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*The Shifting Roles of Business
and Government in the World
Economy*

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The Shifting Roles of Business and Government in the World Economy

by Murray Weidenbaum

The pattern of the world economy is undergoing fundamental shifts. Following the end of the Cold War, it has become fashionable to state that a previously bipolar world has now become tripolar. That is to say, the political and military rivalry between the United States and the Soviet Union has been replaced by a three-way economic competition involving the United States, Germany, and Japan. In the post-Cold War world that is developing, we are witnessing the unfolding of a far more complicated global marketplace. It is important to understand the nature of these new trends, especially as they involve and affect governments, business enterprises, and consumers. As I will try to demonstrate, the likely responses to the changing world economy will cover both the relationships among public- and private-sector organizations as well as the procedures within each of these institutions.

A Tri-Polar World?

It is true that three nations — Japan, Germany, and the United States — have become, at least for the present time, the dominant economic powers. But the reality is far more complicated than that. The United States, Canada, and Mexico are in the process of developing a North American Free Trade Agreement (NAFTA), reducing or eliminating barriers to commerce and business generally in that part of the world. We can readily foresee considerable potential for shifting people and other resources within the entire continent. Ultimately, the Western Hemisphere may become, at least in part, one major trading area. From the viewpoint of the United States, the neighbor to the North — Canada — has long been the number one trading partner. Now Mexico, the neighbor to the South, has become the

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second largest market for American-produced goods and services. The trend to regionalization is clear.

The North American Free Trade Agreement will make Mexico a more attractive place to invest because that nation will have to relax its many restrictions on foreign investment. Perhaps some legislative revisions will be necessary on the part of the United States in the area of labor and the environment in order to win congressional assent. Nevertheless, the logic for open trade among the three major North American nations seems overwhelming.

Surely focusing on the United States is too limited. People outside of the Western Hemisphere are now beginning to realize that many nations in Latin America have now begun to experience sustained economic growth. The region as a whole grew by over 3 percent in 1991 and is repeating that performance in 1992. The development of a broad Western Hemisphere trading relationship is increasingly possible in the early years of the twenty-first century.

Likewise, Germany is by far the most important economy in Europe, but the development of the European Community (EC) is a very ambitious and far-reaching undertaking transcending any one nation. Personally, I discount the controversy over the Maastricht agreement and the reluctance to increase the monetary and other powers of the Brussels bureaucracy. Indeed, I sympathize with that reluctance. But that controversy should not overshadow the very positive progress being made towards creating one internal market in the EC. With the completion of the EC '92 agenda of eliminating internal barriers to trade and investment, the twelve-member EC is becoming the largest marketplace and represents the greatest concentration of economic potential in the world.

Moreover, many other nations are interested in joining — notably Austria, Sweden, Finland and the other members of the European Free Trade Association (EFTA). Later on, perhaps as associate members, countries in Eastern Europe, especially Hungary, Poland, and the Czech republic may become active candidates for membership in the EC.

We should remember that the membership of the EC has not been static. It started off with only six countries — West Germany, France, Italy, and the Benelux Three (Belgium, Netherlands, and Luxembourg). Over the years, the size doubled, with the gradual addition of the United Kingdom, Denmark, Ireland, Spain, Portugal and Greece.

Already, the twelve member nations of the EC do the bulk of their "foreign" trade with each other — about 60 percent. That is a fundamentally different pattern of commerce than the one that existed prior to the formation of the EC, when three-fifths of the external trade of the twelve countries was with other nations. The current internal trade ratio of 60 percent is likely to rise further when other European nations enter the EC trading arrangements later in the 1990s. The six members of EFTA are already in the process of entering into an agreement to eliminate trade restrictions in their commerce with the EC.

Turning to the Asian rim, this part of the global marketplace represents a far more complicated area to analyze than either Western Europe or North America. Formally, there is no counterpart to either the EC or NAFTA. The governments of this region have not embarked on an effort to link their economies or to eliminate barriers to trade and investment. However, the informal commercial and investment relationships across this region are quite significant and deserve some attention. For example, like the EC, about three-fifths of the international trade of the Asian rim countries stays in the area. This is a very different view than most Western observers hold of this region. Thus, we have here a more inward-looking region than many people located outside of the Asian rim yet realize. As we will see, the continued rapid growth of the countries in this region is likely to accelerate the importance of Asian markets for the exporters in this region.

