



The domestic sources of foreign economic policies

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READER'S GUIDE

How should a nation manage its economic ties with the rest of the world? How should the government regulate the flow of goods, people, and investment to and from foreign nations? Debates over foreign economic policies are a recurring, often volatile feature of national politics in all countries. Indeed, how governments should now be dealing with the multiple facets of 'globalization' is perhaps the single most pressing political issue of our time. It is an issue that has been debated in international institutions, national legislatures, and lecture halls across the world; it has mobilized nationalist populist movements at one end of the political spectrum, and transnational environmental and human rights organizations at the other; and it has led to violent protests and demonstrations in the streets of Seattle, Melbourne, Washington, Genoa, and New York. What are the battle lines in these political debates? How are policies decided in different countries? How do differences in political institutions shape these policy decisions? And how do new ideas and information about policy options filter into politics? This chapter examines each of these questions, focusing on the domestic politics of trade, immigration, investment, and exchange rates.

Introduction

Each government must make choices about how best to manage the way its own economy is linked to the global economy. It must choose whether to open the national market to international trade, whether to liberalize trade with some nations more than with others, and whether to allow more trade in some sectors of the economy than in other sectors. Each government must also decide whether to restrict international flows of investment in different sectors and whether to regulate immigration and emigration by different types of workers. And it must either fix the exchange rate for the national currency or allow the rate to fluctuate to some degree in response to supply and demand in international financial markets.

Of course, if every government always made the same choices in all these areas of policy, things would be very simple for us as scholars (and much more predictable for us as citizens of the world). But governments in different countries, and at different moments in history, have often chosen radically different foreign economic policies. Some have closed off their national economies almost completely from the rest of the world, imposing strict limits on trade, immigration, and investment—an example is China in the 1960s, which kept itself almost entirely isolated from the rest of the world's economies. In other instances, governments have adopted the very opposite approach, allowing virtually unfettered economic exchange between their citizens and foreigners—ironically, Hong Kong in the 1960s may be the best example of this type of extreme openness. Most governments today adopt a mixture of policies that fall somewhere in the middle, imposing selective controls on activities that affect some sectors of their economy and restricting exchange with some foreign countries more than with others. Understanding why governments make the particular choices they do requires careful attention to the political pressures they face from different domestic groups and the political institutions that regulate the way collective decisions are made and implemented.

Politics, we know, is all about who gets what, when, and how. Different individuals and groups in every society typically have very different views about what

their government should do when it comes to setting the policies that regulate international trade, immigration, investment, and exchange rates. These competing demands must be reconciled in some way by the political institutions that govern policy making. To really understand the domestic origins of foreign economic policies we thus need to perform two critical tasks:

- 1 Identify or map the policy preferences of different groups in the domestic economy.
- 2 Specify how political institutions determine the way these preferences are aggregated or converted into actual government decisions.

The first step will require some economic analysis. How people are affected by their nation's ties with the global economy, and thus what types of policies they prefer to manage those ties, depends primarily on how they make their living. Steelworkers typically have very different views about most foreign economic policies from wheat farmers, for instance, because such policies rarely affect the steel and wheat industries in similar fashion. Of critical importance here are the types of assets that individuals own and how the income earned from those assets is affected by different policy choices. The second step calls for political analysis. How political representatives are elected, how groups organize to lobby or otherwise influence politicians, and how policies are proposed, debated, amended, and passed in legislatures, and then implemented by government agencies, all depend on the structure of political institutions. Democratically elected leaders face very different institutional constraints from military dictators, of course, and even among our democracies there is quite a wide range of institutional variation that can have a large impact on the behaviour of policy makers.

These two analytical steps put together like this, combining both economic and political analysis in tandem, are generally referred to as the *political economy* approach to the study of policy outcomes. In the next two sections we will consider each of the two analytical steps in some detail, examining the domestic sources of policies in the areas of trade,

immigration, investment, and exchange rates. Then we will shift gears a little, and consider the ways in which ideas and information might affect policy making. We will also discuss linkages between the different policy dimensions and non-economic issues, focusing on environmental and human rights con-

cerns and how they feature in debates over foreign economic policies. Finally, to link all this to the chapter that follows, in the conclusion we will briefly consider the impact of domestic politics on bargaining over economic issues between governments at the international level.

Policy preferences

The guiding assumption here is that, when it comes to taking positions on how to regulate ties with the global economy, individuals and groups are fundamentally concerned with how different policy choices affect their incomes. Of course people may also have important non-material concerns that affect their attitudes toward foreign economic policies. Many people are concerned about the cultural implications of globalization, for instance, and its impact on the world's environment and on human rights, and these concerns may have an impact on their views about the regulation of international trade, immigration, and investment. We will discuss some of these important considerations in more detail later in the chapter. But we begin here with the simplest possible framework in which economic policies are evaluated only in terms of their economic effects. Given that organized producer groups have almost always been the most vocal participants in domestic debates about foreign economic policies, and the debates themselves have been couched mainly in economic terms, this seems like an appropriate way to begin.

Trade

The dramatic growth in international trade over the last few decades has intensified political debate over the costs and benefits of trade openness. In the United States, the controversy surrounding the creation of the North American Free Trade Agreement (NAFTA) in 1993 was especially intense, and similar arguments have arisen in Europe over the issue of enlargement of the European Union and over attempts to reform the Common Agricultural Policy.

Rapid trade policy reforms have also generated a significant political backlash in many developing nations. And recent years have witnessed violent protests and demonstrations by groups from a variety of countries that hope to disrupt meetings of the World Trade Organization (WTO). Political leaders around the world frequently voice concerns about the negative effects of trade and the need to protect their firms and workers from foreign competition.

What is behind all of this political fuss and bother? At first glance it may seem puzzling that there is so much conflict over trade. After all, the most famous insight from all of international economics is the proof that trade provides mutual gains: that is, when countries exchange goods and services they are all generally better off. Trade allows each country to specialize in producing those goods and services in which it has a comparative advantage, and in doing so world welfare is improved (see Chapter 1, Box 1.8).

While there are gains from trade for all countries in the aggregate, what makes trade so controversial is that, among individuals within each country, trade creates winners and losers. How trade affects different individuals depends upon how they earn their living. To flesh out this story, economists have traditionally relied upon a very simple theory of trade devised by two Swedish economists, Eli Heckscher and Bertil Ohlin. In the Heckscher-Ohlin model of trade, each nation's comparative advantage is traced to its particular endowments of different factors of production: that is, basic inputs such as land, labour, and capital that are used in different proportions in the production of different goods and services. Since the costs of these inputs in each country will depend on their availability, differences in factor endowments across countries will create differences in comparative

advantage. Each country will tend to export items whose production requires intensive use of the factors with which it is abundantly endowed relative to other nations; conversely, each country will import goods whose production requires intensive use of factors that are relatively scarce. Countries well endowed with land, like Australia and Canada, are expected to export agricultural products (for example, wheat and wool), while importing products that require the intensive use of labour (for example, textiles and footwear) from more labour-abundant economies like China and India. The advanced economies of Europe, Japan, and the United States, well endowed with capital relative to the rest of the world, should export capital-intensive products (for example, automobiles and pharmaceuticals), while importing labour-intensive goods from less developed trading partners where supplies of capital are scarce compared to supplies of labour.

Building on this simple model of trade, Wolfgang Stolper and Paul Samuelson derived a famous theorem in 1941 that outlined the likely effects of trade on the real incomes of different sets of individuals within any economy. According to the Stolper-Samuelson theorem, trade benefits those who own the factors of production with which the economy is relatively well endowed and trade hurts owners of scarce factors. The reasoning is straightforward: by encouraging specialization in each economy in export-oriented types of production, trade increases the demand for locally abundant factors (and bids up the earnings of those who own those factors), while reducing demand for locally scarce factors (and lowering the earnings of owners of such factors). In Australia and Canada, the theorem tells us that landowners should benefit most from trade, while workers can expect lower real wages as a consequence of increased imports of labour-intensive goods. In Europe, Japan, and the United States, the theorem predicts a fairly simple class division over trade: the trade issue should benefit owners of capital at the expense of workers. The converse should hold in relatively labour-abundant (and capital-scarce) developing economies like China and India, where trade will raise the wages of workers relative to the profits earned by local owners of capital.

By revealing how trade benefits some people while making others worse off, the Stolper-Samuelson theorem thus accounts for why trade is such a divisive

political issue. The theorem also provides a neat way to map the policy preferences of individuals in each economy. In each nation, owners of locally abundant factors should support greater trade openness, while owners of locally scarce factors should be protectionist. There is a good deal of evidence in the histories of political conflict over trade in a variety of nations that fits with this simple prediction (see Rogowski 1989). In Australia, for instance, the first national elections in 1901 were actually fought between a Free Trade party, representing predominantly rural voters, and a Protectionist party that was supported overwhelmingly by urban owners of capital and labour. A very similar kind of political division characterized most debates over trade policy in Canada in the late nineteenth century, with support for trade openness emanating mostly from farmers in the vast western provinces. In Europe and Japan, in contrast, much of the opposition to trade over the last century or so has come from agricultural interests, anxious to block cheap imports of farm products from abroad. In the United States and Europe, at least since the 1960s, labour unions have voiced some of the loudest opposition to trade openness and have called for import restrictions aimed at protecting jobs in labour-intensive industries threatened by foreign competition.

On the other hand, political divisions and coalitions in trade politics often appear to contradict this simple model of preferences. It is quite common to see workers and owners in the same industry banding together to lobby for protective import barriers, for instance, in contemporary debates about policy in Europe and the United States, even though the Stolper-Samuelson theorem tells us that capital and labour are supposed to have directly opposing views. So what is going on here? The critical problem seems to be that the theorem is derived by assuming that factors of production are highly mobile between different industries in each economy. An alternative approach to mapping the effects of trade on incomes, often referred to as the 'specific factors' model, allows instead that it can be quite costly to move some factors of production between different sectors in the economy. That is, different types of land, labour skills, and capital equipment often have a very limited or specific use (or range of uses) to which they can be put when it comes to making products. The plant and machinery used in modern manufacturing industries

Box 3.1 The repeal of the Corn Laws

The story of the repeal of Britain's protectionist Corn Laws in 1846 is perhaps still the best-known example of a political clash over trade policy that fits nicely with the Stolper–Samuelson theorem. With the revival of foreign trade after the Napoleonic Wars, policy debates in Britain began to focus on the protectionist Corn Laws that restricted importation of various grains (wheat, rye, barley, and oats, as well as peas and beans), defended resolutely by the landowning elite. Pressure for reform came most strongly from manufacturers, and especially textile producers in Leicester and Manchester, anxious to reduce labour costs (see McCord 1958). It was these manufacturers who formed the leadership of the Anti-Corn Law League in 1838, and a cotton manufacturer, Richard Cobden, became the League's most famous advocate. The push for reform soon drew a larger following among both the urban middle and working classes, and attracted support from the working-class Chartist reform movement, which organized the 'bigger loaf' campaign in the 1840s (Magnus 1964: 65–6). The effects were soon felt in Parliament, transformed by the Great Reform Act of 1832 and the enfranchisement of voters in the large industrial centres of the West Riding. Cobden himself entered Parliament in 1841, campaigning with the cry 'You must

untax the people's bread!' and the League stepped up its campaign with a storm of pamphlets, petition drives, public meetings, and addresses to labour unions. The widespread economic distress of the early 1840s had a great impact on the Tory prime minister, Robert Peel. He introduced a sliding scale for grain duties in 1841 and then reduced those rates slightly in 1842 and 1844, in an attempt to ease the food crisis, but this aroused fierce opposition from landed interests and from within Conservative ranks. The failure of the potato crop in 1845, and the ensuing crisis, gave Peel the pretext to act. Amid reports of widespread starvation, the prime minister pushed through a bill to repeal the Corn Laws altogether, with support from Liberals and Radicals. The conflict over repeal split the Conservatives irrevocably. Once 'purified' of their Peelite faction, the Tories (known for years as the Protectionists) were increasingly isolated on the trade issue in Parliament. Peel's supporters, including Gladstone, gravitated to the Liberals, and their free-trade platform drew on an immense base of support among urban industrialists, the middle classes, and workers. Gladstone's first budget as prime minister in 1860 effectively eliminated all remaining protectionist duties in Britain.

is very specialized: the presses used to stamp out automobile bodies are only designed for that purpose, for instance, and cannot be adapted easily or quickly to perform other tasks. Steel factories cannot easily be converted into pharmaceutical factories or software design houses. Nor can steelworkers quickly adapt their skills and become chemical engineers or computer programmers.

