COVID-19 and World Order

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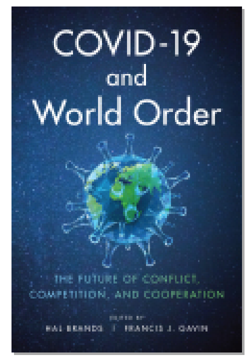

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PART IV / The Future of the Global Economy

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Chapter Ten

Models for a Post-COVID US Foreign Economic Policy

Benn Steil

The COVID-19 pandemic has intensified centrifugal forces in the global economic order, forces which have been growing in strength over recent years. The crisis has animated governments to impose sweeping new restrictions on the movement of people and goods, and many of these are likely to remain well after it has passed.

More than 70% of the world's air, sea, and land ports of entry restrict access to foreigners. In the United States, politicians from both major parties are demanding new "Buy American" rules for government health spending. French President Emmanuel Macron is seeking "full independence" in critical medical supplies by year's-end. Almost ninety countries are now blocking the export of medical goods. Twenty-nine are doing so with food.

Japan is paying companies to move factories home from China; the Trump administration may soon follow suit. The European Union (EU) is imposing new restrictions on foreign investment and takeovers. Even notable free-trade champions, such as Pascal Lamy, former director-general of the World Trade Organization (WTO), are now emphasizing the need to shift international supply-chain management away from an efficiency focus and toward "resilience"—that is, duplication and renationalization—to minimize the consequences of disruption.

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"National security" will become the umbrella logic for all manner of government intervention in this and other areas of commerce.

Not all countries are pulling back from globalization in all its aspects. New Zealand and Singapore, for example, are leading a coalition to *expand* trade in medical products through tariff reduction[1]—the idea being that the crisis shows the need for more commitment to cooperation, not a retreat into autarky. The School of Advanced International Studies project that gave rise to this volume used online communications technology, rather than planes, to bring experts together; this will likely become the global norm in knowledge-based industries. Still, that technology is itself becoming a leading battlefield of national conflict, as so-called fifth-generation (5G) wireless technology ruptures between Chinese and western-led versions.

If the crises of World War I and the Spanish flu of 1918 are anything to go by, the challenges and conflicts raised by COVID-19 are likely to be long-lived. It took a second world war a quarter-century later before de-globalization was stopped and a half-century before it returned to pre–World War I levels.

As the COVID crisis passes, the fraying current order is unlikely to revive itself unaided. Government action will be needed to rebuild or replace it. This essay looks at three models the United States might pursue in order to reshape its relationship to the future global economy.

Orders Old and New

History over the quarter-century following World War I provides useful guideposts for thinking about the types of economic order available to the United States. Broadly, they may be labeled Isolationism, One-Worldism, and Two-Worldism.

Isolationism was the dominant US model from the end of World War I until the Japanese attack on Pearl Harbor in 1941. Its central motif was that the United States must not allow itself to become entangled in the problems of other nations, as that must inevitably act to limit its scope for independent action and drag it into conflicts peripheral to its interests.

One-Worldism was the postwar vision of President Franklin D. Roosevelt, repudiating Isolationism. It presumed that there was sufficient commonality of interest among the United States, the United Kingdom, the Soviet Union, and China to construct mutually beneficial global structures for regulating commerce and political relations. Its cornerstone institutions, conceived in the early 1940s, were to be the United Nations (UN), the International Monetary Fund (IMF), the World Bank, and an international trade organization.

Two-Worldism was the corrective put in train by President Harry S. Truman, based on the belief that fundamental differences in interests and ideology existed between the United States and the Soviet Union which made a political and economic division of Europe unavoidable. Its founding structures were to be two offshoots of the Marshall Plan—the European Coal and Steel Community (a precursor to the EU) and the North Atlantic Treaty Organization (NATO)—along with the General Agreement on Tariffs and Trade (a precursor to the WTO).

