. Rueff, in effect, wanted to go back to a new gold standard (Bordo et al, 1994).

As the reserve countries of the US (as to a smaller extent the UK) continued to increase their balance of payments deficits, French calls for establishing a balance of payments equilibrium began to increase in intensity. But while some economists such as Rueff wanted to leave Bretton Woods all together, the official French position was to resolve the balance of payments issues while preserving Bretton Woods. At a 1963 meeting of IMF governors, the French delegation pointed to a few critiques of the system, even if they wanted to maintain it: one is that the reserve nations needed to address their balance of payment deficits, two that it was unfair that reserve nations could easily finance deficits while other countries could not (Bordo et al, 1994).

Beginning in 1965, the French were buying up large quantities of gold with US dollars. D'Estaing, the French Minister of Finance, justified the buildup of mass gold reserves to accelerate a crisis in the international monetary system which would force the reserve

nations to consider reforms. The same year, de Gaulle suggested that a return to the gold standard was an appropriate move, since at this time, the total gold reserves held by member nations equaled that of the United States. As late as 1966, many French officials continued suggesting that the international monetary system ought to return to the gold standard (Bordo et al, 1994).

As demands for global liquidity grew through this time period, French economists proposed that a new global reserve unit be created: the Special Holdings Unit. This reserve currency would be directly linked to the value of gold. In the French plan, nations would receive an amount of the currency in proportion to the amount of gold reserves they had. This plan was adamantly opposed fiercely by the US because it would eliminate their exclusive ability to create more of the reserve currency, hindering their economic hegemony. In an attempt to appease the French out of their desire for the gold standard, the US suggested creating a new reserve unit that was not linked to gold. However, this backfired when the French decided to take a hard line in negotiations and dropped support for the reserve unit in favor of a complete return to the gold standard (Bordo et al, 1994).

By 1967, US held gold reserves were reaching very low levels. This prompted the US to ask the international community to limit the conversion of dollars into American held gold. The action further fielded French objections to the issue of US balance of payment deficits, France decided to suspend its contribution of gold to the international gold pool to keep prices at \$35 an ounce. Because France refused to contribute, the US had to use more of its gold supply instead. Once news of this was leaked to the public, it triggered a gold buying spree. Since gold prices were intended to be kept at \$35 an ounce, the US was forced to flood the market with their reserves. In light of this, members of the international monetary system agreed to reduce the importance of gold in the system. To do this, countries proposed that only currently held gold would have value in the international monetary system. No newly mined gold would be able to be part of it. This proposal was adamantly opposed by France, with de Gaulle saying that they would not try to maintain the strength of the dollar unless a return to the gold standard was achieved. As well as this opposition, the French proposed for the first time that the price of gold should be increased. Despite French opposition, the new policy was ratified by member countries (Bordo et al, 1994).

France makes for an interesting case because the very system of Bretton Woods that helped postwar weakened countries grow, especially France, would allow them to later become stable enough and point out the flaws in that same system. Another takeaway is the French insistence for a return to a gold standard fueled speculation on the price of gold, putting enormous stress on the reserves of the US. With US reserves dwindling and the market price of gold rising, America and its close allies were willing to forgo the gold-based system all together and put them on the road to abolishing Bretton Woods altogether.

End of the System

The cracks in the system were beginning to show and economist Robert Triffin would sound the alarm. Triffin had reported in the 1960s that there was trouble brewing in concern to the Bretton Woods system. The issues that began to develop are as follows: the dollar would have to be liquid for all countries since this was the currency the world was using, meaning that countries would have to have a reserve of U.S dollars. At the beginning of Bretton Woods this was not an issue as there was not a large amount of U.S dollars around the world. However, this became an issue in the 1950s and 60s since the dollar started to become more readily available. On top of this the United States was starting to run deficits in balance of payments meaning that the United States could no longer back up the amount of dollars in circulation in gold. In the Bretton Woods system, the dollar was pegged to gold at \$35 per ounce.

In a sense the dollar was meant to be “as good as gold” meaning that countries that held these U.S dollars could claim the amount of dollars’ worth in gold during the Bretton Woods system. Triffin argued that having a large amount of U.S dollars around the world would increase inflation in the home country. Meaning, that while it was needed for the United States to spread the money around, this could have a negative impact on the United States and creditors would start wondering if the USD was actually representative of the gold held in the U.S treasury. Therefore, whoever was the leader of the world currency under the Bretton Woods system would have to decide between doing what was needed for the world economy or for its home country.

With the problems beginning to mount and people beginning to lose faith in the value of the dollar, efforts were made to try and fix the system. To combat this, additional “lines of credit” were put in place on top of the existing systems to allow for greater global capital liquidity. Credit swaps and Special drawing rights were such lines of credit.

Special Drawing Rights is a concept that is similar to what the French would propose but would not be directly linked to gold. It is something that the International Monetary fund wanted to create in 1970 for a reserve asset for members. It was unique by not being tied down to one currency but a handful of popular and influential ones. This is something that was invented to combat the issues that the Triffin Dilemma caused but was never fully utilized by countries.

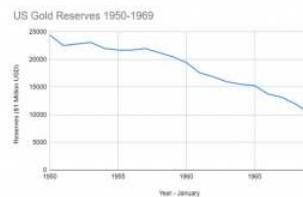
The formation of a Gold pool allowed for an official sale of gold bullion. There was also a private market that was decoupled from the official market that allowed the price of gold to fluctuate. The implementation of both public and private pools only led to a gold run.

These temporary fixes would do little since the biggest problem by far was the abuse of the dollar by the United States itself. Because of the huge bills that would continue to pile up for social programs, and lavish spending on foreign policy that included the growing quagmire that was the Vietnam Conflict, Speculators began to see the dollar as a bigger and bigger target.

The Adjustment Problem and the Nixon Shock

There were no options that would please everyone. Germany would not accept inflation while the United States would not accept a high unemployment rate, all the while the U.S had lost the economic strangle hold it had on the world. Many of the major players on both sides of the second world war had risen from its ashes and had globally competitive economies that could be used as political leverage. This included the Soviet Union which was bent on challenging the U.S. in any and every way possible. Both domestic and foreign affairs made it impossible for the major economies to agree on a solution on Balance of Payments.

During the mid-to-late 1960s several major currencies would experience currency devaluations starting with the Pound sterling in 1964. The importance of the pound would cause not only speculation attacks on the Deutschmark and the Franc but put tremendous pressure on the dollar as well. Both the direct speculative pressure as well as the ripple effects of other currency devaluation forced the U.S to eventually abandon the gold standard system.



The tension between short- and long-term economic goals identified in the Triffin paradox meant that confidence in the US dollar was on the decline. Many countries adopted France's way of thinking and decided they would rather hold onto gold itself rather than the US dollars that it backed. The demand for gold increased significantly as everyone tried to trade in US dollars that had been accumulating overseas. The United States' gold reserves, which had comprised two-thirds of the world's gold just 30 years earlier, were nearing depletion (see Figure 3). There simply was not enough gold in the world for it all to be traded at a rate of \$35 an ounce.

Stress on the Bretton Woods System continued to build until finally, on August 15, 1971, President Nixon announced that the United States would be implementing major changes to its monetary policy. These changes are collectively known as the Nixon Shock. By far the most significant of these changes was the temporary suspension of convertibility of the US dollar to gold. The Bretton Woods System was designed to provide exchange rate stability and monetary policy autonomy, but in a way, it also depended on these two things to function. The "closing of the gold window," as it was called, effectively knocked one leg out from underneath the table and rendered the whole system inoperative. Another change brought forth by Nixon's announcement was the implementation of a 10% tax on goods imported into the United States. This measure was meant to make American products more competitive and help mitigate high unemployment rates.

In his address to the nation, Nixon declared that "the United States has always been and will continue to be a forward-looking and trustworthy trading partner, and... we will press for the necessary reforms to set up an urgently needed new international monetary system." With this statement, Nixon admitted that the Bretton Woods System was unsustainable, at least in its current form. Indeed, some scholars believe these reforms marked the end of the system. Others would argue that it did not truly end until attempts to revive it had failed.

The Smithsonian Agreement and The End

The Smithsonian Agreement was a final push to try and restore confidence in the Bretton Woods System, reset it, and restart it. At the meeting it was decided to revalue the dollar and several major currencies as well in relation to the dollar. The meeting also intended to have regular additional talks like a doctor's visit to continually reevaluate how the system was doing. This, however, was futile as no one was really persuaded by the effort. At last the Bretton Woods system was abandoned once and for all for a free floating system. By 1973, most large economies had moved towards the free floating "system" of today.

Date	Event	Dollar to gold exchange rate
July 1-22, 1944	Bretton Woods Conference	\$35 per ounce of gold
Aug. 15, 1971	Nixon Shock	USD not convertible to gold
Dec. 17-18, 1971	Smithsonian Agreement, 8.5% devaluation of the USD in relation to gold	\$38 per ounce of gold
Feb. 12, 1973	Additional 10% devaluation of the USD in relation to gold	\$42 per ounce of gold

Conclusion

In this chapter we have discussed the key points of Bretton Woods Monetary System: its conception as an idea, its history, the key players in the system, its failings, and how it was viewed by differing powers. Bretton Woods was a system that was implemented after World War II to provide currency stability and greater capital flow. At first, the system held but the changing needs of those at the top and bottom as well as the effects of consistent abuse would play out as the United States was unable to keep up with the amount of USD needed around the globe. Some argue that the United States held too much power within the system as other currencies were chained to the ebb and flow of not only dollars but policy shifts of the United States as well. In modern times, similar situations play out as governments try to balance social policy and the health of their currencies and national economies, but without the safety net that even today, the U.S. somewhat still enjoys.

Essentially, the Bretton Woods System was too inflexible for an economy that required a large amount of liquidity from the U.S while the USD was pegged to gold. It required the United States to put the international economy before its national economy for continuing to distribute USD could cause inflation for the home country. As history shows, this is something that the United States was unwilling to adapt to. Nixon temporarily paused Bretton Woods after his Aug 15, 1971 speech. However, the system as it was could not be salvaged. Whether Bretton Woods was effective or not is debatable. It provided enough stability in those crucial years for the world economy to recover from the devastation of war but at the same time it was not prepared for the emerging globalization that it helped create. The world has moved beyond the Bretton Woods system. The new era of floating exchange allows countries more flexibility but the amount of deficits countries are running are already boiling over and causing economic uncertainty.

The Mundell Fleming Trilemma says that states cannot have it all: capital mobility, fixed exchange rates, and independent monetary policy. Under Bretton Woods countries had fixed exchange rates and independent monetary policy. Today, countries typically choose to not have fixed exchange rates and opt for capital mobility and independent monetary policies. However, the decision of which of the two out the trilemma to choose rests independently on individual countries. When looking at differing perspectives, not everyone agreed on how the Bretton Woods system should function. While the U.S and U.K, to a lesser degree, were the dominating voices in the Bretton Woods agreement, France did not agree with the system. France preferred the tangibility of a global gold standard and questioned why the U.S and the U.K could easily run a deficit while other countries could not. A country might be in a weakened state for a time but if governed even moderately well, it will seek advancement to either make a name for itself or reclaim past glory, but old wounds are not easily forgotten.

In the future, an international monetary system that could blend the strengths of the Bretton Woods System and the floating exchange of today would be able to tackle the weaknesses of both systems while allowing for choice that individual countries desire. Finding such a solution would call for international cooperation but given that every country has its own interests along with international interests to tend with, such a solution seems elusive.

References:

Bordo, Michael D, Barry J Eichengreen, and National Bureau. *A Retrospective on the Bretton Woods System :Lessons for International Monetary Reform*. 1993. Reprint, Chicago ; London: University Of Chicago Press, 1993. <https://www.nber.org/system/files/ch...6876/c6876.pdf>.

Bordo, Michael D. & McCauley, R. N. (2019). Triffin: Dilemma or Myth? IMF Economic Review, 67(4), 824–851. <https://doi.org/10.1057/s41308-019-00088-y>

Bretton Woods: Keynes versus White – OeNB. (n.d.). Retrieved April 24, 2022, from https://www.oenb.at/dam/jcr:a3d4ff9d...op_No18_05.pdf

Hallet, A. H. (2009). Smithsonian Agreement. In K. A. Reinert (Ed.), *The Princeton encyclopedia of the world economy*. (two volume set). (pp. 1292-1294). Princeton University Press. Retrieved April 20, 2022, from <https://ebookcentral.proquest.com/li...n?docID=557122>

Humpage, Owen. "The Smithsonian Agreement | Federal Reserve History." www.federalreservehistory.org, November 22, 2013. <https://www.federalreservehistory.org...nian-agreement>

Smaghi, L. B. (2011, October). The Triffin dilemma revisited. In Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB, at the Conference on the International Monetary System: sustainability and reform proposals, marking the 100th anniversary of Robert Triffin (1911–1993), at the Triffin International Foundation, Brussels (Vol. 3)

Smithsonian Agreement. (2003). In B. Etzel, *Webster's new world finance and investment dictionary*. Houghton Mifflin Harcourt. Retrieved April 20, 2022, from <https://search.credoreference.com/co...itutionId=1164>

U.S. Department of State. (n.d.) Nixon and the end of the Bretton Woods System, 1971–1973. (n.d.). Office of the Historian. Retrieved April 20, 2022, from <https://history.state.gov/milestones...76/nixon-shock>

Why did the Bretton Woods Economic System end. Why Did the Bretton Woods Economic System End – DailyHistory.org. (n.d.). Retrieved April 24, 2022, from https://dailyhistory.org/Why_Did_the_Bretton_Woods_Economic_System_End

This page titled [1.9: Finance- Bretton Woods Monetary System](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.10: Finance- After Bretton Woods 1.10: Finance- After Bretton WoodsEdit Update titlecancel

Learning Objectives

Upon completing this chapter, students should be able to:

- Identify economists' predictions on how the post-Bretton Wood economy would change worldwide.
- Describe how the role of the G5 and G7 affected the International Political Economy.
- Examine the dilemmas of small and big countries as their competitors went off the Bretton Wood system.
- Relate the changes after the Bretton Wood era to today's world.

The collapse of the Bretton Woods System marked the beginning of the Post-Bretton Woods monetary system. The period encompasses the end of the Bretton Woods System to today. Following the Nixon Shock in 1971, the international community entered the Post Bretton Woods System. By 1971, the U.S. economy was experiencing stagflation – this is when an economy is suffering from both inflation and recession, where unemployment is high, and there is little economic growth – and President Nixon sought to devalue the dollar in gold (Amadeo 2022). The devaluation plan did not work and eventually caused the price of gold to increase sharply within the free market, marking the end of the Bretton Woods monetary system. The main factors of the eventual collapse of the system can be attributed to institutional changes and, of course, the ability to convert gold to the dollar. Many events contributed to the issues that led to the collapse of the Bretton Woods system.

The Post Bretton Woods Monetary System is significant because it ushered in a new era of economic policies used by countries today. Following the end of the Bretton Woods system in 1971, most countries allowed their currencies to float, but this policy changed relatively quickly. Some smaller countries in the Caribbean fixed their exchange rate to the U.S. dollar, while countries such as Japan and the United States continued to float their currencies (Annual Report on Exchange 2019). The post-Bretton Woods Era marked an era in which countries worldwide had varying international monetary policies. It also marks an era in which no currency anchors the international monetary system in place, as was the case during the Gold Standard and the Bretton Wood System.

Arising from the Post Bretton Woods System were global crises like the Asian Debt Crisis of 1997 and the Great Recession, which demonstrate the problems with the fall of the Bretton Woods System, including economic imbalances and a lack of a clear orthodox foreign policy. The issues arising from the post-Bretton Woods System led to the creation of groups such as the G5, a group of powerful countries including the U.S., Germany, and Japan established in the mid-1970s to coordinate their economic policies (A Guide to Committees 2019). The G5 was formed due to the lack of an international monetary policy plan vacuum that followed the fall of the Bretton Woods System. The creation of the G5 is an example of the many attempts made by countries to create an economic plan that is unified across countries, whether it includes a few or all countries.

The Post Bretton Woods System is relevant in studying the international economy as it is both the successor of the Bretton Woods System and the current system the global economy is in. Studying the Post Bretton Woods System can provide an overview of the various impacts of the Bretton Woods System and an outlook into what the future of the international economy will look like without a unified economic system in place. This chapter will discuss the historical background that led to the Post Bretton Woods System, the current system (or a lack of a system), case studies on countries using fixed and floating exchange rates, and more.

Historical Background

The origins of the post-Bretton Woods system can be traced back to the era when the

Bretton Woods system was still around, during the late 1950s and early 1960s. The Bretton Woods system had its pros and cons in the eyes of its critics, though some wanted to end Bretton Woods more than others, especially in America, as the system was causing issues for the U.S. Dollar. The most notable figure in American politics who wanted to end the Bretton Woods system was Richard Nixon, the eventual 37th President of the United States.

Nixon believed the Bretton Woods system was holding the dollar hostage, so he sought to end it. In the book *Global Capitalism: Its Fall and Rise in the Twentieth Century* by Jeffrey A. Frieden, he notes that “Nixon regarded his close loss to John F. Kennedy in the 1960 presidential election as the result of the Fed’s willingness to raise unemployment to defend the dollar” (Frieden 2006,

314). Kennedy, who was Nixon's opponent, opposed taking the dollar off the gold standard, as he believed there was no possible use in the United States devaluing its currency.

But despite President Kennedy's wishes, the U.S. government was already finding it difficult to maintain the value of the U.S. dollar (Frieden 2006, 344). Trouble first emerged in 1959 and 1960, when the American payments deficit led to less confidence in the dollar (Frieden 2006, 344). The Federal Reserve had raised interest rates to increase demand for the dollar in foreign markets, driving the American economy into a recession. As the 1960s continued, Frieden notes that "the problem was made more pressing by the two wars the country was fighting: the Vietnam War and the large increase in spending known as the War on Poverty" (Frieden 2006, 344). Due to the unpopularity of the Vietnam War and the War on Poverty, both the Johnson and Nixon administrations resorted to deficit spending. As a result, inflation sharply rose (Frieden 2006, 344).

What happened next was a "real appreciation" of the dollar, as its exchange rate was held constant while American prices rose, meaning that foreigners had less buying power with their dollars (Frieden 2006, 344). Frieden states that the Bretton Woods rules at the time "required people around the world to accept dollars as if they were worth one thirty-fifth of an ounce of gold, or four Deutsche marks, or five franks, but in fact, they were worth less than this, by some calculations 10 or 15 percent less" (Frieden 2006, 344). The strong dollar spelled good news for Americans, as they could buy more foreign goods and make foreign investments for less; they could travel to foreign countries for less, and in 1971.

However, the strong dollar spelled doom for the Bretton Woods system, as it drove foreigners away from using it as they had lower purchasing power than Americans. In response, the United States resorted to imposing capital controls and taxing American foreign investments to try and stem the outflow of dollars. Still, foreigners wanted to dump the dollar, and it became too expensive to defend the gold-dollar price, as there was not enough gold in either the world or American reserves to buy up all the world's dollars (Frieden 2006, 345). Another factor that increased pressure on America to devalue the dollar and move away from the Bretton Woods system was the country's trade position – prices in America became more expensive than in other countries, resulting in foreigners buying less from America. In contrast, Americans bought more from foreign countries (Frieden 2006, 340). In 1971, the United States experienced its first-ever trade deficit, as the strong dollar led to American products becoming more expensive, increasing competitive pressure on American manufacturers (Frieden 2006, 340).



Figure 1. Torn & Cut One Dollar Note Floating Away in Small \$ Pieces

To try and stop the bleeding, the Nixon administration was presented with two possible solutions. The first one, according to Frieden, "was to impose austerity on the U.S. economy to restore the purchasing power of the dollar" (Frieden 2006, 345). He notes that doing this would have lowered American prices and returned the dollar to its official value (Frieden 2006, 345). The other solution was that "the American authorities could raise American interest rates high enough to attract foreigners back to dollars; if the Federal Reserve raised interest rates two or three percentage points, investors might buy more American bonds, increasing the demand for dollars and shoring up their price" (Frieden 2006, 345). Nixon was dissatisfied with both potential solutions and ultimately decided to take the dollar off gold on August 15, 1971, causing the value of the dollar to drop 10 percent, which was then reinforced by imposing a 10 percent import tax, as well as wage and price controls (Frieden 2006, 341-42). The dollar was once again devalued by 10 percent in 1973, and as a result, the U.S. experienced a trade surplus, the economy began to recover, and the unemployment rate declined (Frieden 2006, 342). This marked the beginning of what we know today as the post-Bretton Woods monetary system.

The Bretton Woods system enforced a fixed exchange rate. Since the collapse of the Bretton Woods system, International Monetary Fund members have been free to choose any form of exchange they want and allow their currency to float freely, to peg to another currency, or to adopt the currency of another country. After the Bretton Woods system collapsed in 1973, most countries allowed their currencies to float, but that quickly changed. Small countries with large trade sectors disliked floating their currency. Many smaller Asian economies and countries in Central America and the Caribbean fixed their exchange rate to the dollar. Countries like

the Netherlands and Austria traded with Western Germany and fixed their exchange rates to the German mark (Friedman, Meltzer. n.d).

A country with a fixed exchange rate can sacrifice its independent monetary policy. A small country open to external trade has little scope for independent monetary policy. Still, a large country cannot maintain an independent monetary policy if its exchange rate is fixed and its capital market remains open to inflows and outflows. Given the reduced reliance on capital controls, many countries abandoned fixed exchange rates in the 1980s to try to preserve some power over domestic monetary policy (Friedman, Meltzer. n.d).

Large economies such as the United States, Japan, and Great Britain continued to float their currencies, as well as Switzerland and Canada; some small economies have preferred to retain some influence over domestic monetary conditions. One of the countries that made the opposite choice is Hong Kong which chose to fix its exchange rate to the U.S. dollar even though it used to be a British colony and is now part of China. Some countries stepped further from independent policy by adopting the U.S. dollar as their domestic currency. The most notable change of this general type was the decision by most of the continental European countries to surrender their local currencies in exchange for a new common currency, the Euro (Friedman, Meltzer. n.d).

In the late 1970s, and as part of the Keynesian theory, some countries were in favor of a free market economy, such as the United States, Canada, Germany, and Switzerland, and moved from a social-liberalism political philosophy to a neoliberalism one by abolishing their capital controls; they were following the example set by the United Kingdom in 1979 and most other advanced and emerging economies followed in the 1980s and early 1990s. Some countries believed capital control was bad and not beneficial, but things changed, especially in 1997 with the Asian Financial Crisis. Asian nations that kept their capital controls, such as India and China, could credit allowing them to escape the crisis unscathed. Malaysian Prime Minister Mahathir bin Mohamad imposed capital controls as an emergency measure in September 1998, effectively reducing the damage of the crisis.

When the Bretton Woods System collapsed, many economists predicted a bleak future for the world economy, especially for the future of fixed exchange rates. Economists believed that the chances of returning to a fixed exchange rate would likely not be the case or the solution for countries (Thunder in the Air 1973). Some economists believed that returning a fixed exchange rate would cause countries' monetary policies to collapse and leave behind more adjustment problems (Thunder in the Air 1973). Interestingly, this has not been the case for many countries pursuing a fixed exchange rate. Depending on the goals and policies of a country, a fixed exchange rate can allow it to thrive in a world where capital mobility is increasing. To understand where economists were coming from when making their decisions, it is essential to understand the Mundell-Fleming Model and fixed vs. floating exchange rates.

Mundell-Fleming Model Applied to the Post-Bretton Woods System

The Mundell-Fleming Model presents a “dilemma” for countries in which they must choose an economic policy that contains two of the following three components: free capital mobility, fixed exchange rate, and monetary autonomy. The model aimed to determine how to analyze the differences between an economy with flexible and fixed exchange rates (Mundell 2001). The concept behind the model demonstrates that a country must choose two of the three options in its international monetary and fiscal policy. A country cannot incorporate all three options into its international monetary policy.

For example, “A country that wants to fix the value of its currency and has an interest-rate policy free from outside influence... cannot allow capital to flow freely across its borders” (Two out of Three 2016). The dilemma presented explains the Mundell-Fleming Model trilemma in which countries must choose two of the options available to them. Today, most countries favor the free flow of capital and autonomous monetary policy. Most economists assume that capital has become so mobile that countries face the choice between autonomy in their monetary policy and stability through fixed exchange rates (Majaski 2020).

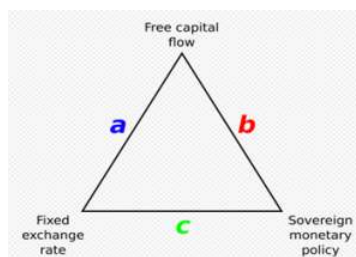


Figure 2.The Mundell Fleming Model Trilemma

Following the fall of the Bretton Woods System, countries had to choose between tying the value of their currency to another currency (fixed exchange rate) or determining their country's currency by the foreign exchange market (floating exchange rate). Smaller countries like the Bahamas are likely to fix their currency rate to a superpower like the United States and the European Union (Annual Report on Exchange 2019). Doing so protects them from paying more when importing products from developed countries. It also helps smaller countries attract foreign investment and stabilize inflation (Fixed Exchange Rate 2022). However, a fixed exchange rate's downside is that it limits the central bank's ability to adjust interest rates to boost the economy.

A floating exchange rate is when the foreign exchange market determines a country's currency price. Currencies that have floating exchange rates can be traded without any restrictions. It also allows governments to intervene to keep the currency at a fair value (Fixed Exchange Rate 2022). Typically larger countries such as the United States and the United Kingdom are more likely to have a floating exchange rate. The downside of the floating exchange rate is that the currency is more likely to be volatile because its value is based on the foreign market.

Case Studies

Once the critical terminology is precise, we can focus on analyzing case studies. We will focus on four cases to further understand the Post-Bretton Woods era. The first two case studies show how countries can unite to address international economic issues: G5 and G7. The second two will focus on the dilemmas of small and big countries as their competitors went off the Bretton Wood system. We will focus on Hong Kong and the Euro to explore why countries choose fixed or floating exchange rates.

The Group of 5 and the Plaza Accord

Many international groups have been formed to deal with International Political Economy issues. The Group of 5 (G5) is an example of these groups. The group comprised France, Germany, Japan, the U.K., and the United States. The alliance between these significant industrial countries was established in the mid-1970s, shortly after the fall of the Bretton Woods system (A Guide to Committees 2019). The alliance's purpose was to coordinate the economic policies of the countries in the group since there needed to be more international cooperation once the Bretton Woods system failed. The Plaza Accord of 1985 was the most relevant Accord between these countries. The purpose of the Accord was to weaken the U.S. dollar to reduce the increasing U.S. trade deficit. They did this by manipulating exchange rates through the depreciation of the U.S. dollar in comparison to the Japanese yen and the German Deutsche mark. The imbalances caused by the failure of the Bretton Wood system that they attempted to correct were explicitly between the U.S. and Germany and the U.S. and Japan. However, their policy changes were only half successful since they failed to fix Japan and U.S. imbalances. Unfortunately, this failure was linked to Japan's "Lost Decade" of low growth and deflation (Friedman et al. 2023).



Figure 3. Rewriting the exchange rates

The Accord stated that the U.S. would reduce the federal deficit while Japan and Germany would boost domestic demand through policies such as tax cuts. Leading up to this agreement, the U.S. dollar appreciated over 47.9%. The appreciation pressured the U.S. manufacturing industry because it made imported goods relatively cheaper. The pressure led influential companies to lobby Congress to step in, which resulted in the Plaza Accord. The yen and Deutsch mark increased significantly through the policies implemented by Germany and Japan, allowing the dollar to depreciate. The goals of the Accord were, therefore, accomplished. However, it did not entirely eliminate the trade deficit between the U.S. and Japan (Friedman et al. 2023).

The Plaza Accord allowed Japan to solidify itself as a powerful player in the international market; however, only some results were positive for the country. The Plaza Accord pushed Japan to increase trade and investment with East Asia, which allowed the country to gain some independence from the United States economy. The rising yen led to a substantial short-term shock to Japanese export-based industries. The government conducted a massive expansionary monetary and fiscal policy campaign to counter this shock and boost the domestic economy. These new policies created enormous credit and asset price bubbles in Japan's markets. Finally, once the bubbles burst, a period known as the "Lost Decade" happened in Japan. This decade was distinguished by low growth and deflation. This was an unintentional effect that the Plaza Accord had on one of its member countries (Friedman et al., 2023). Once the G5 accomplished its goals, two more countries joined, creating the G7.

