GOVERNMEN CORPORAT IN A SHRIN WORLD

WUKLU

TRADE & INNOVATION POLICIES IN THE UNITED STATES, EUROPE & JAPAN



by Sylvia Ostry

A COUNCILON FOREIGN RELATIONS BOOK

GOVERNMENTS & CORPORATIONS IN A SHRINKING WORLD

COUNCIL ON FOREIGN RELATIONS BOOKS

The Council on Foreign Relations, Inc., is a nonprofit and nonpartisan organization devoted to promoting improved understanding of international affairs through the free exchange of ideas. The Council does not take any position on questions of foreign policy and has no affiliation with, and receives no funding from, the United States government.

From time to time, books and monographs written by members of the Council's research staff or visiting fellows, or commissioned by the Council, or written by an independent author with critical review contributed by a Council study or working group are published with the designation "Council on Foreign Relations Book." Any book or monograph bearing that designation is, in the judgement of the Committee on Studies of the Council's board of directors, a responsible treatment of a significant international topic worthy of presentation to the public. All statements of fact and expressions of opinion contained in Council books are, however, the sole responsibility of the author.

For more information about Council publications, please write the Council on Foreign Relations, 58 East 68th Street, New York, NY 10021, or call the Publications Office at (212) 734-0400.

Copyright © 1990 by the Council on Foreign Relations, Inc. All rights reserved.

Printed in the United States of America.

This book may not be reproduced, in whole or in part, in any form (beyond that copying permitted by Sections 107 and 108 of the U.S. Copyright Law and excerpts by reviewers for the public press), without written permission from the publishers. For information, write Publications Office, Council on Foreign Relations, 58 East 68th Street, New York, NY 10021.

Library of Congress Cataloguing-in-Publication Data

Governments and corporations in a shrinking world / trade and innovation policies in the United States, Europe, and Japan / by Sylvia Ostry.

p. cm. Includes bibliographical references. ISBN 0-87609-079-X

1. Commercial policy. 2. International trade. 3. Technological innovations—Government policy. 4. Competition, International. 5. International business enterprises. I. Title. HF1411.0689 1990

200 2 1 22

362'.3-dc20

89-20978 CIP

FOREWORD

Kenneth W. Dam

The October 1987 stock market crash, which was felt across the globe; the role of the FAX machine, electronic mail networks, and satellite broadcasting in the June 1989 revolt in China; and the more recent events in Eastern Europe aptly demonstrate that we are living in a shrinking world. The information and telecommunications revolutions have blurred boundaries and have rendered borders almost obsolete. Now documents can be transmitted across oceans in a matter of seconds. But as the world shrinks and every country becomes more vulnerable to events beyond its borders, national governments are taking steps to establish advantages for their corporations over foreign competitors, especially in high-technology industries. Policies adopted in Washington, Brussels, and Tokyo are increasingly inconsistent with one another, and there is no international arbiter to resolve differences of opinion over which are fair and which are unfair.

In this book, Sylvia Ostry, the former Canadian ambassador for the Uruguay Round of multilateral trade negotiations and the prime minister's personal representative for the economic summit, surveys the emerging international economic order on trade and innovation policies, and focuses on the vast differences in the corporate-government interface in the political economy of policymaking within the Triad: the United States, the European Community, and Japan. She foresees increasing friction and conflict within the Triad. But she does more than just identify emerging problems; she makes recommendations for overcoming the resulting frictions.

Governments & Corporations in a Shrinking World grew out of a Council on Foreign Relations' study group—"The Search for

Stability: Business and Government in an Interdependent World"—that met six times between April and November 1989. I had the privilege of chairing this group, which consisted of corporate executives, policymakers, and academics (see the Appendix). Representatives from eighteen global corporations from the United States, Europe, and Japan had a voice around the study group table. Those corporate representatives were extremely helpful in responding to Sylvia's ideas and in provoking discussion; the study could not have been carried out without their assistance, or that of the policymakers and academics who participated as well.

Nonetheless, this study is Sylvia's and hers alone. Those who know her know that she does not pull punches. She is always candid and often provocative. She deserves great credit for designing the study, executing it, and producing a highly readable book in a timely fashion.

Sylvia undertook the research for this book and wrote it while she was the first Volvo distinguished visiting fellow at the Council on Foreign Relations. On behalf of the Council, I would like to thank the Volvo North American Corporation for its generous funding both for her research and for her support. She was also assisted by her new colleagues at the University of Toronto where she has now become chairman of the Advisory Board and senior research fellow at the Center for International Studies. Her support at the University of Toronto was funded by a grant from the Donner Canadian Foundation and the Ontario Ministry of Treasury and Economics.

