Hegemonic Stability Theory and the 20th Century International Economy

https://www.e-ir.info/2010/01/08/hegemonic-stability-theory-and-the-20th-century-international-economy/

RAHUL PRABHAKAR, JAN 8 2010

In this paper, I argue that the theory of hegemonic stability does not explain the failure of the interwar and the success of the post-1945 international economic orders. "Failure" and "success" are easy to identify in these time periods; flows of goods, services, capital, as well as political stability and global economic growth typify the post-1945 world, but were largely lacking for any sustainable amount of time in the interwar period. In order to consistently treat the theories discussed here, I consider the international economic orders of both time periods, instead of military and security issues. In the following, neoliberal and neorealist theories of hegemonic stability are discussed before alternative, mostly historical-based viewpoints are addressed. I assert that the neoliberal and neorealist theories do not have sufficient explanatory power because they neither explain most variation in economic stability during these time periods nor do they consider how preferences of domestic actors, such as export manufacturers and global investors, are transmitted to the international level. I develop the argument that it is through the international spillovers of domestic policy choices that the openness and stability of flows in trade and capital of the global economy are determined. I then apply this framework to the interwar and post-WWII periods, demonstrating that the lack of international monetary cooperation in the interwar period was due to the preferences of domestic actors in Britain, France, and the United States to sustain an eventually-devastating policy of gold standard adherence. In contrast, post-WWII cooperation and stability was ultimately achieved by a domestic societal consensus (most importantly in the United States) for embedded liberalism, reflected in monetary cooperation through the fixed-but-adjustable exchange rate mechanism. This consensus drove the creation of Bretton Woods institutions, which strengthened internationally-oriented domestic actors, who drove the foreign direct investment and intra-industry trade that set the stage for the current open international economy. This is not to suggest that American hegemony in the immediate post-WWII was not important, but that the internationally-important policy choices of the American hegemon were driven by domestic factors.

The basic theory of hegemonic stability can be approached from the neoliberal or neorealist direction.[1] A hegemon is the indisputably strongest state in the international system which "must have access to crucial raw materials, control major sources of capital, maintain a large market for imports, and hold comparative advantages in goods with high value added, yielding relatively high wages and profits."[2] From the neoliberal perspective, a global hegemon has the requisite economic size and political power to overcome collective action costs and generate international public goods, such as free trade, open flows of capital, and provision of liquidity during crises.[3] The existence of these public goods, in turn, generates economic and political stability.

From the neorealist perspective, structural factors of the international system dominate. Each state is concerned with four basic interests as impacted by the structure of international trade: political power, aggregate national income, economic growth, and social stability.[4] Where there is no hegemon, large states would compete for more modest gains from trade and openness would cause social instability in less developed states, as well as increase their political vulnerabilities. But where there is an ascendant, single hegemonic state, small states have access to a large export market and thus high potential for increases in aggregate national income and economic growth; the hegemon likewise has considerable export opportunities. Given the size of the hegemon and thus relatively low involvement in the international economy, costs of closure (in terms of threat to the hegemon's political power) will be small.[5]

An important consideration in the debate over hegemonic stability theory is the role of the hegemon in generating cooperation. The neoliberal hegemon rescues the financial system through the public good of counter-cyclical liquidity and the neorealist ascendant hegemon opens global trade through sheer economic size, but it is the hegemon which encourages institutionalized cooperation that creates a sustainable, open international economy. According to Keohane, hegemons induce weaker states to join cooperative regimes that decrease transaction costs, reduce uncertainty, and build consistent expectations for economic interactions. This is a more nuanced view than that suggested by the role of neorealist hegemon; the cooperative hegemon has to identify common interests with allies, adjust its own bargaining position, and "invest some of their power resources in the building of institutions."[6] These institutions, in turn, can impart durability for an open international economy in the face of hegemonic decline. Hence, a neoliberal emphasis on international public goods and the neorealist focus on structural factors underpin two basic theories of hegemonic stability, but can be readily revised by considering the role of hegemonic cooperation.

