International Political Economy Final

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It will not be easy to fix Zimbabwe's current hyperinflationary economy. With over 79,600,000,000 percent inflation and 95 percent unemployment, new economic steps must be taken. Liberal and mercantilist developmental approaches have their pros and cons. Zimbabwe should, however, adopt the liberal approach to development in order to create a solid economic foundation and integrate into the international market for long-term growth.

Mercantilist development strategies rely on import-substitution industrialization (ISI). Instead of relying on the international market, a state focuses instead on domestic consumers. This is based on the dependency theory, a Marxist thought, which states that a developing country must remove itself from the international arena that is overseen by the powerful states to develop without hindrance. A state develops their industrial industries to provide for their citizens to accomplish this. Nationalized industrial industries therefore produce a majority of the goods available in a protectionist state. This echoes the basis of mercantilist economic theory in which home industries are protected and imports are limited to encourage self-reliance. The ISI strategy allows countries to grow on their own before entering the international market. Dani Rodrik in an article entitled "Trading in Illusions" cites numerous states as examples of countries that prospered from not immediately opening their markets.

"Public enterprises during the Meiji restoration in Japan; township and village enterprises in China;…infant-industry protection in Brazil during the 1960s and 1970s – these are some of the innovations that have been instrumental in kick-starting investment and growth in the past," (Oatley, 265). Countries such as Japan, Brazil and China are now world leaders in the international market.

Subsidies, tariff and non-tariff barriers are used to protect domestic industries. Tariff barriers include tariffs, countervailing duties and anti-dumping laws. However, because these types of barriers must be approved by the World Trade Organization and often encourage trade partners to put up similar barriers; mercantilist states have turned towards non-tariff barriers. By using safety concerns as an excuse to make it difficult for a foreign good to sell in their state, raising the price through taxes or placing warnings on the packaging, it encourages consumers to buy items that are domestic.

To fund this expensive domestic endeavor, a state must borrow from either international bodies like the International Monetary Fund or other states. The state is also the central authority and ensures that domestic markets are taken care of by nationalizing companies. That way the government can control how the business is run. Price controls are also an aspect to ISI. The state uses controls to help keep domestic goods from becoming too over or underpriced to local consumers.

The focus on equity over efficiency in ISI can lead to recessions and government corruption. A balance of payments crisis can occur if a country is not able to balance domestic costs with paying back loans. A bureaucratic approach to running the economy leads to inefficiencies from politicians choosing to protect firms owned by allies rather than only allowing efficient businesses to thrive. Prices in the country will also rise as efficiency lowers from lack of competition, which fuels innovation and therefore allows few businesses to set high prices for goods that consumers need. The lack of open trade hurts domestic endeavors according to Douglas A. Irwin in “The Employment Rationale for Trade Protection.”

“If the United States took action to reduce the trade deficit (supposedly reducing the number of jobs lost to trade), those capital inflows would necessarily fall. Then domestic investment would have to be financed by domestic savings, implying higher interest rates, which would reduce the number of jobs created by business investment,” (Oatley, 21). By protecting the domestic market from outside investors, the state could actually end up hurting their own workers. Paul Krugman, a liberal economist, does not see international trade as a zero-sum game like mercantilists do. This refutes the notion of factor-price equalization, which states that trade with a less developed country could push wage prices down to the lower level and therefore hurt domestic industries. Krugman dismisses the empirical evidence cited in an article by Lester Thurow on wage decreases in America from competition with Japan. "U.S. real wages, [Thurow] pointed out, had fallen six percent during the Reagan and Bush years, and the reason was that trade deficits in manufactories goods forced workers…into much lower-paying service jobs," (Krugman, 11). This was false because these laborers make up a very small percent of the American work force and could hardly affect the real wage price for the whole country. Liberals see the international market as one of only positive-sums where all parties grow in trade.

Developing countries that use export-orientated growth (EXG) focus on open trade and high rates of export. This is a liberal perspective because open trade with many partners is the most efficient way to export the best goods. Importing from other countries also encourages diversification and lowers prices. Efficiency and freedom of the market are each a foundation to the liberal perspective. The state, however, must invest in industries and education in the beginning to lay the foundation for a free economy. Milton Friedman, a liberal economist, in "Capitalism and Freedom" highlighted the importance of the government acting as an umpire, even for developed countries.

"It is desirable that we use the government to provide a stable monetary framework for a free economy…It is desirable too that we use government to provide a general legal and economic framework that will enable individuals to produce growth in the economy…" (Friedman, 28).

