The Challenges of a Transformed World Economy*

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The world trading system is rapidly approaching a major turning point. In the three major economies that continue to dominate and shape the world economy, new and profound forces are stirring. In Western Europe, a unified and massive market is hesitantly but surely coming into existence and, surrounding the core of the European Economic Community (EEC), a larger European Economic Space is forming with the collapse of the Soviet East European Empire. In North America, with the signing of the Free Trade Agreement between Canada and the United States, a regional trading arrangement is taking shape that could eventually include Mexico and other countries of Latin America. In the Pacific Basin, Japan is taking the lead in creating a highly integrated regional economy through the instrumentalties of trade, foreign aid, and foreign investment.

The integration of national economies into a global and transnational economy is occurring at an astonishing rate in the areas of trade, finance, and production. Today, a world market of goods and services is replacing a world economy composed of relatively isolated national markets. Domestic financial markets have been integrated into a truly global system. The multinational corporation is becoming the principal mechanism for the allocation of investment capital and determination of the location of production throughout much of the world. Western Europe has re-initiated the process of economic unification and the postwar division between Eastern and Western Europe has virtually disappeared. The North Atlantic-centered world economy is rapidly being displaced by a truly global economy in which dynamic non-European economies in East Asia and elsewhere have also become independent and self-generating sources of economic growth and technological innovation.

While this process of globalization and transnational integration is taking

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place, economic regionalism and economic protectionism are also rapidly expanding. Individual states and regional alliances are attempting to influence and, in some cases, to determine, market relations and economic outcomes. As tariffs and formal trade barriers have come down, non-tariff barriers and informal arrangements restricting free trade have proliferated and a system of "managed trade" is spreading. In the area of international finance, resistance to the further integration of capital markets is surfacing and such barriers to market entry as Voluntary Export Restrictions and local-content rules are spreading, especially in the United States and Western Europe. Although the multinational corporation is internationalizing production, alliances among individual states, among states and national corporations, and especially among corporations themselves have become increasingly significant for the organization and functioning of the international political economy.

These contradictory developments can be given two quite different interpretations. One interpretation is that a unified world economy is rapidly coming into existence where political boundaries will be of decreasing significance. This position continues to be dominant in the United States, although it is increasingly on the defensive. This interpretation focuses upon the process of global integration and argues that in the postwar era we have witnessed and are continuing to observe a linear movement toward global interdependence of national economies. Inexorable economic and technological forces are believed to drive the economies of the world to ever higher levels of economic integration and productive efficiency. While this process of economic integration and globalization is an uneven one characterized by frequent backsliding, many believe that it is nevertheless inevitable. The process may be momentarily held back by irrational forces and by threatened interests responding to the forces of economic integration with appeals to economic nationalism and demands for economic protectionism. However, in time the inherent logic of economic efficiency is expected to prevail as people, understanding that their true interests lie with a well-functioning world market, will eliminate protectionist restraints and move in the direction of increased globalization. As the American economist C. Fred Bergsten has put it, although "virtually all countries on occasion attempt to resist these external pressures... efforts to resist the forces of market globalization can
succeed only partially and for limited periods of time.”(1) Try as they might, the nations of the world cannot ultimately escape these irresistible forces of economic unification.

The second interpretation is that what is taking place in the international political economy is a dialectical process. Both the globalization of world markets and state intervention in domestic as well as international markets to achieve political security, and economic goals, are taking place simultaneously. There is no linear process occurring in which the forces of economic integration will eventually triumph over economic nationalism and result in a completely open world economy; instead, complementary developments of increasing globalization and increasing state intervention on the national and regional levels are interacting and reshaping the international political economy. The 1988 U.S. Omnibus Trade and Competitive Act, the rapid overseas expansion of Japanese foreign direct investment, and the program of the European Community for the Completion of the Internal Market by 1992, support this rival assessment of contemporary developments. As has happened in the past, the nation-state is adapting to the changing global economic, technological, and political environment.

