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Mercantilism and Global Security

Michael Borrus, Steve Weber, and John Zysman, with Joseph Willihnganz

FOR THE THIRD time this century the United States faces a new world. It looks in many ways like the world that America has for forty years struggled to create, a world it hardly dared hope for. But even so it poses new and difficult questions about the international system and America's place in it. American competitive troubles, Asian industrial might, and continuing European integration create the basis for a wholly new system of relations among the major powers that will substantially reduce American influence. For the moment, the U.S. still leads, but more by default than from strength.

For over four decades the postwar security system presumed a Soviet enemy, a U.S. military umbrella over allies in Western Europe and Asia, and a system of free trade and stable finance dominated and coordinated by the United States. This system of trade and finance, established within GATT, Bretton Woods, and successor agreements, rested on American industrial and technological leadership. That foundation of power made it possible for the United States to support the rebuilding of Europe and Japan, establish for itself favorable terms of trade, and channel compliance with its security aims.

But now the United States is slipping. Its technological and economic position is declining relative to the other industrialized nations. As a result, the government's ability to exact compliance or exercise leverage in the international system is diminished. The United States has been painfully constrained in its ability to contribute development aid to the Baltics or to invest in reform in Central Europe. If the United States were to conclude that massive assistance to Russia was in fact advisable, it would have to raise the money hat-in-hand just as it did to finance the Gulf War. This change in capabilities is not just a result of temporary trends, and it will not be reversed by balanced-budget amendments, the end of the current recession, or other tinkering at the margins. It is a fundamental change. Having lost its technological and industrial hegemony, the United States will be increasingly subject to the kinds of constraints that it used to impose on others.

America's economic position relative to its two strongest allies has shifted from almost 4 to 1 in 1970 to virtual parity in 1990.[1] For years,

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[1] This measure, comparative GDP, expresses two changes: America's declining position and the change of its principal allies. In 1970 Britain and France were America's principal allies. By 1992, Japan and Germany had regained full sovereignty and become the other principal powers.

many argued that America's decline was mostly the result of industrial catch-up in Europe and Asia. Others blamed imperial overreach, arguing that extensive foreign policy commitments were exhausting the economy's resources. But it is now plain that Europe and Japan have done more than simply catch up in the same old game. The declining U.S. position is largely a reflection of American industry's inability to adjust competitively to changes in global markets, to play effectively in a new game. Many U.S. industries that ignored or simply missed out on production revolutions originating abroad must now buy critical materials and technologies from foreign competitors. Growing numbers of U.S. firms now retain their market position only through heavy doses of trade protection.

THE U.S. HAS fallen in less than a decade from the world's largest creditor to the world's largest debtor. Moreover, overseas borrowing has gone disproportionately into consumption and interest payments on past debt, not into investment in new technology and industrial process. The boom in American exports in the latter half of the 1980s has come only at historically low real exchange rates between the dollar and other principal currencies. This can't hide what is a real change in competitive position, since lowering the exchange rate (reducing prices) amounts to lowering real wages: our firms can compete, but only on less attractive terms for the society. The devaluation has not re-established our position or stymied imports in consumer durables sectors such as autos and electronics. The surge in exports has been in lower value-added and a handful of high-technology sectors rather than in the broad middle ground of industries like capital equipment and consumer durables that American manufacturing used to dominate.

These shifts in America's industrial, financial, and technological position have been complemented by the rapid emergence of powerful new capabilities in Japan and Europe that go beyond mere catch-up. During the postwar years, while the Unites States held fast to the tried-and-true formula of mass production and consumption, other countries began to innovate more rapidly. Our most successful competitors, in particular Germany and Japan, undertook new approaches in two critical domains: policy and production.

In the policy realm, both states made smart use of the fact that their defense burden was relatively light and chose to emphasize investment over consumption, which created excellent macroeconomic conditions for rapid growth. Both governments also encouraged the rapid adoption and widespread diffusion of technology acquired abroad and helped provide for a well-trained work force ready to use it. In Japan, government went a step further by closing through formal and informal means its domestic market to foreign firms, reserving growth in domestic demand for Japanese producers. These kinds of policies helped build strong industries by sheltering them from foreign competition, guaranteeing domestic demand, and encouraging continuous rounds of reinvestment which in time led to real innovations in production. Government policy in effect "created" competitive advantage for domestic firms and "comparative" advantage for the nation in higher wage industries.