On behalf of Sylvia, I would like to thank those members of the study group who went above and beyond the call of duty by commenting extensively on this manuscript when it was in draft form. At the risk of forgetting someone, I should mention C. Michael Aho, Jagdish Bhagwati, Travis Brooks, Bill Diebold, Gary Horlick, Peter Kenen, Charles Levy, Peter Ludlow, Kazuo Nukazawa, Joan Spero, Masao Uchibayashi, Raymond Vernon, Alan Wolff, and John Zysman.

The study group was ably coordinated by C. Michael Aho, director of economic studies and the International Trade Project at the Council, with the assistance of Alison von Klemperer and

Dorothy Price. Dorothy also served admirably as the group's rapporteur. Other members of the Council staff contributed valuably to the project. Thanks are particularly due to Suzanne Hooper and David Kellogg of the publications department. Finally, as chairman of the study group, I would like to thank personally Peter Peterson, chairman of the board of the Council, Peter Tarnoff, president, and Nicholas Rizopoulos, vice president for studies, for their unwavering support throughout the duration of the project.

This is a study. But it has a bottom line. After you have finished reading it, I believe you will agree that each of us in business, government, and private life has a great deal to do to minimize economic frictions among countries, as advances in information and telecommunications technologies draw us ever closer together.

Kenneth W. Dam is Vice President, Law and External Relations, at IBM.

CONTENTS

	Foreword—Kenneth W. Dam	ix
1.	Introduction	1
2.	Trade Policy	17
3.	Innovation Policy	53
4.	Conclusions	79
	Appendix Council on Foreign Relations Study on The Search for Stability: Business and Government in an Interdependent World	111
	Glossary of Abbreviations and Acronyms	115
	Index	117
	About the Author	123

1

INTRODUCTION

The multilateral institutions—the International Monetary Fund (IMF), the World Bank, and the General Agreement on Tariffs and Trade (GATT)—were established after the Second World War in a world far less interdependent than today's. The trade, financial, and technology links that now draw countries more closely together have dramatically changed the policy context for governments, international institutions, and multinational corporations. The GATT, for many reasons, has found it increasingly difficult to adapt to these changes. The multilateral trading system is clearly under stress. One alternative, a trend to bilateral or regional blocs and to more unilateral behavior by powerful trading countries, is likely to accelerate should the Uruguay Round of the GATT fail to deliver an acceptable package. Such a package would have to include the extension of GATT rules well beyond traditional border measures into the domain of what are essentially domestic policies. Yet even as this ambitious eighth round of GATT negotiations draws to a close, new sources of international friction, which lie outside its agenda, are on the horizon.

One major change in the present environment is the growing role of the "global" corporations, the multinationals that increasingly operate on the basis of a worldwide rather than a multicountry strategy. The international economic environment of the coming decades will be shaped not by governments or international institutions but by the *interaction* of the two main actors, governments and global corporations—especially in the Triad: the United States, Europe, and Japan.

Indeed, the present phase of accelerating world integration is dominated less by increasing trade linkages than by rapidly growing investment and technology flows facilitated by the exploding financial linkage of the 1980s. The chief agents of interdependence in this phase are the global enterprises. Neither

governments nor these corporations have a comprehensive overview of the complex web of interaction, including the indirect consequences of a given policy—which often outweigh its short-run, direct impact—and the way that the policy process in one region is affected by, and in turn influences, that in other regions. Yet it is precisely this concatenation, drawn ever tighter by global interdependence, that will determine the international flows of trade, investment, and technology.

Hence it is the interaction between governments and global corporations that will determine the future of multilateralism. Nonetheless, little research has focused on this interaction, or what is termed the political economy of policymaking in the Triad.

To be more precise, such studies of the political economy of policymaking as exist are by and large concentrated on U.S. trade policy. Much less is available on Japan or the European Community (EC), and almost no international comparative analyses or examination of the interrelationship among the policy processes in each region appear in the literature.

To tackle this subject in a comprehensive fashion would clearly involve detailed and careful case studies.² The present study bears no pretense of comprehensiveness. First, it is confined to global corporations and thus does not purport to examine the multifaceted business-government relationships that would include national firms or other groups that deal with governments in the policy process, such as trade unions or farmers. Discussions in the Council on Foreign Relations' working group, which included representatives of American, Japanese, and European global corporations as well as policy and academic experts (see Appendix), were helpful in providing information about the international policy process. But clearly, if this analysis provides insights, their chief merit may well be to point the way to further, more intensive research agendas.