In the specific factors model, the real incomes of different individuals are tied very closely to the fortunes of the particular industries in which they make their living. Individuals employed or invested in export industries benefit from trade according to this model, while those who are attached to import-competing industries are harmed (see Jones 1971; Mussa 1974). In the advanced economies of Europe and the United States, the implication is that owners and employees in export-oriented industries like aerospace, pharmaceuticals, computer software, construction equipment, and financial services, should

be much more supportive of trade than their counterparts in, say, the steel, textiles, and footwear industries, which face intense pressure from import competition. There is much evidence supporting these predictions in the real world of trade politics, especially in the debates over trade in the most advanced economies where technologies (and the skills that complement them) have become increasingly specialized in many different manufacturing and service industries, and even in various areas of agriculture and mining production (see Hiscox 2002; Magee 1980). In the recent debates over regional and multilateral trade agreements in the United States, for instance, some of the most vociferous opposition to removing barriers to trade has come from owners and workers aligned together in the steel and textile industries.

The leading research on the political economy of trade now routinely assumes that the specific factors approach is the most appropriate way to think about

trade policy preferences, at least in the contemporary context in the advanced economies (see Grossman and Helpman 1994; Rodrik 1995), so we will rely upon it for the most part in the discussions below. This model, it is worth noting, is still nested within the broader Heckscher–Ohlin theory that explains trade according to differences in factor endowments. Newer theories of trade, motivated by some clear evidence that not all trade seems to fit well with this simple endowments-based theory (for example, Europe, Japan, and the United States all importing automobiles from each other), have made some significant departures from the standard Heckscher–Ohlin framework. One innovation is to allow that technologies of production and tastes among consumers may vary substantially across countries. Such differences might affect the types of products an economy will be likely to export and import, but the predictions about trade policy preferences derived from the specific factors approach are not otherwise affected: individuals engaged in export industries favour trade, while those in import-competing industries oppose trade. A more complicated innovation in trade theory allows for the possibility of economies of scale. In some industries requiring large investments of capital, the largest firms may enjoy such a dramatic cost advantage over smaller firms that those markets tend to be dominated by only a few, very large corporations. In such cases, in which firms compete with one another and with foreign rivals for different market niches, trade may have different effects for firms in the same industry. These types of complexities are difficult to incorporate into a broadly applicable model of trade, however, so we will not pursue them here. Although it might be pointed out that large firms that enjoy economies of scale in production also tend to engage in foreign investment, locating parts of their enterprise in different nations. Below we will discuss the political implications of this type of multinational investment in more detail.

Immigration

Of course globalization is not simply a matter of the amount of trade in goods and services, it also involves international flows of the factors of production themselves—the migration of workers between nations

and international investment and lending that transfers capital across borders. There is not a radical difference between how we analyse these phenomena and how we examined trade, but neither is the analysis identical in terms of the economic effects and the policy preferences that we anticipate for different sets of individuals within each nation.

Political debates about immigration policy have been rising in volume and intensity in recent years in almost all Western economies. On the one hand, immigration is seen by many as an economic and cultural lifeline that can supply firms in key industries with skilled workers while also injecting new artistic and intellectual life into the nation. On the other hand, many people are concerned that immigrants take jobs away from local workers and create ethnic enclaves that can balkanize a nation and lead to more crime and other social ills. These latter concerns have encouraged the recent imposition of much tighter immigration controls in many countries, while also nurturing the growth of extremist anti-immigrant political movements in several European countries and increasing the incidence of hate crimes directed toward immigrants. The debate seems certain to continue in the years ahead, and grow fiercer.

Historically, immigration has almost always been a more politically controversial topic than trade or investment. The issue is so sensitive that tight restrictions on immigration are nearly universal. Again, this makes little sense if we look only at the aggregate welfare effects of international labour flows. It is easy to demonstrate that when labour is free to migrate to countries where it can be more productive (and earn correspondingly higher wages), there will be an increase in total world output of goods and services. And total output must also increase in any economy that allows more immigrants to enter. This expansion in production makes it possible, in principle, for everyone to enjoy higher standards of living. Migration flows can actually serve the same economic purpose as trade flows. Indeed, in the standard Heckscher–Ohlin model of trade described above, trade is simply a function of country differences in endowments of labour and other factors, and so international movements of goods and international movements of factors are actually substitutes for one another. Countries that are abundantly endowed with labour, like China and India, and in which wages

are thus quite low compared to wages paid elsewhere, are not only natural suppliers of labour-intensive exports for the world market, they are also natural suppliers of emigrants.

As we already know, however, what matters most for politics is not that aggregate welfare gains are possible from exchanges (of goods or factors) between economies; what matters most is that some people gain and other people lose. Which individuals are most likely to oppose immigration? Again, the standard economic analysis emphasizes the importance of the different types of productive factors—including land and capital, as above, with an additional distinction made between high-skilled labour (or ‘human capital’) and low-skilled or blue-collar labour. What is critical, as you will have already guessed, is the impact that immigration can have on relative supplies of factors of production in the local economy. If immigrants have low skill levels, as is typically assumed when discussing the effects of immigration in the advanced economies of Europe and North America, allowing more immigration will increase the local supply of low-skilled labour relative to other factors. The effect is to lower the real wages of all low-skilled workers, as the new arrivals price themselves into employment by accepting lower pay, while raising the real earnings for local owners of land, capital, and skills, as demand for these other factors increases. Of course, if a nation only allows *high-skilled* workers to immigrate, the effect will be lower real wages for high-skilled workers, but higher real earnings for low-skilled workers and owners of land and capital.

The basic results from this simple model of the impact of immigration—often referred to as ‘factor-proportions’ analysis (see Borjas, Freeman, and Katz 1996; Borjas 1999)—are widely applicable. Immigration always harms local workers with similar skill levels to those of the arriving workers, while benefiting local owners of other factors. Even if we allow for high levels of trade, which can partially offset the impact of immigration as economies adjust to the change in factor supplies by importing less of some goods that can now be produced locally at a lower cost, the effects are always in the same direction—although they may become very small in size, and even disappear altogether, if the local economy is very small relative to other economies and if the inflow of immigrants is very small in magnitude (Leamer and

Levinsohn 1995). The effects are even generally the same if we allow that the skills of workers can be highly ‘specific’ to particular industries, though the impact of immigration on earnings will be larger for high-skilled (specific) workers in some industries than in others. Any inflow of unskilled labour will be especially valuable for high-skilled workers in sectors that use unskilled labour more intensively, for example, but it will still benefit all high-skilled workers since output (and demand for their skills) will rise in each industry. On the flip side, an inflow of any type of high-skilled labour will generate the largest decline in earnings for high-skilled workers in the same industry (those who own the very same specific skills as the immigrants). But it will also hurt high-skilled workers in other industries in the local economy whose earnings will suffer, albeit in a relatively minor way, as demand for their types of specific skills falls in response to the expansion taking place in the industry into which the skilled immigrants have moved.

So again, we have a very simple and generally applicable way of identifying the policy preferences of individuals. Individuals can be expected to oppose any policy that would permit immigration of foreign workers with similar skill levels, but they will support other types of immigration. Individuals who make their living from ownership of land and capital are likely to be the strongest supporters of more open immigration laws. If we look at the actual political debates over immigration laws in particular countries, the general alignment of interests seems to fit rather well with these expectations. Typically, the most vocal opposition to changes in immigration laws that would permit more low-skilled immigration comes from labour unions representing blue-collar workers. In the United States, for instance, the AFL-CIO has traditionally taken a very tough stance in favour of restrictive immigration laws and border control measures aimed at stemming illegal immigration into the country from Mexico (Tichenor 2002: 209). American business and farm associations have taken a very different position, often lobbying for more lenient treatment of illegal immigrants and for larger quotas in various non-immigrant working visa categories. In similar fashion, trade union federations in Britain, France, and Germany have raised protests about enlargement of the European Union and the possible influx of low-skilled workers into their

economies from new member countries in Southern and Eastern Europe. High-skilled workers have not shied away from immigration politics either, often lobbying to restrict inflows of immigrants with skills that match their own and would thus pose a competitive threat in the local labour market—the American Medical Association, for instance, the organization which represents doctors in the United States, has pushed hard in recent years to limit the number of foreign doctors granted visa status while also making it more difficult for them to obtain licences to practice.

This simple approach to the political economy of immigration restrictions is very useful, at least as a first step toward understanding the political forces that are likely to shape policy outcomes. It is extremely difficult, however, to analyse the politics of immigration without examining non-economic concerns among individuals having to do with questions of culture and identity. Immigration policy, after all, has a profound impact on who makes up the nation itself. In this way it is quite different from trade policy. A great deal of recent research suggests that divisions among individuals over immigration policy are most strongly related to fundamental differences in cultural values associated with ethnic and racial tolerance and cosmopolitanism (for example, Espenshade and Calhoun 1993; Citrin et al. 1997; McLaren 2001). This question of whether preferences

related to non-economic issues have a profound effect on attitudes toward foreign economic policies is one that we will return to below.

Foreign investment

Capital can also move from one country to another. These movements usually do not take the form of a physical relocation of some existing buildings and machinery from a site in one nation to another site abroad (the equivalent to worker migration). Instead, they take the form of financial transactions between citizens of different nations that transfer ownership rights over assets: a firm in one country buys facilities abroad that it can operate as a subsidiary, for instance, or individuals in one country buy shares of foreign companies, or a bank in one country lends money to foreign firms. All such transactions increase the stock of capital available for productive use in one country, and decrease the stock of capital in another country.

The dramatic increase in the volume of international capital flows over the past forty years, outstripping the increase in trade, has had a profound impact on the international economy. Short-term flows of capital in the form of ‘portfolio’ investment (purchases of company shares and other forms of securities including government bonds), which can

Box 3.2 The ‘new world’ closes its door to immigrants

Beginning in the 1840s and 1850s, there was a huge surge in emigration from England, Ireland, and other parts of Europe and Asia to the ‘New World’ economies in North and South America and Australasia where labour was relatively scarce and wage rates were comparatively high. The rudimentary border controls and open policy toward immigrants in these frontier economies meant that labour flows responded quite quickly to economic events—and in particular, to gold rushes and other ‘booms’ associated with the construction of railways and the birth of new industries. Over time, however, as labour unions became more organized and politically influential in the New World economies, greater restrictions on immigration were imposed. The political pressure for limits on immigration became especially strong during economic

recessions, when local rates of unemployment often rose swiftly and labour groups blamed new immigrants for taking jobs away from ‘native’ workers (see Goldin 1994). Between the 1880s and the 1920s, all the new world economies gradually closed themselves off to immigration (see O’Rourke and Williamson 2000). In the United States, the first bans were imposed on Chinese immigrants in 1882 and then immigrants from all Asia in 1917, when a tough literacy test was also introduced as a way of limiting inflows of low-skilled workers. In 1921 the Emergency Quota Act placed severe restrictions on all new arrivals. The strongest political support for these measures came from north-eastern states with highly urbanized populations working in manufacturing industries, where labour unions were particularly well organized and vocal.

change direction quite rapidly in response to news and speculation about changing macro-economic conditions and possible adjustments in exchange rates, have had a major impact on the choices governments can make when it comes to monetary and exchange-rate policies. Longer-term capital flows in the form of 'direct foreign investment' (where the purchase of foreign assets by a firm based in one country gives it ownership control of a firm located on foreign soil), have perhaps been even more politically controversial since the activities of these multinational firms can have a major impact on economic conditions in the host nations in which they manage affiliates. Many critics of multinational corporations fear that the economic leverage enjoyed by these firms, especially in small developing nations, can undermine national policies aimed at improving environment standards and human rights. The political debate over direct foreign investment is thus highly charged.

Tight restrictions on both short- and long-term investment by foreigners have been quite common historically, although the controls have been much less strict than those typically imposed on immigration. Clearly these controls cannot be motivated by a desire for economic efficiency. If such controls are removed and capital is allowed to move freely to those locations in which it is used most productively (and where it will be rewarded, as a result, with higher earnings), it is easy to show that the total output of goods and services will be increased in both the country to which the capital is flowing and in the world economy as a whole. Again, this expansion in aggregate production makes it possible, in principle, to raise the standard of living for people everywhere. International investment, just like the migration of workers examined above, can serve the same economic purpose that is otherwise served by trade. International flows of capital substitute for the exports of capital-intensive goods and services in the benchmark Heckscher-Ohlin model. In general, then, we can expect that the advanced industrial economies of Europe and the United States, which have abundant local supplies of capital for investment and in which rates of return on capital are thus quite low compared with earnings elsewhere, are the natural suppliers of capital (as well as capital-intensive goods) to poorer nations in which capital is in relatively scarce supply.