There exist alternative and competing viewpoints to the theory of hegemonic stability. Instead of operating at the international level, these perspectives focus on the domestic societal and political groups which influence state preferences towards the degree of openness of the international economy. Analyzing the interwar period which will be discussed later, Eichengreen argues that the "mentality" of the gold standard was a "hegemonic ideology" of "those segments of society that controlled economic policies, including central bankers and national politicians in Europe and the United States."[7] Regarding the post-WWII settlement, Ikenberry posits that British and American policy specialists formed "a set of normative and technical positions that were later embraced by wartime British and American leaders" and which correspond to the general public's receptiveness to an international order incorporating "embedded liberalism."[8] Ruggie's notion of "embedded liberalism," which Maier's historical perspective anticipates, represents the shared understanding among British and American policymakers to legitimate social objectives and creates a more robust welfare state.[9] Thus, different viewpoints steeped in the history of the interwar and post-WWII period go beyond the basic structural conclusion of hegemonic stability theory to arrive at an understanding of why a certain open international economic order was conceived.

Neither the neoliberal and neorealist hegemonic stability theories nor the alternative viewpoints outlined here consider how domestic societal and political preferences for openness in trade and capital and currency stability are transmitted to the international political economy. Neoliberal hegemony says little outside of Kindleberger's lesson "that for the world economy to be stabilized, there has to be a stabilizer, one stabilizer."[10] Neorealist hegemony insufficiently explains variation in global trade openness, as Krasner admits, for: 1900-1913 during which Britain preferred openness despite decline; 1919-1939, when the United States avoided initiating coordination; and 1960-present, when the United States has relatively declined, but trade and capital flows remain robust and open.[11] Hegemonic cooperation cannot be explained in terms of institutions alone, since "institutions created during periods of rising ascendancy remained in operation when they were no longer appropriate"; attendant domestic societal and political pressures are required to sustain the usefulness and viability of institutions.[12] Moreover, for all of their valuable contributions to understanding the international economic order that emerged, historical-based perspectives focused on fixed periods of time say little about how domestic preferences translate into policy outcomes at the international level.

There is considerable scholarly consensus that international cooperation on exchange rates—or lack thereof—is critical to understanding interwar instability and post-WWII stability. States are socially, economically, and politically different from each other, and will thus have heterogeneous preferences towards exchange rates.[13] As Frieden has demonstrated, within these states, domestic actors have divergent preferences: export-oriented manufacturers, international investors, and tradable goods producers prefer exchange rate stability, whereas import-competing manufacturers and producers of non-tradable goods prefer variability that allows for monetary policy stimulus.[14] Moreover, as Broz has argued, if exchange rate stability is considered a public good because it facilitates trade and investment largely without currency risk, then more than one state can actually bear the costs and provide it—after all, major states must consider how their actions affect domestic actors. These actors in powerful countries, such as the United States in the interwar and post-WWII periods, are aware that the international implications of their governments' policies (international externalities) affect their own welfare, and thus "because the international spillovers of domestic policy choices may be positive as well as negative, a stable international monetary regime can exist even when the preferences of major states vary widely."[15] At different times, domestic actors may perceive their interests (defined as the degree of exchange rate stability) differently; these preferences towards exchange rate stability are surely influenced by the prevailing international economy, but it is these interests that are transmitted to national governments which act upon them at the international level.