A basic assumption that propelled the Council project was the idea that global corporations should be "natural stakeholders" in a rules-based multilateral system. This was assumed for one fundamental, indeed elementary, reason—their need for stability and predictability. Indeed, it may be argued that the only genuine public good aspect of an international trade regime—the GATT—is stability itself, or the reduction of uncertainty. The use of rules to reduce uncertainty and thereby increase private investment by fostering a long view, essential to efficient resource allocation, was central to Keynes's proposals on international monetary reform,3 but it is just as relevant to the trading regime.

Nonetheless, the behavior of the global corporations in the present policy context reveals no such consistent attachment to the GATT-based system of rules. Only in the U.S. case could one say—with increasing tentativeness, by the way—that the idea of natural stakeholders has any credibility. So the basic assumption proved quite erroneous if judged either by corporate behavior revealed preference—or by opinion and attitude. The reasons why the assumption proved wrong are not and could not be fully explicated in this study, although one factor that does seem relevant to the differences is cultural, historical, and institutional influences. Seen in this context, the policy activism of American corporations reflects the unique American system of governance. The basic indifference of the European and Japanese enterprises is similarly a historic, institutional, and cultural phenomenon; therefore, if it changes, it will do so slowly and with difficulty in response to international pressure.

Other likely reasons obtain as well. Even in the case of the activist U.S. multinationals, the slowness of GATT procedures and what is regarded as the excessively cumbersome nature of negotiations among over 90 countries are causing growing frustration. In the past negotiations were simpler (mainly over tariffs), and fewer countries were involved. The contrast between the rapidity of change in the world economy and the slow and painful response of the trading institution is very striking to many businessmen. (A good example is in the key area of intellectual property. The United States proposed a counterfeiting code in 1978. Measures to deal with counterfeiting, after more than a decade of mounting loss to corporations in industrialized countries, may be adopted in 1990 as part of the Uruguay Round.) The corporations too often contrast this phenomenon of slowness in the GATT with the greater ease and efficiency in dealing with their own or even their host governments. A latent preference for regionalism or bilateralism is thus emerging for what appear to be simple, practical reasons.

Most of all, perhaps, because the GATT has lacked a continuing and structured relationship with business—in contrast, for example, to the Business and Industry Advisory Committee of the Organization for Economic Cooperation and Development (OECD), or to the close ties between financial enterprises and the IMF or World Bank—it seems remote and unrelated to any immediate concerns of the global enterprises. There is little identification of the mutual interests between them.

Finally, a more fundamental phenomenon may be at work. Few firms are truly global, but many are globalizing through a new wave of investment and corporate alliances. Perhaps truly global firms, having the options of trade or investment, will become neutral or indifferent both to exchange rate changes and to trade rules, in the belief that they can adapt, albeit at some cost, to any "rules" governments establish. We shall return to this issue in the final chapter; the important point here is that the costs of adaptation to a distorted but stable system are far less than those imposed by uncertainty and unpredictability. In a stable system risk can be reasonably assessed; uncertainty makes risk assessment extremely difficult.

This issue of uncertainty is central to the focus of the research, for it is clear that a number of incipient trends on the horizon of the international economic scene are creating pervasive and increasing uncertainty about the future evolution of the world trading system. At the same time, as the decade of the 1990s begins, the industrialized economies are enjoying an unprecedented long period of growth, and trade and investment are buoyant. The steady increase, since the mid-1970s, of the so-called new protectionism (border and domestic nontariff measures for mature industries) may have affected the direction of trade flows, but clearly has been porous enough to permit a healthy pickup in total trade as the rate of growth in investment and output has increased. As I will argue in this and subsequent chapters, another powerful source of international friction or protectionist pressure on both the trade and the investment

fronts is now emanating not from the traditional import-defensive industries but from technologically sophisticated manufacturing industries, whose products form an increasing share of trade among industrialized countries. Thus the apparent paradox-increasing trade and increasing protectionism-should not be considered immutable. To base international policy on such an assumption would be to make policy in a rearview mirror.

The Uruguay Round of GATT negotiations will, if successful, significantly extend and strengthen the rules-based multilateral trading system. It is the most comprehensive and ambitious in the history of the GATT and, more than any previous round, is focused on the international spillover of domestic policies. Launched at Punta del Este, Uruguay, in September 1986, it is to be concluded by December 1990. The fifteen negotiating groups cover four principal categories:

- Market access, including tariff and nontariff barriers in manufactured goods and, for the first time in 40 years, in agriculture.
- So-called new issues of trade-related investment measures (such trade-related aspects of intellectual property rights as patents and copyrights) and trade in services.
- Reform of GATT rules, such as rules concerning subsidies and the actions governments may take to offset them (countervailing duties), rules about measures governments may take when import surges threaten serious injury to domestic industries (safeguards), rules addressing government actions to counter dumping, and rules concerning government procurement.
- Measures to strengthen GATT as an institution by establishing more effective and streamlined dispute settlement procedures, creating better links between the GATT and the World Bank and the IMF, instituting procedures to review countries' trade policies and actions, and giving more ministerial direction to the GATT's work.