One point worth making here about the likely direction of capital flows concerns the distinction between lending and portfolio flows of capital and direct foreign investment (see Ravenhill, Chapter 1 in this volume). It is reasonable to imagine that the former types of international investment are driven purely by the quest to maximize (risk-adjusted) rates of return on capital, in line with the Heckscher-Ohlin model. With the small caveat that capital-poor developing countries are often politically unstable, and high levels of risk can deter investors, we should nevertheless expect large flows of capital from the industrial nations to the developing world. It is much less clear that economy-wide differences in rates of return are critical for explaining patterns in direct foreign investment. There is certainly a considerable amount of direct investment by European, American, and Japanese firms in developing nations, with many firms setting up a 'vertical' multinational structure of enterprises that locates land or labour-intensive parts of the production process in developing nations. But the vast bulk of direct foreign investment in the modern world economy actually takes the form of capital flows between the industrial economies themselves, with firms creating 'horizontal' structures in which similar functions are performed in facilities in different locations (see Graham and Krugman 1995: 36). This type of investment does not fit well with the standard Heckscher-Ohlin predictions based upon factor endowments, and is best explained instead by the special advantages that firms in some industries gain by jumping borders (and trade barriers) and by internalizing transactions within the firm itself. Firms that rely heavily upon specialized technologies and management and marketing expertise may have a hard time selling these kinds of intangible assets to foreign companies it would like to contract with as suppliers or distributors; instead, it may make far more sense to keep all these relationships within the firm (see Hymer 1976; Caves 1982). Many of these types of horizontal multinational firms also appear to have been established to secure access to foreign markets into which they might not otherwise be able to sell because they faced trade barriers. This 'tariff-jumping' motive was a big factor in motivating Japanese auto firms to set up manufacturing facilities in both Europe and North America beginning in the 1980s. The implication is that there is often a strong

connection between the effects of trade policies and investment (and investment restrictions), a topic we will return to in the final section of the chapter.

Now, putting aside the aggregate welfare gains that international movements of capital make possible, which individuals are likely to benefit from such capital flows and which individuals will lose out? Here we can simply apply the logic of the same 'factor proportions' approach we used above to outline the effects of immigration. We might distinguish between different types of capital, in the same way we distinguished between low- and high-skilled labour above, and set apart lending and short-term or portfolio investment flows from direct foreign investment. But to keep things simple here we will just consider them all as a single form of capital. What is critical here, of course, is the impact that inflows of any foreign capital have on relative supplies of factors of production in the local economy. Allowing more inflows of capital from abroad will increase the local supply of capital relative to other factors and thus lower real returns for local owners of capital. At the same time, inflows of investment will raise the real earnings of local owners of land and labour by increasing demand for these other factors of production.

Again, even allowing for the fact that trade flows can partially offset the impact of international movements of factors of production—economies that get inflows of capital from abroad may adjust by importing fewer capital-intensive goods and producing more of them at home, since they are now less costly to make locally—the direction of the effects on the incomes of different groups is always the same. Local owners of capital are disadvantaged by inflows of foreign capital; local landowners and workers (in all categories) are better off. These effects may diminish in size in cases in which the local economy is very small relative to others and the inflow of capital is very small in magnitude, as we noted above when discussing the income effects of immigration, but they are always working in the same direction. And again, parallel with the analysis of immigration flows, these income effects are not drastically affected by allowing that capital can take forms that are highly 'specific' to use in particular industries, though the effects may be larger for owners of some types of capital than others. This is especially relevant when we think about direct foreign investment, which typically involves the

relocation of a particular set of manufacturing or marketing activities that require very specific types of technologies in one particular industry. An inflow of any type of specific capital will of course result in a decline in earnings for local owners of capital in the same industry; it will also hurt all others who own specific types of capital used in different industries, in a more marginal way of course, as demand for their assets will fall in response to the expansion taking place in the industry favoured by foreign investment.

We can thus expect that policies allowing greater inflows of foreign capital will be strongly opposed by individuals who own capital in the local economy, but such policies will be supported by local landowners and workers. There is some evidence that does fit well with these basic predictions. Perhaps the best example involves the way European and American auto companies have supported restrictions on the operations of local affiliates of their Japanese rivals since the 1980s. In Europe, auto firms pushed hard for an agreement with Japan that included in the limits set on the total Japanese market share of the European auto market, cars produced in Japanese affiliates. In the United States, after some initial hesitation (perhaps reflecting the fact that they had themselves set up numerous foreign transplant firms around the world) the US auto firms supported a variety of proposals for 'domestic content' laws that would have placed local affiliates of Japanese auto makers at a considerable disadvantage by disrupting their relationships with parts suppliers at home (Crystal 2003). The 'big three' American firms (Ford, General Motors, and Chrysler) also seized the opportunity to demand high local content requirements in the 'rules of origin' for autos in the negotiations over the 1993 North American Free Trade Agreement, ensuring that they would have a major advantage over Japanese transplants producing cars in Mexico for the North American market. Interestingly, the workers that we would expect to be strongly supportive of incoming Japanese investment in the auto industry, represented by the United Auto Workers union, were actually quite lukewarm—perhaps because they had long advocated that tough domestic content rules be applied to American firms, to prevent them from transplanting their parts manufacturing facilities to Canada and Mexico, and perhaps also in response to concerns that the foreign transplants setting up in southern

American states like Tennessee (Nissan) and Kentucky (Toyota) were not employing union members.

Foreign investment tends to be even more politically controversial in developing nations, where the behaviour of large foreign corporations can have profound effects on the local economy and on local politics. One particular concern among critics of multinational firms has been the role that several large corporations have apparently played in supporting authoritarian governments that have restricted political organization among labour groups, limited growth in wage rates, and permitted firms to mistreat workers and pollute the environment (see Evans 1979; Klein 2002). While the evidence is not very clear, local owners of capital may well have muted their opposition to investments by foreign firms in order to support authoritarian policies adopted by military regimes in some cases: in Nigeria, for instance, where Shell (the European oil company) has long been the major foreign investor, or more recently in Myanmar, where Unocal (an American oil and gas firm) is the key foreign player. But the basic competitive tension between local capitalists and foreign firms (whose entry into the economy bids down local profits) is typically very obvious even in these unstable and non-democratic environments, as local firms have often encouraged their governments to impose severe restrictions on foreign investments, including onerous regulations stipulating that foreign firms use local rather than imported inputs, exclusion from key sectors of the economy, and even nationalization (seizure) of firms' assets (Jenkins 1987: 172). Newer evidence suggests that, as we might expect given the preferences of labour in capital-poor developing nations, left-wing governments backed by organized labour have made the strongest efforts to lure foreign firms to make investments (Pinto 2003).

So far we have considered only the issue of whether governments relax restrictions on *inflows* of foreign capital. Of course, governments can and often do take actions that influence how much investment flows *out* of their economies. And the same holds for labour flows, as governments often try to affect *emigration* as well as immigration—many governments, in countries as diverse as Australia, Canada, and India, are worried about a 'brain drain' of skilled workers and professionals, for instance, and have adopted a range of policies to discourage or tax such labour flows. But

the issue of outward direct investment, often involving the 'outsourcing' of jobs by multinational firms to their affiliates in labour-abundant (low-wage) nations, has become an especially salient political issue recently in Europe and the United States. The political divisions over the issue are largely what we expect from the factor proportions theory: those who own capital are strongly opposed to any restrictions on their ability to invest it abroad in order to earn higher profits, but restrictions on outward investment are strongly supported by local workers who understand that capital outflows will reduce their real earnings. In the United States, for instance, the most ardent advocates of legislation that would raise the tax burden on profits earned abroad by American corporations has been the AFL-CIO and those workers among its membership that have been hit hardest by outsourcing (for example, labour unions in the textile and auto industries). Interestingly, these labour unions have often had support from environmental and human rights groups concerned that competition among developing countries to attract new investments from multinational firms may produce a 'race to the bottom' in environmental and labour standards. Coalitions of labour unions and human rights groups have waged campaigns to try to force US corporations to adhere to strict codes of conduct abroad. We will discuss these types of multi-issue political coalitions below.

Exchange rates

Of course a critical difference between transactions that take place between individuals living in the same country and transactions between people in different countries is that the latter require that people can convert one national currency into another. If a firm in Australia wants to import DVDs from a film studio in the United States, for example, it will need to exchange its Australian dollars for US dollars to pay the American company. The rate at which this conversion takes place will obviously affect the transaction: the more Australian dollars it takes to buy the number of US dollars required (the price of the DVDs), the more costly are the imports for movie-loving Australian buyers. All the trade and investment transactions taking place every day in the world

Box 3.3 Investment, imperialism, and the 'race for Africa'

Beginning in the 1870s, vast quantities of investment capital flowed from the centres of finance in Western Europe to the rest of the world, providing the capital necessary to develop railroads and telegraph networks, ports, and new mining industries in eastern and central Europe, the Americas, and much of Asia. Beginning in the 1880s, the political context in which these foreign investments were made began to change drastically as an intense race developed among the major powers for political control of territories in Africa and Eastern Asia. Governments in Britain, France, Germany, and Belgium made imperial expansion in these regions their most urgent foreign policy priority. Seizing political control of territories in which there was often no clear or stable governing authority, or at least not one capable of defending the area from conquest by outside force, was a way to safeguard the

investments that were being made in these territories (mostly in the production of raw materials, such as cotton, silk, rubber, vegetable oils, and other products of tropical climates, as well as railways and ports, that were all very vulnerable to seizure). These imperial policies were supported most strongly by financial interests and conservative parties, typically backed by commercial and shipping industries as well, and by military leaders anxious about the security implications of falling behind rivals in the control of strategic territories and ports. Indeed, British economist, J. A. Hobson (1902), and following him, Lenin (1916), famously interpreted the imperial expansion of this time as the natural consequence of owners of capital needing access to new investment opportunities overseas; imperialism was, in Hobson's terms, 'excessive capital in search of investment'.

economy are affected by the rates at which currencies are exchanged.

Prior to the First World War, almost all governments fixed the value of their currency in terms of gold, thereby creating an international monetary system in which all rates of conversion between individual currencies were held constant (for further discussion of this international gold standard, see Chapter 1, Box 1.3). Between the Second World War and 1973, most currencies were fixed in value to the US dollar, the most important currency in the post-war world economy. In this system, often referred to as the 'Bretton Woods' system (see Chapter 1, Box 1.4), the United States agreed to guarantee the value of the dollar by committing to exchange dollars for gold at a set price of \$35 per ounce. Since 1973, when the Nixon administration officially abandoned the fixed rate between the dollar and gold, all the major currencies have essentially been allowed to fluctuate freely in value in world financial markets. Among developing nations, however, many governments continue to fix the value of their currency in terms of dollars or another of the major currencies (see Frieden, Ghezzi, and Stein 2001). And groups of nations in different regions of the world, including the members of the European Union, have made separate efforts to stabilize exchange rates at the regional level, even progressing to the adoption of a common regional currency.

The fundamental choice each government must make involves whether to allow the value of the national currency to fluctuate freely in response to market demand and supply, or instead fix the value of the currency in terms of some other currency or external standard—typically, the currency of a major trading partner or, as was common in the past, gold (a precious metal valued highly in most societies throughout history). When a government chooses to fix the value of the national currency, it sets the official rate of exchange and commits itself to buy the currency at that fixed rate when requested to by private actors or foreign governments. Between a 'pure float' and a fixed exchange rate there are intermediate options: a government can choose a target value for the exchange rate and only allow the currency to fluctuate in value within some range around the target rate. The wider this range, of course, the more policy approximates floating the currency.

When it comes to trade, immigration, and investment, economists agree almost universally on the policy choice that is best for maximizing national (and world) output and, hence, general standards of living: removing barriers to all types of international exchange is optimal because it allows resources to be allocated in the most productive way. There is no similar consensus, however, on the best approach to currency policy. Fixing the exchange rate has pros and

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cons, and it is not always clear which are larger. By eliminating fluctuations in the exchange rate, fixing makes international trade and investment less costly for firms and individuals, since they will not need to worry that the benefits from these international transactions will be adversely affected by some sudden, unexpected shift in exchange rates. By doing away with exchange-rate risk, fixing allows the economy to benefit more fully from international trade and investment. But what is the downside? What does the government give up by pledging to buy or sell its own currency on request at the official rate of exchange? The answer, in short, is control over monetary policy.

A nation's monetary policy regulates the supply of money (and the associated cost of credit) in order to manage aggregate levels of economic activity and hence levels of inflation and unemployment. Governments typically use monetary policy to counter economic cycles: they expand the supply of money and lower the cost of credit during recessions to increase economic activity and promote job creation, and they restrict the supply of money and raise the cost of borrowing during 'booms' to slow economic activity and control inflation. When a government commits to fixing the exchange rate, it effectively gives up the ability to tailor monetary policy to manage domestic economic conditions. To see why, just imagine what happens to money supply if, at the given exchange rate, the nation's residents spend more on foreign goods and services and assets in any given period than foreigners buy from firms and individuals in that nation: the country's 'balance of payments', which registers the value of all transactions with the rest of the world, will be in deficit. This means that there is less overall demand for the country's currency than for the currencies of other countries (needed for residents to buy foreign products and assets). To satisfy this excess demand for foreign currencies and maintain the exchange rate at the fixed level, the government will be a net buyer of its own currency, selling off its reserves of foreign currencies (or gold). The automatic effect of maintaining the fixed exchange rate in these conditions then, is to reduce the total supply of the nation's money in circulation and slow domestic economic activity. Just the opposite should occur when the nation runs a balance of payments surplus: excess demand for its currency compared to other currencies will require that

the government increase the supply of its money in circulation, stimulating economic activity.

