

COUNCIL^{on} FOREIGN RELATIONS

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Source: *Foreign Affairs*, Sep. - Oct., 1997, Vol. 76, No. 5 (Sep. - Oct., 1997), pp. 159-171

Published by: Council on Foreign Relations

Stable URL: <https://www.jstor.org/stable/20048206>

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The Global Economy and the Nation-State

Peter F. Drucker

A TRUE SURVIVOR

SINCE TALK of the globalization of the world's economy began some 35 years ago, the demise of the nation-state has been widely predicted. Actually, the best and the brightest have been predicting the nation-state's demise for 200 years, beginning with Immanuel Kant in his 1795 essay "Perpetual Peace," through Karl Marx in "Withering Away of the State," to Bertrand Russell's speeches in the 1950s and 1960s. The latest such prediction by eminent and serious people appears in a book called *The Sovereign Individual* by Lord William Rees-Mogg, former editor of the London Times and now vice chairman of the BBC, and James Dale Davidson, chairman of Britain's National Tax Payers' Union. Rees-Mogg and Davidson assert that for all but the lowest earners the Internet will make avoiding taxes so easy and riskless that sovereignty will inevitably shift to the individual, leaving the nation-state to die of fiscal starvation.

Despite all its shortcomings, the nation-state has shown amazing resilience. While Czechoslovakia and Yugoslavia have been casualties of a changing order, Turkey, a nation that never before existed as such, has become a functioning nation-state. India, rarely united except under a foreign conqueror, is holding together as a nation-state. And every country that emerged from the nineteenth-century colonial empires has established itself as a nation-state, as have all the countries emerging from the breakup of the Eurasian empire forged by

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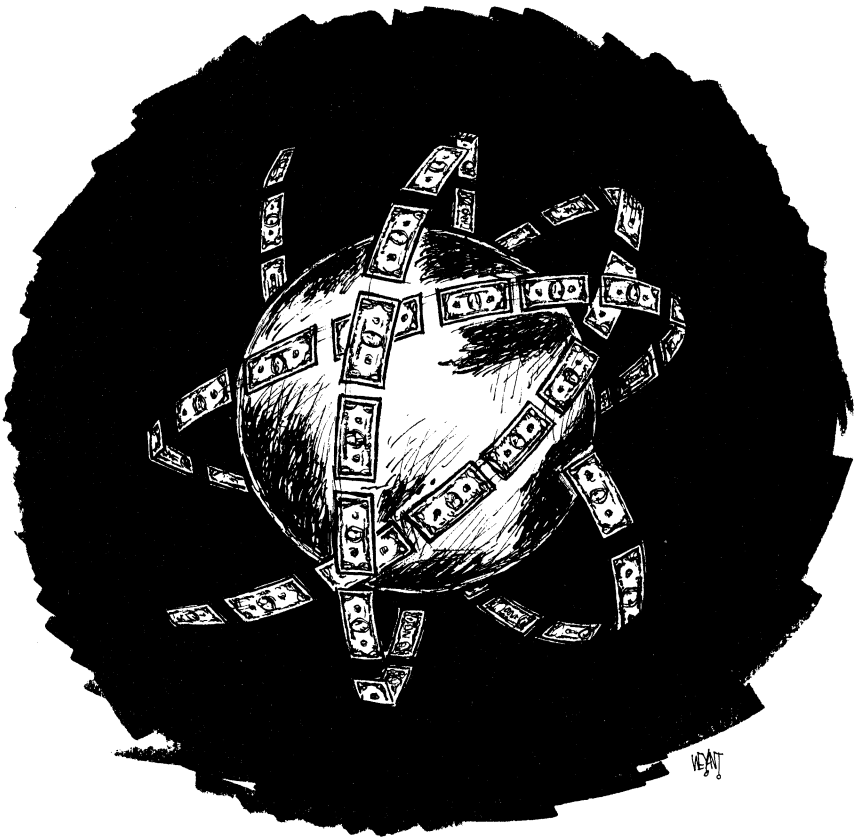
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the czars and tied together even more tightly by the czar's communist successors. So far, at least, there is no other institution capable of political integration and effective membership in the world's political community. In all probability, therefore, the nation-state will survive the globalization of the economy and the information revolution that accompanies it. But it will be a greatly changed nation-state, especially in domestic fiscal and monetary policies, foreign economic policies, control of international business, and, perhaps, in its conduct of war.

