Piotr Zientara

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Selected theoretical issues and policy implications

Wydawnictwo Uniwersytetu Gdańskiego

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Introduction

It is hardly in dispute that nations are nowadays linked to each other *via* trade, migration, and investment to a far greater extent than ever before. This is a direct result of globalisation, propelled by the progressive liberalisation of international trade, the intensification of migratory movements, and the propagation of information technology. Furthermore, the rise of emerging economies, in particular the BRICS countries, has changed the existing world order, thereby emphasising the growing role of international bodies, such as the World Trade Organization (trade liberalisation), the International Monetary Fund (rescue for crisis-stricken countries), and the World Bank (socio-economic development and fight against poverty). At the same time, a crescendo of assorted military conflicts – from Syria and Ukraine to Afghanistan and Yemen – as well as a surge in nationalistic sentiment culminating in the Brexit referendum in 2016 have made the global economy a turbulent place. This means that nowadays national policymakers need to pay far more attention to what is going on in different parts of the world.

All of which strengthens the case for studying international economic relations in general and understanding the dynamics of the global economy in particular. In other words, it seems informative to get to know, for instance, how sovereign countries maintain economic ties with each other, how economic integration proceeds, or how international bodies function. This problem had already featured – or taken centre stage – in the seminal works of classical economists. Indeed, such books as David Hume's *Of the Balance of Trade*, Adam Smith's *The Wealth of Nations*, Jean-Baptiste Say's *A Treatise on Political Economy*, David Ricardo's *Principles of Political*

Economy and Taxation, or John Stuart Mill's *Principles of Political Economy* provide (early) insights into the mechanics of international commerce and finance. However important and illuminating in their own right, these books were written in a different socio-economic reality and for a different audience. Hence they are rarely read or consulted by today's students.

Therefore, given that more and more Polish universities offer courses in English, the need arises for an accessible English-language source of knowledge of modern-day international economic relations (there is no gainsaying that, notwithstanding the budding popularity of Chinese, it is English that continues to hold the status of a modern *lingua franca* and, by implication, is the language of business and economics). Thus, the present book – written in English, but with the specificity of Polish academic undergraduate and postgraduate curricula in mind – aspires to meet this unmet demand. In this way, it fills the gap in the literature: there is, to the best of my knowledge, a paucity of English-language books addressed to those who study international economic relations in English, but at Polish universities.

At this juncture, it is essential to address key nomenclature issues. In the Anglo-Saxon literature the term **international economics** (IE) is used to refer to an academic discipline that focuses on the patterns and outcomes of interactions between entities and individuals located in different countries (Krugman, Obstfeld, & Melitz, 2012). More specifically, it studies cross-border flows of goods and services[1] (**international trade**), flows of capital[2] (**international finance**), flows of workers (**international migration**) and, crucially, the dynamics and consequences of economic integration processes. At the same time, one can come across a discipline known as **international political economy** (IPE), which explores an area where economics overlaps with political international relations. In particular, it attempts to explain how political actors and forces (nation states, international institutions and organisations) shape an international "eco-system",

1 This includes, of course, studying the rationale and effects of related policy instruments (such as tariffs and quotas).

2 Together with the effects of movements of capital on exchange rates.

wherein cross-border economic interactions take place. IPE also seeks to find out how economic interactions affect political structures and processes. Thus IPE scholars give much consideration not only to international trade and finance, but also to **international development** (global poverty and inequalities) and to inter-state co-operation. Furthermore, considering the escalation of intra-state military conflicts, special attention is paid to broadly-understood political risk.

In principle, **this book situates itself at the interface between IE and IPE**. It focuses on issues – such as globalisation, the development gap between North and South, or cross-border flows of labour and technology – that pertain either to IE or IPE. It is, therefore, addressed both to undergraduate and postgraduate students of international economic relations, international political economy, or international economics (it might also be of value to those who are interested in current affairs). Crucially, the issues the books deals with are not only timely, but also highly controversial. Indeed, the fact that abject poverty and civilizational retardation continue to fester in Africa (as well as some parts of Latin America) goes a long way towards explaining why so many people decide to seek a better life in Europe or the USA, which, in turn, has provoked an anti-immigrant backlash. This, among other things, lay behind America's withdrawal from the UN Global Compact for Migration and the rise of anti-immigrant parties in Europe.

