Chapter 2
International Economic Institutions Since World War II

■ Outline

Introduction: International Institutions and Issues since World War II
- International Institutions
- A Taxonomy of International Economic Institutions

The IMF, the World Bank, and the WTO
- The IMF and World Bank
- The GATT, the Uruguay Round, and the WTO
- *Case Study:* The GATT Rounds

Regional Trade Agreements
- Five Types of Regional Trade Agreements
- *Case Study:* Prominent Regional Agreements
- Regional Trade Agreements and the WTO
- For and Against RTAs

The Role of International Economic Institutions
- The Definition of Public Goods
- Maintaining Order and Reducing Uncertainty
- *Case Study:* Bretton Woods

Criticism of International Institutions
- Sovereignty and Transparency
- Ideology
- Implementation and Adjustment Costs

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What Students Should Know after Reading Chapter 2

Chapter 2 introduces the major international governmental organizations of the global economy. This background material is designed to remove some of the mystery about the IMF, World Bank, WTO, and GATT early in the course. Chapter 2 also addresses both the need for these organizations and the criticisms against them. Institutions are supposed to reduce uncertainty and increase stability. Drawing on material from the new institutionalists, such as Doug North, the chapter introduces international institutions as organizations that set the rules that govern behavior and potentially constrain or limit a nation's actions.

Chapter 2 makes the case for international institutions and addresses some of the criticism they have received. It defines international public goods and addresses the free-rider problem. It gives some examples of international economic crises that may have been related to market failures. The main benefits of institutional relationships are the maintenance of order and the reduction of uncertainty. The latter part of the chapter address some of the criticism these organizations receive, including issues related to sovereignty and transparency, ideology, and implementation and adjustment costs.

Another chapter goal is for students to understand the various types of regional trade agreements and the level of policy integration associated with each type of agreement. In the recent past, bilateral and regional trade agreements have expanded more rapidly than multilateral negotiations. Chapter 2 provides a taxonomy of these agreements and includes accompanying arguments for and against as drawn from the economics literature.

Supplemental Lecture Possibilities

1. The Global Players: Given some of the sub-themes of this chapter, it usually takes a day to lecture on what I call the global players: national governments, international multilateral and regional organizations, multinational or transnational corporations, and nongovernmental organizations. Understanding issues related to global economic development, the politics of trade policies and agreements, the responsibilities and criticisms of international economic institutions, and other current developments requires a clear sense of who the players are and what they bring to the table. I define each of these players and address their strengths and weaknesses. I focus on economic development, national sovereignty, and how trade-related laws are negotiated and changed. For development, I focus on the increasing role of direct foreign investment, which covers multinational corporations and national governments. Criticisms of world trade often come from civil society/NGOs, who often have a special role to play in the least-developed countries.

2. In presenting the major international organizations that deal with the global economy, it is useful to do a historical overview. What happened in terms of trade, foreign investment, and exchange rates from World War I through the Bretton Woods conference that made the United States and the United Kingdom think the IMF, World Bank, and something resembling GATT were necessary institutions? By covering prior crises, we can explain the framework in which the Bretton Woods institutions were created and how they operate. The prior lecture on the global players helps students understand why it was easy to create institutions that were banks and more difficult to create an institution that would affect trade laws.

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3. Prior to starting Chapter 3, some instructors prefer to go directly from Chapter 2 to a case study on a specific regional trade agreement. Chapter 14 on the European Union is one such case study. One purpose moving to a specific case study is to familiarize students with the various levels of economic integration as well as the concepts of "widening" versus "deepening." Students tend to be able to handle Chapter 14 without first having a more theoretical base, and it builds some interest in later topics such as foreign exchange. It also gives them a real-world foundation for understanding trade theory.

■ Assignment Ideas

Most important international organizations have Web sites where they provide a large variety of information as well as detailed descriptions about themselves. Students could be assigned to choose an organization, go to its Web site, and use the information there to write a short paper (two to three pages) detailing both the organization's purpose and structure and the institutional environment it creates. In addition, they should be asked to think about which countries have the greatest control over their organization's policies.

The table below contains the URLs for a number of important international organizations. These organizations are particularly relevant throughout the book. Addresses for a large number of additional sites can be found on the United Nations Web server: http://www.unsystem.org.

