

# The Global Third Way

*Forget the protectionism versus free trade debate.*

*The world is following China into a new era of the*

*“power trade.” Washington, D.C., call your office!*

BY ROBERT D. ATKINSON

What is the right strategic response to China’s unrepentant “innovation mercantilism”? One reason it has been difficult for U.S. policymakers to craft an answer that inspires confidence is that, viewed only in the present context, it has been too easy to believe the United States has never before faced such an adversary. But as I argued in the previous issue of *TIE*, it has:

Germany for the first forty-five years of the twentieth century.

Germany then was neither a free trader nor a protectionist—it was a “power trader” that used trade to gain commercial and military advantage over its adversaries. Likewise, China’s trade policy today is guided neither by free trade nor protectionism, *per se*, but by the power trade formula, with an overarching strategy and discrete tactics remarkably similar to Germany’s in its late-Empire, Weimar Republic, and Nazi eras. Understanding how Germany manipulated the global trading system in that period to degrade its adversaries’ capabilities, entrap nations as reluctant allies, and build up its own industries for commercial and military advantage—just as China is doing today—can point the way toward appropriate policy solutions to the China challenge.

One potential solution that will not be available as a practical matter is meeting China’s power trading strategy with an equal and opposite power trading strategy. The approach will need to be more nuanced than that. In this article, I describe how the United States also practiced power trade for much of the Cold War era, but not to boost its economy (which it did in some cases and didn’t in others), but to achieve over-arching foreign policy goals,

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the most important of which was to assure global security and constrain the Soviet Union. But today, America’s relative economic and technological strength is so diminished from where it was even twenty years ago that power trade premised on leveraging U.S. economic competitiveness to achieve broad foreign policy goals is no longer sustainable. President Donald Trump understood that, but shifted not to a new form of power trade, but to protectionism. The Biden administration needs to renew America’s role as a power trader, but with a new focus of maintaining its relative lead, economically and technologically, over China. Doing so will require changes in the strategy and organization of U.S. trade policy.

### POWER TRADE

A principal reason why it is often so difficult to make sense of trade policy, especially U.S.-China tensions, is that the prevailing narrative—and the policy options that go with it—is binary: We have either free trade or protectionism. The “trade war” with China under President Trump certainly wasn’t principally about defending free trade from Chinese corruption; it must have been an unbridled exercise in protectionism, because that is the only other option policymakers seem capable of imagining.

Yet throughout the twentieth century, some nations have adopted an alternative to both free trade and limited trade (protectionism): “power trade.” This is the use of trade and trade policy designed first and foremost to increase national power and decrease the power of adversaries. The recognition of this third pole—something original free trade theorists such as Adam Smith and David Ricardo understood—brings in political economy and the interests of the state, and recognizes trade as more than disembodied transactions between

free and willing buyers and sellers in different nations with the state as either facilitator or inhibitor.

It is time for the United States to adopt this national power approach to trade policy, or rather to revive it—for it is a lost intellectual tradition of trade that dates back to noted development economist Albert O. Hirschman in the 1940s. In his first book, *National Power and the Structure of Foreign Trade*, Hirschman wrote that the rise of Germany as an economic and military power showed that “it is possible to turn foreign trade into an instrument

### New Hope?

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**Katherine Tai** was confirmed as U.S. Trade Representative for the Biden administration by a 98–0 Senate vote on March 17, 2021. Fluent in Mandarin, Tai has pledged to pursue a “worker-centered” trade agenda.

## The Power Trade Model

A key aspect of power trade is that sometimes a power-trading nation must be willing to accept suboptimal or even negative economic results, so long as its adversaries suffer more. As Albert O. Hirschman notes, “[T]he stoppage of trade [with embargos or trade bans] will also do harm to the economy of the country taking the initiative in bringing the stoppage, but this is not unlike the harm an aggressive country can do to itself in making war on another.”

This insight gets at a core difference between the United States and the European Union.

Just as the United States is more willing to expend blood and treasure to advance the goals of national security and global stability, it has long been willing to use statecraft weapons, including trade restrictions, to ensure a more stable world order. Whether one agreed or disagreed with the trade actions Trump took *vis-à-vis* China, they imposed costs on the United States while helping other nations, both by somewhat limiting China’s unfair innovation mercantilist

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practices and by shifting Chinese imports away from the United States. America’s own exporters were also harmed when China subsequently reciprocally raised its tariffs in response to the ones Trump implemented.

In contrast, Europe appears to be largely unwilling to bear any economic pain to confront China’s power trade regime.