It follows that the present work contextualises particular issues by directly referring to current developments; each chapter, which starts by providing a brief overview, contains one or two case studies that aim to illustrate a given problem with real-life examples (moreover, at the end of each chapter there is a summary of main learning points). But there is much more to this than that. In fact, by integrating relevant theoretical considerations with actual occurrences and thoughtful reflection, the idea is to **problematise** particular issues pertaining to the realm of international economic relations. In other words, this book should not leave the impression that it provides just concepts, facts, and data – or things to be learned before an exam. It is fair to say, therefore, that this work, by marrying theoretical knowledge with factual information and careful reflection, adopts a distinctive approach that sets it apart from other (typical) manuals, thereby constituting its *differentia specifica*. Arguably, such an approach conduces to a more profound understanding of the subject matter as well as today's complex, multi-faceted reality. I hope that, thanks to all this, the book will not only be an important help in effective learning, but also an interesting read.

Chapter 1

The global economy: History, structure, actors

Chapter 1 focuses on the structure and workings of the global economy. First, it discusses its history, with the collapse of the Berlin Wall seen as a turning point. Then, special attention is paid to the *raison d'être* of main international organisations and institutions as well as to the game-changing rise of emerging economies, such as India and China. Subsequently, the chapter deals with globalisation, highlighting its multi-faceted nature, assorted causes, and nuanced consequences. In this context, emphasis is placed on the criticism levelled at contemporary integration processes and, by implication, on the debate between globalisation's opponents and advocates. It is hoped, therefore, that the chapter presents the full picture.

1.1. The global economy in historical perspective

1.1.1. The cold-war period

Shortly before the end of the Second World War – in July 1944 – 730 delegates gathered at the Mount Washington Hotel in **Bretton Woods** (a resort in New Hampshire) for the **United Nations Monetary and Financial Conference**[3]. They came up with the Bretton Woods system of monetary management, which established the rules for commercial and financial relations among countries (Solomon, 1982). Chief among them was the

[3] **John Maynard Keynes** (representing the UK) and **Harry Dexter White** (representing the USA) were among the delegates.

Gold Exchange Standard, whereby all currencies were pegged to the dollar, which, in turn, was tied to gold (Krugman, Obstfeld, & Melitz, 2012). The officials also conceived the so-called Bretton Woods institutions: the International Monetary Fund (IMF) and the World Bank[4]. In 1945 the war, which took a particularly heavy toll on Europe and Japan, came to an end. Soon, however, another conflict – which is commonly referred to as the cold war – began. It pitted the USA and its Western European allies against the Soviet Union and its satellites. This meant a *de facto* division of the world into two opposing blocs: the capitalist and democratic West and the communist and totalitarian East.

The globe-spanning antagonism was symbolised, in the words of Winston Churchill, by the existence of the **Iron Curtain**. Those countries that were located on the western side of the divide benefited from the **Marshall Plan** (officially known as the European Recovery Program) – an American initiative to help Europe rebuild its economies and, at the same time, thwart the propagation of Soviet communism (Eastern European countries, including Poland, rejected the aid on politico-ideological grounds). The plan, which was in operation from 1948 to 1952, boosted Western Europe's postwar reconstruction and lay the foundation for its future prosperity. Indeed, the late 1950s and the following decade saw an unprecedented economic boom that ensured full employment and raised living standards across the board. In particular, West Germany underwent a period of spectacular economic growth, which came to be known as "Wirtschaftswunder"[5]. Already in 1947 the **General Agreement on Tariffs and Trade** was signed (the forerunner of the World Trade Organization), which proved instrumental not only in promoting free trade (see Box 1), but also in integrating the West.

