# Chapter 2

## International Economic Institutions since World War II

# Lecture Objectives

- Discuss the history and functions of international institutions in world economy
- Introduce the role of regional trade agreements in the global economy
- Analyze the arguments opposing international economic institutions

# Introduction

- Institutions – rules and organizations that govern and constrain behavior, 2 types
  - Formal institutions – written set of rules that explicitly state what is and is not allowed; example, a constitution
  - Informal institutions – custom or tradition that define appropriate behavior, but without legal enforcement; dispute resolution mechanisms
  - **Different Positions>**
  - Dani Rodrick: institutions are primary; then trade and geography; Krugman: geography then trade and institutions; Sachs: trade (openness) then institutions and geography; IMF/WB: used to be only trade matters; now governance and attention to social effects of growth matter too

# Taxonomy of International Economic Institutions

**TABLE 2.1** A Taxonomy of International Economic Institutions, with Examples

| *Type* | *Examples* |
| --- | --- |
| Commodity or industry-specific organizations: These range from trade associations, to international standards setting bodies, to powerful cartels. | Oil Producing and Exporting Countries (OPEC)<br>International Telecommunications Union (ITU)<br>International Sugar Organization<br>International Lead and Zinc Study Group |
| Commissions and agencies for managing shared resources. | International Boundary and Water Commission (IBWC)<br>Lake Chad Basin Commission<br>Mekong River Commission |

# Taxonomy of International Economic Institutions (cont.)

**TABLE 2.1** A Taxonomy of International Economic Institutions, with Examples

| *Type* | *Examples* |
|---|---|
| Development funds and banks. | Inter-American Development Bank (IDB)<br>North American Development Bank (NADBank)<br>Asian Development Bank<br>Islamic Development Bank |
| International trade agreements involving a few nations (regional trade alliances or trade blocs). | North American Free Trade Agreement (NAFTA)<br>US-Israel Free Trade Agreement<br>Mercado Común del Sur (Mercosúr)<br>Asia-Pacific Economic Cooperation (APEC)<br>Enterprise for the Americas Initiative (EAI) |
| Global organizations for trade, development, and macroeconomic stability. | International Monetary Fund (IMF)<br>World Bank<br>World Trade Organization (WTO) |

# International Institutions

- The three global organizations playing a major role in international economic relations are:
  - The International Monetary Fund (IMF)
  - The World Bank
  - The World Trade Organization (WTO)

Read the **<u>Acheson:</u>** (1) "The Bretton Woods Agreements" and (2) "Preparation for an unknown World."

Let's take a closer look at the functions of these organizations…

# The IMF

- Founded by the Bretton Woods meetings between the Allies in July 1944; delegates from 44 governments founded the IMF to prevent the disastrous economic policies that led to the Great Depression.
- At the close of WWII, allied countries essentially drew up the charter (or Articles of Agreement) of an international institution to oversee the international monetary system and to promote both the elimination of exchange restrictions relating to trade in goods and services, and the stability of exchange rates. The IMF came into being in Dec. 1945 when 29 countries signed the Articles of Agreement.
- It is the central institution of the international monetary system ---- the system of international payments and exchange rates among national currencies that enables business to take place between countries.
- Aims to prevent crises in the system by encouraging countries to adopt sound economic policies; also a fund --- can be tapped by members needing temporary financing to address BOP problems.
- Has statutory purposes (see below)

# The IMF

- The IMF was established to (its functions):
  - Promote international monetary cooperation;
  - Promote exchange stability and orderly exchange arrangements
  - To foster growth and high levels of employment, and
  - to provide temporary financial assistance to countries to help ease balance of payments adjustment
  - Avoidance of competitive devaluations
  - Orderly correction of balance of payments problems

To serve these statutory purposes, the IMF

1. Monitors economic and financial developments and gives policy advice.
2. Lends to member countries with BOP problems.
3. Provides governments and Central Banks technical assistance and training in its areas of expertise.

# The IMF

- Fundamental disequilibrium and exchange crisis
  - A crisis occurs when a country runs out of foreign exchange reserves – a major currency or gold that can be used to pay for imports and international borrowings
  - Members borrow against IMF quotas in the event of financial crisis
- IMF conditionality – requirement for the borrowing member to carry out economic reforms in exchange for a loan (very controversial issue in developing countries).

