Thomas Willett's scholarship over time has been immense. He has been on the editorial boards of several major journals, and serves today as a co-editor of *Economic Inquiry*. He has written or edited over 26 scholarly books, and has published well over 200 professional papers. His research has focused on international economics and finance, but the range of interests reflected in his work is far reaching — including the volunteer army, oligopoly theory, voting theory, public finance and public goods theory, labor economics, concepts of equity, methodology, fiscal federalism, international relations, inflation, and still others to numerous to mention.

Dr. Willett's approach to his abiding interest in international economics has been to bring to that area concepts from public choice and public goods theory is an effort both to explain how the international monetary system has worked historically, and to seek ways to improve its functioning in the present. He is uniquely suited to apply public choice principles to international issues. As a student at Virginia, he studied primarily under Leland Yeager and Alexandre Kafka, yet he went through the program when the public choice revolution was in full cry in Charlottesville. It is that unique combination of a background and understanding of the work of James M. Buchanan and Gordon Tullock, but with an interest and focus on international issues that Dr. Willett brings to us in his lecture this evening. He shows us the influence of the Yeager-Kafka part of the Virginia School, as well as the generalized influence of having gone through the Charlottesville program at its apex.

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The Public Choice Approach to International Economic Relations

by
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I. Introduction

The study of the political economy of international economics (or international political economy as this field is usually designated by political scientists) has received increased attention from growing numbers of political scientists and economists in recent years. Furthermore, the perspectives from which both economists and political scientists view international economic policy issues have undergone substantial shifts, which suggests greatly expanded opportunities for the mutual enrichment of both disciplines.

A number of factors have contributed to this resurgence of interest in political economy by economists. Unlike in the 1960s and 1970s, one can no longer assume that an economics book or article with "political economy" in the title will be written from a Marxist perspective. Mainstream economists have come to realize that economic policies are implemented through a political process and consequently that the theory of optimal economic policy, even where its conclusions are unambiguous, often will fail as a positive guide for predicting or explaining the course of governments' economic policies. While it is difficult to judge their relative importance, other crucial factors have been the widespread recognition of systematic policy failures at both the macro and micro economic levels, the development of public choice analysis, and the emphasis on anticipations of policy actions coming out of the rational expectations revolution in macroeconomics.

On the political science side, as the Cold War thawed and the high politics of international military strategy stalemated, economic issues moved to a higher place on the agendas of competing states, and international relations scholars took increased interest in such issues. Furthermore, a substantial shift in the theoretical orientation of researchers in this field developed as younger scholars began to gain prominence. Bruno Frey (1984b), in an influential survey of the public choice approach to international political economy, argued that:

> Political scientists do not hesitate to claim international exclusive domain. *Power and authority*, and not market relations, are taken to be the central concepts with which to study the problems...[T]here is a marked tendency to reject economic theory. The rejection does not seem, however, to be based on an extensive knowledge of the literature....From the public choice point of view, political scientists' international political economy is deficient in various respects. The most important shortcoming is its non-analytical structure. It lacks a well-spelled out theory of behavior from which to derive (non obvious) testable hypotheses. Rather, the approach is disruptive, historical and (sometimes) anecdotal. No effort is made to put up clear propositions and to subject them to empirical (econometric) testing. (p. 9)

Until recently, Frey's assessment of the substantial majority of writings by political scientists on international political economy was, unfortunately, quite accurate. However, a new generation of international relations scholars, influenced in part by a small group of more senior scholars such as Robert Keohane and Stephen Krasner, displays considerable knowledge of the basic ideas of economic analysis. While often critical of particular aspects of economists' analyses, this new group of scholars' criticisms seldom arise primarily from ignorance. In fact, the technical sophistication of the analysis of some of these scholars in areas such as game theory and public goods theory has been quite impressive. There has been considerable growth in the number of both economists and political scientists using public choice analysis explicitly or implicitly in their study of international economic relations. Papers in the leading international relations journals frequently make use of public choice analysis, and at the meetings of the Public Choice Association there are a number of sessions on international public choice.

Unfortunately, misunderstandings about the nature of public choice analysis are still common. In part this occurs because public choice is often understood to consist of specific models of self- interested rent seeking by interest groups or vote seeking by politicians or budget seeking by bureaucrats. This narrow view is wrong: public choice is an approach, not a specific theory, and it is capable of incorporating a broad range of considerations.[1] Specific theories differ both in their assumptions about the objectives of actors, for example, narrow economic self-interest versus allowance for ideological preferences, as well and about the weights given to different actors in the collective decision-making process, for example, the importance of direct lobbying by interest groups versus voting by the general public. There is substantial variety in the models used by public choice scholars, just as there is among the political scientists working in international political economy.

In my judgment, however, efforts to test the comparative explanatory power of specific public choice theories and to develop theoretical frameworks that explain the variations in explanatory power across different types of issues, institutional structures, and so on, are woefully undersupplied to public choice analysts. In this endeavor, economists can learn much from recent work by their more eclectic colleagues in political science.

As is reviewed in section II below, there are very serious problems with the organizational framework for international political economy initially emphasized in the political science literature which focuses on liberal, Marxist, and realist or mercantilist views. Each of these views pays insufficient attention to the possible range of objectives which governments may seek to pursue and to the political pressures and constraints they may face. Especially lacking is attention to the rent-seeking activities of domestic interest groups, compared to much of public choice analysis. It is gratifying to note, therefore, that in recent years many political scientists have begun to emphasize the role played by domestic interest groups and institutional structures in shaping international economic policies.

In section III I draw on this literature to analyze trends in U.S. trade policies. While interest-group rent-seeking versions of public choice analysis are highly successful in explaining why we have protectionist policies, they have difficulty explaining why we do not have even more protection. The answer, I suggest, lies in considering carefully the institutional framework and applying aspects of the international relations scholars' theory of realism, but in a form which assumes liberal rather than mercantilist trade policies as the government's objective.

In section IV I illustrate the use of public choice for normative analysis, in this case the design of national and international monetary institutions. The insights from public choice analysis on why governments may have incentives to adopt destabilizing rather than stabilizing macroeconomic policies has revolutionized the way most economists (and many policymakers) look at monetary policy issues. The adoption of a constitu-

tional perspective has become much more common. On the international side, this has contributed to a resurgence of support for using pegged exchange rates as a method of enforcing monetary discipline. I argue that while the case for adopting institutional structures to promote monetary discipline is strong, the case for using fixed exchange rates as a general mechanism for this purpose is weak.

