New Forces in the World Economy

A *WASHINGTON QUARTERLY* READER

edited by BRAD ROBERTS

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★★★

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Erik R. Peterson, "Looming Collision of Capitalisms?" *TWQ* 17, no. 2 (Spring 1994); James R. Golden, "Economics and National Strategy: Convergence, Global Networks, and Cooperative Competition," *TWQ* 16, no. 3 (Summer 1993); Richard E. Feinberg and Delia M. Boylan, "Modular Multilateralism: North-South Economic Relations in the 1990s," *TWQ* 15, no. 1 (Winter 1992); Murray Weidenbaum, "Greater China: A New Economic Colossus?" *TWQ* 16, no. 4 (Autumn 1993); John D. Sullivan, "Democracy and Global Economic Growth," *TWQ* 15, no. 2 (Spring 1992); Ernest H. Preeg, "The Post-Uruguay Round Free Trade Debate," *TWQ* 19, no. 1 (Winter 1996); Daniel F. Burton, Jr., "Competitiveness: Here to Stay," *TWQ* 17, no. 4 (Autumn 1994); Ernest H. Preeg, "Krugmanian Competitiveness: A Dangerous Obfuscation," *TWQ* 17, no. 4 (Autumn 1994); Thomas J. Duesterberg, "Trade, Investment, and Engagement in the U.S.-East Asian Relationship," *TWQ* 17, no. 1 (Winter 1994); Ernest H. Preeg, "Who's Benefiting Whom? A Trade Agenda for High-Technology Industries," *TWQ* 16, no. 4 (Autumn 1993); Kenneth Berlin and Jeffrey M. Lang, "Trade and the Environment," *TWQ* 16, no. 4 (Autumn 1993); Richard E. Bissell, "The Natural Resource Wars: Let Them Eat Trees," *TWQ* 17, no. 1 (Winter 1994); Jeri Jensen-Moran, "Trade Battles as Investment Wars: The Coming Rules of Origin Debate," *TWQ* 19, no. 1 (Winter 1996); Paula Stern and Raymond Paretzky, "Engineering Regional Trade Pacts to Keep Trade and U.S. Prosperity on a Fast Track," *TWQ* 19, no. 1 (Winter 1996); Gary Hufbauer and Jeffrey J. Schott, "Toward Free Trade and Investment in the Asia-Pacific," *TWQ* 18, no. 3 (Summer 1995); Sidney Weintraub, "The Depth of Economic Integration between Mexico and the United States," *TWQ* 18, no. 4 (Autumn 1995); Georges Fauriol and Sidney Weintraub, "U.S. Policy, Brazil, and the Southern Cone," *TWQ* 18, no. 3 (Summer 1995); Thomas J. Duesterberg, "Prospects for an EU-NAFTA Free Trade Agreement," *TWQ* 18, no. 2 (Spring 1995); Erik R. Peterson, "Surrendering to Markets," *TWQ* 18, no. 4 (Autumn 1995); Roy C. Smith, "Risk and Volatility," *TWQ* 18, no. 4 (Autumn 1995); David D. Hale, "Is It a Yen or a Dollar Crisis in the Currency Market?" *TWQ* 18, no. 4 (Autumn 1995); W. R. Smyser, "Goodbye, G-7," *TWQ* 16, no. 1 (Winter 1993); Raymond Vernon, "The Japan-U.S. Bilateral Relationship: Its Role in the Global Economy," *TWQ* 13, no. 3 (Summer 1990); Ethan B. Kapstein, "Governing Global Finance," *TWQ* 17, no. 2 (Spring 1994); J. Carter Beese, Jr., "Reengineering Regulation: Maintaining the Competitiveness of U.S. Capital Markets," *TWQ* 18, no. 4 (Autumn 1995); W. R. Smyser, "The Bundesbank: America's German Central Bank," *TWQ* 17, no. 2 (Spring 1994); Donald R. Sherk, "U.S. Policy Toward the Multilateral Development Banks," *TWQ* 16, no. 3 (Summer 1993); Steve Charnovitz, "Promoting Higher Labor Standards," *TWQ* 18, no. 3 (Summer 1995); Joseph LaPalombara, "International Firms and National Governments: Some Dilemmas," *TWQ* 17, no. 2 (Spring 1994).