Thus, as tariffs have come down, quantitative restrictions (QRs) on imports have gone up. For example, in 1980, just 5 percent of American imports were affected by quantitative restrictions; by 1986, 18 percent were so affected. (2) Western Europe and many developing countries have also increased the usage of non-tariff restrictions on their imports. Important sectors of the Japanese economy are and no doubt will continue to be similarly protected. Bilateral and regional arrangements such as the United States-Canadian Free Trade Agreement and the accelerated movement toward European integration are spreading. As The Economist (London) observed, “the world economy shows signs of moving towards a trading system partitioned into three blocs: the Americas, the European Community and the Asia-Pacific region centred on Japan.”(3) In brief, the regionalization of the world economy appears to be accompanying the trend toward economic globalization.

(2) Ibid., p. 72.
Movements toward globalization and regionalism are in fact complementary rather opposed developments. They reflect the conflicting desires of states and firms to enjoy the benefits of a larger world economy at the same time that they protect and, if possible, improve their own position in a fast-moving, increasingly competitive, and potentially unstable world economy. A defensive element appears to exist in all regionalism. While multinational corporations realize that they must establish a strong position in each of the three major regions of the world economy, individual states do not wish to give up control over their domestic economies. Economic regionalism is in effect an attempt to achieve a balance between these two conflicting claims.

It is important to recognize that these movements toward greater regional cooperation differ considerably from one another. As one moves westward from Western Europe to North America and thence across the Pacific, the purpose and process of regional integration becomes less political and institutionalized. The purpose of European integration is to create a European political entity and involves the establishment of complex regional institutions. The objective of North American regionalization is solely economic and involves only modest institutional arrangements. With respect to the Pacific Basin, economic regionalization is primarily the consequence of the trade and investment strategies of individual Japanese corporations whose activities are encouraged by the policies of their government.

The crucial importance of European unification and regionalization in reshaping the overall global economy has caused the American economist Lawrence Krause to speak of a one-bloc world composed of “a unified European economy and all of the rest.” Through economic and political integration the nations of Western Europe are attempting to regain the ground that they lost in World War II and during the postwar era of American preeminence; they are also strengthening their competitive position with respect to the intensifying Japanese economic and technological challenge. As this process of economic unification goes forward in one economic sector after another, from trade to monetary affairs to industrial policy, the West Europeans are in effect re-writing the rules of the emergent global economy. Whether these rules and the reactions that they

stimulate in other regions will lead to inter-regional cooperation of conflict has yet to be determined.

Three Major Challenges

The potential fragmentation of the world economy into rival and exclusive economic blocs would be to no one’s advantage. The logic and benefits of a global international economy are readily acknowledged by almost every disinterested observer. A fragmented world economy, at least over the long term, would mean a decrease in economic welfare and could lead to political conflicts. Every region of the globe would be among the losers. Yet, conflicting political ambitions and serious market imperfections are encouraging states and corporations to pursue economic strategies that, viewed from the perspective of the world as a whole, are far from optimal. The reconciliation of these two equally profound tendencies toward economic globalization and economic regionalism will be very difficult indeed.

Among American economists, two responses to the problem should be noted. The first is that of Jagdish Bhagwati who argues that global multilateralism is the only reasonable solution. The United States, therefore, should continue to press ahead with trade liberalization and work for its ultimate success over the tendency toward economic regionalism. The other position believes that, although an open world economy may be the ideal, the power of the forces behind economic regionalism has been underestimated and economic regionalism should be recognized as a response to new economic realities. Throughout the world economy, they note, oligopolistic competition and state intervention rather than free and open markets are the norm. The only choices, in the opinion of these observers, are between regionalism by default with no agreed rules and a regional world economy with negotiated rules. As Krause has pointed out, the pursuit of an ideal solution may cause us to fail in achieving what economists call “the second best” solution. Or to put it another way, we may be in a situation where the best is the enemy of the possible.

Regardless of which position may be ultimately correct, the internation-

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(6) Krause and Sundberg, op. cit., p. 41.
al community must still answer the question of how one reconciles an increasingly integrated global economy with the simultaneous trend toward economic regionalism. Such a reconciliation will necessitate the solutions of three problems. The first is that of providing political leadership for a more pluralistic world economy. The second is to resolve the conflicts arising from the increasing integration of fundamentally different types of capitalist systems. The third is for a set of rules that can successfully govern a more integrated global economy that has strong tendencies toward economic regionalism. While this paper can not hope to provide the answers to these challenges, it may assist in our understanding their significance.