But, as we will see in detail, the particular combination of domestic and international policy that is geared to high-technology industries—innovation policy—and the new wave of internationalizing investment lie well outside the mandate of even a greatly strengthened GATT at the present. Indeed, the Uruguay Round should be seen as the beginning and not the end of the reform required to adapt the postwar system established by the United States at a time of undisputed political and economic dominance. However, as will be emphasized in what follows, the transition to the multipolar world of the Triad may confront not simply a deficit in multilateralism but a vacuum at the center: an odd trio of a leader without hegemony and two potential hegemonies reluctant to assume leadership in multilateral institutional reform. And, as will be seen, many corporate players that are global in corporate planning are still regional or national in policy outlook.

The remainder of this chapter is devoted to sketching out the main background factors or incipient trends now discernible that are creating the environment of uncertainty about the evolution of the world trading and economic system.

MACRO BACKGROUND FACTORS

Since the early 1980s the world trading system has been affected as much by macroeconomic, or financial, forces and policies as by the micro factors that are its traditional domain. As is well known, a powerful force fueling protectionist pressures in the United States in the first half of the decade was the wide swing in exchange rates and the rapid deterioration in the U.S. trade balance, with its attendant rise in unemployment. The fact that this condition stemmed from incompatible macro policy positions among the key industrialized countries of the Group of Seven (G-7)—the United States, Japan, Germany, France, the United Kingdom, Italy, and Canada—did not mitigate the impact on the American workers and businesses that suffered the consequences and demanded political redress.

As we shall see in the next chapter, while the full fury of the protectionist pressures has abated (in part because of the ex-

change rate realignment the G-7 initiated in 1985), and the Omnibus Trade Act of 1988 has been a vast improvement over most of its 300-plus ancestors of the earlier part of the decade, U.S. trade policy is now set on a new course, whose precise direction is not yet clear. Over the next few years, once again, a key element in how U.S. trade policy actually evolves is likely to be the current account positions of the United States and its main trading partners.

Several reasons lead to this assessment. The first relates to the fiscal deficit. Throughout the policy debate of the 1980s policymakers in the G-7 and economists reached near-universal agreement that a necessary (even, for some, sufficient) "solution" to the problem of the current account imbalances was a sustained and significant reduction in the U.S. fiscal deficit. That consensus view is beginning to erode both internationally and in the United States.

On the international front, while standard communiqué rhetoric still scolds the United States for lack of decisive action on the fiscal front, the heat has dissipated: the fiscal-solution-to-theworld's-problems tone has evaporated. The reason is quite clear in the June 1989 OECD Outlook: "assessing the likely sustainability of a given pattern of current balances has become increasingly difficult." The threat of a dollar crisis—the best international argument to spur U.S. budget action—has become embarrassingly less credible in the face of reasonable exchange rate stability or, indeed, dollar strengthening (which, if continued, would seriously undermine U.S. competitiveness once again). As the OECD said: "in the more open international financial environment of the past decade, current account imbalances have proved financeable on a larger scale, and for longer, than would have been expected earlier."6 The Bank for International Settlements was more straightforward, noting that "adjustment efforts have ceased to figure high on the policy agenda" and rightly emphasizing that "if the matter is to receive more attention, the limits of sustainability will have to be more clearly in view." In the present context—that is, trade policy the issue is not financial but political sustainability of the external deficit.

On the *domestic* front in the United States, the fiscal-deficit-doesn't-matter school has attracted more and more adherents and is certainly gaining strength in public opinion. As one analyst has observed, "the left of center finds common ground with the supply-siders of the far right" in arriving "at a common set of conclusions de-emphasizing the importance of the deficit."

In effect, both international and domestic opinion seem to be converging on a newly emerging theme, that the U.S. budget deficit is largely a U.S. domestic problem, although it will continue to have a significant international impact. More important in terms of political dynamics, the "crisis" rhetoric is proving very difficult to maintain. The fiscal deficit "problem" is not immediate but will emerge only gradually over the long term (one author's "termites in the basement," or the *Economist*'s "prolonged wasting disease"). Anorexia is unlikely to carry the same emotional charge as an imminent heart attack. As fiscal action diminishes in political weight, another consequence will be to raise the priority of micro policies, including trade and innovation policies (see below and chapter 3).