But it is innovation in production and production organization that has increasingly separated the United Sates and its competitors. New methods of manufacturing and technology development, emerging in countries as diverse as Japan, Italy, and Germany, are quickly giving leading firms a competitive edge in technology-intensive, high value-added industries. These new methods, which combine high-volume production, organizational innovations, and advances in microelectronics, amount to a wholly new approach to making and selling goods. The most powerful new model of production is labeled variously as flexible volume production, flexible automation, or lean production. It allows firms not only to produce a variety of products with costs, quality, and market responsiveness far superior to mass production, but also to adjust quickly to changes in consumer tastes by introducing a new product and then adjusting to consumer reaction by fine-tuning product configurations and volumes to actual demand. Heavy investment and these new approaches to manufacturing and marketing establish a real advantage in component, materials, and machinery technologies that have broad commercial and military application.

The U.S. economy retains the advantage of being the world's largest; its technological and scientific resources are still broader and deeper than those of its competitors. But rapidly expanding capabilities in Europe and Asia now permit a serious challenge to American economic leadership and create the potential for autonomy where there was once U.S.-imposed constraint. Indeed, it is America's autonomy that is now threatened as it risks substantial dependence in industry, finance, and critical segments of technology.

Such a realignment of economic capabilities will have political consequences. At a minimum, the balance of constraints and opportunities facing states will shift dramatically. In 1956 the United States threatened a run on the pound to constrain British, French, and Israeli foreign policy. Today Japan and Germany have the financial leverage to influence the American exchange rate and monetary policy. Again, consider what happened when the United States wanted to punish Toshiba for having sold precision military technology to the Soviet Union. The U.S. government sought to ban Toshiba products from the U.S. market, but could not: too many major U.S. customers depend on Toshiba for critical components and technologies. Such examples demonstrate that America's ability to exact compliance through its position in trade and finance has been deeply eroded, leaving it without the array of foreign policy levers it enjoyed in the past and with vulnerabilities it has not had to cope with until now.

In sum, a radical re-alignment of economic capabilities, combined with the end of the Cold War, creates the possibility of fundamentally new relationships among great powers, and the regions that they dominate. The certainties of the bipolar world are gone, and the bonds that were a part of that world are loosening.

Three Regions

THE SECURITY system that develops over the next decade will reflect a world that is slowly dividing itself into three powerful trading groups: Asia, North America, and Europe. Though the world may be "globalizing," its major components are these three regions. Multinational corporations and financial institutions roam the globe, but each has a home—a country that necessarily shapes its character, and both constrains and directs its choices. And though the three major regions are interconnected (in part by the activities of these firms), each also commands an independent industrial and technological base, vast financial resources, and a developed domestic market capable of sustaining steady growth. This provides each with the economic foundations for independent action.

Consider first the Japan-centered Asian trade and investment region. Since 1985, trade within Asia has grown substantially faster than between Asia and other regions since 1985. The major source of imports for each Asian economy is usually another Asian economy, most often Japan. By almost any significant measure Japan, rather than the United States, is now the dominant economic player in Asia. Japan is the region's technology leader, its primary supplier of capital goods, its dominant exporter, and its largest foreign direct investor and foreign aid supplier. Financial ties further reinforce intra-Asian trends. From 1984 to 1989, for example, there was as much Japanese investment in Asia as in the previous thirty three years, doubling the cumulative total. The result of such trade and investment is a network of producers across Asia, generally controlled by Japanese firms, that diffuses technology and production know-how to other firms in the Japanese periphery. As other Asian nations absorb production knowledge and emulate the Japanese model of success, innovations in policy and manufacturing spread throughout the region much more quickly and effectively than they do to either Europe or North America. The presence of such broad economic strength across Asia guarantees the region increasing autonomy.