The role of Japan is especially impressive. Americans often are preoccupied with companies in other nations buying some of our key economic assets. Thus, we do not always appreciate the fact that Japan is a major source of foreign investment for such nations as Thailand, Malaysia, and Indonesia. Japan is also the major source of imports for those countries and the major destination for their exports. ASEAN or the Association of Southeast

Asian Nations (Malaysia, Indonesia, Philippines, Thailand, Singapore, and Brunei) is now a larger market for Japan than the United States. Seven countries in the area now buy more from Japan than from any other nation — Malaysia, Indonesia, Singapore, Thailand, South Korea, Taiwan, and the Philippines. Moreover, in the near future it is likely that Japan will provide the largest market for the ASEAN exporters. That is already the case in Indonesia and Malaysia — as well as Australia.

However, these are not isolated situations. The other more advanced economies in the Pacific rim — notably South Korea, Taiwan, and Hong Kong — are also large providers of investment capital and have become key trading partners for the less economically advanced nations in this region. For example, Hong Kong and the neighboring Chinese province of Guangdong have attracted considerable foreign investment. In fact, what some observers call the greater "Hong Kong enclave" is likely soon to enjoy a gross domestic product as large as that of France.

Paced by a rapid rate of investment and given the abundance of trained human capital, the Asian rim has become the fastest growing part of the world, averaging over five percent a year in real economic growth. That trend is generally expected to continue at least for the rest of this decade and perhaps well into the twenty-first century.

A Chinese Economic Area?

Without underestimating the strategic role of the Japanese economy in the Asian rim, there is another way of looking at economic developments in this region. Over the years, scholars in the United States have referred to the Chinas as a multiple — two Chinas, three Chinas, and more. They have in mind the fact that several of the major economies of this region have a predominantly Chinese population. In addition to mainland China, this category includes such other rapidly growing areas as Taiwan, Hong Kong, Macao, and Singapore. The overall Chinese economy includes other key locations where business executives, traders, and financiers of Chinese background make important economic contributions.

It seems quite clear that the "Chinese-based economy" has resisted the global recession which has plagued virtually every advanced industrial nation. This informal economy is currently the world leader in terms of economic growth, industrial expansion, and exports. It contains an array of potential consumers that far exceeds the markets in Europe or the Western Hemisphere.

This dynamic pattern contrasts with the recent slowdown in the pace of Japanese economic and financial activity. Japan's foreign direct investment flows reached a peak of \$67 billion in 1989 and have been declining since. The 1991 total came to a modest \$41 billion, lower than the 1988 rate. Japanese direct investment in Asia declined simultaneously, from a peak of a little over \$8 billion in 1989 to less than \$6 billion in 1991. Moreover, Japanese banks have tended to reduce their participation in the international banking market. The \$53 billion reduction in their foreign banking assets in the second quarter of 1992 was the largest recorded to date. Of course, in absolute terms, Japan continues to be the dominant economy in Asia and will continue to hold that position for many years.

Nevertheless, some analysts believe that the Chinese-based economy of Asia is rapidly emerging as a new epicenter for commerce and finance. This strategic area contains substantial amounts of technology and manufacturing capability (Taiwan), outstanding marketing and services acumen (Hong Kong), a fine communications network (Singapore), a tremendous pool of financial capital (all three), and very large endowments of land, resources, and labor (mainland China). A talking doll, to take a modest example, may be designed in Hong Kong and assembled in China, with a computer chip made in Taiwan.

The informal Chinese economy differs from the more official economies which usually are dominated by large multinational firms. The Chinese-based economy consists mainly of midsize family-run firms, rather than the huge corporations characteristic of Japan, Western Europe, and the United States. From Guangzhou to Singapore, from Kuala Lumpur to Manila, this influential network — often based on extensions of the traditional clans — has been described as the backbone of the East Asian economy. A substantial amount of cross-

investment and trade takes place, often on a family basis. Frequently, these business ties involve "overseas" Chinese who are dealing with people in the province of China from which they or their ancestors migrated (*tongbao* or compatriots).

Several economic indicators, ranging from modest to basic, illustrate the point. Eight years ago, the special economic zone of Xiamen in mainland China booked 10 telephone calls a month to Taiwan. Currently, such calls are averaging 60,000 a month and the number continues to rise. In 1987, fewer than 7,000 Taiwanese visited the mainland. The current rate is approximately 1 million a year. Bilateral trade, which can legally be conducted only through third countries, was about \$1.5 billion in 1987. The current figure is about \$6 billion, a four-fold increase. In addition, about 4,000 Taiwan enterprises have set up factories in China, mainly in the south.