Integration with the international market is the key to accomplishing this development method. Open capital flows is also a way that a state using EXG increases the amount of competition and investment in the domestic arena.

The economic liberal theory aims to keep minimal government control of monetary policies. EXG, however, relies on the state to create a domestic comparative advantage before letting markets take over. To counterbalance the inequality that markets create, the state must initially limit spending and keep debt low while keeping a strong political stance to ensure that there is no unrest. Political disorder could disrupt producers or consumers engagement with the market. The government must also invest in education to ensure that workers are producing the best goods possible. An educated workforce is then able to produce higher value goods than those without. Exports are therefore worth more, which means that the state can sell less for more than if they exported only cheaply made goods. In the end, equality is not an issue as the markets will kill inefficient industries to make way for those with high productivity and worth.

Focusing on a push towards efficiency over equity can make prices high, which can hurt domestic buying power. The government's tight fiscal policy and focus on encouraging industries makes it difficult for them to spend extra money on domestic issues. Without heavily subsidizing and protecting all industries, those using the EXG strategy leave inefficient or cheap industries to the volatility of the international market. The use of bilateral trade agreements can also hurt domestic workers. Robert E. Scott in "The China Trade Toll" showed that our trade relationship with China has led to the U.S. losing jobs. This is due to a growing trade deficit from the U.S. consumer-driven economy.

"U.S. exports to China in 2001 supported 166,700 jobs, but U.S. imports displaced production that would have supported 1,188,200 jobs…," (Oatley, 9).

From 2001- 2007, the use has lost 382.5 jobs as the trade deficit increased by 30 billion. (Oatley, 7). This is a prime example of how liberal tendencies may create a dependency on another country due to the most efficient countries producing certain goods. However, if the state invests enough into important industries in the beginning then they could avoid reliance on another state.

Countries have switched from ISI to EXG during a crisis because of the need to grow without a budget deficit. After facing a huge inflation rate from protectionist policies, Chile had a political upheaval. President Salvador Allende was killed and General Augusto Pinochet came into power. Although an expert at military affairs, Pinochet was at a loss at how to fix the high inflation rates. Eventually, Chile was turned towards a liberal strategy by American-educated Chileans called “The Chicago Boys.” These University of Chicago graduates had watched the economy spiral downward during Allende’s leadership and kept note of how to fix it. A businessman named Javier Vial invited Milton Friedman, a world-renowned liberal economist, to give lectures and plant the seeds that government control created an inflationary economy. Friedman was also invited to speak to Pinochet, using an example of cutting a dog’s tail to show that immediate action needed to be taken. “If you cut the tail to a dog in pieces, step-by-step, you will kill the dog. This is the same as inflation. You have to cut it at once and then the country will start moving,” was what Friedman said to Pinochet according to Vial. This encouraged people to support economic reform.

The Chicago Boys were then allowed to create the new economic plan for the frantic state. Five-hundred businesses were privatized to increase efficiency. Without the temptation to use industries for political gains as government officials tend to do, businesses focused on increasing profits through producing goods that people wanted to purchase. The government budget was also cut, including military spending. Trade barriers were taken down to open up Chile to the international market and increase exports. This encouraged competition and therefore decreased inflation as more capital was able to freely flow into the country. However, this economic method led to a huge jump in income inequality as the cost of living rose. Unemployment rose to 30 percent. Chile began to grow at a fast rate at the cost of income inequality. This was the first case that a communist country turned towards liberal notions. Milton Friedman in his lectures noted that a free economic system always leads to political freedom. This occurred in Chile as a democratic election overthrew General Pinochet after the market system took over the economic system. Other Latin American countries were hesitant to adopt this successful economic model due to General Pinochet's violent regime. The blood of the 2400 that went messing or died during his reign tainted the liberal model and much of Latin America stuck to ISI for some time.

Bolivia was using an ISI strategy of growth and had the seventh highest inflation rate in history at 23,500 percent. The 189 military coups of Bolivia's past showed that it was a political unstable country, which had a huge affect on economic issues. The inflation would increase by one percent every 10 minutes, making the price of essential commodities such as food difficult to attain. This was especially difficult for the poor as seven out of 10 Bolivians lived below the poverty line. The government was causing this. By spending 30 times more than it received from domestic taxes, it was creating a huge budget deficit from getting shaky loans from banks full of petrodollars and constantly printing money. Bolivia could get no loans from any other international body or country. Jeffrey Sachs, a Harvard professor, was invited to come to Bolivia and give advice on how to fix this economic conundrum. With inflation at 60,000 percent in the 1980s, Sachs aided the new minister of planning Gonzalo Sanchez De Losada in creating a new economic plan. Called "shock therapy," the new economic model included abolishing price controls, import tariffs and reliance on loans and cutting and balancing the government's budget. In response, the cost of fuel, food and transportation all rose in price. This state would be a shining example of how economic reform could work quickly and fix a hyperinflationary economy. This lead to a huge change in Latin America as large countries such as Brazil and Argentina began to use shock therapy to fix their own inflationary economies.