Name	**URL**
Asia-Pacific Economic Cooperation (APEC)	www.apecsec.org
European Union (EU)	europa.eu
International Labor Office (ILO)	www.ilo.org
International Monetary Fund (IMF)	www.imf.org
Organization for Economic Cooperation and Development (OECD)	www.oecd.org
Organization of American States (OAS)	www.oas.org
United Nations Conference on Trade and Development (UNCTAD)	www.unctad.org
World Bank Group	
World Bank and links to its subgroups	www.worldbank.org
International Finance Corporation (IFC)	www.ifc.org
Multilateral Investment Guarantee Agency (MIGA)	www.miga.org
World Trade Organization (WTO)	www.wto.org

Note that the World Bank is divided into five subgroups, two of which have their own Web sites. These five subgroups are: the International Development Association (IDA), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), the International Bank for Reconstruction and Development (IBRD), and the International Center for Settlement of Investment Disputes (ICSID).

The following questions can be worked into the assignment:

- What is the role of the organization you chose to write about?
- What kind of public good does it try to provide?
- Describe the main elements of the institutional environment it supports.
- What is its structure? Do some countries have a greater voice in setting policies?

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■ Answers to End-of-Chapter Questions

1. What is an institution? Give examples of both formal and informal institutions. Explain how they differ from organizations.

Answer: An institution is a set of rules of behavior. It sets limits or constraints on social, political, and economic interaction. The rules can be formally recognized in a code of laws, club rules, or an organization's standards of behavior. The rules of an institution may also be informal as in the case of table manners or social customs. Examples of formal institutions include civil codes, commercial codes, and university standards of behavior (e.g., regarding plagiarism or sexual harassment). Examples of informal institutions include gift exchanges on birthdays, eating salad with the small fork, and giving up your seat to an elderly person on a crowded bus.

Institutions differ from organizations in the same way that the government of the United States differs from the Constitution. The latter is the set of rules that governs the former. Organizations are associations of individuals or groups, institutions are the rules that determine the limits and imperatives of their behavior.

2. What are the arguments in favor of international organizations? What are the arguments against them? Which do you think are stronger?

Answer: Arguments in favor: International organizations are essential for the containment of national or regional crises and the avoidance of their propagation internationally. By providing a set of rules (institutions) which are certain and known (transparent), they reduce uncertainty and increase stability. In many instances, they overcome problems of free riding in the international economy in order to insure the provision of (international) public goods such as lender of last resort financing for resolving a liquidity crisis, or open markets in a recession.

Arguments against: The text describes the problems with institutions in terms of issues of sovereignty (may force adoption of domestic policies against nation's will or interests), transparency (decision making at institutions may be dominated by others pursuing their own interests), ideology (advice may be bad or biased), and implementation and adjustment costs (asymmetries in negotiation power and in ability to absorb costs imposed). Overall, critics question whether institutions generate economic inequality and compound risks to vulnerable groups.

The issue of which arguments are stronger is ambiguous. Either can be viewed as more cogent. The key is that students understand both arguments and that they develop a set of reasons to support their views.

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3. Give the arguments for and against free trade agreements. How might the signing of a free trade agreement between the United States, Central America, and the Dominican Republic have harmed Bangladesh?

Answer: Proponents of RTAs view them as building blocks for freer, more open, world trade. They are able to perform this function because it is easier for a few countries to reach agreement on difficult trade matters than it is for a large number of countries to reach the same agreements. Furthermore, the domestic effects of a reduction of trade barriers are less dramatic since fewer countries are involved. Import flows and job losses and displacements are smaller and more easily managed. In addition, RTA members can experiment with new agreements, such as labor and environmental standards that are too contentious in a larger set of negotiations. Opponents question these assumptions and argue that RTAs undermine progress toward multilateral agreements, such as the Doha Round of the WTO. They argue that RTAs polarize countries because they are discriminatory against nonmembers and because they disadvantage smaller countries that enter into agreements with large ones, since the small countries lack the ability to negotiate effectively and they are often unable to take advantage of the market opening of the larger country due to their limited infrastructure and other resources.

Bangladesh may be hurt by a free trade agreement between the United States and Central America due to the trade diversion that might result. If Bangladesh is the lowest cost producer of apparel, for example, then a lowering of U.S. tariffs against Central America could result in production for the U.S. market shifting from Bangladesh to Central America.

4. What are public goods and how do they differ from private ones? Give examples of each.

Answer: Public goods are nondiminishable and nonexcludable. Private goods generally share neither of these characteristics. Private goods include most things that are bought and sold in private markets (restaurant meals, clothing, houses, cars, etc.) while public goods are often provided collectively. Public goods include national defense, public airways, civil and commercial codes, and so forth.

5. What are the main tasks or functions of (1) the International Monetary Fund, (2) the World Bank, (3) the General Agreement on Tariffs and Trade, and (4) the World Trade Organization?

Answers:

(1) The IMF's role is to act as a lender of last resort in the case of a debt crisis or foreign exchange crisis. It provides technical expertise and advice and assists national governments with necessary but difficult reorganizations of their national economies.