Following the end of the Cold War three decades ago, Two-Worldism, now stripped of its ideological basis, morphed into a One-Worldism based largely on the structures created by the United States in the late 1940s. Not surprisingly, a certain triumphalism pervaded Washington, a sense that we had arrived at "The End of History."[2]

Over the past decade, however, growing economic and political conflict between the United States and China, political conflict between the United States and Russia, and the election of a nationalist US president in 2016 have conspired to undermine the viability of this "One World" order. The COVID-19 pandemic, which has given rise to a surge in US-China tensions and global trade and migration barriers, is accelerating its destruction. The recent resignation of WTO director-general Roberto Azevêdo is emblematic of this fact. It is therefore essential for US policy makers now to examine critically whether they wish to arrest its demise or to replace it with a different model for US engagement.

Model 1: One World

A "One World" economic model for the future is premised on the belief that the United States and China can coexist on a mutually beneficial basis within a set of common rules, norms, and institutions governing economic exchange. This was the premise that underlay American thinking when China acceded to the WTO in 2001. That premise was itself based on the belief that China was evolving in a liberal direction, one in which the state would play a progressively lesser role in the economy.

Since the emergence of Xi Jinping as paramount leader in 2012, however, China has moved decidedly in the opposite direction. The Communist Party of China eliminated term limits to accommodate Xi's indefinite rule, and state-owned enterprises (SOEs) have come to play a far larger and more critical role in the economy—not the smaller one that had been anticipated a decade prior. This phenomenon has had a profound effect not just on China but on economics and politics in the United States.

To boost state-led investment, China pursues policies to restrict the income flowing to workers and retirees. Taxes are regressive, social safety nets minimal, and the rights of urban-dwelling rural migrants few. SOEs do not pay dividends, and bank deposit rates are capped. This latter policy enables banks to borrow cheaply and lend on to SOEs at a modest markup, secure in the knowledge that the government will not allow default—irrespective of how bad the investments prove to be. With returns on savings miserly and government support nominal, Chinese households have the lowest consumption rate (as a share of output) in the world, and the nation as a whole has the highest savings rate of any in history.

China's surplus savings and persistent state-generated overproduction spill over abroad, most notably into the world's most open national economy: the United States. The US absorbs it by fueling excess credit creation (through the proliferation of "CDOs-cubed" and the like), which seeds financial crisis, as well as by accelerating de-industrialization and manufacturing job loss.

These effects do not owe entirely to Chinese policy, and surely many segments of American society have benefited from cheaper credit and cheaper goods. But the political ramifications of the concomitant dislocations are distinctly hostile to the perpetuation of One World. The election of US President Donald J. Trump in 2016 on a platform of heavily taxing Chinese imports, however ineffective a response to the underlying problem, was a powerful sign that China's model is unsustainable under the current architecture of international economic relations.

In order for One World to survive, it will have to be reincarnated along different lines. At the broadest level, China will need to allow household income to rise at the expense of investment. Whereas such change may sound technocratic and innocuous, it would be highly consequential. It would curtail SOE expansion and the political power that local governments enjoy in directing it. If banks, for example, were merely obliged to compete for savers' deposits, the relentless funneling of underpriced savings to over-indebted enterprises would begin to dry up.

At present, gross domestic product (GDP) in China is not the output of a largely self-regulating economic system, as it is in the developed world, but a political *input* that determines how much borrowing, lending, and production there must be to satisfy government wants. When China declares a 6% GDP growth target and then meets it, it does so only by stoking the inexorable growth of bad loans that goes along with it. With China's true debt likely running at about 300% of national income, the country is nearing its debt capacity.[3] It needs to change course in its own economic interests as well as those of the wider world.

A rebalancing of the Chinese system in favor of households, sufficient to halt the flow of surplus goods and savings to the United States, would require the shrinking of overextended Chinese enterprises, massive loan write-offs, slower growth, and less government control over who makes what for what end. It would, in effect, mean nothing less than a reversal of Xi's vision for China's next stage of development. It is for this reason that it has not happened.