The G7 Group is an intergovernmental group comprising the United States, the United Kingdom, Canada, Germany, Italy, Japan, and France. All these countries have shared political, social, and economic values, such as representative governments, liberal democracies, and free markets; in fact, the G7 countries made up more than half of the global net worth in 2020 (Zachary, McBride. 2014). Russia was part of this group until 2014, and when Russia decided to annex Crimea in March of 2014, the other group members suspended Russia's membership in the "G8." Many scholars argue that Russia was an essential member of the group, even though Russia does not share the same political and economic values as the rest of the member countries. In fact, the G7 group became more influential once Russia joined (Zachary, McBride. 2014).

Case: Hong Kong and the United States Dollar

A case study we will explore in this chapter is Hong Kong pegging itself to the U.S. dollar as a fixed currency. Hong Kong's economy is externally oriented, meaning it is led by exports (Chiu 2001). Hong Kong was an affected country as its competitors went off the Bretton Woods system. Hong Kong is prone to challenges in its financial system due to "the structure of the economy, characterized by a high degree of openness, complete absence of exchange controls and sizable financial flows" (Chiu 2001). Hong Kong has a long history of having a fixed exchange rate because it needs a currency to anchor itself to bring economic stability. After the Bretton Woods era ended, the Hong Kong dollar floated for nine years between 1974 and 1983. In the beginning, it was a prosperous era for Hong Kong, with a growth of over 10%, and inflation wavered from 4-6% from 1974 to 1976. By 1979, it all began to slow down, and prosperity was ending due to the growth of a broad money supply and domestic loans escalating to average annual rates of 35% and 43% (Chiu 2001).

Consumer inflation surged to over 15% from 1980 to 1981, and the exchange rate of the Hong Kong dollar depreciated by over 20% from 1979 to 1982 (Chiu 2001). These economic problems were caused by Hong Kong's lack of an effective monetary anchor to peg its currency. There was a lack of governmental control over the supply of interbank liquidity or interest rates; the government had no control or oversight over it. In the early 1980s, Hong Kong attempted to mend the problem by introducing piecemeal measures in the early 1980s to slow down the excessive credit and monetary creation (Chiu 2001). This would allow the Exchange Fund to borrow from the interbank, leading to a stricter liquidity requirement for interbank deposits (Chiu 2001). It was not the most effective strategy, so the government turned to persuasion to influence retail deposit rates set by the Hong Kong Association of Banks (Chiu 2001). At the same time, there was uncertainty regarding Hong Kong's political transition, and nervousness about how adequate the banks were functioning led to uncertainty in its currency. The Hong Kong Dollar fell 15% in two days, and it caused the public to go into panic (Chiu 2001). Hong Kong linked itself to the U.S. dollar at a fixed rate of HK \$7.80 to restore economic confidence (Chiu 2001). Reforms were added to oversee banks to avoid another crisis focused on interbank liquidity and stricter guidelines. The 1997 Asian Financial Crisis also affected Hong Kong by having a high unemployment rate and bringing volatility to its economy. Hong Kong quickly recuperated by buying stock and implementing more reforms in 1998. With an unpredictable move, the government bought HK\$118 billion (US\$15 billion) worth of stock purchases to lower the interest rate (Chiu 2001). The reforms the government implemented were to provide transparency in the currency board arrangements and have even more explicit expectations for liquidity rules (Chiu 2001).

"Having experienced five consecutive quarters of negative year-on-year growth, the Hong Kong economy started to recover in the second quarter of 1999 and staged a distinct rebound in 2000, with real GDP growth of around 10%." (Chiu 2001). The Post Bretton Woods Era showed how resilient Hong Kong's economy is and how successful it has been since pegging itself to the U.S. dollar.

Case: The Euro

A case study we will explore in this chapter is the Euro and how it is a floating currency whose value changes based on supply and demand. In January 1999, eleven of the fifteen countries in the European Union merged their national currencies into a single European currency and made the Euro. The motivation behind the currency merger was to bring economic stability to the European Union. The creation of the Euro would bring currency stability because there would be no exchange rate risk since the Euro would be used in the European Union. The Euro would also lower transaction rates because it would only handle one currency rather than each country in the European Union having its own.

Moreover, it would reduce inflation because of the independent European Central Bank.

Lower inflation would stabilize countries with poor inflation records, such as Spain and Italy.

During the creation of the Euro, members agreed to limit budget deficits under a Stability and Growth Pact. The Stability and Growth Pact is a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies (Europa Commission). It began with the Maastricht Treaty signed in 1992 by European member states, which

paved the way for the creation of the Euro as the common currency of the European Union (Europa Commission). The Maastricht Treaty evolved into the Stability and Growth Pact, where European Union member states agreed to strengthen the monitoring and coordination of national fiscal and economic policies to enforce the deficit and debt limits (Europa Commission). Throughout the years, there have been amendments made.

Although preventative measures have been put in place for the Euro to succeed, the economic crisis in Greece due to the 2010 revelation that they had been misstating their public spending demonstrated some flaws in the system. Overall the Euro has brought economic stability and prosperity to the European economy by having an international presence. States with dominance in the global economy meet in international groupings such as the IMF and the G8 to promote stability in the global market. The Euro is the second most important world currency (European Union 2022). It also increases financial integration, making investment capital easier and more efficient since only one currency exists (European Union 2022). The cost of transferring 100€ has been reduced from 24€ to 2.40€ since rules on cross-border euro payments were introduced in 2001. Member states also benefit from resistance to external shocks due to the size and strength of the European Union. The member states are more resilient if there is any volatility or turbulence in the global economy (Europa Union). As of 2019, the Eurozone has 19 member states and is used in non-European states such as Monaco, Vatican City, Kosovo, San Marino, and Montenegro. Inflation is low in the member states, wavering at under 3%. The Euro has fluctuated over the years, reaching a low of \$0.82 in 2000 and a high of \$1.58 in 2008.

The Current International Monetary System

After the Bretton Woods system ended, the international finance world entered a “non-system” era. However, the Bretton Woods system created essential institutions we currently have as remnants of the Bretton Woods system, such as the International Monetary Fund and the World Bank (Kugler, Straumann. 2020, 666 – 667).

The International Monetary Fund

The International Monetary Fund (IMF) was established in 1944. It was the first attempt to create an international institution that could maintain fixed exchange rates based on the international cooperation of the central banks among the participant countries. The

IMF was established on twenty articles agreed upon to create the Bretton Woods system. The IMF’s duty is to provide liquidity to member countries struggling with financial deficits. Even though the Bretton Woods system collapsed in 1971, the IMF remains in function, and it has developed over time, especially with the consecutive financial crisis (Kugler, Straumann. 2020, 668 – 676). Before the 2008 financial crisis, there was a need to change the IMF’s

policy to prevent future crises. First, the boom in the markets, the enormous inflows of capital, and emerging economies reduce the despondency of IMF lending. Second, the critical opinions from within and outside of the IMF. One of the major criticisms was that the institutional rhetoric had not been matched by policy action to address poverty or income distribution. Instead, the IMF kept its policy to maintain macroeconomic stability. Third is financial programming. The central banks worldwide lost their core policies and shifted to an inflation-targeting system. Then the IMF, the World Bank, and the U.S. Department of Treasury agreed to reform the IMF’s policy. Many critics’ analyses questioned the function of the IMF. Marxist analysis sees the IMF as an institution to maintain the hegemony of the United States and Wall Street (Reinhart, Trebesch. 2016, 3-6).

After the 2008 global financial crisis, the world hoped for a new Bretton Woods system to save the global economy after the financial crisis became too severe. The French president, Nicolas Sarkozy, and the British Prime Minister, Gordon Brown, hoped for a “new Bretton Woods” during the G20 meeting in November 2008 (Helleiner 2010, 619 – 620). The financial crisis was the worst the world had ever seen since the Great Depression, and then the Bretton Woods System came along in 1944 as a constitution for the financial system. However, the post-Bretton Woods era is known as the globalization and deregulation of the financial market. The non-system model in the 1980s and 1990s encouraged countries to adopt more financial liberalization policies and to deregulate current policies; neo-liberal values limited the states’ abilities and supported free financial markets. Importantly, it should be noted that Margaret Thatcher, a former prime minister of the United Kingdom, and Ronald Reagan, a former president of the United States, were advocates for neo-liberal values. They both came to office when the global financial system needed a new model to adopt, and one of Thatcher’s first decisions was to end Britain’s 40-year-old exchange control system (Gabor

2010). An international debt crisis in the early 1980s pushed the International Monetary Fund and the World Bank to try to protect global markets from countries that defaulted or might default. Nonetheless, the 2008 financial crisis was one of the consequences of the non-system model and deregulation; it made the countries rethink their policies and implement more regulations on the global financial system (Gabor 2010).

Conclusion

Overall, the Bretton Woods system had many advantages and disadvantages. Bretton Woods provided a stable exchange rate that allowed international trade growth. On the other hand, it was a complex structure to maintain long term since it required the coordination of policies among member countries, and people lacked confidence in the system.

After the system failed, many economists theorized that, after Bretton Woods, fixed exchange rates would vanish (Thunder in the Air 1973). However, countries have shown that using fixed exchange rates can allow economies to thrive. Using Mundell-Fleming and understanding fixed and floating exchange rates are essential to analyze the impact of Bretton Woods and the post-Bretton Woods era.

Some examples analyzed in this chapter to further understand this era are the G5 and G7 and case studies of Hong Kong and the Euro. The G5 and G7 prove that countries will work together to rebuild the international economy after Bretton Woods (A Guide to Committees 2019). The Hong Kong case study is fascinating because the government decided to link its currency to the U.S., even if the Bretton Woods System failed because countries were linked to the U.S. dollar. When done correctly, Hong Kong proves that fixed exchange rates benefit certain economies (Chiu 2001). On the other hand, the Euro is an excellent example of how floating exchange rates are also beneficial depending on the situation. The Euro's value changes based on supply and demand. This approach of currency allows twenty European countries to thrive under the umbrella of the European Union (Europa Commission).

Furthermore, the post-Bretton Wood era allowed the creation of new international economic structures still present today. Some examples of these structures are the IMF and the World Bank. The Bretton Woods system created a new wave of globalization still alive today. Understanding the creation, the destruction, and the repercussions of the Bretton Wood system allows us to understand patterns in International Political Economy. After this chapter, we will explore multiple examples of events that have been impacted by the Post Bretton Woods System in place.

The Bretton Woods system will never be replicated again due to the complexities of attempting to manage the entire world. Furthermore, this attempt will set the tone for new crises, such as the Asian financial crisis and the 08 crisis, that will be covered in future chapters.

Bibliography

“A Guide to Committees, Groups, and Clubs.” 2019. IMF. 2019. <https://www.imf.org/en/About/Factsheets/About-Committees-and-Clubs>.

Amadeo, Kimberly. “How a 1944 Agreement Created a New International Monetary System.” The Balance. The Balance, May 26, 2022. <https://www.thebalance.com/bretton-woods-system-and-1944-agreement-3306133>.

“Annual Report on Exchange Arrangements and Exchange Restrictions 2018.” International Monetary Fund. International Monetary Fund, April 16, 2019. <https://www.imf.org/en/Publications/Exchange-Arrangements-and-Exchange-Restrictions/Issues/2019/04/24/Annual-Report-on-Exchange-Arrangements-and-Exchange-Restrictions-2018-46162>.

Exchange-Restrictions/Issues/2019/04/24/Annual-Report-on-Exchange-Arrangements-and-Exchange-Restrictions-2018-46162.

“Benefits of the Euro.” European Union. Accessed May 1, 2023. https://european-union.europa.eu/insights/benefits_en.

Chiu, Priscilla. “Hong Kong’s Experience in Operating the Currency Board System.” International Monetary Fund, 2001. <https://www.imf.org/external/pubs/ft/eng/chiu.pdf>.

“Fixed Exchange Rate.” Corporate Finance Institute. Corporate Finance Institute, December 16, 2022. <https://corporatefinanceinstitute.com/exchange-rate/>.

Frieden, J. A. (2006). Chapter 15: The End of Bretton Woods. In *Global Capitalism: Its Fall and Rise in the Twentieth Century* (pp. 341–346). essay, W.W. Norton & Company.

Friedman, Milton, and Allan Meltzer. “After Bretton Woods.” Encyclopædia Britannica. Encyclopædia Britannica, inc. Accessed April 29, 2023. <https://www.britannica.com/topic/monetary-system/Bretton-Woods>.

Gabor, Daniela. 2010. “The International Monetary Fund and its New Economics.” Wiley Online Library, (September). <https://onlinelibrary.wiley.com/doi/10.1002/9781118111111.ch10>.

Helleiner, Eric. 2010. "A Bretton Woods Moment? The 2007-2008 Crisis and the Future of Global Finance." In *International affairs* (London), 619-636. 2010th ed. Vol. 86.

Kugler, Peter, and Tobias Straumann. 2020. "International Monetary Regimes: The Bretton Woods System." In *Handbook of the History of Money and Currency*, 665-685.

Laub, Zachary, and James McBride. 2014. "The group of seven (G7)." Council on Foreign Relations, (May). <https://www.files.ethz.ch/isn/179927/group%20of%20seven.pdf>.

Majaski, Christina. "What Is a Trilemma and How Is It Used in Economics? with Example." Investopedia. Investopedia, October 10, 2022. <https://www.investopedia.com/terms/t/trilemma.asp>.

Mundell, Robert. "On the History of the Mundell-Fleming Model – International Monetary Fund." International Monetary Fund. International Monetary Fund. Accessed April 27, 2023. <https://www.imf.org/External/Pubs/FT/..00/mundell.pdf>.

Reinhart, Carmen M., and Christoph Trebesch. 2016. "The International Monetary Fund: 70 Years of Reinvention." *Journal of Economic Perspectives* 30, no. 1 (Winter): 3-28. <https://www.aeaweb.org/articles?id=10.1257%2Fjep.30.1.3>.

"Stability and Growth Pact." Economy and Finance Europa. Accessed May 1, 2023. https://economy-finance.ec.europa.eu...tability-and-growth-pact_en.

"The Euro." European Central Bank, December 22, 2022. <https://www.ecb.europa.eu/euro/html/index.en.html>.

"Thunder in the air." *Economist*, July 21, 1973, 63+. The Economist Historical Archive (accessed April 26, 2023). <https://link.gale.com/apps/doc/GP410...02&sid=bookmark-ECON&xid=f60eb4b0>.

"Two out of Three Ain't Bad." The Economist. The Economist Newspaper, August 27, 2016. <https://www.economist.com/schools-br...three-aint-bad>.

This page titled [1.10: Finance- After Bretton Woods](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.11: Finance- Sovereign Debt 1.11: Finance- Sovereign DebtEdit Update titlecancel

Learning Objectives

- Define sovereign debt and outline how it affects the global economy and international politics, including examples of different varieties of sovereign debt.
- Outline the most common types of sovereign debt as it relates to IPE.
- Identify who our key players are in the global economy and how different ideologies can lead to high borrowing/lending.
- Evaluate a country's risks for borrowing as well as the consequences of trusting certain lenders.
- Apply concepts that help guide us through sovereign debt and analyze the dynamics within sovereign debt.



Figure 1: US national debt clock runs out of space. Source: WikiCommons

In simple terms, sovereign debt is a term used to describe how much money a country's government owes. This kind of debt refers to money owed by sovereign states to public and or private creditors, which can result in serious implications on the global economy and the debtor country. In a lot of cases, governments borrow for their respective countries so that they can increase spending without raising taxes (Pettinger, 2018), continue funding commitments like hospitals and schools during economic hardships such as a recession, and invest in the country's future (Abbas & Pienkowski, 2022). Additionally, the majority of the time, countries borrow money to continue funding public services without having to cut expenses during a recession, this practice is known as "tax smoothing" (Abbas & Pienkowski, 2022).

However, the act of lending money to a country can lead to numerous complications when the debtor country is unable to pay back its loans. In many cases, the countries that receive the most from lenders are countries that are considered credible and not at a huge risk of nonpayment or even defaulting on loans; this is known as the reputation theory. For example, a country that isn't considered a liability for lenders is the U.S., and an example of a country that may be considered a risk for lenders would be Greece, which took out substantial loans to fund projects for the Olympics in 2004 that they later were unable to pay off. A bad reputation or high debt levels doesn't always come from the inability to repay debt but it can sometimes be a consequence of "natural disasters, or external shocks such as commodity price volatility or unexpected changes in capital flows" (UNCTAD, 2015). However, regardless of the reasons, inability to repay debt can lead to an increase in a country's cost of borrowing, ruin its reputation, higher borrowing costs, political instability, spillovers, and sometimes even economic collapse.

The topic of sovereign debt is not one that can be escaped; debt is a constant cycle and due to recent events, it has continued to be a hot topic in research. Today, the practice of debt restructuring has become an important new topic of conversation due to the debt ceiling crisis in the United States, the Covid-19 pandemic, and the Russia-Ukraine war. Past national debt issues have resulted in more serious research on debt sustainability, fiscal policy, budget management, debt restructuring, and the impacts of debt like financial instability and inflation. New practices like the development of programs like the Government Debt and Risk Management Program have emerged to focus on institutional strengthening and technical capacity development (World Bank). Additionally, transparency practices between sovereign states and budget changes based on past debt issues have become a main priority. Finally, this chapter will provide an overview of sovereign debt by diving into its risks, history, past case studies on debt crises, and any related payback theories, highlighting the severity of the topic and its impact on the global economy.

Related Concepts and Theories

Sovereign debt used to be labeled as low risk, but when a country's spending surpasses the money they take in and they begin drowning in debt that surpasses its GDP, fear arises. When this happens, questions like do these countries have a plan to repay? do they have a weak economy? and who is the owner of the debt? begin to circulate. Although these questions are all valid when debt becomes complicated, the most crucial issue is a country's ability to repay, which leads us to the ultimate question: why do sovereign states repay?

In most cases, lenders loan money to a state to increase soft power and influence, take cash off of their hands and place it into the market for a return on investment, or as a form of assistance to a state in need of funds (Wright 2013). However, when a private or public lender decides to loan money to a state, they first must determine if this makes fiscal sense for their government. This question leads us to the reputation theory, developed by Michael Tomz, which argues that the borrower state's reputation is what guides the creditor's decision to loan them money, and the borrower state is incentivized to repay the loan to maintain their reputation in global credit markets (Tomz 2007). Tomz believes when an investor is deciding whether to lend to a government or not, they first take a look at the borrower's history of repayment, and their positive relations with creditors. Put simply, this theory is similar to how credit cards and credit score work; when someone avoids maxing out their accounts and pays their bills on time, they get a better credit score which then gives them a better reputation that helps them open up new lines of credit and take out loans. Additionally, the reputational theory "predicts how investors treat first-time borrowers and how risk premiums evolve as borrowers become more seasoned" and helps explain why states with good reputations sometimes default (Tomz, 2007).

Tomz theorizes the following: new borrowers will be faced with higher interest rates than a more seasoned borrower to lower the risks that come with lending to a potential lemon, one of three types of borrowers who are expected to not pay back or at least make consistent payments on loans. Similarly, the contextual inference is important to Tomz; investors will show low regard for debtors who default without a valid excuse while upgrading debtors who exceed expectations.

The additional two types of borrowers, according to Tomz, are stalwarts; borrowers who almost always repay their loans regardless of good times or bad, and fairweathers; borrowers who will make consistent payments to repay their debt only during good times, not bad. Tomz then goes on to argue that the concept of reputation has "sustained lending and repayment across the centuries," and is "the first test of a government bond, and governments regularly articulate a reputational rationale for repaying their loans" (Tomz, 2007). Additionally, as a consequence of not repaying, borrowers will be unable to borrow in the future because their disregard for foreign commitments has put off investors. However, regardless of the reputation for repayments on loans, we see countries with different reputations receive loans, why is that?

Most sovereign states do not take on debt with the intention of not paying it back and gaining a bad reputation and not all lenders place importance on reputation when there will be financial gain. This simple fact renders the reputational theory somewhat useless; at the end of the day, there will always be money to lend and regardless of reputation, if a sovereign state has the extra money to lend and potentially get it back with gained interest, they will gladly give out loans. Taking the limitations of Tomz's reputational theory into account, additional mechanisms guiding the nature of lending and borrowing between states and public or private creditors have shed some light on the situation. Some of these mechanisms, authored by Panizza, Sturzenegger, and Zettelmeyer, include direct punishments on the defaulting state, domestic costs, and the threat of overseas asset seizures. Altogether, these mechanisms criticize the reputational theory and further prove that the evidence provided by Tomz does little to lend support to the argument that sovereign debt is "based on maintaining a good reputation in credit markets" (Panizza, Sturzenegger, and Zettelmeyer, 2009).

New theories provided by Panizza, Sturzenegger, and Zettelmeyer first focus on direct punishments being a motivator for sovereign states to repay their debts. These punishments include an increase in the cost of borrowing, sanctions or super sanctions, trade retaliation, and capital market exclusion. Since sovereign debt has limited legal penalties and mechanisms to enforce repayment, direct punishments can be used to "interfere with a country's current transactions, trade, and payments" (Panizza, Sturzenegger & Zettelmeyer 2009, 661). Incentives to repay debt do not always have to be direct threats of punishments by creditors but rather threats of collateral damage to a debtor country's economy and or government. However, looking back in history, direct threats of punishment, whether from creditors themselves or the credit market, seem to have stimulated more repayment than reputation.

A more serious punishment is sanctions or super sanctions, such as gunboat diplomacy which can be described as the use of military force to obtain foreign policy objectives. In their paper on Supersanctions and Sovereign Debt Repayment, Mitchener and Weidenmier (2005) argue that in the gold standard period, nations that were unable to repay and defaulted, faced the risks of blockades around their ports and the seizing control over their country, however this method of gunboat interventions is not common today. However, a more influential form of direct punishment is trade retaliation. After conducting a study, Andrew K. Rose (2005) found that "debt negotiations are associated with a decline in bilateral trade of approximately 8% per year, and that defaults affect trade for a long period, 15 years (Panizza, Sturzenegger & Zettelmeyer 2009, 679). Additionally, sovereign debt defaults have negative consequences on export-focused industries but can also benefit import-competing firms if the trend of defaults reducing trade remains. Although this theory of trade retaliation does hold some truth, it still faces criticism because "the relationship between trade and default is not affected by including trade credit" and sovereign defaults have been found to be "negatively associated with domestic private firms' access to foreign credit" (Panizza, Sturzenegger & Zettelmeyer 2009, 679).



Figure 2: Gunboat diplomacy common under Teddy Roosevelt's administration

Another form of punishment is capital market exclusion. Market exclusion is evident following a default, but the period between exclusion and regained access to capital markets is quite short; “in the 1980s, countries were excluded from markets for about four years on average after their defaults ended and after the 1980s, reassess following exit from default was even faster” (Panizza, Sturzenegger & Zettelmeyer 2009, 676). Additionally, to further criticize the reputation theory, countries that are seasoned defaulters seem to be excluded from capital markets for a shorter period than a first-time defaulter, and since “sovereign debt models based on reputation in capital markets dispensed with the assumption of permanent capital market exclusion,” when permanent exclusion is extremely rare, the reputation theory barely upholds. Lastly, an increase in the cost of borrowing after a default episode can be a reason to repay; but not a good one. Like market exclusion, costs of borrowing seem to increase immediately following a debt default but it doesn't last for long, in fact, the effects defaults have on borrowing costs are small and eventually, they disappear; the effects are not long-lived and do “not seem to be a plausible deterrent of default” (Panizza, Sturzenegger & Zettelmeyer 2009, 677).

Finally, aside from direct punishments, domestic costs are also incentives for repayment. For domestic costs, debt defaults can further worsen a state's bad output; “Sturzenegger (2004) finds that default episodes are associated with a reduction in the growth of approximately 0.6 percentage points and if it comes with a banking crisis, growth can decrease by 3.3 percentage points” (Panizza, Sturzenegger & Zettelmeyer 2009, 679). Additionally, the domestic costs of defaults can be linked to political economy issues; defaults can lead to issues for the politicians and government officials that decide to default, such as the loss of their jobs or even damage to their current and future political careers. Since it has been shown, by Richard N. Cooper (1971) and Jeffrey A. Frankel (2005), that “currency devaluations are often followed by electoral losses of the ruling party and reduce the tenure of the chief of executive and minister of finance,” sovereign debt defaults can potentially have the same effect (Panizza, Sturzenegger & Zettelmeyer 2009, 682). Overall, defaults can result in a country's GDP to dip below trend GDP, can increase the risk of a banking crises, and can “lead to a fall in FDI flows into a country”; all of which can incentivize sovereign states to repay (Panizza, Sturzenegger & Zettelmeyer 2009, 680).

How can Sovereign Debt Exist and Function?

There are many reasons for a state to repay loans such as maintaining reputation or “good faith,” and keeping a borrowing country as a profitable enterprise for foreign investors. Debtors usually borrow with intentions of repaying, but as stated earlier in the chapter, this doesn't always happen. Not all theories of repayment hold; there will always be different challenges being faced by states and sometimes debtors are at risk of defaulting. Consequently, when a borrowing state defaults, both the creditor and debtor can lose billions of investment capital, so under what circumstances can sovereign debt exist and function?

Sovereign debt can be an effective tool for proper statecraft; specifically, it can be helpful for a borrowing state to increase funding without having a huge tax burden on its citizens. As long as states have the ability to make payments on money borrowed and repay on time, sovereign debt can then be viewed as low risk. Debtors can benefit economically from the foreign investment into their markets by helping support ambitious projects, infrastructure, boost domestic industries, etc. (Sovereign Debt 2018). Debtors want to operate in “good faith” which means fulfilling contractual obligations and this is how sovereign debt can exist by creditors giving reasonable loans and debtors honoring their commitment and creating policy that aids in repayment of loans. Sovereign debt is somewhat of a “give-and-take” relationship and creditors will always look to invest with states that are considered low-risk and can usually repay loans.

Creditors can benefit from loaning out money because it is a way for states to put assets into the global market and hopefully get a return on investment. However, they can run a risk of defaulting or taking “haircuts” and not getting the return on the investment they sought. States that lend have the authority to influence or compel borrowing states to repay by excluding states from foreign markets, freezing assets in international banks, gunboat diplomacy, and placing economic sanctions on a borrowing state (ICMA 2017). This gives creditors more leverage and confidence when loaning money which in turn benefits debtors that need foreign investments. The constant flow of funds is what keeps the global economy functioning at its maximum potential, but for this to be

the case, states need to ensure that they can trust their money in borrowing states. Theories such as reputation and punishment illustrate sovereign debt as an entity that states can evaluate risk and thus only invest in stalwart or even fairweather borrowers (Tomz 2007). This can be effective in most cases but there are exceptions, states will invest in risky borrowers or lemons if the creditor feels as though the benefits outweigh the risks (Tomz 2007). Creditors that feel that they can effectively gain collateral if a debtor defaults, will gladly run the risk of loaning money (Sovereign Debt 2018). This means that even under unfavorable conditions, state creditors will make exceptions and lend money if it results in a profit or at least increased soft power.

The important thing to note here is that sovereign debt can exist and function by giving the debtor much-needed funding for domestic projects. The creditor gets to invest money that could otherwise be sitting around; a chance to earn interest and increase soft power around the globe. Even nations with poor borrowing histories can entice creditors because these states can increase punishment if the borrowing government defaults (Shalal 2023). Include higher interest rates and extend their reach into new territory (Shalal 2023). As long as creditors are willing to loan out money and debtors can make payments, sovereign debt is beneficial, and even good business practice in a lot of cases, and can promote global economic growth.

Why does a Country Default?

When a country defaults, the government is breaking its contractual obligation to repay a loan (Materson 2022). This can have serious implications on the global economy as well as the economy of the creditor and debtor. Countries that default on loans will be considered a higher risk on future loans and could even face permanent exclusion from certain markets. So for our purposes, we will discuss why a sovereign state defaults on a loan in the first place.

