Cambridge University Press
978-1-108-47695-9 — Trade and American Leadership
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Excerpt
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The Domestic Diplomacy of Trade and the Paradoxes of Power and Wealth

> Foreign economic policy is a major instrument in the conduct of United States foreign relations. It is an instrument which can powerfully influence the world environment in ways favorable to the security and welfare of this country. It is also an instrument which, if unwisely formulated and employed, can do actual harm to our national interests.
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> National Security Council Report 68 (1950)

INTRODUCTION

The United States demonstrated in the Cold War that it is fully capable of balancing the imperatives of what the National Security Council (NSC) called "security and welfare." Adam Smith preferred the terms "defense" and "opulence" to describe this great dichotomy of foreign policy, just as his nineteenth-century successors distinguished the "high politics" of war and peace from the "low politics" of trade and investment. Herman Goering famously observed that countries must choose between "guns and butter"; talk of "blood and treasure" came back into vogue after 9/11, and in his inaugural address Donald Trump promised to deliver "prosperity and strength." Whatever we choose to call them, power and wealth have always been the principal means and ends of foreign policy. Statesmen must secure the country's borders and ensure the people's safety, and also promote economic opportunity through trade and investment. These two aims are often in tension, and sometimes in conflict, but they are neither wholly distinct nor mutually exclusive. A country that pursues security without regard to its welfare risks stagnation and bankruptcy, and a country that pursues welfare without regard to its security courts indolence and invasion. Finding the right mix, and steadfastly pursuing it, is a supremely difficult task for a democracy in which lawmakers do not habitually defer to the president, government is more often divided than unified, and voters are not fond of taxes or conscription. Yet Harry Truman and his eight successors managed to pull it off.

Economic policy was a critical element in the US grand strategy. "The only sure victory," according to NSC-68, "lies in the frustration of the Kremlin design by the steady development of the moral and material strength of the free world and its projection into the Soviet world in such a way as to bring about an internal change in the Soviet system." To this end, the NSC urged that the doctrine of containment be complemented by "an international economy based on multilateral trade, declining trade barriers, and convertible currencies," aid to Western Europe and other allies, and "assistance in the development of under-developed areas."[1] Americans sacrificed a great deal to implement this plan in the ensuing decades and obliged others to sacrifice even more. There were times that the strategy faltered, sometimes tragically, but containment ultimately delivered exactly what it promised: The growing gap in material prosperity between East and West, coupled with a costly arms race and Moscow's imperial overstretch, precipitated the collapse of Communism.

We would do well to learn both the positive and negative lessons from that experience, but should also heed a warning from NSC-68. Foreign economic policy "is an instrument uniquely suited to our capabilities," according to the NSC strategists, "provided we have the tenacity of purpose and the understanding requisite to a realization of its potentials,"[2] and yet it also has the capacity to harm the national interest. Apart from an outright military attack, there may be no damage that an adversary can wreak upon the United States greater than the self-inflicted wound of an ill-conceived foreign economic policy. Short-sighted pundits and policymakers cannot see that trade is as much about creating value with partners as it is about claiming value for oneself, and that missteps in this field can cripple exporters, stifle innovation, burden consumers, embolden rivals, and make erstwhile allies rethink their ties to an unreliable friend. That is precisely the danger that the United States now faces, as anticipated by a prescient contemporary of NSC-68. "We have met the enemy," said Pogo Possum in 1953, "and he is us."[3]

[1] A Report to the National Security Council by the Executive Secretary (Lay), "NSC-68" (April 14, 1950), *FRUS 1950*, Volume I, pp. 259 and 291.
[2] Ibid., p. 258.
[3] Kelly (1953), p. i.

HOW THE PAST CAN INFORM MODERN ECONOMIC STATECRAFT

What follows in this book is an historical review and contemporary critique of how American policymakers balance power and wealth as tools and objectives in foreign policy. This analysis is inspired by a profound concern that an overreaction against the perceived excesses of globalization threatens to overturn the foundations of an international order that not only worked out well during the Cold War but is also adaptable and scalable to a new world in which the opportunities and the dangers are more widely distributed. Though the critics in the Trump administration cannot be faulted for their recognition that power and wealth are intimately related, they show a remarkable knack for coming up with precisely the wrong answers. By replacing internationalism with protectionism, promoting an “America first” ethos that reduces partners to clients, and taking a wholly transactional and zero-sum view of economic exchange, the radically anachronistic policies that they promote are unlikely to deliver either prosperity or strength. They instead threaten to render the United States economically impotent and politically impoverished.

