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Trade Lessons from the World Economy

Peter F. Drucker

ALL ECONOMICS IS INTERNATIONAL

IN RECENT YEARS THE ECONOMIES of all developed nations have been stagnant, yet the world economy has still expanded at a good clip. And it has been growing faster for the past 40 years than at any time since modern economies and the discipline of economics emerged in the eighteenth century. From this seeming paradox there are lessons to be learned, and they are quite different from what practically everyone asserts, whether they be free traders, managed traders or protectionists. Too many economists, politicians and segments of the public treat the external economy as something separate and safely ignored when they make policy for the domestic economy. Contrary lessons emerge from a proper understanding of the profound changes in four areas—the structure of the world economy, the changed meaning of trade and investment, the relationship between world and domestic economies, and the difference between workable and unworkable trade policies.

The segments that comprise the world economy—the flows of money and information on the one hand, and trade and investment on the other—are rapidly merging into one transaction. They increasingly represent different dimensions of cross-border alliances, the strongest integrating force of the world economy. Both of these segments are growing fast. The center of world money

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flows, the London Interbank Market, handles more money in one day than would be needed in many months—perhaps an entire year—to finance the real economy of international trade and investment. Similarly, the trades during one day on the main currency markets of London, New York, Zurich and Tokyo exceed by several orders of magnitude what would be needed to finance the international transactions of the real economy.

Today's money flows are vastly larger than traditional portfolio investments made for the sake of short-term income from dividends and interest. Portfolio money flows were once the stabilizers of the international economy, flowing from countries of low short-term returns to countries of higher short-term returns, thus maintaining an equilibrium. They reacted to a country's financial policy or economic condition. Driven by the expectation of speculative profits, today's world money flows have become the great destabilizers, forcing countries into precipitous interest rate hikes that throttle business activity, or into overnight devaluations that drag a currency below its trade parity or purchasing-power parity, thus generating inflationary pressures. These money flows are a pathological phenomenon. They underline the fact that neither fixed nor flexible foreign exchange rates (the only two known systems) really work. Contemporary money flows do not respond to attempted government restrictions such as taxes on money-flow profits; the trading just moves elsewhere. All that can be done as part of an effective trade policy is to build resistance into the economy against the impact of the flows.

Information flows in the world economy are probably growing faster than any category of transactions in history. Consisting of meetings, software, magazines, books, movies, videos, telecommunications and a host of new technologies, information flows may already exceed money flows in the fees, royalties and profits they generate. Unlike money flows, information flows have benign economic impacts. In fact, few things so stimulate economic growth as the rapid development of information, whether telecommunications, computer data, computer networks or entertainment media. In the United States, information flows—and the goods needed to carry them—have become the largest single source of foreign currency income. But

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just as we do not view medieval cathedrals economically—although they were once Europe's biggest generators of economic activity next to farming, and its biggest nonmilitary employer—information flows have mostly social and cultural impacts. Economic factors like high costs restrain rather than motivate information flows.

The first lesson is that these two significant economic phenomena—money flows and information flows—do not fit into any theory or policy. They are not even transnational; they are nonnational.

WHAT TRADE DEFICIT?

For practically everyone international trade means merchandise trade, the import and export of manufactured goods, farm products and raw materials. But international trade is increasingly services trade—little reported and largely unnoticed. The United States has the largest share of the trade in services among developed countries, followed by the United Kingdom. Japan is at the bottom of the list. The services trade of all developed countries are growing fast, and it may equal or overtake their merchandise trade within ten years. Knowledge is the basis of most service exports and imports. As a result, most service trade is based on long term commitments, which makes it—excluding tourism—impervious to foreign exchange fluctuations and changes in labor costs.