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4 It should be noted that the delegates also put forward a proposal for the creation of the International Trade Organisation (ITO). This body was meant to establish a regulatory framework for international trade. The ITO would have complemented the IMF and the World Bank. Its charter was approved at the Conference on Trade and Employment (held in Havana in March 1948), but it was not ratified by the US Senate. As a result, the ITO never came into existence. Only after half a century did the World Trade Organization saw the light of day.

5 It was *The Times* that coined this term.

In the same year, the state of Israel came into existence. Jewish statehood, however, was not accepted by Arab countries, which has fuelled mutual hostilities ever since. Crucially, in 1957 six Western European countries signed the **Treaty of Rome**, which established the European Economic Community (EEC), the precursor of the European Union.

Box 1. Selected theories of international trade

Smith's theory of absolute advantage holds that the existence of differences in productivity between countries drives specialisation and leads to gains from trade. **This means that each country should specialise in the production of a good it produces most efficiently or, in other words, in the production of which it has an absolute advantage.**

The Ricardian model of comparative advantage is based on the concept of **opportunity cost**, which is the cost of any activity measured in terms of the value of the next best alternative forgone (that is, not chosen). It is the sacrifice related to the second best choice available to someone who has picked among several mutually exclusive choices. The opportunity cost is also the cost (as a lost benefit) of the forgone products after making a choice. Consider the following example: in Portugal 1 metre of cloth costs 1.5 litres of wine and 1 litre of wine costs 2/3 metres of cloth. In the UK 1 litre of wine costs 2 metres of cloth and 1 metre of cloth costs 0.5 litres of wine. England can benefit from trade with Portugal as long as the latter has a comparative advantage in one industry. What matters, therefore, is not England's productivity in wine production relative to Portugal's productivity in wine production (as Smith argued), but the opportunity cost of cloth production in England compared with the opportunity cost of cloth production in Portugal. In other words, it is essential to compare respective opportunity costs rather than productivities. The opportunity cost of the production of wine is lower in Portugal than in the UK, while the opportunity cost of the production of cloth is lower in the UK than in Portugal. **Hence gains from trade can accrue if each country specialises in the production of the product in which it has the lower opportunity cost or, in other words, a comparative advantage.** It follows that Portugal should produce wine, the UK – cloth.

The gravity model is rooted in the Newtonian concept of gravity (i.e., each body attracts another with a force proportional to the product of their masses and with a force inversely proportional to the square of the distance between the centres of their masses). It follows, theoretically, that the volume of trade increases proportionally to the size of economies and decreases proportionally to the distance between them. In practice, all this means that the size of an economy is directly related to the volume of imports and exports and that distance between markets influences transport costs and, accordingly, the cost of imports and exports. Besides, if two countries have cultural ties, it is likely that they also have strong commercial links.

The Heckscher-Ohlin theory, which was proposed by Eli Heckscher in 1919 and subsequently developed by Bertil Ohlin, is based on several assumptions. These include: (1) numbers of countries, factors, and commodities are all two; (2) there are no barriers to trade; (3) perfect competition in the commodities and factors markets; (4) in both countries, there are no economies of scale; (5) transport costs are zero; (6) manufactured goods are homogenous; (7) consumer tastes are similar in both countries; (8) production technology is the same in both countries; (9) factors are perfectly mobile within each country, but perfectly immobile between countries; (10) countries differ in factors endowment; (11) manufactured goods are characterised by different factor-intensity. It holds that a country will export those goods whose production consumes relatively much of a factor that is relatively abundant in this country, and will import goods whose production requires relatively much of a factor that is relatively rare there. **In other words, a labour-abundant country will specialise in and export labour-intensive commodity, whereas a capital-abundant country will specialise in and export capital-intensive commodity.**

The Rybczynski theorem states that at constant relative goods prices, a rise in the endowment (supply) of one factor will lead to a more than proportional expansion of the output in the sector which uses that factor intensively, and an absolute decline of the output of the other good. In the context of the Heckscher-Ohlin model of international trade, open trade between regions means that changes in relative factor supplies, which can lead to an adjustment in quantities and types of outputs between those regions, would return the system towards equality of production input prices (like wages) across countries. To put it another way, wages converge across trading partners with similar technologies, a phenomenon known as factor price equalisation.