Before a state officially defaults there are several steps taken to try to avoid this. One example is that creditors will take a “haircut” which lowers the amount a debtor will have to pay in hopes of getting a partial return on an investment (Boyle & Rohrs-Schmitt 2022). When a debtor finally defaults on a loan the financial and economic impact can be severe on both parties; debtors that are dependent on foreign investment to boost their economy will see the national economy immediately slow down (Boyle & Rohrs-Schmitt 2022). A debtor can default on a loan due to many factors stemming from economic hardship such as war, corruption, revolution, financial mismanagement, or financial crisis (Boyle & Rohrs-Schmitt 2022). When states borrow from creditors they must also create smart fiscal policies that maximize the loans and leave avenues for repayment to be possible.

Some theories as to why states default on loans include Misfortune or sudden changes in the global market or domestically (Sovereign Default 2018). Natural disasters can affect a state’s ability to make payments on loans if the debtor has a decrease in liquid money. Spikes in global interest rates and a rise in prices can also cause a state to default (Sovereign Default 2018). We see this on a macro and microeconomic level as a 1% increase in interest rates can be the difference in a debtor’s capacity to afford a loan. The price increase can cause a state to default as well because the cost of operating has increased which can quickly make a loan obsolete and ineffective. The one criticism of the theories listed above is that experienced and fiscally smart governments should craft policy and borrow accordingly to include a buffer with unforeseen events in mind (Sovereign Debt 2018). Overall, debtors should not borrow if they are not confident or lack the capability to make payments on loans.

Case Studies in Sovereign Debt

From this point on, we’ll review a couple of important case studies in sovereign debt. First, we’ll look at a country that experienced a recent debt crisis—Greece. Their case is indicative of the stress austerity measures can inflict upon a domestic population. Then, we’ll talk about the nation with the highest debt-to-GDP ratio as of 2022—Japan. Multiple aspects of their scenario, including that they owe most of their debt to themselves, are unique. Both nations have interesting relationships with sovereign debt and they will demonstrate the various methods a nation can use to manage it. Lastly, we will discuss the U.S. sovereign debt, when it reached the highest in history, and the current national debt.

Case: Greece

Many economists have been closely monitoring Greece as a recent example of a sovereign debt crisis. Despite being a member of the European Union since 1992, Greece has had a challenging economic relationship with the rest of Europe, particularly since the introduction of the euro. At the time, Greece was unable to adopt the Euro because it did not meet the fiscal requirements which included having inflation below 1.5 percent, a budget deficit below 3 percent, and a debt-to-GDP ratio below 60 percent. This was despite the Euro being introduced in 1999 with the expectation that all EU members would use one common currency. (Council on Foreign Relations). Fast Forward to 2001, Greece finally decided to get rid of its currency (drachma) and join the EuroZone—leading to the first step down the debt crisis.

As a result, Greece started borrowing a lot of money at cheap interest rates, which caused its debt to increase quickly. Greece was additionally subject to the same monetary policies as other eurozone members due to its membership in the currency union, regardless of its specific economic conditions. Soon this led to Greece being unable to devalue its currency in response to economic difficulties like high inflation or slow development because it no longer had authority over its currency. In 2001 the country received assistance from Goldman Sachs (2.8 billion euros) to set up a complicated financial transaction called a currency swap. Per the agreement, Greece swapped its existing debt, which was in US dollars and Japanese yen, for debt in euros. As a result of the currency swap, Greece was able to get a sizable upfront payment, which it used to lower its debt-to-GDP ratio and create the illusion that its economy was stronger than it was. The agreement caused controversy since it not only concealed the real size of the nation's debt but also allowed Greece to borrow money at lower interest rates than it would have otherwise been able to.

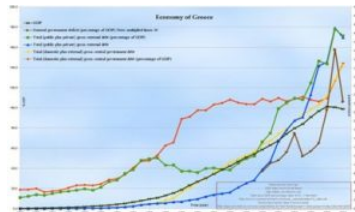


Figure 3: The Greek Economy

Greece took its final economic hit in 2004 when it hosted the Summer Olympic Games. Costing \$11.6 billion, the event raised their debt-to-GDP ratio to greater than 110%, prompting fiscal monitoring from the European Commission. Typically, Greece would be able to combat its rising debt by borrowing and spending more to obtain growth greater than its interest rates. In 2008, however, the global banking crisis (set off by the U.S. subprime mortgage market collapse) caused the cost of borrowing to rise to the point where Greece couldn't afford to borrow at rates low enough to credibly repay. To prevent complete collapse, the EU provided Greece with roughly \$146 billion in loans on the condition that the Prime Minister saw through austerity measures like significantly cutting government spending and increasing taxes. In 2010, the European Central Bank began its Securities Market Program wherein it would help struggling nations (like Greece) by buying some of their bonds. This would provide a stable stream of demand for nations with riskier bonds, boosting confidence among other investors. The main goal of this program was to maintain economic stability in Europe and prevent the spread of more sovereign debt issues across the continent.

In 2012, the EU and the IMF approved a new joint bailout of around \$172 billion for Greece, which included a large debt write-down. (Essentially, a write-down occurs when it is realized that debt will not be paid back. Keeping the debt listed dishonestly markets that the money will be returned and can be depended on). After all these steps and some more minor revisions to Greece's bailout, the debt situation began to normalize in 2014, with Greece issuing low-interest rate Eurobonds for the first time in four years. The provision of bonds was successful, and Greece raised a significant amount of money from them. After completing a third bailout in 2018, Greece now owes the EU and the IMF \$330 billion—a debt-to-GDP ratio of roughly 180%. Greece has committed to running a budget surplus (taking in more money than what they spend) until 2060 to pay them back.

This case study of Greece demonstrates how risky it might be to have a big debt in a currency you have no control over.

Case: Japan

We are now going to turn to another case, the country with the highest debt-to-GDP ratio of any major economy in the world, Japan. In December 2022, Japan's government debt represented 225.9% of its nominal GDP, up from 225.9% the previous quarter. (CEIC Data)

Despite having the highest debt-to-GDP ratio of any nation in the world, Japan's own central bank owns roughly half of it. Regarding the portion owned by the Bank of Japan, one advisor of former Prime Minister Yoshihide Suga said, "It is 500 trillion yen of borrowed money that in effect carries no interest and never has to be paid back," (Landers, 2021). Also, since all of Japan's debt is issued in yen, it is unlike other nations (Greece, for example) which have debts in a currency they can't control. While Greece must repay creditors in Euros, which it can't print, many Japanese economists take the position that they can simply print more yen when needed to satisfy their internal lending mechanism.

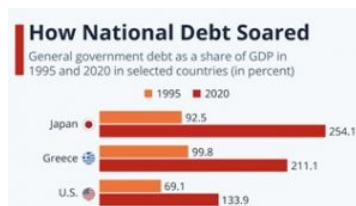


Figure 4: How National Debt Soared

Since Japanese companies and customers tend to prefer saving their money over spending, government borrowing, and spending is the only effective method Japan has had to generate demand. Though printing too much money does run the risk of causing inflation, Japan has been stuck regarding that for decades, unable to meet the annual 2% mark they've been aiming for. Instead, they've languished at around 0%. This shows us that sovereign debt totals can be deceptive—though Japan has struggled greatly with economic growth in the 21st century, they haven't had a significant debt crisis where they've been unable to pay back their lenders. Their system of internal lending is something the U.S. does as well, though only about 20% of U.S. debt is owed to itself as opposed to Japan's 50%. When one needs to borrow and spend to create the demand necessary for growth, having the debts issued in one's currency can provide truly unique opportunities to “look the other way” regarding the issue of sovereign debt altogether.

Case: The United States

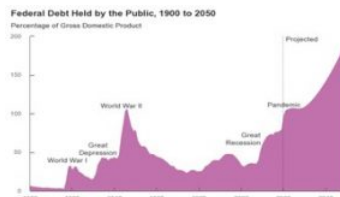


Figure 5: US Federal Debt

Looking at the U.S. sovereign debt, the U.S. government has been running a budget deficit for many years, which means that it spends more money than it brings in through taxes and other revenue sources. As a result, the government needs to borrow money to finance its spending, which adds to the national debt. In terms of the percentage of GDP, which is a commonly used measure to assess a country's debt burden, the highest level of U.S. sovereign debt was around 106% of GDP in 1946, immediately after the end of World War II. The United States has had public debt for longer than it has existed as a nation, yet for more than a century and a half, it had managed to function without any, until the country joined World War I, and had to take out record-breaking amounts of debt. At that time, the U.S. government had incurred significant debt to fund its war efforts. However, the U.S. was able to reduce its debt burden over time, and by the 1970s, the debt-to-GDP ratio had fallen to around 30%. Since then, the debt-to-GDP ratio has increased again, and it reached a high of around 106% in 2021, due in part to the economic impact of the COVID-19 pandemic and the government's efforts to stimulate the economy.

Speaking of today (2023), the public's fear about federal spending is rising, and politicians from both parties say that cutting the budget deficit is one of their top priorities. The federal government's \$31.38 trillion debt ceiling has already been reached, which is believed to be the highest of all times. According to Statista, the forecast for the U.S. national debt in 2023 is believed to be 122.89% of the GDP and 134.87% in 2027.

Conclusion

After discussing sovereign debt both theoretically and practically, it can be concluded that there seems to be a significant correlation between the two. One of the ideas that effectively explains Greece's issue with sovereign debt is the Tomz Reputational Theory. When one considers what Tomz said, that nations with stronger repayment reputations are more likely to receive loans at lower interest rates, it is clear how Greece's economic instability led to a worsened reputation. The increase in interest rates that Greece had to pay to borrow money on the global bond market was one of the most obvious immediate repercussions. Following the debt crisis, several nations became more cautious when lending money to Greece and demanded higher interest rates in the event of a default. As a result, other nations began to enact stricter fiscal regulations and debt management procedures in order to prevent similar catastrophes.

Similarly, International bodies like the IMF and the European Commission have expanded their monitoring and oversight of countries' economic policies as a result of the crisis. In their financing initiatives, these institutions started to focus more emphasis

on the necessity of sustainable debt levels, structural changes, and economic stability, and nations that applied for aid had to meet stringent criteria before being granted loans. As Panizza, Sturzenegger & Zettelmeyer (2009) criticized the reputation theory, direct punishment such as increasing the cost of borrowing is not always the right measure or motivation for countries to repay, since it caused Greece to spiral down economically even more.

However, not all theories hold truth to them, especially not in the case of the United States. As mentioned earlier in the chapter, the United States has been running a budget deficit for many years and is well known for having the most significant external debt in the world. However, the country's reputation for not being able to repay its loans and its overaccumulation of debt has done nothing to stop it from continuously borrowing money, why is that?

Contradicting the reputational theory, the United States has no incentive to repay its loans based on reputation; its name has already been tainted but there seems to be no end to the debt crisis. Additionally, not many direct threats or punishments have been held over the United States to ensure repayment, ultimately making it a special case that contradicts almost all sovereign debt theories.

In conclusion, this chapter has defined and explored the complexity of sovereign debt, including related theories such as the Tomz reputation theory, reasons for repayment and defaulting, and case studies from Greece, Japan, and the United States. By examining and questioning these topics, we have recognized certain puzzles and future research topics that can use these studies to better analyze current debt issues, including the US debt ceiling crisis and the rising sovereign debt issues across the globe caused by the pandemic.

Due to the high risks that come with an over-accumulation of debt and defaulting, it is important that future research can look back on the theories, criticisms, and case studies, mentioned in the above chapter, to have a better understanding of sovereign debt management. In particular, past case studies, such as Greece's debt crisis, can perhaps be applied to and offer insights into the US's debt ceiling crisis by highlighting the long-term economic consequences of unsustainable debt levels, the challenges the debtor could potentially face if they default, and ways to prevent defaulting from happening. Additionally, these past case studies, as well as repayment theories, can further motivate responses to the pandemic-induced debt crisis we see today. As national debts are on the rise today due to the covid-19 pandemic, reasons to default as mentioned in the chapter can be tied back to today's crisis and can expand research on debt relief initiatives and new solutions to promote economic recovery from global emergencies.

Overall, the study of sovereign debt is crucial in maintaining global financial stability and promoting economic recovery. Additionally, it is a complex continuous issue that will always require ongoing research and attention to sustain it and prevent risks. By addressing related topics, repayment, and defaulting theories, and case studies, as well as questioning them, we can look towards future research to expand on this and work towards responsible debt management.

Bibliography

- Abbas, S.M A., and Alex Pienkowski. 2022. "What Is Sovereign Debt?" International Monetary Fund. <https://www.imf.org/en/Publications/fandd/issues/2022/12/basics-what-is-sovereign-debt>.
- Ams, J., Baqir, R., Gelper, A., & Trebesch, C. (2018). *Sovereign Default* (p. 50) [Review of *Sovereign Default*]. (Original work published 2018).
- Boyle, Michael J., Investopedia Team, and Kirsten R. Schmitt. 2022. "Sovereign Default: Definition, Causes, Consequences, and Example." Investopedia. <https://www.investopedia.com/terms/s/sovereign-default.asp>.
- Buchholz, Katharina, and IMF. 2022. "Chart: How National Debt Soared." Statista. <https://www.statista.com/chart/23558/increase-national-debt/>.
- Congressional Budget Office. 2020. "File:US Federal Debt Held By Public as of Sep. 2020.png." Wikimedia Commons. https://en.Wikipedia.org/wiki/File:US_Federal_Debt_Held_By_Public_as_of_Sep._2020.png.
- DeSilver, Drew. 2023. "5 facts about the U.S. national debt." Pew Research Center. <https://www.pewresearch.org/short-reads/2023/02/14/facts-about-the-us-national-debt/>.
- Howarth, David, and Lucia Quaglia. 2015. "The political economy of the euro area's sovereign debt crisis: introduction to the special issue of the Review of International Political Economy." Taylor & Francis Online. <https://www.tandfonline.com/doi/abs/10.1080/09692290.2015.1024707?journalCode=rri.p20>.
- Masterson, Victoria. 2022. "Why do countries default on their debts? | World Economic Forum." The World Economic Forum. <https://www.weforum.org/agenda/2022/03/russia-default-debt-crisis/>.

- Milligan, Susan. 2023. "CBO: U.S. Debt Growing Dramatically Worse as Lawmakers Quibble Over Borrowing Cap." USNews.com. <https://www.usnews.com/news/national-news/articles/2023-02-15/cbo-u-s-debt-growingdramatically-worse-as-lawmakers-quibble-over-borrowing-cap>.
- "National Debt by Country / Countries with the Highest National Debt 2023." n.d. World Population Review. Accessed April 25, 2023. <https://worldpopulationreview.com/country-rankings/countries-by-national-debt>.
- Nelson, Rebecca M., Martin A. Weiss, Derek E. Mix, and Paul Belkin. 2012. "The Eurozone Crisis: Overview and Issues for Congress." Congressional Research Service. <https://sgp.fas.org/crs/row/R42377.pdf>.
- O'Neill, Aaron. 2023. "U.S.: National debt in relation to GDP 2027." Statista. <https://www.statista.com/statistics/...on-to-gross-domestic-product-gdp/>.
- Panizza, Ugo, Federico Sturzenegger, and Jeromin Zettelmeyer. 2009. "The Economics and Law of Sovereign Debt and Default." *Journal of Economic Literature* 47, no. 3 (September): 651-98. 10.1257/jel.47.3.651.
- Pettinger, Tejvan. 2018. "Why does the Government Borrow?" Economics Help. <https://www.economicshelp.org/blog/5481/economics/why-does-the-government-borrow/>
- Prieur, Benoît. 2011. "File:NYC National Debt Clock.JPG." Wikimedia Commons. https://commons.wikimedia.org/wiki/File:NYC_National_Debt_Clock.JPG.
- Reich, Robert B. 2015. "How Goldman Sachs Profited From the Greek Debt Crisis." *The Nation*. <https://www.thenation.com/article/archive/goldmans-greek-gambit/>.
- Rogers, William A. 1928. "1904 cartoon: Theodore Roosevelt and his Big Stick in the Caribbean." Wikimedia Commons. <https://commons.wikimedia.org/wiki/File:Tri-bigstick-cartoon.JPG>.
- Shalal, Andrea. 2023. "Debtors, Creditors Agree Steps to Jumpstart Debt Restructurings." *Reuters*, April 13, 2023, sec. World. <https://www.reuters.com/world/sovereign-debtors-creditors-agree-steps-jumpstart-debt-restructurings-2023-04-12/>.
- Thanatostalk, C.M Reinhart, World Bank, and Eurostat. 2012. "File:HellenicOeconomy(inCurrentEuros).png." Wikimedia Commons. [https://commons.wikimedia.org/wiki/File:HellenicOeconomy\(inCurrentEuros\).png](https://commons.wikimedia.org/wiki/File:HellenicOeconomy(inCurrentEuros).png)
- "Timeline: Greece's Debt Crisis." n.d. Council on Foreign Relations. Accessed April 25, 2023. <https://www.cfr.org/timeline/greeces-debt-crisis-timeline>.
- Tomz, Michael, and Mark L. Wright. 2013. "Empirical Research on Sovereign Debt and Default." SSRN Electronic Journal. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2239522.
- United Nations UNCTAD. 2015. "Roadmap and Guide for Sovereign Debt Workouts." UNCTAD. https://unctad.org/system/files/official-document/gdsddf2015misc1_en.pdf.
- World Bank. n.d. "Government Debt and Risk Management Program." World Bank. Accessed April 25, 2023. <https://www.worldbank.org/en/topic/debt/brief/government-debt-and-risk-management-program>.

This page titled [1.11: Finance- Sovereign Debt](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.12: Finance- 1982 Debt Crisis 1.12: Finance- 1982 Debt CrisisEdit Update titlecancel

Return on Assets for the US Banking Industry between 1970-1994 (FDIC, n.d)

Years	Percent
1970	0.83%
1975	0.69%
1980	0.77%
1985	0.70%
1990	0.50%
1994	1.18%

In August of 1982, Mexico announced that it would no longer be able to service its debt of 80 billion dollars; it was among sixteen Latin American nations to do so, alongside eleven other least developed countries (abbreviated as LDC) in other parts of the world. By the end of 1983, forty-seven individual nations were affected (Sims et al., 2020). Originating in 1970's lending practices born from multiple global oil price shocks, real returns had decreased in rich countries, and developing countries saw their need for funds increase. This situation was tenable during the 70's due to near-zero interest rate short term loans, but as the focus of the developed world turned to reducing inflation, and the tightening of U.S. and European monetary policy that accompanied it, this arrangement became unsustainable (Sim et al., 2020). The crisis, which arose during a global recession, further plunged the affected LDCs into economic crises as the private financing that they relied upon was abruptly cut off (Sims et al., 2020). The problem that led to the crisis was one of insolvency: the affected nations simply could not pay off their loans without major economic reforms. This observation informed the initial response of a U.S. led effort to address the crisis called the Baker Plan (Peinhardt, 2019). Private lenders were encouraged to restructure their debts, and the International Monetary Fund (abbreviated as IMF) lent the afflicted countries enough funds to cover the interest on those debts. The LDCs were given these loans on the condition that they make structural economic reforms to encourage economic growth and rid themselves of budget deficits through liberalization and fiscal austerity. This policy had several unintended consequences, leading to what is often called "the lost decade," a period where these nations experienced a drop in per capita income of approximately 10%, high unemployment, and either non-existent or negative growth (Sims et al., 2020). Furthermore, for many nations, real wages dropped by 30% and inflation rose above 1000% (Peinhardt, 2019). This happened because many of the nations turned to reducing spending on infrastructure, health, education, and state employment. Thus, the private lenders began to negotiate loan loss provisions with their debtor nations (Sims et al., 2020). The U.S. government followed suit in 1989. Altogether, about one third of the debt was forgiven in exchange for another agreement to implement domestic reforms that would make the remaining debt serviceable known as the Brady Plan (Sims et al., 2020). The effect the crisis had on U.S. banks is reflected in the data below, showing how the net income to total capital and the net income to total assets were less than 9% and 0.5% of the industry averages (FDIC, n.d). Furthermore, between the years of 1987 and 1989, the overall income of the US banking industry fell mainly due to factors such as loan charges and loan-loss provisions (FDIC, n.d).

Besides the direct damage done to the economies and citizens of the LDCs affected by the 1982 Debt Crisis, there was also a broader problem that reverberated out of it. This being that in the rush to ensure there would not be a panic due to potential insolvency among the private lenders, regulatory standards that pertained to those banks were loosened. While this did prevent the banks from failing, it likely contributed to a weakening of market discipline and set a precedent that would encourage greater risk taking in the following decades (Sims et al., 2020). The incentivizing of economic reforms within recipient countries also became a standard part of the distribution of foreign capital in the aftermath of the Debt Crisis (Sims et al., 2020). Finally, the crisis showed the inadequacies of Import Substitution Industrialization, and led to it falling out of favor as a development strategy (Peinhardt, 2019).

Historical Background

The rising inflation in the United States reached its peak during Presidents Lyndon B. Johnson and Richard Nixon's presidential terms. In the 1960's, prices of everyday products rose to an all-time high, hitting consumers with the direct effects of high inflation.

Government spending continued to increase as the Vietnam War stretched across decades, depleting US reserves and straining the economic strength of the nation. Nixon succeeded in securing his presidency by promising to bring an end to the conflict but was still left with a nation struggling under the consequences of inflation (Cantú et al., 2015).

The United States in the early 1970s was entering a period of stagflation, a condition in which a state is faced with high rates of unemployment as well as high rates of inflation. Choices of the past such as the gold standard and the power granted to oil producing countries caused an imbalance in the global economy. Following the tumultuous time of World War II, the “Gold Standard” gave power to the U.S. dollar by using the country’s abundant gold reserve to value the dollar. Over time as the reserves were depleted, the dependence on the US dollar continued to increase – but the country now lacked the backing to uphold the value. In 1970 when the “Gold Standard” was eradicated, the presence of oil embargoes in the global economy led to a shift in the economically dominant countries. The now “floating dollar” was valued based on its status in the market, but because of the previous reliance on the dollar to purchase oil in a global market, the oil exporting countries were able to provide an influx of dollars into Western Banks. States that had the means to produce oil controlled the prices, but the sudden increase in cost sent countries on a scramble to acquire the funds to be able to maintain enough oil for growing populations. The Western Banks were eager to loan out the funds received from oil-exporting countries, but this would eventually lead to a crisis of borrowers vs. lenders (Frieden, 2015).

The Volcker Shock in 1979 was a leading factor towards the downfall of developing country’s economies. Growing interest rates in response to inflation combined with a decrease in product demand leading to an extreme decline in the profitability of common commodities. Paul Volcker was exercising contractionary policies, attempting to control inflation at a negative impact to employment rates, and straining banks/reserves. Countries exporting goods to the United States suffered due to the drop in export-related earnings and the lowered values of local currency. These developing countries heavily depended on the export value not only to provide for any necessary imports, but also to maintain employment and avoid state bankruptcy. On top of these conditions, the introduction of the dollar into the market allowed the “purchasing price” of the dollar to increase, making it increasingly difficult for developing countries to purchase dollars needed to obtain oil and other imports on a global economic scale. The heightened purchasing price of the dollar together with increased interest rates made loan repayment nearly impossible. Countries that had borrowed had to produce increasing amounts of exports to match previous revenue as the demand and price for these goods decreased (Hilsenrath, 2021).

The incomplete loan payments shifted the blame to borrowers, with lenders also believing that the funds given out were not being properly allocated by the countries. On the opposing side, borrowers blamed the lenders for not properly vetting the states that money was granted to, and excessively distributing funds. Lenders had not thoroughly accounted for the risks associated with loans given, but the argument goes both ways – borrowers also had not responsibly planned to repay loans or allocate funds received. The conflict between lenders and borrowers was the centerpiece of the debt crisis, forcing global agencies such as the IMF and World Bank to contribute greatly to recuperating the economies of afflicted nations instead of the minimal part they had played over the past decade. The subsequent Baker (1985) and Brady (1989) Plans served to utilize new loans to cover previous loans and ensured that any debt issued would be paid back in full. The plans isolated the countries from each other, treating each one independently, and relied on cooperation between the IMF, national governments, and beneficiaries/creditors (Hilsenrath, 2021).

Main Theories and Their Takeaways

The period following the crisis’ emergence was dedicated to finding a solution to protect the U.S financial system and its solvency which signified the government’s need to design a set of strategies that could restructure the existing loans and set aside loss reserves. Given the magnitude of the situation, the regulatory system was unable to hinder the crisis and governments eventually realized that lending banks would no longer be able to recover the initial value of existing loans. This led to international efforts to rearrange from simply postponing debt to debt relief via the collection of funds from the World Bank and the IMF, as well as the conversion of bank loans into bonds that reduced the concentration risk on commercial banks. Such strategies developed thanks to a series of plans and tactics designed by the US government throughout the 1980s. As the issue continued to escalate, most banks-with government guidance- came up with a mutual three-step strategy that encompassed 1. keeping loans as current as possible 2. making time to rebuild capital and 3. transforming loans into improved assets.

The first of these plans to resolve the debt crisis was the Baker Plan, launched in 1985 at an IMF/World Bank meeting in Seoul, with the purpose of tackling the international debt crisis through structural reform. This plan was designed following the idea that China’s trade surplus could be helpful in alleviating debt among Third World countries, that were becoming increasingly indebted and incapable of relieving their own debt. The Baker Plan covered fifteen countries, ten of which were in Latin America. This strategy primarily consisted in avoiding bankruptcy of developing countries by establishing that the borrower countries could

increase exports to a point that would be beneficial to reduce their debt burden to regular levels, and thus grow their way out of the debt crisis (Cline, 1989). Thus, the structural reform stressed three main points: 1. trade liberalization, 2. more liberal policies of direct foreign investment, and 3. an adjustment to the enterprise sector. More specifically, this strategy meant that industrial countries were set to contribute by increasing net loan disbursements of MBDs by providing \$3 billion annually, equal to \$9 billion over the course of three years. Consequently, countries in debt had to begin adopting market-oriented policies, in order to develop more productive economies so the IMF and World Bank could encourage commercial banks to increase loans to less developed countries (Aliquo, 1986). However, the Baker Plan failed at restoring LDCs to reliable credit status due to the plan's inability to produce the increases to money flows initially predicted.

Eventually, the failed Baker Plan was succeeded by the Brady Plan, also known as Brady Bonds: a strategy that has been praised as the ultimate solution for the LDC debt crisis because of its comprehensive design that provided an optimal solution to the debt crisis. Initially, this plan was drawn by a recognition made by the U.S government about debtors not being able to pay their debts while restoring growth, which is why this strategy instead focused on seeking permanent reductions among principal and existing debt-servicing contracts, thus helping to open the floor for negotiations among creditor banks and nations in debt, which ultimately transitioned the efforts from debt rescheduling to debt relief. To illustrate, large funds were collected from the IMF, the World Bank, and other institutions to expedite debt reduction. By using these funds, LDC's were able to implement debt-equity swaps, exit bonds, and buybacks: reducing their debt burdens. Furthermore, to qualify for financing privileges, LDCs first had to fix their economic policies by introducing reforms that encouraged growth and augmented their debt-servicing capability inside their domestic economies. Overall, this strategy discounted the debts by reducing interest rates and ensuring repayments. The Brady Plan eventually succeeded in reducing debt servicing by a significant amount. As a result, the Brady Plan evolved into the first step for LDCs to borrow and fix their markets again since WWII (Peinhardt., 2019).

In addition, as the crisis spread across nations in Latin America, the U.S government created a simultaneous solution known as the International Lender of Last Resort, which utilized fractional reserve banking and a government monopoly of legal tender issuance to serve as a failsafe for Latin American countries. Altogether, the International Lender of Last Resort became a source of money and liquidity guarantor with a macroeconomic responsibility of ensuring liquidity of the economy as a whole, serving to address the "panic-induced collapse of the fractional reserve banking system." (Saxton, 1999). The International Lender of Last Resort can prevent credit problems from further devolving into monetary crises. On the other hand, solutions were also implemented with the use of regulatory forbearance, which is a central policy that allows financial institutions to continue working and providing their services, even if their capital is entirely drained by regulators extending the time periods for banks to adhere to regulatory needs. Therefore, during the 1982 crisis, forbearance was given to large banks with reserves against LDC loans, this has been noted to be necessary by some scholars given that the majority of the largest banks in the U.S were assumed to be insolvent, so instead of creating panic among the current banking system, regulators chose an easier route of requiring U.S banks to cast aside some reserves for LDC debt, showing priority for keeping the stability inside the banking system. In fact, forbearance gave the lending institutions time to come up with new preparations with their LDC debtors, while gaining extra capital that will make up for the losses among Latin American loans, making them less impactful.