Europe not only saves money, which it can invest in commercial companies, by keeping its military modest; it protects its companies from Chinese economic retaliation by not rocking the boat, including by signing a bilateral investment treaty with China. In this sense, the European Union is not a power trader. It does not seek to achieve any goals outside of Europe, other than to expand markets for EU goods and services. What Europe does not seem to appreciate is that China’s ongoing move up the value chain means it will inevitably eat away at Europe’s competitive advantage in its key advanced manufactures, unless its mercantilist policies are jointly challenged. Yet Europe never misses a chance to target the United States and its digital services and technologies that were at the forefront of the last generation of technological competition (such as search engines), while failing to focus on the next wave.

—R. Atkinson

of power, of pressure and even of conquest. The Nazis have done nothing but exploit the fullest possibilities *inherent* in foreign trade within the traditional framework of international economic relations.” China has emulated Germany, and more, in its practice of power trade, using export controls, foreign infrastructure financing, producers’ subsidies, theft of intellectual property, forced technology transfer, manipulation of international standards, import bans, and a host of other “power” tactics designed to dominate key global industries and intimidate other nations.

Neither free trade nor protectionism (including complete decoupling) will be effective in preserving America’s lead over China. The United States needs to embrace a new form of power trade, one focused first and foremost on limiting China’s technological rise, while advancing ours.

### THE U.S. PRACTICE OF POWER TRADE IN THE POST-WAR ERA

Prior to World War II, American trade policy was premised on protectionism, especially when northern Republicans were in the White House seeking to advance industrial interests over agrarian interests. Indeed, as one 1930 article noted, “Until within a year or two only the

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economist and the Democrat dared to raise voices in seemingly unpatriotic and sacrilegious opposition to the protective tariff. Most others worshipped at its shrine.”<sup>1</sup>

But with the emergence of a Democratic majority after 1932, later compounded with the rise of the American industrial and military might after the war, protectionism was rejected for a more confident and global approach to trade. That approach quickly became premised on the

over-arching goal of limiting Soviet expansionism in the Cold War. The Soviet Union was a very different kind of competitor—a military and ideological threat, but not an economic one. This enabled the United States to install a free-trading system for the first and third worlds, while effectively shutting out the communist second world from a significant amount of trade.

Because of this, the conventional view of post-war U.S. trade policy is that America preached, practiced, and profited from free trade. At one level this is true, but the U.S. embrace of free trade, and the important exceptions to it, were overwhelmingly in the service of power trade and achieving state goals. Free trade was a means, not an end.

If the United States was to assume the role of global hegemon to defend freedom against the Soviet challenge, it needed not only a strong military and a strong economy, but deeply intertwined trade relationships that propped up allies and also created dependencies to help contain the “Russian bear.” As Walt Rostow, head of policy planning at the State Department, wrote in 1963, “The major issues of our trade control policy are political—not strategic, economic, or commercial.”

The more the United States could increase global trade, the more leverage it could attain relative to other nations—provided, of course, that it continued as the unalloyed economic and technology leader. As Hirschman wrote, “the total gain from trade for any country would be nothing but another expression for the total impoverishments which would be inflicted upon it by a stoppage of trade.” Hence, from the attempted formation of the International Trade Organization after World War II, to the formation of the Global Agreement on Tariffs and Trade (GATT) in 1947, and John F. Kennedy’s Geneva Round tariff reductions, to the free trade consensus that persisted until the election of Trump, a central goal of U.S. foreign policy was to expand trade and global integration, while at the same time using trade and other tools to keep nations on America’s side and limit Soviet power, and later to achieve other foreign policy goals. Indeed, if the United States had not played that liberalizing role, albeit as a Cold War tool, it is likely there would be significantly less global trade and integration today, as the natural inclination of most countries was and is self-interested mercantilist export expansion.

That successful strategy advanced U.S. geopolitical interests (and global economic wellbeing) for decades. It was

a significant force multiplier, until it wasn’t. That is because the United States used power trade not to directly enhance its economy—it actually often sacrificed its own economic interests—but to extend U.S. global influence, keeping allies close and prosperous, pressuring non-aligned nations, and limiting the Soviets.

The United States often cut lopsided trade deals with countries it wanted on its side. These deals opened up U.S. markets more than the markets of other countries. Indeed, one of the most significant trade assets the United States had at its disposal was its domestic market, the world’s largest by far. So for decades, U.S. administrations made U.S. market access contingent on other nations taking certain steps, such as protecting human rights, rejecting Soviet influence, or enabling the U.S. military to build and operate bases.