Next, consider Europe. Trade within the European Community has grown faster than trade between the region and the rest of the world since the establishment of the EC in 1958. Intra-EC trade is now the dominant proportion of each member-state's trade. Discounting intra-European trade, Europe's percentage of world exports and imports drops dramatically: exports from 44.6 percent to 13.8 percent, and imports from 42.6 percent to 11 percent. Trade within Europe will only increase further with the creation of a single market and possibly a single currency. And, as in Asia, financial ties reinforce trade ties. Like Japan and the rest of Asia, Europe appears to have both an industrial/technological base capable of providing for itself and an emerging political will to develop and maintain that capability, and to respond more effectively to external constraints. Though Europe (like Asia) is by no means a single political actor, European governments increasingly cooperate to create regional economic capabilities and policy. Today Europe is in a position to court autonomy.

The United States, with the largest economy in the world, sits at the center of the North American region, which is also strengthening internal trade and financial ties. Canada and the United States are already each other's largest trading partners. The North American Free Trade Agreement, if implemented successfully, will expand that trade further and bring Mexico—America's third largest trading partner—fully into the fold. The Free Trade Agreement may also spawn de facto trade barriers to goods and services coming from outside the region, thus insulating it from the two other groups and reinforcing the drive toward autonomy.

Competing Visions

Economic relations among these three trading regions will set the parameters within which security issues are resolved. There are several visions of what the emerging system could be like.

The most attractive vision is an extension of the present system of free trade. Though trade in the industrialized world is rarely wholly "free," the unrestricted flow of goods, services and capital among regions, as within them, would remain the overarching goal of such a system. Governments would continue to act on the belief that progressively freer trade benefits everyone in the end, even given the painful costs of domestic adjustments to competition. Governments would primarily negotiate the rules of trade, not trade outcomes, and they would continue to make use of the framework for these negotiations established in the postwar multilateral institutions like GATT. The system would be managed by a loose alliance of the three regions' principal powers. A consensus on shared goals for the world economy would replace a hegemonic distribution of power as the foundation for cooperation and stability. There might be relative shifts in position among the three centers of power. Some countries might get rich more quickly, but all would get richer over time, and the significance of those differences would be submerged in the shared goal of peaceful economic expansion. The security system that would emerge from such an order could be built around collaboration and cooperation among the advanced countries, something approximating a latter-day (but global) concert of Europe. We call this kind of world "true multilateral cooperation." In it, the United States would continue to be *primus inter pares*.

A less desirable vision begins with the economic regions fending off trade competition from one another as a way of avoiding most of the painful domestic adjustments. Each region would concentrate on its own internal development and would try to avoid the strains of direct competition by protecting markets. Round after round of "defensive protectionism" would disengage further the three economies and transform the world by steps into three nearly independent sub-economies. Trade would continue to become more concentrated within each group and perhaps decrease among them. Each group would work to limit its exposure to and dependence on the others, and whatever unavoidable links were left between them would be managed by agreement, rather than by markets. In this world of economic regions each group would command its own currency, industrial and technological base, and its own financial system—all insulated from those of the others. The result in economic terms would be three relatively autonomous trading groups with low levels of sensitivity to each other's choices and even lower levels of vulnerability to each other's actions. There might be some shift in relative position in this scenario as well, but all would be wealthy—though, having given up the benefits of global free trade, not as wealthy as they could be.

What kind of security system could we expect from such an economic arrangement? Three large, inwardly oriented groups could coexist comfortably—in principle—so long as there was mutual recognition that the drive for regional autonomy and political stability within each group was defensively motivated and posed no threat to similar arrangements outside. With internal growth and autonomy assured at home, disputes between regions could be marginal in this live-and-let-live world of regional coexistence.

Security arrangements in this relatively benign world could, however, look very different from what we have become accustomed to in the postwar world. In fact, this might not be a security "system" at all. Certainly, low levels of interdependence would make conflict among the regions unlikely. Would there be much cooperation? The optimistic view is that there would probably not be formal, institutionalized cooperation (as there was in NATO, where an attack on one was an attack on all), but that would not necessarily be a bad thing. As security threats in the new world will be more diffuse than in the past, regions, or countries, would cooperate on an ad hoc basis, with like-minded countries forming coalitions around specific challenges—a "Persian Gulf" coalition, or a "Sarajevo" coalition, for example. In a world without hegemony, "security cooperation à la carte" sounds practical, cheap (compared to supporting institutions like NATO) and fairly stable. In security debates this vision has become something approaching conventional wisdom as a "second-best" solution in the post-Cold War world.