Much of the recent discussion of exchange rates as a nominal anchor has failed to distinguish sufficiently between genuinely fixed and adjustably pegged exchange rates, but this distinction is absolutely crucial for predicting the likely effects of particular exchange rate regimes. Furthermore, economic theory shows that the economic costs and benefits of fixed versus flexible exchange rate regimes vary systematically across countries. Thus the adoption of a fixed exchange rate regime may be a very sensible strategy for some countries, but for others it could be quite costly. In countries where fixed exchange rates are inappropriate, the focus should be on domestic institutional arrangements to promote monetary discipline. This issue nicely illustrates the need to combine political, economic, and institutional analysis in policymaking — the hallmark of the public choice approach.

II. Public Choice Analysis and International Political Economy

Following the influential formulations by Robert Gilpin (1975, 1985), early treatments of international political economy by political scientists often focused on three major contending theories or schools of thought: realism (also frequently called mercantilist, nationalist, or statist views); liberalism (sometimes labeled as interdependence or sovereignty at bay views); and Marxism.[2] As a description of significant differences in world views held by important actors in the global political economy, this trilogy is quite useful, I believe. However, as a basis for organizing enquiry into issues of positive political economy i.e., the attempt to explain why governments adopt particular policies rather than what policies they "should" adopt, this approach is seriously deficient.

One typical difficulty with work based on this trilogy is its failure to distinguish systematically between the positive and normative elements of these approaches.[3] Another source of difficulty is the frequent but misleading implication that these are not just three important approaches, but that they are the only three relevant alternatives. Gilpin (1987), for example, argues that:

> Scholars and other individuals differ, however, on the nature of the relationships between economic and political affairs. Although many positions can be identified, almost every one tends to fall into one of three contrasting perspectives, ideologies, or schools of thought. They are liberalism, nationalism, and Marxism.... These three ideologies are fundamentally different in their conceptions of the relationships among society, state, and market, and it may not be an exaggeration to say that every controversy in the field of international political economy is ultimately reducible to differing ~~corruptions~~ conceptions of these relationships (pp. 24 25).[4]

Such statements, however, are fundamentally misleading. As Tollison and I (1982) have argued, a public choice perspective on the nature of domestic and international political relations is excluded or ignored from these three major approaches as they are typically described in the literature.

As users of the trilogy are usually careful to point out, the stylization of these three approaches can hardly do justice to the variety of thought encompassed within each school. For example, while for purposes of the trilogy, Marxist and dependencia views are usually lumped together, there are, indeed, considerable differences of view both within and between writers in these two groups (see Gilpin 1987, and Staniland 1983). Likewise, while the standard summary of liberalism treats it as only being concerned with economic well being, Adam Smith is famous for his dictum that "defense is more important than opulence."

With this caveat in mind, let me offer a brief summary of the trilogy of approaches as typically described in the International Political Economy literature. Realism, from a methodological perspective, is actually very similar to traditional economics as often practiced by international economists. It treats the nation state as unified rational actor as is standardly done in much of international trade theory. If they do not come at it from a public choice perspective, many economists tend to look at trade conflicts among nations as conflicts of optimal tariffs instead of disagreements among domestic economic interest groups.[5] I remember being very heavily influenced by Leland Yeager in an international economics class at the University of Virginia when he told us we should be wary of treating a nation as if it were a single entity. My experiences in government and what I have learned about public choice over the years have reinforced Yeager's observation and strongly influenced my approach

to international economic relations. There are, of course, some important insights to be got from taking a unified rational actor approach. As Milton Friedman taught us, we do not want to automatically toss out a theory because it has simplified assumptions, since simplifying is the essence of good theorizing. Nevertheless, we need to be very careful how we go about it. In analyzing many of the national security issues which have formed the traditional domain of international relations scholars, the "unified actor" is a highly sensible approach, but as one turns to issues of international economic policy, its explanatory power drops sharply.[6]

From the standpoint of public choice theories, the realist approach corresponds in one sense to the Leviathan model since the government is assumed to be autonomous from domestic societal pressures, and those who capture it pursue their own interests. However, in public choice applications such as Brennan and Buchanan (1980) the government is typically assumed to be rent seeking, while in the realist literature the standard assumption is that the government pursues some broad concept of national interests, i.e., that it is public spirited. Such public spiritedness stops at the national boundary, however, and interstate relations are characterized by conflict. Where conflicts arise, it is assumed that national security considerations will (and should) dominate economic concerns, and, in the economic area, the focus is on relative rather than absolute gains.[7] The major independent variable for this approach is the international distribution of power.

The Marxist approach offers a theory of government almost exactly opposite that of the realists. Government within the Marxist paradigm is endogenous, not autonomous. In public choice terminology, the traditional Marxist view rests on an interest-group rent-seeking model, but one with a very special formulation of interest groups. There is only one group that matters, and that is the capitalist class. To the Marxists, a focus on conflicts of economic interest is a big advantage. They do not assume that everyone shares a commonality of interest and that economic relations will be harmonious. But as public choice analysis demonstrates, even apart from the deficient positive and normative aspects of Marxian economic theory, the Marxists tend to look at all distributional conflicts in terms of homogeneous labor versus homogeneous capital. This misses the essence of many distributional conflicts. As Mancur Olsen (1965) points out so nicely, the free-rider analysis says we need to look at disaggregate costs and benefits to individual actors. This dictum applies as much when class is a unit of analysis as it does when looking at the unified rational actor models of realists as a theory of government.

The third school, the liberal approach, is basically an application of orthodox economics. Typical is Robert Gilpin's (1987) characterization that "the liberal perspective on political economy is embodied in the discipline of economics as it has developed in Great Britain, the United States, and Western Europe" (p. 27). The idea of the liberal model is that the state is out to maximize national economic efficiency. It predicts that because, in the liberal view, international trade is beneficial and trade restrictions are inefficient, there should be a trend toward free trade. This formulation of the liberal approach explains, or at least is consistent with, some of the broad developments in international trade policies for significant periods of time. For roughly a generation following the Second World War there was a very decided trend toward trade liberalization in the industrial countries. Unfortunately, by the late 1960s or early 1970s this trend had slowed and begun to be reversed. While tariffs continued to fall, the use of quotas and "voluntary" quantitative restrictions rose and the net incidence of protectionism began to increase.

In the literature on International Political Economy, one of the other names for realism is modern or neo-mercantilism. As trade barriers began to rise, many of the realists writers in international relations, for example Gilpin (1987), interpreted this as strong evidence for the relevance of their approach. I want to argue, among other things, that this interpretation is fundamentally misconceived.

