Theme II 1b: Challenges in the Global Economy

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The threat is nearly invisible in ordinary ways. It is a crisis of confidence, It is a crisis that strikes at the very heart and soil and spirit of our national will

Jimmy Carter, Crisis of Confidence, 1979

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[1] Gas guzzled: OPEC's 1973 oil embargo threw America into crisis and underlined the political power of energy. David Falconer/Wikimedia Commons

Criteria for Significance

1. Instability of Financial and Monetary System
    a. Unstable currency values and high debts
2. Illiberal trading order
    a. Decline in free trade and rise of new protectionism
3. Declining rates of economic growth and uneven development across the global economy

Ai. Structural Issues and Consequences of the Golden Age of Capitalism

1. US-enabled growth eventually led to increasing convergence in developed economies as they endeavoured into similar industries and advanced to similar levels of industrial sophistication, increasing rivalry between developed countries
    a. From 1970s to 1986, US and Germany's labour costs were twice of Japans but equalised. Similarly, US's productivity decreased by thrice compared to Germany and 50 times compared to Japan. **Increasingly similar factors of production led to less differences in factor endowments. To reap comparative advantages, the basis of trade decreased**
    b. Trigger Price Mechanism was enacted in 1977 to impose tariffs on Japanese steel exports should they be sold lower than the trigger price. This was due to an advanced Japanese steel industry which outperformed the inefficient American one. **US prioritised its own steel industry as both countries competed for steel dominance in the market.**
2. Undud changes in the global economic structure that growth had depended on due to America's unsustainable unilateral management removed the benchmark for currency values, destabilising the FMS and de-liberalising trade
    a. Maintaining the adjustable peg exchange rate depleted US gold supply. (1948-1959: 24 billion USD to 19.5 billion). In 1971

Aii. US Abandonment of the Bretton-Woods System (1971)

1. Closing the gold window meant that the US dollar would be allowed to float against other currencies without a quality benchmark. A easily vacillating US currency increases volatility for other currencies pegged to it as well, thus inviting speculation and inflation, destabilising the FMS.
    a. MNCs, international banks and private investors, realising the profit to be made in the money market trade, indulged in extensive currency trading. Chiefly in the Euromarkets only, currency trade increased from less than 25 billion a day spiked to over 100 billion in 1973. Consequently, currency fluctuates at a faster rate, destabilising the FMS
    b. 1970s currency wars saw countries engaged in competitive devaluation to ensure that the prices of their goods, determined by transportation and exchange rates costs stay competitive. **Not knowing the value of the currency promotes traders to hedge or buy insurance against future volatility, fuelling speculation which could lead to inflation.** Consumer prices in Western economies doubled.

2. Collapse of the BWS meant that the external discipline provided by it was also removed, widening policy options for governments whom stimulated demands to offset recession by increasing wages which generated inflation
    a. UK's Barber Boom was a product of extensive tax cuts and liberalisation of the banking system. It was possible as Britain did not have to grapple with defending the pound now without the BWS's peg. Bank lending rose from 71 million to more than a billion and the monetary supply (M3) grown by 25%. The boom was short lived as inflation spiked to 24% [2]and the country fell into a recession (2.4%)
    b. 1975 Without the need to defend the peso, the Argentinian government could enact populist policies without worrying about the fixed exchange rate. Rodrigazo saw a 150% devaluation of currency and 45% increase in wages. Consequently, purchasing power fell rapidly as prices doubled. [3]Inflation went up to 450%[4]
3. Countries signed alternative agreements to stabilise their currencies against each other, reducing volatility and instability within the FMS by fixing exchange rates, regaining investors and trader's confidence to engage in international finance.
    a. 1971 Smithsonian Agreement signed by the G10 agreed to create a new standard for the dollar, devaluing it from $35 to $38 an ounce of gold while other countries agreed to revalue their currencies.
    Probe: However, gold prices rose to 60 an ounce in 1972 and 90 an ounce by 1973. By 1973, the Smithsonian Agreement effectively collapsed as all major currencies were floating
    b. 1971 European Monetary System saw an adjustable exchange rate arrangement set up among European countries to stabilise exchange rates and stop inflation, facilitating inter-European trade. After 1983, exchange rate variability within the European Monetary System declined substantially.

