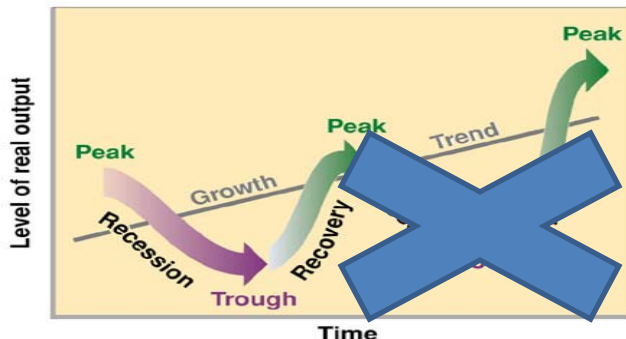


# **Embedded Liberalism in the International Economy**

Hegemonic Leadership and  
International Governance

# Review: state intervention in the domestic economy: three lessons of the Great Depression

- Economic stability is not assured through market forces
- And market forces that lead to economic downturns create political instability
- Political stability requires state intervention to achieve economic stability



- deficit spending and bailouts to keep workers and capitalists happy so they don't turn to communism and fascism
- Regulation to stabilize the economy and flatten the business cycle

# **But Free Trade tends to undermine these new roles for the state**

- Inefficient industries must fail!
- Employment must fluctuate with supply and demand for labor
- **If they leave their economies open, what would happen to the welfare state?**
- **And If they maintain the welfare state, what happens to Free Trade?**

# Liberals and Socialists defeated Fascism in WW II



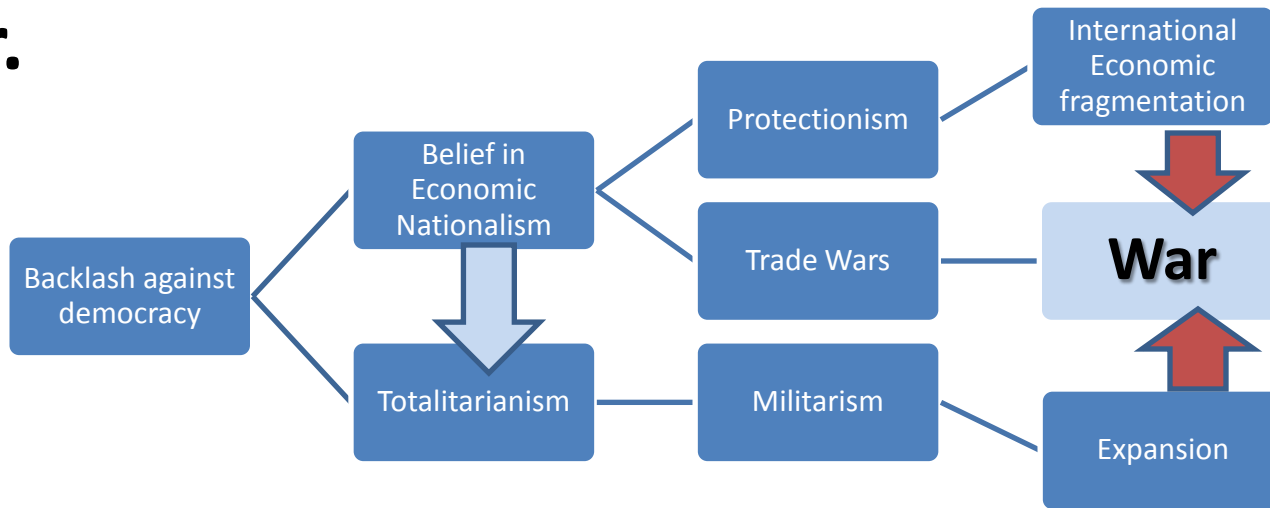
# **But the Tendency toward Econ. Nationalism remained powerful**

- Nonetheless, after WW II the liberal states wanted to restore open and free trade.....