THE NATION-STATE AFLOAT

CONTROL OF money, credit, and fiscal policy was one of three pillars on which Jean Bodin, the brilliant French lawyer who coined the term "sovereignty," set the nation-state in his 1576 *Six Books of the Republic*. It has never been a sturdy pillar. By the late nineteenth century, the dominant currency was no longer state-minted coins or state-printed bank notes, but credit created by fast-growing privately controlled commercial banks. The nation-state countered with the central bank. By 1912, when the United States established the Federal Reserve System, every nation-state had its own central bank to control the commercial banks and their credit. But throughout the nineteenth century, one nation-state after another put itself (or was put) under the control of the nonnational gold standard, which imposed strict limits on a country's monetary and fiscal policies. And the gold exchange standard, established in the Bretton Woods agreements after World War II, while a good deal more flexible than the pre-World War I gold standard, still did not give individual countries full monetary and fiscal sovereignty. Only in 1973, when President Nixon floated the U.S. dollar, did the nation-state—or so it was claimed—attain full autonomy in monetary and fiscal affairs. Surely governments and their economists had learned enough to use such sovereignty responsibly.

Not many economists—at least in the English-speaking world—want to go back to fixed exchange rates or anything resembling the old system. But even fewer would claim that nation-states have shown skill or responsibility in using their new fiscal and



monetary freedom. Floating currencies, it was promised, would make for stable currencies, with the market controlling exchange rates through constant small adjustments. Instead, there has been no period in peacetime, save the early years of the Great Depression, in which currencies have fluctuated as widely and abruptly as since 1973. Freed from external constraints, governments have gone on spending binges.

The Bundesbank in Germany is practically free from political control and is dedicated to fiscal rectitude. It knew that the spending spree the politicians proposed during the country's reunification was economic folly, and it said so loud and clear. Still the politicians went ahead, gaining short-term popularity while risking long-term economic costs. The Bundesbank predicted everything that has come to pass, including unemployment rates in both East and West Germany not seen since the dying days of the Weimar Republic. It is the same with politicians everywhere; it makes little difference which party is in power or how much it promises to cut or control.

VIRTUAL MONEY

WHILE THE hope that governments will practice self-discipline is fantasy, the global economy imposes new and more severe restraints on government. It is forcing government back into fiscal responsibility.

Virtual money has won in every instance, proving that it is the arbiter of economic policies.

Floating exchange rates have created extreme currency instability, which in turn has created an enormous mass of “world money.” This money has no existence outside the global economy and its main money markets. It is not being created by economic activity like investment, production, consumption, or trade. It is created primarily by currency trading. It fits none of the traditional definitions of money, whether standard of measurement, storage of value, or medium of exchange. It is totally anonymous. It is virtual rather than real money.

But its power is real. The volume of world money is so gigantic that its movements in and out of a currency have far greater impact than the flows of financing, trade, or investment. In one day, as much of this virtual money may be traded as the entire world needs to finance trade and investment for a year. This virtual money has total mobility because it serves no economic function. Billions of it can be switched from one currency to another by a trader pushing a few buttons on a keyboard. And because it serves no economic function and finances nothing, this money also does not follow economic logic or rationality. It is volatile and easily panicked by a rumor or unexpected event.