The Soviet Union used ISI to protect its domestic industries and encourage socialist motives. The Kremlin owned all industrial and military endeavors. The economy was fueled by the use of political prisoners as free labor to work and produce goods. Oil prices allowed the government to spend over one-third of its budget on military protection such as ballistic missiles. The central government was using the military to provide protection from outside influences. The Soviet Union domestic economy was in trouble however. Oleg Gordievsky, a KGB defector warned Britain of the economic problems that the Soviet Union faced because of this focus on military spending. Oil prices were the only reason that the economy was not feeling a deficit, according to Gordievsky. There was a deficiency of basic necessities such as panty hose, toothbrushes and soap. Workers were unproductive because there was little incentive to increase their productivity if the government controlled wages. Reliance on the price of oil left the Soviet Union even worse off as the price crashed and people began to turn towards market ideals. Grigory Yavlinsky, an economist in favor of change, watched Poland's reforms and was asked by Mikhail Gorbachev to create plan from socialism to free market economy. Yavlinsky wanted to use shock therapy but Gorbachev was hesitant, believing that each country needed to change in its own way. They tried China's mix of political stringency with open markets. This would not work as Russia had an 80 percent industrialized economy that then had to switch to new market ideals. China built new industries out of their agriculturally based system without hindrance.

Even today, countries are struggling with mercantilist versus liberal pros and cons. Syria is attempting to move away from a mercantilist economy towards a market-propelled one. The market is currently lacking, especially in the agricultural field that has slowly gotten less protection. These changes will not be easy as the high subsidies to businesses helped keep necessities such as food and fuel low priced and jobs prevalent. The government wishes to instead turn more towards foreign investment, which will cause prices to spike in the short-term until capital begins flowing into the country. Opening trade in 2005 has led to a flood of cheap goods from foreign competitors. The social sector has suffered with money not going towards investment into education and health care. Syria hopes that FDI will help change this. The opening of capital flow can be effective only after a macroeconomic overhaul. Sebastian Edwards analyzes this in “A Capital Idea?”

“The best prescription to fight financial turmoil, now as then, are sound macroeconomic policies, sufficiently flexible exchange rates, and banking reforms that introduce effective prudential regulations and reduces moral hazard and corruption,” (Oatley, 292).

Other countries are not interested in changing their stratigies. Bolivia is currently using the mercantilist ISI development strategy. By paying huge subsidies on fuels, the government has kept prices artificially low. The government nationalized the oil industry as well and used the profit to promote wealth equality through creating new infrastructure (roads) and social programs. When Evo Morales, the current president, removed the fuel subsidies and the prices rose, civil unrest ensued as bus drivers went on strike and stores were ransacked. After failing to tempt public workers with a 20 percent pay raise and extra incentives for the agricultural sector, Morales put the subsidies back on. Most of the economy is run by either the state or informal businesses such as street vendors, which made it difficult to quell the uprising against oil prices. The state running a business creates lack of efficiency and poor economic choices. Nationalized companies are less efficient than private sector businesses in two ways which are highlighted in “State Capitalism Comes of Age” by Ian Bremmer.

“First, commercial decisions are often left to political bureaucrats, who have little experience in efficiently managing commercial operations…Second, motivations behind investment decisions may be political rather than economic…Such behavior distorts the performance of energy market by increasing the cost that everyone pays for gas and oil.” (Bremmer, 3-4).

When politics comes before businesses practices, false booms can be created as was in Bolivia. This makes it nearly impossible to create a more liberal economy to decrease inflation without violent civil unrest and political instability. Low prices and barriers discourage foreign investment, which could help the country grow. ISI strategies create a dependency on a government that must balance protecting domestic industries with keeping a budget to fund isolationist tendencies. Bolivia continues to accept aid from America. Thirty-million dollars was accepted by Bolivia for development aid. This is problematic because it is obviously not helping change the impoverished nation if the government continues to pump money into social programs. This is a problem according to Jeffery Sachs in “The Development Challenge.”