# IMF Quotas and SDRs

- Each of the 184 members charged a quota subscription (source of funding for the IMF). Each member is assigned a quota based on its relative size in the world economy.
- A member's quota determines its maximum financial obligation (payments) and its voting power and its bearing on its access to IMF financing.
- Quotas are denominated in SDRS (IMF's unit of account) [see **Handout**]
- Subscription: member must pay in full at joining; up to 25% to be paid in SDRs or accepted currency (USD, euro, yen, or pound) while the rest (75%) paid in member's currency.
- Voting power: quota determines voting power in IMF decisions. Each member has 250 basic votes + one additional vote for each SDR100,000 of quota. US has 371,743 votes (17.1% of total); Palau has 281 (0.013% of total).

# Challenges facing the IMF

- Access to financing: the amount of financing a member can obtain from the IMF (access limit) is based on its quota.
- Under *Stand-by & Extended Arrangements*, a country can borrow up to 100% of its quota annually and 300% cumulatively.
- **CHALLENGES FACING THE IMF**

1. Rapid tech. advances & communications >(implies) increasing globalization and integration of markets > financial crises tend to spread faster.
2. With interdependence, a country's economic performance depends on other economies AND on a stable global economic environment.
3. Economic &financial policies followed by individual countries follow how well or how poorly the world trade and payments system operates.

- Thus, globalization calls for greater international cooperation which means increased responsibilities of international organizations such as IMF.

# Challenges facing the IMF(contd)

4. Introducing reforms aimed at strengthening the architecture- or framework of rules and institutions --- of the international monetary financial system to deal turbulence in emerging financial markets (LA and Asia).

5. Work in complementary fashion with other institutions established to safeguard global public goods (maintain order & reduction of uncertainty); be an open institution (allow input from sub-national groups (civic society)).

**Problems**: (1) autonomy versus sovereignty – less national autonomy does not imply loss of sovereignty! (2) quality of advice; (3) lack of transparency in decision-making; (4) the dominance of allied powers in institutional structures and refusal to reform this imbalance.

# The World Bank

- Also founded at the Bretton Woods Conference
- Founded as the International Bank for Reconstruction and Development (IBRD)
- World Bank has 184 Members
- Money comes from donor nation contributions and sales of debt securities in private markets
- Set to promote long-term economic development, including the financing of infrastructure projects (road-building and improving water supply).
- The IMF and WB complement each other: IMF deals with BOP and international reserves during adjustment while the WB does long-term development and poverty reduction issues.

# The World Bank

- Main functions: development lending
- Today, IBRD is one of the five subgroups making up the *World Bank Group*
  - IDA (International Development Assn.),
  - IFC (International Finance Corp.),
  - MIGA (Multilateral Investment Guarantee Agency),
  - ICSID (Int’l Cent. For Settlement of Investment Disp.)

# The World Bank

- Main functions
  - Investing in people, particularly through basic health and education
  - Focusing on social development, inclusion, governance, and institution-building as key elements of poverty reduction
  - Strengthening the ability of the governments to deliver quality services, efficiently and transparently

# The World Bank (cont'd)

- Protecting the environment?
- Supporting and encouraging private business development
- Promoting reforms to create a stable macroeconomic environment, conducive to investment and long-term planning

# GATT

- Began with 23 nations (1947) based on principles established in 1934 Reciprocal Trade Agreement Act. Due to the failure to establish the ITO, GATT was formalized in 1960 to deal with trade issues.
  - **Nondiscrimination**: enshrined in the concept of most favored nation (MFN); every WTO member must treat every other member as it treats its most favored trading partner
  - **National treatment**: imports must be given similar treatment on the domestic market as domestically produced goods.

# GATT (cont'd)

- Functioned through **trade rounds**: inter-state negotiations to reduce tariffs and other barriers to trade
  - Geneva (1947)
  - Annecy, Torquay, Geneva II, Dillon (1949-1961)
  - Kennedy (1964-1967)
  - Tokyo (1973-1979)
  - Uruguay (1986-1993)

# From GATT to WTO

- The GATT functioned through trade rounds – inter-state negotiations to reduce tariffs and other barriers to trade
- After the Tokyo Round of the 1970s, tariffs were brought to record lows
  - However, Uruguay Round was launched in 1986 to address previously neglected trade issues, such as (1). agriculture and textiles, as well as new trade issues, such as (2)  intellectual property rights and (3) trade in services

# From GATT to WTO

- Uruguay Round established the WTO
  - reaches beyond GATT to new trade issues
    - GATS, TRIPS, TRIMS
  - has a more effective dispute settlement mechanism
  - monitors national trade practices more consistently
- Doha Round (2001-current)--- focus on development in developing countries
  - Focused on trade between developed and developing nations (wide areas of disagreement).