One example is the run on the dollar in the spring of 1995, which forced President Clinton to abandon his earlier spending plans and embrace a balanced budget. The run was triggered by the failure of the Republican majority in the Senate to pass a constitutional amendment calling for a balanced budget. Even if the amendment had passed, it would have been meaningless. It was riddled with loopholes and required ratification by 38 states to become law, which at best would have taken many years. But the world’s currency traders panicked and started a run on the U.S. dollar. Already undervalued 10 percent against the Japanese yen, the run pushed the dollar down another 25 percent—from 106 yen to the dollar to less than 80—in

two weeks. More important, the run caused the near-collapse of the U.S. bond market, on which the United States depends to finance its deficits. The central banks of the United States, England, Germany, Japan, Switzerland, and France instantly swung into concerted action to support the dollar. They failed, losing billions in the attempt. It took the dollar the better part of a year to climb back to its original (still undervalued) exchange rate.

A similar panic-driven run on the French franc in 1981 forced President Mitterrand to abandon promises that had helped get him elected three months earlier. There have been panic runs on the Swedish krona, the British pound, the Italian lira, and the Mexican peso. Virtual money won every time, proving that the global economy is the ultimate arbiter of monetary and fiscal policies.

Currency runs, however, are not the appropriate cure for fiscal irresponsibility. In the case of Mexico, they were worse than the disease. The 1995 run on the peso wiped out six years of hard-won economic gains that had turned the country from a basket case into an emerging economy. But so far there is no other control on fiscal irresponsibility. The only thing that can work is fiscal and monetary policies that free a country from depending on borrowing short-term, volatile world money to cover its deficits. This is likely to require a balanced budget—or something very close to balanced—over any three- or five-year period. And this then puts severe limitations on the nation-state's fiscal and monetary autonomy, which the 1973 floating of exchange rates was supposed to set free for all time.

The process of restoring such nonnational and supranational restraints is well under way. The Eurobank's currency for the entire European Economic Community, planned to be in place before the century's end, would transfer control of money and credit from the individual member states to an independent transnational agency. Another approach, apparently favored by the U.S. Federal Reserve Board, would give a consortium of central banks similar authority, thus maintaining the trappings of national fiscal sovereignty while taking away much of its reality. Both approaches, however, would only institutionalize what has already become an economic reality: basic economic decisions are made in and by the global economy rather than the nation-state.

The unrestrained financial and monetary sovereignty given to the nation-state by floating exchange rates 25 years ago has not been good for government. It has largely deprived government of its ability to say no. It has transferred decision-making power from government to special interest groups. It is largely to blame for the precipitate decline in confidence in and respect for government that has been a conspicuous and disturbing trend in almost every country. Paradoxically, losing its fiscal and monetary sovereignty may make the nation-state stronger rather than weaker.

BREAKING THE RULES

FAR SUBTLER but perhaps even more important is the impact of the global economy's rise on the basic assumptions and theories on which most governments, especially in the West, base their international economic policies. There are any number of signs that something is going on in the world economy that breaks the rules that have been at work for decades.

Why did the dollar fall against the yen by more than 50 percent when President Reagan and the Japanese government agreed to give up the fixed 250:1 yen-to-dollar rate in 1983? While the dollar was indeed overvalued, its purchasing power parity with the yen was around 230. No one expected it to drop below 200 yen. Instead, the dollar went into free fall and did not come to rest until it had lost almost 60 percent of its value against the yen, that is, until it hit 110 yen two years later (only to fall again 10 years later to 80 yen). Why? To this day, there has been no explanation. Even more mysterious, the dollar showed such a sharp fall only against the yen. In fact, it increased its value against some other key currencies. Again, no one anticipated this and no one can explain it.