This is a study of economic statecraft. That term encompasses the universe of practices in international relations by which states either employ their wealth to promote their power or vice versa. Whereas in garden-variety trade policy both the means and the ends are strictly commercial, in economic statecraft some of those same tools are employed in pursuit of larger aims. In addition to trade barriers, as well as agreements to reduce or eliminate them, the instruments of economic statecraft include trade preferences and sanctions, the regulation or promotion of foreign investment, immigration rules, exchange rate policy, foreign assistance, etc., all of which may be directed toward such equally varied ends as peace, victory, regional stability, the strengthening of allies, the weakening of adversaries, security of supply for food and fuel, and promoting positive change in other countries’ internal or external policies.

Thinking about economic statecraft requires that we use both sides of the brain, and not shy away from topics just because they are outside our comfort zone. This point is especially relevant whenever we consider the relationship between war – hot or cold, potential or actual – and the trading system. The economics of military conflict remain a surprisingly underdeveloped field, owing to the widespread misconception that war is so abnormal as to constitute a rare and special case (if it is considered at all). Economic models typically make a great many simplifying assumptions that elide past the details of a messy reality, one of them being that countries are in a state of perpetual peace. Intellectual honesty obliges us to recognize that while war is morally abhorrent it is not historically aberrant.

It is a sad but unavoidable fact that most of human history can be divided between those periods in which countries were more often at war than they were at peace and those in which mankind believed it had outgrown armed conflict. Even if one counted only the declared wars, and set aside covert operations, armed interventions, and other forms of low-intensity conflict, the record is sobering. In the years from 1917 to 2017, the United States fought nine declared wars[4] that stretched across forty-one years. It also lived through eighteen recessions that lasted thirty-eight years.[5] With wars being half as frequent but twice as long as recessions, we might expect economists to devote as much attention to these political failures as they routinely do to market failures. Quite to the contrary, the belief that war is rare "has been so powerful as to focus the operation of a substantial body of [economic] theory on the workings of a peacetime economy only."[6] The twentieth century's literature on the economics of war could fill no more than a modest bookshelf. One of these volumes was devoted entirely to showing how and why "economists seem to have turned their attention very little to this area of policy,"[7] and most of the others dealt primarily with war finance.

The problem is worsened by the common assumption that markets offer a sovereign remedy for all afflictions, not least war itself. "If goods don't cross borders," Frédéric Bastiat is often quoted as saying, "armies will." The problem with this sentiment, besides the fact that Bastiat never actually said this,[8] is that lazy minds eagerly treat it as an unassailable verity rather than a testable proposition. It instead offers a good example of what social scientists call a falsifiable statement – a well-formed hypothesis that can be discarded if we find contrary evidence. That evidence is bountiful: Many of history's deadliest wars have been fought between adversaries that traded with one another right up to the day that troops replaced exports. The internal market of the United States was fully open before the Civil War, for example, and the First World War erupted at a time when European markets were closely integrated. This is not to suggest that commerce and conflict are unrelated. Much of this book is devoted to the proposition that trade is an important

4 In this tally I include United Nations Security Council resolutions and authorizations of military force approved by Congress that are associated with the Korean War, the Vietnam War, and the two Gulf wars.
5 Calculated from National Bureau of Economic Research data at www.nber.org/cycles.html.
6 Milward (1979), p. 1.
7 Goodwin (1991b), p. 1.
8 See Snow (2010).

instrument of foreign policy, providing a versatile set of tools that can serve the needs of aggressors, defenders, or peacemakers. Even when we put a hard edge on soft power, however, we need to acknowledge the tactical limitations of this instrument. That, too, is a recurring theme in this book.