What's wrong with this picture? Many would say the only real downside is that the gains from inter-regional free trade would be lost. While this loss would be unfortunate, it is maintained, the only real "threat" it poses is moderately lower income levels for all. The real trouble, however, is that this vision of regional coexistence rests on outdated arguments. Regional coexistence is not likely to be stable in the twenty-first century because of new patterns of technology development, and new ideas that have evolved to explain and interpret the competition that results. Powerful material and intellectual forces exist that could tilt this peaceful world into mercantile rivalry and unpredictable conflict.

The Cult of the Economic Offensive

THE PRINCIPAL force that could propel the regions into bitter economic rivalry is the possibility that there can be *enduring* national winners and losers from trade competition. This possibility is grounded in provocative new theories of trade and technology that undermine the basic intellectual premises of free trade and confirm recent experiences in high-technology competition.

Strategic trade theory, as it is often called, proposes that governments can by unilateral action permanently alter the competitive balance of trade in critical industries. By providing subsidies or protection, governments can give domestic firms—or entire industries—resources to build an improved global market position. If other countries do not similarly support their firms, the first country will have "created" advantage. If the industries selected for this special treatment serve as catalysts for the rest of the economy, their improved welfare benefits the entire economy. By promoting these key sectors governments can, in effect, secure permanent gains for the nation as a whole.

The trouble is that these gains come at the expense of other nations and possibly at their permanent expense. As one state's firms capture increasing market share, another state's firms suffer; and since the firms suffering are in the same critical catalyst position in their own economy, the whole economy suffers. Moreover, if the industries in question are natural oligopolies because of high investment or technological barriers to entry (as with the aircraft or semiconductor industries), the "created" advantage one firm enjoys might be enough to drive other firms permanently from the market. This generates serious consequences for other national economies, which find themselves suddenly dependent on critical components and technologies they can no longer produce at home. The promise of autonomy becomes, instead, a threat of dependence.

When we combine strategic trade arguments with an understanding of how technology develops, and how strongly that development affects the evolution of modern industrial economies, the implications become even sharper. The clearest way to think about how technology develops is to picture each nation moving along a technology "trajectory." Industrial technologies are not like pure science in that they do not come in a universal language with open and equal access to everyone. Production technologies accrue locally in networks of shared knowledge, learning, and experience—in firm-supplier links, skilled workers, and the like. This kind of knowledge is rarely traded among nations (except as partially embodied in products and technology licenses). This means that technological innovation tends to build up local assets within national borders and place states on distinct trajectories, or paths, that powerfully shape possibilities for future growth. If a nation's markets and firms are organized in such a way that these innovations spread easily, a few critical industries can strongly influence how an economy fares.

Together, strategic trade and technology theories open up the possibility that nations or regions could come to see themselves competing in a win-or-lose, zero-sum game for their economic futures. But can promotional policies really affect competition as profoundly as these theories suggest? Can governments really pick winners over losers? The answer is that it may not matter whether they can or not. It only matters whether nations *believe* they can. And if one government plays the strategic trade game, other governments will have trouble standing aside. In fact, nations, or regions, might feel provoked to develop strategic trade policies simply out of the fear that others might be doing the same.

GOVERNMENTS will find it difficult to deny themselves the tools of strategic trade. Strategic trade is based on the notion of a "first mover advantage." This advantage can prove decisive in capturing markets and particularly in generating a cycle of reinvestment and learning that creates enduring advantage in high-technology competition. For these reasons, it is not a viable policy to sit back and watch while others move ahead. In fact, it can be seen as potentially devastating if governments believe that markets and technologies critical to supporting further economic development at home will be lost to those who moved first.