In effect, then, fixing the value of the currency makes monetary policy a hostage to exchange-rate policy. Even if a government sets the exchange rate at a level that it hopes will generate *no* balance of payments deficits or surpluses, since the balance of international transactions in any period will depend heavily upon external economic conditions and events in foreign countries, it has very little control. A recession abroad, for instance, will reduce purchases of a nation's products by foreigners and lead to a deficit on the balance of payments and so, if currency values are firmly fixed, this recession will be 'transmitted' to the home nation by the subsequent reduction in its money supply.

The crux of the choice between fixed and floating exchange rates is the choice between stability and policy control: a stable exchange rate will increase the economic benefits attainable from international trade and investment, but this requires giving up the ability to adjust monetary policy to suit domestic economic conditions. Governments in the most advanced economies have generally decided that policy control is more important to them than exchange-rate stability, at least since the early 1970s. Governments in smaller, developing nations have mostly chosen exchange-rate stability over policy control. In part this is because these countries tend to rely more heavily upon trade and foreign investment as sources of economic growth. This choice is also more attractive for governments in smaller countries trying to defeat chronic inflation. Government promises to deal with runaway inflation in these countries may not be regarded as credible by private actors if governments in the past have shown a tendency to act irresponsibly (for example, by printing and spending large amounts of money) when facing electoral challenges. Since the expectations that private actors have about government policy feed directly into the prices (and wages) set, inflationary expectations can have devastating effects. In such circumstances, fixing the nation's currency in terms of the currency of a major trading partner which has a comparatively low rate of inflation can serve an important function, providing a way for the government to commit itself more credibly to a low-inflation monetary policy. In essence, by committing to keep the exchange rate fixed, the

government is ceding control of monetary policy in a very clear and visible way, and anchoring inflation at home to the inflation rate in the partner country (see Broz and Frieden 2001; Giavazzi and Pagano 1988).

In terms of the effects on aggregate welfare, the wisdom of fixing exchange rates is thus not always crystal clear. The best or most preferred policy for different sets of individuals within each country can be similarly difficult to identify. Consider first the case in which we assume that factors of production are mobile between sectors in the domestic economy (they are not 'specific' to particular sectors) and so we can apply the logic of the Stolper-Samuelson theorem and the factor-proportions analysis. Since exchange-rate volatility serves, in effect, as an added barrier or cost to international trade and investment flows, we have a place to begin when trying to map the policy preferences of individuals: in each economy, owners of locally abundant factors are more likely to support a fixed exchange rate, while owners of locally scarce factors are more likely to prefer a floating rate. In the capital-abundant, labour-scarce advanced economies of Europe and the United States, we might thus expect a simple class division over exchange-rate policy: fixed rates benefit owners of capital at the expense of workers. We could expect the reverse alignment of class interests in the labour-abundant, capital-scarce economies of, say, China and India. In such countries, greater exchange-rate certainty should encourage more trade and greater inflows of foreign investment, and both types of international flows will benefit workers at the expense of local owners of capital.

But here we cannot think about exchange-rate stability without thinking also about monetary policy control. In general, workers might be expected to oppose fixed exchange rates in most circumstances, since they are likely to bear greater costs than others when monetary policy can no longer be used to avert economic downturns that result in higher levels of unemployment. Owners of capital, on the other hand, care less about unemployment rates than they do about keeping inflation in check, which is typically much easier for the government to achieve (as noted above) when monetary policy is committed to keeping the exchange rate fixed. Just as in the case for the nation as whole then, owners of labour and owners of capital may have to make a difficult choice about

where they stand in terms of the trade-off between the effects of greater currency stability and less monetary policy control. In contemporary, labour-scarce Europe, for instance, workers would seem to be better off along both dimensions if exchange rates were more flexible, while owners of capital should prefer fixed rates. There is some evidence that fits with this interpretation. Labour unions in Western European countries generally provided the most vocal opposition to government policies aimed at fixing or stabilizing exchange rates in the 1970s and 1980s, particularly in France and Italy. But the record is mixed. While the labour-backed Socialist government that came to power in France in 1981 initially abandoned exchange-rate stability as a goal, by 1983 it was committed to a fixed currency peg (see Oatley 1997). In fact, during the inter-war period in Europe, *left-wing* governments tended to keep their currencies fixed to the gold standard longer than other governments (Simmons 1994). And looking across a broader range of countries, in which labour is the locally abundant factor and capital is scarce, the preferences of these broad classes of individuals when it comes to exchange rates becomes even more difficult to predict.

Perhaps one major reason why it is difficult to find compelling evidence to support simple class-based interpretations of exchange-rate politics is that individuals tend to see things very differently depending on the industries in which they are employed and invested. If we allow, as in previous discussions above, that factors of production are typically very specific to particular industries, we get a very different picture of the alignment of individual preferences on the exchange-rate issue. And the picture is also much clearer. Individuals employed or invested in sectors that invest or sell in foreign markets are likely to favour exchange-rate stability, since fluctuations in rates impose costs on their international transactions and because they have a relatively small economic stake in domestic (versus foreign) macro-economic conditions. Those individuals associated with firms and banks that invest heavily in foreign markets, for instance, and export-oriented sectors that sell a large proportion of their output abroad, should thus tend to support fixed exchange rates. On the other hand, owners and employees in import-competing industries and those producing non-traded services (for example, building, transportation, sales) whose

incomes depend overwhelmingly on domestic economic conditions, are likely to favour flexible exchange rates that allow the government more control over monetary policy. There is some compelling evidence supporting these predictions, especially in the debates over exchange-rate policy in the most advanced economies. In Europe in recent decades, for instance, the strongest support for fixing exchange rates (and ultimately, for creating a common European currency) has come from the international banks, multinational firms in a diverse range of industries (including auto firms such as BMW and Mercedes), and from export-oriented sectors. The strongest opposition to fixed rates has tended to come from owners and labour unions associated with import-competing industries such as coal, steel, and textiles, especially in nations like France and Italy that have battled relatively high rates of inflation (see Frieden 1994). In developing nations, recent studies have indicated that governments are more likely to float their currency when the import-competing manufacturing sector accounts for a large proportion of the local economy (Frieden, Ghezzi, and Stein 2001).

Finally, when a government does decide to fix or stabilize its currency it must also decide the *level* at which to set the exchange rate. Whether the currency should be 'stronger' (that is, take a higher value versus other currencies) or 'weaker' (a lower value) is a second, important dimension of exchange-rate policy. Even when the currency is floating, in fact, if it happens to move strongly in one direction or another, the issue can become a salient one, since the government may be called upon to intervene in an effort to raise or lower the exchange rate toward some new target. What is interesting in this regard is that the alignment of the various groups in terms of preferences for fixing versus floating the currency are not quite the same as the way they are positioned on the issue of the actual rate that should be set or targeted. A stronger currency will harm those in both export-oriented *and* import-competing industries, since it will make their products less attractive to consumers relative to the foreign alternatives. Individuals in these sectors should prefer a weaker currency. But a weaker currency will harm all others in the local economy by eroding their purchasing power when it comes to buying foreign goods and services. Owners and employees in non-traded sectors should prefer a

stronger currency, as should any multinational firms or international banks that are investing abroad and purchasing foreign assets (Frieden 1994). In the real world of politics, in instances in which the level of a nation's exchange rate has in fact become a salient political issue, these types of coalitions do appear to emerge. Devaluation of the US dollar became a major election issue in the 1890s, for instance, with the rise of the Populist movement, supported predominantly by export-oriented farmers who demanded a break from the gold standard in order to reset the dollar exchange rate at a lower level. The Populists were opposed most strongly by banking and commercial interests in the north-eastern states who favoured a strong dollar (see Frieden 1997).

Key points

- According to the Stolper–Samuelson theorem, trade benefits those who own the factors of production with which the economy is relatively well endowed and trade hurts owners of scarce factors.
- In the alternative 'specific factors' model, individuals employed or invested in export industries are the ones who benefit from trade while those who are attached to import-competing industries are disadvantaged.
- The leading research assumes that the specific factors approach is the most appropriate way to think about the effects of trade in the contemporary advanced economies.
- Immigration harms the real earnings of local workers with similar skill levels to those of the arriving workers, while benefiting everyone else in the host country.
- Inflows of foreign capital will hurt individuals who own capital in the local economy, while benefiting all local landowners and workers.
- Individuals attached to firms and banks that invest abroad or export a large proportion of their output are likely to favour a fixed exchange rate. On the other hand, owners and employees in import-competing industries and those producing non-traded services are likely to favour a flexible exchange rate.
- A stronger currency will harm those in both export-oriented *and* import-competing industries, while benefiting all others in the local economy.

Box 3.4 The politics of the rising dollar

Between 1980 and 1985 the US dollar rose by approximately 50 per cent in value against the Japanese yen and by roughly similar amounts against the German deutschmark and the British pound. The rapid dollar appreciation placed immense strain on US producers of traded goods and services and by 1985 the Reagan government was being lobbied strenuously by a large variety of groups asking for some kind of action to halt the rise (see Destler and Henning 1989). The strongest pressure came from groups in a broad collection of export-oriented sectors, including grain farmers, firms like IBM and Motorola in the computer industry, and Caterpillar, a large exporter of construction equipment and machinery. The voices of these exporters were swelled by protests coming from firms in import-competing industries, including the major auto companies and the steel makers. The initial reaction from the Reagan administration was to sit tight, and characterize the rise of the dollar as a sign that the rest of the world held the United States and its economy in high esteem. The government had set a course to restrain inflation when entering office in 1981, and had raised US interest rates considerably. Taking action to devalue the dollar would have thrown into substantial doubt this commitment to defeat inflation. After

their initial pleas were rebuffed by the White House, however, many groups from the steel, autos, and textile industries began demanding new forms of trade protection instead, bombarding Congress with calls for trade barriers that would make up for the competitive effects of the dollar appreciation. It was this threat of runaway protectionism in Congress that finally prompted the government to take action on the dollar. In 1985, the White House reached an agreement with the governments of Japan, Germany, Britain, and France, which became known as the Plaza Accord (a reference to the lavish New York hotel in which it was negotiated). This deal provided for a cooperative effort to manage a gradual depreciation of the dollar against the other currencies, with each government agreeing to alter its macro-economic policies in such a way as to ease demand for the dollar compared with other currencies (for example, the Reagan government agreed to lower interest rates and to make a new effort to reduce the size of the US budget deficit). By giving up some control over macro-economic policy, in coordination with other governments, the White House was able to reverse the rise in the dollar and ease the strain imposed on US producers of traded goods and services.

Institutions

Once we have specified the preferences of different individuals and groups on any particular issue we need to think about how much influence they will have over policy outcomes. This is where political institutions come in. Political institutions establish the rules by which policy is made, and thus how the policy preferences of different groups are weighed in the process that determines the policy outcome. It is appropriate here to start with the broadest types of rules first, and consider the formal mechanisms by which governments and representatives in legislative bodies are elected (or otherwise come to power). These broad features of the institutional environment have large effects on all types of policies. But then we can move on to discuss more specific aspects of the

legislative process and administrative agencies that have implications for the formulation and implementation of trade, immigration, investment, and exchange-rate policies.

Elections and representation

Perhaps it is best to start with the observation that the general relationship between democratization and foreign economic policy making is a matter that is still open to considerable theoretical and empirical doubt. Part of the puzzle is that there is a great deal of variation in the levels of economic openness we have observed among autocratic nations. In autocratic

regimes, the orientation of policy will depend upon the particular desires and motivations of the (non-elected) leadership, and there are different theoretical approaches to this issue. Non-elected governments could pursue trade and investment liberalization in an effort to maximize tax returns over the long term by increasing aggregate economic output. Such policies may be easier to adopt because autocratic leaders are more insulated than democratic counterparts from the political demands made by any organized domestic groups that favour trade protection and limits on foreign investment (Haggard 1990). Perhaps this is an apt description of the state of affairs in China as it has been gradually opening its economy to trade and investment over the past two decades, and non-democratic governments in Taiwan and South Korea pursued trade liberalization even more rapidly in the 1960s. On the other hand, autocratic governments may draw political support from small, powerful groups in the system that favour protection. Many such governments appear to have used trade and investment barriers in ways aimed at consolidating their rule (Wintrobe 1998). The experience in Sub-Saharan African nations since the 1960s, and in Pakistan and Myanmar, seems to fit this mould. Without a detailed assessment of the particular groups upon which a particular authoritarian regime depends for political backing, it is quite difficult to make predictions about likely policy outcomes under non-democratic rule.