● **WHY?**

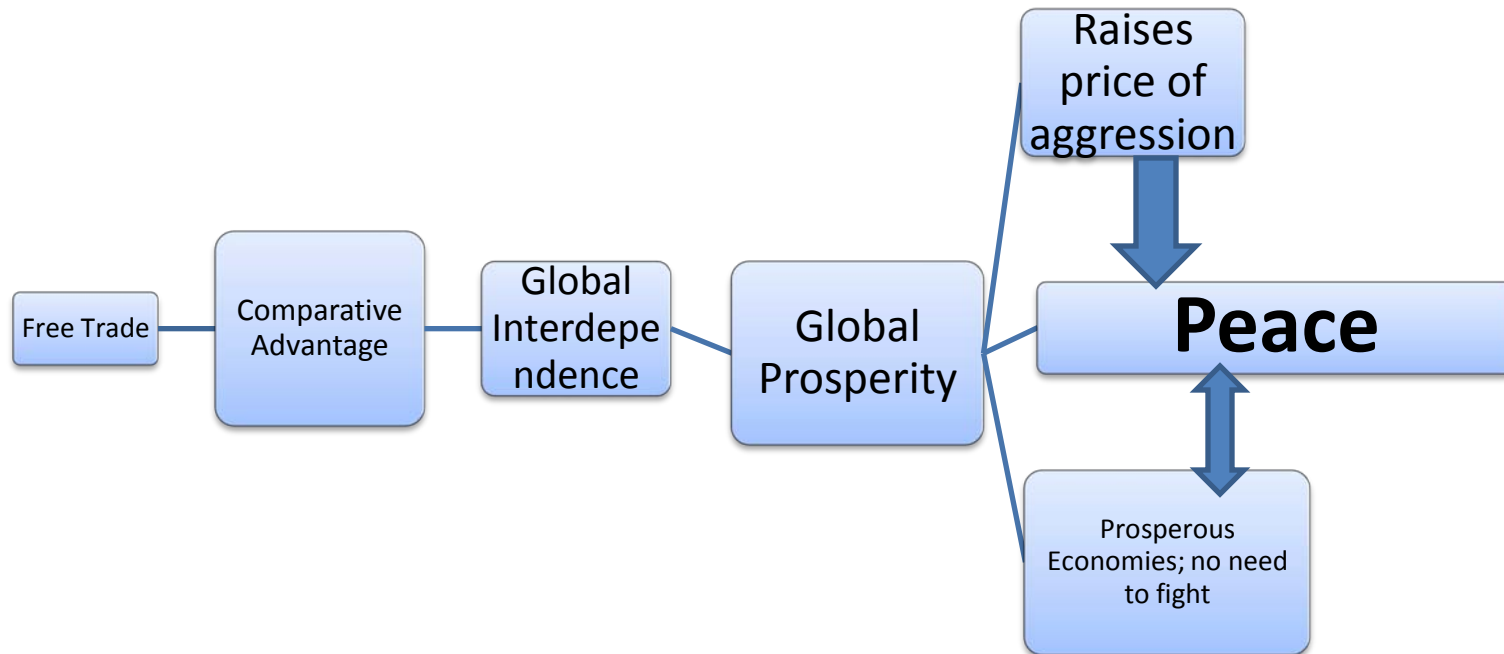
If the tendency toward econ. Nat. was so powerful, why was there an effort to restore liberalism in the international economy?

- **Liberal beliefs about the economic causes of war.**



**Dominant belief after WW II: Fascist Dictatorship + Protectionism leads to war**

# And belief that Free Trade leads to Peace



To preserve the welfare state, peace, and democracy the international liberal economy would need to be  
**repaired**

- What kind of repair was needed: International **embedded Liberalism—embed Liberalism in the global economy**
  - Transplant from the simplest notions of democracy : no long-term winners and losers
  - Limited liberalism: open trade but allowing for government intervention to stimulate the economy and to maintain the welfare state
  - This will.... Reduce the need for economic nationalism and the rise of socialism and fascism