After long years of negotiations and economic strategy development for LDCs, the Debt Crisis of 1982 came to an end after the world's largest banks, recognizing the failures of the Baker Plan, developed a successful strategy for resolving the crisis through the Brady Plan.

In the Baker plan there were multiple actors involved, such as the World Bank and other developmental banks, which were all due to the help of Mr. Baker himself (Bindert, 1986). Mr. Baker called the World Bank and helped the debtor nations even more, as well as the commercial banks helping loan the fifteen indebted countries (Bindert, 1986). Ten of these Latin American countries were Argentina, Brazil, Venezuela, Uruguay, Chile, Ecuador, Colombia, Peru, Bolivia, and Mexico, which was the first debtor nation to carry out this plan (Bindert, 1986). During the debt crisis in Mexico it was hoped that the debtors would be finally out of debt since capital markets became accessible, but it actually went in the complete opposite direction (Rabobank, 2013). The economy stopped growing, inflation increased drastically, and debt went much higher (Rabobank, 2013). To be more specific, external debt went up over 50% of GDP in the late 1980s, which mainly symbolizes the failure of this plan (Rabobank, 2013). In conclusion this plan resulted in the failure of the Baker plan, but later on a new plan emerged which ultimately was successful.

Mexico: Debt Crisis and the Brady Plan

External debt	% of GDP

1978	≈35%
1979	≈32%
1980	≈30%
1981	≈31%
1982	≈50%

External Debt Burden between 1978-1982 (Rabobank, 2013)

In February 1982, the Mexican government was forced to lower the value of the peso and increase the “dollar debt burden” (Rabobank, 2013). During mid-1982 the United States and the Federal Reserve Chairman gave out a 1.5 billion dollar loan to Mexico, with 2 billion dollars of cash as well but only under the 90-day rollover rule (Rabobank, 2013). When the Brady plan was created after the failure of the Baker plan, institutions like the IMF and the World Bank wanted to focus on decreasing debt instead of rescheduling them (FDIC, n.d). FDIC also states “It is estimated that under the Brady Plan agreements between 1989 and 1994, the forgiveness of existing debts by private lenders amounted to approximately 32% of the \$191 billion in outstanding loans, or approximately \$61 billion for the 18 nations that negotiated Brady Plan reductions” (FDIC,n.d). With the Brady plan being successful in reducing down debt and helping lenders loan to the debtors, the International Lender of Last Resort also made an impact during the debt crisis. As previously mentioned, the International Lender of Last Resort was created by the United States as a cooperative partnership through institutions and banks (Sims et al., 2013).

According to Sims et al. (2013), commercial banks came to a conclusion they had to redistribute the debt of Latin American countries, and the IMF, alongside other agencies, funded the LDCs to pay their interests on their loans. In other words, the IMF and other banks were the main actors involved in the rescue commitment in order to help LDCs stabilize their economies. Hayes (2020) mentions as well that the Federal Reserve acts as “the lender of last resort to institutions that do not have any other means of borrowing, and whose failure to obtain credit would dramatically affect the economy.”

Brazil: Debt Crisis and Import Substitution Industrialization

The debt crisis in Brazil is best framed and contextualized by the Brazilian economic model of Import Substitution Industrialization (ISI). ISI began as an economic framework in the 1930s and 1940s predominantly in Latin America, and particularly in Brazil. This framework emphasizes developing domestic industry for domestic consumption rather than building industry for the sake of exporting to the foreign market (Guimarães 2010). This is done by stimulating domestic expansion via government subsidies, tax breaks, and state ownership of certain industries; in addition, imports under the ISI model are limited by tariffs and outright bans on certain goods (Guimarães 2010). All these policies are meant to develop domestic production where goods stay within an economy to stimulate domestic production and consumption, and thus wealth production.

In the context of Brazil from the 1960s to 1980s, the economy flourished with an average GDP growth of 9% (Macrotrends 2023). However, the economic tides reversed by 1982 as the international debt crisis infected the Brazilian economy. ISI is a model heavily reliant on foreign investment because of its emphasis on developing capital-heavy industries, such as steel and heavy industry manufacturing. When foreign investment dried up, the Brazilian government- already heavily in debt- was unable to sustain the level of investment able to maintain a system of ISI. The economy collapsed, with inflation reaching meteoric levels.

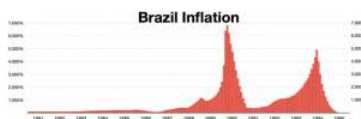


Figure 1: Brazil Inflation 1981-1995 (Wikideas, 2022)

In exchange for access to the funds of the Brady Plan, Brazil- like other Latin American nations- began a process of liberalizing its economy in the 1990s. With liberalization came an opening of the country to imports through reducing tariffs and lifting of import bans, leading to a growth in both imports and exports. Slowly, the economy began recovering, and inflation rates fell in the 1990s as a result of liberalization and the economic recovery produced by the Brady Plan.

A clear example of the effects of Brazil's protectionist policies came from its computing industry between 1984-1992 which greatly limited the import of foreign made hardware and software. Not enough government funding was given to research which resulted in products that were of much lower quality and more expensive than those from foreign competitors. By the time this ban was lifted most of the developed countries were using computers in all their economic sectors while very few businesses in Brazil were digitizing their work still using paper methods.

The story of Brazil during the 1982 Debt Crisis is a cautionary tale regarding the limits of Import Substitution Industrialization for generating long-term economic growth. While Brazil witnessed immense economic growth in the decades prior, the lesson of 1982 is that an economy entirely reliant on foreign debt will inevitably collapse when sources of debt dry up due to global economic crisis.

Criticisms of Responses

During the years following the breakdown of the crisis, many scholars and critics studied the strategies that were used to put an end to the crisis. Therefore, some opinions that emerged are valuable to highlight here in order to understand the strategies more in-depth after reviewing how they were useful for resolving the Debt Crisis of 1982. Respectively, the Baker Plan was highly criticized because it initially aimed to administer LDCs the necessary money and policies to keep debt levels untouched and for them to be capable of managing their debt more easily; however, this theory quickly proved to be ineffective given that major banks did not increase their lending to debtor countries, and these nations also failed to commit to reorganizing their internal economies. For the Baker Plan to be successful, critics argue that the fundamental approach to get out of the debt crisis will directly have to come from fixing economic policies inside the debtor countries. The main mistake behind the Baker Plan was resolving problems for lenders, instead of resolving the issues faced by borrowers, distinguishing the plan as counterproductive because it eventually led to the exhaustion of the ability of creditors to contribute with financial assistance, making such a strategy unreliable for the crisis and for any future financial international issues (Cavallo, 2020).

As for the Brady Plan, it was constantly said to be successful after still recognizing that shareholders of the world's largest banks had to assume losses after also taking over a decade of negotiations to make it successful. Nonetheless, it was the strategy that put an end to the issue and continues to be highlighted today given that its strategy was capable of reducing debt in a constantly growing economy, in order to regain growth that stimulates new capital sources.

Conclusion

The focal point of the Debt Crisis is highlighted by the conflict between borrowers and lenders. Borrowing entities such as developing countries, struggled under the demands of lenders needing loan repayment. The inadequate assessment of the risks of excessive lending inserted funds improperly into the global market. This left developing countries to fall into bankruptcy while lending countries suffered the consequences of inflation. A dependency on external agencies such as the IMF provided some relief to the economic strain but can not be accepted as a permanent solution.

Historically, the reliance of states on other nations or organizations to solve issues has created an imbalance in global politics. These repeated actions continue to have negative impacts on the global market, as well as the functionality of cohesiveness between state economies. After the initial solution to the Debt Crisis was formulated, similar patterns appear; the IMF is brought in to support developing countries and the cycle of dependency continues. Although the intention to build infrastructure and policies that will enhance the independent economic status of the nation persists, corruption and self-interest derail the efficacy of outside involvement (Hilsenrath, 2021).

The Brady and Baker plans were arguably inherently flawed in their continuation of the dependence created by renewed loans. Countries were given new loans to pay off existing ones but the original issue still wasn't addressed; these nations still lacked the structure to utilize funds efficiently and not enough work was being done to build a stronger economic foundation. The fixation on the monetary part of the crisis allowed ignorance of weak economic systems, further increasing possibilities of the pattern to repeat in the future (Frieden, 2015).

From a logical perspective, the borrower vs. lender conflict could be avoided if loan distribution was based on country prosperity and if countries borrowed based on ability of repayment. In a real world standpoint, the loss of exports from less financially stable

countries and the abundance of funds in reserves led to price increases, inflation, and unemployment. The difficulty of choosing between the two results leads to the construction of multiple, short-lived policies that can allow the global economy to retain some balance and continue providing benefits to participating nations. When other factors such as war, embargoes, political tension, and resource depletion are considered, the probability of finding a solution with longevity narrows (Frieden, 2015).

Works Cited

- Aliquo, N. A. (1985). Treasury Secretary James Baker's Program for Sustained Growth for the International Debt Crisis: Three Steps toward Global Financial Security. *Dick. J. Int'l L.*, 4, 275.
- Bogdanowicz-Bindert, C. A. (1986). The Debt Crisis: The Baker Plan Revisited. *Journal of Interamerican Studies and World Affairs*, 28(3), 33–45. <https://doi.org/10.2307/165706>.
- Cantú, C., Park, K., & Tornell, A. (2015). Lessons from the 1982 Mexican Debt Crisis for Greece. *VoxEU.org*. <https://voxeu.org/article/lessons-19...-crisis-greece>.
- Monteagudo, M. (n.d.). The debt problem: The baker plan and the Brady Initiative: A Latin American Perspective – core.ac.uk. Retrieved April 20, 2022, from <https://core.ac.uk/download/pdf/216911883.pdf>.
- Cavallo, E. (2020). Baker or Brady: Lessons of past financial crises for the pandemic recovery. *Ideas Matter*. Retrieved April 21, 2022, from <https://blogs.iadb.org/ideas-matter/en/baker-or-brady-lessons-of-past-financial-crises-for-the-pandemic-recovery/>.
- Fincyclopedia. (2020). Regulatory forbearance. *Fincyclopedia*. Retrieved April 21, 2022, from <https://fincyclopedia.net/banking/r/...ry-forbearance>.
- Frieden, J. (2015). Latin American Debt Crisis of the 1980s (Jeffrey Frieden, Harvard University). *Www.youtube.com*. https://www.youtube.com/watch?v=zhV9x79PLRU&ab_channel=AddingtonCoppin
- Guimarães, A. Q. (2010). State Capacity and Economic Development: The Advances and Limits of Import Substitution Industrialization in Brazil. *Luso-Brazilian Review*, 47(2), 49–73. <http://www.jstor.org/stable/40985095>
- Investopedia. (2021). Investopedia. Retrieved April 20, 2022, from <https://www.investopedia.com/terms/l/...lastresort.asp>.
- Jilsenrath, Jon (2021). What the Inflation of the 1970s Can Teach Us Today | WSJ. *Www.youtube.com*.
- MacroTrends (n.d.). Brazil GDP growth rate 1961-2023. Retrieved April 18, 2023, from <https://www.macrotrends.net/countries...dp-growth-rate>
- Peinhardt, C. (2019) Finance and Development 1 [Lecture]. University of Texas at Dallas, Richardson, TX, United States.
- Rabobank (2013). The Mexican 1982 debt crisis. Rabobank. (2013, 19 September). <https://economics.rabobank.com/public...-debt-crisis/#>.
- Saxton, J. (1999). An lender of last resort, the IMF, and the Federal Reserve. Retrieved April 22, 2022, from https://www.jec.senate.gov/public/_c...2518-49e3-abee332698e16597/unemp_loan-international-lender-of-last-resort-the-imf-and-the-federal-reserve—feb-1999.pdf
- Sims, Jocelyn, and Jessie Romero. (2020). Latin American Debt Crisis of the 1980s. *Federal Reserve History*. <https://www.federalreservehistory.org...an-debt-crisis>. – The LDC Debt Crisis. (n.d.). In *History of the 80s (Vol. 1 – An Examination of the Banking Crises of the 1980s and Early 1990s)* (Vol. 1, p. 20). FDIC. https://www.fdic.gov/bank/historical...ry/191_210.pdf.
- Wikideas. (n.d.). File:Brazil inflation 1981-1995.WEBP. *Wikimedia Commons*. Retrieved April 18, 2023, from <https://commons.wikimedia.org/wiki/F...1981-1995.webp>
- Wikimedia Foundation. (2021). Baker Plan (debt relief). *Wikipedia*. Retrieved April 21, 2022, from [https://en.Wikipedia.org/wiki/Baker_..._\(debt_relief\)](https://en.Wikipedia.org/wiki/Baker_..._(debt_relief)).

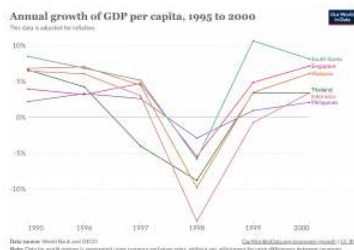
This page titled [1.12: Finance- 1982 Debt Crisis](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.13: Finance- The Asian Financial Crisis

The Asian Financial Crisis is a classic example of a financial crisis and currency bubble. It was caused by mismanagement and speculation, what makes it notable however was the leadup, quick recovery, and global reactions to the crisis. Before the crisis many of the Asian economies looked to be infallible, growing at extreme rates for a sustained period. The most notable example of this is the Four Asian Tigers (South Korea, Taiwan, Singapore, and Hong Kong) who all saw massive growth from the 1960s to the 1990s which was credited to Neoliberal policies such as a small welfare state, lax regulation, and low taxation. These factors also directly contributed to the financial crisis putting doubt into the veracity of these policies. These doubts are suspect themselves though due to several low-regulation solutions to the problems presented by the crisis and the very quick recovery after the crisis, credited to international intervention and resiliency within the economies themselves. In addition, there is inquiry as to how neoliberal the policies of those four nations and other Asian countries were. This prompts the key question of the crisis that remains to this day. Can the growth rates of the East Asian economies be achieved while avoiding the risks of systemic financial crises? The answer to this remains unclear, but what is clear is that there are numerous policy lessons to be learned from understanding the crisis. Some of these policy lessons have easy solutions that could reduce systemic financial risk, while others come with significant economic side effects. Drafting policy is important and could be used to prevent economic ramifications yet can be difficult to create and implicate. Regardless, the story, lessons, and ramifications of the crisis should be in any economist or policy maker's tool belt.

Lead-up to the Crisis

In the run-up to the crash, a currency bubble was formed. A currency bubble is a situation where the value of a currency is artificially held high either by governments or the private sector. This can be done for monetary policy reasons, such as seeking to make imports cheaper or increasing exports. This can also be done by the private sector in a speculative cycle that causes the value to balloon. The Asian financial crisis was caused by both, the government provided fixed exchange rates meaning that they were perpetually artificially holding the value of the currency up and there was significant "hot money" in the private sector. Hot money is money that quickly moves around the market in search of returns. This can cause a standard hiccup in the market to spiral out of control as the hot money flows out causing a multiplicative effect on market movements. This can be useful when markets are moving up but as the bubble began to pop it made the crash much worse.



The exact date of the start of the bubble popping and the crisis beginning can be pinned to July 2, 1997. On that day, a consortium of speculators attacked the Thai Baht selling off lots of assets in the Baht and foreign investors sold their Baht reserves to convert into dollars. This forced the Thai government to drop their currency peg to the US dollar and it fell 16% that day and would fall over 50% in the following year. This was repeated throughout the Asian countries that fell victim to the crisis. Countries were put under further pressure due to China devaluing their currency the Renminbi, which in turn caused the Japanese currency, Yen to fall in value multiplying the potential gains from future attacks making them more common and large. This, in combination with increased American interest rates which created a strong dollar, meant that there were capital outflows that in turn caused the collapse of the currency bubble as people quickly sought to convert their Asian currencies to others due to the fixed exchange rates. The Asian governments were then unable to keep up with these exchange obligations and were forced to let the value of the currency float. These floating rates subsequently crashed, starting the crisis in earnest.

Another multiplicative factor in the crisis was the public and private debt load of the Asian countries. In the years leading up to the crisis, the GDP growth of these nations was massive, seeing rates as high as 10% year over year (see Figure 1). These rates were partially spurred by a high level of spending and borrowing. Companies would take out massive loans to invest in themselves and consumer debt became very common. This would not be a problem if growth continued but due to the currency crisis, it made it

difficult for companies to repay their debts. Selling internationally became much less profitable and domestically the crisis was causing a decrease in spending. Thus, companies and consumers were forced to default on debts worsening the crisis.

These debts proved additionally difficult as companies' balance sheets were put under pressure. Previously sound investments and low levels of leverage (Leverage is taking out debt to invest in a speculative financial instrument in pursuit of higher gains. As the name suggests it increases both gains and losses.) turned into huge potential losses. These losses could normally be shored up with foreign investment, but foreign investment had dried up due to fear of the crisis. These balance sheet losses forced some companies to sell off huge portions of their balance sheets to get away from potentially bankrupting losses. Ironically these types of large selloffs multiplied the size of the crisis. All these different components would have continually built off of each other crashing Asian economies into the ground for potentially decades, much akin to the 2008 financial crisis, but luckily for these Asian economies, they held vast foreign debt. This debt may have been part of causing the crisis in the first place, but it also gave incentive to these investors to intervene.

IMF Intervention

The IMF was involved in the aftermath of the Asian Financial Crisis in efforts to help stabilize the economies of the three main Asian countries affected, Thailand, South Korea, and Indonesia. The IMF was asked to step in by the suffering countries and help. The IMF contributed an initial amount of \$35 billion to programs and to make policies that were needed to resolve the financial crisis. The IMF assisted in making monetary policies in the most severely affected Asian countries to stop the declining exchange rate of their currencies. In addition to assisting with financial policies, the IMF also helped with structural reforms to financial institutions in the countries. The IMF also assisted in closing insolvent financial institutions that would only cause further losses as well as attempting to stabilize institutions that were seen as potentially helpful in stopping the collapse of the economies. The structural reforms also included strengthening the financial supervision and regulation to prevent another crisis from happening in the future by trying to change the institutions fundamentally to prevent the same problems that caused the crisis from occurring again.

The programs the IMF put in place were less successful than they initially had hoped for due to many different factors including financial packages that were not delivered, problems with short-term debt collection, and an imbalance between them and the financial reserves the countries have. One of the main results of the IMF's assistance in the financial crisis other than helping stabilize the economies in the affected countries was its laying of groundwork and recognition that they needed to prepare better and have more preparations in place in the event of further financial crises around the world. While the IMF policies and reforms were credited with helping the slow and eventual easing of the financial troubles found in Korea, Thailand, and Indonesia, they were deemed slow in actual effectiveness in helping resolve some of the fiscal issues that were plaguing the countries.

The effects of the IMF assistance to the countries led to their eventual recovery and have led to the increased recovery of the economies in both countries. In helping the countries that were most severely affected by the financial crisis the IMF helped put in place reformations and policies as well as establishing guidelines as to what worked and what didn't in their effort to help. While the IMF provided funds and assistance to the countries many of the policies, they had pushed onto the countries were looked upon with caution because the IMF had previously made an economic crisis in Mexico worse in the short term before adapting things to make them more suitable and eventually help Mexico. While the fund was focused on helping the Asian countries, they applied measures that helped calm Financial Crises in Central and Latin American countries, to the Asian Financial Crisis, whose circumstances and causes differed.

In terms of the IMF's response, the IMF's remedies appeared to be ill suited for the case of the Asian Financial Crisis. During the earlier financial crises in the Central and Latin American countries, it was excessive government spending that played a role in causing the crises and led to effects such as inflation and trade account imbalances. The overall impact of these effects was the overvaluation of currencies and capital flight. In that case the IMF aimed for a reduction in government spending and utilizing improved tax collection to increase revenue as well as raising interest rates to keep funds within the countries and to prevent excessive speculation. The IMF also aimed to devalue currencies to encourage exports. These solutions were somewhat successful in countries able to implement them.

The Asian Financial Crisis however, possessed a different set of characteristics. For example, rather than recording deficits, government budgets reflected surpluses, not much price inflation, positive interest rates and account balances along with high saving rates. Furthermore, the Asian countries had thriving exports and domestic growth. Ultimately, what worked to cause the financial crisis was foreign capital flight and the IMF's insistence, along with the international community including Europe, Japan,

and the U.S., that the Asian countries liberalized capital markets was poor advice, especially since the Asian countries were not well-equipped to cope with large inflows of foreign capital.

In an article written by Deena Khatkhate for the economic and political weekly, she goes on to explain and provide insight into the reasons that the IMF intervention into Southeast Asia and the reform policies they started with would not be effective in handling the crisis. She explains that a large part of the problem in Korea was that many of the issues came from private sector debt and large companies and the IMF policies were garnered towards the public sector deficit, as was the case in Central and Latin America.

Other issues raised by the IMF investment into Southeast Asia was it caused a financial sector panic as the large inflow of financial packages and investment with ineffective policies set in place thwarted the IMF's initial plan and forced them to reconsider what would work in the region. The Financial crisis started to tame itself when the IMF, Korea, and Thailand started to negotiate with foreign investors and banks in the private sector over short-term credit and converting some of it into medium-term bonds. Another policy that helped ease the crisis revolved around raising interest rates to a high level in order to try and stop the cycle of appreciation and depreciation from occurring. This policy ultimately helped stop the cycle and allowed the markets to stabilize and the currency rate to recover. Indonesia took a different method to halting their financial crisis and getting it under control. They redesigned the programs that the IMF had put in place and in this admitted that the original programs were the wrong type to tame the financial crisis. The redesigned programs that the Indonesian currency board and IMF put together were more focused on short-term debt repayment that would be at a fixed exchange rate. The IMF intervention and the policies and reformations they helped to implement have led to significant restructuring in the affected countries as well as holding the private sector and large corporations to stricter standards designed to mitigate the chances of a future financial crisis. The reformations and policies also put in place bureaucratic organizations designed to help enforce laws and regulations put in place during the financial crisis.

Therefore, the IMF failed to differentiate between cases such as Central and Latin America, and the case of Asia, misunderstanding that unlike the case of Central and Latin America, the Asian Crisis was a product of the Asian Countries inability to handle the large inflows of foreign capital and therefore implemented ill-advised measures such as raising interest rates and encouraging surpluses in the budgets, under the assumption that the case of the Asian countries were similar to that of the Central and Latin American countries and therefore this mistake on the part of the IMF helped lead to the crisis. We can link this back to the Mundell-Fleming Trilemma as the loss of monetary independence as a result of the Asian countries prioritizing a stable exchange rate and free capital flows. Due to the failure of the IMF in this case, the Asian countries were unable to regain confidence in the Asian economies and currencies leading to the crisis. The IMF's decision to advise the cutting of spending, in the Asian countries who had budget surpluses had a detrimental effect on the economic crisis and reflected a misunderstanding, on the part of the IMF, as to what the problem facing the Asian economies were. Unlike Central and Latin America, the problems facing the economy were not a result of the government but because of the private sector and their imprudence.

Understanding the Crisis through the Mundell-Fleming Trilemma

The Mundell-Fleming Trilemma is an economic theoretical framework, the lens through which the Asian Financial Crisis, can be better understood. The Trilemma model states a country must choose between free capital mobility, exchange rate management and monetary autonomy and that a country's government can only choose between two of these three things. This model can be applied to the case of the Asian economies because this model can be used to demonstrate that with the rise of capital mobility in the post Bretton Woods era, the governments of the Asian countries had to make a choice between independent monetary policy or exchange rate stability. This is why the Asian economies, including Thailand, South Korean, Indonesia and Malaysia, chose two out of the three options at different points in time, depending on the policy priorities of that given time. These policy priorities are best articulated by this table utilized by the Ministry of Economy, Trade, and Industry of Japan shown below.

	Exchange rate stability	Free capital flows	Monetary independence
1) The Bretton Woods system (came into effect December 1945 by IMF agreement)	Fixed exchange rate system based around the US dollar (intervention currency) under the gold exchange standard	Approval by IMF agreement of regulations for capital transactions (Gradually international capital flows became active and caused devaluation pressure.)	Degree of monetary independence relatively high
2) Floating exchange rate system in effect since the Nixon Shock of August 1971 (mainly for developed countries)	<u>Change to the floated exchange rate system</u> (In exchange markets, sometimes volatility became high and overshooting happened.)	Since the 1980s, progress has been made in capital account liberalization. International capital flows became more active.	Degree of monetary independence relatively high
3) Thailand, Indonesia, Malaysia, etc., just prior to the Asian currency crisis	Exchange rate system virtually pegged to the US dollar (Due to this system, exchange rate became stable and capital inflow increased.)	Progress in capital account liberalization due to deregulation (The degree of progress was different in each country.)	<u>Degree of monetary independence relatively low</u> (Priority was given to the maintenance of pegged-to-dollar system.)
4) IMF policy prescriptions for the Asian currency crisis	Change to the floated exchange rate system (Stability in exchange rate was not given immediately by the IMF prescriptions.)	Maintenance of capital account liberalization (Rapid spillover of capital happened.)	<u>No monetary independence</u> (High-interest policy was taken in order to prevent currency depreciation.)
5) Regulated Malaysian exchange and capital transactions	Change to the fixed exchange rate system (Exchange rate against the US dollar was fixed.)	<u>Introduction of regulated exchange and capital transactions</u> (In order to prevent rapid spillover of capital)	Regaining monetary independence free from high interest policy (Monetary policy was eased.)

While the Asian Economies did not necessarily make a permanent or rigid choice of which of the three factors to maintain, the choice of which factors to sacrifice depended on the policy priorities of the specific time frame. At the time of the financial crisis, as shown on the table, the Asian economies made the choice of having a fixed exchange rate, pegging it to the US Dollar while pursuing capital account liberalization. This was done to incentivize foreign investment into the Asian economies, however as per the Trilemma model, that meant the Asian Economies sacrificed the ability to pursue independent monetary policies for the purpose of exchange rate stability open capital accounts.

Therefore, the impact of this was that when the Financial Crisis occurred, the Asian economies, having sacrificed an independent monetary policy could then use monetary policy to combat the crisis, worsening the impacts of the crisis as a lack of independent monetary policy hindered the Asian countries from being able to respond effectively to the crisis and stabilize their economies.

Country Case Studies

The countries involved within the Asian Financial Crisis had their own unique set of circumstances and ways of recovering from the crisis. The destabilization of the Thai baht surged the recession of many economies across Asia. The vulnerabilities of many different countries were shown and thus needed a fix. The IMF was a key player in revitalizing many economies across the continent. Some of these countries include Thailand, Indonesia, South Korea, Malaysia, and the Philippines.

Thailand

In 1996 Thailand's booming economy began to come to a simmer by late 1996 they began to realize the economy was headed for a decline. The worst estimates were still far off from the true economic decline they would soon face. In Early 1997, Thailand was warned of impending doom. Investors were speculative of the baht and the reserves of the government were depleting. The country ran out of foreign currency to exchange and thus the crisis started. Markets crashed, investors pulled out, and the economy suffered heavily. As a result of the country going into panic mode, the Prime Minister General of Thailand Yongchaiyudh resigned due to his inability to form any sort of macroeconomic policy that would aid the country. The Bank of Thailand on the other hand was viewed as stable and a very respectable establishment. They managed their reserves very well and instated very cautious macroeconomic policies that managed inflation and currency exchange rates. Nonetheless, they still could not avert the crisis.

The IMF stepped in and created a set plan for Thailand. They needed to regrow financial institutions as there were around 56 closures across the country. Restructuring the budget of the government provided for additional funding in crucial areas that needed support. They amped up the private sector of the economy and improved the current account position. By doing this, they were attempting to encourage foreign investment in the country and gain back capital for the country. They focused on monetary policy that could strengthen currency exchange rates and also heavily restructured the financial policies by intervening in weak banks and increasing capitalization in the banking system. As time went on, Thailand finally started recovering around late 1998 as their GDP grew almost 4 percent in 1999.