The Need for Collective Leadership

Throughout the postwar era the United States has provided the necessary leadership for the world economy. However, the relative decline of American power over the course of the past two decades has decreased both the capacity and the willingness of the United States to perform this leadership function. While the United States continues to be the world’s dominant military power, American economic power has declined considerably relative to Japan and Western Europe. The United States has become the world’s largest debtor and American competitiveness has decreased in one technology after another where it once was virtually unchallenged. In addition, it should be appreciated that an important motivation behind American global economic leadership was national security and the promotion of the anti-Soviet alliance. This motive for trade liberalization has greatly declined with the diminution of the Soviet military threat. As American national priorities shift from those of the Cold War to the economic competition with Japan, Western Europe, and other rising economic powers, American economic leadership in the interest of an open world economy will surely decline.

Although President George Bush speaks of a “New World Order” and his Secretary of State James Baker talks about a “new architecture,” and despite the brilliant success of American leadership in the Gulf War, the United States does not have the resources available to exercise the lead-

(7) Krause and Sundberg, op cit., pp. 4-5.
ership that it did in the past. The continuing federal budget deficit and the failure of American political leadership to address the deficit effectively are testimony enough to the seriousness of the problem. For example, whereas the United States gave billions in aid to revive Western Europe in the early postwar era, President Bush has been able to offer only a few tens of millions to help rebuild the devastated economies of Eastern Europe. The financial constraints on the American economy cause many American and foreign observers to foresee a retreat by the United States into some form of political isolationism as the country seeks to resolve its very serious domestic social and economic problems. In fact, only Japan and Germany among the industrialized countries have the capital that will be required to build President Bush's New World Order.

Since the late 1970s and 1980s, international economic and political leadership has in fact been more equally shared by the several major economic powers. This collective leadership was principally manifested in the so-called G-7 discussions of macroeconomic policy coordination. The high point of these cooperative efforts was the Plaza Agreement of September 1985, which was successful in bringing about a substantial currency realignment. Despite several subsequent agreements whose primary purpose was to stabilize the dollar, this collective effort to manage the international monetary system has fared less well. In fact, according to two writers on the subject, frictions among the major economic powers over trade, capital, and oil has caused a breakdown in fiscal and monetary coordination. (9)

The issue posed for the international community is the need for collective leadership. The rules and institutions that have governed the world economy during the postwar era were essentially created by the United States and, to a lesser extent, other Western powers. The political foundations of these institutions, however, are rapidly eroding due to fundamental shifts in the global distribution of economic and political power. If there is to be a new and stable world economic and political order, the institutions that preside over this order must reflect the transformed underlying distribution of power. In other words, both international econo-


(9) Aho and Stokes, op. cit., p. 171.
mic and political institutions must be reformed to give increased authority and responsibility to the rising powers in the international economic and political system.

More specifically, if, as appears desirable, the United Nations and especially the Security Council are to play an increasingly important role in President Bush's New World Order then these bodies should reflect the new power realities more than they do at present. For example, it might be advisable to combine the seats of France and Great Britain into a European seat and to give the extra seat to Japan. Similarly, if Japan and especially Japanese capital are to play a greater role in the world economy it is only reasonable for Japan to expect increased authority in the IMF and the GATT. Other reforms might include increased representation of the newly industrializing countries (NICs) and the developing countries. While the specifics of reform are not important, it is important to begin thinking about the institutionalization of the emerging international economic and political order.

Harmonization or Mutual Recognition of Economic Systems

When Karl Marx coined the term "capitalism" in the middle of the last century and applied it to all market-type economies, he greatly mislead us. With the emergence of Japanese capitalism and, more recently of South Korean and other East Asian NICs, we Westerners have begun to realize that capitalist or market economies can take more than one form. In fact, it is possible to identify three distinct types of capitalist societies with contrasting modes of economic organization and functioning principles. As I shall argue below, this situation has become of increasing significance for the international political economy.

