Time to End Rampant Mercantilism

By Robert Atkinson, President, Information Technology and Innovation Foundation

The global downturn has sharpened the debate over whether the current structure of globalization is sustainable. But the debate over globalization was there before and will be here after the crisis, unless we take steps now to create a new kind of globalization that shifts nations' core economic strategies away from mercantilist, export-led strategies to innovation-based, domestic growth strategies. This is particularly important because with the ICT revolution, nations' economic prosperity is increasingly based on how well they use ICT, not just how well they produce it.

ICT is in fact driving growth in most G-20 nations today. Looking just at the economic impact of the commercial Internet, ITIF has estimated that the global economy is $1.5 trillion larger than it would be otherwise and by 2020 will add roughly $3.8 trillion annually to the global economy—more than the total GDP of Germany. The economic benefits of IT are even larger (including not just the Internet but the use of computers and other ICT). ITIF has estimated that because of the impact of the IT revolution, the U.S. economy is approximately $2 trillion larger in terms of annual GDP than it would be otherwise.

Why has ICT had such far-reaching and profound effects? The short answer is because ICT is what economists call a "general purpose technology." As ICT (hardware, software and telecommunications) has gotten cheaper, better and easier to use, it has become pervasive in its use and its impacts, going far beyond the Internet and personal computers. ICT is embed-

ded in a vast array of products, and not just technology products. Indeed, in 2006, 70 percent of microprocessors did not go into computers but into cars, planes, HDTVs, etc., enabling their digital functionality and connectivity. Connecting these IT tools is a robust and growing wireless and wireline telecommunications network.

The emergence of this power digital economic engine means that it is now possible to significantly raise productivity and growth in a whole host of sectors that were long considered "stagnant," many of which like financial services, wholesale and retail trade, hospitality services, are not mostly traded internationally. Unfortunately, many nations today are overlooking these significant opportunities for ICT-enabled growth, instead preferring to focus on growing their economies by increasing their exports and reducing their imports, particularly in the limited number of high tech industries. These nations operationalize this export-led strategy by a wide array of means, many of them with negative-sum, beggar-thy-neighbor effects. These tactics include tariff and non-tariff barriers to imports, subsidies to attract investment and promote exports, forced technology transfer and production offsets, theft of intellectual property, and tax policies, including border-adjustable value-added taxes, that subsidize exports. And many nations, especially China, turbo-charge these tactics by rampant and widespread currency manipulation designed to give their nation's products and services a subsidy in the global marketplace.

At the heart of these negative-sum policies is a misguided economic philosophy that many nations have mistakenly bought into: a mercantilism that sees exports in general, and high-value added exports in particular, as the Holy Grail to success. A generation ago many nations thought that import substitution was the Holy Grail. But as that was shown to be a failure, most switched to export-led growth strategies, through repressed domestic consumption, low labor costs, and policies to favor exports and limit imports.

There are two major problems with this approach. First, even if this strategy might have worked for some smaller nations like Taiwan and South Korea in the past, it simply cannot work today. Neither markets in the United States or Europe—or even both combined—are large enough if nations like Brazil, China, India, Russia, and Japan continue to promote exports while limiting imports as their primary path to prosperity.

But there is a more fundamental problem with this pervasive mercantilism. It is just bad economic policy for most of the nations pursuing it and certainly for the global economy as a whole. While it might lead to higher wealth in a few relatively small export-based industries, it does nothing to raise productivity in the rest of the economy. For example, while the Indian IT sector has created new opportunities for India, it accounts for only around three percent of national value-added. Productivity in India is just eight percent of U.S. rates, while Chinese productivity is but 14 percent. The productivity gap is better but still problematic in more developed nations. Despite some extremely productive and innovative multinational export-based firms, overall Japanese productivity is just 70 percent of U.S. rates and South Korea just 50 percent. Attract all the multinational chip factories or software support centers they want, without higher productivity levels across the board in all sectors, it will be extremely difficult for these nations to significantly raise their standards of living.

These anemic levels of productivity in non-traded sectors do not occur by happenstance. They are a result in part of these nations focusing on mercantilist practices for their traded sectors. These policies win the favor of powerful constituents, including domestic producers seeking protection from competition, including foreign competitors (as small retailers have done in India to limit Wal-Mart from selling to consumers); businesses and consumers who don't want to pay for products with high levels of intellectual content (e.g., software, music, movies and other content, and pharmaceutical products); workers and their unions seeking policies to protect their jobs from competition and automation; and government bureaucrats whose top-down control is challenged. In contrast, mercantilism only risks alienating some WTO officials, who normally turn a blind eye to such practices.

As a result, over the last several decades the global economic system has become systematically distorted, with an increasing number of nations favoring beggar-thy-neighbor policies to attract and grow high wage industries. These policies lower, not increase global output. When a nation engages in mercantilist policies it is by definition distorting the location of economic activities compared to where it should locate. For example, if China forces Boeing to produce aviation parts in China as a requirement for letting Boeing sell jets in China, the odds are that this lowers global innovation and productivity, because absent this threat Boeing would produce parts in other factories with higher productivity. Likewise, when nations turn a blind eye to theft of intellectual property, they reduce revenues for the producers of that

IP, in turn reducing their ability to invest in innovation or higher productivity. And when nations keep their currency artificially low they contribute to production shifting from more productive and innovative plants to less productive and innovative ones.

If export-led mercantilism is not the answer, what is? The answer is an economic policy grounded in what is increasingly known as "innovation economics." Innovation economics is based on the view that the path to higher incomes is raising domestic productivity by all firms in all sectors. It is also based on the view that it is not the amount of capital (financial or human) that nations have that is most important, but how that capital is used. And it is based on the view that micro-economic factors (e.g., product and labor market competition, technology policies, etc.) are more important to growth than macro-economic ones.

Under an innovation economics doctrine, the central task of global economic policy should be to encourage all nations to make raising domestic productivity a key priority. In particular, policies should seek to spur competition and the use of the best production tools–often by increasing the use of ICT to raise the productivity of all sectors. For example, Indian retail banking is just nine percent as productive as U.S. levels and its retail goods sector productivity is just six percent. If India could raise productivity in these two sectors to just 30 percent of U.S. levels, it would raise its standard of living by over 10 percent.

Doing this, however, means working to develop a global consensus that domestic productivity growth should be the key focus on economic policy in every nation. This can start by the nations who engage less in mercantilism (particularly the United States, Canada, and Europe) agreeing to cooperate to fight it. In particular, it is time for Europe and the United States to recognize that just as fighting communism was in our collective interest after WWII, today fighting mercantilism is in our collective interest in the 21st century. Joining the fight should be global bodies like the WTO, international development organizations like the World Bank and the IMF, and national or regional development organizations like the Agency for International Development, the Overseas Private Investment Corporation, and the European Bank for Reconstruction and Development. These organizations need to commit to not only stop promoting export-led growth as a key solution to development, they also need to tie their assistance to steps taken by developing nations to move away from negative-sum mercantilist policies, especially currency manipulation, thereby rewarding countries whose policies are focused on spurring domestic productivity, not on protecting the status quo.

Globalization is a wonderful vision and can be an even more wonderful reality, but only if nations abandon negative-sum mercantilist policies and embrace innovation economics policies focused on raising productivity for all sectors, and making sure that all individuals can benefit from this growth. If that happens, developed and developing nations will benefit greatly.