Reagan and his economic advisers wanted a cheaper dollar so as to eliminate a growing trade deficit with Japan. According to all theory and 200 hundred years of experience, a lower dollar should mean more American exports to Japan and fewer American imports from Japan. Japanese exporters, especially the automobile and consumer electronics manufacturers, went into hysterics and announced that the end of the world had come. American exports did indeed go up

sharply, but even more to some countries against whose currencies the dollar gained in value. But Japanese exports to the United States, despite the dollar depreciation, rose even faster than U.S. exports to Japan, so that the U.S. trade deficit with Japan actually went up rather than down. Every time in the last 15 years that the dollar has slid against the yen, the American administration of the day has predicted that Japan's trade surplus with the United States would shrink. Every time the Japanese have screamed that they were ruined. And every time Japan's export surplus has increased almost immediately.

One popular explanation is that Japanese manufacturers are geniuses. But although the major exporters are very sharp, genius cannot overcome a 50 percent drop in revenues in virtually no time. The true explanation is that Japan benefited as much from the lower dollar as it was penalized by it. Japan is the world's largest importer of foodstuffs and raw materials, all of which are priced in dollars. It spends roughly as much on importing these commodities as it earns dollars by exporting finished manufactured goods. An individual Japanese manufacturing company like Toyota may lose because the dollars it gets for its cars exported to the United States earn only half as many yen as before, but for the entire Japanese economy the drop in the dollar's value against the yen was simply a wash.

But this raises another, even more mysterious riddle. What explains why the Japanese did not have to pay more for the commodities they imported? According to all theory and earlier experience, commodity prices in dollars should have gone up as much as the dollar went down. The Japanese should have had to pay as much as they did before the dollar was devalued. If that had happened, as it always had before, there would indeed be no Japanese surplus in trade with the United States. But commodity prices in dollars today are lower than in 1983—and there is no explanation for this either.

There is only one piece of the puzzle that makes sense, but it is even less compatible with traditional international trade theory. The U.S. Department of Commerce estimates that 40 percent or more of goods exported from any developed country go to overseas subsidiaries and

There is no explanation for some of the conundrums of a global economy.

affiliates of domestic companies. Officially and legally, they are exports. Economically, they are intracompany transfers. They are machines, supplies, and half-finished goods that have been engineered into the production of the plant or the affiliate abroad and must be continued, whatever the exchange rate. To change this relationship would take years and cost more than foreign exchange savings could possibly recover. Forty percent of what is reported as trade in goods is thus “trade” only as a legal fiction. And that proportion is steadily growing.

International trade theory takes for granted that investment follows trade. Most people think “international trade in goods” when they hear the words “international trade.” But increasingly today, trade follows investment. International movements of capital rather than international movements of goods have become the engine of the world economy. And while trade in goods has indeed grown faster since World War II than in any period in history, trade in services has been growing even faster, whether it be financial services, management consulting, accounting, insurance, or retailing. Service exports 20 years ago were so small that they were rarely recorded in trade statistics. Today they are a quarter of U.S. exports and the only producers of sizable American export surpluses. They follow few, if any, of the rules of traditional international trade. Only tourism, for instance, is highly sensitive to foreign exchange rates and their fluctuations.

I have intentionally stuck to American economic conundrums, but similar ones can be found in the economy of every developed country and most developing countries. The centers of the world economy have shifted away from the developed countries. Only 15 years ago it was generally believed that the growth of developing countries depended on the prosperity of the developed ones. In the last two decades, the developed countries have not done particularly well; but world trade and production have boomed as never before, with the bulk of the growth occurring in emerging countries. The explanation, in large part, is that knowledge has replaced the economist’s “land, labor, and capital” as the chief economic resource. Knowledge, mainly in the form of the training methods and philosophies developed in the United States during World War II, exploded the axiom that low wages mean low productivity. Training now enables a country’s labor force to attain world-class productivity while still paying an emerging country’s wages for at least eight or ten years.

The Global Economy and the Nation-State

These new realities require different economic theories and different international economic policies. Even if a lower exchange rate improves a country's exports, it also weakens a country's ability to invest abroad. And if trade follows investment, lower foreign exchange rates for a country's currency diminish exports within a few years. This is what happened to the United States: the cheaper dollar increased American manufactured exports in the short term. But it also impaired the ability of American industry to invest abroad and thus to create export markets for the long term. As a result, the Japanese are now far ahead of the Americans in market share and market leadership in the emerging countries of East and Southeast Asia.