Aiii. Oil Crisis (1973 and 1978)

1. Sharp rise in oil prices raised the cost of production and brought about global recessions, delivering the most devastating blow to global economic growth and development to the point that they triggered the onset of the Crisis Decade.
    a. 1973 Oil Crisis quadrupled oil prices to $12 due to the OAPEC oil embargo that tightened oil prices (cut 1.2 million barrels of oil). Resulted in the first world recession (1974-1975) as consumer prices rose to an average of 10% compared to the 4% the earlier decades and unemployment grew to exceed 4%.
    b. Due to the Iranian revolution, oil supply from Iran dropped from 6 million a barrel to 500000 in 1979. Panic buying due to perceived shortage tripled the price to 38 dollars a barrel. Resulted in a second world recession in the 1980s as economic growth was uneven and averaged only 2.8% while inflation rate doubled to 14% in the 1980s.

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[2] https://www.ruffer.co.uk/en/thinking/articles/market-views/2022-09-barber-boom
[3] https://en.wikipedia.org/wiki/Rodrigazo
[4] Luis Ignacio Jácome. "Central Banking in Latin America: From the Gold Standard to the Golden Years", *IMF Working Papers* 2015, 060 (2015), accessed October 11, 2025, https://doi.org/10.5089/9781484303184.001

2. The oil crisis brought about improper financial recycling of petrodollars, generating the unstable financing conditions in the financial and monetary system that led to the debt crisis of the 1980s.
    a. Large volumes of Arab petrodollars were invested discreetly as sovereign wealth funds into major commercial banks of US and EU, contributing to the rapid growth of a less regulated Eurodollar.[5] **As it fell outside of many central bank's regulatory purview, it was more volatile.** Currency trading in the euromarket spiked to 100 billion a day in 1973.
    b. The 1973 oil crisis had created a vast shortage in developing countries whom still needed to finance their imports of oil and machinery. To prevent bankruptcy, they borrowed from oil-funded banks. Their economies had yet to reach a point of stability that would guarantee that they could eventually pay back. This ballooned debt, as it rose to 18% of GDP in 1977
3. The oil crisis
4. Various countries were able to adapt by diverting from oil intensive industries while others profited from the crisis as oil prices spiked, resulting in a relatively high economic growth rate as compared to the rest of the world.
    a. For oil producing states, the spike in oil prices increased. During the 1973 oil crisis, this revenue was estimated to be 70 billion while in 1979, it was estimated to 114 billion as compared to OECD's average of <2%
    b. Japan shifted from oil-intensive industries to new ones like electronics while innovating in existing oil-intensive industries like automobile to create fuel-efficient cars. Japan also accelerated its nuclear plans and build more hydroelectric plants. Japanese GNP growth rate was 5% during the crisis

Aiv: Protecitonism

1. Protectionist measures were set up by developed countries against developing countries due to their lower prices, making them more attractive and to stimulate competition within their own region. Eroded the liberal trading order by limiting trade.
    a. European Community's 1962 Common Agricultural Policy (CAP) blocked agricultural imports from developing countries into the community and artificially stimulated competition in its markets. **This forced trade to be contained within the EC and gave rise to the impression of a "Fortress" and a "Europe for Europeans"**
    b. 1974 Multi-Fibre Arrangement was leveraged on by developed countries to placed restrictions on cheaper textiles and clothing which accounted for nearly a quarter of exports from developing countries, **denying developed countries a huge amount of their exports earnings**
2. Protectionist measures enacted against developed countries to protect other developed countries economies from competition from more efficient foreign industries and fuel-efficient products especially at the onset of the oil crisis.