The United States also provided foreign aid, technical assistance, and technology transfer to help nations such as Japan, South Korea, and Taiwan build up their industries, so they could serve as bulwarks against global communism. The State Department even encouraged U.S. companies to build factories overseas to help keep unaligned nations in America’s orbit and instructed its officers abroad to promote foreign exports to the U.S. market.

This was all in the belief that U.S. industrial superiority was beyond challenge. President Harry Truman boasted that American “industry dominates world markets and our workmen no longer need fear the competition of foreign workers.” In 1953, the President’s Advisory Board for

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## China Threat Over-Hyped?

**B**ecause the belief in American economic and technological supremacy was the bedrock of post-war power trade, many in the foreign and economic policy communities continue to deny there is any decline. As Larry Summers wrote in 2019, “In many ways, U.S. concerns over China and technology parallel concerns over the Soviet Union in the post-Sputnik missile gap period just before President John F. Kennedy’s election in 1960. Or over Japan in the late 1980s and early 1990s, when it was often joked that ‘the Cold War is over and Japan won’.”

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*Former U.S. Treasury Secretary* **Larry Summers**

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Mutual Security called for the unilateral elimination of U.S. tariffs on automobiles and consumer electronics imports because “U.S. producers are so advanced no one can touch them.” State Department attitudes in the 1950s were well captured by one official who stated, “The U.S. trade surplus is a serious problem and we must become really import minded.”

Likewise, the United States was willing to sacrifice U.S. firms’ foreign sales to pressure other nations to behave in ways that were aligned with the United States, seeing trade embargoes as key diplomatic levers. For example,

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after the Chinese Tiananmen Square massacre, the Bush administration imposed an embargo on equipment exports, including telecom equipment, to China. This had the unfortunate but not unexpected effect of spurring the Chinese government to launch a major industrial policy effort to build its domestic capabilities in telecom equipment, one that helped launch Huawei and ZTE.<sup>2</sup>

And for most of the post-war period, the U.S. government defended the dollar as the global reserve currency so U.S. power could be applied through financial sanctions, even though a strong dollar meant higher prices for U.S. exporters and lower prices for foreign importers.

Perhaps the archetypal example of the United States favoring its geopolitical interests over its economic interests came in the trade conflicts with Japan in the late 1970s and 1980s, as Japan pursued a mercantilist, export-led economic growth strategy. Japan had implemented a number of policies to skew trade in its favor and to limit U.S. companies’ access to Japanese markets. It put in place high tariffs, import quotas, and onerous regulations, inspections, and standards requirements on U.S. products. It limited U.S. ownership of Japanese enterprises, manipulated the yen’s value, and shut U.S. companies almost entirely out of strategic markets, including autos, semiconductors, and mainframe computers. All the while, it dumped key products on U.S. markets.

Pressure mounted from business, labor, and Congress for the White House to file unfair trade complaints under

GATT and to declare Japan an unfair trader under then-existing U.S. law. But the Reagan administration was torn about how much to pressure Japan, with the national security agencies (State, Defense, and the National Security Council) and economist-dominated agencies (Treasury and the Council of Economic Advisors) on one side, and the more commercially focused agencies (Commerce and the U.S. Trade Representative) on the other. The attitude of the former group was that Japan was our unsinkable aircraft carrier, and that U.S. trade and economic interests should take a backseat to geopolitical concerns. As Assistant National Security Advisor Gaston Sigur insisted at the time, “We must have those bases. Now that’s the bottom line.” So while the United States took some steps, more assertive steps were tabled due to broader foreign policy concerns.

With the denouement of the Cold War, the Clinton administration signaled a new strategic approach that would elevate economic concerns alongside geopolitical and national security concerns. Clinton Secretary of State Warren Christopher told the Senate Foreign Relations Committee that “among the three pillars of the new administration’s approach to foreign policy, economic growth ranked first.” President Clinton created the National Economic Council as a counterpart to the National Security Council to facilitate this reordering of priorities, and Robert Rubin, the NEC’s first chair, observed that “the big change” with Clinton’s approach was that “the economic component of any problem gets on the table at the same time as other issues.” Or, as Mickey Kantor, Clinton’s chief trade negotiator, put it, “Trade and international economics have joined the foreign policy table.”

But the temporary economic boom starting in the second half of the 1990s, coupled with foreign policy entanglements (Bosnia, Iran, Iraq, Israel-Palestine, Somalia, and others) made economic concerns less pressing. And then came 9/11, once again leading the United States to emphasize geopolitical and national security concerns at the expense of economic ones. And that spilled over into trade agreements. For example, the U.S.-Australia free trade agreement was initiated in part because of the role Australia played in the war in Iraq. And agreements with Bahrain, Morocco, Oman, and Peru were all to support both economic and political interests.