The need for new theories and policies explains the sudden interest in what is being promoted by James Fallows, editor in chief of *U.S. News and World Report*, and others as the "national development policies" of the nineteenth-century German economist Friedrich R. List. Actually, the policies List preached in 1830s Germany—protection of infant industries so as to develop domestic business—were not List's and were not German. They are strictly American, growing out of Alexander Hamilton's 1791 "Report on Manufactures," which Henry Clay, 25 years later, expanded into what he called the "American System." List, in the United States as a political refugee from Germany, learned them while serving as Clay's secretary.

What makes these old ideas attractive is that Hamilton, Clay, and List did not focus on trade. They were neither free traders nor protectionists. They focused on investment. Asian economies, beginning with Japan after World War II, have been following policies similar to those Hamilton and Clay advocated for the infant United States. The international economic policies likely to emerge over the next generation will be neither free-trade nor protectionist, but focused on investment rather than trade.

SELLING TO THE WORLD

IN THE global economy, businesses are increasingly forced to shift from being multinational to being transnational. The traditional multinational is a national company with foreign subsidiaries. These subsidiaries are clones of the parent company. A German subsidiary

of an American manufacturing company, say, is a self-contained operation that manufactures almost everything it sells within Germany, buying its supplies there and employing almost exclusively Germans.

Most companies doing international business today are still organized as traditional multinationals. But the transformation into transnational companies has begun, and it is moving fast. The products or services may be the same, but the structure is fundamentally different. In a transnational company there is only one economic unit, the world. Selling, servicing, public relations, and legal affairs are local. But parts, machines, planning, research, finance, marketing, pricing, and management are conducted in contemplation of the world market. One of America's leading engineering companies, for instance, makes one critical part for all of its 43 plants worldwide in one location outside of Antwerp, Belgium—and nothing else. It has organized product development for the entire world in three places and quality control in four. For this company, national boundaries have largely become irrelevant.

The transnational company is not totally beyond the control of national governments. It must adapt to them. But these adaptations are exceptions to policies and practices decided on for worldwide markets and technologies. Successful transnational companies see themselves as separate, nonnational entities. This self-perception is evidenced by something unthinkable a few decades ago: a transnational top management. The world's best-known management consulting firm, McKinsey & Co., for instance, though headquartered in New York, is headed by an Indian. And for many years the number two man at Citibank, the only big commercial bank that has gone transnational, was Chinese.

The U.S. government is trying to counteract this trend by extending American legal concepts and legislation beyond its shores. It is doing so with respect to antitrust laws, an almost uniquely American concept. It is also trying to rein in transnational companies through American laws covering torts, product liability, and corruption. And America goes to battle against transnational companies through economic sanctions against Cuba and Iraq.

Although the United States is still the world's largest economic power—and likely to remain so for many years—the attempt to mold the world economy to American moral, legal, and economic concepts

is futile. In a global economy in which major players can emerge almost overnight, there can be no dominant economic power.

Nonetheless, there is certainly need for moral, legal, and economic rules that are accepted and enforced throughout the global economy. A central challenge, therefore, is the development of international law and supranational organizations that can make and enforce rules for the global economy.

WAR AFTER GLOBAL ECONOMICS

THOUGH INCOMPATIBLE, the global economy and total war are both children of this century. The strategic goal in traditional warfare, in Clausewitz's famous phrase, was "to destroy the enemy's fighting forces." War was to be waged against the enemy's soldiers. It was not supposed to be waged against enemy civilians and their property. There were always exceptions, of course. Sherman's march through Georgia at the end of the U.S. Civil War was aimed at civilians and their property rather than the threadbare Confederate army. But that it was an exception—and meant to be one—is one reason it is still so vividly remembered. A few years later, in the Franco-Prussian War of 1870-71, Bismarck took great care to keep France's financial system intact.