Indonesia

Like Thailand, the start of the crisis had parallels to what happened in Thailand. A poorly structured financial sector contributed to the fall of the economy. The sector was undercapitalized and was highly neglected due to the bank's abysmal decision-making plummeting the sector's financials. Doubts were cast on the government to maintain the stability of the currency, as short-term private sector debt arose. Inflation hit and the value of the rupiah plummeted. The value of the Rupiah went from 2,500 to 10,000 Rupiah per U.S dollar. The society of Indonesia suffered because of the economic turmoil. The political tensions from before the economic collapse had worsened and led to an increase in crime, violence and corruption. Safety nets were instituted within the country to ease economic hardship and strengthen the economy. These safety nets were not enough however, and rife with corruption. As the crisis worsened and society became more unstable this would ultimately lead to the end of the Suharto Government itself. As a result of this, the President of Indonesia, Suharto resigned.

The IMF came in towards the end of 1997 and established a three-year plan to restore the economy. The first step was the restoration of the currency. They implemented firm base money control as a primary focus. To anchor banking sector reform, they wanted to create an effective bankruptcy system and bring in governmental stability. Progress was stagnant throughout the initial stages of the program as scandals within the banks impeded progress. This eventually led to the suspension of the program in 1999 and the IMF needed to institute a new plan to aid the country. A newly elected government was able to efficiently implement a new plan that brought in 10 billion USD to aid the program. They focused on the banks by having similar goals as the program that preceded it but with increased supervision of the banks and the government. The economy was able to recover but inflation never fully recovered.

South Korea

Initial thoughts of the crisis led many to believe that Korea would not be impacted by the ramifications of the crisis started by the fall of the Thai Baht. The Korean economy was one of the strongest in Asia as its GDP was around 450 billion USD. They had a stable inflation rate and their currency exchange rates remained relatively stable. Despite this strength, debt was the factor that led to their collapse as they faced pressure regarding their payments. The debt accrued since the early 1990s had reached a record high. In addition to the debt bubble another contributing factor for the collapse was the deregulation of the banking sector. Specifically, the short term borrowing side. No or little regulations regarding short term lending led banks to use short term lending to finance long term investments.

	1994	1995	1996	1997	1998	1999	2000
Total External Debts	89.8	119.8	157.4	174.2	163.8	152.9	148.5
Short-term debts	38.5	54.9	75.9	63.8	39.0	42.5	49.4
Long-term debts	51.4	64.9	81.5	110.5	124.9	110.5	99.0
Foreign currency	89.5	119.4	156.9	173.9	162.7	149.9	144.0
Korean won	0.3	0.4	0.4	0.3	1.1	3.0	4.4
Government	7.2	6.6	6.1	11.2	15.9	19.8	19.2
Short-term debts	0.0	0.0	0.0	0.0	0.1	0.0	0.0
Long-term debts	7.2	6.6	6.1	11.2	15.8	19.8	19.2
Monetary authority	0.8	0.7	0.6	11.5	22.0	12.8	11.3
Short-term debts	0.1	0.1	0.1	0.1	0.3	1.2	1.1
Long-term debts	0.7	0.7	0.5	11.4	21.7	11.6	10.1
Banking Sector	48.4	72.0	99.4	91.1	72.5	67.6	61.8
Short-term debts	29.8	44.3	61.1	49.2	31.1	33.8	37.7
Long-term debts	18.6	27.7	38.3	41.8	41.4	33.9	24.1
Other Sector	33.5	40.4	51.3	60.5	53.4	52.7	56.2
Short-term debts	8.5	10.5	14.7	14.4	7.5	7.5	10.6
Long-term debts	24.9	29.9	36.6	46.1	45.9	45.2	45.6
Usable gross reserves	21.5	28.5	29.4	9.1	48.5	74.1	96.1
Debt-Equity ratios in manufacturing (%)	302.5	286.8	317.1	396.3	299.2	199.7	215.3

Note: 1) End of period

Sources: Bank of Korea (1998, 2003), Chopra et al (2001), Ministry of Finance and Economy

In Late 1997 the IMF came to help with Korea's economic struggles. The IMF decided to focus on macroeconomic policies. They wanted to aid the Won by implementing strategies to control the interest rates. This attempt stabilized the currency and the IMF shifted its focus toward structural reform. This featured retooling the corporate and financial sectors and regaining capital back into the economy. They wanted to restore capital by freeing assets to support stability. The Korean economy recovered quickly leading up to 1999 and 2000.

Malaysia

The Philippines and Malaysia were affected quite differently than the other Asian countries. Their macroeconomics varied significantly from the Asian countries as they were much stronger and more secure in the areas of fiscal responsibility, for example, debt and inflation. Moreover, they had a stable corporate sector and banking system allowing for ease of regrowth when the crisis hit. The IMF supported this as in the early 1990s, macroeconomic restructuring was a primary focus of theirs. [Fig 6: Mahathir Mohamed (sp)]

When the crisis hit the initial fall of the economy was similar, as the fall of the Baht was a catalyst and inflation still hit. Investors withdrew, leading the economy to further tank and become unsupported. The stock market saw a ton of red with the currency's destabilization. This led the governments of Malaysia and the Philippines to intervene and not have the IMF intervene as heavily as they had to in other countries.

Effects and Implications

The impact that the Asian Financial Crisis of 1997-1998 can be seen through not simply an economic perspective, but a political and social perspective as well. These impacts and effects were able to be seen on a small regional, national, and global scale. The financial crisis caused a lot of havoc as it was claimed to be homegrown and due to neoliberalism, thus many placed the blame on state practices, arrangements of national governance, and capitalism. The aftermath of the Asian Financial Crisis resulted in currency crashes and market crashes in several countries that became known for their economic progress at the time. The countries that experienced the crisis enjoyed a large economic growth in the years leading up to 1997 which caused such effects to be more visible from inside and outside perspectives.

Through a political perspective, Indonesia was one country that experienced examples of what can be described as a main erosion of authority. Suharto was a previous President of Indonesia and had led the country for over 30 years. Even with thirty years of knowledge under his sleeve, the crisis ultimately led to his fall in leadership. There was controversy when it came to his presidency which involved corruption and favoritism, ultimately alienating those in status classes and groups such as business circles. These issues were pushed away because of the main focus that Suharto had allowed the country to grow economically. The rates of growth played a role, along with the strong grip of the government, as they had allowed Suharto to remain protected until the Asian Financial Crisis began making its way to Indonesian currency and markets. The once prevalent growth of the country was eroded due to the currency crisis, and the value of the Rupiah declined immediately which deeply impacted the national economy. Indonesia had an issue it had not dealt with before and due to that, they had to change their way of living like many other countries that experienced the effects of the crisis. Within less than a year, in May of 1998, demonstrations and protests began taking part to show the public was no longer on Suharto's side. The presidency of Suharto ended on May 21 almost immediately after he lost support from the military.

In the social life aspect, the sudden change, the way of living had to be adjusted to fit with the new situation. One country in which this is visible is South Korea, as it went through an increased inequality when it came to income. The rate of poverty right before the crisis was at 3.0 percent in 1997 but rose to 6.4 percent at the beginning of 1998 and grew to 7.5 percent towards the end of that same year. This rate could have been possibly higher as the survey of Urban Workers' Survey of Income and Expenditure does not include those unemployed or those in rural areas, which are more prone to fall under the poverty rate. Even without the data that would have a greater impact on the result, the difference within the same year of the crisis is huge. Another example would be Malaysia where the poverty rate was decreasing right before the crisis however following the incident, the poverty rate began to be reported with a quick increase. On a separate note, countries also endured regional impacts, one of which was

Thailand. The Socio-Economic Surveys collected data in Thailand throughout the years 1996-1998 in rural and urban regions to showcase income differences. The Northeastern part of the country had the most noticeable sharp decline, but the inner vicinity of Bangkok had a national average of 3.3 percent increase. With several more countries involved, it is evident the effects were not minor and were not seen years later, the impact was clear and made its way into everyday society and people's way of living.

On the financial side, stock markets experienced large shifts in several countries throughout 1997 to 1998. The biggest decline was Indonesia which experienced an 80% decline, closely after Malaysia underwent a 74% decline, the Philippines with 54%, Thailand with 42%, and South Korea with 29% (Lairson and Skidmore 2003, p. 405). Debt increased due to borrowed foreign currency and left countries stuck in unprecedented situations. These numbers were a result of what can be divided into three explanations, investor panic, unanticipated shocks, and what can be described as weakness and mismanagement of domestic economies and the structure they are in.

As with many issues, the ability to pinpoint the explanations allowed for lessons to be learned. One crucial aspect would be the accurate spread of information to allow for transparency. Lack of information and accuracy leads to panic amongst investors, companies, governments, and people. The panic led to options being taken with minimal regard for the events that would follow. International investors already had restricted information in markets which led to panicked decisions when more information was shared, this resulted in issues arising. Regulations and proper management are important as well, governments should be able to calculate risk and make choices with that in mind. Fixed exchange rate regimes can contribute to crises. The countries involved already had weak banking sectors which made the impact more costly because of interest rates. These along with other lessons can

be taken from what occurred during the Asian Financial Crisis. The effect of this crisis left ripples not just on a small scale, but on a much larger one instead.

The major implications of the Asian Financial Crisis are lessons about currency policy and reducing systemic financial risk. In the realm of currency policy, it was shown that while artificially holding the value of your currency high can increase economic growth and have trade benefits it creates a litany of systemic issues. If countries are to peg the value of their currency, then they should ensure that they have vast reserves for times of crisis and take careful monetary policy steps to reduce the likelihood of such crises. The much more reasonable and popular step is to let the value of the currency to float with the ability of a central bank to intervene, in some cases majorly. This allows for a steady decrease or increase of value in the currency to happen safely while maintaining much of the ability to modify its value to fit the policy priorities of the government. The other major lesson is the regulation of speculative markets. While the crisis was inevitable with the former policy positions of the countries it was spurred by unregulated speculators seeking to turn a profit. There is no need to completely shut down such markets but low levels of regulation such as financial disclosures before large moves and cracking down on investor cartels and insider information would do much to stem the risk of these markets. Some of the broader risks of quick growth and debt load are more difficult to parse and are still being studied today. With time, it may be possible to design an economy that is both capable of explosive growth and resistant to systemic financial risk, but for now, we must make wise policy decisions maximizing one while minimizing the other. The Asian Financial Crisis is a perfect lesson in what not to do before a crisis while being an excellent example of what to do after a crisis. We shall continue to use it as an important piece of evidence in our policy-making toolkit.

Bibliography

- Asian Development Bank, 23 Feb. 2015, <https://think-asia.org/handle/11540/2484?show=full>.
- Ba, Alice D.. "Asian financial crisis". Encyclopedia Britannica, 13 May. 2021, <https://www.britannica.com/event/Asian-financial-crisis>. Accessed 20 April 2022.
- Britannica, The Editors of Encyclopaedia. "B.J. Habibie". Encyclopedia Britannica, 7 Sep. 2021, <https://www.britannica.com/biography/B-J-Habibie>. Accessed 21 April 2022.
- Bugge, Victor. 1997. *Carlos Menem with Chavalit Yongchaiyudh*. <https://openverse.org/image/b8fabdbf-15f6-49f6-931d-043ac625a98f>.
- Essential Action. n.d. "How the IMF Helped Create and Worsen the Asian Financial Crisis." Accessed April 24, 2023. <https://www.essentialaction.org/imf/asia.htm>.
- Evers, Joost. 1970. *Suharto, President of Indonesia*. https://commons.wikimedia.org/wiki/File:Den_Haag_v.l.n.r._Prins_Bernhard,_President_Soeharto,_mevrouw_Soeharto,_koningin_Juliana.jpg.
- Finance and development. Finance and Development | F&D. (n.d.). Retrieved April 24, 2022, from <https://www.imf.org/external/pubs/ft...08/06/khor.htm>
- Hale, G. (2011, February 28). Could we have learned from the Asian financial crisis of 1997-98? Federal Reserve Bank of San Francisco. Retrieved April 22, 2022, from <https://www.frbsf.org/economic-research/publications/economic-letter/2011/february/asia-financial-crisis-1997-1998/>
- Katz, S. Stanley. 1999. "The Asian Crisis, the IMF and the Critics." *Eastern Economic Journal* 25 (4): 421–39.
- Khatkhate, D. "East Asian Financial Crisis and the IMF: Chasing Shadows." *Economic and political weekly* 33.17 (1998): 963–969. Print.
- Knowles, James C., et al. "Social Consequences of the Financial Crisis in Asia." *Think Asia*,
- IMF Staff. "Recovery from the Asian Crisis and the Role of the IMF — an IMF Issues Brief." *International Monetary Fund*, June 2000, <https://www.imf.org/external/np/exr/.../062300.htm#VI>.
- Sharma, Shalendra D. *The Asian Financial Crisis : Crisis, Reform and Recovery*. Manchester, UK: Manchester University Press, 2018. Print.

This page titled [1.13: Finance- The Asian Financial Crisis](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.14: Finance- The Great Recession of 2007-08 1.14: Finance- The Great Recession of 2007-08

Edit Update titlecancel

The Great Recession (2006-2009), often referred to as “the subprime mortgage crisis” and “the 2008 financial crisis” is historically the second-worst economic recession to have plagued the American economy. The aftermath of the recession was extensive, Bems et al. (2013) note “From 2008 to 2009, real-world trade fell by about 15 percent, exceeding the fall in real GDP by roughly a factor of 4”. The consequences of the Great Recession were wide-ranging, but the dismantling of the housing market would have the most significant effect for years to come. Homeownership had been a central component of the American dream; as real estate and property value steadily increased, many Americans began to rush toward the thriving market, until it popped. This chapter will analyze how the combination of various factors would result in the great financial crisis and how the impacts of the resulting policies have shaped our world today. By the end of this chapter students should be able to identify the four causal theories behind the Great Recession, be knowledgeable about the origins and development of the Great Recession, understand the political impacts of the Great Recession, and be able to differentiate between the policy responses of the U.S. and Europe and understand the effects each had.

Background

Mortgaged Backed Securities

A mortgage involves a bank lending a buyer money to buy an asset such as a home. This mortgage can be bought and sold by other parties while the buyer slowly pays back the loan plus interest to whoever holds the mortgage. Lenders began to bundle thousands of these mortgages and then to sell them to investors as mortgage backed securities (MBS) (Duca 2013). MBS were originally fairly low risk, high reward, as the interest accrued from these securities was high, and strict and responsible lending practices decreased the chance of people defaulting on their mortgages. Even if there were some who defaulted, the investor would still receive compensation in the form of the assets of the defaulters, which they could sell off to recover their losses. Ratings agencies acknowledged the safety of these investments by labeling them as AAA bonds.

Seeing the safety and profitability of MBS, investors both domestically and abroad became increasingly interested in buying up MBS shares. Unfortunately, the subsequent rise in demand could not be met by the number of mortgages made available by responsible lending practices. In response, lenders loosened the restrictions on qualifying factors for loans, granting loans to people with insufficient qualifications, poor credit, and low income. The housing bubble continued to grow as the increased demand for housing, loans, and MBS was met by banks’ irresponsible and predatory lending practices. Predatory lending practices can be conceptualized as the fraudulent and deceptive tactics lenders utilized to dupe borrowers into mortgage loans beyond their means. Despite the risk associated with these new loans, referred to as subprime mortgages, they were not rated as risky. Instead, they were packaged alongside AAA rated bonds and sold as low risk to investors. This allowed investors to receive high returns on the ‘junk’ mortgages. The industry that was at one time considerably stable had become much more fragile.

Collateralized Debt Obligations

Another important financial instrument at play was the Collateralized Debt Obligation (CDO). CDOs pay investors from its grouping of financial revenue-delivering resources. In this case, the CDOs were made up of mortgages. As mortgages were paid, investors received returns through betting that mortgages would continue to be paid. These CDOs were separated into tranches based on risk, like the MBS arrangement.

Timeline

2000: 2000 is a significant starting point as there is little evidence of any subprime lending prior to the turn of the century. After 2000, however, there was a dramatic increase of subprime lending rising in correlation to the price of housing (Bailey 2008). This correlation is attributed to previously unqualified individuals becoming qualified for loans, resulting in an increase in demand for homes. This led to housing becoming increasingly expensive and bigger loans being given to more people with previously insufficient qualifications.

January-March 2006: The first quarter of 2006 was when the housing market began to turn. The bubble popped when people began to default on loans. Once mortgage payments began to balloon, because of irresponsible and predatory lending, the occurrence of defaults soared. The economy witnessed a very rapid decline in the housing market, although supply was up, demand was considerably low.

October-December 2006: As large financial institutions became aware of the conditions of the housing market, they halted any more purchases of subprime mortgages, and the banking lenders of these mortgages were left with a substantial amount of loans. As a result, Ownit Mortgage Solutions, a subprime lender, would end up having to declare bankruptcy in December of 2006 (Bailey, 2008).

April 2007: The bankruptcy of New Century Financial on April 03, 2007 is often seen as a key landmark of the financial crisis. New Century Financial had once dominated the United States as its largest mortgage lender, so its bankruptcy forecasted an emergency in the housing market amid a spike in homeowner defaults.

June 2007: On June 12, 2007, it was announced that two Bear Stearns-managed hedge funds, both of which had invested in subprime asset backed securities, were on the brink of bankruptcy due to the decline in value of highly rated MBSs. The following week Bear Stearns attempted to bailout its hedge funds but by July both had filed for bankruptcy (Bailey 2008). Although financial institutions and banks were able to recoup their losses in the form of assets, the demand for housing was so low at this point that they would've had to sell at a loss. Similarly, those who were still paying towards their mortgage found that they were paying for homes that had plummeted in value. This led to even more people defaulting on their mortgages because it wasn't worth it to keep up the payments on such low valued homes.

July 2007: As an increasing number of borrowers defaulted, the CDOs also failed to deliver returns, causing investors to lose billions of dollars. In the span of seven years, 2000 to early 2007, Bear Stearns had quadrupled its stock price. But in just a few months their stock had plummeted, losing 90% of its value in July of 2007 (Bebchuk). Bear Stearns also began looking for alternate avenues as they approached bankruptcy.

August 2007: Countrywide Financial was a major provider of home loans in the early 2000s, owing much of its revenue to the profitability of subprime loans. In late August, Bank of America bought Countrywide in response to their \$20 billion depreciation in value and the emergence of ethical investigations regarding their lending practices (Fraedrich 2014).

January 2008: In the first part of January, The World Bank predicts that global economic growth will slow in 2008, as the credit crunch hits the richest nations. In the latter half, Global stock markets, including London's FTSE 100 index, suffered their biggest falls since 11 September 2001.

March 2008: In March of 2008, there was a run-on Bear Stearns leading the government to assist JP Morgan in their acquisition of Bear Stearns by promising \$30 billion of subprime-backed securities (Bailey, 2008).

September 2008: The biggest shocks came in September. On September 15, 2008, financial giant Lehman Brothers filed a bankruptcy petition in the United States Bankruptcy Court for the Southern District of New York (Ball, 2018). The next day the U.S. government announced that they would bail out American International Group (AIG) due to their status as a "too big to fail" company. AIG had been a crucial player in the market and is credited for the insurance policy known as credit default swaps (CDS). CDS were insurance contracts sold against mortgage-backed securities. Imitating the function of home insurance, they provided protection against the risk of defaults. When the capabilities of AIG's CDS insurance policy proved deficient, the credit rating of AIG depreciated, and they were required to pay the money promised. The result was a near-failure of the institution with a loss of \$99.3 billion in 2008. (McDonald and Paulson 2015, 81). On September 25-26, 2008, the bankruptcy of Washington Mutual became the biggest bank failure in U.S. history having "... \$307 billion assets, \$188 billion deposits, and over 2,300 branches in fifteen states when it failed" (FDIC).

Late 2008 – 2009: Over the next few months, the financial crisis worsened. Merrill Lynch, a large financial institution, was sold to Bank of America with the support of the U.S. Government. The Federal government also reassumed control of Fannie Mae and Freddie Mac, two government-sponsored enterprises, both centered in the U.S housing finance system (Frame, 2015). The effects of the Great Recession did not stay within the bounds of the United States. Soon concern centered on the growing sovereign debt of several European Union members, resulting in the start of the 2009 Eurozone crisis (Lane, 2012).

Causal Theories

Throughout the Great Recession, there was consistent debate as to its causes. Over the years, explanations have generally fallen into four categories: (1) bad monetary policy, (2) financial innovations, (3) moral hazards generated by the government, and (4) global economic imbalances. Although the debate over this topic continues, it is widely accepted that the convergence of these four aspects is what triggered the Great Recession.

Bad Monetary Policy

The bad monetary policy referred to here is the decision of the Federal Reserve to keep interest rates low in an effort to pull the economy from a state of recession. The 2001 recession was the result of the lack of foresight on the developing asset price bubbles, Bailey et al., expounds “There had been an overinvestment in technology capital stock in the 1990s, and the subsequent slump in technology investment after the tech bubble burst was instrumental in the causing of the 2001 recession”.

It should be noted that failure to reduce interest rates would likely have made climbing out of the 2001 recession much more difficult. The biggest failure of monetary policy during this time is not necessarily the failure to raise interest rates but that the government failed to pay attention to the red flags associated with the growth of the housing bubble and react accordingly. Following the Dot-Com bubble, they should have been more aware of the dangers associated with bubbles and realized that there was a need to raise interest rates again when the price and demand for housing began to increase so rapidly.

Financial Innovations

When it was realized how much profit could be made from the use MBS and CDO, banks were eager to come up with ways to generate progressively large returns on investments. Without the oversight and risk assessment of ratings agencies and the SEC, the profitability capable of being made by using these instruments incentivized increasingly risky and irresponsible business practices. Economist Xavier Vives (2010) provides insight, “Prior to the 2007 crisis, banking had evolved from the traditional business of accepting deposits and granting and supervising loans, to providing services to investors (asset/investment fund management, advice and insurance) and companies (consultancy services, insurance, mergers and acquisitions, underwriting share offerings and debt securities, securitization, risk management), while also engaging in proprietary trading”. This shift in the roles of banking institutions facilitated the implementation and misuse of MBS and CDO which in turn led to an increase in deceptive and predatory lending practices in order to meet the demands of investors.

It is also believed that risky ventures were promoted within financial firms, such as Lehman Brothers and Bear Stearns, by compensation structures that produced large cash bonuses to the highest earners. Although it is not believed that either institution made risks knowing the market would collapse, Bebchuk argues that these compensation structures incentivized executives to make decisions that they knew would likely result in massive losses sometime down the road (Bebchuk 2010). In this way, MBS, CDO, and the compensation structures within financial institutions played a large role in facilitating behavior that would ultimately lead to the market crashing.

Moral Hazards

The third explanation offered is that U.S. government policies created a moral hazard in the market. The argument made is that the leaders of the largest financial institutions acted under the assumption that they were safe from systematic risks, knowing that regulators were not acting to rein them in, and that the government would bail them out if a crisis occurred because of their behavior.

“Too big to fail” refers to the government’s tendency to bailout and otherwise assist large banks, financial institutions, and companies when they are in trouble. The companies and institutions that fall into this category are deemed to be so important to the economy that government will inject millions of dollars into them, to keep them afloat. It can be argued that these practices have greatly aided in cushioning the blows of bursting economic bubbles. It could also be said that an institution’s “too big to fail” status, is a reason why they are a safe investment (Shull 2012). But others feel that large institutions and companies willingly take on more risk knowing that if the market does take a turn for the worse, they can rely on the government to bail them out. During and following the 2008 financial crisis, many pointed to this as the reason why so many big firms failed to adequately assess the riskiness of their investments.

Arguably the largest role the government played in the cause of the 2008 financial crisis was the failure of the SEC to scrutinize the practices of the ratings agencies. While these agencies are private firms, they are overseen by the Securities and Exchange Commission who is responsible for ensuring transparency and legitimacy in firm dealings. The fact that the SEC was clearly not living up to its duties in this sense created a moral hazard. As a result, it is argued that these firms abdicated their responsibility to rate the mortgages and financial instruments accurately and instead delivered the ratings that allowed banks to get higher returns on their investments.

Global Economic Imbalances

Lastly, while the Great Recession originated in the U.S, it is necessary to analyze how global imbalances ignited the crisis. The Asian Financial Crisis (1997), commonly referred to as the “global saving glut”, is often noted to have had major implications on

economies across the globe, including on the U.S. economy. The fall of U.S. interest rates has direct ties to the situation that emerged from the Asian Financial Crisis, understood as the decision of emerging markets to send capital to developed countries. Once the U.S. began to receive capital it subsequently resulted in the decline of returns received from long-term investment, specifically Treasury bonds (Yu, 2015).

None of these explanations stand alone. Each one of them represents an important part of the financial crisis and in combination, they resulted in an economic failure that would not only affect every corner of the United States but would also permeate the borders of countries abroad.

Policy Response to the Crisis

Governments have two economic levers at their disposal: fiscal policy and monetary policy. Both mechanisms of action were key in responding to the 2008 economic crisis. Even though the crisis began in the United States and originated due to US financial machinations, the entire global financial apparatus was intertwined through a network of mortgage-backed securities and highly leveraged debt. The interconnection of the financial system meant that every country was affected; governments across the globe were forced to react. Key policy differences emerged in the wake of the crisis. The contrast between Europe and the United States is especially instructive here to help understand two contrasting positions on the role of government in response to the economic crisis. Emerging from the crisis, the big policy debate was between intervention and austerity. The United States generally took a more interventionist response at both the monetary and fiscal levels through quantitative easing, lowering interest rates, and fiscal stimulus. However, Europe took a more conservative approach and injected capital in a more targeted manner, focusing on stimulus to specific adversely affected industries, debt guarantees, and asset purchases.

The United States' response to the crisis spanned three presidential administrations and was the focus of 5-8 years of national debate. The response can generally be viewed in two phases: Bush-era and Obama-era responses, the repercussions of both would be felt throughout the oncoming decade. Between these two eras it is also important to focus on how the 2008 financial crisis directly affected the 2008 presidential election, specifically John McCain's bid for presidency.

While the Presidency of George W. Bush was not characterized by fiscal restraint, the administration was reluctant to intervene excessively in the economy through fiscal stimulus due to fears of government bloating (Hennessy & Lazear, 2013). However, the Bush response was characterized by two significant stimulus bills. First was the Economic Stimulus Act of 2008. Enacted on February 13, 2008, this bill focused on providing tax rebates to single Americans making less than \$75,000 a year and families making up to \$150,000 a year to the tune of \$600 per individual taxpayer and \$300 per child (Economic Stimulus Act of 2008, 2008). The bill also contained provisions for disabled and senior citizens and significant tax breaks offered for housing-related investments. The administration expected that this expansionary measure would boost household spending and wave off recession.

When the Economic Stimulus Payments (ESPs) arrived, households did raise their spending "...by ten percent in the week the payment arrived and by 4 percent over the 7 weeks including and following arrival," (Broda & Parker, 2014). This had a small, but noticeable effect on consumer demand "...we estimate that the receipt of the ESPs directly raised the demand for consumption by between 0.5 and 1.0 percent in the second quarter of 2008 and by 0.16 to 1.81 percent in the third quarter of 2008," (Broda & Parker, 2014).

Yet, the view of most mainstream economists is that this was too little, too late; the crisis persisted. Real GDP growth shrunk from 2.2% in Q4 2007 to 1.4% in Q1 and Q2 of 2008 (Figure 2). With GDP forecasted to plummet further and the unemployment rate skyrocketing to 6% and climbing, (Figure 1) the administration decided to pass another bill authorizing the Treasury Department to attempt to stabilize the market through a variety of different interventions.

This bill, The Emergency Economic Stabilization Act of 2008, provided the Treasury with the leeway to purchase up to \$700 billion in troubled assets to remove these assets from companies balance sheets. However, only \$475 billion of these funds were authorized (Zestos, 2016). The thought process behind the bill was that since financial firms carried significant debt in the form of worthless bonds made up of subprime mortgages, the government could purchase these toxic assets and allow the firms to proceed with decreased liability. While 934 institutions received funds through TARP, much of the funding was concentrated in the hands of a few firms (Zestos, 2016). Nearly 70% of total TARP disbursements were distributed to only twelve firms since these firms were dubbed 'too big to fail' and cumulatively carried trillions of dollars in assets. The top two, AIG and General Motors, are clearly not the typical financial institutions bailed out during crisis.