The dynamic is reminiscent of "the cult of the offensive" among European military organizations prior to World War I.[2] In that case, a group of states set up and trained their armies according to the idea that military offense was dominant over defense—which led to the conclusion that a tremendous advantage came to the side that struck first. They turned out to be wrong about the nature

[2]Stephen Van Evera and Jack Snyder developed this notion.

of war in 1914—in fact the defense turned out to have the advantage—but "the cult of the offensive," as wrong as it was, nevertheless changed the character of relationships among the European states. On the strength of the idea, states that prepared their armies for quick decisive strikes forced their neighbors to do the same rather than plan for defense. In a world where offense was believed dominant, even states that preferred the status quo had to protect themselves against the possibility that others would launch pre-emptive strikes—and the *only* way to do that seemed to be by preparing to do the same thing themselves. Readying armies to pre-empt became a prudent policy even if the advantages of doing so were uncertain, because what was clear was that it would certainly be much worse *not* to act while somebody else did. The logic of strategic trade coupled with the notion of technology trajectories has similar implications for economic competitors. Nations or regions may be provoked to develop strategic trade policies in an effort to seize a first mover advantage, or simply out of fear that others might be doing the same. In either case even the appearance or suspicion that *other* governments might be attempting to do this could be sufficient to tip benign regionalism into mercantile rivalry.

This tendency will be reinforced by a new dynamic developing between military and commercial technology. In the Cold War system technologies "spun-off" from military to commercial applications because military technologies were frequently more sophisticated than those available in the civilian sector. The classic example is integrated circuit technology which was developed first for military and aerospace application. Now, because of the new industrial capabilities mentioned earlier, the dynamic is frequently reversed—that is, advanced commercial technologies "spin-on" into military applications.

What does this portend for security cooperation? The advent of spin-on has already prompted governments to regard many commercial technologies as militarily sensitive and therefore warranting secrecy orders. But this is not the most significant implication. More important, spin-on implies that nations which cede commercial markets may also sacrifice the ability to develop critical military systems. Lacking the supply base of resident skills, knowledge, process, and subsystems know-how of related commercial industries, it may not be possible to maintain leading-edge military capability. This creates a whole new level of security vulnerability; for the control that trade rivals have over militarily relevant commercial technologies can be used to extract concessions or impose constraints in return for granting access to technology. Taken together, these dangers reinforce the temptation to "grab" key technologies and markets before others can: doing so would guarantee domestic availability of the industrial resources needed to field state-of-the art military forces and eliminate the need to make unacceptable concessions.

The prospects for mercantile rivalry between three large economic regions, each with a market large enough to influence global competition and large enough to capture most scale economies, are real. If they are unconnected by intimate ties of trade and investment, free from any common threat, standing in relative autonomy, one must ask of these three regions: What will bind them together? The only answer may be this: Fear; fear of one another.

Ideas Matter

THE NEXT security system could be defined by true multilateral cooperation, by peaceful regional coexistence, or, most dangerously, by mercantilist regional rivalry. The risk is that if regions come to view trade as a zero-sum game in which one region's gain is another's loss, they could start to regard each other as rivals competing not just for one-time gains in wealth, but for long-term growth and welfare. There are powerful intellectual, political, and technological forces that could push the world into this kind of mercantile rivalry. Existing international institutions would be hard pressed to cope with the instability that would result. America's principal task is to revitalize its own economy while effectively managing the evolving relationships among the three big centers of power.

Relationships are based not only on the distribution of power but also on ideas and the institutions that are connected to them. The security system that emerges over the next decade will reflect the new realities of economic power but it will also be shaped by the visions brought to it by the major actors. This was true even within the demanding constraints of a bipolar world. At the end of World War II, the United States and the Soviet Union both moved to construct security systems to balance the power of the other, but they chose to do so in very different ways according to different sets of ideas. The Soviet Union put together a network of bilateral treaties that connected Moscow to each of the Eastern European states but kept those states separate from each other: the organizing principle was "divide and conquer" and its success lay in making each Warsaw Pact nation individually dependent on Stalin for security and economic intercourse. The United States could have done the same and there would have been concrete advantages to doing so.[3] But Washington chose a different model, the model that became NATO, where the allies were bound together in a system of indivisible security and each was protected equally by an American military umbrella. Security in the West became what economists call a "non-excludable good"—which was at the root of the burden-sharing or free-riding complaints that the United States frequently leveled at its allies. But it did so only because the United States chose to fashion its alliance relationships in that way.