In formal democracies that hold real elections, the most fundamental set of political rules is the set that defines which individuals get to vote. If the franchise law gives more weight to one side in a policy contest compared to others, it can obviously have a large impact on policy outcomes. Where only those who own land can vote, for instance, agricultural interests will be privileged in the policy-making process. If this landowning elite favours trade protection, as it did in Britain in the years before the Great Reform Act of 1832, then such a policy is almost sure to be held firmly in place. By shifting political power away from landowners and towards urban owners of capital and labour, extensions of the franchise had a major impact on all forms of economic policy during the late nineteenth and early twentieth centuries in Europe, America, and elsewhere. In England, the extension of voting power to the middle and working

classes, achieved in the reforms of 1832 and 1867, had the effect of making free trade politically invincible—with a huge block of workers along with the urban business class supporting trade openness, and only a tiny fraction of the electorate (the traditional rural elites) against it, a government that endorsed tariffs or restrictions on investment would have been committing electoral suicide. In the United States and Australia, on the other hand, where labour and capital were in relatively scarce supply, the elimination of property qualifications for voting and the extension of suffrage had exactly the opposite effect, empowering a larger block of urban voters who favoured high tariffs. In general, extensions of the franchise to urban classes tend to produce more open policies toward trade, immigration, and investment in labour and capital-abundant countries, and more closed or protectionist policies in labour and capital-scarce economies.

The precise rules by which representatives are elected to national legislatures are the next critical feature of the institutional environment. Scholars have suggested that in parliamentary systems in which legislative seats are apportioned among parties according to the proportion of votes they receive ('proportional representation'), narrowly organized groups have far less impact on policy making in general than they do in electoral systems in which individual seats are decided by plurality rule (see Rogowski 1987). Parliamentary systems with proportional representation tend to encourage the formation of strong, cohesive political parties, which appeal to a national constituency and have less to gain in electoral terms by responding to localized and particularistic demands (McGillivray 1997). Other types of systems, in contrast, tend to encourage intra-party competition among individual politicians and the development of a 'personal vote' in particular electoral districts and thus are more conducive to interest group lobbying. The implications for foreign economic policies are usually spelled out in very clear terms: we expect that proportional representation systems with strong political parties (e.g. Sweden) will typically produce lower levels of trade protection and other restrictions than alternative types of electoral systems (e.g. Britain, the United States) in which particular local and regional interests have a greater influence.

Box 3.5 The institutional foundations of the gold standard

Why was the gold standard, the system of fixed exchange rates that appeared to work so well in bringing order and stability to the global economy between the 1880s and 1914, so difficult to re-establish in the 1920s? One very important reason has to do with the major changes in political institutions that took place in Western nations around the time of the First World War. The gold standard required that governments give up control of monetary policy in order to keep the value of their currencies fixed in terms of gold (and one another). In essence, macro-economic policy was held hostage to exchange-rate policy, so that currency values were stable. This was especially difficult for small economies that happened to run large balance of payments deficits at the set rates of exchange. To maintain their exchange rates they were forced to reduce the supply of their money in circulation and raise interest rates, thereby reducing economic activity at home and increasing unemployment. If they were already in the midst of an economic recession, this meant making the downturn even worse. Governments could only follow through with this type of commitment to a fixed exchange rate if the economic costs of recession—which fell predominantly upon workers who lost jobs and

income and small businesses and farmers driven into debt—did not have direct political consequences in terms of their ability to remain in office. This changed in many nations around the turn of the century when electoral laws were reformed, extending the franchise to larger proportions of the population (including workers who had previously been denied the right to vote in many places). Around this same time labour organizations, including both trade unions and labour parties, grew in political strength in almost all the Western economies, using strikes to push for political reforms while gaining significant electoral representation for the first time. Given these profound changes in the lie of the political land, the attempts to recreate the gold standard in the inter-war period appear to have been doomed from the outset. Governments elected by much broader segments of the population were increasingly unwilling give up their ability to manage domestic economic conditions, especially during recessions, just in order to maintain the gold parity. Eventually, after weathering several smaller crises, the system collapsed when governments began abandoning the gold standard altogether after 1929 in response to the onset of the Great Depression.

These conclusions about the impact of particularistic groups in different types of electoral systems rest upon a critical insight derived from theoretical work on collective action in trade politics: that there is a fundamental asymmetry between the lobbying pressure generated from groups seeking protectionist policies and the lobbying pressure that comes from groups who oppose such restrictions. The main reason for this is that restrictions on imports and other types of exchange, when imposed one at a time, tend to have very lopsided effects. As we know from the analysis of the specific factors model above, the benefits of a tariff on a particular good are concentrated on the owners of capital and labour engaged in that particular industry. If the tariff is substantial, these benefits are likely to be quite large as a share of the incomes of those individuals, and thus they will typically be willing to spend a good deal of their time and energy (and savings) lobbying to ensure they get the tariff they want. The stakes are very high for them. By contrast, the costs of

the tariff are shared among all the owners of other types of specific factors in the economy; they are dispersed so broadly, in fact, that they tend to be quite small as fraction of the incomes of these individuals. Thus it is unlikely that those hurt by the new tariff will be prepared to devote resources to lobbying against the policy proposal. Collective political action will always be much easier to organize in the relatively small groups that benefit from a particular trade restriction than in the much larger groups (the rest of the economy) that are hurt by the restriction (see Olson 1965). Perhaps the best example of this logic is the extraordinary political power that has been demonstrated by the small, highly organized agricultural groups in Europe, the United States, and Japan over the past fifty years. These groups, which together represent a tiny fraction of the population in each political system, have been able to win extremely high (if not prohibitive) rates of protection from imports and lavish subsidies (see Tyers and Anderson 1992).

Other aspects of electoral institutions may also play a role in shaping policy outcomes. In general, smaller electoral districts in plurality systems may be expected to increase the influence of sectoral or particularistic groups over elected representatives and thus lead to higher levels of protection (Rogoswki 1987; Alt and Gilligan 1994). In larger districts, political representatives will be forced to balance the interests of a greater variety of industry groups when making decisions about policies and will be less affected by the demands of any one industry lobby, and a larger share of the costs of any tariff or restriction will be 'internalized' among voters within the district. From this perspective, upper chambers of parliaments, which typically allocate seats among representatives of much larger electoral districts than those in lower chambers, tend to be less inclined toward trade protection and other types of restrictive foreign economic policies. Meanwhile, in legislative chambers in which seats are defined along political-geographic lines without regard for population (for example, in the United States Senate, where each state receives two seats), agricultural, forestry, and mining interests in underpopulated areas typically gain a great deal more influence over policy making than they can wield in chambers (e.g. the United States House of Representatives) where legislative seats are defined based upon the number of voters in each district.

We have generally been focusing on trade policies, since most of the past research on the effects of institutions has tended to concentrate on tariff levels. But recent studies also suggest that differences in electoral institutions can have a significant impact on exchange-rate policies. In particular, in plurality systems in which elections are all-or-nothing contests between the major parties, governments appear to be far less likely to fix exchange rates and give up control over monetary policy than governments in proportional representation systems (see Clark and Hallerberg 2000). It appears that the costs of having ceded control over monetary policy in plurality systems, should the government face an election contest during an economic slump, are much higher than elsewhere. This difference also appears to be more pronounced for governments in plurality systems in which the timing of elections is predetermined by law (Bernhard and Leblang 1999).

Legislatures and policy-making rules

The rules that govern the way national legislatures go about making laws can have profound effects on the way the preferences of individuals and groups are aggregated into different types of foreign economic policies. These rules determine the way new policies are proposed, considered, amended, and voted upon. They structure the interactions among different legislative and executive bodies and they establish which branches have what types of agenda setting and veto power over policy.

Most of the recent research on the impact of legislative institutions on foreign economic policies has been focused on American trade policy, but the implications from this work are quite general and so it is worth close scrutiny. The point of departure for many studies is the infamous Smoot-Hawley Tariff Act of 1930, which was such a disaster that it helped inspire a fairly radical change in the rules by which the Congress has dealt with trade policy ever since. The core of the legislative problem, as many see it, is the possibility for 'log rolling' or vote trading between protectionist interests. The benefits of a tariff or trade restriction can often go to an import-competing industry located almost entirely in one electoral district, with the costs born generally by individuals in the rest of the economy. In such cases, lobbying pressure by these industries can generate a protectionist log roll when tariffs are being set by voting among members of a legislature: each member of the legislature will propose generous protective measures for industries in his or her own district without accounting for the costs they impose on individuals elsewhere. To gain support for these measures, each member will vote in favour of similar measures proposed by other legislators. If members can vote indefinitely on a sequence of such proposals, a policy that includes every new tariff can be the equilibrium outcome (supported by each legislator's belief that a vote against another's proposal would induce others to retaliate by offering an amendment to withdraw protection from the defector's district). The result of such unchecked log rolling is a vast array of protective measures, such that all individuals are far worse off than they were before the bill was passed (see Weingast, Shepsle, and Johnsen 1981).

Box 3.6 The Reciprocal Trade Agreements Act of 1934

In 1930 the US Congress passed the infamous Smoot–Hawley Tariff Act, which raised import duties on a vast array of manufactured and agricultural goods (some to over 200 per cent), and was quickly dubbed the ‘worst tariff bill in the nation’s history’ even before it was passed. Retaliation from other countries, in the form of higher tariffs, was swift and substantial, and the subsequent sharp decline in world trade and the collapse of the fragile international monetary system increased the depth and scope of the Great Depression. The 1930 tariff bill was widely regarded as a case of protectionist log rolling run wild. The Senate alone made 1,253 amendments to the original House bill, and duties on over 20,000 items were altered (Pastor 1980: 77–8). When the Democrats won control of the White House, and majorities in Congress, in 1932, they looked for a way to make a change. Rural interests still made up a large part of the Democrats’ electoral base, especially in the south, and still strongly favoured trade and the party’s traditional anti-tariff platform. Unilateral tariff reductions were politically sensitive in the midst of a recession, however, and were not popular at all among workers, who had thrown their support to the Democrats in the 1932 campaign. Roosevelt’s secretary of state, Cordell Hull, a long-time advocate of free trade, instead designed new legislation that would permit

the president to negotiate bilateral treaties with trading partners to restart trade by making reciprocal reductions in import duties. Passed as the Reciprocal Trade Agreements Act in 1934, the legislation granted the president authority (for three years) to negotiate alterations of up to 50 per cent in the existing import duties. When that initial authority expired in 1937, Congress renewed it and continued to do so in the decades that followed. Beginning in 1974, the president’s authority was expanded to cover negotiations over a range of non-tariff barriers to trade, although various procedural and monitoring provisions were also introduced to constrain executive behaviour, and the Congress maintained the power to approve or reject any trade agreement by vote (under the so-called ‘fast-track’ provision that prohibited amendments and set a firm time limit for a ratifying vote). The delegation of policy-making power to the executive branch, which can aggregate the costs and benefits of protection across the entire nation and bargain for reciprocal changes in the policies of other governments to open foreign markets to American exports, is credited with reorienting US trade policy away from protectionism in the decades since 1934 (see Destler 1995; Gilligan 1997; Lohman and O’Halloran 1994; Bailey, Goldstein, and Weingast 1997).

According to conventional wisdom, the Smoot–Hawley tariff was just such a log-rolling disaster, and Congress reacted to it in a remarkably sensible way by redesigning the rules governing the way trade policy was made. Specifically, Congress delegated to the executive branch the authority to alter US trade policy by negotiating reciprocal trade agreements with other countries. This practice of delegating negotiating authority to the president has been continued since 1934. By delegating authority over policy to the president, who would presumably set trade policy to benefit all individuals within the one, *national* electoral district, this innovation eliminated the spectre of protectionist log rolling altogether and ensured that all the costs of trade protection were fully ‘internalized’ by a decision maker accountable to all voters. In addition, by empowering the president to negotiate trade agreements that elicited reciprocal tariff reductions from other countries, the change helped

to mobilize support for trade liberalization among export interests who could now expect improved sales abroad as a result of tariff reductions at home.

The lessons drawn from this case are almost certainly overdrawn, and the conventional account has some gaping inconsistencies. In particular, there appears to have been no learning at all on the part of members of Congress between 1930 and 1934: the congressional voting records indicate that, amongst the members voting on both bills, almost all those who voted for Smoot–Hawley in 1930 voted against the RTAA in 1934 (see Schnietz 1994). Moreover, it is not at all clear that protectionist log rolls have been an otherwise unsolvable problem for tariff legislation in the US Congress (or elsewhere)—what of all the cases in which *liberalizing* bills were passed by legislatures in the absence of delegation? In the US Congress itself, the major acts passed by the Democrats when in control of government before the 1930s (the Wilson

Tariff of 1894 and the Underwood Tariff of 1913) stand out in this regard. Examples also abound in the legislative histories of other Western democracies. It should not be a mystery as to why. In parliamentary systems, political parties play critical roles in controlling the legislative agenda. In proportional representation systems these parties compete for a share of the national vote, and so legislation designed to appease district-specific interests holds little appeal. Even in plurality rule systems, however, the majority party that forms a government typically imposes strict control over the policy agenda in a way that prevents such self-defeating log rolls. Finally, the notion that presidents, simply by dint of having a large (national) constituency, must be champions of freer trade, is hopelessly ahistorical. Here again, we cannot ignore the critical role played by political parties. In the US case, the Republican base of support between the 1840s and 1940s was concentrated among manufacturing interests in the north-east and midwest states and was staunchly protectionist, and a long list of Republican presidents championed high tariffs in election campaigns and backed the most protectionist of Republican tariff bills in Congress (see Hiscox 1999). More generally, in all the Western democracies, political parties typically have very distinct core constituencies among the electorate, defined in regional or class terms, to whom they are principally accountable when designing policies. Whether a government allows protectionist amendments during legislative deliberations of policy, and whether a president supports trade liberalization, will depend on their partisan affiliation and the preferences of their party's core electoral base.