Discussions of these three schools of thought typically do not make clear what positive theory of political economy underlies the predictions of free trade policies associated with the liberal view. An informed median voter model would give this prediction, but so would a Leviathan model if it is assumed that the government pursues the public interest by maximizing aggregate economic efficiency. Just such a public-interest theory of government actions was, for a long period, implicitly or explicitly held by many economists. This view of a disinterested government underlies the optimal policy approach to economic analysis which focuses only on aggregate efficiency effects and typically ignores distributional considerations and problems of implementation.[8]

If one's view of international economic relations is limited to this trilogy of approaches, one misses an awful lot of what is going on in terms of increased protectionist pressures in the United States and the world today. This occurs, in part, because analysis based on these perspectives is often founded on a misunderstanding (or perhaps ignorance) of public choice and basic economics. One key feature of the liberal approach, as it appears in the International Political Economy literature, is the assertion

that there is no basis for conflict within the political economy. Frieden and Lake (1991), for example, argue that three assumptions are essential to the liberal perspective. "First,...that individuals are the principal actors within the political economy and the proper unit of analysis...Second...that individuals are rational, utility maximizing actors...[and] Third,...individuals maximize utility by making tradeoffs between goods" (p. 6). They incorrectly conclude that "These three assumptions imply that there is no basis for conflict within the political economy" (p. 7). Likewise, Robert Gilpin (1987) argues that "In the abstract world of economics, the economy and other aspects of society exist in separate and distinct spheres...national boundaries are assumed not to exist...A fundamental harmony of interest among individuals, groups, and states is assumed to underlie the growth and expansion of the market and of economic interdependence" (pp. 21-22). Economists, with their emphasis on the potential for mutual gains from exchange, certainly do tend to see a higher ratio of harmony to conflict in life than do international relations scholars of the realist school . But seeing interactions as positive rather than zero-sum games does not imply that there is no basis for conflict. Even were one concerned only with one's own absolute gains, there are still incentives to maximize one's own share of the gains. Thus there are incentives both for cooperation and for conflict. Today, basic international economics texts are usually clear that the gains from trade discussed are net gains, so that aggregate efficiency increases in the sense that the gain to the gainers is sufficient that the losers could be compensated and everyone be made better off. As we all know, in the real world such compensation is seldom made. In truth, there are losers from international trade as well as gainers, and this generates distributional conflict. That this distributional conflict is highlighted with the standard tools of economics in modern international economics texts and is at the core of public choice analysis is often completely missed by political scientists writing general overviews of international political economy.[9]

Writers on approaches to international political economy now generally recognize that there is a public choice approach, but frequently consider the public choice approach to be synonymous with the liberal approach (see Frieden and Lake 1991).[10] This characterization is quite right from the standpoint of the methodology used. The public choice approach applies economic methodology to politics and distributional conflicts. It is also true that most practitioners of public choice share liberal values. But in terms of world views of how the political economy operates, the public choice view differs fundamentally from the standard economics view

because public choice analysis focuses on the distributional conflicts which can occur.

With its focus on methodological individualism public choice analysis forces one to stop focusing only on aggregate economic efficiency. In this sense, the public choice approach is as much a critique of the optimal policy approach of standard economics as it is of realism. In each case, public choice analysis says you have to abandon the assumption that nations are unified rational actors in which all distributional conflict has been resolved. It forces one to focus on distributional conflict, not necessarily as the only factor in the analysis, but certainly as a very key factor. Thus public choice analysis agrees with the Marxist view that conflicts of economic interest have an important impact on government policy making, but offers greater insight into the nature of these conflicts. It is not just aggregate capital versus aggregate labor.

A second deficiency in the early literature on international political economy which the public choice approach is helpful in highlighting was its tendency to reductionism to explain policy choices by a single factor. Sometimes accompanying the view that there are but three grand theories or approaches to international political economy was the idea that one of these approaches could explain most of what determined government policy. Fortunately, support for this view is rapidly breaking down under the weight of studies investigating the behavior of policy. Not only economists, but quite a number of political scientists have begun to do statistical analysis and carefully structured case studies of the influences shaping economic policies during different episodes, and a number of political scientists now emphasize the roles of domestic interest groups and institutions.[11] In the wake of this scholarship it is clear that many different factors influence economic policy. Further, these different factors are important at different times, for different types of policies and different institutional arrangements under different conditions. Any one of the grand theories has some important explanatory power, but each falls far short of complete explanation.

It did not take many months working in government for me to learn that the factors influencing international trade policy formulation were very different from the factors influencing international monetary policy formulation.[12] Interagency meetings on international monetary policy came very close to conforming to a unified rational actor model. To be sure, the Federal Reserve Board's views weren't always exactly in line with the Treasury's, but this typically was a relatively minor squabble. Here one generally was faced with economists from different agencies facing

common problems and trying to figure out how to deal with them. There was little concern about the effects of policy on specific industries or congressional districts. Most of the analysis would be on how a policy would likely work in aggregate and whether we could sell it to other countries. Discussion of distributional considerations almost always focused on effects among rather than within countries.[13] In contrast, trade policy issues prompted negotiations within the government before we began any international negotiations. In trade policy meetings the Labor Department would worry about the effects on domestic labor. The State Department would emphasize effects on foreign relations. The Commerce Department's arguments had a schizoid quality, as one might expect. They had one set of officials from the international business side who favored liberal trade and another set favoring protection for domestic business. The Council of Economic Advisers, Treasury, and Office of Management and Budget would generally try to advocate aggregate economic efficiency or consumer or taxpayer interests, as the objectives. It was a completely different environment from the monetary one.

Such observations suggest we need to develop a framework in which many factors affect policy. Just because there are many influences on government, we don't want to stop, throw up our hands and say the whole process is so complex that we'll give up and conclude that anything can happen. There is considerable scope for analysis that systematically looks at the conditions, circumstances, institutions, and characteristics of issue areas that will make some factors more important than others. What are the conditions under which interest groups will be more important? What are the conditions under which the government is likely to be more autonomous? What conditions foster bureaucratic politics? One of the virtues of the public choice approach is that it gives us a systematic framework from which we can theorize at the multi-factor level by looking carefully at incentive structures.

By systematically considering the costs and benefits of actions by different individuals or groups and the constraints they face, we can develop theoretically useful and potentially empirically falsifiable propositions. For example, adopting Steven Krasner's (1972) view that the President can win any confrontation with the bureaucracy if he really wants to, but that constraints on his time and energy prevent him from controlling everything, we can develop systematic predictions about the factors which will influence the effective degree of autonomy of various bureaucracies on various issues. The less important is the issue to the President and the less likely are other influential actors such as other

bureaus, domestic interest groups, and foreign governments to raise complaints, the more autonomy a particular bureau is likely to have.