(2) The World Bank's mission, in general terms, is to assist the economic development of nations through the provision of loans, technical expertise, and advice.

(3) GATT is a series of multilateral trade negotiations and resulting treaties which binds the tariffs and trade policies of nations and limits their ability to arbitrarily change them. Its mission is to keep markets for goods open and to ensure that nations follow a set of rules governing fair trade.

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(4) The WTO is an umbrella organization created by the Uruguay round of GATT. Its role is similar to GATT's, but it has expanded its function to include agreements on services, agriculture, and textiles and apparel, all of which were omitted from the previous rounds of GATT. In addition, it provides rules for the resolution of trade disputes between nations and acts as a forum for the discussion and implementation of further reductions in trade barriers.

6. When nations sign the GATT agreement, they bind their tariffs at their current level, or lower. Tariff binding means that they agree not to raise them except under unusual circumstances. Explain how tariff binding in the GATT prevents free riding during a global slowdown.

Answer: During a global slowdown, nations may be tempted to raise barriers to imports. The hope is that reduced imports will provide greater incentive for domestic production and add jobs in import-competing industries. This part of the strategy usually works but at the cost of the loss of jobs in export industries. Export industries are hurt if other nations retaliate and impose similar barriers to imports.

The problem is that every country wants to let the others be the ones to keep their markets open. The free-rider problem occurs because nations that impose import barriers are free riding on the policies of nations that do not similarly impose barriers. Tariff binding eliminates this possibility.

7. Kindleberger's study of the Great Depression of the 1930s led him to believe that market economies are sometimes unstable and that nations can get locked into prolonged downturns. Other economists are not convinced. Suppose that you disagree with Kindleberger and that you believe that market based economies are inherently stable. How would you view the need for international institutions to address the provision of each of the public goods in Table 2.5?

Answer: If the international economy is inherently stable, then the need for international institutions decreases. Most of the cases where there is a failure to provide the public goods in Table 2.3 are a consequence of the failure governments to implement sound economic policies.

Governments may try to close markets during a recession but enlightened governments recognize this as self-defeating since other nations will retaliate. Government closure of markets is a governmental failure, not a market failure.

Private capital markets will channel funds to developing countries if these countries have the right policies. Again, the problem of capital shortages in developing countries may be as much a failure of the developing country's economic policies as it is a failure of markets.

Private markets will seek out payment methods that are acceptable to all the parties involved.

Financial crises caused by a shortage of liquidity are an indicator of deeper problems. At times, it is necessary to let bad firms fail. These types of crises will burn themselves out and leave little lasting impact on the international economy.

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8. What are the five main types of regional trade agreements and what are their primary characteristics?

Answer: The five main types of regional trade agreements are: (1) a partial trade agreement; (2) a free trade area; (3) a customs union; (4) a common market; and (5) an economic union.

(1) A partial trade agreement frees up trade between two or more countries in a few goods. An example is the U.S.-Canada Auto Pact which created free trade in cars and car parts in the 1960s. It later formed the basis for the U.S.-Canada free trade agreement.

(2) A free trade area allows goods and services to cross international borders without paying a tariff and without limitations imposed by quotas. Many items, such as labor and environmental issues, are usually left out of the agreement. Example: NAFTA.

(3) A customs union is a free trade area plus a common set of tariffs toward non-members. In this situation, members have free trade with each other and agree to levy the same tariff on imports from non-members. Examples: MERCOSUR, and from the mid-1970s to early 1990s, the European Union.

(4) A common market is a customs union plus an agreement to allow the free mobility of inputs such as labor and capital. Example: the European Union in the 1990s.

(5) An economic union is a common market with substantial coordination of macroeconomic policies, including a common currency, and harmonization of standards and regulations. Example: the 12 European Union members that participate in the euro.

Since most formal agreements combine incomplete elements, this classification is more clear-cut than the messier reality.

9. Critics of the global institutions have a variety of complaints about the WTO, the IMF, and the World Bank. Explain the main categories of complaints.

Answer: The text describes the problems with institutions in terms of issues of sovereignty (may force adoption of domestic policies against nation’s will or interests), transparency (decision making at institutions may be dominated by others pursuing their own interests), ideology (advice may be bad or biased), and implementation and adjustment costs (asymmetries in negotiation power and in ability to absorb costs imposed). They especially question the dominance of the United States and industrialized nations in determining the policies institutions set for client countries, since those policies may be wrong or biased or impose particular harm to some groups in the client nations’ populations. Overall, critics question whether institutions generate economic inequality and compound risks to vulnerable groups.

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