# But getting embedded liberalism is a collective action problem

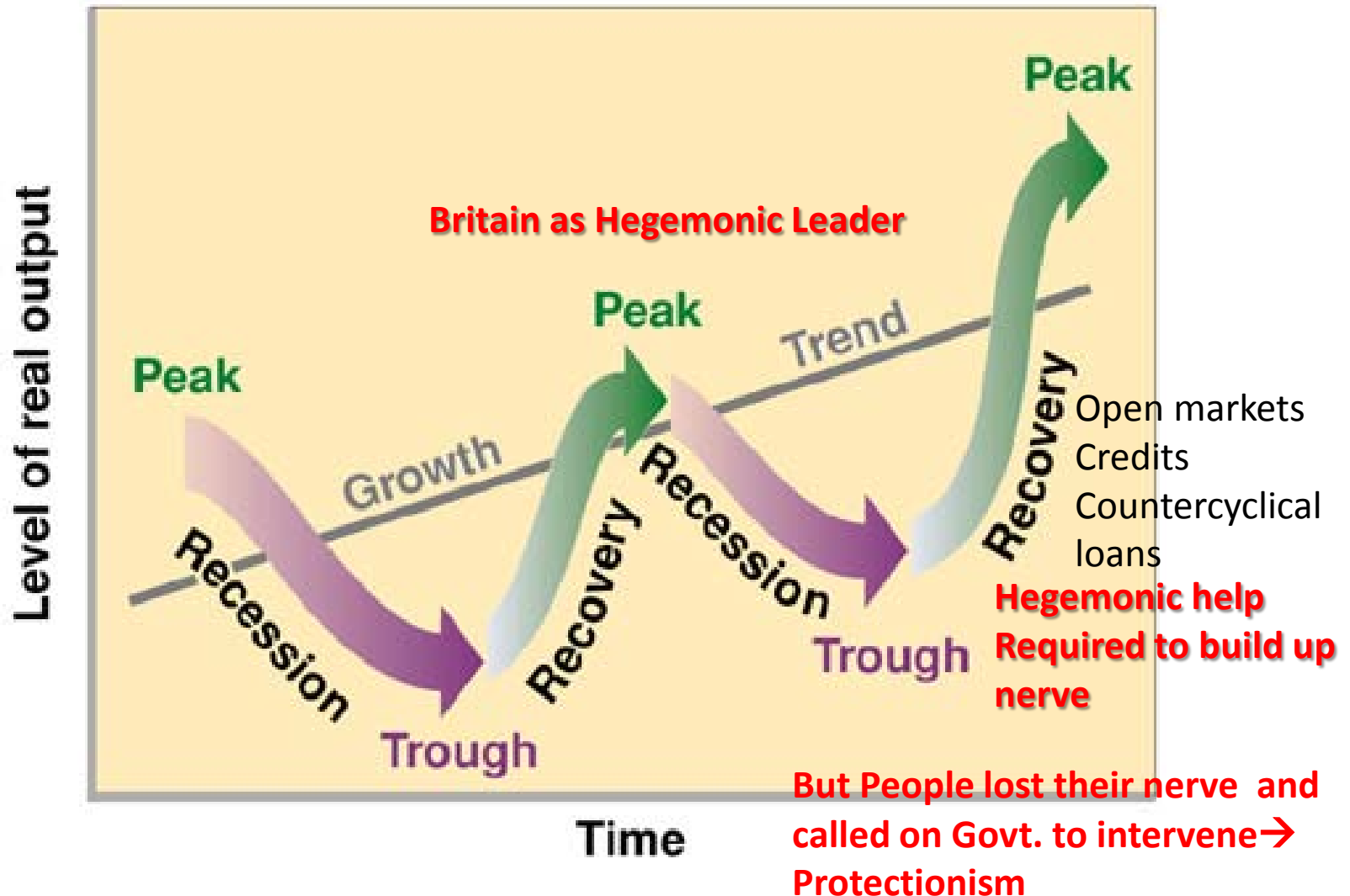
	Cooperate (free trade) requires Leadership	Defect (protectionism)
cooperate	<p>5, 5</p> <p>Comparative advantage Growth for all, I keep my market open even with BOP deficits because I can get loans until things will get better</p>	<p>0,3</p> <p>I keep my market open but you close yours; I lose so eventually I will retaliate</p>
Defect (protectionism)	<p>3,0</p> <p>You keep your market open, I close mine, I win, you lose and eventually you retaliate</p>	<p>1,1</p> <p>We both close our markets; you close yours, I retaliate, you retaliate, and so on.....no more free trade</p>