Likewise, for a given level of presidential interest, the more complex the issue and the more difficult it is to assure instructions are carried out, the more effective is the control that the bureau will have. Thus, for example, the votes cast by the U.S. Executive Directors in the International Monetary and World Bank Fund on major loans are easier to control than the Federal Reserve Bank of New York's official interventions in the foreign exchange market (as long as such intervention is not entirely prohibited), which in turn is less difficult to monitor than whether the U.S. delegation to the Law of the Sea negotiations was adhering to its negotiating instructions (which it often was not).

In developing a framework for the analysis of questions of positive political economy, it is important to move beyond stressing the importance of particular considerations. Such championing was very useful in earlier stages of the development of the modern field of political economy, but today the most valuable contributions to knowledge are more likely to come from the less glamorous task of studying the conditions which will lead to systematic variations in the relative importance of the various single factor explanations. (See Dillon, Odell, and Willett 1990).

In this endeavor, it is important to recognize that the relationships among the various single factor explanations will not always be linear; sometimes there will be important interaction effects. For example, in response to Ayre Hillman's (1989) analysis, which posed a horse race between interest-group rent-seeking and public-interest-type conservative welfare function explanations of protectionism, I argued that there were often important interactions between these two factors. If you look at the incidents of major special trade protection in the United States over the last several decades, it certainly is heavily skewed toward the groups that are most successful in direct political lobbying. Thus the insights from the public choice models of interest group rent seeking are clearly quite important. If you look at the timing of such protection, however, it is heavily influenced by the existence of adverse economic conditions for the industry in question. The ability to present an at least superficially plausible cover to the often large number of legislators who do not have a strong direct interest in the issue is frequently quite important in securing majority support for protectionist measures. Thus for cases of major special protection, it seems that high scores on both rent seeking and perceived conservative social welfare function criteria are typically both necessary conditions, with neither being sufficient by itself.[15]

III. The Political Economy of Trade Policy: Why Don't We Have More Protectionism?

Trade policy, especially the case of special protection for individual industries, is a perfect example of highly concentrated benefits and very diffuse costs from protection so there are substantial incentives for interest group lobbying. When one looks at exchange rate and international monetary policies, both the costs and benefits are usually highly diffused. Public choice theory predicts that these are instances where a government would have a good deal more scope for autonomy than in trade policy areas. Indeed, just such an analysis was recently provided by a political scientist, Joanne Gowa (1988). Her article is an excellent example of the public choice analysis being used in the international relations literature.

Another important issue is how we see the nature of the domestic conflicts of interest over international trade policies. Still one of the most prominent international trade theories today is the Heckshcr-Ohlin factor proportions theory. In the famous 2 factors 2 goods 2 nations version of that theory, you have two countries, two goods, and two factors of production, labor and capital. Internal distributional conflict is formulated in terms of aggregate labor versus aggregate capital, exactly the distributional conflict highlighted by the Marxists. So as international trade theorists turned to political economy and public choice analyses, many examples of their formal analysis were exactly what one would expect from the Marxist tradition.

Such analysis offers important insights. If one is looking, for example, at the NAFTA debate, there was clearly a systematic difference between the positions of organized labor and the majority of industries.[16] However, while the labor versus capital conflict has important explanatory power, it also misses a lot. If one considers trade policy issues such as voluntary export restraints or special quotas, what is most often seen is labor and capital in the same industry coming in together and arguing for protection for their industry. To explain such behavior, one must turn to a specific factors model of trade.[17]

This is a powerful illustration that public choice is an approach, not a specific theory. It gives us a way of thinking about these issues. It emphasizes the need to look at distributional aspects, not just aggregate efficiency, and to consider carefully the objective functions of policy makers and the constraints they face, but it does not give us any one determinant outcome because we have a whole host of theories to work with. Predictions would vary depending on which specific model of the operation of the economy was used, e.g., specific factors versus Heckscher-

Ohlin trade theory, and which model of the political process, e.g., interest group versus median voter models.

As a first cut, we would expect from the informed median voter model that free trade would predominate because the vast majority of individuals are going to benefit from free trade. If we have a median voter model where we are each voting our own interest, free trade should be the norm, not the exception. Why does this not hold? Key concepts from public choice of the rational ignorance of the consumer-voter, and of differential incentives to organize and lobby, explain the disproportionate influence of small, well-organized groups. Trade policy is a tailor-made laboratory experiment to explain these insights of public choice analysis. So if we consider, as did Bruno Frey [1984] a decade ago, that the chief task of public choice analysis of international trade policy is to explain why we have protectionism, we've done that hands down.

Interesting issues remain about the structure and forms of protection, for example, the use of tariffs versus quotas. In the industrial countries while tariff levels have continued to fall, the incidence of quantitative restrictions has risen. To international trade economists concerned with economic efficiency it appears that not only do governments give too much protection, but they also give it in excessively costly ways since quotas and voluntary export restraints typically impose greater aggregate economic costs than equivalent tariffs. At first look this appears consistent with the Virginia public choice view which sees rational ignorance generating incentives to generate transfers in forms which are less easily visible even if more costly in contrast to the Chicago view that assumes that the potential process will see through such fog factors so that transfers will tend to be effectual in ways which minimize efficiency costs.

On closer reflection, however, the evidence on this issue from trade policy experience is not so clear. While quotas tend to generate greater economic costs than equivalent tariffs, they also tend to generate greater rents for the interests protected so that it is not clear that the efficiency costs of the quotas per dollar of rents transferred is always greater than for tariffs. Likewise, while it is correctly argued that voluntary export restraints tend to transfer rents abroad, this is not necessarily inefficient since it may be part of an implicit international compensation mechanism which reduces the likelihood of trade wars. The structure of international commitments under the GATT and its successor, the World Trade Organization, have also likely played an important role in influencing the forms of protection adopted. The conflicting views of the Chicago and Virginia approaches on the forms of transfers in general, and in the trade

area in particular, is an important area for further political economy research.[18]

Perhaps an even greater puzzle for public choice analysis, however, is explaining why we don't have a great deal more protectionism than we do. Why do we still have a basically liberal trading system despite lots of exceptions? On the spectrum between free trade and autarky, we are far closer to free trade than we are to autarky. How do we explain this?