Despite the distortions, the story of the RTAA does still hold some valuable lessons for thinking about ways in which legislative rules can affect foreign economic policies. The explicit institutional connection that the RTAA forged between tariff reductions at home and reciprocal reductions in tariffs abroad, surely played a role in generating increased support for trade policy reform among export-oriented industries and thus made it easier for all policy makers to support trade liberalization. This same link is now more or less routine, of course, for policy making in most Western governments as a consequence of their membership commitments in the WTO. For nations outside the WTO, however, most of them developing

countries, where attempts to liberalize trade policy have a poor political track record, this does suggest that governments are more likely to succeed with trade reform if they can do so as part of a bilateral or regional free trade agreement with major trading partners.

The RTAA also offers a lesson about group access to lawmakers that is often overlooked. Up until 1934, congressional committee hearings were pivotal in shaping the trade legislation voted upon in the US House and Senate. The hearings format, which assigned particular days for receiving testimony on the duties to be levied on different commodities, was especially convenient for industry group lobbying. This system was changed completely in 1934. After the RTAA, hearings were typically limited to general discussions about whether to extend the president's negotiating authority and, after 1974, whether to implement previously negotiated agreements (under 'fast-track' provisions that prohibited amendment). Closing off this very direct channel by which groups had been able for years to lobby for changes in duties on particular items, may have had the most profound effect on trade policy-making in the United States. In general, *any* type of policy-making rules which provide routine access for organized groups to exert lobbying pressure to change particular features of legislation will make trade protection and other forms of restriction more likely—including open legislative hearings and 'commissions' or industry advisory panels set up within government agencies to gather opinions from producer and labour groups (see Alt and Gilligan 1994; Verdier 1994).

Legislative institutions can influence other types of foreign economic policies too. One line of work by scholars has been focusing on the general differences between multi-party coalition governments and single-party majority governments. Coalition governments appear to have less incentive than majority governments to alter their monetary policy prior to elections to try to boost economic activity in an 'opportunistic' fashion, since voters find it difficult to assign blame or credit to any single party within the coalition. An implication seems to be that coalition governments are also much more likely than other types of government to adopt fixed exchange rates and give up control over monetary policy (see Bernhard and Leblang 1999).

Bureaucratic agencies

Lastly, there is the issue of how foreign economic policies are implemented or administered by the bureaucratic agencies of each government. The rules that are established to regulate these agencies and the way they make decisions can play a powerful role in shaping policy outcomes. Legislatures delegate the responsibility for implementing their laws to these agencies, establishing the rules by which they are to operate, the ways in which their performance is monitored and evaluated, and so on. Built into these relationships between the legislature and the bureaucracy, however, there is always some measure of 'slack'—that is, some room for bureaucrats to manoeuvre free from legislative interference. This bureaucratic independence can have important effects in terms of foreign economic policies.

When it comes to the implementation of trade policies, for example, there is often a real fear that the bureaucratic agencies that administer various aspects of trade laws may develop a far too cozy relationship with the sectors of the home economy that they are supposed to be regulating. This danger of bureaucratic 'capture' appears to be very real. In the US case, the Departments of Commerce and Agriculture are both regarded as unapologetic advocates of protection for their 'clients'—American business firms and farmers. Indeed, the International Trade Administration, located within the Department of Commerce, is renowned for having 'gone native'. Charged with making rulings on petitions from US companies claiming that foreign firms are dumping products below cost in the American market, the ITA finds in favour of local firms in approximately 99 per cent of cases (see Bovard 1991).

This problem is by no means unique to the American system. In Japan, the Ministry for International Trade and Industry (MITI), and the Ministry for Agriculture, Forestry, and Fisheries (MAFF), have long been known for their extremely close ties with Japanese industry and the farming and fishing communities (see Okimoto 1988: 310). While MITI was for many years heralded by Western observers as the model for a new kind of autonomous state bureaucracy, capable of expertly targeting subsidies to particular manufacturing industries that would excel in competition with foreign producers

(Johnson 1982), comprehensive evidence from recent studies indicates that MITI actually allocated support to favoured industries in a highly political and ineffective way, much like captured bureaucracies elsewhere (see Beason and Weinstein 1993).

In general, extreme cases aside, the interplay between bureaucratic independence and accountability is a complex thing. In some issue areas, greater independence is generally regarded as desirable. Central banking is perhaps the most important case. The general problem, which we have discussed briefly above, is often referred to as the time inconsistency of monetary policy. Governments have an incentive to allow an unexpected rise in inflation that boosts economic activity, especially when facing an upcoming election. But since private actors know this, any promises a government may make to keep inflation in check may not be considered credible. Even if the government has all the best intentions, private actors might nevertheless keep inflation expectations high. By delegating control over monetary policy to an independent central bank that is insulated from any political temptations to alter monetary policy, the government can beat the problem. Moreover, independent central banks also appear to play an important role in shaping currency policies. Recent studies have indicated that governments in countries with independent central banks are less likely to engage in electorally motivated manipulations of exchange rates (Clark and Reichert 1998). And a related claim is that governments that can commit credibly to low inflation by establishing an independent central bank are less likely to need to fix their exchange rate in order to gain anti-inflationary credibility. Central bank independence and fixed exchange rates, in other words, can function as policy substitutes (see Clark and Hallerberg 2000).

Key points

- Restrictions on the franchise can give more weight to one side relative to others in contests over foreign economic policies. Extensions of the franchise to urban classes tend to produce more open policies toward trade and investment in labour and capital-abundant countries, and more closed or protectionist policies in labour and capital-scarce economies.

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- Collective action is easier to organize in the relatively small groups that benefit from a particular trade restriction than in the much larger groups that are hurt by the restriction, so the strongest lobbying pressure tends to come from protectionist groups.
- Proportional representation systems with strong political parties typically generate lower levels of trade protection and other restrictions than plurality rule systems in which particular local and regional interests have a greater influence.
- Small electoral districts in plurality rule systems tend to increase the influence of sectoral or particularistic groups over elected representatives when compared to larger districts, and thus lead to higher levels of protection.
- In plurality rule systems in which elections are all-or-nothing contests between the major parties, governments are less likely to fix exchange rates than governments in proportional representation systems.
- Whether a government allows protectionist log rolling in a legislature, and whether a president supports trade liberalization, will depend on their partisan affiliation and the policy preferences of their party's core electoral constituency.
- An explicit institutional connection that links tariff reductions at home with reciprocal reductions in tariffs abroad (e.g. a free trade agreement), can generate much stronger support for trade policy reform among export-oriented industries.
- Rules that provide access for organized groups to exert lobbying pressure to change particular features of legislation make trade protection and other forms of restriction more likely.
- The delegation of policy-making authority to bureaucratic agencies or bodies independent from national legislatures may not produce policies less affected by lobbying from protectionist interests, since groups may gain privileged access to decision makers in such agencies.
- The existence of an independent central bank makes it less likely that a government will choose to fix the exchange rate.

Conclusions, extensions, and complications

There is really no such thing as the 'national interest' when it comes to foreign economic policy—or, rather there is no *one* national interest, there are many. Different individuals have very different conceptions of what is best for the nation and, not coincidentally, best for themselves, when it comes to setting foreign economic policies. This chapter has attempted to outline the principal divisions that usually characterize domestic political battles over trade, immigration, investment, and exchange rates. These divisions, as we have seen, tend to fall along either class or industry lines. Owners of capital and workers are typically pitted against one another when it comes to restrictions on inflows of labour or capital, for example, but they tend to take the same position in each industry on trade and exchange-rate issues since the effects of policy can be very different for different sectors of the economy.

Once we know who wants what, the next task involves figuring out who gets what they want from

the political process. This second step involves understanding how policies are decided in different countries and thus how differences in political institutions affect economic policy choices. Our ultimate goal is to figure out why governments in different countries often choose very different types of trade, immigration, investment, and exchange-rate policies. We might also hope to form some reasonably accurate predictions about what our governments are likely to do in the future. Understanding why governments make the choices they make, and predicting what they will do next, requires careful attention to the political pressures they face from domestic groups and to the ways in which the preferences of these groups are aggregated into collective decisions by political institutions. But there are at least three additional complications to this simple analytical picture that we should discuss briefly here: the first has to do with the knowledge or information that

individuals have about the effects of different policies and about the preferences of others; the second extension involves allowing for linkages between the various policy issues and between these issues and other non-economic policy concerns; and the third complication involves international bargaining and the ways in which we might think about the connection between domestic politics and international politics.

Information and the role of ideas

Who gains and who loses? And who wins the political contest between those who gain and lose? Answering those questions in each issue area is the heart of the standard political economy approach that we have outlined above. In keeping with traditional assumptions, we have been taking it for granted that individuals know what they want, know what others want too, and know what types of policies will have what kinds of effects. These are heroic assumptions. A great deal of the most recent research in both economics and political science, in fact, has tried to depart from this notion that people have full or complete information about their world, examining the effects of uncertainty, asymmetry in information among actors, and changes in knowledge that might be attributable to learning and the impact of new ideas. It is useful in this respect to distinguish between two basic types of information that individuals may be missing: people may be lacking knowledge about the effects of different policies on economic outcomes, or they may not have full knowledge about other people (including government leaders) and their preferences. We can discuss each of these informational problems separately.

What if we allow that individuals are not sure about the effects of different types of policies? It took us quite a while to disentangle the various effects of trade, immigration, investment, and exchange-rate policies above, with the help of several simplifying assumptions, so this does seem an important question to pose. It clearly provides a large window through which new ideas, in the form of new beliefs about cause-and-effect relationships between policies and outcomes, might have a large impact on

policy making. Indeed, this is the view espoused by John Maynard Keynes (1936: 383) in his famous contention that 'the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else.'

Several prominent scholars have indeed argued that foreign economic policies have changed markedly in response to new ideas about policies and their effects. The abandonment of mercantilist restrictions on trade and investment by most European governments in the nineteenth century has been attributed, in some large measure, to the ideas of Adam Smith and David Ricardo and the development of classical trade theory (Kindleberger 1975; Bhagwati 1988). The multilateral liberalization of trade and investment among Western economies in the post-Second World War era, allowing governments considerable scope for managing their domestic economies to avoid recessions, has similarly been traced to the refinement of classical and neoclassical economic theories and the ideas of Keynes himself (Ruggie 1982; Goldstein 1993). More recently, the rush to liberalize trade by governments in developing nations has been attributed to a learning process and the discrediting of the idea that rapid development could be achieved by import-substitution policies (see Krueger 1995). Competing ideas about cause-and-effect relationships often appear in policy debates, and dominant ideas are frequently embedded within policy-making institutions as the foundations for rules followed by bureaucratic agencies (Goldstein 1993). Yet there remains much debate about the degree to which these types of ideas are independent of the interests that might be served by them. Weber's famous analogy compared ideas to 'switchmen' who determine the tracks along which human behaviour, pushed by interests, travel (Weber 1913). From a more sceptical perspective, one might suggest that the individuals who gain and lose the most from any economic policy, such as tariffs on trade, have all the knowledge they need about its effects and need no new ideas from economists to help them out; the policies just reflect the wishes of those interested actors who have the most political clout, and the ideas that attract our attention are just the ones sprinkled like holy water over the new legislation

Box 3.7 The rise of free trade in Europe

The publication of *The Wealth of Nations* by Adam Smith in 1776 stands out as an intellectual landmark in the history of thinking about international trade, pointing out the critical role that trade plays in encouraging specialization and the resulting gains in efficiency and wealth. Smith adroitly punctured the old doctrine of mercantilism, which favoured expanding exports while restricting imports and hoarding gold, making it clear that national wealth is defined not by stocks of gold but by how much citizens can consume with the resources they have at their disposal. But the modern theory of international trade really began with the arrival of David Ricardo's *Principles of Political Economy and Taxation* in 1817. Ricardo demonstrated that trade is mutually beneficial for all countries, even a country that cannot produce anything more efficiently than other nations in terms of the costs of its inputs. As long as the costs of production are different in different nations, Ricardo's analysis showed that it must be true that, in terms of the opportunity costs of production (the

value of other things that might have been produced with the inputs used to make a given item), each nation will be better at producing some things than others and thus there is a basis for specialization and exchange that will leave both countries better off. This 'law of comparative advantage', which Paul Samuelson has called the most beautiful law in economics, has had a profound impact on all scholarly and political debates about trade ever since. That the cause of free trade was taken up enthusiastically by the leading English political economists, including John Stuart Mill, all inspired by Ricardian theory, and that these ideas also spread rapidly throughout Europe during the nineteenth century, has led many scholars to suggest that the broad shift away from trade protectionism in Europe (which began in 1846 with the repeal of the Corn Laws that Ricardo himself had attacked) was due in large measure to a profound change in the way leaders understood the economic effects of trade (see Kindleberger 1975; Bhagwati 1988).