China's production and dumping of excess goods and savings in the United States is but an element in the growing economic frictions between the countries. Systematic Chinese commercial espionage, intellectual property theft, forced technology transfer, and open intervention on behalf of domestic firms have all contributed mightily to American disenchantment with the growing integration between the two countries. The enormous economic and political implications of the global shift toward 5G wireless technology only raise the stakes for a continuation down the current path.

The past decade has also witnessed growing tensions between the United States and China over One World economic institutions. Misguided foot-dragging by Congress over governance reform at the IMF and World Bank during the Obama administration—reforms that increased China's voice but left the United States with sole veto power—acted as a powerful impetus for China to promote new alternative institutions: the Asian Infrastructure Investment Bank (AIIB), the New Development Bank (or "BRICS" Bank), and the Belt and Road Initiative (BRI). The last of these, BRI, has seen China lend hundreds of billions of dollars for infrastructure development to mostly developing nations, affording it growing political influence. Extended without the sort of transparency and conditionality required by the World Bank, these loans were initially greeted warmly by recipient governments. Charges by the United States that the initiative amounted to "debt-trap diplomacy," however, may soon be borne out as BRI borrowers, having entered recession with the COVID crisis, approach default and plead for write-offs.

Also worrying for the One World model is the way in which the United States has brought WTO dispute settlement to a standstill by refusing to allow appointments to the appellate body. The resignation of Director-General Roberto Azevêdo in May 2020 clearly signaled his view that the organization, which has not concluded a round of multilateral trade liberalization since 1994, has been reduced to a state of impotence.

Saving One World is now a tall order. Even if 2021 sees a change in the US administration and outlook that keeps the WTO on life support and seeks to reengage

China constructively, China appears set on a path that makes a mockery of what the WTO was established to do: lower trade barriers among market economies. When China's economy was, at its accession, less than 10% the size of what it is today, this mattered much less—particularly since China seemed to be headed in the right direction. Now, however, it is undermining the stability of the global economy and creating dangerous political frictions.

Since the potential benefits of One World dwarf those of Isolationism, and exceed those of "Two Worlds" with a lower risk of military conflict, the United States should, in its own interest, make a sincere effort to save it. The way to do so is to restock the WTO appellate body with judges and to join with allies in Europe and Asia to challenge China's policies in four broad areas: intellectual property protection and enforcement, trade secrets protection, forced technology transfer, and state subsidies.

Such cases will be difficult to prosecute, and the outcome is highly uncertain. Yet if the United States and its allies win all or most of them, China, which has a respectable record on implementing WTO decisions[4] and cares deeply about world opinion, may decide—wholly in calculation of its own interest—to change course and comply. In fact, China losing at the WTO would give it a face-saving way to make shifts in policy that might otherwise prove impossible to engineer owing to the appearance of caving to unilateral US threats and demands.

If China loses and does not comply, the United States and its allies would win the legal right to "suspend concessions or other obligations"—that is, to retaliate with tariffs, quotas, and the like. This too may fail to motivate Chinese compliance. Given the legal complexities inherent in such cases, the US and its allies may also lose one or more of them. In the case of Chinese noncompliance or US losses, Washington may reasonably conclude that the WTO—and the One World model on which it was built—has outlived its usefulness. It might then look to set up alternative regimes together with like-minded nations, or to go it alone—a model to which I now turn.

Model 2: Isolationism

The term "Isolationism" does not mean ignoring the outside world. Rather, it is a "doctrine of isolating one's country from the affairs of other nations by declining to enter into alliances, foreign economic commitments, [or] international agreements."[5] If this is not the stated meta-policy of the Trump administration, it is clearly the destination toward which it has been headed since 2017.