While some of these goals are certainly inviolable, such as preventing another 9/11, others are elective, like focusing on human rights issues in China. In fact, the number-one item President Obama spoke about with Chinese President Hu Jintao when Hu visited the United States in January 2011 was Chinese human rights, arguably reducing the leverage that the United States might have held on pressing economic issues.



This willingness to sacrifice U.S. economic and industrial interests for broader geopolitical ones generally worked as long as the United States had an unalloyed competitiveness lead, particularly in advanced industries. But the first cracks came in the early 1970s when the balance-of-payments crisis led President Nixon to get the United States off the gold standard. Less than a decade later, the rise of Japan (and the Asian tigers, plus Germany and handful of other European nations) raised new competitive challenges. This initially disrupted the post-war power trade consensus, with some pundits and scholars, such as Chalmers Johnson and Clyde Prestowitz, arguing that the U.S. government was wrongly sacrificing competitiveness interests on the altar of foreign policy.

But by the 1990s, the stumbles of Japan, along with the rise of Silicon Valley and the U.S. information technology industry, showed to many that this was all a tempest in a teapot. As a result, the intellectual provocation was dismissed as temporary quirkiness by misguided scholars.



**Robert Rubin** was the first chair of the National Economic Council, established in 1993.

## The Economists— Always Fighting to Be Heard

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After that, the foreign policy community continued once again advocating for the U.S. version of power trade with impunity.

However, the rise of China after the mid-2000s, the resultant steep decline in U.S. manufacturing output and jobs, and the 2008 financial crisis together posed a more significant challenge to America’s ability sustain its dominant economic role. China’s shift in 2006 away from low-cost commodity manufacturing to high-value advanced technology, later supplemented with its “Made in China 2025” program and technology-focused Five-Year Plans, only exacerbated that relative weakness.

However, because the belief in American economic and technological supremacy was the bedrock of post-war power trade, many in the foreign and economic policy communities continue to deny there is any decline. As Larry Summers wrote in 2019, “In many ways, U.S. concerns over China and technology parallel concerns over the Soviet Union in the post-Sputnik missile gap period just before President John F. Kennedy’s election in 1960. Or over Japan in the late 1980s and early 1990s, when it was often joked that ‘the Cold War is over and Japan won’.”

But despite the denial of the Panglossians, this decline is real, and it was the source of President Trump’s statement that our allies had played us for “suckers.” Trump asserted, in typically inarticulate ways, that if the United States had not been engaged in global power trade with the wrong strategic objectives, then the U.S. economy and especially the industrial heartland would be much stronger.

The reality was that the United States was not being taken advantage of for much of the period; nor were U.S. policymakers dupes. Foreign nations may have been gaining economically, but it came at a cost of their strategic autonomy. The United States may have been gradually losing ground economically, but it was gaining global power, culminating with the American victory in the Cold War and the rise of Pax Americana in the 1990s and 2000s.

But that willingness to trade off U.S. economic advantage, as well as the failure of the United States over the past thirty years to establish even a semblance of a national economic competitiveness

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strategy, meant that America's economic lead deteriorated. Whole industries, like solar photovoltaics, telecommunications equipment, rail, and machine tools, hollowed out, and others, such as heavy truck manufacturing, steel, semiconductors, and pharmaceuticals, lost significant domestic production capacity. The Covid-19 pandemic further highlighted the weaknesses of American supply chains.

With America now losing its overwhelming economic and technological advantage, it can no longer practice the post-war version of power trade that weakened core industrial interests. As Hirschman pointed out, power trade relies on creating dependency, and with the weakening of the U.S. economy relative to competitors, that became increasingly difficult for the United States to achieve because other nations, especially China, were becoming less dependent.

By 2016, voters in many swing states thought that the post-war version of U.S. power trade had run its course—or at least that something wasn't working right—and they voted for Trump, since he promised change. Once in office, Trump and his trade representative, Robert Lighthizer, did indeed deliver change. "America First" meant that the United States would no longer practice power trade of any kind, especially the post-war version that aimed to spread freedom and democracy. But rather than change to a new form of power trade focused on China, they chose to mostly revert to pre-war American protectionism with tariffs and domestic content requirements as the policy tools of choice.

Trump was right that it is no longer in America's interest to accept one-sided trade arrangements or unilateral export controls which favored foreign trading partners (even though he proceeded to put in place the latter to America's detriment), while simultaneously precluding U.S. exporters from deriving matching advantages in overseas' markets. But he was wrong to default to protectionism.