The current state of interdependence between mainland China and Hong Kong is also striking, at least to an outsider. Each is the other's largest trading partner and largest source of external investment. Apparently there were far more people working in China for businesses owned by Hong Kong or on orders received from them than the entire manufacturing work force of Hong Kong itself (in a reported ratio of 4 to 1). The data support the conclusion of William Purves, chairman of the Hong Kong Bank Group, that "Investment and expertise channeled from Hong Kong have turned southern China into one of the industrial powerhouses of Asia."

At the more macroeconomic level, some private analysts, adding up the foreign exchange reserves of the various Chinas, come to a present total of \$200 billion, or far in excess of that of any other economic power. This is an impressive aggregation with considerable potential for influencing the direction of future economic developments.

Indeed, in 1991 Taiwan alone was the largest single foreign investor in Malaysia and also in Vietnam. Cumulative foreign direct investment from the newly-industrialized economies of Taiwan, Hong Kong, and Singapore is beginning to surpass that of both Japan and the United States in Indonesia, Malaysia, and Thailand. Not too surprising, the rapidly

developing Asian rim countries are turning to new suppliers within their own region for their imports. These newly developing countries now buy 33 percent of their imports from other nations within the region compared to less than 24 percent as recently as 1985.

Former World Bank president Robert McNamara has provided an upbeat long-term appraisal of China's economic prospects. He states that, if China achieves its economic goals for the year 2000 and then moves forward at satisfactory but not spectacular growth rates, that nation's per capita income in 2050 may be roughly equal to that of the United Kingdom in 1965. The total size of its economy would approximate that of the United States or Western Europe. One U.S. economist estimates that the economy of mainland China alone will exceed that of Japan by the year 2020, if not sooner.

Merely contemplating the economic implications of extension of current trends into the twenty-first century is awe-inspiring. I leave the subject of potential political unification to others, and I will focus on the economic aspects. Surely the more complete industrialization of this part of the world is a prospect that Western analysts have not fully examined, although a few already are referring to a forthcoming "Chinese Century." The "Chinese Productivity Triangle" is another, and more modest, description that is in use. It is no exaggeration to state, as has Professor Robert Wu of Chinese University of Hong Kong, that Greater China is a potential economic superpower.

In any event, a historical parallel comes to mind: the key role in international commerce of the Hanseatic League. For many centuries during the late middle ages, the League tied together first the merchants and then many of the cities of northern Germany and the Baltic area. Historians stress the fact that the Hanse cities did not set up a joint or unified government. Rather, the business and government leaders cooperated on matters of mutual economic and financial interest. A shifting array of participants can be identified over the centuries. Some of the large German cities in the qualifying area did not participate at all, and many entered into the cooperative arrangements for only limited periods of time.

Unlike the European Community or the North American Free Trade Agreement, the

Hanseatic League was not a compact among sovereign powers, nor did it constitute a supergovernment. Individual members continued to owe their traditional allegiance to the specific political power that controlled the part of the region in which they resided. Technically, the League was an amorphous organization, lacking legal status and possessing neither finances of its own nor an independent army or navy.

Nevertheless, the Hanse merchants cooperated in many important ways, providing mutual support in times of danger. They constituted an identifiable economic grouping which competed with businessmen from Holland, Italy, and on different occasions, many of the nations facing the Baltic Sea. Despite the obvious limitations of a nongovernmental organization spread over considerable distances — Bergen in Norway was an important Hanse location as was Novgorod in Russia — for almost five centuries the Hanseatic League was an economic power to be reckoned with.

Personally, I have no crystal ball which permits me to forecast with any degree of assurance the direction of the future nature of economic relationships in Eastern Asia. Will a modern version of the Hanseatic League be created? Will a counterpart to the European Community arise? Will the more modest arrangements being developed in North America be the precedent that will be followed? Or will the present informal relationships be relied on in view of their substantial success?

Whatever the answer, we must acknowledge that trends rarely move in a straight line for an extended period of time. In the recent past, we have seen setbacks occur in the economic and political development of Southeast Asia and future detours are likely. Nevertheless, unifying forces seem to dominate, especially in the long run.

Whichever course is followed, it is reasonable to expect that some type of response will occur to the economic unification that is now occurring in the two other major competitive areas, Western Europe and North America. It is intriguing to note that economic experts from the various Chinese-speaking areas met earlier this year to discuss the possibility of a Greater Chinese Economic Zone.

Responding to Trade Barriers

It is useful to compare the emerging trading regions or blocs with the great expansion of business enterprise. Governments continue to raise or maintain barriers to commerce in an effort to protect domestic production and employment. Simultaneously, the pressures of economic incentive and technological change impel companies to seek resources and markets on a world-wide scale.