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Introduction

THE WORLD ECONOMY has moved to the center of the international political stage in the mid-1990s. With the end of the Cold War, economic factors have assumed increasing importance relative to strategic factors in the foreign policies of the major powers. Moreover, a genuinely global economy is rapidly emerging, one that is defined not just by trade but also by investment and the diffusion of advanced technologies and expertise. This volume examines the features of the emerging world economic order. It surveys the new forces in the world economy with an eye toward their political and policy implications. It is conceived not just as a tool for economists seeking to understand a changing economy but also for political scientists and policymakers, who must increasingly understand the way in which economic realities impinge on the sources of order and disorder in the post–cold war era.

In sketching out the post–Uruguay Round trade policy debate in this volume, Ernest Preeg writes that the debate about free trade in the new era "is not fully engaged and remains conceptually ill-defined. . . . a full-scale debate on short- and longer-term objectives for the international trading system—writ large to include investment, competition, and technology-oriented policies—should begin." Thus he neatly defines the purpose of this volume—to bring into focus key trends in a rapidly changing world economy, to explore critical substantive issues, and to help stimulate a debate in the academic and policy communities not just about the trading system but also about the evolving policy agenda of the United States as it confronts new economic realities.

This volume draws on materials published in *The Washington Quarterly* between 1990 and 1996. *TWQ* is a journal of international public policy issues published by The MIT Press for the Center for Strategic and International Studies of Washington, D.C. It has a broad intellectual purview. Economic issues are but one set of themes given sustained attention by the journal as part of a broader effort to think afresh about statecraft, international security, and, more broadly, the international engagement of the United States. Two other compendiums of articles from the journal were published by MIT Press in 1995: *Weapons Proliferation in the 1990s* and *Order and Disorder after the Cold War.*

As a compilation of articles, this volume includes materials published at different times for different purposes. Their organization here into chapters suggests an orderliness to the original editorial plan where none existed. We have simply set out to capture some of the best new thinking on the subject and we present a selection of it here in cumulative form. Please note that authors have not been given the opportunity to update their articles prior to their republication here. Although parts of some essays have necessarily been overtaken by events, each contribution makes arguments that remain relevant in any assessment of the new global economic agenda. Please note further that all biographies are current to the time of original publication. The views expressed are those of the authors and should not be attributed to any institutions with which they are or were affiliated or to the publishers, CSIS and MIT Press.

Chapter I offers a survey of new forces in the global economy. One is the changing political context wrought by the end of the Cold War and the greater economic competition emerging among the industrialized democracies that heretofore had to submerge competing interests in the name of cold war solidarity. These competitive forces are weighed against those compelling greater cooperation economically. This chapter also reviews the changing nature of North–South economic relations, the growing prominence of Asia in the global economy, the link between democratization and liberalization, and the new demands on trade policy after the conclusion of the Uruguay Round. These articles reveal a world economy undergoing rapid and profound changes in the post–cold war era and subject to a large set of new political demands.

Chapter II reviews the debate about the competitiveness of the U.S. economy vis-à-vis other economically advanced states. The articles included here assess the strengths and weaknesses of the U.S. economy and predict the likely evolution of the competitiveness debate. They reveal a United States well positioned to prosper and lead in the new world economy, but also a country reluctant to undertake the burdens of adjustment and the responsibilities of leadership.

Chapter III sketches out the emerging patterns of trade and investment and their connection to other political concerns. What impact will protectionist pressures in the United States and elsewhere have? Can free trade cope with the new demands of high-technology industries and environmental politics? How will the trading system respond to new environmental concerns? The articles included here reveal a rapidly changing world economy. They also underscore the importance of an international economic policy agenda that does more than simply and mechanically extend the past into the future.