(to borrow an equally memorable metaphor from Kindleberger). The relationship between ideas and interests is still very murky, and will remain so until we have a better understanding of where new ideas about policy come from, and what explains which ideas catch on and spread.

But by focusing just on the role of new ideas and how they might change knowledge about policies, we may actually be missing the bulk of the iceberg here when it comes to the impact of incomplete information. We noted in the discussions above that while foreign economic policies such as tariffs on imported goods generate real costs for a large set of owners and workers in all the other (non-protected) sectors of the economy, these costs are dispersed across such a large number of individuals that the per-person losses can be extremely small. Not only will it not pay for those affected to take political action to oppose the tariff in these cases, it may not even pay for them to spend any time or resources acquiring accurate information about the policy and its effects. Public opinion experts typically regard foreign economic policies as a particularly complex set of issues about which survey respondents have very low levels of information

(see Bauer, Pool, and Dexter 1972: 81–4). Survey responses to questions about these issues tend to vary drastically with simple changes in question wording, making it very difficult to pinpoint where the public stands on any policy question at any particular point in time (see Destler 1995: 180). One implication is that voters may be very susceptible to issue framing or manipulation by political leaders and organized lobby groups whenever these issues become more prominent. Recent research on political communication and public opinion has highlighted this possibility (for example, Manheim 1991; Zaller 1992: 95). To the extent that this type of influence can be exercised, the politics of globalization may be regarded, at least to some degree, as a competition in issue framing among organized interests on different sides of the debate trying to sway public opinion to their side. This did appear to be an important dimension of the intense debate over NAFTA in the United States in 1993 (Holsti 1996: 52).

Another interesting implication of incomplete information among voters is that it may provide an explanation for why governments so often seem to do very inefficient things when setting foreign

economic policies. Economists are fond of pointing out that if a government really wanted to redistribute income to particular groups of owners and employees, using restrictions on trade is a very inefficient way to go about it. It would be far better just to make a direct, lump sum payment to these groups that stand to benefit from protection, and thus avoid the inefficiencies generated by the allocation of resources to such uncompetitive industries. But if the costs of such direct payments to taxpayers are more visible (because they must appear, say, in the government's annual budget), they are more likely to generate a backlash among the voters on whom the burden falls. If this is true, it may make sense for a government to use trade policies to redistribute income to favoured groups because these policies provide an effective disguise in a low-information environment (see Tullock 1983). From this perspective, the use of trade protection can be characterized as 'optimal obfuscation' (Magee, Brock, and Young 1989).

Finally, what happens if we allow that individuals, even if they are fully informed about the effects of foreign economic policies, may nevertheless be uncertain about the motivations or intentions of the government managing them. One circumstance in which this type of incomplete information can become important is when setting exchange-rate policy, as we have discussed above. Since governments have an incentive to print money and allow a burst of inflation when facing an election, any promises they make to keep inflation in check may not be considered credible by private actors who understand that the government has an incentive to bluff and portray itself as 'tougher' on inflation than it really is. The problem is that no one can be sure that the government values its low-inflation reputation enough (relative to how much it wants to win re-election) to keep its pledge; even if the government would have followed through with its promises, private actors might nevertheless keep inflation expectations high. If there is no independent central bank to which control of monetary policy can be ceded, governments in these circumstances are likely to be drawn more to fixing the exchange rate, especially in countries that have a history of chronic inflation. Fixing the value of the currency is a way for the government to signal to private actors that it is committed to keeping inflation

under control by raising the potential costs to itself should it fail.

Another important context in which incomplete information about the government may play a key role in shaping policies is the case in which a government is attempting to reform trade policy in the face of stiff opposition from groups in import-competing industries. In such cases, since the government may indeed have an incentive to back down if it encounters a major political revolt, any promises it makes in advance to hold fast to the reforms may not be considered credible by the groups (who know full well that the government could just be trying to bluff its way through the painful reforms). Thus, even if the government does fully intend to stick with the reforms, it may have to weather a long and costly (and perhaps even violent) political protest. Again, tying its own hands in some clear and visible way can be an especially attractive policy option for a government in this situation, and by signing an international trade treaty with a major regional partner, it might be able to do the trick. This desire to make a credible commitment to trade reform is widely held to have been a large reason why the Mexican government initiated the negotiations that produced the NAFTA agreement in 1993, after two decades of failed efforts to lower trade barriers unilaterally (see Whalley 1999*b*).

Combinations of policies and issue linkages

Up to this point we have been examining one type of foreign economic policy at a time. It is clear, however, that the effects of different policy instruments often depend upon how *other* policies are set. In the basic Heckscher–Ohlin model, trade and factor movements are *substitutes* for one another—more of one type of international flow will generally mean less of another and vice versa. If exports of labour-intensive products can move easily across a border between a labour-abundant economy (where wages are low) and a labour-scarce economy (where wages are high), this will tend to equalize labour costs over time, reducing the incentives for workers themselves to try to migrate between countries. If exports between the

countries are blocked or impeded, more workers are likely to try to cross the border into the country that pays higher wages. When a dam is placed in front of flows in one channel it tends to divert flows into other channels.

This interaction among policies can become very interesting because we know that while trade and factor flows are substitutable in general terms, they actually have different types of effects on individuals. Individuals may thus have preferences over different combinations of policies. Perhaps the best example concerns the relationship between trade flows (and trade barriers) and direct investment. There is a great deal of evidence that firms engage in direct investment in markets as a way of 'jumping' trade barriers that would inhibit exports, and they even seem to reduce exports and invest more to stave off anticipated pressure for tariffs among local firms—a phenomenon known as 'quid pro quo foreign investment' (Bhagwati et al. 1987; Blonigen and Feenstra 1996). Local firms may be able to raise trade barriers, since they should have the lobbying support of their workers whose jobs are endangered by high levels of imports, but they are less likely to win restrictions on inward direct investment by foreign firms since workers in the industry will benefit from any new inflows of capital. Indeed, the best *policy combination* for local workers in an industry facing competition from a (relocatable) foreign producer is a high tariff *and* no restrictions on inward foreign investment. Local firms would prefer restrictions of *both* types of exchange, but would accept any restrictions rather than none at all if those are the politically feasible options. This political logic helps explain the common pattern in policies toward the automobile industry in Europe and North America, where restrictions on imports were negotiated with Japanese auto firms but no restrictions were imposed to block the same firms from investing heavily in production facilities within both markets.

Exchange-rate policy can also be 'in play' at the same time as trade policy. Trade policy and exchange-rate policy are partially substitutable: a 1 per cent depreciation of the currency is equivalent to a 1 per cent across-the-board tariff on imports and a 1 per cent subsidy for all exports. But clearly the coalition that supports depreciation—those invested and employed in both import-competing and exporting

industries—is different from the coalition that would support higher tariffs (import-competing interests). Exchange-rate policies tend to be more rigid than trade policies, in general, mainly because the credibility of monetary policy commitments is undermined by frequent shifts in policy. But when there is an opportunity for the government to alter the exchange rate, intense lobbying for protection by import-competing groups (or even just the threat of it), may induce export interests to help persuade the government to weaken the currency—an outcome that would ease the competitive pressure on producers threatened by imports, while not harming (benefiting, in fact) those engaged in export industries. This seems to have been the case in the United States in the early 1980s, as the value of the US dollar rose dramatically. While the White House appeared to prefer to leave both its currency and trade policies unchanged, fearing a spate of protectionist legislation from Congress in response to lobbying by firms and unions in import sensitive sectors, and hearing support for depreciation from export interests as well, it moved in 1985 to weaken the value of the dollar. Similarly, in many Latin American nations in the 1980s and 1990s, governments attempting reforms aimed at lowering barriers to trade were able to render these changes more politically palatable to threatened sectors by devaluing exchange rates at the same time (see De Gregorio 2001).

Perhaps even more important, in some ways, than these connections between different foreign economic policies are the linkages that have been made with increasing frequency in recent policy debates between these policies and a variety of *non-economic* issues. Some of these linkages are not new. Trade and investment policies have always been connected in various ways to the issue of national security. Most governments place tight controls on trade in weapons and dangerous chemicals, for instance, and restrictions on foreign investment in strategically important industries (for example, energy, airlines, and broadcasting) are also common. And governments have strong incentives to lower barriers to trade and investment more rapidly among alliance partners than with other nations in the international system, as the post-Second World War experience in Europe, and among the industrialized democracies more generally, makes clear (see Gowa 1994). All individuals

within an economy tend to share similar concerns about national security, so this form of issue linkage tends to affect policy making in a fairly straightforward way, generating more support among all citizens for policy options that contribute most clearly to national security. But foreign economic policies are now linked more regularly with a range of other non-economic issues about which individuals tend to have more varied opinions. Most importantly, trade and investment are now frequently linked to discussions of environmental policy and to human rights issues in the political debates about globalization in Western democracies.

How do these issue linkages affect the analysis of the politics of trade and investment? The clearest impact is the involvement of a variety of organized environmental and human rights groups in recent debates over regional trade agreements and the WTO (see Destler and Balint 1999). The members of these groups care deeply about addressing environmental and human rights problems in their own countries and in other countries around the world, and they either believe that globalization is making these problems worse and thus should be restrained in some way, or they argue that trade and investment provide economic leverage which can and should be used to persuade governments in developing nations to improve environmental and labour standards and democratic institutions. The position taken by many of these groups is that all trade agreements, including the WTO itself, should include provisions for minimum environmental and labour standards that would be enforced (if necessary) by the imposition of trade sanctions. Many environmental groups have also lobbied for changing the existing rules of the WTO, so that laws that discriminated against foreign products on environmental grounds (for example, import bans on tuna caught using nets that also endanger dolphins) would be permissible. But environmentalists and human rights activists have also expressed grave concerns about the behaviour of multinational firms in developing nations, with much of the focus being on whether these large corporations are moving production to areas in which they can pollute and otherwise damage the environment, or run 'sweatshop' factories in which they mistreat and underpay workers, avoiding the regulatory supervision that would prevent such behaviour in

their home countries. The policies recommended by these groups, and especially by human rights organizations worried by the lack of democratic institutions in countries such as China, typically involve a more proactive use of economic sanctions—that is, Western governments cutting off trade with, and investment to, such 'problem' nations until their leaders make significant political reforms. Consumer boycotts aimed at particular corporations that are investing in such nations are usually warmly recommended too (although these types of consumer actions represent private, market behaviour and are thus not a question of public policy).

One important general development has been the formation of what might be called 'Baptist and bootlegger' coalitions between some of these issue groups and the business and labour organizations that have an economic stake in restricting international trade and/or investment. This type of coalition gets its name from American politics in the era of Prohibition, when strong support for the ban on alcohol sales came from Baptists, on moral grounds, and from bootleggers, who made large fortunes selling alcohol on the black market (see Yandle 1984). In recent debates over the NAFTA in the United States, for instance, environmental groups such as the Sierra Club, joined with labour unions in lobbying against the agreement on the grounds that it did not contain provisions that would ensure a substantial improvement in environmental and labour standards in Mexico (see Destler and Balint 1999: 42–5). And recent 'anti-sweatshop' campaigns, organized by human rights groups and student activists, and targeting foreign investment and outsourcing by US apparel manufacturers to nations such as Vietnam and China, have been backed financially and supported enthusiastically by American textile unions and firms producing locally.

The concern among many analysts, especially among those who generally support international economic integration for its ability to raise living standards in all countries, is that these types of political coalitions may be hijacked by their protectionist members who support restrictions on international trade and investment *regardless* of whether they have any positive (or negative) long-term effects on environmental conditions or human rights standards. It would be far better, many argue, to pursue

improvements in environmental and human rights standards by working towards separate international treaties dealing with those precise issues in a more direct way, perhaps by compensating developing nations for making costly improvements to their environmental and labour laws. Sanctions could severely limit economic growth in the very poorest developing countries where governments are likely to resist making political concessions (especially democratic reforms that increase the risk that they will be toppled from power). The issues are complex, however, and the political problems are difficult. The 'Baptists' are drawn to supporting economic sanctions rather than other policy instruments (for example, new international treaties, or foreign aid grants to nations that improve their environmental standards) because they have calculated that these alternatives are politically infeasible. With the support of the 'bootleggers' for restrictions on trade and investment, however, they might stand a greater chance of getting something done that will have beneficial effects.

The general point here is that our simple, one-issue-at-a-time approach to the analysis of foreign economic policies becomes much more complicated when we allow that different policy instruments are often up for grabs at the same time and have partially substitutable effects, and if we account for the fact that a variety of groups are often interested in using the tools of foreign economic policy to advance non-economic types of goals. Often it is the institutional context in which government decisions are made (many of the features of which we have discussed above) that determines which types of policy instruments are more adjustable than others and which types of political coalitions are more viable than others. The most comprehensive and persuasive accounts of economic policy making will take all these complexities into account.