Let us examine the many ways that companies respond to government-imposed obstacles. In a passive mode, exporters can absorb the added costs imposed by governments — at least to some extent. In the case of import quotas, companies frequently shift to higher-priced items. This was the response of South Korean and Taiwanese shoe producers in the late 1970s to numerical limits on the imports into the United States of shoes from those two countries. It is ironic to contemplate the effect of this attempt at U.S. protectionism: unit profits rose for foreign producers, while unit prices increased for American consumers.

In a more active response to governmental trade barriers, businesses draw on a variety of alternatives to direct exporting. In many cases, they set up new manufacturing facilities (so-called greenfield operations) in the host nation. On other occasions, they buy up existing local firms. This is the dominant way that U.S. firms establish a continuing presence in Western European markets. Other alternatives that business firms rely upon to develop positions in the markets of other nations include subcontracting production, purchasing locally, and developing new products jointly with local firms.

But multinational enterprises frequently face sharp limits to foreign ownership of local businesses. These may be direct investment barriers, or indirect but often equally powerful tax, regulatory, and foreign exchange advantages limited to local companies. As a result, international enterprises often enter into joint ventures with local firms who can reap the benefits of the special treatment. For these reasons, in Asia and in Eastern Europe, joint ventures and other strategic alliances are often the dominant modes used by foreign companies attempting to develop a presence in local markets.

Joint ventures and other cooperative strategies are often considered as "second-best" relative to exporting or the operation of a wholly owned facility. However, they can provide important benefits. These include, in addition to market entry, the advantage of working with a partner that is knowledgeable about the local market, as well as the sharing of production costs and risks.

In some circumstances, a host government may be willing to accept the construction, expansion, or acquisition of a local branch by a foreign company on the condition that the firm meets a specified performance requirement or provides other concessions. Before IBM was allowed to increase its operations in Mexico, the company agreed to set up a development center for semiconductors, to purchase high-technology components from Mexican companies, and to produce software for Latin America in Mexico.

In the case of defense production, some of the cross-border alliances may at their heart be involuntary on the part of the foreign partner. Many companies have been given a greater role in the development and/or production of the military aircraft their governments were buying from more advanced nations as part of the overall procurement agreement. In the case of more standard manufactured goods, other ways around investment barriers include entering into agreements with local firms who will produce the item under licensing arrangements. For services, franchising to a domestic enterprise serves a similar purpose.

These governmental obstacles include local political or industrial pressures, local distribution systems strongly favoring home-produced products, and heavy transportation costs. Enterprises in advanced economies can thus respond to attractive overseas markets without directly penetrating them. Some U.S. workstation manufacturers have established licensing partnerships with Japanese firms desiring to enter the world-wide workstation market in return for access to the lucrative Japanese portion of the important computer market.

Governments on occasion restrict repatriation of earnings or foreign businesses fear future expropriation of their assets. In such circumstances, uncertainty as to future public-sector policies constitutes a major obstacle to investments by foreign firms. Global enterprises

still interested in doing business in such locations often set up affiliate or correspondent relationships with local firms. This minimizes risk and liability — and also limits profit potentials.

In many other instances — especially in the more developed nations — companies face high business taxes and onerous regulatory costs. Not all of these barriers are erected by foreign governments. When these barriers occur in the home country, the enterprise has the option of expanding overseas. In more extreme cases, entire business operations are moved to a more favorable policy environment in another country.

Companies which have difficulty introducing products in the home country due to delayed approval or stricter governmental requirements can license their products to firms in other countries in an effort to introduce them to markets more quickly. The highly regulated pharmaceutical industry in the United States appears to be in this position.

It is helpful under these circumstances to do business in several countries. In that event, when faced with rising government burdens in one nation, a firm can shift its high value-added activities to other nations in which it operates, specifically those with lower taxes and less burdensome regulation. In the case of informal barriers — such as in nations whose traditions tend to favor established companies over newcomers — the response by foreign firms often is to market through local distributors. It should be emphasized that traditional business reasons are also involved in the choice among the available methods of penetrating foreign markets. Indeed, those business concerns — such as cost and transportation advantages — may often be the dominating influence.

The Feedback on Government Policy

In the years ahead, the combined power of economic incentives and technological change will increasingly have feedback effects on the decisions of voters and government officials as they develop new national (and regional) policies dealing with the global economy.

In a basic sense, the mobility of enterprises — of their people, capital, and information — is reducing the power of government. Public-sector decision makers increasingly are being forced to understand that they now have to become internationally competitive in the economic policies they devise. Governmental activities that impose costs without compensating benefits or that reduce wealth substantially in the process of redistributing income undermine the competitive positions of domestic enterprises. The result is either the loss of business to firms located in other nations or the movement of the domestic company's resources and operations to more hospitable locations.