Chapter IV explores the growing prominence of regional free trade groupings in the overall trading system. Free trade organizations and movements in Asia, the Americas, and in the transatlantic community are described and evaluated. Authors offer a generally optimistic assessment of the prospects for these groupings. They also explore the critical policy question related to the linkage between regional and global efforts: Are they complementary or conflictual?

Chapter V focuses on the new global power of financial markets. These markets have changed fundamentally over the last decade, with consequences for the autonomy of states and the authority of national policymakers little contemplated or understood. The articles included here describe the new prominence of these markets, evaluate the risks and uncertainties they present in this new era, and speculate about their future roles.

The final chapter, VI, focuses on issues of public policy and the governance of the emerging global economy. Articles included here evaluate the continuing and future roles of institutions like the G–7, the multilateral development banks, the Bundesbank, and the International Labour Organization, as well as important bilateral relationships. They also explore questions related to the capacity of national governments to govern an economy characterized increasingly by the interaction of nongovernmental actors, whether transnational firms or global markets. Authors home in on the continued roles and authority of governments in a context of waning capacity.

The picture that emerges from these articles is of a world economy that is both extremely dynamic and facing an uncertain future. The positive forces leading to greater prosperity are numerous and compelling. But the sources of friction are many. So too are the instances in which economic forces appear to have outstripped both our understanding of them and our capacity to manage them. Moreover, it is essential that this picture become familiar to those in international politics accustomed to consigning economic questions to near irrelevance. The emerging global economy is creating fundamental new political realities that will touch directly on the nature of relations of power among states and thus on their foreign policies and security perceptions. A comprehensive worldview is essential if policymakers are to shape constructively the opportunities inherent in this period of global political and economic transition.

This editor owes a debt of gratitude to the many authors whose work is included here. Their energy in helping to shape the public debate and their skill in crafting new ideas and cogent arguments have made my work a pleasure. I also owe a very large debt to my colleague Ernest Preeg, who has carried the title of associate editor for economic policy on the *TWQ* masthead, a title that little conveys his role as tutor, critic, and catalyst in the process of generating these materials. Useful advice, assistance, and support has come from many other quarters, not least from Erik Peterson and Michael Mazarr, who succeeded me in summer 1995 in the leadership role in the journal as I relinquished the tasks of journal management and returned to full-time research and writing as an analyst at the Institute for Defense Analyses. Lastly, this volume also reflects the editorial skill and commitment to quality of those members of the *TWQ* editorial staff who, over the years, have made such a great difference: Yoma Ullman, Nicholas Koukopoulos, James Rutherford, and Denise Miller, in particular.

Brad Roberts
Washington, D.C.
October 1, 1995

Contents

I. The Global Economy of the 1990s

Looming Collision of Capitalisms?

Erik R. Peterson

ACCELERATING GLOBAL economic integration is bringing national economic policies into sharper competition, especially among the advanced capitalist economies. How these competing domestic policies are managed through the turn of the century and beyond will have profound implications not only for the international economy but also for broader international security and political relations. The risk is that increasingly nationalist economic policies, fanned by deteriorating economic conditions and social pressures, will propel the preeminent economic powers—and the rest of the world with them—into an era of "*realeconomik*" in which parochial economic interests drive governments to pursue marginal advantage in an international system marked by growing interdependencies.

The conclusion in December 1993 of the General Agreement on Tariffs and Trade (GATT) Uruguay Round, the culmination of seven years of tortuous negotiation by governments to strip away more of their own policy prerogatives, refuted the proposition that the major economic powers—the United States, the European Union (EU), and Japan—were leading the collective effort to break down traditional trade barriers and trade-distorting domestic policies globally. Although it culminated in agreement, the process revealed the extent to which those powers were disinclined to do the "heavy lifting" in liberalizing their policies that many of the less prominent economies had already done to advance the round. In effect, the protracted negotiations highlighted the thresholds of national tolerance among the predominant economies beyond which the political costs for the respective governments were unacceptably high.