In highly oversimplified terms, the three types of capitalist economies can be identified as follows: The oldest form of capitalism is what might be called "stockholder" capitalism. In this form of capitalism, capital is owned by and primarily responsible to the stockholders. Although most Americans believe that this is the only true market economy, this type of capitalism is that found principally in the Great Britain and the United States. In contrast to Anglo-Saxon capitalism is the "corporatist" or "welfare state" capitalism of continental Europe. Although these economies differ in many respects, powerful banks and labor unions, are frequently
as important or even more important than stockholders in the governance and functioning of industrial capital. Of equal significance, this corporatist capitalism tends to be characterized by greater social welfare concerns and state interventionism in the governance of business affairs than is true in Anglo-Saxon capitalism. Finally, we have the “shareholder” capitalism of Japan and East Asia. In this distinctive form of capitalism, the firm is held accountable to a large number of interests including labor, society, and other corporate actors. More than in continental Europe, the state through “administrative guidance” and other mechanisms plays an important role in business affairs.

Until quite recently, the existence of these three different modes of capitalist organization and functioning was of little consequence. The international economy could be and was considered by economists and policy makers to be comparable to a set of “black boxes connected by exchange rates”. Policy makers were generally indifferent to what took place inside the boxes. The economic policies and economic structures of other societies were not of primary concern to their trading partners. Or, to put in another way, domestic and international economics were regarded as separate spheres. The domestic economy was an autonomous arena of economic activity and the international economy functioned according to the rules laid down by the Bretton Woods system.

This situation began to change in the late 1960s and the 1970s with the increasing interdependence of national economies due especially to expanding trade, the deregulation of financial markets, and the internationalization of production by multinational corporations. As national economies have become more interdependent, the separation between the domestic and international spheres has broken down. This trend was accentuated as services became an increasingly important component of international commerce. With these developments, policy makers in one nation become more and more concerned with those domestic economic structures and private economic practices of other societies that might affect international competitiveness and the welfare of their own nations. Thus, with increasing global interdependence, the integration of national economies, and the increasing importance of services, the differences among the three types of capitalist economies have become of greater economic and political importance.

The differences between Anglo-Saxon and continental European capitalism, on the one hand, and East Asian capitalism, on the other, have
become a source of intense controversy. In particular, several aspects of Japanese capitalism and, to a lesser extent, NICs capitalism are regarded by many as “unfair” and contrary to the spirit of a liberal, open world economy. While I shall concentrate on the issues raised by the nature of Japanese capitalism, much of what I have to say is relevant for other East Asian capitalist economies.

The first issue is what Peter Drucker has called “adversarial trading methods” by which he means “a wall around the home market to protect social structures and tradition, plus a determined push beyond it for world domination for selected Japanese industries.” The second is the highly integrated structure of the keiretsu form of business organization which both Americans and West Europeans believe to be an effective barrier to entry by foreign firms into the Japanese domestic economy. The third is “Japan Inc.” or what Westerners regard as the unfair and pervasive role of the state in the market. According to a broad spectrum of Western opinion, these three aspects of the Japanese political economy set Japan apart and necessitate a special response.

The foremost response, Drucker points out, of both Anglo-Saxon and continental capitalism to Japan and other Asian economies has been the shift away from the Bretton Woods doctrine of unconditional reciprocity to that of conditional reciprocity. The former provides that general economic concessions will be made in exchange for general concessions. The latter, on the other hand, requires that specific concessions be made for specific concessions. Not infrequently the concessions demanded are ones that in the past would have been considered by everyone as falling outside the domain of trade relations. Thus, in the so-called Structural Impediments Initiative (SII) talks, which began in September 1989 and produced an interim report in April 1990, the issues put on the agenda by the United States included such internal Japanese matters as public works expenditures, the distribution system, and macroeconomic policies.

In Drucker’s words, “reciprocity is the way, for better or worse, to integrate a modern but proudly non-Western country such as Japan (and the smaller Asian ‘tigers’ that are now following it) into a West-dominated world economy.” The United States and West Europeans, however, appear to differ in their approach. Whereas the former is seeking to

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(11) Drucker, op. cit.
remove what it regards as internal Japanese barriers to outside goods and investments, the Europeans have fashioned an impressive array of policy instruments such as local-content rules and anti-dumping regulations specifically designed to regulate Japanese imports and investments into the EEC. Although the ostensible purpose of the shift to conditional reciprocity is to force changes in the nature of Japanese capitalism and despite the differences in the American and West European approaches, the actual effect, Drucker argues, will be to increase protectionism against the Japan capitalism and accentuate the tendency toward economic regionalism.