This analysis is built around two sets of problems. The first is what I deem the three paradoxes of power and wealth, each of which concerns difficult choices and trade-offs in the conduct of economic statecraft. Any country that is not a mere price-taker in the global power market, and plans to use the tools of low politics to secure the aims of high politics, must offer a solution to at least one of these three riddles. The second set of problems concerns the domestic diplomacy of foreign economic policy, by which I mean the often difficult task of devising and executing a consistent strategy in a democracy. Policymaking in the United States is special in many respects, and unique in a few. Americans have a well-established aversion to the concentration of power, as reflected in a Constitution that deliberately fragments authority along lines that are horizontal (i.e., the separation of powers) and vertical (i.e., federalism). While these politically centrifugal instincts help to preserve liberty, they also confound coherent policymaking. Taken together, the paradoxes and the challenges of domestic diplomacy make for a system in which both the problems and the solutions are subject to change – sometimes steady and incremental, and sometimes sudden and radical.

THE THREE PARADOXES OF POWER AND WEALTH

The very term "economic statecraft" may seem self-contradictory, conflating as it does the functions of the market and the state. Anyone who explores this territory will come across advocates who hold very different notions, from wide-eyed prophets of the open market to jaded practitioners of power politics. Where the one group typically sees the chief function of the state primarily in negative terms, favoring the negotiation of agreements by which governments mutually agree to get out of the way, security-minded analysts and officials take quite a different view. It is little wonder that paradoxes abound in this field.

The Paradox of Hegemony: A Leader Either Hobbles Itself or Enables Challengers

Much of this book is devoted to the theory and practice of hegemony. A hegemon may be simply described as a country whose power and wealth dwarf those of all other contenders, and is prepared to use these resources to guide and shape the international system. (We might alternatively call such a country a leader, an imperialist, or a bully, but even polemicists can appreciate the utility of neutral terminology.) Hegemony is more of a process than a state of being, and this distinction can pass from one country to another. The nineteenth and early twentieth centuries were dominated by French and then German challenges to British hegemony, followed by a comparatively easy transition to US leadership, just as the rivalry between the United States and China is one of the defining – and most hazardous – characteristics of the twenty-first century.

The theory of hegemonic stability first emerged in the 1970s as a way of explaining why global markets are often closed but sometimes open.[9] It rests upon the importance of public goods and the ability of a hegemon to deliver one of them. As first described by Paul Samuelson in 1954, public goods share two special characteristics: They are nonexcludable (no one can be prevented from enjoying them) and nonrivalrous in consumption (any person's use of that good does not diminish its availability to others). A sidewalk is one such example. Everyone benefits from the sidewalk; I do not exhaust that amenity when I take a stroll, nor can I lawfully push anyone else into the street. A further characteristic shared by most public goods is that they are subject to a free-rider problem, and hence they tend to be underprovided. A rational, self-interested actor sees no advantage in supplying a public good when it expects others to exploit that investment, and the sidewalk may never be built if everyone waits for everyone else to supply it. This market failure offers a rationale for the state to provide what private interests will not. We task municipal governments with building sidewalks, and the federal government is responsible for interstate highways.

Overcoming the free-rider problem is even more difficult when a public good is international. An open world market is, after universal peace, the second greatest of all global public goods. It is also predictably underprovided, with free trade having historically been scarcer than protectionism. The facile solution is to rely on global government. We have a World Trade Organization (WTO), but just how did the WTO and its predecessor, the General Agreement on Tariffs and Trade (GATT), come to be? According to the theory of hegemonic stability, we would never have produced the GATT in 1947 without US hegemony, just as the more or less open markets of the late nineteenth century depended on the Pax Britannica. Only a hegemon has both the motive and the means to supply an open global market. The motive stems from the hegemon's economic

[9] See, for example, Gilpin (1987), Kindleberger (1973), and Krasner (1976). See Meardon (2014) for the development of Kindleberger's ideas first in practice and then in theory.