International bargaining and domestic politics

Finally, in anticipation of the chapter that follows, it is worth pausing here briefly to consider the ways in

which the domestic politics of foreign economic policies may be translated into international-level bargaining over these same issues. What we really require here is a theoretical model of the policy-making process that takes into account all of the incentives and constraints operating among actors at both the domestic and international levels. This is the type of model Putnam (1988) famously envisioned using the metaphor of the 'two-level game'. A government engaged in international economic negotiations actually plays two different political 'games' at the same time, he suggested, with its actions constituting 'moves' that must be seen not only in the context of the demands made by individuals and groups in *domestic* politics, but in view of the bargaining power that it has when negotiating *international* agreements with other governments. Government leaders negotiate with other leaders at the international level over the terms of economic agreements, and in those negotiations the relative size and strength of the economy can make a tremendous difference to the terms that can be demanded. But the leaders must be attuned to the preferences of the domestic groups whose support they need to remain in office and the set of international deals that would actually be ratified or supported by these groups at home.

To date, theoretical work along these lines has focused mainly on differences between the preferences of legislative and executive branches of government, and their different agenda-setting and vetoing powers, and how these features of domestic politics affect the outcomes of international negotiations and agreements (see Evans, Jacobson, and Putnam 1993; Milner 1997*a*). Much of the attention has been directed to the so-called 'Schelling conjecture', which holds that a hawkish domestic constituency—represented in the simplest models as a legislature that prefers very little international cooperation—can actually improve the bargaining power of the executive branch in its dealings with foreign counterparts (Schelling 1960: 28–9). Recent work has also focused on how executive-legislative divisions affect the credibility of governments during international negotiations (for example, Martin 2000) and whether international agreements are negotiated to allow for greater flexibility in cases when

future changes in domestic political coalitions might lead to substantial shifts in the types of policies a government can implement (Downs and Rocke 1995).

While full of insights about the effects of domestic political institutions on the prospects for international cooperation, this line of work has so far paid very little attention to the roles played by organized interests and voters in shaping legislative and executive preferences on particular policy issues. In fact, to date, standard political economy models of trade politics, emphasizing the role played by organized lobby groups in the formulation of policy, have not been linked at all to two-level game models of negotiations over trade and other economic agreements. Moreover, the existing work on two-level games tends to concentrate overwhelmingly on parameters that operate only on one level—domestic politics in the home nation. Features of the strategic relationship between nations, such as the economic and military asymmetries that might affect relative bargaining power, or common ties to alliances or international institutions that might affect incentives to cooperate, are largely ignored. We clearly need a better two-level mouse trap: a model that incorporates a fuller representation of organized interests and lobbying at the domestic level, while also allowing for the ways in which incentives and constraints are generated at the international level.

In practice, most international political economists work with partial theories that focus on one set of causal variables operating at one level. Some argue that the features of the international system, such as the distribution of economic power, and any specific nation's position within it, impose broad but important constraints upon what governments can and cannot do when setting policies. Others, in keeping with the orientation of this chapter, argue that the prime focus of our attention should be placed on what is going on within nations—their particular sets of political institutions and the preferences and lobbying activities of different group of individuals—since it is these things that primarily determine the policies chosen by governments. But in principal, almost all scholars recognize that politics at both the domestic and international levels should be a feature of any complete analysis of foreign economic policy.

Integrating theoretical insights about politics at these two levels is an extremely complex and challenging task that still remains, to a very large extent, undone.

Key points

- To understand the domestic origins of foreign economic policies we need to perform two main tasks: first, map the policy preferences of different groups in the domestic economy, and then specify how political institutions affect the way these preferences are aggregated into actual government decisions.
- Policy preferences depend mainly on the types of assets people own, and how the income earned from those assets is affected by different policies.
- Political institutions affect policy outcomes by defining who gets to vote, how political representatives are elected, and how policy making takes place in legislatures and is delegated to presidents and government agencies.
- New ideas about cause-and-effect relationships appear to have had a large impact on foreign economic policies in different eras. The relationship between ideas and interests is far from clear, however, and we need a better understanding of where new ideas about policy come from and what explains which ideas catch on and spread.
- Foreign economic policies involve a complex set of issues about which most voters have very low levels of information. As a result, the politics of globalization may be regarded to some degree as a competition in issue framing among organized interests.
- If private actors have incomplete information about the degree to which the government is committed to policy reforms, the government may have an incentive to tie its own hands in some visible way (e.g. by fixing the exchange rate, or signing a trade treaty) to signal its intentions in a credible way.
- Since the effects of a change in one type of foreign economic policy may depend upon choices made about other types of policy, individuals may have preferences over different combinations of policies that are closely related (e.g. tariffs and restrictions on inward investment induced by tariffs).

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- Trade and investment policies are also linked to discussions of *non-economic* issues. One important development has been the formation of ‘Baptist and bootlegger’ coalitions between environmental and human rights groups concerned about globalization and business and labour organizations that have an economic stake in restricting international trade and investment.
- Governments may be thought of as playing political games at two levels, their actions constituting moves that are both responses to demands made by groups in *domestic* politics and responses to offers made by other governments in *international* negotiations.
- We need a better theory of two-level games that incorporates fuller representations of both domestic and international politics. In practice, most international political economists employ partial theories that focus only on variables operating at one level.

QUESTIONS

- 1 If the economic case for trade liberalization is so strong, why is it that governments continue to impose barriers to trade and are so frequently engaged in trade disputes?
- 2 Trade theory does not imply that every individual within each nation will benefit from the lowering of trade barriers, just that aggregate benefits will exceed aggregate losses. Who stands to benefit most from trade liberalization in the advanced economies of Europe, Japan, and the United States and who is most likely to be disadvantaged? What about in developing nations with different types of factor endowments?
- 3 Can these different groups of individuals reach some kind of agreement so that trade liberalization can benefit everyone? What are the political obstacles to this type of agreement?
- 4 Is it inappropriate to think only, or primarily, in terms of economic gains and losses when evaluating the effects of increased international trade? How important are other types of concerns (for example, national security, income inequality, environmental hazards, human rights abuses) in the political debates that determine policy outcomes?
- 5 What types of electoral and policy-making institutions tend to mitigate the effects of lobbying by protectionist groups when it comes to the determination of trade policy? Are electoral systems based upon proportional representation likely to generate less protection than plurality systems?
- 6 Do the economic effects of immigration shape the political struggles over changes in immigration law? Or do the politics of immigration reflect other types of cultural and social divisions within host countries?
- 7 What are the economic effects of foreign investment for the source country and for the host country? Does foreign investment generate a ‘race to the bottom’ in labour and environmental standards in developing countries? Does it inhibit democratic reform?
- 8 What economic and political changes during the twentieth century led to the abandonment of fixed exchange rates among the advanced economies? Why do many developing countries continue to fix their exchange rates?

FURTHER READING

Trade

- Destler, I. M. (1995), *American Trade Politics*, 3rd edn. (Washington DC: Institute for International Economics). This is required reading for anyone interested in how US trade policy is made. It provides a comprehensive analysis of American political institutions and policy making.
- Hayes, J. P. (1993), *Making Trade Policy in the European Community* (London: Macmillan). This book provides a thorough discussion of the processes of trade policy making in the European Community.
- Hiscox, M. J. (2002), *International Trade and Political Conflict* (Princeton: Princeton University Press). An analysis of historical changes in levels of factor specificity in several Western nations, relating these changes to shifts in political alignments in trade politics.
- Krueger, A. O. (1995), *Trade Policies and Developing Nations* (Washington DC: Brookings Institution). An engaging discussion of trade liberalization in developing nations in recent years.
- Rogowski, R. (1989), *Commerce and Coalitions* (Princeton: Princeton University Press). A sweeping analysis of coalitions in trade politics in a variety of historical contexts, based upon an application of the Stolper-Samuelson theorem.

Immigration

- Borjas, G. J. (1999), *Heaven's Door: Immigration Policy and the American Economy* (Princeton: Princeton University Press). A provocative analysis of the effects of immigration in the United States in recent decades.
- Fetzer, J. S. (2000), *Public Attitudes toward Immigration in the United States, France, and Germany* (Cambridge: Cambridge University Press). This book uses available survey data to compare public attitudes toward immigration in the United States, France, and Germany and the determinants of anti-immigrant sentiments.
- Tichenor, D. J. (2002), *Dividing Lines: The Politics of Immigration Control in America* (Princeton: Princeton University Press). A very impressive history of immigration politics in the United States.

Investment

- Crystal, J. (2003), *Unwanted Company: Foreign Investment in American Industries* (Ithaca, NY: Cornell University Press). An excellent study of political debates about inward direct foreign investment in the United States.
- Graham, E., and Krugman, P. R. (1995), *Foreign Direct Investment in the United States* (Washington DC: Institute for International Economics). This book provides a comprehensive analysis of the economic and political effects of inward foreign investment.
- Moran, T. (1998), *Foreign Direct Investment and Development* (Washington DC: Institute for International Economics). An excellent study of the effects of direct foreign investment in developing nations.

Exchange Rates

- Frieden, J., Ghezzi, P., and Stein, E. (eds.) (2001), *The Currency Game: Exchange Rate Politics in Latin America* (New York: Inter-American Development Bank). A very interesting collection of research on the politics of exchange rate policies in Latin America.
- Henning, R. C. (1994), *Currencies and Politics in the United States, Germany, and Japan* (Washington DC: Institute for International Economics). This book provides a clear and

detailed discussion of exchange-rate policy making in the United States, Germany, and Japan.

Simmons, B. A. (1994), *Who Adjusts? Domestic Sources of Foreign Economic Policy During the Interwar Years* (Princeton: Princeton University Press). An impressive analysis of the political determinants of exchange-rate policies adopted by Western nations in the inter-war period.

Institutions

Gilligan, M. (1997), *Empowering Exporters: Reciprocity and Collective Action in Twentieth Century American Trade Policy* (Ann Arbor: University of Michigan Press). A fine study of the importance of institutionalizing reciprocity in trade policy making.

Hiscox, M. J. (1999), 'The Magic Bullet? The RTAA, Institutional Reform, and Trade Liberalization', *International Organization*, 53/4: 669–98. A critical review of research on the RTAA that emphasizes the role of political parties and their core constituencies in the politics institutional change.

Rogowski, R. (1987), 'Trade and the Variety of Democratic Institutions', *International Organization*, 41/2: 203–23. A classic analysis of the ways in which different types of electoral institutions affect trade policy outcomes in democracies.

Wintrobe, R. (1998), *The Political Economy of Dictatorship* (Cambridge: Cambridge University Press). An excellent analysis of policy making in non-democratic regimes.

Extensions and complications

Elliott, K. Ann, and Freeman, R. (2003), *Can Labor Standards Improve under Globalization?* (Washington DC: Institute for International Economics). This book provides a comprehensive review of the debates about whether trade and investment policies should be linked to agreements about improving labour standards in developing nations.

Goldstein, J., and Keohane, R. O. (eds.) (1993), *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change* (Ithaca, NY: Cornell University Press). An important collection of essays discussing the impact of new ideas on foreign policy outcomes.

Graham, E. (2000), *Fighting the Wrong Enemy: Anti-Global Activists and Multinational Enterprises* (Washington DC: Institute for International Economics). A compelling analysis of the effects of direct foreign investment in developing nations that argues that criticisms made by environmental and human rights groups are misguided.

Irwin, D. (1996), *Against the Tide: An Intellectual History of Free Trade* (Princeton: Princeton University Press). A sweeping account of theoretical developments in economics that support the case for trade liberalization.

WEB LINKS

For regular research reports and briefs on policy issues:

www.iie.com/ Institute for International Economics.

For theoretical background on international economics and helpful beginner guides:

www.internationalecon.com/ International Economics Study Center.

www.amosweb.com/gls/ Amos World Economics Glossary.

For data and analysis of public opinion on international economic issues:

<http://people-press.org/pgap/> The PEW Global Attitudes Project.

www.pipa.org/ The Program on International Policy Attitudes (PIPA).

For data on world trade, migration, and investment:

www.wto.org/english/res_e/statis_e/its2003_e/its03_toc_e.htm WTO's International Trade Statistics.

www.migrationinformation.org/Profiles/ ILO's International Labour Migration Database.

http://r0.unctad.org/en/subsites/dite/fdistats_files/WID3.htm UNCTAD's World Investment Directory.

For information and statistics on trade, immigration, investment, and exchange-rate policies:

<http://cs.usm.my/untrains/trains.html> UNCTAD's TRAINS Database of Trade Control Measures.

www.wto.org/english/tratop_e/dda_e/tnc_e.htm WTO's Negotiations Committee.

www.ustr.gov United States Trade Representative (USTR).

<http://europa.eu.int/comm/trade/> European Union Trade Policy.

www.meti.go.jp/english/index.html Japanese Trade Policy.

www.migrationpolicy.org/ The Migration Policy Institute.

www.imf.org/external/np/tre/tad/exfin1.cfm IMF's Country Finances and Exchange Rates.

www.federalreserve.gov/ Federal Reserve Board.

www.bankofengland.co.uk/ Bank of England.

www.ecb.int/ European Union Central Bank.

www.boj.or.jp/en/ Bank of Japan.