The interwar and post-WWII periods are suitable cases to test the framework that domestic precedes international politics—the international monetary regime is the product of spillovers from the divergent domestic interests within differing states. Through the *Pax Britannica* of the nineteenth century and into the twentieth century, British support of the gold standard resulted from a powerful domestic coalition of the "City of London, landlords, bondholders, and international-competitive industry."[16] Britain did not *solely* support the gold standard, however; France was actually the international lender of last resort in the Barings Crisis of 1890 and the 1906-1907 American financial crises. Again, this did not arise out of some altruistically conceived interest, but through domestic pressures for a depreciated franc that came from small agriculture, relatively weak export manufacturers, and a mostly domestic financial sector. In France, the national interest of protecting domestic actors from global financial collapse dominated, and so its central bank acted as lender of last resort.[17]

British support for the gold standard and France's lukewarm and fluctuating support for the gold standard are especially evident in the interwar period. As Eichengreen describes, the Treasury in Britain emphasized wage reductions as the most efficient way to lower labor costs, a mandate dictated by the gold standard and preferred by the internationally-oriented banks in the City of London. These same banks had threatened in 1924 that London's position as the world's financial center would fade if the government did not return to the gold standard.[18] Workers, who "had participated in the war effort and now expected recompense," tried to resist by going on general strike, but were defeated.[19] Maier encapsulates this dominant preference (lower labor costs) of internationally-oriented domestic actors across Europe: "Industry spokesmen felt that profits were faltering, capital accumulation and investment was imperiled, and in turn, international competitiveness endangered. They sharply attacked what they perceived as the politically determined costs of labor and of new social insurance obligations."[20] Similarly, France's mindset of sheltering domestic actors from the international economy did not change; as Clavin describes, the government hoarded gold when it returned to fixed exchange rates to combat the inflation of the early 1920s. This nationally-motivated decision helped render the gold standard order unstable, by depleting the reserves of other central banks (except the United States, which also accumulated gold) and forcing other governments to raise interest rates to maintain the standard.[21]

The interwar decisions of the United States, so much the focus of hegemonic stability theorists, are likewise attributable to the dominance of specific domestic interests over others. U.S. foreign portfolio investment had grown from $1 billion in 1914 to $3 billion in 1919, while the government held foreign bonds worth $12 billion; all of this meant the U.S. was the world's banker.[22] Predictably, internationally-oriented industrialists and bankers supported a return to the gold standard. But, international engagement by the government and Wall Street—by adhering to the gold standard and serving as a source of investment and credit for the rest of the world—was solely out of domestic interest. The world's largest foreign lender also imported twelve percent of total global imports, but began to erect protectionist barriers, particularly in agriculture.[23] With the late 1920s stock market and speculation boom, American foreign investment was re-directed inwards and corresponding central bank policy reflected the inward shift: "international considerations played almost no role in the deliberations about the bank rate rise at the Federal Reserve Board."[24] Adherence to the gold standard, policed through rising interest rates that entailed increasing unemployment, falling wages, and deflation, nevertheless endured in all the major states until finally broken by the outrage of general domestic society: the Communist-led Reich Committee of the Unemployed in Germany, the British National Unemployed Workers' Movement, American farmworkers, automobile factory workers, and war veterans, to name a few.[25] What Kindleberger conceives as the failings of the "hegemonic" United States—failure to maintain a relatively open import market, lend counter-cyclical long-term capital, lend at last resort—were the result of domestic pressures from powerful businessmen to their allies in the White House and on the regional boards of the Federal Reserve, which (incredibly!) raised interest rates as late as October 1931.[26] Therefore, the international spillovers of domestic policy choices (mostly in the operation of monetary policy) were decidedly negative, and as has been widely perceived, important to the severity and length of the Great Depression.