There is little doubt that the current economic troubles confronting Washington, Brussels, and Tokyo were a major factor in limiting the scope of the final GATT agreement. Those troubles have also elevated the levels of economic nationalism and unilateralism, both of which can be expected to intensify further as longer-term structural problems in all three economies generate additional political and economic dislocations in the years ahead.

Because of the increasingly binding constraints placed on national economic policy-making by the process of global economic integration, the temptation for the major economies to engage in defensive strategies by supporting national "strategic" industries—especially high-technology in-

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The Washington Quarterly • 17:2

dustries—could bring the major capitalisms into collision. The operative question is whether the governments concerned will succumb to the growing tendency to "pursue relative gains at the expense of mutual gains [and] political power at the expense of economic welfare,"[1] or whether they will be able to devise a system of rules and an appropriate institutional vehicle to defuse the potential for escalating economic clashes between respective "national champions."

Accelerating Economic Globalization

It has long been recognized that the traditional line of demarcation between domestic and international economic policy-making is fading. Economic shocks ranging from the oil embargo by the Organization of Petroleum Exporting Countries to the "Black Monday" international stock market crash in October 1987 have underlined the susceptibility of national markets to developments abroad. For governments worldwide, the internationalization of the world economy has also meant the progressive deterioration of their capacity to manage their economies. Macroeconomic policies have been increasingly undermined by the offsetting effects of international responses; an increase in interest rates to decelerate economic growth, for example, is more likely than ever before to be countered by an increase in interest-sensitive capital flows from abroad.[2]

But international trade and investment linkages have expanded to such an extent that sensitivities of economies to decision making in other economies are now substantially more pronounced. Advances in communication and information technologies, the pursuit by multinational enterprises (MNEs) of complex cross-border strategies, the formation and development of regional trading blocs, the GATT process, economic liberalization undertaken in a host of developing economies, and ongoing efforts at marketization in former command economies are metamorphosing the international economic and financial system. As these elements bring about higher levels of global integration, constraints on national economic policy-making will continue to grow—and with them the potential for wider conflict over national policies.

The real-time capabilities offered by new communication and information technologies have already had a tremendous impact on international capital flows. Daily global capital movements have increased to well over $1 trillion in 1992. The implications of these movements for national macroeconomic policy-making are profound. Alan Greenspan, chairman of the Federal Reserve, noted in August 1993 that the internationalization of finance and the reduction in constraints on international capital flows "expose national economies to shocks from new and unexpected sources, with little if any lag."[3] As a result, he stressed the importance central banks should attach to developing new ways of assessing and limiting risk. But those ways remain to be identified.

Nowhere has the impact on policy-making of these cross-border capital flows been more obvious recently than in the EU, where international speculative pressures played a significant role in the partial collapse in the European Monetary System in 1992. Those forces contributed to the circumstances that led London and Rome to withdraw from the semifixed exchange rates under the Exchange Rate Mechanism (ERM); since the British and Italian withdrawal, they have also forced the Spanish to devalue the peseta and brought the Belgian franc under extreme stress. As the *Economist* noted in October 1993, "[t]he financial markets have discovered, in a way they are unlikely to forget for years, their power to crack the system."[4] In short, we have entered a new stage in the development of international finance in which financial markets—and even some individuals—can dramatically influence the outcome of policy decisions by states.