Even merchandise trade is no longer confined to the sale and purchase of individual goods. Increasingly it is a relationship in which a transaction is only a shipment and an accounting entry. More and more merchandise trade is becoming "structural" and thereby impervious to short-term (and even long-term) changes in the traditional economic factors. Automobile production is a good example. Plant location decisions by manufacturers and suppliers are made at the time of product design. Until the model is redesigned, say in ten years, the plants and the countries specified in the original design are locked in. There will be change only in the event of a catastrophe such as a war or fire that destroys a plant. Or take the case of a Swiss pharmaceutical company's Irish plant. Rather than sell a product, it ships chemical intermediates to the company's finished-product plants in

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19 countries on both sides of the Atlantic. For this the company charges a "transfer" price, which is a pure accounting convention having as much to do with taxes as with production costs. The traditional factors of production are also largely irrelevant to what might be called "institutional" trade, in which businesses, whether manufacturers or large retailers, buy machinery, equipment and supplies for new plants or stores, wherever located, from the suppliers of their existing plants, that is, those in their home countries.

Markets and knowledge are important in these types of structural and institutional trade decisions; labor costs, capital costs and foreign exchange rates are restraints rather than determinants. More important, neither type of trade is foreign trade, except in a legal sense, even when it is trade across national boundaries. For the individual business—the automobile manufacturer, the Swiss pharmaceutical company, the retailer—these are transactions within its own system.

Accounting for these developments, U.S. trading activity is more or less in balance. The trade deficit bewailed in the media and by public and private officials is in merchandise trade, caused primarily by an appalling waste of petroleum and a steady decline in the volume and prices of farm exports. The services trade account has a large surplus. According to little-read official figures, published every three months, the services trade surplus amounts to two thirds of the merchandise trade deficit. Moreover, government statisticians acknowledge gross underreporting of service exports, perhaps by as much as 50 percent.

THE COMING OF ALLIANCES

TRADITIONAL DIRECT INVESTMENT abroad to start or acquire businesses continues to grow. Since the 1980s direct investment in the United States by Europeans, Japanese, Canadians and Mexicans has grown explosively. But the action is rapidly shifting to alliances such as joint ventures, partnerships, knowledge agreements and outsourcing arrangements. In alliances, investment is secondary, if there is any at all. A recent example is the dividing up of design and production of an advanced microchip between Intel, a U.S.-based microchip *designer*, and Sharp, the Japanese electronics *manufacturer*.

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Both will share the final product. There are alliances between scores of university research labs and businesses—pharmaceutical, electronic, engineering, food processing and computer firms. There are alliances in which organizations outsource support activities; a number of American hospitals, and some in the United Kingdom and Japan, let independent suppliers do their maintenance, housekeeping, billing and data processing, and increasingly let them run the labs and the physical therapy and diagnostic centers. Computer makers now outsource the data processing for their own businesses to contractors like Electronic Data Systems, the company Ross Perot built and sold to General Motors. They are also entering alliances with small, independent software designers. Commercial banks are entering alliances with producers and managers of mutual funds. Small and medium-sized colleges are entering alliances with one another to do paperwork jointly.

More and more, the capital investment in alliances is symbolic. Complementary knowledge is what counts.

Some of these alliances involve substantial capital investment, as in the joint ventures of the 1960s and 1970s between Japanese and U.S. companies to produce American-designed goods in Japan for the Japanese market. But even then the basis of the alliance was not capital but complementary knowledge—technical and manufacturing knowledge supplied by the Americans, marketing knowledge and management supplied by the Japanese. More and more, investment of whatever size is symbolic—a minority share in each other's business is regarded as "bonding" between partners. In many alliances there is no financial relationship between the partners. (There is apparently none between Intel and Sharp.)

Alliances, formal and informal, are becoming the dominant form of economic integration in the world economy. Some major companies, such as Toshiba, the Japanese electronics giant, and Corning Glass, the world's leading maker of high-engineered glass, may each have more than 100 alliances all over the world. Integration in the Common Market is proceeding far more through alliances than through mergers and acquisitions, especially among the middle-sized companies that dominate most European economies. As with struc-

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tural and institutional trade, businesses make little distinction between domestic and foreign partners in their alliances. An alliance creates a relationship in which it does not matter whether one partner speaks Japanese, another English and a third German or Finnish. And while alliances increasingly generate both trade and investment, they are based on neither. They pool knowledge.