The attractions of Isolationism are obvious. All else being equal, governments prefer the freedom to act, unencumbered, and to stand aloof, unentangled. And since the United States is the world's richest and most powerful nation, it can, at least in many circumstances, benefit from a strategy of divide-and-conquer—that is, dealing with weaker nations bilaterally and on a narrow transactional basis.

Yet all else is not equal, and there are obvious costs to this strategy. When the United States forswears commitments to others, others forswear commitments to the United States. Those countries may, of course, also choose to bind together with alternative suitors to pursue aims antithetical to US interests. In turning away from multilateralism, the United States liquidates moral capital accumulated over decades, capital built on the foundation of long-standing commitment to the values of political and economic liberalism—values which transcend its narrow national interests. This commitment is the basis of what Harvard's Joseph Nye has called America's "soft power"—its ability, without applying force or coercion, "to get others to do what they otherwise would not."[6] No other nation, certainly not China or Russia, combines economic and military power with a compelling vision for the organization of human society. There is clear value to the United States in being able to leverage moral authority in crafting agreements and not simply presenting itself as just another self-interested brute.

Curiously, the Trump administration has not argued that America's historic multilateral initiatives were misguided (even if Trump himself may believe so). Instead, it has argued that the conditions which made them successful no longer apply. The 2017 National Security Strategy, for example, while stating that "putting America first is the duty of [its] government and the foundation for U.S. leadership," actually pays homage to the country's postwar multilateralist diplomacy—in particular, the creation of the Marshall Plan in 1947 and NATO in 1949. It claims, however, that over recent decades others have "exploited the international institutions we helped to build."[7]

Whereas this claim has merit in the case of China's demands, under the umbrella of the WTO, for the right to access markets abroad freely while closing them at home, it is deeply misguided with respect to other countries and institutions. On the security front, alliances have lowered the cost of US political and military action abroad.[8] NATO's Article 5 collective defense provision has been invoked only once in the alliance's history—by America's allies, supporting it after the September 11, 2001, Al Qaeda terrorist attacks on New York and Washington. On the economic front, multilateral institutions have accorded Washington far greater influence than is justified by its role in the global economy. When the United States designed the IMF and World Bank back in 1944, for example, it accounted for half the world's output. Today it accounts for under a quarter. Could anyone imagine the United States today, under such vastly less favorable circumstances, creating powerful international institutions in which it could grant itself the sole right of veto? It is unthinkable. Yet the fact that it retains such outsize influence in the so-called Bretton Woods institutions is testimony both to its foresight at the time and to its responsible stewardship (with notable exceptions) of the liberal order since then.

Indeed, the Truman administration, working with a Republican Congress, pushed America out on the multilateralist path not just for short-term benefit but with the expectation that it would pay dividends for generations. "The recovery of Western Europe," wrote Republican senator Henry Cabot Lodge, Jr. in 1947, "is a twenty-five to fifty-year proposition, and the aid which we extend now and in the next three or four years will in the long future result in our having strong friends abroad." Forty-two years later, with the fall of the Berlin Wall, we saw just how right he was. Moscow's Warsaw Pact collapsed almost overnight, whereas those alliances Washington forged as offshoots of the Marshall Plan—NATO and the European Union—rose to new heights of popularity, with the freshly liberated countries of central and eastern Europe clamoring for entry.

The isolationist path along which the United States has been moving since 2017, in contrast, has generated bitterness and resentment abroad while achieving none of its goals at home. On the economic front, it was supposed to have revived domestic manufacturing and manufacturing employment. Yet after nearly four years of ever-widening and greater import tariffs—that is, taxes on Americans buying abroad—these efforts have shown no signs of success. Take steel and aluminum tariffs, which President Trump imposed on contrived "national security" grounds. Whereas imports of both metals declined after the tariffs took effect, the import of products *using* them soared in consequence—prompting the president to impose another round of tariffs to contain the damaging effect on American metal-using industries.