The point is that this choice was not determined by the distribution of power, but was based on a distinctive set of American ideas about world order, ideas that were firmed up by American diagnoses of the failures of international arrangements during the interwar years. The United States sought to avoid the discriminatory bilateral trade deals with Eastern Europe that contributed to Nazi power and the "checkerboard" system of weak guarantees in Western Europe that gave way so easily to aggression. Americans also believed that pluralistic and democratic states that traded freely could live together peacefully and grow economically, without threatening each other's vital interests.

The two sets of ideas were brought together in the multilateral institutions of the postwar Western world. Peace, prosperity, and democracy might not have been shared equally within those institutions, but they were to be shared by all. What emerged from this design did not match perfectly the American conception, but it came remarkably close. Economic and military power certainly helped the United States induce or compel sometimes reluctant nations to join the fold and comply with the bargains. But the substance of the bargains was as much a product of American vision as it was a product of economic strength.

Today a new basis for security relationships is forming. Hegemonies are gone, economic power is dispersed, and new ideas—about trade, security, development, and order—are emerging from new centers of power. These ideas will help to shape the relationships which in turn will determine the quality of life in the international system for both the most powerful states and their smaller neighbors. There are more strong voices on the world stage today than fifty years ago, and each has different things to say. The United States will have to listen. It must also shape the script.

The Challenge

IT IS POSSIBLE for the United States to be effective without being dominant, but this will require a clear presentation of the kind of world we want to live in ten years hence and a program for getting from

[3]For an extended discussion of this point and the following one see Steve Weber, "Shaping the Postwar Balance of Power," *International Organization* (Summer 1992).

here to there. Mercantilist rivalry is not a necessary consequence of the new distribution of power, but it could arrive by default. To avoid it, the United States must act from strength at home and with multilateral cooperation abroad.

The first priority is to re-establish American economic strength. Neither external agreements nor combative trade policy can compensate for what we fail to do for ourselves. Only we can provide the kind of macro-economic environment, human and physical infrastructure, and mechanisms for the domestic development and diffusion of technologies that make it possible to be one of the winners in the big leagues of global economic competition.

The trick will be to re-establish American economic strength while avoiding beggar-thy-neighbor trade and technology practices that could push the world into mercantilist rivalry. That is where multilateral cooperation comes in: America's own economic redevelopment agenda provides the opportunity to establish new multilateral agreements to contain mercantilist behavior.

Achieving such multilateral cooperation will require several new actions. The United States and its allies need to agree to a set of principles that endorses reciprocal access to regional markets, investment opportunities, and supply-base technologies. Reciprocity of access permits as much openness as each regional economy can tolerate politically, and forces compromises in domestic practices that impede access whenever domestic industries seek foreign market opportunities. Effective reciprocity will in turn depend upon some degree of consensus about what domestic and business practices are appropriate. Some code of behavior will be needed to eliminate the most extreme and disruptive practices. To make up for the inevitable gaps and loopholes in that code, states will have to negotiate specific bargains.

The complex arrangements needed to achieve these goals will be difficult to negotiate in large multilateral forums like GATT. The experience of the U.S.-Japan Structural Impediments Initiative shows that it is hard enough to bargain over the domestic practices of two economic systems, let alone three or more. Indeed, most of what will be accomplished will be on a bilateral basis. Consequently, it is crucial that bilateral negotiations take place in a multilateral context with rules of procedure and sufficient transparency to ensure that those who are not direct participants can make their needs and interests felt. The agenda for cooperation is daunting, but no more daunting than the GATT agenda must have looked to statesmen at the end of the 1940s.

The stakes may be as high now as when the GATT was conceived. Now, as then, real wealth and power are at stake. Then it was concentrated in U.S. hands; now it is regionally dispersed. Then we expected the system would benefit U.S. interests; now the United States has no such confidence. Hegemony is long gone, and a new world beckons. Now America needs to act not from the belief that we are and can remain dominant, but from an understanding of how we can be effective in circumstances in which we no longer are. □