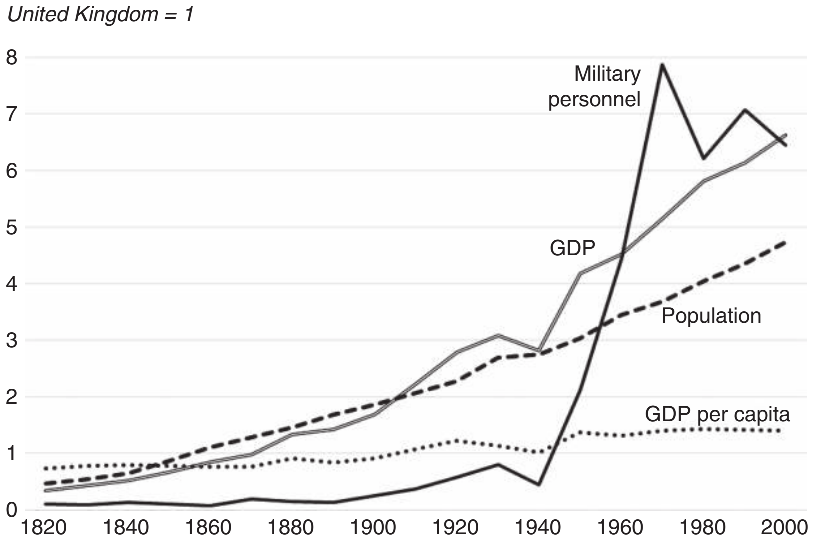

FIGURE 1.1 Power and wealth of the United States vis-à-vis the United Kingdom, 1820–2000.

Source: GDP, population, and GDP per capita from the Maddison Historical GDP Data at www.worldeconomics.com/ Data/MadisonHistoricalGDP/Madison %20Historical%20GDP%20Data.efp. Military personnel from http://correlatesof war.org/ data-sets/national-material-capabilities.

efficiency: It needs access to foreign markets to take full advantage of its competitiveness. As for the means, a hegemon has the market power and political influence to entice or coerce a critical mass of countries to join it at the negotiating table.

The theory explains why markets were generally open during the UK and US hegemonies, and why they were generally closed prior to British hegemony and again from 1918 to 1945. The Great War left England too weak to exercise its old role, and the United States was not prepared for global leadership until we got into the regrettable habit of numbering our world wars. The data illustrated in Figure 1.1 suggest that Washington could have relieved London long before it actually did so. The United States surpassed the United Kingdom in population by 1860, in gross domestic product (GDP) by 1875, and in GDP per capita by 1920. None of that mattered until the nascent hegemon stopped shirking its responsibilities. The gap between American resources and ambitions can best be seen in the relative size of the military, which remained far smaller than its British counterpart until the Second World War was well underway.[10] Prior to that conflict, Washington took only a few, poorly considered steps toward the center of the global stage. The horrors of the First World War and the failures of the Versailles Peace Conference made the American people recoil from a premature foray into leadership, but then the attack on Pearl Harbor and the dawn of the atomic era forced a complacent public to reassess its instinctive insularity. The transatlantic transfer of power was accomplished without a direct confrontation between the old and new hegemons, as the two countries shared culture, interests, and – above all – enemies.

The peaceful transition from British to American hegemony was exceptional. Political thinkers have recognized for millennia that the rivalries between hegemons and their challengers are as perilous as they are perennial, and that conflict is made all the more likely by the tendency of challengers to grow faster than hegemons. It is now fashionable to call this relationship between economic growth and political conflict the Thucydides Trap, after its original proponent.[11] "The real cause" of the Peloponnesian War, according to Thucydides, was that the "growth of the power of Athens" alarmed Sparta and "made war inevitable."[12] Athens owed its growth to mastery of ceramics and commerce, a pair of peaceful and seemingly apolitical arts that the Spartans disdained. Two millennia later, Lenin argued that the power of capitalist countries "does not change to an equal degree," and it was inconceivable "that in ten or twenty years' time the relative strength of the imperialist powers will have remained unchanged."[13] European rivalries led first to competition at the colonial periphery, and then to war in the metropolitan heartland. We should take notice whenever thinkers at the opposing poles of Western thought express essentially the same idea. For all else that divided Thucydides and Lenin, they both perceived a Law of Uneven Growth by which differing rates of economic expansion disturb the status quo, leading to political friction and war. Their only real disagreement concerned the desirability of change: Where the Greek Realist dreaded the instability spawned by unequal growth, the Russian Bolshevik saw an opening. These are not abstract musings from bygone days. China's rapid growth may be just as destabilizing as Thucydides would fear, and disrupt the equilibrium just as much as Lenin would hope. What is most remarkable about Beijing's rise is not only that it is

10 The Civil War is not captured by the once-a-decade observations shown in Figure 1.1. In 1865 the United States quite temporarily had 3.6 times as many men under arms as the United Kingdom.