The Stolper-Samuelson theorem describes a relation between the relative prices of output goods and relative factor rewards, specifically, real wages and real returns to capital. The theorem states that – under some economic assumptions (constant returns, perfect competition, equality of the number of factors to the number of products) – a rise in the relative price of a good will lead to a rise in the return to that factor which is used most intensively in the production of that good and, conversely, to a fall in the return to the other factor. The owners of abundant factors gain from free trade, the owners of rare factors lose out. The former generally advocate free trade, while the latter lobby for (protectionist) restrictions.

The Leontief Paradox relates to the findings of the eponymous scholar, who, having analysed the US economy, found that the country, being rich in capital, should – in line with Heckscher-Ohlin theory – export more capital-intensive goods and import labour-intensive goods. However, the opposite turned out to be true.

Three factor proportions theory (N-factor theory) was proposed by Jaroslav Vanek, who argued that Leontief might have oversimplified the production functions and failed to recognise the endowments of natural resources. To improve the Heckscher-Ohlin model, he reconceptualised abundance and intensity. He saw international trade of goods as an intermediary tool of trade of the factor's services contained in traded goods.

Theory of technological gap takes as its premise that the same technology is rarely available in all countries and a delay in its diffusion from one country to another is the main reason for trade.

Yet it was also a time that saw the demise of the British and French colonial empires, which marked a new stage in the history of Africa and Asia. The **decolonisation** reached its apogee in 1960 when several African countries, most notably Nigeria, Ivory Coast, and Chad, became independent (in India British rule ended already in 1947; Vietnam, a French colony, regained sovereignty in 1954). The process also intensified the rivalry between the USA and the Soviet Union as the two antagonists, vying for global hegemony, sought to pull newly-born states into the orbit of their influence. This also took the form of competition in space, which culminated in the American landing on the Moon. From a political point of view, therefore, the 1960s were a time of international upheaval, disintegration, and tenseness (in fact, the Cuban missile crisis risked unleashing a new world war, thereby seriously jeopardising peace). But, economically, this was a period of stability and prosperity, albeit mainly in the USA and Western Europe (even though the economic situation in communist countries somehow improved, it was then that the technological-*cum*-developmental gap between the two blocs began to widen sharply)[6].

The next decade, however, was marked by disruptive shocks and economic destabilisation. First, in August 1971 the USA unilaterally withdrew from the Bretton Woods system. The dollar subsequently floated and became a **fiat currency** (thus deriving its value from government regulation or law). This action, known as the **Nixon shock**, turned the dollar into a **reserve currency** (held by governments as part of their foreign exchange reserves and serving as the international pricing currency)[7]. Then came an oil shock – also referred to as the 1973 oil crisis – when the members of the Organization of the Petroleum Exporting Countries (OPEC) imposed an oil embargo. The resulting steep rise in the price of petrol had a considerable impact on Western economies, but allowed oil-exporting countries to accumulate wealth (which, in turn, set off a reversal of the traditional direction of international capital flows – from capital-rich developed economies to less industrialised developing countries). Not only did high oil prices made oil-importing economies fall into recession, but also (indirectly) triggered a transition to a post-industrial economy. Indeed, a sharp fall in demand for steel and coal hit old industrial regions in the USA and the EEC particu-

6 One of the symbols of US technological advancement was the deployment of UNIMATE, the first industrial robot, on a General Motors assembly line at the Inland Fisher Guide Plant in Ewing Township in New Jersey in 1961. The same can be said about the creation of the ARPANET (see the text proper) and the invention of the computer mouse by Douglas Engelbart and Bill English (1968).