**Collective Action requires that the strong help the weak to cooperate**

# Remember that Kindleberger says that **Hegemonic Power is required for cooperation to create a system of embedded liberalism**

- Hegemonic states have the resources to
  - Open markets even with a trade deficit
  - Extend credits to countries with payments deficits
  - Provide countercyclical lending and be a lender of last resort in the “trough”
- That softens the contradictions.....
- What does “leadership” mean
  - Ruggie says it is the fusion of power and purpose
  - It means assisting others in a liberal world economy

# Hypothetical Recovery with Hegemonic leadership of international liberalism



# But It takes power and willingness to be a liberal hegemon

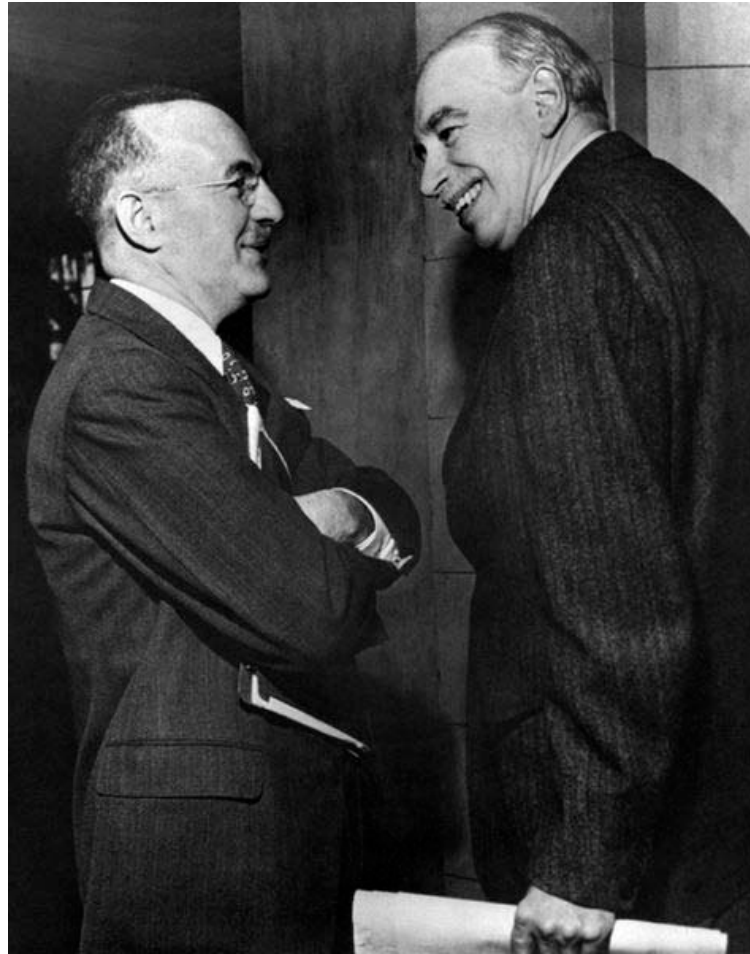
- Britain had both.. the capability to
  - Extend credits for payment deficits
  - Offer a market for others' goods
  - Be a lender of last resort
- But then Britain began to decline
- And the US had the capability but not the willingness

# How could a liberal trading system be revived without a hegemon? Bretton Woods Conference

- “If Goods can’t cross borders, soldiers will”



# The architects of global governance in the services of embedded liberalism: Keynes and White



**Their Agenda: Create Free Trade Again**

# They had to think of a way to embed Liberalism without a hegemon!

- Resolving the “dilemma between internal and external stability.”
- Intergovernmental collaboration to facilitate balance-of-payments equilibrium so states would not have to deflate their economies and could pursue domestic intervention to achieve full employment **AND**
- Multilateralism in trade and finance
- The world could have its cake and eat it too!