But during this century's first war, the Boer War, the rule was changed. The goal of warfare was redefined as destroying the enemy's potential for waging war, which meant destroying the enemy's economy. Also, for the first time in modern Western history, war was systematically waged against the enemy's civilian population. To break the fighting spirit of the Boer soldiers, the British herded Boer women and children into history's first concentration camps.

Before this century, the West generally observed another rule: enemy civilians residing in one's country were to be left unmolested so long as they did not engage in political activity. But in World War I, Britain and France interned all enemy aliens, although the United States, Germany, and Austria refrained. Until 1900, businesses and property owned by foreign nationals or by companies domiciled in an enemy country were left undisturbed. Since World War I—with the British again taking the lead—such property was confiscated and put under government custodianship in wartime.

The rules of total war are so firmly established by now that most people take them to be akin to laws of nature. With missiles, satellites, and nuclear weapons, there can be no return to the nineteenth-century belief that the military's first task is to keep war away from the country's civilians. In modern war, there are no civilians.

But while destroying the enemy's economy helps win the war, it impairs the victor's chance of winning the peace. This was one of the most significant lessons of this century's two postwar periods, the 20

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would harm a country's
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years after 1918 and the 50 years after 1945. The unprecedented American policies after World War II, including the Marshall Plan, brought about the speedy recovery of the former enemy economies, and with them 50 years of unprecedented economic expansion and prosperity for the victors as well.

These policies came into existence because George Marshall, Harry Truman, Dean Acheson, and Douglas MacArthur remembered the catastrophic consequences of World War I's punitive peace. If "war is the continuation of policy by other means," to quote another maxim from Clausewitz, then total war will have to be adjusted to the realities of the global economy.

Since businesses are moving from multinational to transnational, total-war doctrines may actually be detrimental to a country's war effort these days. For example, Italy's largest armaments producer during World War I was an automobile company named Fiat. Austria-Hungary's largest armaments producer in its fight against Italy during World War I was the wholly owned Austrian subsidiary of Fiat. It had been founded a year or two after the parent company started in Italy, but by 1914 it was substantially larger and more advanced than its parent, owing to the greater size of Austria-Hungary's market. To make this Italian-owned subsidiary the center of Austria's war production required literally nothing but a new bank account.

Today such a wholly owned subsidiary would assemble and sell whole cars, but might only manufacture brakes. That subsidiary's brakes would be used by all the company's plants worldwide, and it would receive all the other parts and supplies it needed from other subsidiaries throughout the world. This transnational integration

could cut the costs of the finished automobile by as much as 50 percent. But it also makes an individual subsidiary practically unable to produce anything if cut off from the rest of the company. In many developed countries, businesses integrated transnationally now account for one-third to one-half of their industry's output.

I do not pretend to know the answers to the growing contradiction between peacetime and wartime economies. But there is a precedent. The most innovative political achievement of the nineteenth century was the International Red Cross. First proposed in 1862 by a Swiss citizen, Jean Henri Dunant, it became the world's first transnational agency within 10 years and it is still the world's most successful one. What it did in setting universal rules for treating the wounded and prisoners of war may need to be done now with respect to the treatment of civilians and their property. That too, in all likelihood, will require a transnational agency and, as in the case of the Red Cross, substantial curtailment of national sovereignty.

Since the early Industrial Revolution, it has been argued that economic interdependence would prove stronger than nationalist passions. Kant was the first to say so. The "moderates" of 1860 believed it until the first shots were fired at Fort Sumter. The Liberals of Austria-Hungary believed to the very end that their economy was far too integrated to be split into separate countries. So, quite clearly, did Mikhail Gorbachev. But whenever in the last 200 years political passions and nation-state politics have collided with economic rationality, political passions and the nation-state have won. 🌐