7 In 2014 the US dollar accounted for 42.5% of global payments, while the yuan for only 1.4% (IMF, 2014c).

larly hard. Haunted by the spectre of structural unemployment and social exclusion, these areas experienced industrial decline and, consequently, prolonged economic hardship.

At the same time, first symptoms of the infirmity of the European welfare state began to emerge. Accordingly, serious doubts were cast over the rationale and effectiveness of **Keynesian economics** which, at that time, served as the standard economic model (and thereby was regarded as a sort of economic orthodoxy). And it was the UK that, as if in microcosm, embodied most of the weaknesses characterising – and the woes affecting – most contemporary Western European economies. In effect, Britain, suffering from stagflation (a combination of slow growth and high inflation) and burdened with a loss-making state-owned heavy industry (which was a drain on the public purse), became the **"sick man of Europe"**. In 1979 **Margaret Thatcher** became Britain's prime minister – the first woman to hold that office in the UK. Later nicknamed (by a Russian journalist) the "Iron Lady", she came to be known for her uncompromising leadership style and single-minded pursuit of economic liberalisation (Hanson, 1991). In the same year, the **European Monetary System** (EMS), the ancestor of the euro area, was set up.

The late 1970s saw a series of developments that were to prove instrumental in changing the *status quo*. The Soviet invasion of Afghanistan deepened the antagonism between the two blocs, but ultimately turned out to be the USSR's undoing (apart from other ramifications, the invasion caused many Western countries to boycott the Olympic games held in Moscow in 1980). Likewise, the election of a Pole to the papacy in 1978 foreshadowed – and played a non-negligible role in – the collapse of communism a decade later. Furthermore, the market-oriented reforms introduced by **Deng Xiaoping**[8] in the same year paved the way for the emergence and rise of China around the turn of the century. In 1979 a popular revolution overthrew the USA-allied regime of Mohammad Reza Pahlavi in Iran. As a result, the country became a theocracy and a sworn enemy of America,

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[8] It is important to bear in mind that Deng took power in December 1978 at the Third Plenum of the 11th Central Committee Congress of the Communist Party of China.

calling it “the Great Satan”. But it was also the 1970s that saw the making of the first mobile-phone call[9], the invention of the Apple I computer (and the floppy disk) and, critically, the deployment of the **Advanced Research Projects Agency Network** (ARPANET)[10], which was one of the first operational packet-switching networks and hence the progenitor of what was to become the Internet. All these developments laid the foundation for the information technology (IT) revolution, which was to transform the socio-economic reality in the following decades.

What happened in the 1980s, however, turned out to be of truly historic character. To begin with, in 1980 the **Solidarity trade union** was set up in Poland – the first independent labour organisation in the Soviet bloc (Zientara, 2014). As is well known, the activism of Solidarity, alongside the pope’s unswerving support for democracy and America’s anti-communist policy (including the arms race), precipitated the collapse of communism in 1989, which, in turn, put an end to the cold war and, by implication, the Yalta-imposed bipolar world order. But in the same year anti-government demonstrations on Beijing’s **Tiananmen Square** were bloodily put down, thereby dashing hopes of China’s democratisation[11] (the West criticised the government for the massacre and imposed economic sanctions, including an arms embargo). On the other hand, the late 1980s saw, under the influence of **monetarism** (fathered by Milton Friedman and the Chicago School), the introduction of sweeping free-market reforms in some Western countries. This was the case of the UK, where the Thatcher government liberalised swathes of the economy (most notably, finance and the labour market), at the same time embarking on a sweeping programme of pri-

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9 The first mobile-phone call was made by **Martin “Marty” Cooper**, a Motorola engineer, in April 1973 on Avenue of the Americas in New York.

10 The ARPANET came into being already in 1968. Although constituting a major breakthrough in its own right, it is now seen as technically inferior to another packet-switching network, called the CYCLADES (invented by **Luis Pouzin**). This is because on ARPANET strings of packets were akin to train carriages, travelling from station to station. By contrast, on CYCLADES packets were like cars, travelling independently to their individual destinations.