Japan of course regards these Western actions as an effort to dictate the nature of its domestic society and an illegitimate interference into its internal affairs. There is a deep suspicion that the actions are an attempt to strip Japan of those aspects of its political economy responsible for Japanese economic success. There is undoubtedly some merit in these resentments and suspicions. While the keiretsu may very well be, as Westerners charge, a barrier to entry by foreigners into the Japanese economy, it is also without a doubt the most efficient form of business organization in the contemporary world. One can, therefore, certainly understand why Japanese economic and political leadership is reluctant to respond to what may be interpreted as Western demands to dismantle them.

Yet, the problem that the Americans seek to address in the SII talks and the West Europeans attempt to resolve with the shift to a policy of conditional reciprocity, involves a valid underlying issue: In a highly, interdependent world, different domestic economic structures and private economic practices do matter, and they impinge upon international competitiveness in ways that outsiders regard as basically unfair and illegitimate. It is necessary to ask, therefore, how much harmonization or mutual recognition of domestic economic structures and private economic practices is necessary for continued economic integration to proceed smoothly.\(^{(12)}\) Or, to put the issue differently, how much divergence in government regulations, industrial subsidies, and other state actions affecting the domestic competitive environment and international commerce is tolerable in a highly interdependent world economy? While it would be unreasonable to demand uniformity of economic structures and private economic practices, political reality requires greater convergence

\(^{(12)}\) Aho and Stokes, op cit., p. 177.
than now exists.

Both the United States and Western European nations appear to have concluded that greater harmonization of economic structures and private economic practices rather than mutual recognition is necessary in the case of Japan. And, as might be expected, they believe that it is the Japanese that must change. For them, the very nature of Japanese capitalism itself constitutes a barrier to entry to foreign goods and outside firms. And, also, as might be expected, the Japanese regard these foreign demands as not only an outrageous interference in their internal affairs, but as a surreptitious attempt to undermine the domestic sources of the comparative advantages of Japanese firms over their American and European competitors.

While there is considerable merit in both positions, the crucial issue is the political one of reconciling them in a satisfactory way. Outsiders have to be convinced that Japanese economic behavior is essentially fair; as for the Japanese themselves, they must be convinced that outside demands are legitimate. Unless this issue is resolved, the United States and West Europeans will seek to protect themselves against the Japanese, and the Japanese will conclude that once again the Western world is ganging up against them. The result could be the fragmentation of the world into regional blocs and possibly even the outbreak of economic warfare. If these developments were to occur, everyone would be a loser.

**New Rules for a More Integrated World Economy**

The problem of harmonization or mutual recognition of economic systems arises in part because the rules and assumptions of the postwar Bretton Woods system are no longer adequate to govern the international economy. These rules, with several important exceptions, reflected the American commitment to a liberal economic order, that is, one based on multilateralism, the Most Favored Nation Principle, unconditional reciprocity, the principle of National Treatment, and non-discrimination. These basic precepts were embodied in the international institutions such as the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT), that continue, at least formally, to govern the international economic system.

These rules were based on several important assumptions. One fundamental assumption was that the domestic and international economic
realms were largely independent of one another. In this compartmentalized world economy, national economies were not highly interdependent. Trade, finance, and other areas of economic activity and policy were separated from one another. Comparative advantage was regarded essentially as a product of nature rather than as a product of deliberate state policy. The basic task of the norms governing international trade was to proscribe certain types of behavior; these rules told nations what they could not do, not what they must do. They were directed primarily at formal barriers to trade and not to domestic practices and informal barriers such as government procurement and economic structures that might restrict imports. These norms were formulated for a world in which international trade was not greatly affected by foreign production by multinational corporations, financial flows, and factor movements.