MNEs are another major driver of global economic integration. By virtue of increasingly complex strategies involving multitier networks of firms that are geographically dispersed and through strategic alliances with other firms, MNEs are establishing unprecedented linkages among economies worldwide. According to the United Nations Conference on Trade and Development (UNCTAD), the strategies of MNEs have generally moved beyond a "simple integration" approach involving strengthened links with their foreign affiliates and with independent firms serving as subcontractors or licensees; the new strategy, which UNCTAD characterizes as "complex integration," provides for heightened geographical distribution of the value-added chain.[5] That MNEs account for a staggering one-third of world private productive assets suggests how important the ramifications of such a shift of strategy are.[6]

According to UNCTAD, sales by MNEs outside their countries of origin were $5.5 trillion in 1992—as opposed to total world exports for the same year of about $4.0 trillion; furthermore, the stock of foreign direct investment (FDI) worldwide reached $2 trillion in 1992, as opposed to one-half that amount in 1987.[7] These data reflect the substantial role that MNEs are playing in integrating the world economy and suggest the extent to which private-sector forces have become a factor in national economic decision making. As discussed in greater detail below, a number of countries with policies that were previously anathema to MNEs have refashioned their approaches so that attraction of foreign investment is a key component of their economic development strategies.

The development of regional trading blocs has also generated higher levels of economic interdependence and by definition represents the voluntary acceptance by the respective member states of constraints on national policy prerogatives. Because the EU, the North American Free Trade Agreement (NAFTA), and the emerging trading framework in Asia are based on political as well as economic considerations, the trend toward regionalism transcends the surrender of policy prerogatives for purely economic reasons.[8] Nevertheless, the impact is to advance economic integration between member states. In the case of the EU, where the impact of German monetary policy clearly transcends the national economic challenges inherent in reunification, the linkages may be more pronounced than some member states would want.

The GATT process, of course, has also steadily broken down barriers between international and domestic policy-making. The GATT is no longer the vehicle through which only tariff barriers are broken down; the nontariff barriers that were the focus of the Tokyo Round and the issues at the fore of the Uruguay Round—trade in services, trade-related investment measures, intellectual property protection, price supports and subsidies, countervailing duties, dumping, and dispute settlement—have exposed the nerves of national economic interests as never before. The demonstrations from Brussels to Tokyo attested to the degree to which GATT negotiations have become (and should be) a major domestic political issue. By definition, the GATT process and the Uruguay Round—in the event it is ratified—represent "another stake in the heart of the idea that governments can direct economies."[9]

Economic and financial liberalization in developing economies represents another stimulus to growing integration. A select number of developing countries with liberalized investment environments are now primary targets of portfolio and foreign direct investment flows.[10] Over the past 10 years, international portfolio investment in developing countries has mushroomed. Market capitalization has grown by a factor of 11, from $67 billion in 1982 to $770 billion in 1992. As a percentage of world equity market capitalization, developing countries increased their share over this period from 2.5 percent to 7 percent. The trend can be expected to continue as secondary markets in developing countries widen and deepen. Simply put, the key reason for this rapid growth in developing-country capital markets is profitability. According to the International Finance Corporation, emerging stock markets took 8 of the top 10 positions as best performing markets last year.[11] Gains of over 20 percent were registered in markets stretching from Mexico City to Amman to Bangkok. In addition, over the past eight years emerging markets as a group have significantly outperformed their counterparts in developed countries.[12]

The pattern of FDI to developing countries has been no less extraordinary. According to UNCTAD, FDI flows to developing countries increased from $25 billion in 1991 to $40 billion in 1992; if high growth is sustained in Asia and Latin America, annual flows could double in real terms to $80 billion by the end of the century.[13] What is behind this trend? Simply put, economic liberalization has replaced statism, trade liberalization has followed protectionism, and privatization has replaced nationalization. For these countries, the necessity of conforming their national economic decision making to the realities of the international system is now a matter of record. In many cases, those adjustments have extended beyond actions to attract FDI inflows to include fundamental policy shifts such as imposing discipline on fiscal deficits, developing clear legal and commercial systems, streamlining bureaucracies, simplifying taxation systems, and liberalizing trade policies.[14]

Although they are not yet as fully integrated into the world economic system, the former command economies that are seeking to marketize their systems are another driver of international integration. For the first time since the beginning of the century, they are opening their economies to the world economic system and enacting national policies designed to encourage the development of market forces.