## Summary of GATT Rounds

| Round | N of Countries | Subjects and Modalities | Main Outcomes | Value of Trade Covered | Average Tariff Cut | Average Post Round Tariffs |
|---|---|---|---|---|---|---|
| Geneva 1947 | 23 | Tariffs; Item-by-Item Negotiation | Concessions on 45,000 tariff lines | $ 10 billion | 35% | |
| Annecy 1949 | 33 | Tariffs; Item-by-Item Negotiation | Modest tariff reductions | | 37% | |
| Torquay 1950 | 34 | Tariffs; Item-by-Item Negotiation | 8,700 tariff concessions | | 26% | |
| Geneva 1956 | 26 | Tariffs; Item-by-Item Negotiation | Modest tariff reductions | $2.5 billion | 15% | |
| Dillon 1960-1961 | 26 | Tariffs; Item-by-Item Negotiation | Tariff adjustments following creation of EEC | $4.9 billion | 20% | 17% |
| Kennedy 1962-1967 | 62 | Tariffs; Linear cuts | 30,000 tariff lines bound | $40 billion | 35% | 8.7% |
| Tokyo 1973-1979 | 102 | Tariffs; NTBs; Linear cuts; Codes | | $155 billion | 34% | 6.3% |
| Uruguay 1986-1994 | 103 start, 128 end | Tariffs; NTBs; Item-by-Item and Linear; WTO | WTO Dispute Resolution | $3.7 trillion | 39% | 4.0% |

# From GATT to WTO (cont.)

- Uruguay Round Agreement signed in 1994
- The round established the WTO:
  - 144 members as of 1 January 2002
  - reaches beyond GATT to new trade issues;
  - has a more effective dispute settlement mechanism; and
  - monitors national trade practices more consistently

# The WTO

- **Main Tasks of the WTO**
  - Administering WTO trade agreements
  - Forum for trade negotiations
  - Handling trade disputes
  - Monitoring national trade policies
  - Technical assistance and training for LDCs
  - Cooperation with other international agencies

# The WTO

- **Interdependence Norms – 2 principles**
  - Liberalization – negotiations to reduce protection, i.e. towards more *globalization*

1. Nondiscrimination – enshrined in the concept of most favored national status (MFN): every WTO member must treat each of its trading partners as it treats its most favored partner.

**Problem**: The MFN clause allows trade discrimination, especially regional trade agreements (NAFTA, EU): WTO-allowed as long they don’t harm overall level of international trade.

2. National treatment – imports must be given a similar treatment on the domestic market as domestically produced goods

# The WTO

- **Sovereignty Norms**
  - Reciprocity – negotiations proceed in terms of exchange of “concessions” of substantially equivalent value.
  - Safeguards – right of government to preserve economic stability through (nondiscriminatory) protection recognized.

# The Future of the WTO

- The Doha round?
  - Deep conflict between developing countries and industrial countries
    - Costs of current commitments
    - Failure of AICs (advanced industrial countries) to carry out their agreements on ATC( agreement on textiles and clothing) and agricultural trade/price supports
    - TRIPs (trade-related aspects of intellectual property rights) and TRIMs (trade-related investment measures) problems
  - Developing countries seem to be the real supporters of trade liberalization these days

# Regional Trade Agreements (RTAs)

- > trade agreements between countries
- A country can belong to different RTAs (for example, Mexico, Brazil)
- Besides economic organizations, regional trade agreements form a key part of the institutional structure of the world economy
- Regional trade agreements have proliferated around the world since the beginning of the 1990s

# Five Types of Regional Trade Agreements

- 1. Partial trade agreement (PTA) – two or more countries liberalize trade in a *selected group of product categories. Note: as more product groups are included, PTA tend to FTA but excludes (safety, health, and technical standards). Example: US & Canada – mad cow disease*
- 2. Free trade area (FTA) – trade in goods and services fully liberalized between two or more countries
  - North American Free Trade Agreement (NAFTA)

# Five Types of Regional Trade Agreements (cont.)

- 3. Customs union (CU) – an FTA + a common external tariff (CET). But excludes tariffs & quotas, e.g. quotas on Japanese autos
  - European Union in the 1970s and 1980s
  - MERCOSUR in South America
- 4. Common Market – a CU + *free mobility* of factors of production (without CET) , usually labor & capital.
  - European Union in the 1990s
- President Fox (2000): pressed US to move from FTA to CM; September 11,2001 froze any negotiations.

