



Economic Competition & International Trade: From Decoupling to Industrial Policy *A Response from Eric Chewning*

As Brent McIntosh adeptly points out, “Support for U.S. economic competitiveness is not fundamentally a discrete set of policy proposals. It must be an integrated policymaking mandate.”

But what would such a policymaking mandate look like? Particularly one that might appeal to limited government, free-market-oriented conservative internationalists.

The example from President Ronald Reagan’s 1985 Commission on Industrial Competitiveness might be helpful. The commission, convened in response to Japan’s rapid economic rise, was led by John Young, president and chief executive officer of Hewlett-Packard. It recommended a focus on crosscutting policies to improve America’s business environment for all companies—that is, a “horizontal” industrial policy emphasizing four areas: technology, capital, human resources, and trade.¹

The Young Commission also offered a particularly useful definition of competitiveness:

The degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while at the same time maintaining or expanding the real incomes of its citizens.

¹ For context, industrial policies are targeted government interventions with the aim of increasing the positive externalities of select economic activities. In theory, industrial policies address market imperfections. In an environment with full information and strong governance, policymakers should invest selectively to take advantage of externalities and spillovers that some activities have relative to others. In practice, governments face two key issues: imperfect understanding of existing constraints, incentives, and opportunities and their vulnerability to corruption, manipulation, and rent seeking. These policies can vary between “vertical” policies that favor specific firms or narrow sectors and “horizontal” policies that target broad sectors by improving their business environment. The more “horizontal” these policies are, the more they approach the characteristics of public goods.

Note three important concepts: free and fair market conditions, the test of international markets, and rising standards of living at home.

By this measure, America's performance in the 21st century has been mixed. Since 2001, the U.S. trade deficit, the amount by which we import more than we export, has grown by 121 percent. On the other hand, per capita GDP, a measure for standard of living, grew by 71 percent.

In contrast, since entering the World Trade Organization in 2001, China's trade surplus has grown by 1,853 percent and its standard of living has increased by 1,022 percent.

Now, U.S.–China economic relations are not necessarily zero-sum, and China should be expected to outperform on some metrics given the significantly lower base of economic activity. That said, such rapid economic growth is unprecedented. For example, the closest analogue might be Japan's economic growth from 1973 to 1995, when its economy grew by a factor of 12. China's recent economic growth is a factor of 16. Today, it is the world's second-largest economy in absolute terms—and the largest when measured on the basis of purchasing power parity.

China's State-Capitalism Approach

China's model of state capitalism is based on investment spending, significant state ownership of the largest companies, controlled market access for foreign players with forced technology transfer, direct intervention in markets and firms, and blurred lines between party, state, and corporate leaders.

Over the past two decades, China has seen significant GDP growth and rise in incomes, supported by significant rates of investment in assets like capital equipment, factories, residential structures, and inventories (approximately 45 percent of GDP versus 20 to 30 percent in peer economies).

These investments are enabled by China's high household savings rate (23 percent of GNI versus 8 percent in the United States). Households save money that is then lent by state-owned banks to corporations that use that money to invest in their business operations.

A significant portion of this lending goes to state-owned enterprises (SOEs), which represent approximately 30 percent of the full economy but 65 percent of the largest 500 firms. SOEs are contributing to China's rising rates of corporate debt (150 percent of GDP versus 75 percent in the United States).

The majority of large SOEs are wildly inefficient and destroy value, with economic profit concentrated in a handful of “superstar” private sector entities. Their size, protected status, and state subsidization enable SOEs to bring down the expected returns of global industries like manufacturing. This contributes to the economic pressures to move work from higher to lower cost regions.

Going forward, this state-capitalism model may be challenged as China’s annual GDP growth slows. The experience of comparable developing economies suggests there are several potential structural challenges to China’s growth trajectory, including slowing productivity gains, shifting demographics, lack of globally competitive multinational companies, and rising corporate debt levels. Much hinges on China’s ability to reduce reliance on debt-fueled investment as a growth driver and boost consumer spending and productivity in the economy.

An Integrated Policy Response for American Competitiveness

As McIntosh rightly calls out, “Policymakers must also recognize that their goal should be protecting the U.S. business environment, not individual businesses.” This is a foundational concern with Chinese state capitalism: It undermines the U.S. business environment. Therefore, U.S. policymakers need to get China to change its behavior and/or take steps to improve the competitiveness of U.S. companies.

The Trump Administration’s Section 301 Tariffs (which are still in place) were launched, in part, to further the first objective. Let’s briefly explore the second.

A horizontal industrial policy focused on American competitiveness should have five objectives:

1. *Capture growth from trade shifts.* McKinsey Global Institute estimates \$4.6 trillion in trade flows could shift over the next five years because of both economic and noneconomic factors. To capitalize on this opportunity, policymakers and business leaders need to work together to ensure a level playing field for companies based in the United States and like-minded countries. This includes working with allies on things like standard-setting in new technologies, mutual defense trade agreements, and incentives to replant supply chains out of China.

2. *Ensure access to capital.* U.S. investor expectations for rapid returns make investment in physical capital less attractive. U.S. firms in capital intensive manufacturing industries average higher returns on invested capital than European and East Asian

counterparts, but they have failed to reinvest in plants, property, and equipment. Depreciation of physical capital is outpacing investment, resulting in a net aging of equipment and facilities. Equipment tends to be older, particularly in industries with more small and mid-sized manufacturers—indicating that smaller firms may struggle to invest in modernizing equipment.

3. *Adopt Industry 4.0 technologies.* In order to boost productivity, American manufacturers need to embrace digitally enabled technologies, processes, and business models. However, early indications on U.S. competitiveness are not encouraging. For example, the World Economic Forum Global Lighthouse Network highlights factories that serve as aspirational targets for the adoption of Industry 4.0 digital manufacturing technologies. Currently, just 7 of 69 lighthouses operate in the United States. Twenty operate in China.

4. *Foster resilient supplier ecosystems.* Firms thrive in ecosystems surrounded by suppliers and research institutions. Business leaders and federal, state, and local governments need to work together for a holistic approach to address the health and comprehensiveness of many small- and medium-sized suppliers—an effort that would have positive implications for spurring new economic activity.

5. *Focus on developing people, not just saving jobs.* As production technology changes, so too must the workforce. Real wages for production workers have increased by only 6 percent since 1997, while the U.S. median income has risen by 34 percent. One industry survey found a “technical skills gap” to be the most likely cause of derailed manufacturing plans in the next two to four years. U.S. firms must address the underlying factors that have made attraction and retention increasingly difficult.

Conclusion

Given the ability to translate economic output to military power, there are national security implications to economic competitiveness. As President Reagan said in his 1987 State of the Union Address, “It is now time to determine that we should enter the next century having achieved a level of excellence unsurpassed in history. We will achieve this, first, by guaranteeing that government does everything possible to promote America’s ability to compete.” Now, a quarter way into the 21st century, it is clear that democratic governments have a necessary role in addressing the market-distorting impact of China’s state-capitalism model, so that their companies can compete.