THE VITAL LINK

FOR DEVELOPED ECONOMIES, the distinction between the domestic and international economy has ceased to be a reality, however much political, cultural or psychological strength remains in the idea. An unambiguous lesson of the last 40 years is that increased participation in the world economy has become the key to domestic economic growth and prosperity. Since 1950 there has been a close correlation between a country's domestic economic performance and its participation in the world economy. The two major countries whose economies have grown the fastest in the world economy, Japan and South Korea, are also the two countries whose domestic economies have grown the fastest. The same correlation applies to the two European countries that have done best in the world economy in the last 40 years, West Germany and Sweden. The countries that have retreated from the world economy (most notably the United Kingdom) have consistently done worse domestically. In the two major countries that have maintained their participation rate in the world economy within a fairly narrow range—the United States and France—the domestic economy has put in an average performance, neither doing exceptionally well nor suffering persistent malaise and crisis like the United Kingdom.

The same correlation holds true for major segments within a developed economy. In the United States, for instance, services have tremendously increased their world economy participation in the last 15 years; finance, higher education and information are examples. American agriculture, which has consistently shrunk in terms of world economy participation, has been in continual depression and crisis, masked only by ever-growing subsidies.

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Conversely, there is little correlation between economic performance and policies to stimulate the domestic economy. The record shows that a government can harm its domestic economy by driving up inflation. But there is not the slightest evidence that any government policy to stimulate the economy has an impact, whether it be Keynesian, monetarist, supply-side or neoclassical. Contrary to what some economists confidently promised 40 years ago, business cycles have not been abolished. They still operate pretty much the way they have for the past 150 years. No country has been able to escape them. When a government policy to stimulate the economy actually coincided with cyclical recovery (which has been rare), it was by pure coincidence. No one policy shows more such coincidences than any other. And no policy that "worked" in a given country in recession A showed any results when tried again in the same country in recession B or recession C. The evidence not only suggests that government policies to stimulate the economy in the short term are ineffectual but also something far more surprising: they are largely irrelevant. Government, the evidence shows clearly, cannot control the economic weather.

The evidence of the past four decades does show convincingly that participation in the world economy has become the controlling factor in the domestic economic performance of developed countries. For example, a sharp increase in manufacturing and service exports kept the U.S. economy from slipping into deep recession in 1992, and unemployment rates for adult men and women never reached the highs of earlier post-World War II recessions. Similarly, Japan's sharply increased exports have kept its current recession from producing unemployment figures at European levels of eight to ten percent.

WHAT WORKS, WHAT DOES NOT

THE EVIDENCE IS CRYSTAL clear that both advocates of managed trade and conventional free traders are wrong in their prescriptions for economic growth. Japan's industrial policy of attempting to select and support "winning" business sectors is by now a well-known failure. Practically all the industries the Japanese Ministry of International Trade and Industry (MITI) picked—such as supercomputers and

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pharmaceuticals—have been at best also-rans. The Japanese businesses that succeeded, like Sony and the automobile companies, were opposed or ignored by MITI. Trying to pick winners requires a fortune-teller, and the world economy has become far too complex to be outguessed. Japan's economy benefited from a competency—an extraordinary ability to miniaturize products—that was virtually unknown to MITI. Pivotal economic events often take place long before we notice their occurrence. The available data simply do not report important developments such as the growth of the service trade, of structural and institutional trade, of alliances.

Lesson one of the East Asian superstars: stop trying to control the economic weather.