Part of the answer can be provided within an interest group framework when we remember that not all well-organized groups benefit from protection. Indeed, Helen Milner (1988) has argued that a major reason for the lower degree of protectionism in the U. S. during the economic strains of recent decades as compared with the 1920s and early 1930s is due to the substantially greater amount of lobbying today by export industries and multinational corporations as a result of increasing economic interdependence. (See also Dester and Odell 1987.) For a full explanation, however, I believe that we need to go beyond interest group models and consider also the role of the foreign policy objectives of the executive branch and changes in institutional structures. This involves giving the realist model some credit. It ends up having far more explanatory power in combination with other factors than I had expected.

Like most economists, when I first started applying public choice analysis to trade policy issues, my focus was on the protectionist bias in the operation of the political system.[19] I was shocked when I started reading literature from political scientists talking about the liberal bias or the free trade bias in American trade policy.[20] What in the world were they talking about? When I finally understood their terminology, it turned out that what they were arguing made a lot of sense.

In discussing the biases of institutional arrangements you always need to be careful to specify the bias as compared with what alternative. Compared with the idealized norm of policies which produce aggregate economic efficiency, the political process clearly tends to operate with a protectionist bias due to incentives of well-informed and politically active special interests as is highlighted in standard public choice analysis. But compared with the trade policy institutions that we had prior to the mid 1930s, today's institutional framework for making trade policy decisions does have a distinctly liberal trade bias. If you take simple interest group models of trade policy, their predictions tend to look much more like the disastrous Smoot-Hawley tariff of the 1930s than the much milder incidence of protectionist policies that we see today.

With the increasing pressures for protectionism that have been generated in recent years, why has the actual increase in protection been so much less than in the 1930s? Part of the answer is that despite all of the complaints about the performance of the American economy we are far removed from the horrendous economic conditions of the 1930s. But another very important part of the answer is that we operate under a fundamentally different institutional framework for trade policy making today then we did when Smoot-Hawley was passed. Major reforms were fostered by the debacle of the Great Depression and Smoot-Hawley.

These reforms reflected a basic shift in how trade policy was viewed. Previously, it was viewed almost totally as a domestic political issue. Smoot-Hawley is easy to explain in terms of rent seeking by interest groups, domestically oriented legislators, and a relatively indifferent executive branch.[21] While the depth of the Great Depression was hardly due entirely to Smoot-Hawley, the beggar-thy-neighbor trade policy it helped trigger was highly visible, and this temporal association gave important ammunition to liberal-trade advocates. Trade policy clearly could be seen as an important element of foreign, not just domestic, policy. With the disaster of Smoot-Hawley fresh in mind, Congress proved willing to reduce substantially its say in the making of trade policy. The role of the executive branch in formulating trade policy was substantially strengthened by changes both in the institutional framework and in the ideological or conceptual frameworks of many of the participants in the policy process. Arguments for free trade became closely associated with broad U.S. national security and foreign policy interests.[22]

Cordell Hull, the Secretary of State during that period, was a key player in this process. He drew the lesson that the seeds of World War II were sown by the failure of postwar international economic planning at the end of World War I, which in turn contributed to the Great Depression. He was a firm believer in free trade, not so much for its economic benefits, but because this would be a major plank of U.S. foreign policy to build a more secure world. U.S. policy toward trade became dominated by the idea that whether it was in our immediate economic interests or not, fostering a liberal international economic system certainly lay in our foreign policy interest. Combined with reforms of the institutional framework giving the executive branch a much stronger say in making international trade policy, this shift of attitude generated a fundamental change in the policy process. In the early postwar period these changes in domestic institutional structures were reinforced by international commitments under the General Agreements on Tariffs and Trade.

There is a wonderful irony in this analysis because essentially what I am arguing is that the realist model of the unified rational actor of the state pursuing its perception of the national interest actually has substantial explanatory power with respect to U.S. international trade policy in the postwar period, but that what it explains is liberal not protectionist trade policies.[23] On this interpretation, the increased protectionism which we see in the United States today is a reflection of a decrease rather than an increase in the explanatory power of the realist model in terms of its focus on the autonomy of the state. When one looks at the structure of the increased protection, what one sees primarily is not a highly autonomous government undertaking increasingly active strategic trade policies based on maximizing the national interest, but rather a weakened and fragmented government which is forced to cater increasingly to a multitude of domestic political pressures. Increased import competition has increased domestic political pressure for protection. At the same time, but for a variety of reasons including the end of the Cold War, there has been a general decline in the strength of the executive branch relative to Congress. Both Democratic and Republican administrations have continued to advocate much more liberal trade policies than those favored by the typical member of Congress, but the political strength of executive branch arguments has declined. Though the power of executive branch support for liberal trade policies on foreign policy grounds is still substantial, witness the passage of NAFTA, it is substantially less than it was in the 1940s and 1950s.

In summary, I would argue that we have a relatively simple explanation for the current trend toward increased, but still rather limited, protectionism in the United States. Part of it is increased interest group lobbying because of increased import competition. The traditional public choice analysis from an interest group perspective has important explanatory power, but taken in a vacuum it would predict considerably more protection than is observed. Countering these pressures we have the clout of a relatively strong executive branch with lots of institutional arrangements biased in the direction of giving us more liberal trade policy outcomes than would come out of a policy process dominated by Congress. It's the decline in the power of the realist model (in its liberal form) relative to the domestic interest groups, rent-seeking model that gives rise both to the particular incidents of discretionary voluntary export restraints, quotas, and so on, and which have also given rise to recent pressures to revise again our basic trade policy institutions, this time to reduce the power of the executive branch.

IV. Monetary Discipline

Let me now turn briefly to an analysis of macroeconomics and international monetary issues. Here, public choice analysis has had a major impact. The vast majority of economists working on these issues do look at them in fundamentally different ways today than in the days when I was learning my international monetary economics at the University of Virginia. In those days, when considering reform of the international monetary system, almost everyone focused on the provision of a stable international monetary environment in a way that minimized constraints on discretionary macroeconomic policy making. In other words, we asked how do we give maximum freedom to domestic policy makers? Even in those days there were some economists who were saying, no, we should really be focusing on discipline in monetary policies, that an unconstrained government would have an inflationary bias. But this was really a very distinct minority. Today this normative view is widespread, albeit not universal, among economists.[24]

The key insight underlying this shift in view is the recognition that governments cannot always be counted upon to operate in the public interest and to maximize aggregate efficiency. While substantial use is still made of optimal policy models, applied policy economists increasingly recognize the need to take into account the political pressures and incentives which governments face. The recent literature in money and macroeconomics is full of analysis of political business cycles and time inconsistency issues which can generate incentives for governments to follow destabilizing policies.[25]

In considering the design of international monetary regimes, one can draw very different types of implications from such analysis. One approach is to assume that there will likely be considerable instability in domestic macroeconomic policies and to adopt an international regime which will minimize the effects of this instability on international activities and other countries. This offers a powerful damage control argument for flexible exchange rates for larger countries.