Integrating Markets Versus Integrating Policies

It should be stressed that there are fundamental differences among these forces driving international economic integration. Some can be referred to as "organic" integration—the private cross-border flows of capital, goods and services, technology, and information driven in large part by MNEs. Others promote "inorganic" integration—the formal and politically oriented trade agreements forged among countries to reduce tariff and non-tariff barriers and harmonize trade-relevant domestic economic policies.

Organic integration is the result of strategies enacted by international private-sector actors to maximize the efficiency of their operations in the light of increasing global competition. As noted above, to an ever greater extent MNEs are distributing their operations internationally regardless of political institutions and frameworks to seek innovation or to achieve cost savings at various stages in the value-added chain. Although the pattern of this distribution of economic activity may be (and often is) influenced by regional economic blocs such as the EU and the NAFTA, it will be influenced only to the extent that such frameworks can be incorporated into prevailing global strategies. Increasingly, however, that activity is falling outside the regional blocs and generating higher levels of more global economic integration in the process.

These kinds of private-sector-driven economic dependencies must be differentiated from the "inorganic" or formalized efforts at economic cooperation undertaken among and between states. Such arrangements are based by definition on perceived mutual gains from economic cooperation, but generally they also represent a mixture of economic and political concern. The EU is clearly grounded in political and security objectives advanced in the period immediately after World War II; for its part, the NAFTA also has a strong political character. As a result, the inorganic integration fostered by regional blocs may not necessarily reflect the market fundamentals that are driving the interdependence now created by the private sector. Furthermore, the political nature of regional blocs suggests the possibility that they might be tempted to engage in aggressive trade policies that could generate a protectionist equivalent of an arms race.[15] They could ultimately become the means by which organic integration is resisted.

Together, these organic and inorganic forces driving economies into heightened interdependence can be compared to a set of tightening constraints in a linear programming model that serve to progressively limit the area in which national economic policy-making is feasible. It follows that governments are likely to resist the restrictions this kind of global convergence places on their policy prerogatives, especially when they are facing acute short-term economic challenges or when the adjustments forced by growing integration entail profound economic or social change. In short, integration of policies is lagging behind integration of markets.

Capitalisms in Collision?

The salient question is how governments can protect their national economic interests in an increasingly integrated global economic and financial framework. More and more, the preeminent economic powers in particular are finding the answer in drawing lines beyond which they will resort to defensive strategies grounded in parochial interests. The result is the development of political conditions that encourage the outbreak of economic nationalism.

The current political and economic environments in the United States, Europe, and Japan do not augur well for the level of cooperation necessary to avoid the neomercantilist confrontation that could flow from competing national policies. The overarching security concerns generated by the common threat from the erstwhile Soviet

Union are a thing of the past, and immediate economic concerns now overshadow residual security ties. It is a time of fundamental redefinition of security, political, and economic relations—but the process of redefinition is proceeding in the absence of the international leadership and corresponding institutions necessary to meet the challenges of escalating economic rivalry.

The trauma that Washington experienced in fall 1993 in deciding on whether to adopt a free-trade agreement with Mexico—an economy only 4 percent of the U.S. gross national product and with a $5.5 billion trade deficit—amounted to a highly visible demonstration of U.S. attitudes about trade. Although of course the NAFTA was adopted, the emotional and sometimes vacuous debate served to highlight the extent to which economic nationalism threatens the historic role of the United States as leader of the global economic system. But apart from the NAFTA debate, there are other symptoms of this uncertainty. Regular calls in the U.S. Congress and elsewhere for unilateralist approaches to trade and foreign investment issues suggest that the concepts of "fair" rather than "free" trade and "reciprocal treatment" rather than "national treatment" in international capital flows are steadily gaining ground.