11 See Allison (2015).

12 Thucydides (400 BCE), p. 355.

13 Lenin (1916), p. 144.

accelerated by the trading system that Washington worked so hard to establish, but that US policymakers had little choice in the matter. They could not have their cake without China eating it too.

This is the paradox of hegemony: A hegemon must establish an open world market to reap the rewards of competitiveness, but in so doing it facilitates the rise of its challengers. This paradox bedeviled London in its day, and Washington now faces the same dilemma. Just as the British provided Germany with the means to rise, so too has the United States enabled China's growth. But what else could it have done? A generation ago, US policymakers saw much to be gained by encouraging the world's most populous country to emerge from the chaos of the Cultural Revolution and reintegrate into the global community. That was a fateful decision with long-term consequences, even if the implications were not as apparent in the waning days of the Cold War as they are today.

The Paradox of Preferences: Discrimination Expands as Its Value Declines

The choice between openness and closure is the largest strategic decision that the community of states will make for the trading system, and critically depends on a willing and able hegemon, but the exceptions can be just as important as the rule. International society must also decide how much discrimination it will tolerate, whether in the positive form of preferences or the negative form of sanctions. Preferences may be nicer than sanctions, but they are no less an exercise of power. Yet while the benefits that a hegemon expects to derive from both forms of discrimination may grow over time, two more paradoxes constrain its ability to utilize these instruments effectively.

The paradox of preferences is that policymakers will be drawn toward trade discrimination just when the value of that tool is in decline. This paradox is a product of the hegemon's evolving economic and political position. The hegemon may focus on grand strategy and the virtues of multilateralism when its power is unchallenged, but over time the tactical deployment of discriminatory options may figure more prominently in its calculations and actions. American economic efficiency peaked just after the Second World War, which is also when Washington was most insistent that trade liberalization be deep and nondiscriminatory. As time went on and tariffs declined, however, the attractiveness of discrimination rose. One advantage of preferences is that they allow the hegemon to support poorer partners without asking a cash-strapped legislature to approve more foreign aid. The economic appeal of "trade, not aid" also rests on the benefits that it can extend to declining domestic industries. Duty-free treatment for imports of clothing from preferred partners, for example, can be made contingent on their use of American fabric. This encourages the relocation of apparel factories to the partner country while also providing a captive market for the dwindling US textile industry. These schemes have a win–win appeal, but can work only if the overall level of protection remains high enough for preferences to matter.

Preferences offer another example of how this hegemon has followed the same path as its predecessor. The United Kingdom and the United States went through a comparable sequence. Both favored an open form of bilateralism at early stages of their hegemony, and then adopted a more discriminatory approach as their own competitiveness waned. The tariff-reduction treaties that the British started to negotiate in 1860, and the comparable agreements that the United States championed from 1934 to 1946, each included most-favored-nation (MFN) clauses promising their partners that no other country would be granted exclusive preferences. If England reached a bargain with (for example) Sweden in 1875, and the United States did the same in 1935, the tariff reductions that they each extended to Stockholm (and vice versa) would be granted to all other countries to which they accorded MFN status. Both hegemons used nondiscriminatory, bilateral agreements to produce a distributed multilateral system. Britain turned to more discriminatory alternatives when it lost ground to Germany, culminating in the restrictive Imperial Preferences negotiated at the Ottawa Conference in 1932. Prior to the Ottawa Agreements, many of the British dominions operated on an "open door" basis in which they made no distinction between imports from the British Commonwealth, its colonies and territories, and the rest of the world. This reintroduction of discrimination was highly objectionable to Washington, which equated preferences with protection, but what was good for the English goose eventually became equally attractive to the Yankee gander. The United States began to negotiate discriminatory free trade agreements (FTAs) just when serious doubts emerged over its competitive position vis-à-vis Japan in the 1980s, and that process accelerated when China replaced Japan and the Soviet Union as the principal challenger to US wealth and power.

The proliferation of discriminatory programs and agreements since the mid-1970s is politically logical but economically puzzling. It would have been quite valuable for a country to enjoy preferential access to the US market in 1932, when the average tariff on dutiable goods was 59%, but in those days only Cuba and the Philippines were granted this boon. The attraction would still be high at the start of the GATT era, with US tariffs averaging 20% in 1947. Preferences were not an important part of the US trade regime until 1976, however, starting with a Generalized System of Preferences (GSP) that extended duty-free