At the other extreme, many have drawn the conclusion that such propensities for domestic instability increase the case for fixed exchange rates in order to force macroeconomic discipline upon governments and constrain such propensities. Over the past decade, this idea of using the exchange rate as a nominal anchor to constrain domestic inflation has gained enormous popularity.[26] The argument is certainly not without merit, but it has been greatly oversold.

There are two fundamental issues which have received inadequate attention by many advocates of this approach. One is whether the exchange rate will be an effective constraint on domestic policies. The second is whether it is the most appropriate type of constraint. These two considerations will, of course, interact. The more costly is the constraint, the less likely it is that it will remain in effective operation. What matters primarily for policymaking are political costs. How these are affected by the distribution of economic costs and benefits from exchange rate policies has unfortunately been studied much less than is the case for international trade policies.

Contrary to the way the argument is often presented, discipline considerations do not present an independent argument for fixed exchange rates in general, although they may for particular countries. Granting the case for the adoption of institutional mechanisms to foster discipline, the question becomes whether such arrangements should be domestically or internationally based. There is, of course, a vast literature on the merits of different types of institutional arrangements designed to promote monetary discipline.[27] Potential problems have been identified with all of the approaches, so evaluation must rest on the comparison of various imperfect alternatives. Such evaluation must consider both issues of political implementation and of the economic effects of the alternative approaches. While the former issue is largely one for public choice analysis, standard economic analysis is relevant for the latter.

We can draw powerful implications from the theory of optimum currency areas.[28] This literature argues that there is no one right answer for all countries about the relative desirability of fixed versus flexible exchange rates. There are costs and benefits to each, and the balance may vary tremendously depending upon the characteristics of the country involved. A major conclusion is that on economic grounds fixed exchange rates are generally more desirable for small open economies and flexible exchange rates are more desirable for large economies. Intuitively, one can think of the issue as being whether in the face of disturbances the international sector should be adjusted to the domestic economy or the domestic economy should be adjusted to the international sector. Fixed exchange rates imply the latter strategy. For small open economies like Austria, Estonia, and Hong Kong, this form of monetary constraint may make a good deal of sense.[29] For large economies like Germany, Japan and the United States, it does not. In such countries one should look to domestically based institutional approaches to provide monetary discipline.

Failure to recognize the differences in countries' economic interests with respect to exchange rate regimes was a major source of difficulty with the Bretton Woods international monetary system established at the end of World War II and a major cause of the collapse of its adjustably pegged exchange rate mechanism in the early 1970s. This is a failure which has been repeated in the recent political push for a European Monetary Union.[30]

A second lesson from the Bretton Woods system that still has not been universally learned is the fundamental distinction between adjustably pegged and genuinely fixed exchange rates and the difficulties of operating the former. For the exchange rate to serve as a genuine source of long-run monetary discipline, it must be extremely difficulty to change. Examples are parities under the gold standard and currency board arrangements, such as those in Estonia, which provide substantial institutional impediments to changing the rate. Often, however, discussions of exchange rates as nominal anchors refer to temporarily pegged exchange rates. In some circumstances, they may give an economy a beneficial short-term quick fix, but they should not be confused with more genuinely fixed rates which provide a long-run constraint on domestic monetary and fiscal policies.[31]

While unlikely to provide an important long-run source of discipline, such adjustably pegged exchange rates could, on economic grounds, provide a reasonable compromise between fixed and flexible exchange rates for some countries. This was one of the basic ideas of the Bretton Woods system. The general failure of this approach to operate well in practice is another illustration of the importance of public choice analysis. In designing economic regimes, we must consider not just whether a mechanism exists to deal with each type of major problem which may arise, but also whether it is technically feasible and whether political incentives will permit its implementation. When I first studied the problems of the Bretton Woods system as a graduate student, I assumed that this was a typical example of governments adopting policies which conflicted with the advice of economists. To my surprise, I learned that Bretton Woods was designed primarily by economists including John Maynard Keynes who was the chief British negotiator. On purely economic grounds, it was a logically consistent system. The Bretton Woods system became inconsistent and eventually broke down in large part because political considerations kept the mechanisms provided from being implemented in a timely fashion.[32]

For an adjustably pegged exchange rate system to work well, exchange rate parities must be adjusted promptly in the face of emerging disequilibrium. There are considerable technical difficulties in identifying emerging disequilibrium, but an even greater problem is the political incentive to delay adjustments. While exchange rate adjustments will impose net economic costs on some groups and net benefits on others, the conventional wisdom of officials is that they will face more political heat from those who are hurt than they will reap in political gains from those who are helped. Furthermore, devaluations are widely considered to be an admission of the failure of a government's economic policies. This is compounded by the tendency of officials to try to calm speculative markets by publicly pledging that exchange rates will not be changed, thus increasing their political incentives to attempt to maintain the peg, even when they have increasing doubts about its long-run sustainability. Statements by top Mexican officials during 1994 provide a recent example of such behavior. Uncertainties about future balance of payments developments and their implications for equilibrium exchange rates contribute to the tendency for overly optimistic forecasts that pegs can be maintained. The interaction of these considerations resulted in the breakdown of the Bretton Woods exchange rate system after a series of increasingly large exchange rate crises. This was repeated with the breakdown of the pegged rates within the European monetary system in 1992 and 1993.[33] The Mexican exchange rate crisis in 1995 provides more evidence.[34]

With all of this theory and history pointing to the problems of pegged rates, why have they retained such popularity among governments? The answer, at least in part, comes from the same source that creates many of the incentives for unstable domestic macroeconomic policies in the first place – the difference between short-run and long-run effects combined with the short time horizon adopted by many government officials. In the case of macro policy, unless policies are fully anticipated and wages and prices are highly flexible, the initial effects of changes in policy show up more heavily on output and less on prices. Consequently, expansions have more favorable effects in the short run than over the longer term, whereas just the reverse occurs with contractions. These considerations give governments perceived incentives to generate inflationary surprises and disincentives to bear the short-run costs of disinflation. (The substantial disinflation in most industrial countries during the 1980s suggests, of course, that these aren't the only considerations at work).

Pegging exchange rates has a similar incentive structure. There may be considerable short-run benefits to establishing a pegged rate while the prospective costs of having to deal with substantial exchange rate disequilibrium typically will not occur until well into the future. With luck, one may be able to buy some short-run anti-inflation credibility on the cheap by implying a strong commitment to the current peg or a limited rate of downward crawl, while retaining the option for future exchange rate adjustments if needed.[35] With the far-sighted actors assumed in most of our game theoretic literature, such a strategy of attempting to have one's cake and eat it too would not be expected to work. But, in the real world, such considerations do not seem to be sufficient to keep governments from sometimes trying. One can only hope that the recent failures of this strategy will provide a cautionary note.