In aftermath of the Second World War, the United States found itself as the indisputably strongest country in the world. Yet, the stability of the post-WWII international economic order is not merely due to the structural fact of American hegemony for the immediate post-WWII period, but by the domestic consensus and stake in the international economy. The policy choices of the post-WWII American hegemon at Bretton Woods were driven by dominant domestic preferences for an internationally-integrated economic order and latitude for protecting social welfare. This is clearly reflected in the fixed-*but-adjustable* exchange rate regime that emerged from Bretton Woods. Minimal physical damage as a result of war, Roosevelt-inspired internationalism, and the effects of vast economic mobilization were favorable conditions for continued engagement with the rest of the world.[27] Domestic economic interests—namely, export manufacturers—faced little competition from the devastated European economies. Sustaining import markets around the world became a primary task for the world's "sole major creditor country."[28] Moreover, what Maier terms as corporate pluralism, composed of the "the institutional foci for the twentieth-century achievement [that] included trade unions, ambitious state economic agencies, and bureaucratized pressure groups," points to the alignment of preferences between internationally-oriented domestic interests and domestic political elites.[29] This alignment reflects Ruggie's embedded liberalism compromise, in which "multilateralism and the quest for domestic stability were coupled and even conditioned by one another reflected the shared legitimacy of a set of social objectives to which the industrial world had moved, unevenly but 'as a single entity.'"[30] Even as Ikenberry notes that conservative bankers supported a more traditional return to the gold standard, this particular domestic interest was discredited by the experience of the Great Depression and the hostility of the Roosevelt administration to such interests.[31] Keynesian management of the domestic economy was seen as necessary for the international economy; this widely-supported extension meant striking a social bargain, and "the opponents of Bretton Woods proposals—including New York bankers, advocates of high tariffs, and isolationists—began to be seen as an odd bunch, outside the political mainstream."[32] By the end of the war, the general public was accustomed to interventionist government and broad demand for social insurance existed, which had not during the interwar period. Therefore, as the end of the Second World War brought occasion and opportunity for "new" economic thinking, American domestic interests were dominated by internationally-oriented sectors *and* a public demanding greater social welfare, with whom the Bretton Woods proposals largely resonated.

The details of the Bretton Woods institutions reflect the influence of domestic interests for open and sustainable trade and capital flows. American and British policymakers at Bretton Woods agreed that currency stability and convertibility ought to be prioritized, and that an international stabilization fund (in the form of the International Monetary Fund) would assist governments by allowing for "multilateral and expansionary solutions to capital and trade imbalances."[33] Thus, short-term disequilibrium in exchange rates would be tolerated and managed through international cooperation.[34] Domestic national interests also influenced trade negotiations, as the General Agreement on Tariffs and Trade (GATT) enshrined the most-favored-nation rule, yet more restrictive customs unions and free trade areas were permitted, while Britain's imperial preference system was unaddressed. In the area of trade, as in monetary relations, the Bretton Woods institutions did not see balance-of-payments difficulties as reasons for national retrenchment; quantitative restrictions were allowed in circumstances "*explicitly* including payments difficulties that resulted from domestic policies designed to secure full employment."[35] Therefore, the domestic preference for international engagement and social welfare protection—in essence, embedded liberalism—provided strong support for an open and stable international economy.

The evolution of the gold-dollar standard (gold pegged at $35 per ounce) and its eventual breakdown evidence how the positive international spillovers of domestic policy choices in the immediate post-WWII period provided support for an open international economy, even in the absence of clear American hegemony in the late 1960s and early 1970s. The fixed-but-adjustable exchange rate mechanism required nearly constant international coordination, while trade negotiations began to be formalized through GATT "rounds." As hegemonic cooperation suggests, American-led institutionalization of the open international economy provided lower transaction costs and reduced uncertainty between states, while it also strengthened internationally-oriented domestic sectors of society (export manufacturers, global investors, etc.).[36] This "feedback" from the international economy, by strengthening domestic preference for an open system, took the form of: the growth of intra-industry trade in similar commodities through economies of scale in production and an explosion in foreign direct investment by multinational corporations with globally integrated production facilities. Hence, initial domestic preference for open flows of trade and investment through the post-WWII embedded liberalism of Bretton Woods institutions (especially the fixed-but-adjustable exchange rate regime) had led, by the time of relative American hegemonic decline in the late 1960s, to a sustainable open international economy because of the preferences of *domestic* actors in the United States and other countries.[37]

In sum, I have argued that an examination of interwar failure and post-WWII success must begin with an analysis of domestic preferences. This paper has posited that domestic influences upon international monetary cooperation in major states, such as Britain, France, and the United States, were a crucial determining factor in the global economic stability or lack thereof in the interwar and post-WWII periods. There are other considerations as well, namely political and military. For example, the Bundesbank's supportive actions of the gold-dollar standard in the late 1960s are partially a function of West Germany's security interests with the United States. The link between economic and military power is a topic deserving of thorough treatment. At various points in this paper, the role of policy elites in helping to shape domestic preferences could have been more deeply discussed, most notably the rise of Keynesian economists in the implementation of Roosevelt's New Deal. Nevertheless, what has been argued here is for a re-focusing on the question of hegemony, a shift to examining how the interactions and preferences of domestic actors can spill over into the international economy—with profoundly negative or positive consequences for overall stability and success.