The net result of tariffs has been to make US firms relying on foreign parts less competitive globally, to raise costs for US consumers, and to harm US exporters—particularly farmers—whose products have been hit with foreign retaliation.[9] Meanwhile, the protected industries, which remain behind the global curve on automated production, continue to stagnate or decline. China, the main target of the president's tariff strategy, has, notwithstanding the so-called Phase One trade deal in 2019, neither materially increased US imports nor made any significant structural and market-access reforms. (In fact, the deal obliges China to apply *more* state direction.)[10] The Trump administration and its congressional supporters now speak of new "reshoring" initiatives, such as domestic-content requirements, partly in response to COVID-induced shortages. But these are certain only to further erode US competitiveness; there are more sensible and cost-effective ways to promote supply-chain resilience.[11]

Furthermore, in renouncing the (now-)11-nation Trans-Pacific Partnership (TPP) agreement, the Trump administration has abandoned the chance to shape the rules and norms of economic exchange in Asia. Putting aside the well-documented economic benefits of liberalizing trade multilaterally,[12] the United States has ceded the initiative on regional trade to China—an aspiring hegemon with interests increasingly at odds with those of the US. And once the nations of the region build up an alternative panoply of mutual commitments, even if motivated by fear rather than opportunity, it will become difficult, if not impossible, for the United States to reclaim influence. Washington's aim, in short, should therefore be not to isolate America further, through tariffs or "reshoring" requirements, but to revive or reconstitute multilateralism in a more effective form.

Model 3: Two Worlds

In April 1947, six weeks prior to Secretary of State George Marshall's Harvard speech setting out the background to what would become the Marshall Plan, a joint State, War, and Navy department staff committee report concluded that minimizing "the costs and duration of United States economic assistance" to revive western Europe would "require a substantial increase in trade with Soviet-dominated areas" in the east. For this and many other reasons, they thought it vital to press for an understanding with Moscow over the future political and economic architecture of Germany and Europe. But American trade with the east, the committee added, could *only* be "arranged on terms compatible with the economic and political independence of western-oriented areas."[13] And once Marshall concluded that Stalin would never allow this condition to be met, he laid down requirements for American aid—in particular, economic integration among the participant nations—that he knew the Soviet dictator would never abide. Thus was the shift from the FDR's "One World" vision to Truman's "Two World" policy initiated reluctantly but decisively.

We are at precisely such a crossroads with regard to America's relations with China. Though China does not oppose the One World model, it uses it to its advantage by exploiting, rather than embracing, the developed world's commitment to open markets. It seeks not to replace One World institutions but to increase its influence over them and, in areas, to counterbalance them with schemes of its own (like BRI). In President Xi's words, China seeks "a future where we will win the initiative and have the dominant position."[14]

This is not just rhetoric. In service of its "Made in China 2025" industrial policy, which pledges the government to pursue Chinese supremacy in areas of strategic economic and security importance, China has committed at least $1.4 trillion in public funds over the coming five years to investments in artificial intelligence, data centers, mobile communications, and other technology-related projects—all of which are to be based on domestic firms.[15] Governments that criticize Chinese policy—such as Germany over Huawei and 5G, Sweden over human rights, Norway over the Nobel Peace Prize, and Australia over COVID—have been met with import bans, or threats thereof, from Beijing.[16]

For the United States, continuation down a One World path while China persists in distorting the global economy and orchestrating its dominance of strategic technologies will only heighten economic dislocation, political polarization, and security risks. If China, like the Soviet Union in 1947, rejects the basic American vision of a liberal order, then the United States must be prepared to initiate a shift to a Two Worlds model.