The recent Mexican experience is quite instructive in this regard. It appears that in the short run, the Mexican adoption of a slowly crawling peg did help secure lower wage settlements and contributed to the extremely successful disinflation from triple to single digits. Surely the major cause of success, however, was the prudent monetary and fiscal policies the government followed. Unfortunately, by tying much of the credibility of their policy strategy to the exchange rate, the government put itself in a very vulnerable position. The emergence of strong indications of substantial overvaluation coincided with an approaching presidential election, so that there were particularly strong political incentives to delay adjustment. On top of this, it now appears that the disequilibrium was worsened by expansionary fiscal and monetary pre-election policies. Over this period, instead of there being a discipline effect from the pegged rate system, it added to the incentives for pre-election expansion. The old government managed to keep the emerging balance of payments crisis under control before the election, but a very heavy price was paid by the new government when the rapid depletion of international reserves caused by capital outflows forced a devaluation soon after it took office. Because of the emphasis on the pegged system in the government's policy strategy, what should have been the moderate economic effects of a needed exchange rate adjustment due to changing balance of payments conditions became instead a crisis of confidence in the government's whole economic strategy. This led to a substantial increase in inflation and inflationary expectations and a much greater depreciation of the exchange rate than would have needed if an adjustment had been made in a timely fashion.

In summary, I believe that one should be very wary of efforts to use the exchange rate as a source of monetary discipline. While this can be effective in some cases – the hard currency pegs of Austria and the

Netherlands to the German mark are examples – the nature of the pegging relationships involved must be carefully analyzed. The case for adopting institutional arrangements to promote monetary and fiscal discipline is strong, but for countries of substantial size, exchange-rate based mechanisms will typically not be the most effective approach and, indeed, are subject to substantial abuse. In general, we need to look to domestically rather than internationally based mechanisms for promoting discipline.[36]

V. Concluding Remarks

This lecture has touched upon only a few of the areas in which public choice analysis has been fruitfully applied to the study of international economic relations. Beyond the traditional focus of international economics on international trade and monetary issues, today there is also increasing interest in areas such as international environmental and resource management, international cost sharing of the provision of public goods, economic sanctions and security aspects of international trade, and the role of international organizations. Public choice analysis and the closely related approaches of the transaction cost economics and the new institutional economics have made important contributions in all of these areas as well.[37] The scope for such applications is far from exhausted. My hope (and expectation) is that public choice analysis will increasingly inform the work of international economists and political scientists specializing in international political economy and that this, in turn, will have an increasing impact on the formulation of international economic policies and the operation of international economic institutions.

Endnotes

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[1]Interestingly, while Frey (1984a, 1984b) mentions the stress on rigor as one of the main characteristics of the public choice approach to international political economy, Colander (1984), comparing the approaches to political economy analysis taken by international trade and public choice economists, describes the trade economists as formalists while arguing that "public choice theorists are non formalists and integrate far more ideas into their implicit model..." (p. 7). He goes on to argue that there are significant potential gains from trade between these approaches. While it seems fair to say that, on average, the degree of rigor declines and breadth of ideas increases as one goes from the work of international trade economists to public choice economists to political scientists writing on political economy, a full spectrum of rigor and breadth is reflected in the work of all three groups. See Odell and Willett (1990). I have argued for the fruitfulness of taking a broad public choice approach to the analysis of the political economy of monetary policy in Willett (1990). For valuable characterizations of key elements of the public choice approach to analyzing international issues in addition to Frey (1994a, 1984b), see Smith (1991).

[2]See, also Barry Jones (1983) and the popular readers in international political economy edited by Crane and Amawi (1991) and Frieden and Lake (1991,1995). Many of the major articles in international political economy have been conveniently collected in a series of volumes published by Edward Elgar. These include Baldwin (1993a), Cohen (1993), Grieco (1993) and Lake (1993).

[3]In his book, Gilpin (1985) changes his label for these approaches from models to ideologies and argues that they are akin to different paradigms in the sense of Thomas Kuhn in that they are not subject to empirical testing. This is likely a fair characterization of some of the normative elements of these approaches, but it does not apply to their formulations as theories of positive political economy. In places, Gilpin does use the

distinction between positive and normative analysis, but he does not apply the distinction systematically to his analysis of the three approaches.

[4]Frieden and Lake (1991) likewise begin their discussion of "Three Perspectives on International Political Economy" with the statement "nearly all studies in International Political Economy can be classified into one of three mutually exclusive perspectives: Liberalism, Marxism, and Realism" (p. 5). In the latest edition of their reader, Frieden and Lake (1995) give considerably less weight to these three approaches and focus more on a four-way classification based on the strength of states versus societal pressures and international versus domestic considerations. In my judgment, this is a much more productive framework.

[5]Of course, there are also important non-economic motives for tariffs, such as economic sanctions adopted for foreign policy reasons.

[6]See Kaempfer and Lowenberg (1992) for a public choice approach to international relations from the perspective of one tool, namely, economic sanctions.

[7]One of the strongest recent advocates of the primacy of realism over relative gains is Joseph Grieco (1990). In my judgment, Grieco substantially overstates the extent to which security considerations should generate a rational focus on relative economic gains and ignores the extent to which rent seeking by interest groups induces governments to behave as if they were pursuing relative rather than absolute gains. The focus in GATT on viewing import liberalization as a cost is an example of this later point. See, for example, Finger (1991). For an excellent critical review of the recent international relations literature on absolute versus relative gains, see Milner (1992), and on the broader debate between neo-realism and neo- liberalism, see Baldwin (1993b).

[8]I contrast the optimal policy and political economy or public choice approaches to international monetary analysis in Willett (1983).

[9]See, for example, Lindert (1991) and Markusen, Melvin, Kaempfer and Maskus (1995). Other frequent mischaracterizations of standard economics and liberalism include statements that "Liberalism also assumes that a market exists in which individuals have complete information..." (Gilpin 1987, p. 28) and that the "economic rationality" of the liberal perspective is "...a notion which soon confirms rational choice to the maximization of only those objectives which can be satisfied through market exchanges and which therefore ignores (and ultimately illegitimizes) all those other needs, wants, and desires which an individual

may well seek to satisfy through his actions and choices" (Barry Jones 1983, p. 175). For further analysis of mischaracterizations in the political economy literature of modern economics and international trade theory, see Dillon, Lehman and Willett (1990).