11 Economic reforms resumed in China only after Deng Xiaoping’s southern tour in 1992.

vatisation, whereby several loss-making state-owned enterprises were sold (Hanson, 1991). These changes, coupled with the advent of (productivity-enhancing) computerisation, helped transform the British economy, accelerating the pace of de-industrialisation and prompting the growth of the service sector. Soon similar trends were to manifest themselves across the rich world.

1.1.2. The world after the collapse of the Berlin Wall

In the 1990s powerful transformative forces came to the fore. Eastern European countries began to undergo a painful transition from communism to capitalism (Zientara, 2014). As unprofitable mismanaged state-owned enterprises were shut down or privatised, massive layoffs ensued. The virtual absence of the social safety net only exacerbated the pain. In a similar vein, in 1991 India introduced free-market reforms, opening itself up to international trade and foreign investment. As a result, red tape was cut, tariffs were lowered, and taxes reduced. A year later also China invigorated its programme of economic liberalisation. All this underlay – and was a harbinger of – the fast-growing role of emerging markets in the world economy. In 1992 the signing of the **Maastricht Treaty** created the European Union (while Britain and Italy were forced out of the EMS). In 1994 the **North American Free Trade Agreement** (NAFTA) took effect, integrating more tightly the economies of Canada, the USA, and Mexico, while in 1995 the **World Trade Organization** (WTO) came into existence (see below). Crucially, the invention and propagation of the World Wide Web[12] revolutionised the way people worked and communicated, stimulating the founding of internet-based start-ups (or so-called dotcoms) and the development of e-commerce (Berners-Lee, 2010; Gelernter, 1991). Then in 1997 the Asian financial crisis broke out, raising the spectre of a worldwide economic slump. These fears intensified when in America a dotcom bubble inflated and burst in 2000.

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12 **Tim Berners-Lee**, a British computer scientist, is the father of the World Wide Web.

The 2000s got off to an inauspicious start. First came the above-mentioned stock market crash and then the so-called **war on terror**. After al-Qaeda's terrorist attacks on the World Trade Center in September 2001, the USA launched military operations in Afghanistan and later in Iraq (to disastrous effect). On the Continent euro coins and banknotes entered into circulation in 2002 (and the countries that adopted the currency automatically formed the **euro area**). Two years later eight ex-communist countries (alongside Cyprus and Malta) joined the European Union. The accession had far-reaching implications. It triggered off, among other things, an unprecedented wave of migration from East to West. Thanks to the EU's freedom-of-movement rule, hundreds of thousands of Eastern Europeans found employment and brighter prospects in one of the old Member States (Zientara, 2014). This produced a backlash against immigrants across Western Europe. In America, too, there was a crescendo of anti-immigrant rhetoric, culminating in the decision to construct a fence alongside the US-Mexico border. But the USA also experienced a **shale-gas revolution**, which sent the price of electricity down (thereby enhancing the competitiveness of American business) and, crucially, contributed to a decrease in US carbon-dioxide emissions (thereby reducing the country's carbon footprint).

Yet, above all, the first decade of the 21st century saw the rapid spread of mobile telephony and, with smartphones replacing older handsets, the emergence of m-commerce. At the same time, Web 2.0 became, as it were, a reality – a process reinforced by the emergence of social media (with Facebook and Twitter to the fore)[13]. In 2007 there was a spike in food prices, which had a negative impact on the disposable incomes of those living in the poor world (though some farmers in less developed countries benefited from the rise). Then the financial crisis erupted, resulting in the deepest recession (known as the **Great Recession**) since the Great Depression. The

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[13] The term, coined by Darcy DiNucci, denotes a new chapter in the history of the WWW, whereby users are no longer limited to the passive viewing of content on a given site, but interact with the site's owners (administrators) and with each other by generating content and getting engaged in various forms of online collaboration (of which Wikipedia, founded by Jimmy Wales in 2001, is the best example).

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