To effect it will require persuading allies to join in a progressive *multilateral decoupling*—an escalating quarantining of Chinese firms and industries that persist in either illegal activities (such as espionage and theft) or unfair trade practices (like dumping to eliminate competition). Simultaneously, it should seek to construct a new multilateral trade regime, populated by nations that meet basic standards for respecting fair and open markets. A mass withdrawal from the WTO by such nations, followed by the erection of a parallel organization based on stronger open-market principles, would be the cleanest way to move forward. However, it may be legally and practically sufficient for those same nations simply to operate a new trade rubric side by side with a moribund WTO. This rubric might combine elements of TPP and the mothballed Transatlantic Trade and Investment Partnership (TTIP), covering tariffs on goods and services, intellectual property rights, e-commerce rules, inward investment, regulatory cooperation, labor and environmental standards, and dispute resolution. The United States should, further, initiate a "Manhattan Project" with allies in Europe and Asia to massively accelerate 5G and 6G wireless technology development. Such an initiative is necessary in order to leapfrog China in an arena of vital strategic importance, covering capabilities as diverse as threat detection, feature and facial recognition, and health care.[17]

This agenda would result in what has been called a "splinternet," and, as former Google CEO Eric Schmidt has rightly emphasized, it is far less desirable than finding a way to coexist peacefully and profitably with China under one set of standards and a genuinely global market for technology and communications. But much the same was said about the division of Europe in 1947. Two Worlds was, however, clearly a less-bad option than trying to appease Stalin. And if China is going to grow both more authoritarian and more ubiquitous in the global economy, it is bound to result in yet more political turmoil, both within the United States and internationally. In this case, Two Worlds, for all its manifest limitations, is the better way to go.

Whereas a Two World agenda may have sounded extreme a year ago, it has already taken embryonic shape. The European Union, for example, has embarked on an effort to assert "strategic autonomy" from China, which includes plans to bar foreign companies that have received large grants, loans, tax credits, or other state aid from buying EU companies or competing with them for EU contracts. The agenda has been accelerated by the COVID pandemic, which has triggered fears of China and others exploiting the crisis at the expense of European firms. Paradoxically, the biggest barrier to cooperation on the initiative with Washington has been the Trump administration's tariff and other aggressive trade threats against the EU.[18] It is high time for Washington to get its priorities straight and to coordinate a determined multilateral response to Beijing's challenge.

Of course, the United States must always be prepared to act alone to protect its core interests, but that should become the *last* resort—no longer the first. The new strategy must be based on nurturing and acquiring allies, not on disparaging and punishing them. Creating allies is precisely the strategy the United States employed so successfully in the aftermath of World War II.

Final Thoughts on the Role of COVID

Whereas the COVID pandemic is hardly the genesis of spiraling economic conflict between the United States and China, it has clearly exacerbated that conflict. Beijing's lack of candor and transparency, if not outright dishonesty, as the virus spread through Wuhan in late 2019, followed by China's later mass export of defective and misbranded personal protection equipment, has fueled American distrust and determination to act.

Looking forward, international opinion toward the global order will be shaped by how the world emerges from this COVID crisis. In particular, the way in which the United States, China, the European Union, Russia, and the United Kingdom behave in the race to produce a vaccine will be consequential.

"Vaccine nationalism"—the desire to acquire vaccines and to use them at home before allowing distribution abroad—is an obvious and understandable temptation. The United States, at the height of the lockdown, was losing 16,000 lives and $80 billion a week.[19] Yet if the winners in the vaccine race fail to include in the initial round of inoculations foreign frontline medical workers and others abroad in urgent need of protection, it will undermine their claims to be responsible stewards of, or stakeholders in, the global order.

The sharp, negative reaction around the world to reports of the Trump administration buying up virtually the entire summer supply of the anti-COVID drug remdesivir, coming on the back of its invocation of the Defense Production Act to block the export of medical goods, should be a warning shot.[20] If the United States succumbs to vaccine nationalism, it will become vastly more difficult for it to rally nations to its vision for future global economic structures. Generosity, in contrast, will afford it considerably more leverage in trying to reform the present One World model or to draw allies to its side for a shift to Two Worlds.

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