Almost every one of the principal features of the postwar Bretton Woods system has changed, is changing, or is being challenged. For example, the fundamental purpose of the GATT and its rules was to govern the exchanges of products. Services, foreign investment, and intellectual property rights were left outside the rules of the GATT. At the insistence of the United States, agriculture was also excluded. Other exceptions to GATT rules were made, in particular for customs unions. The problem of the adjustment of trade and payments imbalances and the differing responsibilities of those countries with deficits and those with surpluses was never satisfactorily resolved. Moreover, as reflected in the debate over harmonization and mutual recognition, in a highly interdependent world, the rules must go beyond proscription to telling states what they must do if their trading partners are to consider their domestic economic structures and private economic practices to be basically fair. In brief, those economic activities and problems of greatest concern today in bilateral and multinational negotiations were precisely the ones that were not covered by the original GATT framework.

As the American economist Paul Krugman has pointed out, the rules and assumptions of the Bretton Woods postwar era appear to be no longer appropriate for a highly integrated world economy characterized by oligopolistic corporations, scale economies, and comparative advantage. To these obstacles, one must add the challenge posed by the task of

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integrating the three different types of capitalism. Nor are these rules, which are based on the assumption of a free and open market, really appropriate for a world economy characterized by extensive state interventionism and by an increasingly unified and powerful European Economic Community.\(^{(14)}\)

Among these changes in the world economy is the changing nature of trade itself, especially among the more advanced industrial countries. More and more, this trade is in high technology products produced by oligopolistic firms in imperfectly competitive markets. As this type of trade is closely tied to foreign investment, in the words of Canadian scholar and trade official Sylvia Ostry, it raises the highly controversial issue of “asymmetries in foreign investment and technology access.”\(^{(15)}\)

For example, whereas Japanese foreign direct investment in the United States in 1989 was $32.5 billion, American investment in Japan was only $1.64 billion.\(^{(16)}\) Moreover, as Ostry points out, a “technonationalism” is spreading that is causing barriers to arise against foreign access to domestic technologies.\(^{(17)}\)

The fundamental problem is that we now live in a vastly different world economy from the one envisioned by the founders of the Bretton Woods system. In an increasingly global economy composed of global firms producing global products for a global market, the rules and assumptions of the GATT are of decreasing relevance. GATT was designed for a world of national firms producing national products for national markets. These rules do not apply to global products with no national identity, products whose components are made in one country assembled in a second and ultimately sold in a third. Moreover, as mentioned earlier, the GATT was designed for a world in which products were mainly exchanged. It can not easily deal with services, multinational corporations, and situations where products and services are intimately joined. Its instruments to manage trade are essentially national. We have yet to formulate truly international rules.

Perhaps the solution, as some propose, is to attempt once again to create a truly comprehensive International Trade Organization that could

\(\text{(14) Krause, op cit., pp. 18-19.}
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\(\text{(15) IMF Survey, October 29, 1990, p. 322.}
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\(\text{(16) Ibid.}
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\(\text{(17) Ibid.}
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deal with the manifold issues of a complex and highly integrated global system.\(^{(18)}\) In a world of oligopolistic competition and government interventionism, it is argued, the solution lies in the area of competition policy. Through a collective effort, the major economic powers would determine what is fair and appropriate competition with respect to such matters as industrial policy and monopolistic behavior. Whatever the solution, the rules, in Krause’s opinion, must permit legitimate state interference in the market at the same time that it sets some limits on such intervention.\(^{(19)}\) Unless the challenge of formulating rules for a more highly integrated world economy is somehow resolved, the process of economic globalization is certain to slow and could even be reversed.

**Conclusion**

In his influential book, *The Economics of Interdependence*, whose subtitle was *Economic Policy in the Atlantic Community*, the American economist Richard Cooper argued that an increasingly interdependent world economy required greater international cooperation to overcome the instabilities and dangers of divergent national policies.\(^{(20)}\) Since Cooper wrote that book in 1968, the world economy has become increasingly integrated in the areas of trade, finance, and production. Today the problems of divergent regional policies must be added to those of national policies. Moreover, what was in 1968 essentially a bilateral and Atlantic-centered world economy has become a truly trilateral world economy in which Japan and the East Asian economies are of increasing significance. It is a world in which both economic globalization and economic regionalism are profoundly reshaping the world economy. In this infinitely more complex world economy, the problems of economic leadership, the harmonization of capitalistic systems, and the fashioning of new rules have become major challenges.