Still, the outstanding overall performance of Japan and other Asian countries cannot be explained away as merely a triumph of conventional free trade. Two common economic policies emerge from a recent World Bank study of eight East Asian "superstars"—Japan, South Korea, Hong Kong, Taiwan, Singapore, Malaysia, Thailand and Indonesia. First, they do not try to manage short-term fluctuations in their domestic economies; they do not try to control the economic weather. Moreover, not one of the East Asian economies took off until it had given up attempts to manage domestic short-term fluctuations. All eight countries focus instead on creating the right economic climate. They keep inflation low. They invest heavily in education and training. They reward savings and investment and penalize consumption. The eight started modernizing their economies at very different times, but once they got going, all have shown similar growth in both their domestic and international economies. Together they now account for 21 percent of the world's manufactured goods exports, versus nine percent 30 years ago. Five percent of their populations live below the poverty line, compared with about 40 percent in 1960, and four of them—Japan, Hong Kong, Taiwan and Singapore—rank among the world's richest countries. Yet the eight are totally different in their culture, history, political systems and tax policies. They range from laissez-faire Hong Kong to interventionist Singapore to statist Indonesia.

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The second major finding of the World Bank study is that these eight countries pursue policies to enhance the competitiveness of their industries in the world economy with only secondary attention to domestic effect. These countries then foster and promote their proven successes in the world economy. Though MITI neither anticipated nor much encouraged Japan's world market successes, the whole Japanese system is geared to running with them. Japan offers its exporters substantial tax benefits and credits, which remain scarce and expensive for domestic businesses, and it deliberately keeps prices and profits high in a protected domestic market in order to generate cash for overseas investment and market penetration.

The same lessons were being taught until recently by the two countries in the West that showed similar growth: West Germany and Sweden. These countries, too, have very different domestic policies. But both created and maintained an economic growth climate, and through the same measures: control of inflation, high investment in education and training, a high savings rate obtained by high taxes on consumption and fairly low taxes on savings and investment. Both also gave priority to the world economy in governmental and business decisions. The moment they forgot this—when the trade unions a few years back began to subordinate Germany's competitive standing to their wage demands, and the Swedes subordinated their industries' competitive standing to ever-larger welfare spending—their domestic economies went into stagnation.

An additional lesson of the world economy is that investment abroad creates jobs at home. In both the 1960s and the 1980s, expanded U.S. business investments overseas spurred rapid domestic job creation. The same correlation held for Japan and Sweden, both of which invested heavily in overseas plants to produce goods for their home markets. In manufacturing—and in many services, such as retailing—investment per worker in the machinery, tools and equipment of a new facility is three to five times annual production. Most of this productive equipment comes from institutional trade (that is, from the home country of the investor), and most of it is produced by high-wage labor. The initial employment generated to get the new facility into production is substantially larger than the annual

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output and employment during its first few years of operation.

The last 40 years also teach that protection does not protect. In fact, the evidence shows quite clearly that protection hastens decline. Less-protected U.S. farm products—soybeans, fruit, beef and poultry—have fared a good deal better on world markets than have the more subsidized traditional crops, such as corn, wheat and cotton. Equally persuasive evidence suggests that the American automobile industry's share of its domestic market went into a precipitous decline as soon as the U.S. government forced the Japanese into "voluntary" export restraints. That protection breeds complacency, inefficiency and cartels has been known since before Adam Smith. The counter-argument has always been that it protects jobs, but the evidence of the last 40 years strongly suggests that it does not even do that.

FREE TRADE IS NOT ENOUGH

THE WORLD ECONOMY HAS BECOME too important for a country not to have a world-economy policy. Managed trade is a delusion of grandeur. Outright protectionism can only do harm, but simply trying to thwart protectionism is not enough. What is needed is a deliberate and active—indeed, aggressive—policy that gives the demands, opportunities and dynamics of the external economy priority over domestic policy demands and problems. For the United States and a number of other countries, it means abandoning ways of thinking that have dominated American economics perhaps since 1933, and certainly since 1945. We still see the demands and opportunities of the world economy as externalities. We usually do not ask whether domestic decisions will hurt American competitiveness, participation and standing in the world economy. The reverse must become the rule: will a proposed domestic move advance American competitiveness and participation in the world economy? The answer to this question determines what are the right domestic economic policy and business decisions. The lessons of the last 40 years teach us that integration is the only basis for an international trade policy that can work, the only way to rapidly revive a domestic economy in turbulence and chronic recession.

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