[10]Frieden and Lake (1991) argue that "...the principal Liberal approach known generally as ***public choice*** or ***rational choice*** thinks of the political area as a market place...This view, closely related to long-standing theories of interest group pluralism, sees government action as the result of competition among politicians, and among their constituents" (p. 7).

[11]See, for example, Destler (1986), Destler and Odell (1987), Goldstein (1993), Gourevitch (1986), Katzenstein (1978), Milner (1988), O'Halloran (1994), Putnam (1988), Verdier (1994), and the contributions in Ikenberry *et al.* (1988) and Odell and Willett (1991). Political scientists coming to international political economy from a background in comparative politics are much more likely to stress the importance of domestic political considerations than those coming from international relations theory.

[12]During 1969 and 1970, I served as a senior staff economist at the Council of Economic Advisers. From 1972 to 1977 I worked at the U.S. Treasury, first as Deputy Assistant Secretary for International Research and Planning and then as Director of International Monetary Research.

[13]This was in the 1970s. More recently, especially with the strong dollar of the first half of the 1980s, concern with effects on particular economic groups appears to have begun to play more of a role in discussion of U.S. international monetary policies. See, Destler and Henning (1989) and Henning (1994).

[14]See Willett (1989).

[15]The conservative welfare function formulation is concerned with reductions in income which appear to be caused by adverse economic developments beyond the control of the group in question. This formulation can thus explain the relevance of public interest cloaked arguments for support of steel and auto workers with well above average worker incomes. Note that to be politically effective, public interest cloaked arguments do not necessarily need to be economically sound. The public choice concept of rational ignorance has considerable explanatory power.

[16]See Kaempfer and Layok (1996).

[17]For a nice discussion of the distinctions between the Hecksher-Ohlin and specific factor theories, see the basic international economics text by Lindert (1991). For political economy applications of these theories, see Magee, Brock and Young (1989), Minford (1993), and Rogowski (1987) and (1989).

[18]See the recent contribution by Cote and Morris (1995). Specifically on this issue with respect to the use of tariffs versus quotas, see the analysis and references in Kaempfer and Willett (1989) and Kaempfer, Tower, and Willett (1990).

[19]Amacher, Tollison, and Willett (1979). For recent applications, surveys and references to the recent public choice and political science literature on the political economy of protectionism, see Baldwin (1985), Cohen (1990), Conybeare (1987), Goldstein (1993), Hillman (1989), Nelson (1988), Odell (1990), Odell and Willett (1990), Oye (1992), Rodrik (1995), and Rowley, Thorbecke and Wagner (1995). On the issue of tariffs versus quotas see the analysis and references in Kaempfer, Tower and Willett (1990) and Kaempfer and Willett (1989). While most applications have been to the United States and other industrial countries, there have also been an increasing number of important applications to developing countries as well. See, for example, Krueger (1993).

[20]See Goldstein (1988).

[21]See the analysis and references in Eichengreen (1989) and Ferguson (1984). The classic analysis of the role of special interests is by Schattschneider (1935).

[22]For detailed discussion of these changes see Destler (1986), Goldstein (1988, 1993) and Haggard (1988). For evidence that median legislator models explain changes in U.S. tariff levels well before these institutional changes, but not afterwards, see Hansen and Prussa (forthcoming). On the role of ideology in U.S. trade policy see also Baldwin (1985) and McArthur and Marks (1988).

[23]Realist models of hegemonic stability theory are also used to explain the increase in protectionist pressures across the industrial countries as a function of the perceived decline in the United States' hegemonic power to impose a liberal trading order. Various versions of hegemonic stability theory stimulated by the initial work of Charles Kindleberger have been subject to considerable debate in the International Political Economy literature. For a sympathetic interpretation see Gilpin (1987), and for a succinct critical survey of the key issues, see Gowa (1990). Of particular interest is the argument due to Conybeare (1984) that the Kindleberger version requires a public interest or broader security- minded goal for the hegemonic government since a narrow national economic-interest-maximizing hegemonic government would likely impose an optimal tariff.

[24]For discussion and references on the discipline debate see Willett and Mullen (1982).

[25]See, for example, the analysis and references in Mayer (1990), Persson and Tabellini (1994), Sheffrin (1989) and Willett (1988).

[26]For discussion and references on the nominal anchor debate see Bruno (1991), Westbrook and Willett (forthcoming) and Willett and Al-Marhubi (1994).

[27]See the analysis and references in Dorn and Schwartz (1987), Wijnholds, Euffinger, and Hoogduin (1994) and Willett (1988).

[28]For surveys of this literature see Talvas (1993) and Tower and Willett (1976), and for recent applications see Sweeney, Wihlborg and Willett (forthcoming).

[29]Hochreiter and Winckler (1995) argue that Austria did not fully meet the criteria for forming an optimum currency area with Germany when the Austrian hard currency policy was initiated, but that the strategy generated responses such as increased wage and price flexibility which moved Austria closer to these criteria. For policy, what is most important for countries deciding to pursue a pegged rate strategy is that they not deviate too greatly from the optimum currency area criteria.

[30]See Willett (1994). On the political motivations behind the push for a European Monetary Union, see also the contributions and references in Eichengreen and Frieden (1995).

[31]It is often difficult to tell just how "fixed" a particular exchange rate regime is. While neither Austria nor the Czech Republic have formal legal obligations to maintain their fixed exchange rates, these governments' commitments to maintaining these pegs appear to be quite strong, and the political costs of abandoning them would likely be quite high.

[32]On Keynes's tendency to assume that government policies will be determined by experts operating in the public interest, free from political pressures, see Buchanan and Wagner (1977). On the establishment and breakdown of the Bretton Woods system, see the analysis and references in Soloman (1982) and Willett (1977).

[33]On the operation of the European Monetary System and the 1992 and 1993 crises, see Abegaz *et al.* (1994), Fratianni and von Hagen (1992), Portes (1993), and Wijnholds, Euffinger, and Hoogduin (1994).

[34]See Willett (1995).

[35]For a similar argument, see Cohen (1993).

[36]On the recent interest in central bank independence and optimal contracting approaches to promoting monetary discipline, see Banaian, Burdekin and Willett (1995), Burdekin and Willett (1995), Cukierman (1992), Grüner and Hefeker (1995), Lohmann (1992), and Walsh (1995).

[37]See, for example, Eckert (1979), Gowa (1994), Kaempfer and Lowenberg (1992), Keohane (1984), Vaubel and Willett (1991) and Yarbrough and Yarbrough (1992).

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