# How to do it?

- Currencies had to be stable but No more Gold Standard!!!
  - It demanded deflation which would harm welfare state
- But There would be Fluctuating exchange rates in the absence of the gold standard.....
- Not good. Why?
- So.....



# Create conditions for stable currencies w/o the Gold Standard

- Keynes and White had to come up with a way to get stable currency
- Stable currency depended on
  - Fixed Exchange Rates
  - Currency convertibility



**So they came up with a bright idea!**

# Keynes and White created the IMF at Bretton Woods



Fixed exchange rates with IMF as “lender of last resort,”  
and provider of liquidity

- $\uparrow$  imports +  $\downarrow$  exports  $\rightarrow$  trade deficit  $\rightarrow$  need to pay up  $\rightarrow$  borrow from IMF  $\rightarrow$  currency stability  $\rightarrow$  trade stability

# How does it work?

- The Quota System
- How a quota is determined
- What you give
- What you get
  - voting rights in relation to your quota
  - borrowing rights in relation to your quota

**Next Problem: How to get Free Trade Make everyone  
promise to keep economies open, no matter what:  
(WTO)**



# Main Principles of the GATT/WTO: All promise not to defect from cooperation

- Multilateralism
- Reciprocity
- Exceptions
- Development

# The WTO as a solution to the problem of cooperation for Free trade

	Cooperate (free trade)	Defect (protectionism)
cooperate	<p>5, 5 carrots:            GATT and IMF assurances that if I keep my market open even with BOP deficits I will receive help for my problems and assurance that others will not cheat.</p>	<p>3,3 sticks            DSM raises the costs of defection</p>
Defect (protectionism)	<p>3,3            You keep your market open but if I close mine, You report me to the WTO for non-compliance and we use the DSM. If I lose, I must pay you compensation</p>	<p>1,1            We both close our markets; you close yours, I retaliate, you retaliate, and so on.....no more free trade. No access to MFN, reciprocity, etc.</p>



Problem with these governing institutions: The war had weakened the economies of the industrial powers



Hiroshima



Tokyo



# Destruction in Europe



# And the institutions were too weak to solve collective action problems

- Inadequate IMF resources
- GATT was only a set of rules---promises no good without resources to back them up

So the United States rose to the  
occasion.....



# How did the U.S. exercise hegemonic leadership of an liberal world economy?

- the United States assumed primary responsibility for the management of the world monetary system partially under the disguise of the IMF.
- The dollar became the basis of the international monetary system.
- The US took in the world's distressed goods and began to build a trade deficit itself

# Liquidity and Credit



# Taking in the world's (well...Europe and Japan's) distressed goods



# What were the results?

- The Welfare State was protected
- Decline in Trade Barriers → Economic Growth

	Per Capita Income	
	1950	1973
Western Europe	\$4,594	\$11,534
U.S. and Canada	\$5,257	\$9,288
Japan	\$1,926	\$11,439

# Embedded Liberalism was successful (in the Western World) !

- **GATT negotiations reduced tariffs**
- **Since 1948, world trade** has consistently grown faster than **world** output. |
- one quarter of **world** production is now traded.
- Meaning that one quarter of **world** production is subject to the WTO rules of international **trade**.



# Why was the US now willing to play the role of hegemon?

- It possessed the capabilities but why was it now willing?

# Marxist explanations

- Overproduction and capitalist class control of the economy
- Need for U.S. export markets to relieve overproduction
- Bankers pushed U.S. leadership of the world economy

"After the war, our economic policy will be aimed at full employment and full utilization of a greatly enlarged industrial plant. These objectives, however, cannot be realized unless we find new outlets for products of farm and factory--outlets that will be steady and profitable after war demands have dropped off."

-- U.S. Treasury

Department report to President Roosevelt in 1944:

# Economic Nationalist explanations

- Hegemony is a source of wealth, power and security
  - Control over raw materials
  - Control over sources of capital
  - Control over markets
  - Competitive advantage in the production of highly valued goods: control over high technology

# Liberal explanations: Free Trade leads to Peace and American Prosperity

- "peace is only possible if countries work together and prosper together. That is why the economic aspects are no less important than the political aspects of the peace."