These warning signs are the result of the growing perception in the United States that new approaches are necessary to ensure fair access for trade and investment by U.S. firms. The perception is grounded in the view that what was recently referred to as "unilateralist national treatment"[16]—namely, the position on international investment that Washington has maintained for decades—is not being reciprocated by many of its investment partners. Of course, the recent domestic economic difficulties have thrown fuel on the fire.

In Europe, where the economic problems at present are even more pronounced,[17] where the partial collapse of the ERM has generated profound doubts about the outlook for a single European currency, and where the tenuous ratification process of the Maastricht agreement has left leaders searching for ways to advance the integration agenda, attention is predominantly inward. The seriousness of the challenge was underlined in October 1993 when the president of the European Commission, Jacques Delors, warned that the then European Community was drifting toward becoming a free-trade zone that could break up in as little as 15 years.[18] The EU is clearly in a period of intense consolidation and restructuring.

Japan is also engaged in political and economic soul-searching. The Hosokawa coalition has embarked on a program of political reform with potentially important longer-term implications for Tokyo's position in the international economic system. The outcome, however, is by no means assured. To sustain the reform process that it initiated immediately prior to the November 1993 meeting of the members of APEC (the Asia-Pacific Economic Cooperation), the government must continue to pass through the political thicket of its own eight-party coalition before contesting with the opposition Liberal Democratic Party to push through its initiatives. It must also do so against the backdrop of stagnating or declining growth, severe volatility in the financial markets, less than promising longer-term growth projections, and a highly resistant bureaucracy.

When considered together, these

developments in the United States, Europe, and Japan have led some analysts to revisit arguments advanced in the 1970s about the ungovernability of democracies.[19] But there is also reason to question whether relations between the capitalist countries themselves will be governable. It is no exaggeration to suggest that the political agendas in all three major economic powers are predominantly inward-looking and focus primarily on reviving national economic growth and employment. All three are engaged in economic triage. Evidence of economic parochialism in the pursuit of those objectives appears to be growing on a day-by-day basis. In short, they could be on a course that suggests the potential for the rise of neomercantilism.

"Strategic" Trade at Issue

In particular, there is the possibility of an escalation of industrial policies that would bring "national champions" and "strategic" industries—especially those in high technology—into sharper conflict. The magnitude of the threat has been set out by the Organization for Economic Cooperation and Development (OECD):

> Government support for economically strategic industries could become a major source of international dispute in the 1990s. The move over the last decade towards subsidies and other forms of state assistance for important technologically advanced sectors is set to accelerate. The proliferation of such policies, which affect a relatively narrow band of often identical sectors, could well develop into a keenly competitive "subsidy race," with harmful and far-reaching implications for the international system of trade, investment and technology.[20]

Despite the predominately unfavorable—or, at best, mixed—experience with allocating government resources in support of strategic industries,[21] the temptation for governments is to engage in "picking winners" because of the political benefits they engender and the rationale under "strategic trade" theory that "technology trajectories" have a clustering effect of positive externalities extending throughout a wider part of the economy.[22] Some advocates of this theory suggest that such interventionist national policies can be advanced without undermining the pursuit of an open, integrated world economy.[23] Others point to the impending competition for "national futures."[24] That this new genre of thought on competition theory is predicated on results with pronounced sensitivities to changes in assumptions has not prevented it from assuming rising political currency.[25] Nor have the new political advocates of strategic trade been deterred by steadily mounting empirical evidence suggesting that protection and subsidization of industries can actually weaken their competitive position.[26]

Whatever the underlying explanations, from the standpoint of competing national policies the advancement of strategic trade objectives can be achieved through a wide array of policy measures—including but not limited to trade-related policies such as "orderly marketing agreements," industrial and technology policies that provide subsidy, research and development support and other "cover," discriminatory procurement practices, and exemption of relevant sectors from antitrust law.

Assuming such strategic trade poli-