Political scientists and economists have long understood that people vote with their feet. They leave localities, regions, and nations with limited opportunity in favor of those that offer a more attractive future. In this era of computers, telephones, and fax machines, enterprises are far more mobile than that; information — that key resource — can be transferred in a matter of seconds, or less. The fear of losing economic activity to other parts of the world can be expected to reshape future domestic political agendas in fundamental ways. Even if many of those public-sector barriers remain, the private sector will increasingly learn how to overcome them or even just to live with them. Of course, there are costs involved when businesses respond to governmental barriers to international business. At times, these costs may be very substantial, especially in the short run. However, in a global economy, these barriers become far from absolute.

The shift in influence from the public sector to the private sector is underscored, especially in the United States, by the end of the Cold War. During the old rivalry between the two military superpowers, the national government by necessity played the dominant role. The position of the private sector was that of a supporting player. Business enterprises produced the weapons needed by the armed forces, but under detailed governmental supervision.

In the civilian-oriented economy, these responsibilities are reversed. It is the business firm that makes the key decisions which determine who is employed, what products they

produce, and how competitive is the result. Government still has a vital part to play, but it is as a supporting player and facilitator.

The Feedback on Business Decisionmaking

In addition to altering government policy, the global marketplace also exerts an important feedback effect on business decision making. Many multinational companies are now becoming transnational organizations with activities and responsibilities spread across many parts of the world. The traditional notion of a single powerful center of corporate control and decision making is frequently becoming passé.

For an increasing number of transnational companies, profits and sales from abroad — on occasion from a single foreign country — surpass that of the country of origin. In that sense, these businesses are losing their national identities. An external observer of one of these enterprises sees large flows of resources, people, and information among relatively interdependent or autonomous units. The absence of traditional centralized controls increases the reliance on the good will of the many participants. This requires a changing process of coordination, cooperation, and shared decision making.

The largest, pace-setting firms are often taking on many of the characteristics of an open and interactive network. They selectively share control, technology, and markets with organizations beyond their formal structure. As a result of rapid changes in technology and markets, the traditional boundaries between formal enterprises and more informal business relationships are gradually blurring. Especially in knowledge-intensive forms of production, the distinction between maker and user is neither as clear cut nor as invariant as it is in the case of the production and distribution of physical goods.

Just as there are transaction costs in transfers between firms, similarly there are internalization costs in intra-firm relationships, especially when they occur across national borders. The transnational enterprise relies more heavily on its own intellectual resources than does the old-fashioned exporter. This is particularly the case compared to the domestically

oriented producer that sells overseas through a separate international trading company. The newer form of enterprise has to gain knowledge of foreign markets, including relations with local suppliers and dealing with several levels of foreign governments.

Of course, networking is not a totally new concept. The basic idea, if not the term itself, is traditional in such non-manufacturing sectors of the economy as construction and contract research. In both of these sectors, many of the key decisions on a product or structure are made by firms other than the prime or lead contractor. The shifting role of government and the changing nature of global markets underscore the growing need for business leaders to continuously experiment, to learn to manage complexity, and to live with ambiguity.

Conclusion

The tension between business and government is not new. It is being exacerbated by the rapid rate of social, economic, and technological change around the globe. Fortunately, there is a third force that I believe ultimately will carry the day — the citizen as consumer. In spending their own money, consumers give far greater weight to price and quality than country of origin. The real liberalization of international trade and investment in the years ahead will arise, not from changes in government policy, but from the competition among firms in the private sector of the various national and regional economies.

To the extent that human capital is increasingly seen as the key resource in business and economic competition, the nations and companies that perform well will be those that can generate, attract, and keep educated, skilled, and experienced workers, managers, and entrepreneurs. For a nation like the United States, that means more than borders that are more open than at present. It means encouraging the entry of immigrants that can contribute most favorably to the society and to the economy of which it is a vital part.

Looking ahead to the twenty-first century, the Chinese economic and trading area might well reach across the Pacific. It would form a major part of the economic and Pacific equivalent of NATO, the North Atlantic Treaty Organization. But unlike NATO and like the

Hanseatic League of old, that area would not be dominated by a single government unit or depend on a military or political pact. On the contrary, it would be both contributor to and beneficiary of the world's largest and most open commercial region.

In any event, the rapidly changing global marketplace of the 1990s, and likely beyond, will provide both threat and opportunity for business firms, governments, and consumers. Invariably, this change will generate both winners and losers. The outcomes for specific individuals and organizations will depend in large part on their ability to understand and to respond promptly to changing economic and technological trends.

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