[5] https://en.wikipedia.org/wiki/Petrodollar_recycling#Petrodollar_warfare

    a. The 1977 Trigger Price Mechanism was enacted to impose tariffs on Japanese steel exports should they be sold at prices lower than the trigger price. **Protect the inefficient US steel industry which encountered increasing factors of production due to rising oil prices.**
    b. The Voluntary Export Restraint (VER) Program under Reagan capped the entry of Japanese cars into the American market to about 1.7 million a year to protect American products from the more appealing fuel efficient Japanese cars due to high oil prices.
3. Protectionism was not a challenge as it aided countries in improving their trade balances, giving them time to recover or stimulate domestic growth and encouraged MNCS to divert their investments to developing countries not yet subjected to protectionist measures. Resulting in growth.
    a. As the US was in a trade deficit of about 2 billion dollars in 1971 and the 2 oil crisis, Nixon's protectionist policies such as the VER and TPM as well as imposing a 10% surcharge on dutiable imports allowed it's economy to expand steadily, hitting a growth rate of 2.8% in the late 1980s from the meagre 0.3% in the early 1980s
    b. 1986 Mexico's accension to the GATT paved the way for offshoring as MNCs like Daewoo Electronics to built factories to assemble colour television to avoid US trade restrictions. These factories represented an investment of roughly 20 million. Mexico's GDP growth in the 1990s was 5.3%.[6]
4. Protectionism's illiberalizing effects on the global trading order was limited due to the inauguration of international mechanisms that promoted free trade by setting up free trade areas or impose legal penalties on protectionism
    a. 1992 ASEAN FTA saw the average tariff rate for goods in the common effective preferential tariff list fell from 13% in 1993 to 2.36% in 2003. **Trading environment conducive for trade**
    b. 1995 saw the World Trade Order (WTO) established to liberalise trade. As the WTO was legally binding, unlike its predecessor (GATT) and include clauses on both trade and non-trade barriers, it prevented the implementation of protectionist measures in the spirit of free trade.

Av. Debt Crisis

1. The debt crisis of the 1980s saw many developing countries default on their loans, bringing about a loss of confidence in the international banking system. The resultant contraction of money supply due to bank runs and deposit withdrawals almost brought about the collapse of the international financial and monetary system.
    a. 1982 Mexico announced that it was unable to meet its obligation to service its 80 billion in mainly US-denominated debt obligation to US and foreign banks, followed by more than 25 countries with a combined outstanding bank debt of more than 200 billion, resulting in 6 times as high of real interest rates as compared to the 1970s.

[6] https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=1990&start=1980

   b. The total exposure of US banks to developing countries at the end of 1982 was about 290% of bank capital. **This meant that the international credit system was overexposed to the risk of sovereign defaults as many banks had been lending way over their equity limit.** Gross commercial bank lending to all developing countries dropped from 52 billion in 1981 to short of 10 billion at the end of the 1980s
2. The debt crisis also saw the debtor countries need to service their loans, hampering their ability to import goods from the developed countries. As a result, this created trade deficits between developing and developed countries in the long run, limiting the liberal trading order as they were financially unable to sustain their trade.
   a. The annual growth rate for imports of the 17 most indebted countries recorded a fall to negative 6% as compared to the 5% during the GAC
   b. The USA recorded a negative swing in its trade balance of about 12 billion while other developed market economy countries were smaller but still significant (3 billion for Japan and 4 billion for Europe). Growth of international trade was subdued to average growth of 4% each year as compared to the average of 8% during the GAC.
3. Furthermore, the debt crisis saw developing countries while burdened by their debt, forced to accept conditions attached to loans, exacerbating the economic difficulties of these countries, ushering in a "lost decade of development." This slowed the global economic growth and worsening the uneven economic development.
   a. As IMF and World Bank's economic policies were influenced by the Washington Consensus that were inappropriate for countries in the pilot stages of development or on the throes of economic collapse, the capital market liberalisation policies make countries susceptible to financial shocks. This manifested during the 1994 Peso crises when investors pulled out when they doubted Mexico's ability to maintain its fixed exchange rate with the dollar. Growth rates per capital experienced a negative growth of almost 9 percent
   b. World Bank loan forced a country to impose structural adjustment programmes and austerity measures as a method of decreasing government spending. Zambia saw a 25% increase in infant mortality and large proportions of the population were languished a illiterate and unskilled due to forced cuts to health and education spending. **A languished, illiterate, and unskilled population was unable to add value to economic development.**
4. In response to the debt crisis, key economic actors acted decisively to provide aid to affected developing countries, averting the risk of the international financial and monetary system collapsing and restoring the stability of it.
   a. Mexico and the IMF reached an agreement in November 1982 that in exchange for 3.84 billion in IMF credits, Mexico agreed to carry out a strict austerity program, preventing the crisis from exacerbating by a swift response only after 1 year.
   b. Around 40 countries in Africa have had programmes with the IMF and World Bank (More than 200 billion in foreign aid) since the early 1980s while over a hundred IMF-World Bank programmes were initiated in 18 countries in Latin

America, averting the supposed collapse in financial banking when these countries defaulted on their loans.