“Aid intended for transformational development aims to support long-term economic change by helping a country achieve structural transformations that should allow it ultimately to escape dependence on outside aid,” (Sachs, 2). With an undying dependence on development aid, Bolivia has yet to create the “structural transformations” needed to show the success of aid.

Argentina attempted to use liberal economic strategies but was lured to fund unsavory practices by the unholy trinity and political unrest. The unholy trinity is a term coined in "The Triad and the Unholy Trinity: Problems of the International Monetary Cooperation" by Benjamin J. Cohen to describe the impossibility of a state changing capital mobility, national policy autonomy (money supply and interest rates) and still having a fixed exchange rate all at the same time. A state must choose just one of these features or will create an inflationary economy. "…the Unholy Trinity reduces to a direct trade-off between exchange-rate stability and policy autonomy," (Cohen, 251). Argentina pegged the peso to the dollar in a fixed exchange rate. The Argentinean central bank would therefore have to hold $1 in its vaults for every peso in circulation. This method attracted a large amount of foreign direct investment, which reduced the need for the government to manipulate the money supply. The peso than became overvalued as the fixed exchange rate did not meet Argentina's purchasing power parity. This meant that the government needed to manipulate their monetary policy, change the money supply or raise interest rates to manipulate money circulation in order to meet their currencies true worth on the international market that is measured in PPP. This caused a spike in prices, which would be politically unsavory to Argentinean leaders. Instead, the government began to borrow heavily from outside sources to continue domestic spending. This created a balance of payments crisis. As debt rose, so did inflation as FDI began to leave the country. In order to keep the capital flowing into the country, the country attempted to change their money supply through loans. This was the epitome of the unholy trinity and left Argentina in a huge debt crisis. This shows the importance of sticking to economically viable strategies for long-term success while using the liberal economic model.

Iran has been using mercantilist strategies in order to protect domestic industries. The government was spending $100 billion, 10 percent of the GDP, to keep necessities such as food, fuel and electricity prices low. This helped the rich pay for upkeep of their large homes and vehicles. After subsidies were removed by President Mahmoud Ahmadinejad, the price of petrol rose by 75 percent and diesel skyrocketed 2000 percent. The end of subsidies was an attempt to end the wasteful usage of resources, encourage the top 40 percent of the income scale to tighten fiscal tendencies and allow the government to spend more money on expanding infrastructure such as roads. This created a problem however, considering how reliable every commodity is on oil prices due to transportation of the goods. Inflation rose as well as unemployment as businesses cut down on expenses to balance the new increased price. The government promised to balance this out by giving high subsidies to Iranian manufacturers, which is just a continuation of inefficient ISI policies.

Zimbabwe should take note of the importance of trade openness mixed with a healthy institutional foundation. The examples of Bolivia and Argentina show the importance of an open market in a stable economy. Bolivia is too reliant on the government to make viable economic decisions. By having the state run the biggest economic endeavors, it encourages corruption and politically popular decisions over a healthy economy. However, simply switching to a more open market practice will not fix things for all countries as it did in Chile. Instead, Zimbabwe needs to take a note of Argentina. Although the state was using a balanced budget and attempting to discourage inflationary currency manipulation with a fixed exchange rate, political strife overcame efficiency desires. Only by focusing on efficiency and creating a healthy domestic foundation will a country successfully use EXG to develop. Foreign aid should be used minimally and only after the government has been turned into an uncorrupt group of institutions.

However, true trade liberalization and growth can only be successful with a democratic society. "Africa's Capitalist Revolution" by Ethan Kapstein highlights success of states that lie on the same continent as Zimbabwe with political liberalization.

"Even where democracy remains fragile, as in Kenya, leaders understand that the old patrimonial ways of doing business are becoming increasingly costly to maintain," (Kapstein, 1).

Only through changing domestic institutions can Africa begin to become a healthy addition to the international community.

"Trade is critical to Africa's economic growth, because Africans' incomes cannot rise if the countries are unable to export goods and services to richer regions…African countries themselves must do more to create free-trade zones and promote commerce with other developing nations," (Kapstein, 6).

Aid should therefore be in the form of the west encourage growth by dropping tariffs and intellectual property protection against developing countries. A state can only change from internally by those that understand the culture and needs of the citizens. Zimbabweans need to improve their own freedoms within their country before the west will be able to accept them as a viable trading partner. The government must not be swayed by painful liberal economic policies and stick an economically viable road to increase investment and therefore growth.