This consequence seems logical for several reasons. First, all forecasts by international agencies, while differing in detail, agree that the improvement in the U.S. current account imbalance has plateaued, at best. The bilateral balance with Japan, indeed, is forecast to widen in the future after recent diminution, and I shall return to this shortly. While U.S. fiscal action would certainly improve the outlook, that (as argued) seems increasingly unlikely (although eventually the "peace dividend" from disarmament may have an impact). Moreover, recent studies of the U.S. "twin deficits" stress the importance of other factors in explaining the evolution of the current account factors such as U.S. household savings behavior (for which a budget surplus is the only practicable but increasingly elusive solution) but also structural "competitiveness problems," which are partly the result of the slowdown in capital formation during the high-deficit 1980s. 10 Be that as it may, these problems will require new micro policies, both domestic and international. The pressure for such policies is thus likely to build, both because they are considered essential in themselves and because, in the absence of fiscal action, the stalled current account adjustment process will once again create mounting popular demands in the United States to "do something" about the imbalances, especially in U.S.-Japanese trade.

In the early 1980s, one observer commenting on the growing pressure in the United States for "aggressive reciprocity" vis-à-vis Japan noted the widespread perception of "unequal access," stemming from other countries' "unfair" behavior. He remarked that "the real basis for the current perception of unequal access stems not from a careful analysis of protection itself, but primarily from growing frustration over the U.S. bilateral trade deficit with Japan, which reached \$16 billion in 1981 and is expected to hit \$20 billion to \$22 billion in 1982."11

The result of that earlier frustration, after repeated unsuccessful "market opening" exercises at the sectoral level, was the 1988 Omnibus Act, and especially "super 301," which I will discuss in the next chapter. The bilateral trade deficit with Japan at present, however, is nearly three times the earlier figure.

In probing Japan's current account adjustment process, recent economic analysis raises puzzling questions about the role of the exchange rate. Under the impact of the high yen, Japanese industry undertook a number of structural measures that appear to have made Japanese exporters "currency-neutral." These measures included foreign direct investment in both the United States and the Asian newly industrializing economies (NIEs) and, more recently, in Europe. This permits the corporations to mitigate the impact of currency swings on profit by shifting output if necessary. In addition, a rapid and continuing move into higher-value-added products is making many Japanese exporters less price-sensitive.

Another element in the renewed concern about the U.S. bilateral balance with Japan has been concentrated on the atypically low Japanese import propensity, and a number of econometric studies have sought to estimate its extent and nature. In addition, recent studies have suggested that a marked differential exists between productivity growth in export-oriented sectors and in domestic sectors of Japanese industry, so that the real exchange rate (measured on the basis of overall prices or unit labor costs) significantly understates Japanese competitiveness. ¹² This opens up the politically unappealing prospect, in the absence of other policy measures in both the United States and Japan, of further substantial and continuing U.S. dollar depreciation.

More generally, it is far from clear that American industry will be able to remain globally competitive without further dollar depreciation to offset prospective differentials between the growth rates of U.S. and foreign productivity:

During the past decade, Japanese manufacturing productivity has been expanding at a 5.8% annual rate compared to 3.3% for the U.S. and 2.6% for Europe. Because of the dollar's decline during the late 1980's, American unit labour costs have risen by only 2.2% per annum compared to 5.0% for Japan and 3.2% for Germany (when their currencies are converted into dollars). But the price benefits of the 1985–1987 devaluation will soon fade if Japanese productivity continues to grow twice as rapidly as America's and the dollar remains constant in real terms. Since Japanese capital spending now exceeds America's in absolute terms and is twice as high on a per capita basis, it is probable that Japanese manufacturing productivity will remain in the 5–6% range during the early 1990's and that America's will not exceed 3.0%. 13

On present indications of both U.S. fiscal policy and G-7 exchange rate policy aimed (broadly speaking) at stability, all these separate strands of analysis and argument presage greater political pressure for micro—that is, trade and innovation—policies to "deal with" the Japanese bilateral surplus.

Finally, the macro background picture with respect to the EC stands in sharp contrast to that of Japan. The persistent and growing current account surplus of Germany is increasingly oriented within Europe, while the bilateral balance with the United States is declining. Less and less inclination to analyze the German surplus within the context of the international adjustment process is evident in international forums. It is viewed, rather, as entirely a European issue to be dealt with (if any policy measures are required) as part of the ongoing process toward European Monetary Union. Furthermore, even the transatlantic debate over German fiscal policy (a possible quid pro quo of easing for U.S. tightening) has become muted in the face of the new growth buoyancy in Europe, attributed in part to the quickening momentum of Europe 1992. In sum, no large clouds on