# Five Types of Regional Trade Agreements (cont.)

- 5. Economic Union – common market + coordination of macroeconomic policies (including common currency, harmonization of standards and regulations)
  - United States, the 50 states
  - Canada, the provinces
  - BENELUX (Belgium, Netherlands, Luxemburg)

The EU tends to become an Economic Union ?

**Problems:** adoption of the social contract; mobility of factors of production; the sovereignty issue (U.K.); old versus new members (the latter have non-conforming institutions).

# Prominent Regional Trade Blocs

**TABLE 2.3** Prominent Regional Trade Blocs

| *Region/Country* | *Objective* |
|---|---|
| **Africa** | |
| COMESA—Common Market for Eastern and Southern Africa (1993) | Common market |
| ECCAS—Economic Community of Central African States (1992) | Common market |
| ECOWAS—Economic Community of West African States (1975) | Common market |
| **Asia** | |
| AFTA—ASEAN Free Trade Arrangement (1992) | Free-trade area |
| ANZCERTA—Australia-New Zealand Closer Economic Relations (1983) | Free-trade area |
| APEC—Asia-Pacific Economic Cooperation (1989) | Free-trade area |

# Prominent Regional Trade Blocs (cont.)

**TABLE 2.3** Prominent Regional Trade Blocs

| *Region/Country* | *Objective* |
|---|---|
| **Europe** | |
| CEFTA—Central European Free Trade Arrangement (1992) | Free-trade area |
| EEA—European Economic Area (1994) | Common market |
| EFTA—European Free Trade Association (1960) | Free-trade area |
| EU—European Union (1957) | Economic union |
| **Middle East** | |
| ACM—Arab Common Market (1964) | Customs union |
| AMU—Arab-Maghreb Union (1989) | Economic union |
| GCC—Gulf Cooperation Council (1981) | Common market |
| **Western Hemisphere** | |
| ANCOM—Andean Common Market (1969) | Common market |
| CACM—Central American Common Market (1961) | Customs union |
| CARICOM—Caribbean Community (1973) | Common market |
| MERCOSUR—Southern Cone Common Market (1991) | Common market |
| NAFTA—North American Free Trade Area (1994) | Free-trade area |

# The Role of International Economic Institutions

- Primary difference between international institutions and national governments: the former have limited enforcement power
- However, international institutions help provide order and reduce uncertainty
  - Order and certainty are public goods – intangibles that are different from most goods and services

# Public Goods (Kindleberger goods)

- Public goods are:
  - Non-excludable – the normal price mechanism does not work as a way of regulating access to them
  - Non-rival (or non-diminishable) – they are not diminished or reduced by consumption
  - **<u>Problem of free riding</u>**: the production of public goods (coordination and international financial and trade architecture) relies on voluntary association.
- Private markets fail to supply public goods because of free riding – *people have no incentive to pay for a public good because they cannot be excluded from its consumption even if they did* not *pay*.

# International Public Goods

**TABLE 2.4** Four Examples of International Public Goods

| *Public Good* | *Purpose* |
|---|---|
| 1. Open markets in a recession | To prevent a fall in exports from magnifying the effects of a recession. |
| 2. Capital flows to less-developed countries (LDCs) | To assist economic development in poor countries. |
| 3. International money—for settlement of international debts | To maintain a globally accepted system for paying debts. |
| 4. Last resort lending | To prevent the spread of some types of financial crises. |

# Opposition to International Institutions

- International institutions receive two types of criticism
  - 1. Globalization is dangerous and should be limited
    - However, how would curtailing economic and social interactions between people from different countries be beneficial?
    - <u>**Idea:**</u> globalization, economic integration, openness may promote economic growth BUT it gives rise to: increasing poverty; skewed distribution of income; undermines human rights, environmental standards etc.

# Opposition to International Institutions (cont.)

- 2. International institutions are undemocratic: decision-making is closed to participation by civic and social groups, and thus doesn't focus on the most vulnerable groups (**Stiglitz critique**)
  - However, global institutions were created to resolve technical economic problems; they have thus been slow to respond to social problems
  - BUT today, international institutions are today heavily focused on social aspects: fostering education and health standards, and civil and human rights

# Opposition to International Institutions (cont.)

- International institutions face problems in efforts to address criticism.
  - Who is represented by the various groups demanding a voice? Who should the institutions listen to first?
  - Are the demands of a given group good for the nation's development as a whole?

# Coming Attraction

- Chapter 3 deals with theories of trade