The political conversation around TARP became especially fraught, with critics focusing on companies using federal funds to increase executive pay as an example of how forcing the government to take on the risk that these companies incurred simply encouraged negligence. However, the program is widely credited with helping stave off an intensification of the economic crisis.

The 2008 financial crisis also had major effects on that year's presidential race. During the 2008 presidential race, Senator John McCain failed to gain public confidence due to his apparent lack of economic experience, which gave voters little confidence he would be able to handle the financial crisis taking place. Initially, he indicated that the US economy was doing well; however, the banking sector in the United States was reeling from one of the most severe shocks in decades. In a later statement, Senator McCain explained that he was referring to the productive and resilient character of work in the United States, but that did little to restore confidence in his competence. McCain continues to attempt to deflect criticism of his lack of economic experience by saying that his words about the underlying soundness of the economy were addressed to American workers.

McCain had a hard time connecting with the American people while adhering to the president's economic policies and delivering a message of optimism and compassion to them. Before revising his position and recommending that the government assist families in keeping their homes, John McCain stated that the United States of America is in a better place now than it was eight years ago.

The comment McCain made about the robustness of the fundamentals had been made on other occasions for more than a year, and had been causing some concern among voters, failing to restore confidence among voters that he could handle the 2008 crisis. The fact that he made the same comment in September 2008, when the fall of Lehman Brothers led to the stock market downturn, became detrimental to his campaign and would be cited as one of the reasons for his electoral loss later that year.

In January 2009, President Barack Obama took office, leading a country that was weathering an 8%+ unemployment rate and had seen 3 consecutive quarters of declining GDP (Figures 2 & 3). The President's first major piece of legislation was the American Recovery and Reinvestment Act of 2009. This bill sponsored a planned \$787 billion (total outlays would amount to \$840 billion) in fiscal stimulus. This stimulus was more focused on providing relief to low and middle-income taxpayers and in providing boosts to economic activity through increased funding on mandatory spending (Medicare/Medicaid, unemployment insurance, etc). Taking place over the course of 10 years, the goal of this bill was to sustain economic growth. This package included nearly every sector of the economy, aiming for a holistic revitalization effort for consumers and businesses.

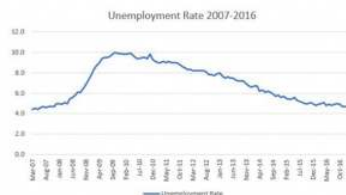


Figure 1: United States Unemployment Rate (Data Source: U.S. Bureau of Labor Statistics)

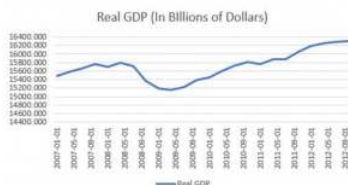


Figure 2: United States Real GDP 2007-2012 (Source: U.S. Bureau of Economic Analysis)

The Obama administration also introduced several regulatory reforms under the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2011. These reforms focused on providing consumers protection against financial sector risks by minimizing the scope of risky activities that financial institutions could undertake. For example, the Volcker Rule was designed to ban proprietary trading by commercial banks to minimize the number of speculative investments that put consumers' funds at risk.

Monetary Policy

The role of U.S. monetary policy in managing the Great Recession can be analyzed through three efforts. First, the Fed lowered the target federal funds rate from 5.25% in August 2007 to 0% by December 2008 (Board of Governors of the Federal Reserve System (US), 2022). This was intended to spur economic activity by decreasing barriers to borrowing money that would be used for starting businesses, building homes, or personal spending. Secondly, the Fed operated as a 'lender of last resort', offering a variety of different programs to help inject liquidity into troubled markets. These liquidity programs peaked at \$1.6 trillion in value by December 2008 (Wessel, 2011). These programs allowed credit markets to stabilize, increasing financial trust and confidence. By 2008, the Fed turned to Quantitative Easing, the purchasing of financial assets held by banks in exchange for currency reserves. This had the effect of increasing the domestic money supply, feeding the market with capital, leading to increased investment and economic activity.

European Response

Europe represents a distinct counter-factual to the United States' approach. While the United States immediately responded with different stimulus packages and expansionary monetary policies, the EU, after one large stimulus package, eventually turned to austerity, cutting spending and raising taxes, in order to deal with the long-run effects of the crisis. The so-called 'Troika', the European Central Bank, the European Commission, and the International Monetary Fund, guided the response for the Eurozone countries. These three institutions heavily pushed budget cuts and shrinking the welfare state in response to what they saw as a fiscally unsustainable European budget.

These responses are often compared to each other because the US recovery and the European recovery resulted in different outcomes. The United States recovery was slow but consistent. Europe recovered in 2009, around the same time as the United States, but then fell into another recession in 2011 that lasted for two years. By 2014, unemployment in Europe was twice that as the U.S. (12.1% compared to 6.7%) and in Spain and Greece, two nations who cut their government spending the heaviest, their unemployment was at 26.7 and 27.8% in 2014. (Weisbrot, 2014) These results are typically linked back to the austerity response. "After some stimulus in both areas, the eurozone governments also engaged in more and earlier budget tightening than the United States did; and the International Monetary Fund (IMF) has shown a clear relationship between this fiscal tightening and reduced GDP growth." (Weisbrot, 2014).

As we can see in Figure 4, the Keynesian approach fared better in restoring GDP to pre-crisis levels in comparison to the austerity approach adopted by the European countries. These effects are clear in the data. "Some countries, such as Germany, are also experiencing sustained growth, but those that adopted stringent austerity policies, such as Ireland, Greece, Spain, and Portugal, have yet to recover. Iceland, one of the worst affected countries, held a referendum on austerity; 93% of the population rejected it and, so far, austerity has been delayed and limited. As a result, Iceland has had much better economic performance than the latter group of austerity cases..." (McKee et al., 2012)

The comparison is not perfect because the EU economic system is different from the United States, however, one can analyze the effects of the United States' and EU's measures. In a paper analyzing the austerity response, economists from the University of Michigan and Switzerland found that "...austerity in government purchases – defined as a reduction in government purchases that is larger than that implied by reduced-form forecasting regressions is statistically associated with below-forecast GDP in the cross-section." (House et al., 2017)

However, the United States' approach is also imperfect, with many researchers citing the slow recovery rate experienced by the economy as a reason why the approach was lacking. Nonetheless, it is seen that the European approach failed to instigate long-term recovery, while the United States approach mostly succeeded. This had significant repercussions for how policymakers responded to future crises.

Long-Term Effects

By the end of 2008, twelve out of thirteen of America's most important financial institutions were on the edge of failure. According to the IMF, eighteen of the twenty largest financial institutions accounted for over half of the losses reported during the recession. Countries with rapid credit growth and larger current account deficits while leading up to the crisis felt the policies made during the crisis were constraining or too restrictive. However, stricter rules on bank activity limited the possibility of such a crisis occurring again. Countries with stronger fiscal positions experienced smaller losses during and after the crisis. The significant fiscal stimulus packages offered by most countries helped mitigate the current crisis from spreading and prevent other crises from occurring.

Globalization offers many benefits, but the globalization of finance creates an environment of interdependence that can cause crises in one country to spread throughout the globe. The 1982 Debt Crisis was driven by dollar-denominated bank loans to developing countries, the Asian Financial Crisis was driven by financial outflows and international speculation against fixed exchange rates, and the US housing market crash was driven by excessive lending made possible by financial inflows from other countries. In each case, international finance caused domestic issues to spread beyond their borders. Weinberg (2013) states that among the economies that experienced a banking crisis in 2007–08, about 85 percent are still operating at output levels below pre-crisis trends. The long-term effects of the crisis can be seen in countries' economies and in their responses to crises.

Economic legacy

The OECD performed research looking into how economies recovered from the Great Recession, comparing pre-crisis trends and projects with the actual outcomes in output and jobs that occurred after the recession. They found that "Among the 19 OECD countries which experienced a banking crisis over the period 2007-11, the median loss in potential output in 2014 is estimated to be

about 5½ per cent, compared with a loss in aggregate potential output across all OECD countries of about 3½ per cent.” (Ollivaud & Turner, 2014).

This loss in output is not the only detrimental consequence of the crisis. Its legacy is also seen in the rate of long-term unemployment. Economists found that “Both short-term and long-term unemployment increased sharply in 2008-9 during the Great Recession. But while short-term unemployment returned to normal levels by 2013, long-term unemployment remains at historically high levels in the aftermath of the Great Recession.” (Kroft et al., 2014).

The lasting effects on output and unemployment translated into real effects on citizens in these countries. In the years following the recession, the trail of damage that was left in its wake has been clearly identified. “We estimate the impact of the Great Recession of 2007–2009 on health outcomes in the United States. We show that a one percentage point increase in the unemployment rate resulted in a 7.8–8.8 percent increase in reports of poor health. Mental health was also adversely impacted, and reports of chronic drinking increased.” (Wang et al., 2017).

Policy Legacy

One can see lessons learned from the Great Recession in countries’ responses to the economic decline caused by the COVID-19 pandemic. Policymakers responded rapidly, passing large fiscal stimulus, and eventually spending trillions in order to avert another crisis. Moody’s analytics studied the effect of this significant fiscal stimulus on the recovery from COVID-19 and found “The massive global fiscal policy response to the pandemic deserves significant credit for limiting the severity and length of the recession that occurred when the pandemic struck, and for the subsequently strong global economic recovery” (Yaros et al., 2022). Wary of repeating their mistakes in the Great Recession, most governments responded with significant stimulus, causing a V-shaped recovery, allowing their economies to bounce back with strength.

This recovery was not perfect. As the U.S.’s strong fiscal response caused a rise in inflation and interest rates, there was a depreciation in the value of securities that banks had invested in. This led to the recent collapse of Silicon Valley Bank, the second largest banking failure in U.S. history. In response, the government bailed Silicon Valley out and has promised to stand behind the deposits of all banks to decrease the likelihood of runs (Turner, 2023). While the U.S. has surely learned some lessons on economic damage control, the same cannot be said for the part they play in creating moral hazards in banking systems and financial markets.

Conclusion

The Great Recession showed the effects of a globalized and financialized economy. It is also illustrative of some of the greatest debates in the worlds of fiscal and monetary policy: intervention vs. austerity in the fiscal arena and contractionary vs. expansionary monetary policy. As the world grows more and more interconnected, the lessons from the Great Recession will only become more salient.

References

- Baily, M. N., Johnson, M. S., & Litan, R. E. (2008,). The origins of the financial crisis .Brookings. Retrieved April 24, 2022, from <https://www.brookings.edu/research/t...ancial-crisis/>
- Ball, L. M. (2018). The Fed and Lehman Brothers: Setting the Record Straight on a Financial Disaster. Cambridge: Cambridge University Press. <http://doi.org/10.1017/9781108355742>
- Bebchuk, Lucian Arye, Alma Cohen, and Holger Spamann. “The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008.” *Yale Journal on Regulation* 27, no. 2 (December 31, 2010): 3. <http://dash.harvard.edu/bitstream/1/12025608/1/SSRN-id1513522.pdf>.
- Bems, R., & Johnson C. J., & Yi, K. (2013). The Great Trade Collapse (NBER Working Paper No.18632). National Bureau of Economic Research.Annual Review of Economics. <https://www.nber.org/papers/w18632>
- Ben Bernanke, (2010), Monetary policy and the housing bubble: a speech at the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010, No 499, Speech, Board of Governors of the Federal Reserve System (U.S.)
- Board of Governors of the Federal Reserve System (US). (2022, April 20). Federal Funds Target Range. Retrieved from Federal Reserve Bank of St. Louis: <https://fred.stlouisfed.org/series/DFEDTARL>
- Broda, C., & Parker, J. A. (2014). The Economic Stimulus Payments of 2008 and the Aggregate Demand for Consumption. *Journal of Monetary Economics*, S20-S36.

- Cooper, Michael.(2008), McCain on U.S. Economy: From ‘Strong’ to ‘Total Crisis’ in 36 Hours. The New York Times. Accessed April 18, 2023. <https://www.nytimes.com/2008/09/17/w....16251777.html>.
- Duca V. J., (2013). Subprime Mortgage Crisis. Federal Reserve History, 23. Economic Stimulus Act of 2008. (2008). H.R. 5140. 117th Cong. Retrieved from <https://www.congress.gov/bill/110th-...ouse-bill/5140>
- FDIC. “Status of Washington Mutual Bank Receivership.” FDIC: Federal Deposit Insurance Corporation. Accessed April 20, 2023. <https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/wamu-settlement.html>.
- Fraedrich, John, Ferrell, Jennifer Sawayda, and Jennifer Jackson. “Countrywide Financial: The Subprime Meltdown.” *Center for Ethical Organizational Cultures- Auburn University*, 2014. <https://harbert.auburn.edu/binaries/documents/center-for-ethical-organizational-cultures/cases/countrywide.pdf>.
- Frame, Fuster, A., Tracy, J., & Vickery, J. (2015). The Rescue of Fannie Mae and Freddie Mac. The Journal of Economic Perspectives, 29(2), 25–52. <https://doi.org/10.1257/jep.29.2.25>
- Guillen, Mauro F. “The Global Economic & Financial Crisis: A Timeline.” The Lauder Institute. University of Pennsylvania – The Lauder Institute. Accessed April 23, 2023. https://lauder.wharton.upenn.edu/wp-content/uploads/2015/06/Chronology_Economic_Financial_Crisis.pdf.
- Hennessy, K., & Lazear, E. (2013, September 16). Who really fixed the financial crisis? Retrieved from Politico: <https://www.politico.com/story/2013/...l-crisis096794>
- Houde, J.-F., Newberry, P., & Seim, K. (2017). Economies of density in e-commerce: A study of amazon’s fulfillment center network. National Bureau of Economic Research. <https://doi.org/10.3386/w23361>
- House, C., Proebsting, C., & Tesar, L. (2017). Austerity in the aftermath of the Great Recession. <https://doi.org/10.3386/w23147>
- Kroft, K., Lange, F., Notowidigdo, M., & Katz, L. (2014). Long-term unemployment and the Great Recession: The role of composition, duration dependence, and non-participation. <https://doi.org/10.3386/w20273>
- Lane. (2012). The European Sovereign Debt Crisis. The Journal of Economic Perspectives, 26(3), 49–67. <https://doi.org/10.1257/jep.26.3.49>
- McDonald, Robert, and Anna L. Paulson. “AIG in Hindsight.” *Journal of Economic Perspectives* 29, no. 2 (April 17, 2015): 81–106. <https://doi.org/10.1257/jep.29.2.81>.
- McKee, M., Stuckler, D., Belcher, P., & Karanikolos, M. (2012). Austerity: A failed experiment on the people of Europe. *Clinical Medicine*, 12(6). <https://doi.org/10.7861/clinmedicine.12-6-603a>
- Shull, Bernard. “Too Big to Fail: Motives Countermeasures, and the Dodd-Frank Response.” Levy Economics Institute, February 2012. Accessed April 13, 2023. <https://www.levyinstitute.org/publications/too-big-to-fail>.
- Turner, John. “Why Did Silicon Valley Bank Fail?” Economics Observatory, March 17, 2023. Accessed April 20, 2023. <https://www.economicsobservatory.com/why-did-silicon-valley-bank-fail#:~:text=The%20collapse%20of%20Silicon%20Valley,hold%2Dto%2Dmaturity%20securities>.
- U.S. Bureau of Economic Analysis. (2022, April 20). Real Gross Domestic Product [GDPC1]. Retrieved from Federal Reserve Bank of St. Louis: <https://fred.stlouisfed.org/series/GDPC1>
- U.S. Bureau of Economic Analysis. (2022, April 20). Unemployment Rate. Retrieved from St. Louis Federal Reserve: <https://fred.stlouisfed.org/series/UNRATE>
- Wang, C., Wang, H., & Halliday, T. (2017, May). Health and health inequality during the Great Recession: Evidence from the PSID. *Economics and human biology*. Retrieved April 25, 2022, from <https://pubmed.ncbi.nlm.nih.gov/29413585/>
- Weisbrot, M. (2014, January 16). Why has Europe’s economy done worse than the US? The Guardian. Retrieved April 23, 2022, from <https://www.theguardian.com/commenti...onomy-is-worse>
- Wessel, D. (2011, December 7). Separating Fact from Fiction on the Fed’s Loans. Retrieved from Wall Street Journal: <https://www.wsj.com/articles/SB10001...82331689233426> World Bank. (2021, October 1). Africa Overview.

World Bank. Retrieved April 22, 2022, from <https://www.worldbank.org/en/region/afr/overview#1> World Bank. (2022, April 12). Overview.

World Bank. Retrieved April 22, 2022, from <https://www.worldbank.org/en/country/china/overview#1>

Written by Mico Mrkaic, Senior Economist. “The Most Surprising Long-Term Impacts of the 2008 Financial Crisis.” World Economic Forum, [https://www.weforum.org/agenda/2018/...covery-10-year s-after-the-crisis](https://www.weforum.org/agenda/2018/...covery-10-year-s-after-the-crisis).

Weinberg, John. “The Great Recession and Its Aftermath.” Federal Reserve History, <https://www.federalreservehistory.org...:~:text=From%20peak%20to%20trough%2C%20US,5%20percent%20to%2010%20percent>.

Vives, X. (2010). The Financial Industry and the Crisis. In Smits, R. (2002). Innovation studies in the 21st century:: Questions from a user’s perspective. Technological forecasting and social change. (321-329). BBVA.

Yaros, B., Rogers, J., Cioffi, R., & Zandi, M. (2022, February 24). Global Fiscal Policy in the Pandemic. moodysanalytics.com. Retrieved April 25, 2022, from <https://www.moodysanalytics.com/-/media/article/2022/global-fiscal-policy-in-the-pandemic.pdf>

Yu, Q., Fan, H., & Wu, X. (2015). Global Saving Glut, Monetary Policy, and Housing Bubble: Further Evidence.

Zestos, G. K. (2016). The Global Financial Crisis: From US Subprime Mortgages to European Sovereign Debt. New York: Routledge.

This page titled [1.14: Finance- The Great Recession of 2007-08](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

1.15: Finance- International Institutions (International Monetary Fund) 1.15: Finance- International Institutions (International Monetary Fund)Edit Update titlecancel

The International Monetary Fund (IMF) is widely regarded as the central institution of global financial governance. It takes a substantial role as the lead crisis lender in mitigating financial risk factors that are associated with high rates of globalization to prevent “cross-border financial contagion” (Larsen, 2001). With globalization at its peak, many countries are easily susceptible to the rippling effects of financial crises triggering financial instability. When this happens, the IMF steps in as the de-facto “international lender of last resort” and serves as a source of emergency funding to countries that have high debts and face the risk of default in payment (Fischer, 1999). The IMF is a huge institution with a broad range of member nations, employees, and funding sources. The institution has dedicated itself to its mission statement of, according to the homepage of its website, ensuring greater “global monetary cooperation, secure financial stability, facilitating international trade, promoting high employment and sustainable economic growth, and reducing poverty around the world” (IMF, 2023). Thus, the IMF’s role as the world crisis lender has transformed it to one of the most powerful multilateral institutions.

How the International Monetary Fund Works

Currency

Because the IMF is an institution that also oversees exchange rates, the money that enters its reserves cannot be classified as a form of currency; rather, it’s an asset. The IMF has created its personal international reserve asset called Special Drawing Rights (SDR) whose value is determined daily and is backed by five world currencies; US dollar, Euro, Chinese Yuan, Japanese Yen, and the British Pound (IMF, 2023). In order to be one of the five currencies that backs the SDR, there are two criterion that need to be met: export criteria, which requires that the nation must be an IMF member and one of the world’s top 5 exporters, and free use of currency, which requires that the currency be regularly used to make international payments and widely traded in principle exchange markets (IMF, 2023).

SDR is also very important when it comes to the number of votes a member country has within the IMF. Typically, each country has a set number of votes, but is able to gain additional votes, and overall influence in the IMF, for every 100,000 SDR that it contributes to the IMF reserves.

Funding

With the International Monetary Fund being thought of as a world lender, a question arises: where does this money, or SDR, come from? The IMF has three main ways of funding its reserves; member quotas, New Arrangements to Borrow (NAB), and Bilateral Borrowing Agreements (BBA) (see [IMF website](#) for more information about member quotas).^[1]

Member Quotas

The funding that brings in the most money to the IMF is member quotas. The quotas are assigned to each member country, which there are currently 190 of, by the IMF’s Board of Governors in what is called the Quota General Review and are based on its relative position of the member country in the world economy. This position is reevaluated in roughly five year intervals using the following formula to assess a country’s economic global standing:

$$(0.50 * \text{GDP} + 0.30 * \text{Economic Openness} + 0.15 * \text{economic variability} + 0.05 * \text{Foreign Reserves})$$

Evidently, as a country’s place in the world economy rises, so do their quotas. These quotas not only represent the financial commitment that the member country has to the IMF, It also dictates the country’s voting power, their access to IMF resources and SDR allocations. Quotas can also be amended on an ad-hoc basis. Most important was the 14th General Review of 2010 bc it had the largest quota increase and had considerable impact on major realignment shares (IMF, 2017). The 2020 quota reform is the latest, and evidently determined there was no need to increase member quota from the 2010 general review. Notably, the 2010 general was the most influential in IMF history since the review did recommend an increase in quotas of its member states to a combined SDR 477 billion (about US\$ 659 billion) from about SDR 238.5 billion (about US\$ 329 billion) from the previous quota that was initiated in 2008 (IMF, 2023).

New Arrangements to Borrow (NAB)

Multilateral borrowing, the second most influential form for IMF reserve, employs the use of New Arrangements to Borrow (NAB) which works as a credit arrangement between the IMF and creditors. Under NAB there are 40 participants composed of 40 IMF member countries and 2 institutions. Additionally, NAB is only activated in times where the IMF needs to supplement its quota

resources for lending purposes (IMF Staff, 2020). However, 85% of creditors need to comply in order for NAB to be activated. The latest NAB reform, instituted in Jan. 2021, took effect following consents from NAB participants almost doubling its size to \$521 billion for the period from 2021- 2025.

Bilateral Borrowing Agreements (BBA)

The bilateral borrowing arrangements are seen as a last-ditch effort after quotas & the NAB for the IMF to fill its reserves and maintain its 1 trillion lending capacity. These bilateral borrowing agreements are used to cause the onset of the global financing crisis. The IMF has arranged several borrowing agreements with leading institutions who are the creditors. Typically, these agreements have a term lasting three years which is also extendable for an additional year under the discretion of the creditor. The 2020 bilateral borrowing agreements are currently on track to include 42 creditors with 40 of them already proven effective, and prospective agreements with the remaining two underway garnering a total of SDR 135 million (US \$ 193 billion).

Conditionality

To effectively enhance global financial security, a substantial variation in the lending policies of the IMF can be justified under the basis of conditionality. Conditionality is when economics and policy literatures come into play in determining the varied amounts a country can borrow and subsequently lend (IMF, 2023). It is through this that the institution takes into special consideration the design of the loan to be disbursed while simultaneously undertaking any policy adjustments to ensure longer-term debt sustainability and to further stimulate economic growth. In this case, conditionality are the policies the IMF expects a member to follow to get full loan credit (IMF, 2023). We can witness the bipolarity of these IMF loan programs; on one hand they are explicitly linked to amounts, depending on factors including the country's GDP, and on the other they rely on implementation of certain conditions. There are several different types of conditionality in these IMF loan programs that depend on its content, degree to which it is binding, and specifics.

Indeed, the degree to which it is binding as well as the level of specificity advertently creates two major categories of conditionality; “hard conditions” which are more stringent and specific in nature, and may often require countries to implement significant policy reforms in short period of time, and “soft conditions” which are relatively less stringent providing countries with more flexibility on implementation and policy reforms (Edwards, 2011).

Hard conditions include performance criteria (PCs), which can be further subdivided into structural PCs, and prior actions (PAs) which typically are regarded as hard conditions as they are explicitly specified in IMF program documents as requirements that must be performed for the borrower country to receive full loan credit. PCs usually specify quantitative targets for key macroeconomic policy variables, such as limits on external borrowing, government budget balances, and international reserves (IMF, 2023). Furthermore, IMF programs have increasingly incorporated “structural” PCs which involve qualitative measures that include requirements such as privatization of state-owned enterprises, price control removal, reformation of social welfare policies, and bolstering national financial regulation (Mussa, 1999). On the other hand, Prior action (PA) requirements are measures that the country agrees to implement before accepting the loan.

The IMF also has other additional types of conditionality which are essentially non-PCs as they don't quantitatively target macroeconomic policy tools, inherently making them less stringent. They include indicative targets which are non-binding on the borrower country and structural benchmarks which are like structural PCs but less stringent in that the “benchmarks” used are “measures that do not need to be monitored objectively enough to be PCs or for small steps in a critical reform process that would not individually warrant an interruption of Fund financing.” (Copelovitch, 2010) Adherence to these conditions are monitored by the IMF. It conducts periodic program reviews that occur at intervals of four to twelve months depending on the designated program length.

The International Monetary Fund (IMF) determines its lending policies based on two factors: liquidity, where the Fund provides financing to a country to help it pay off its debts, and moral hazard, which creates incentives for borrower countries and international lenders to take on more risk with the expectation that the IMF will provide future bailouts (IMF, 2023). The IMF weighs these factors to determine the amount of lending and concessions it provides to countries.

As the IMF makes its lending decisions, many economists have speculated about how it weighs this tradeoff. Existing literature suggests a couple of perspectives regarding the underlying thinking, including economic and political perspectives. From a purely economic standpoint, the IMF's policy on the value of borrowing is contingent on the economic policies that rendered a borrower country bankrupt, as well as macroeconomic shocks resulting from capital flight by investors. However, other scholars argue preference heterogeneity is the key determinant of variation of IMF loan size and conditionality with the G5 countries exercising de facto control in the executive board hence acting collectively as its political principal (Copelovitch, 2010).

International Monetary Fund Loan Types

The IMF has several lending instruments or systems that are programmed to provide assistance or relief in critical situations. The main lending instruments can be categorized into two primary programs or “facilities” – the Stand-By Arrangement (SBA) and the Extended Fund Facility (EFF) (IMF, 2023). Whereas SBAs are designed to provide loan assistance on a short-term basis, EFFs are intended to assist countries facing longer-term crises, requiring implementation of more extensive reforms.

Countries from around the world draw on IMF credit in a variety of ways. In March 2009, the IMF established its current credit line, known as the Flexible Credit Line (FCL). The FCL was designed to promote flexibility and, to a lesser extent, offset the stigma of IMF borrowing. It allowed countries, particularly middle-income and low-income countries, to use this line of credit as a precautionary instrument to handle potential balance of payment needs without being subject to traditional IMF conditionality (IMF, 2010). This was designed to help governments, particularly middle- and low-income countries, in managing external vulnerabilities and reducing the risk of financial crises. The FCL enabled countries to draw on its credit line without certain conditions, as it is open to countries known to have strong policy frameworks as well as good track-records in economic performance (IMF, 2023). In this way, the FCL works as the renewable credit line providing a valuable backstop to countries facing imminent danger of regional financial crises

The IMF also issues concessional loans to lower income countries under the Poverty Reduction and Growth Facility (PRGF) which replaced two former policy instruments in the mid-1980s to late-1990s; the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) (Edwards, 2011). Generation of source funding for the Poor Reduction and Growth facility (PRGF) loans are primarily facilitated by payment of quotas.

History of the International Monetary Fund

1944 Bretton Woods Conference

Coming off of multiple economic disasters like WW1 and the Great Depression, there was a need for some form of economic stability as the long-standing gold-standard was showing obvious signs of weakness and was beginning to crumble. As a response to these shortcomings 44 countries came together at Bretton Woods, New Hampshire in 1944 for what would later be known as the Bretton Woods Conference or the United Nations Monetary and Financial Conference. These 44 countries came together with the intention of creating a new international monetary system which led to the drafting of the Article of Agreement, subsequently creating an international organization that would supervise the new international monetary system, hoping to promote world trade, investment and economic growth by maintaining stable exchange rates.