[1] Andrew Wyatt-Walter, "The United States and Western Europe: The Theory of Hegemonic Stability" in *Explaining International Relations Since 1945*, ed. Ngaire Woods, 128-129.

[2] Robert Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (pb 2005), 33-34.

[3] Charles Kindleberger, *The World in Depression 1929-1939* (1973), 292.

[4] Stephen Krasner, "State Power and the Structure of International Trade," *World Politics*, 28 (1976), 319.

[5] Krasner 322-323.

[6] Keohane 137-138.

[7] Barry Eichengreen and Peter Temin, "The Gold Standard and the Great Depression," *Contemporary European History*, 9, 2 (July 2000), 185.

[8] G. John Ikenberry, "A World Economy Restored: Expert Consensus and the Anglo-American Postwar Settlement," *International Organization*, 46, 1 (Winter 1992), 291-292.

[9] "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order," *International Organization*, 36, 2 (Spring 1982), 379-415. Charles Maier, "The Two Postwar Eras and the Conditions for Stability in Twentieth-Century Western Europe," *The American Historical Review*, 86, 2 (April 1981), 327-352.

[10] Kindleberger 305.

[11] Krasner 338-340.

[12] Krasner 342-343.

[13] The well-known tradeoffs of different exchange rate regimes are demonstrated by the Mundell-Fleming model, which states that fixed exchange rates, full capital mobility, and domestic monetary policy independence cannot simultaneously operate in the international system for any extended period of time. Specifically, in a fixed exchange rate environment, monetary policy independence is constrained because of the need to adjust (often meaning *increase*) interest rates to maintain currency stability.

[14] Jeffry Frieden, "Invested Interests: The Politics of National Economic Policies in a World of Global Finance," *International Organization* 45: 425-51.

[15] J. Lawrence Broz, “The Domestic Politics of International Monetary Order: The Gold Standard,” in*Contested Social Orders and International Politics*, ed. David Skidmore (Nashville: Vanderbilt University Press, 1997), 55-58.

[16] Broz 69.

[17] Broz 73-74.

[18] Clavin 50.

[19] Eichengreen 193.

[20] Maier 339.

[21] Patricia Clavin, *The Great Depression in Europe, 1929-1939* (pb 2000), 62-63.

[22] Clavin 19.

[23] Clavin 87.

[24] Clavin 96-97.

[25] Eichengreen 202.

[26] Eichengreen 204.

[27] Clavin 201.

[28] Ruggie 395.

[29] Maier 351.

[30] Ruggie 398.

[31] Ikenberry 305-306.

[32] Ikenberry 317.

[33] Ikenberry 298.

[34] Wyatt-Walter 134.

[35] Ruggie 397.

[36] David Lake, “British and American Hegemony Compared: Lessons for the Current Era of Decline,” In*History, the White House, and the Kremlin: Statesmen as Historians* , Michael G. Fry, ed. (London: Frances Pinter; New York: Columbia University Press, 1991), 115.

[37] I do not have space to examine the domestic sources of support for open trade and capital flows in other countries, especially France and Germany. Suffice it to say that the actions of the U.S. Federal Reserve and European central banks to resolve monetary difficulties resulting from the gold-dollar standard evidences support for an open international economy during the late 1960s and 1970s.

—

Written By: Rahul Prabhakar
Written At: University of Oxford
Written For: Walter Mattli
Date Written: December 1, 2009