Because the current trade debate is a Manichean one between free trade and protectionism, conceiving an alternative framework has proven difficult. While the United States practiced power trade in the Cold War era, it used its power to push for a global free trade system, democracy,

and human rights. Free trade and power trade, therefore, were viewed as synonymous. Consequently, an entire generation of trade and foreign policy scholars assumed that not only was a global free trading system ideal, but even inevitable. And opponents thought protectionism was the only viable alternative.

#### **IMPLICATIONS FOR TRADE AND TRADE POLICY**

What does this all mean for U.S. trade policy? First, it means that the United States should still embrace power trade, but with the overarching goal of increasing its competitive advantage over China. Making this shift will not be easy because many in the trade and economic policy establishments will deny that national economic competitiveness is even a valid concept, having concluded in the 1990s that it was a "dangerous obsession."<sup>3</sup>

Moreover, even when free traders have recognized the need for strong advanced technology industries, if for no other reason than national defense, many stipulate that free trade serves those interests because it not only maximizes U.S. GDP; it knits together other nations into a web of mutually dependent commerce, reducing the risk of conflict. This has long been the defense against responding to power trade with something other than one-sided free trade. As Hirschman wrote: "When derided as utopians or accused of a lack of patriotism, however, free traders have usually fallen back upon the argument that foreign trade enriches a country and thus helps its defense... in addition, free traders have tried to belittle the danger of dependence pointed out by their adversaries."

But free traders would be correct if they were describing a world of two-sided free trade between the United States and its democratic allies. In such a world, where the United States is endowed with capital and skills, free and open trade would in fact not only boost U.S. GDP, but enable America to specialize in higher value-added production, helping U.S. national defense.

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But that ideal world is far from what America confronts today. Many nations are quasi-protectionists, or rapidly moving in that direction, as we see today with Europe and its protectionist calls for “digital sovereignty.” Most U.S. competitors have put in place robust national industrial strategies targeting key industries, many of them consistent with fair market behavior, but many not. Moreover, with China behaving as an unrepentant power trader despite facing limited global resistance in recent years, a growing number of nations, including India, are emulating its mercantilist policies. The China model provides a powerful siren call for the many mercantilists around the world.

The lesson from China’s largely unchallenged rise has been that nations can flout international trade rules with little consequence. Prior to China’s rise, nations that wanted to indulge in mercantilist protectionism knew they were “sinning,” and they worried about punishment. Now the biggest sinner, China, denies it is a sinner, and casts stones instead at the American house of Donald Trump. And of course, China is a powerful, predatory power trader intent on gaining global dominance in most advanced technology industries. In such a world, two-sided free trade is not possible with a significant number of countries, and one-sided free trade for the United States means going onto the modern commercial battlefield armed with only a bow and arrows.

Moreover, conventional trade theory is still grounded in the concept that trade involves commodity-based industries like wine and textiles; examples Ricardo used to

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explain why trade was welfare maximizing for both parties. But for innovation-based industries, initial advantages can become sustained advantages as marginal costs of production go down, while network effects increase. And in those industries, predatory policies like subsidies and intellectual property theft can slowly starve foreign innovation-based competitors of the resources to invest in the next round of innovation. Indicative of this, World Trade Organization rules are stuck in the analog era of

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traditional twentieth-century trade in physical goods, with little to no progress on moving to the modern era with updated rules on intellectual property and services and digital trade. Moreover, U.S. trade theory and practice generally refuses to prioritize key industries as part of a new power trade policy, thinking “computer chips, potato chips; what’s the difference,” a quote attributed to Michael Boskin, head of President George H. W. Bush’s Council of Economic Advisors.

Hirschman rejected this view when he wrote, long before the rise of strategic trade theory in the 1990s, “The theory of imperfect competition has shown that this situation is only very rarely realized.” This is why he believed “international trade might work to exclusive or disproportionate benefit of one or a few of the trading nations.”

The theory of power trade also helps make sense of recent patterns of trade and globalization. In the linear framework of free trade versus limited trade, globalization is either increasing or it is shrinking. This has led some to argue that we are moving to a “post-globalization world” where “all countries are beginning to wall themselves off.”<sup>4</sup> This concern is usually meant to refer to a global economy that is not like the one we thought we were living in with an inexorable movement toward tighter and tighter economic integration. But what these concerns are really getting at is that we no longer live in a U.S. power trading regime designed to bring and hold an alliance together. Rather, we are in a world of power trade, with constant thrusts and parries for advantage and protection, and one that the United States has no choice but to practice. ♦

#### ENDNOTES

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