After ratification by 29 countries, the Article of Agreement entered into force in December 1945. Thus, the IMF was born, tasked with three main goals: “promoting international monetary cooperation, supporting the expansion of trade and economic growth, and discouraging policies that would harm prosperity” (IMF, 2023). Another notable outcome of the Article of Agreement was the establishment of the Bretton Woods system as the exchange rate standard that pegged the exchange rates for gold to the US dollar, with the IMF.

1956 Suez Canal Crisis

The first big test for the IMF came in October of 1956 with the Suez Canal crisis that involved Egypt, France, United Kingdom, and Israel (occupied Palestine). Previously, the IMF was mainly tasked with helping countries establish currency convertibility. That was until the Suez Canal closed as a result of Egypt nationalization of the canal in July of 1956 and France, the

United Kingdom and Israel took military action against Egypt in October (Boughton, 1997). By September the countries began to look to the IMF for financial assistance. Egypt requested that the IMF stabilize its economy after it had taken control of the Suez Canal. Israel requested assistance to offset the effects of repressed inflation as it was a new country and had yet to set a fixed exchange rate for its currency. France requested assistance as it had an abundance of financial burden related to previous wars and reduced agricultural ability due to climate conditions. Last to make a request from the IMF was the UK whose request differed from the others as they requested assistance not to avoid economic crisis but from the possible psychological impact of a political crisis on its financial markets (Boughton, 2000). In 1956-1957, beginning with the Egyptian credit, total drawings from the IMF reserve jumped to 1.7 billion, with the four participants of the Suez crisis loans totaling 989 million, roughly 60% of the total loans for the year (Boughton, 1997).

This event was what launched the IMF into a position of international leadership when it comes to crisis management. When faced with this very politically charged crisis, the institution was able to maneuver it with both a flexible, neutral stance and proved the importance of the IMF as well as showcasing its capabilities.

1971 Nixon Shock

On August 15th, 1971, U.S. President Richard Nixon unpegged the U.S. dollar to gold as part of one of his new economic policies to “defend the dollar”. In his speech “The Challenge of Peace ” Nixon asks that the U.S. secretary pause the convertibility of the U.S. dollar into gold or other reserve assets with the exception of conditions determined to be in the interest of monetary stability and of the best interest of the United States (Youtube, 2021). This evidently marked the end of the Bretton Woods system and the fixed exchange rate the IMF was initially tasked to oversee and be responsible for.

As a result of the death of the Bretton Woods System, the world turned to a new international monetary system with IMF members being able to choose from multiple forms of exchange arrangements that they feel would best fit their economic needs. These arrangements include; floating exchange rates, pegging their currency to another or a basket of currencies, adopting the currency of another country all together, participating in a currency block, or forming part of a monetary union (IMF, 2023). Additionally, since countries were no longer required to keep a rigid fixed exchange system, the original concern of currency manipulation arose once again. In this sense the original job of the IMF had not shifted, if anything the IMF’s job of exercising firm surveillance over its members’ exchange rate policies (Ghosh, 2021) became more important than ever.

1982 Debt Crisis

The Debt Crisis of 1982 was spurred by the rising inflation in the United States. With interest rates rising as a response, many developing countries that had taken out large amounts of loans were finding it difficult to impossible to make the payments they needed. This became evidently clear when Mexico defaulted on \$80 billion in debt. While the crisis had started in Mexico, it spread to cover many developing countries. As a response, banks stopped many developing countries’ access to loans. This action further exacerbated the crisis, as these countries had been using these loans to pay off their previous loans as they had drastically increased due to variable interest rates rising. As a result, a plan needed to be put into place so that investors could get a portion of their capital back.

The IMF was in an ideal position for helping bring forward the needed changes. Through the short-term loans which helped with the liquidity issues, allowing time for structural reforms to take place. The long- term loans which were needed to resolve the overall crisis, however, came with changes that had to be made to receive the capital. These loans were known as conditional loans and provided a way to force the countries that needed major change to change. If a country ran a large deficit, it was less likely that they would be able to pay back the loans as the cost of the loans went up. In turn these conditions forced the cutting of the spending. Eventually, the crisis came to a halt due to the Brady Plan in 1989, but it was the IMF who was able to cushion the blow from many of the detrimental economic impacts.

Additionally, the crisis also marked a shift in the response in how the IMF set the conditions for their loans. Prior to the crisis the conditions mainly focused on macroeconomic measures (Gilpin, 2001). Following the crisis, the measures became more focused on structural problems and overall economic conditions.

1997 Asian Financial Crisis

As covered in chapter on the Asian Financial Crisis, the IMF played a role in resolving and reducing the crisis. The crisis was unlike the 1982 Debt Crisis as it was not due to the running of fiscal deficits, but rather a deficit in their current account. This meant that the response and conditions of IMF support also had to vary. Rather than the focus on changes to the spending of governments the goal had to be to address the problems that were plaguing their economies. The focus of “these reforms were designed to deregulate and liberalize the economy” (IMF Policies in Asia, 1999).

This crisis demonstrated the IMF shortcomings as it was not as successful at achieving its intended goals and implementing policy as it was in the 1982 Debt Crisis or the Suez Canal Crisis. This crisis demonstrated that the IMF was not omnipotent at achieving reform in countries that had a crisis. In these situations, if they attempted to achieve too much or went against an opposing government the reforms were either partially or entirely muted by internal politics.

IMF in Present Day

In recent times the International Monetary Fund has been essential in assisting countries that are on the verge of economic crisis caused by either flawed fiscal policy or war. At the time of writing, Argentina (SDR 33.2 Billion), Egypt (SDR 13.4 Billion), Ukraine (SDR 8.9 Billion) and Pakistan (SDR 5.5 Billion) are the biggest debtors to the IMF.

Argentina has continuously been one of the most indebted countries to the IMF due to its very complex economic standing over the years caused mainly by the country’s poor investment climate, high inflation and stale economic growth (Porzecanski, 2021). As of

now Argentina is experiencing its fourth review of its current 30-month Extended Fund Facility Arrangement and approval of this will give the country access to an additional SDR 4 billion. The main concern that the IMF policies are working towards is updating the country's macroeconomic framework. To do so Argentinian and IMF representatives have agreed to strengthen their fiscal policy by; implementing energy subsidies and better management of capital spending, proactive debt management, mobilization financing from multilateral and bilateral sources as well as focusing on the rise of inflation plaguing the country.

Egypt requires less assistance from the IMF than Argentina, and for a different reason. Egypt has been shifting from its former rigid exchange rate to one that has a bit more flexibility. In the past these rigid and heavily surveillance exchange rates were not working for the country and would often lead to imbalances in its foreign reserves and a large external financing gap. The large external financing gap was caused between projected demand and supply of foreign currency financing and demand to rebuild foreign central bank reserves (IMF, 2022). The IMF has been tasked with observing two-way movements of currency as well as supplying money to fix a large external financing gap. Conditions usually include development of privatization of the most profitable industries and greater transparency policies when it comes to state-owned and fiscal policies.

Egypt is undergoing a financial transition, but the IMF also helps nations that are undergoing turbulent events like wars. Considering the current Russian-Ukrainian War, the Ukraine government has requested assistance from the IMF to offset the public debt, fiscal deficit, and social impact the country is experiencing. Apart from the standard IMF assistance, because of the highly uncertain outcome the country is currently facing, Ukraine was able to be approved for the IMF's Upper Credit Tranche (UCT) which lends additional funds to countries in dire need. As far as policies that the IMF is implementing to help Ukraine there is a focus on debt sustainability, financial stability with an emphasis on disinflation and lastly establishment of anti-corruption institutions that will help promote public trust and overall governance of the country.

The Russian-Ukrainian war affects more than just those two nations. For roughly a decade Pakistan has been dealing with a currency crisis due to the rapid devaluation of the Pakistani Rupee caused by the shift from formal currency exchange to one determined by the market, a drop in the country's foreign reserve, trade deficit, inflation and debt (Humza, 2023) and as of recently there are perceived spillover effects from the Ukraine war afflicting the country. To offset all of these economic strains, the country has often turned to the International Monetary Fund for assistance with the most recent request coming in August of 2022. The IMF accepted the countries request and stated in the September 2022 press release that although the EFF commitments that were agreed upon were poorly implemented the Pakistani government was taking the steps necessary to ensure proper application and would be receiving IMF assistance. The commitments the Pakistani government agreed to include employing new tax measures, limiting spending, strengthening of the energy sector, reduction of poverty and protection of those who are the most vulnerable to the economic crisis.

Criticisms of the International Monetary Fund

The role of the IMF as head of global financial governance has been viewed critically by renowned economists. They accuse the IMF of failing to maintain global financial stability, misdiagnosing causes and solutions of financial crises, exacerbating poverty in the developing world, and catering to the demands of developed countries and Wall Street bankers. Most criticisms of the IMF generally stem from two key areas of its operation – conditionality and implementation.

Some field scholars speculate that reduced conditionality for certain states stems from the geopolitical logic of US and its foreign policy allies receiving more favorable treatments as “valued clients,” like Germany, France, the UK and Japan (Copelovitch, 2010). Other scholars cite the ‘principal-agent’ theory which portrays the IMF staff as “rent-seeking bureaucrats” whose engagement in lending guarantees them more generation of capital reserves as countries pay back with interest (Breen, 2013).

We can see the conflicts surrounding the conditions imposed by the IMF and their perceived unequal application in the Thai financial crisis of 1997 and their reaction to the US financial crisis of 2008. One of the IMF conditions for Thailand in 1997, which was characterized as a recommendation, was bankruptcy reform. This bankruptcy reform pushed by the IMF “curbed state support for debt-stricken firms. That led to strings of bankruptcies and thousands of job losses” (Cropley, 2008). This reform was not met with enthusiasm. There was fierce opposition from many in Thailand, although in the end the legislation was passed. The role the IMF played in what many see as forcing harmful change in Thailand is still a sore subject. When America faced its own financial crisis in 2008, the reaction from many in Asia regarding the steps taken by the government and the IMF were bitter. “This Hamburger Crisis is showing the hypocrisy and the true color of the West, from the World Bank to IMF to the United States,” Thai Business Radio FM 98 host Danai Ekmahasawadi said (Cropley, 2008).

Issues in implementing the changes recommended by the IMF look different for different countries. Let us return to our example of Thailand in 1997. The implementation of IMF suggested reforms were rapid in some areas and limited in others. Thailand had

conformed to most recommendations made by the IMF, as they had closed 58 financial institutions involved in the crisis. However, not every recommendation was fully followed. This shows that the IMF had limits at achieving its goals. The Heritage Foundation sums it up quite well that “even when a government is genuinely committed to implementing reform, as it [was] in Thailand, progress can be slow” (O’Driscoll, 1999).

This issue of implementation was echoed in Indonesia’s response to the IMF. Indonesia was in a period of violent political upheaval when the IMF came into the country, and the reforms were considered harsh by many (O’Driscoll, 1999). This resulted in little reform actually being done.

We can see that the IMF is not always able to institute reform in countries which have had a crisis. In these situations, if they attempt to achieve too much or go against an opposing government, reforms may be either partially or entirely muted by internal politics. When a country does not want to make the changes recommended by the IMF, or is unable to make them, the IMF does not hold any actual power to force them. The reforms in Indonesia demonstrated that even with compliance to some measures, others that may be more politically risky may not be achieved.

Conclusion

The International Monetary Fund was created out of the ashes of war and economic depression, to provide cooperation and help rebuild economies. What began as a venue to share economic knowledge became one of the most powerful tools in our global economic arsenal. Over the years the IMF has adapted to new economic environments and implemented innovative strategies to keep our global economy from disaster.

This chapter covered how the IMF works, including the currency it uses, how it sources its funds, its requirements for member states, and the loans it gives out. The IMF includes a broad variety of countries, each with their own unique issues and needs (see Figure 14.4). You learned about how the IMF has addressed those needs historically, and the measures it continues to take today. In addition, the IMF is in a constant state of evolution, and its operations can shift drastically over time. You can now understand how the IMF began, and how it reached its current policies.

Fig 14.4. The IMF family: Circle of national flags (World Bank, 2023), which is the emblem of the meetings of the World Bank Group and the IMF.

Can the IMF evolve enough to continue its relevance in a world that is increasingly turning away from constraints placed on the global economy? The whims of the IMF have struck many as exclusionary and US-centric. Nations feel constrained by the IMF’s policies of “conditionality” and there have been increasing arguments over what some nations perceive to be unequal application of IMF rules (Copelovitch, 2010).

Beyond common criticisms of the IMF, it is true that general member support due to other global factors is decreasing. We see a decrease in Western influence on the international economy as Asian nations increasingly generate global output and tensions between key nations like the US and China rise. China is increasingly attempting to situate itself as a competitor to the IMF on the global stage. It gave large scale loans to the Global South in the mid-2000s and has begun to present itself as a new option for countries that would rather not turn to the IMF and its conditional lending policies for help (Sundquist, 2021). This tension impedes the cooperation that is central to the success of the IMF and brings with it a more general global shift away from liberalized globalization and towards more inward, nation-specific economic policies. This shift reduces the efficacy of the IMF, as it requires widespread member support and participation to succeed (Wolf, 2019). As the US, one of the key participants in the IMF, increasingly turns towards populist politics and protectionism, the IMF may not be able to adapt sufficiently.

General global evolution will also force the IMF to adapt quickly or suffer the consequences. Technology brings with it rapidly shifting complications for the International Monetary Fund, including massive shifts in labor markets and the dangers of cybersecurity attacks (Wolf, 2019). Ballooning global debt also underpins an increasingly unstable global financial system.

That said, the historical track record of the IMF cannot be disputed, and its greatest asset is exactly its capability to adapt and change. Perhaps someday an increasing rejection of globalization and international tensions will bring an end to the IMF, but as things stand now, the International Monetary Fund is a cornerstone of global financial governance, and its impact on the global economy is profound.

Bibliography

About IMF Quotas, 2017. https://www.youtube.com/watch?v=zoI5Di_ClvM.

- "About the IMF: History: The End of the Bretton Woods System (1972–81)." Accessed April 23, 2023. <https://www.imf.org/external/about/histend.htm>.
- Boughton, James M. "From Suez to Tequila: The IMF As Crisis Manager." IMF, July 1, 1997. <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/From-Suez-to-Tequila-The-IMF-As-Crisis-Manager-2266>.
- . "Northwest of Suez: The 1956 Crisis and the IMF." IMF, December 1, 2000. <https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Northwest-of-Suez-The-1956-Crisis-and-the-IMF-3899>.
- Breen, Michael. "Who Controls the IMF?," 13–26, 2013. https://doi.org/10.1057/9781137263810_2.
- Congressional Research Service. "Exchange Rates and Currency Manipulation," In Focus, September 22, 2022. <https://crsreports.congress.gov/product/pdf/IF/IF10049>.
- Copelovitch, Mark S. "Master or Servant? Common Agency and the Political Economy of IMF Lending." *International Studies Quarterly* 54, no. 1 (2010): 49–77.
- . *The International Monetary Fund in the Global Economy: Banks, Bonds, and Bailouts*. Cambridge: Cambridge University Press, 2010. <https://doi.org/10.1017/CBO9780511712029>.
- Cropley, Ed. "Bitter Asians Wag the Finger at U.S. Bank Bailouts." *Reuters*, September 19, 2008, sec. ETF News. <https://www.reuters.com/article/us-financial-asia-hypocrisy-idUSBKK36977820080919>.
- Edwards, Kim, and Wing Hsieh. "Recent Changes in IMF Lending," 2012.
- Euromoney. "Asian Financial Crisis: When the World Started to Melt," December 1, 1997. <https://www.euromoney.com/article/b1320d324dc5wg/asian-financial-crisis-when-the-world-started-to-melt>.
- Fischer, Stanley. "On the Need for an International Lender of Last Resort." IMF. Accessed April 22, 2023. <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp010399>.
- Gilpin, Robert, and Jean Gilpin. "Global Political Economy." In *Understanding the International Economic Order*, 313–16. Princeton University Press, 2001. <https://doi.org/10.1515/9781400831272-014>.
- IMF. "IMF Conditionality." Accessed April 23, 2023. <https://www.imf.org/en/About/Factsheets/Sheets/2023/IMF-Conditionality>.
- IMF. "IMF Lending." Accessed April 23, 2023. <https://www.imf.org/en/About/Factsheets/IMF-Lending>.
- IMF. "IMF Quotas." Accessed April 23, 2023. <https://www.imf.org/en/About/Factsheets/Sheets/2022/IMF-Quotas>.
- IMF. "IMF Staff and the Argentine Authorities Reach Staff-Level Agreement on the Fourth Review Under the Extended Fund Facility Arrangement." Accessed April 23, 2023. <https://www.imf.org/en/News/Articles/2023/03/13/pr2368-imf-staff-and-argentine-authorities-reach-staff-level-agreement-on-review-under-eff>.
- IMF. "IMF Timeline." Accessed April 23, 2023. <https://www.imf.org/en/About/Timeline>.
- IMF. "Key Questions on Egypt." Accessed April 23, 2023. <https://www.imf.org/en/Countries/EGY/Egypt-qandas>.
- IMF. "Pakistan: Seventh, and Eighth Reviews of the Extended Arrangement under the Extended Fund Facility, Requests for Waivers of Nonobservance of Performance Criteria, and for Extension, Augmentation, and Rephasing of Access-Press Release; Staff Report; Staff Statement; and Statement by the Executive Director for Pakistan." Accessed April 23, 2023. <https://www.imf.org/en/Publications/CR/Issues/2022/09/01/Pakistan-Seventh-and-Eighth-Reviews-of-the-Extended-Arrangement-under-the-Extended-Fund-522800>.
- IMF. "Press Release: IMF Board of Governors Approves Major Quota and Governance Reforms." Accessed April 23, 2023. <https://www.imf.org/en/News/Articles/2015/09/14/01/49/pr10477>.
- IMF. "Proposed Decisions to Modify the New Arrangements to Borrow and to Extend the Deadline for a Review of the Borrowing Guidelines," February 13, 2020. <https://www.imf.org/en/Publications/Policy-Papers/Issues/2020/02/13/Proposed-Decisions-to-Modify-the-New-Arrangements-to-Borrow-and-to-Extend-the-Deadline-for-a-49048>.
- IMF. "Special Drawing Rights." Accessed April 23, 2023. <https://www.imf.org/en/Topics/special-drawing-right>.
- IMF. "What Is the SDR?" Accessed April 23, 2023. <https://www.imf.org/en/About/Factsheets/Sheets/2023/special-drawing-rights-sdr>.

IMF European Department, the Ukraine team. “Amid War, Ukraine Is Maintaining Macroeconomic Stability and Embarking on Reforms.” IMF, April 5, 2023. <https://www.imf.org/en/News/Articles/2023/04/05/cf-amid-war-ukraine-is-maintaining-macroeconomic-stability-and-embarking-on-reforms>.

International Monetary Fund. “Member Financial Data,” April 21, 2023. <https://www.imf.org/external/np/fin/tad/balmov2.aspx?type=TOTAL>.

International Monetary Fund Middle East and Central Asia Dept. “Pakistan: 2017 Article IV Consultation-Press Release; Staff Report; Informational Annex; and Statement by the Executive Director for Pakistan.” *IMF Staff Country Reports* 2017, no. 212 (July 13, 2017). <https://doi.org/10.5089/9781484309759.002.A000>.

International Monetary Fund. “IMF at a Glance.” IMF, accessed April 23, 2023, <https://www.imf.org/en/About/Factsheets/IMF-at-a-Glance>.

International Monetary Fund. “Where the IMF Gets Its Money.” IMF, accessed April 23, 2023, <https://www.imf.org/en/About/Factsheets/Where-the-IMF-Gets-Its-Money>.

Larsen, Flemming. “The Challenges of the New Financial Economy: The Efforts of the IMF to Reduce the Risk of Financial Crises — Statement by Flemming Larsen, Director, IMF Office in Europe.” IMF. Accessed April 22, 2023. <https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp111501>.

McQuillan, Lawrence. “International Monetary Fund | Britannica,” April 13, 2023. <https://www.britannica.com/topic/International-Monetary-Fund>.

Mussa, Michael, and Miguel Savastano. “The IMF Approach to Economic Stabilization.” *NBER Macroeconomics Annual* 14 (1999): 79–122.

O’Driscoll, Gerald. “IMF Policies in Asia: A Critical Assessment.” The Heritage Foundation. Accessed April 23, 2023. <https://www.heritage.org/asia/report/imf-policies-asia-critical-assessment>.

Porzecanski, Arturo. “Argentina and the IMF | Wilson Center.” Accessed April 23, 2023. <https://www.wilsoncenter.org/blog-post/argentina-and-imf>.

Reserve Bank of Australia. “The Australian Economy and the Global Financial Crisis.” Reserve Bank of Australia Bulletin, December 2011, accessed April 25, 2023, <https://www.rba.gov.au/publications/bulletin/2011/dec/pdf/bu-1211-8.pdf>.

Resnick, Bruce, and Cheol Eun. *International Financial Management 6th (Sixth) Edition By Resnick*. 6th ed. McGraw-Hill/Irwin, 2011.

Sundquist, James. “Bailouts From Beijing: How China Functions as an Alternative to the IMF | Global Development Policy Center,” March 8, 2021. <https://www.bu.edu/gdp/2021/03/08/bailouts-from-beijing-how-china-functions-as-an-alternative-to-the-imf/>.

Wolf, Martin. “The Future of the IMF – F&D | The IMF at 75.” IMF. Accessed April 22, 2023. <https://www.imf.org/en/Publications/fandd/issues/2019/06/the-future-of-the-imf-wolf>.

World Bank. “World Bank Annual Report Logo.” Accessed April 25, 2023. <https://www.worldbank.org/content/dam/wbr-1/Annual-logo.png>.

Youtube. *President Nixon Address to the Nation Outlining a New Economic Policy: “The Challenge of Peace,”* 2021. <https://www.youtube.com/watch?v=0BVj2gT6CgI>.

-
1. Note that several images for this chapter were unusable because the IMF does not allow reuse of images even for noncommercial content. ↩
-

This page titled 1.15: Finance- International Institutions (International Monetary Fund) is shared under a CC BY-NC 4.0 license and was authored, remixed, and/or curated by Clint Peinhardt via source content that was edited to the style and standards of the LibreTexts platform.

1.16: Backlash against Globalization 3.0

1.16: Backlash against Globalization 3.0

Edit Update titlecancel

A backlash against globalization has been on the rise in recent decades. Globalization refers to the increase in collaboration between nations, companies, and economies because of the transnational trade of goods and services. It denotes the interdependence of various systems on an international level (Lang, 2006). The anti-globalization movement roughly refers to the broad sentiments associated with an apparent decrease in support among the public and with policy decisions. Globalization has had a wide-ranging impact on global economics, culture, and politics. Backlash can be seen in every individual category, with general overlap between topics (Walter, 2021). Thus, those who oppose political globalization do not necessarily oppose social or economic globalization. However, some qualms go hand in hand. For example, opposing the European Courts of Human Rights, as many do, is a mixture of political and cultural anti-globalization sentiments (Walter, 2021). There are three eras of globalization worth noting that provide context for globalization and backlash against such integration.

Our current era is a new era of globalization that took off around the late 1980s as the Soviet Union fell, and almost all countries were choosing to adopt some level of democracy. Most importantly, during this time, an overwhelming majority of countries chose to open their markets and adopt capitalism. This was the introduction of globalization 3.0. In his 2007 essay, *The World is Flat*, American political commentator and author Thomas L. Friedman divides the history of globalization into three eras. Each era refers to a period in time that was defined by very high economic growth along with increased collaboration and integration in the global economy of the time. These eras particularly occurred under periods with a recognizable hegemonic power which resulted in stable trade. However, international economic integration waxes and wanes and there was often protectionist sentiment that would be a regular pattern in all three eras.

Globalization 1.0, or Pax Mongolica, is defined by the Mongol Empire in the early 13th century (as well as the Yuan Dynasty) which usurped unprecedented territory, but especially important- their hegemonic power resulted in a stable overland trade route from Europe to China, even spreading economic integration to the Horn of Africa. Globalization 2.0, known as Pax Britannica, involved European expansion in the 19th to early 20th century, where there was rapid economic growth with the rise of the Industrial Revolution. During this period, there was stability under the hegemon of the British Empire.

Globalization 2.0 ended around the interwar period from 1918-1938, the same time that the British Empire's place as the global hegemon fell and the United States' position as a global hegemon arose. The continued pattern is that when there is a hegemon there to bring stability, it promotes trade, collaboration, and growth in economic activity. There are always winners and losers in the global economy and the various factors involved may lead to a backlash by those who feel threatened by certain patterns of integration.

The final and most recent era is Globalization 3.0. This is our current era and is defined by newfound possibilities for global collaboration but also increased competition. In this era we are witnessing, as seen in past eras, unprecedented levels of integration with rapid increases in the ability to trade in terms of scale and speed, especially through advanced tools such as the introduction of the internet in the 21st century. It is also coinciding with a power shift away from the West and increasingly towards Asia. This era has sparked great controversy over the politicization of topics that are otherwise apolitical in nature (Lang, 2006). Economic globalization has faced backlash in the form of protests against the International Monetary Fund (IMF) and other international financial institutions, while others worry about lasting effects on national sovereignty because of political globalization. These are just a handful of the various antiglobalization sentiments shared by many. The backlash is not a new concept- it has been building for decades. Researchers suggest spikes in opposition occur when mass public groups incur losses, whether that be the election of former president Donald J. Trump or other developments such as youth-led movements for climate action (Walter, 2021).

The rise in skepticism in globalization 3.0 has had a direct correlation to a rise in protectionism, isolationism, and nationalism-related policies. Some of these policies are inherently harmful to and threaten the current means of international order. These theories and policies will be defined and analyzed throughout the following sections.

Globalization

Historical Background

Opposition towards globalization has been increasing. Scholars believe the concept was introduced in the early 18th century as various world powers, cultures, and economies became more and more integrated. Others attribute the dawn of globalization to Christopher Columbus' journey to the New World, leading to the Columbian Exchange, during which European influence traveled

across oceans to the Americas and vice versa. Regardless of one's interpretation of the commencement of the concept, globalization made it so that past borders were no longer a limit to trade. Author Anthony Giddens defined globalization as “the stretching of social connections between the local and the distant” (Giddens, 2013), highlighting the cooperation of distant nations. From the globalization of trade to that of production and finance, the collaboration of nations has been subject to opposition for quite some time.

The “post–Cold War” world ushered in an unprecedented wave of geopolitical change. Following the fall of the Soviet Union, the United States quickly positioned itself at the top of the “food chain,” the unparalleled “hyperpower.” In Globalization 3.0 we are witnessing a power shift from the West to other rising states, such as China and India, whose economies may continue to overpower that of the West. Evidently, the shifting of power and influence has prompted heated debate, many of which have sparked new policies based on economic theories rooted in anti-globalization sentiments.

The Economics of Globalization

Discussing the backlash against globalization naturally leads to a discussion of the economic dimensions that make it up. The second liberal international order that rose after World War II can today be found in at least two forms. The first is referred to by some as hyper globalization and includes policies on rules within countries that promote capitalist markets, the movement of capital between countries, free trade between countries, and the equal treatment of foreign direct investment. The second is known as embedded liberalism, which, like the first form, promotes the free movement of goods and services between countries and understands that this can cause disruptions to societies. Therefore, it includes the sheltering of the most vulnerable parts of society while also compensating those who are negatively affected by an open economy (Lake et al., 2021). However, the push towards economic liberalism has resulted in conflicts with those who prefer policies closer to the Westphalian order. This refers to a system of international relations that emerged in Europe after the Thirty Years’ War in the mid-17th century, prompted by the signing of the Treaty of Westphalia in 1648. This system was characterized by the principle of state sovereignty, which established clearly that each state had exclusive control over its territory, government, and domestic affairs. The Westphalian order also established the idea of non-interference in the internal affairs of other states, the recognition of borders, the concept of territorial integrity, and the principle of equal legal standing between states. The problem arises as those with neoliberal ideals push for the acceptance of liberal economic domestic policies as a normative idea (Lake et al., 2021). The following sections will explore economic theories which support globalization and theories which attempt to explain backlash against globalization.

The Benefits of Globalization

In an ever-changing world, where the height of our technology has allowed societies to network with others through improved communication and transportation, international trade has been rapidly increasing since the 1900s (Esteban Ortiz Ospina et al., 2014). Proponents of globalization look to the impact it has had on the increased access to goods that societies have been able to trade and the reduced prices that come with it as both local and foreign producers compete against each other to sell their goods to the public (Joyce S. Osland, 2003). The “vent for surplus” theory was first founded by Adam Smith and later critiqued by Hla Myint, who is a Burmese economist known for his contributions to welfare economics, highlighting the importance of export orientation as an effective growth tool. He suggested that, because businesses and nations have the capability to produce more than what their local public can consume, these businesses and nations will look to the international market as another source of consumption for their excess goods (Victor S. Venida, 2000). The capacity to produce more and the extra source of consumption by the “vent for surplus theory” not only explains why the trend of globalization has increased, but it also explains how consumers would support globalization as they have access to cheaper goods and see that their economy is growing.

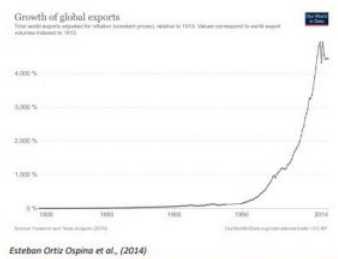


Figure 1: Growth of Global Exports (Source: Our World in Data)

‘Competition’ is a major theme in the debate surrounding globalization and later in this chapter, you will learn about how it is the fear of losing competitiveness that leads some to pursue protectionist policies or back out of international trade altogether. Still, supporters also cite competition as a contributing factor to how it leads to nations experiencing socio-economic rewards that they

would not have gained had they not globalized. Due to the competition between developed and developing nations, supporters have cited that competition has led to developing countries enhancing the quality and specialization of their workforce in hopes to better compete with their counterparts (Joyce S. Osland, 2003).

However, despite the number of arguments researchers and academics will cite in support of globalization, there is still a wide range of literature that argues against globalization, highlighting the negative consequences that certain parts of the world are facing because of it. Now that you understand on a basic level some of the benefits of globalization, such as the increased incentive to specialize and improve technical skills for developing states, greater access to cheaper goods for consumers, as well as a larger market for producers to sell those goods. We will next explore the backlash against globalization.

Backlash Against Globalization

Non-material Issues

Globalization has brought about many non-material issues that have impacted societies. One of the main issues is the erosion of cultural diversity, as globalizing forces, such as the spread of Western media, and consumerism, have led to the homogenization of cultures, particularly among younger generations (Croteau & Hoynes, 2013). These aspects have led to the loss of traditional knowledge, practices, and beliefs as well as the marginalization of minority cultures. Additionally, globalization has led to the concentration of power and wealth in the hands of a few global corporations and countries, exacerbating social inequality and poverty (Ferri, 2003). At the same time, the majority of the world's population has not seen significant improvements in their standards of living. This has led to growing social and economic disparities within and between countries, contributing to political unrest, migration, and other social challenges. Finally, globalization has also contributed to environmental degradation, as increased economic activity has led to greater exploitation of natural resources and increased pollution.

This new economic activity has three major contributing factors: increased ability to transport more goods faster, economic specialization, and biodiversity loss brought about by globalization (Stobierski, 2021). Economic specialization is the process by which an organization concentrates its labor and resources on the production of a particular resource to create a comparative advantage for the economy. This hyper-focus or concentration has led to the overconsumption and extraction of natural resources to the detriment of some local communities and the environment, resulting in overfishing, increased pollution, extreme deforestation, and other environmental issues arising from trying to meet a competitive advantage in the global market. At the same time, decreased biodiversity is brought about by the loss of habitats and overhunting brought about by economic specialization and consumer demands. Another factor decreasing biodiversity is the introduction of invasive foreign plants and animals worldwide due to global shipping networks. That being said, states and the public are becoming increasingly aware of these non-material issues and have started to take action to minimize the negative non-material issues brought about by globalization. We will next explore the backlash against globalization using current economic theories and politics.

Theories on Backlash Against Globalization

There are three anti-globalization theories that are built upon classical trade theories to relate globalization to income inequality: These are a neo or enriched version of the Heckscher-Ohlin and Stolper-Samuelson model (neo-HOSS), new new trade theory (NNTT), and the theory of economic geography.

Originally introduced by Haskel et al. (2012), neo-HOSS theory adds to the HOSS model the idea that workers are heterogeneous, each with various levels of skill. The implication of doing so is that a drop in the relative price of a labor-intensive good by some force reduces the wage of lower-skilled labor, but also that the gains from the force which pushes prices down are distributed to only a small portion of higher-skilled labor. It is important to note that this force could be either globalization or technological advances, but finds that the more that globalization is shown to be linked to a decrease in prices, the greater the backlash to globalization will be (Flaherty et al., 2021).

New new trade theory, on the other hand, focuses on a firm level to explain the effect of globalization-induced wage inequality. NNTT reasons that, due to the high associated costs of imports and exports, only the largest firms will be able to enter this market, and that the gains from trade will make them even larger. Subsequently, domestic markets will be overtaken by the largest global firms, driving down profits for domestic firms and completely driving out local establishments. Adding the previously discussed idea of heterogeneous workers into the theory, profits are concentrated for workers at the top firms, and workers in smaller domestic firms are left out, as demonstrated by Helpman et al. (2010) and Akerman et al. (2013).

Looking at an even broader scale, economic geography “explores the origins and effects of one of a society’s most readily observable features: the unequal distribution of economic activity across space” (Flaherty et al., 2021). This theory, also called new

economic geography, originates from trade economics, mainly by Krugman (1991), Krugman et al. (1995), and Ottaviano et al. (1998). Findings from Broz et al. (2021), as discussed earlier, show how globalization's effects are felt most significantly at a community level. Flaherty et al. (2021) complement their findings by demonstrating how globalization leads to economic stagnation and decline on a regional level, leaving only a handful of cities to benefit. The causal mechanism behind this theory is that globalization lowers trade costs, allowing firms to gain more from locating themselves in areas with the most benefits. Such areas become large cities because they have advantages like access to ports or natural resources, access to key infrastructure, a large and specialized labor pool, and a diverse consumer base. As firms can locate in these large cities because of lowering trade costs from globalization, the areas continue to grow in a process known as agglomeration. However, this growth is at the cost of less advantageous cities. The result is large inequality between regions and within the largest cities (Breinlich et al., 2014).

Again, these theories are constrained in that they do not discuss the non-economic mechanisms through which inequality arises and only offer purely material reasons for the backlash against globalization. Data from Jones (2018) suggests that over half of Americans view trade favorably, despite the literature that inequality has been growing. This is indicative of factors other than just economics impacting attitudes toward globalization. In addition, neo-HOSS, NNTT, and the economic geography theory are most applicable to high-income countries. Further research will need to test their robustness when applied to lower-income countries. Next, we will analyze political ideologies that further our understanding of backlash to globalization.

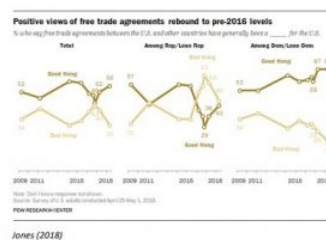


Figure 2: American Public Opinion on International Trade

Backlash Against Globalization: Nationalist Populism

Nationalism and populism are two theories that are often combined when discussing international relations. Nationalism is the political ideology that sovereignty interests and identity takes precedence over other states, while populism is the political strategy of appealing to the people of a state rather than the elites. The difference between them for this discussion is the economic solutions they propose to solve the issues brought on by globalization. Right-wing populism proposes protectionism, whereas left-wing populism proposes redistribution, an idea that is also supported by embedded liberalism. Nationalist populism, therefore, describes the meeting of these two like theories on an international level without specifying their specific economic leaning (Singh, 2021). Although nationalist populist values differ across regions, left-wing populism shares in its rejection of surrendering economic sovereignty to an international organization. Specific values include hostility towards international trade, investment, and finance, and in the case of European nationalist populists, there is also hostility towards European integration (Eichengreen, 2020). Although nationalist populism was not founded as a counter to globalization, its growing presence in areas that have been negatively affected by globalization indicates its role in weakening the liberal economic order. Broz et al. (2021) find that the distributional effects of globalization, a steady decline in manufacturing, pressure from countries like China on lower-skill and education workers, and the financial crisis of 2008 were major factors in the explosive growth of nationalist populism in the OECD. In addition, the distributional effects of globalization were felt most significantly at the community level, especially those with middle-class incomes and industrial communities.

However, focusing on the economic side of nationalist populist theory results in a purely material explanation for the rise in the backlash against globalization and ignores the debate over whether the driving force against globalization is material or nonmaterial in nature. There are other findings that align with that of Broz et al. (2019) where the losers of globalization, those who are more exposed to its risks, and individuals with lower skills are more likely to support anti-globalization policies and parties (Walter, 2021). At the same time, other findings such as Rommel et al. (2018) do not align with the idea that those more affected by the negatives of globalization are more likely to vote for anti-globalization measures.

The Politics of Anti-globalization

As alluded to in the economic theories behind the backlash to globalization, a contention of importance and issue is in the political arena, with regard to cultural backlash or the ability to respond to those risks.

The impact globalization has on people helps reveal the backlash against globalization and why. Nationalism, populism, and social grievances play a key role in a general population and reaction to policy or globalization. A key issue is alienation, where people feel alone and separated from issues. This has been brought up in many different works of literature from classical liberalism to Marxist ideas. Failing to address this key part also affects backlash. The current backlash against globalization is a complex issue, stemming from a reaction to the failure of traditional parties not adequately responding to pressing issues. The deindustrialization of regions, combined with feelings of neglect and being on the losing end of policies, has helped make domestic (American) sentiment against globalization (Broz, Frieden, Weymouth, 2021). Multiple crises in the last two decades, such as the Great Recession, the coronavirus pandemic, inflation, oil shocks, the rising cost of living, and many more regional conflicts, have built a lengthy line of grievances and gripes people have over globalization.

In America, people who have been on the losing end of these policies and feeling alienated from governance have as a result found economic populism to be popular. In other parts of the globe, the backlash extends into responses due to being on the losing end of trade deals or suffering external factors that are not expected. For example, places that historically suffered from colonization and imperialism are much more cynical about the benefits of globalization. We also must look at how areas manage debt, as well as how it factors into the economic response. This all factors into an enormous chain of events that can affect the ability of the state or region to respond to a crisis, and by extension, motivate backlash to globalization. In an upcoming case study, we will see some of these factors in action.

Case Studies

Case Study: Backlash in Puerto Rico

An example of how these factors come into play is the current economic crisis and response in the U.S. territory of Puerto Rico. This territory had over \$72 billion in debt in 2016, was defaulting on the debt, and was already in austerity with its budget (Espada, 2021). In 2015, poverty levels were at 46%, and the island was in an economic depression since 2006 (Caraballo-Cueto, 2021). The island has suffered a mass exodus, as people are fleeing the island because of poverty and lack of opportunities. This resulted in the creation of a fiscal board, PROMESA, by the U.S. federal government in 2016 (Espada, 2021). This board has received little praise from the people residing on the island, as austerity and tax exemptions for businesses were the policies perceived by them (Espada, 2021).

Part of this policy distrust goes back to the 50s and 60s when, during an industrialization plan initiated by the American federal government, there was hard growth at the cost of families and culture of the island, and forced migrations (Caraballo-Cueto, 2021) (Fuentes-Ramirez, Hosteler-Diaz, 2020). In Ricardo R. Fuentes-Ramirez's analysis, *The Political Economy of Puerto Rico: Surplus Use and Class Structure*, "between 1950 and 1972 annual growth rates were on average 6.1 percent, but more than half of the population remained in poverty and unemployment never fell below 10 percent" (Fuentes-Ramirez, Hosteler-Diaz, 2020). For this economic success and opening of markets, Puerto Rico required a constant valve of migrations to the mainland to help reduce poverty and get population control. This resulted in the splitting of families as men would leave for the mainland due to patriarchal cultural norms, leaving wives and loved ones to take over the home. This fractured cultural norms in the society (Caraballo-Cueto, 2021) (Fuentes-Ramirez, Hosteler-Diaz, 2020).

This caused massive stratification in Puerto Rican society, as the losers of the policy were highly impacted and saw little benefits as a result. This has led to a massive distrust in future policy jumps by the federal government and combined with well-known policies such as the Jones Act. This act triggered protectionism, hurt Puerto Rican consumers, and also caused a rift between island elites and the federal government (Caraballo-Cueto, 2021) (Fuentes-Ramirez, Hosteler-Diaz, 2020).

As the island has been deindustrializing due to economic shortfalls and people fleeing, this has also led to leaders trying to use tax exemptions to try luring businesses in and trying to create demand for services by bringing new capital funding to the island (Espada, 2021). This has resulted in the islanders triggering massive protests against the policies, denouncing people from the mainland United States as invaders and a danger to their culture. This also followed an upsurge of populist rhetoric and backlash against expanding markets (Espada, 2021).

Here we can see how past policy failings, along with poverty, and people losing against past policy can trigger backlash to globalization or its concept. While there were benefits and a jumpstart to the economy, because governance failed to accommodate and help those affected, this caused people to feel alienated and become distrustful of globalization. When analyzing why people react negatively to shifts in global markets and opening markets, we must take cases like the one above into consideration to examine the impacts on those negatively affected.

Case Study: Protectionism in The United States

Protectionist sentiment is also important in trade and politics as firms, employers, and political institutions feel pressure to adopt protectionist policies in times of concern for the domestic economy. A primary example of modern backlash to globalization comes from US protectionist sentiment in response to China's increasing influence and dominance as an economic superpower. At the core of this sentiment has been the concern for the loss of manufacturing jobs as they shift overseas to China and other such countries where labor is cheaper. The US manufacturing industry has experienced challenges from increased global competition and many Americans believe that outsourcing is resulting in unemployment and wage stagnation, especially in areas like the Rust Belt and red states experiencing industrial decline (Economist, 2023). The backlash against globalization was a major issue during the Trump administration during which the administration placed tariffs on billions of dollars worth of goods from around the world, especially from China (BBC, 2019). During his campaign, Trump argued protectionist policies would bring jobs back and reduce the trade deficit. This was an example of protectionist policies gaining traction in US economic policy. Such policies particularly found success under a Republican, right-wing, and conservative-leaning administration whose party has significant support from red states whose middle class has been losing in terms of economic geography. The tariffs placed on China during the Trump administration reflect an attempt to shield the US from foreign competition.

Another common way protectionism policies are promoted in the US government is through lobbying. Lobbying is a form of democratic participation where corporations and individuals can protect their interests and promote economic growth. Conservative states tend to lobby for protectionism in which communities vocalize their concerns over job security. There are concerns that the public trust in the political system is slowly eroding due to the potential for corruption and conflicts of interest. Despite these concerns, protectionist policies can safeguard domestic industries from unfair foreign competition, and measures such as tariffs and trade restrictions can address unfair practices. These protectionist policies are essential for national security and for reducing dependence on foreign countries, such as China, for strategic goods and therefore help maintain US national sovereignty. Prioritizing and protecting American jobs is supporting the interest of U.S. workers and globalization is threatening this. Outsourcing of U.S. jobs to foreign countries and economic inequality are damaging American national identity and the domestic economy (Aiden, 2022). American communities and industries continue to be disproportionately impacted by globalization and free trade and protectionist policies are a way for stakeholders to address these grievances. Lobbying, like tariffs, also helps threatened industries shield themselves from foreign competition. These are just some of the ways anti-globalization sentiments are expressed, particularly noteworthy as a major player in US politics.

Conclusion

Even though there are both proponents and adversaries on the topic of globalization, both parties can agree on the fact that globalization is an international phenomenon that has dominated the 21st century. The literature revolving around Globalization 1.0 (Pax Mongolica) and Globalization 2.0 (Pax Britannica) has been extensively covered and discussed but as the international community is currently experiencing Globalization 3.0, many citizens, government officials, and business owners are concerned as to how this new phase of globalization will affect their personal lives and the socio-economic conditions of their countries. Many have been sympathetic to the theories and beliefs of National Populism, wishing to protect their jobs against outsourcing to countries that have a cheaper labor force and increase the number of manufacturing jobs that have been lost due to globalization. And through an NNTT lens, as goods get cheaper and cheaper, the wages of low-skilled laborers will also decrease as their wages are directly affected by the products they help sell and create.

Globalization affects and shapes the economic conditions that people experience which in turn affects the political beliefs a person adopts. It is evident, with Puerto Rico being the prime example, that ideas of protectionism and national populism are appealing when it is evident that local and national job producers are being outsourced or taken by foreign markets. And as the gap between different economic classes grows, making clear distinctions between those who benefit from globalization and those who don't, there will be a continued backlash against globalization. It is debatable as to whether the backlash against globalization will be successful in stopping its continued spread and growth and only time will tell if it ever succeeds.

References

- Alden, E. (2022, May 10). The dangerous new anti-globalization consensus. Council on Foreign Relations. Retrieved April 18, 2023, from <https://www.cfr.org/article/dangerous-new-anti-globalization-consensus>
- BBC. (2019, May 10). Trade wars, Trump tariffs and Protectionism explained. BBC News. Retrieved April 19, 2023, from <https://www.bbc.com/news/world-43512098>

- Beltekian, E. O.-O. and D. (2014). Trade and globalization. Our World in Data. Retrieved from <https://ourworldindata.org/trade-and-globalization>
- Breinlich, Ottaviano, G. I. ., & Temple, J. R. . (2014). Regional Growth and Regional Decline. In Handbook of Economic Growth (Vol. 2, pp. 683–779). Elsevier B.V. <https://doi.org/10.1016/B978-0-444-53540-5.00004-5>
- Broz, J., Frieden, J., & Weymouth, S. (2021). Populism in Place: The Economic Geography of the Globalization Backlash. International Organization, 75(2), 464-494. doi:10.1017/S0020818320000314
- Caraballo-Cueto. (2021). The Economy of Disasters? Puerto Rico Before and After Hurricane Maria. Centro Journal, 33(1), 66–.
- Croteau, D., & Hoynes, W. (2014). Media/Society: Industries, images, and audiences (5th ed.). SAGE Publications.
- The Economist Newspaper. (2023, January 9). What America's protectionist turn means for the world. The Economist. Retrieved April 19, 2023, from <https://www.economist.com/finance-and-economics/2023/01/09/what-americas-protectionist-turn-means-for-the-world>
- Eichengreen, B. J. (2020). The populist temptation: Economic grievance and political reaction in the modern era. Oxford University Press.
- Espada, M. (2021, April 19). How Puerto Ricans are fighting back against using the island as a tax haven. Time. Retrieved April 20, 2022, from <https://time.com/5955629/puertorico-tax-haven-opposition/>
- Flaherty, T., & Rogowski, R. (2021). Rising Inequality As a Threat to the Liberal International Order. International Organization, 75(2), 495-523. doi:10.1017/S0020818321000163
- Fuentes-Ramírez. (2020). The Political Economy of Puerto Rico: Surplus Use and Class Structure. Latin American Perspectives, 47(3), 18–29. <https://doi.org/10.1177/0094582X20912529>
- Giddens, A. (2013). The Consequences of Modernity (1st ed.). Wiley. Retrieved from <https://www.perlego.com/book/1535427...-modernity-pdf> (Original work published 2013)
- Haskel, Lawrence, R. Z., Leamer, E. E., & Slaughter, M. J. (2012). Globalization and U.S. Wages: Modifying Classic Theory to Explain Recent Facts. The Journal of Economic Perspectives, 26(2), 119–139. <https://doi.org/10.1257/jep.26.2.119>
- Jones, B. (2018, May 10). Americans are generally positive about free trade agreements, more critical of tariff increases. Pew Research Center. Retrieved from <https://www.pewresearch.org/fact-tank/2018/05/10/americans-are-generally-positive-about-freetrade-agreements-more-critical-of-tariff-increases/>
- Krugman. (1991). Increasing Returns and Economic Geography. The Journal of Political Economy, 99(3), 483–499. <https://doi.org/10.1086/261763>
- Krugman, & Venables, A. J. (1995). Globalization and the Inequality of Nations. The Quarterly Journal of Economics, 110(4), 857–880. <https://doi.org/10.2307/2946642>
- Lake, Martin, L. L., & Risse, T. (2021). Challenges to the Liberal Order: Reflections on International Organization. International Organization, 75(2), 225–257. <https://doi.org/10.1017/S0020818320000636>
- Lang, M. (2006, December 1). Globalization and Its History. The Journal of Modern History, 78(4), 899-931. <https://doi.org/10.1086/511251>
- Manuel Anselmi. (2017). Populism: An Introduction. Taylor and Francis. <https://doi.org/10.4324/9781315268392>
- Osland, J. S. (n.d.). Broadening the Debate: The Pros and Cons of Globalization. (2003). Eugene McDermott Library – The University of Texas at Dallas. Retrieved from <https://journals.sagepub-com.libproxy.utdallas.edu/doi/pdf/10.1177/1056492603012002005>
- Ottaviano, & Puga, D. (1998). Agglomeration in the Global Economy: A Survey of the “New Economic Geography.” World Economy, 21(6), 707–731. <https://doi.org/10.1111/1467-9701.00160>
- Rommel, T., & Walter, S. (2018). The Electoral Consequences of Offshoring: How the Globalization of Production Shapes Party Preferences. Comparative Political Studies, 51(5), 621–658. <https://doi.org/10.1177/0010414017710264>
- Singh. (2021). Populism, Nationalism, and Nationalist Populism. Studies in Comparative International Development, 56(2), 250–269. <https://doi.org/10.1007/s12116-021-09337-6>

- Stiglitz, J., & Pike, R. M. (2004). Globalization and its discontents. *Canadian Journal of Sociology*, 29(2), 321-324.
- Stobierski, T. (2021, April 15). Effects of globalization on the environment. *Business Insights Blog*. Retrieved April 16, 2023, from <https://online.hbs.edu/blog/post/globalization-effects-on-environment#:~:text=Increased%20greenhouse%20gas%20emissions%2C%20ocean,reduce%20biodiversity%20around%20the%20globe>.
- Venida, V. S. (n.d.). (2000). *The Economic Theory of Globalization*. Eugene McDermott Library – The University of Texas at Dallas. From <https://www-jstor-org.libproxy.utdallas.edu/stable/42634424?seq=1>
- Villanueva. (2021). Recovery work, life-work, and the extractive economies of finance capital in post-María Puerto Rico: A response to Beverley Mullings. *Geoforum*, 125, 107–109. <https://doi.org/10.1016/j.geoforum.2021.07.008>
- Walter, S. (2021). The Backlash Against Globalization. *Annual Review of Political Science*, 24(1), 421–442. <https://doi.org/10.1146/annurev-polisci-041719-102405>

This page titled [1.16: Backlash against Globalization 3.0](#) is shared under a [CC BY-NC 4.0](#) license and was authored, remixed, and/or curated by [Clint Peinhardt](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

Index IndexEdit Update titlecancel

D
dire

Detailed Licensing Detailed LicensingEdit Update titlecancel

Overview

Title: [Open International Political Economy \(Peinhardt\)](#)

Webpages: 28

Applicable Restrictions: Noncommercial

All licenses found:

- [CC BY-NC 4.0](#): 92.9% (26 pages)
- [Undeclared](#): 7.1% (2 pages)

By Page

- [Open International Political Economy \(Peinhardt\)](#) - [CC BY-NC 4.0](#)
 - [Front Matter](#) - [CC BY-NC 4.0](#)
 - [TitlePage](#) - [CC BY-NC 4.0](#)
 - [InfoPage](#) - [CC BY-NC 4.0](#)
 - [Table of Contents](#) - [Undeclared](#)
 - [Licensing](#) - [CC BY-NC 4.0](#)
 - [1: Chapters](#) - [CC BY-NC 4.0](#)
 - [1.1: History of Globalization](#) - [CC BY-NC 4.0](#)
 - [1.2: Trade- International Institutions](#) - [CC BY-NC 4.0](#)
 - [1.3: Trade- Preferences and Interests Groups](#) - [CC BY-NC 4.0](#)
 - [1.4: Trade- Domestic Institutions and Policymaking](#) - [CC BY-NC 4.0](#)
 - [1.5: Trade- Development, Growth, and Inequality](#) - [CC BY-NC 4.0](#)
 - [1.6: Trade- Preferential Agreements](#) - [CC BY-NC 4.0](#)
 - [1.7: Production- Domestic Interests and Institutions](#) - [CC BY-NC 4.0](#)
 - [1.8: Production- International Institutions](#) - [CC BY-NC 4.0](#)
 - [1.9: Finance- Bretton Woods Monetary System](#) - [CC BY-NC 4.0](#)
 - [1.10: Finance- After Bretton Woods](#) - [CC BY-NC 4.0](#)
 - [1.11: Finance- Sovereign Debt](#) - [CC BY-NC 4.0](#)
 - [1.12: Finance- 1982 Debt Crisis](#) - [CC BY-NC 4.0](#)
 - [1.13: Finance- The Asian Financial Crisis](#) - [CC BY-NC 4.0](#)
 - [1.14: Finance- The Great Recession of 2007-08](#) - [CC BY-NC 4.0](#)
 - [1.15: Finance- International Institutions \(International Monetary Fund\)](#) - [CC BY-NC 4.0](#)
 - [1.16: Backlash against Globalization 3.0](#) - [CC BY-NC 4.0](#)
 - [Back Matter](#) - [CC BY-NC 4.0](#)
 - [Index](#) - [CC BY-NC 4.0](#)
 - [Glossary](#) - [CC BY-NC 4.0](#)
 - [Detailed Licensing](#) - [CC BY-NC 4.0](#)
 - [Detailed Licensing](#) - [Undeclared](#)

Detailed Licensing Detailed LicensingEdit Update titlecancel

Overview

Title: [Open International Political Economy \(Peinhardt\)](#)

Webpages: 28

Applicable Restrictions: Noncommercial

All licenses found:

- [CC BY-NC 4.0](#): 92.9% (26 pages)
- [Undeclared](#): 7.1% (2 pages)

By Page

- [Open International Political Economy \(Peinhardt\)](#) - [CC BY-NC 4.0](#)
 - [Front Matter](#) - [CC BY-NC 4.0](#)
 - [TitlePage](#) - [CC BY-NC 4.0](#)
 - [InfoPage](#) - [CC BY-NC 4.0](#)
 - [Table of Contents](#) - [Undeclared](#)
 - [Licensing](#) - [CC BY-NC 4.0](#)
 - [1: Chapters](#) - [CC BY-NC 4.0](#)
 - [1.1: History of Globalization](#) - [CC BY-NC 4.0](#)
 - [1.2: Trade- International Institutions](#) - [CC BY-NC 4.0](#)
 - [1.3: Trade- Preferences and Interests Groups](#) - [CC BY-NC 4.0](#)
 - [1.4: Trade- Domestic Institutions and Policymaking](#) - [CC BY-NC 4.0](#)
 - [1.5: Trade- Development, Growth, and Inequality](#) - [CC BY-NC 4.0](#)
 - [1.6: Trade- Preferential Agreements](#) - [CC BY-NC 4.0](#)
 - [1.7: Production- Domestic Interests and Institutions](#) - [CC BY-NC 4.0](#)
 - [1.8: Production- International Institutions](#) - [CC BY-NC 4.0](#)
 - [1.9: Finance- Bretton Woods Monetary System](#) - [CC BY-NC 4.0](#)
 - [1.10: Finance- After Bretton Woods](#) - [CC BY-NC 4.0](#)
 - [1.11: Finance- Sovereign Debt](#) - [CC BY-NC 4.0](#)
 - [1.12: Finance- 1982 Debt Crisis](#) - [CC BY-NC 4.0](#)
 - [1.13: Finance- The Asian Financial Crisis](#) - [CC BY-NC 4.0](#)
 - [1.14: Finance- The Great Recession of 2007-08](#) - [CC BY-NC 4.0](#)
 - [1.15: Finance- International Institutions \(International Monetary Fund\)](#) - [CC BY-NC 4.0](#)
 - [1.16: Backlash against Globalization 3.0](#) - [CC BY-NC 4.0](#)
 - [Back Matter](#) - [CC BY-NC 4.0](#)
 - [Index](#) - [CC BY-NC 4.0](#)
 - [Glossary](#) - [CC BY-NC 4.0](#)
 - [Detailed Licensing](#) - [CC BY-NC 4.0](#)
 - [Detailed Licensing](#) - [Undeclared](#)