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Checkers Or Chess? Facing State Capitalism — Part I

Law360, New York (April 15, 2011) -- The expression "We're playing checkers, while they're playing chess" is often used to suggest that a more sophisticated game is being played by a more advanced player at the expense of an amateur player. This was certainly true for decades with regard to Olympic basketball — that is, until the U.S. got beat. However, could this also be true with respect to economic models used to organize economies?

The Development of State Capitalism

In 1998, Daniel Yergin and Joseph Stanislaw wrote "Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World," which chronicled the development of economic thinking across the 20th century that led to modern day capitalism, as it replaced other outdated, underperforming and more social-based economic models.

Reliance on the private sector for job growth and innovation, while letting market forces of supply and demand dictate price, drove unparalleled economic growth and achievement that made the American economy the envy of the world. In contrast, the Soviet experience, with its reliance on central planning, state ownership as a means of production, and a collective approach to agriculture and manufacturing, proved just how ineffective it was at wealth creation and innovation.

Capitalism was not always popular in the last century, however. It was met with a great deal of skepticism and outright hostility immediately following the Great Depression (which is not so different from the critical remarks heard following the collapse of the global financial markets in 2008). Ultimately, a market-based capitalist approach won out, and by the last decade of the 20th century, it was the dominant economic model and the one to be emulated the world over. But is it the way to organize an economy to commanding heights in the 21st century?

In recent years, a new economic model has emerged — state capitalism. Led by China, state capitalism is a hybrid of sorts, and it is being closely analyzed by many developing countries as perhaps a model worth mimicking.

State capitalism invites just enough free market chaos into the economy to create a semblance of competition, but it retains a large reliance on central planning, making it nothing like the various kinds of economic socialism familiar to the 20th century. It features its own unique blend of market liberalization, allowing the market to set prices in many areas, while still retaining control over key factors of production.

State capitalism is also characterized by its ability to take advantage of the open and free market approach now common in OECD (Organization for Economic Cooperation and Development) countries, while remaining fairly protective of critical aspects of the domestic market. It mobilizes the resources of the entire state toward the achievement of strategically defined economic and commercial objectives. It welcomes, but closely manages, foreign inbound investment. It courts R&D-related investment while allowing it to quickly indigenize innovation.

It forces joint ventures between foreign companies and domestic players to further aid in the transfer of knowledge, business acumen and technology, helping it to scale what otherwise might be difficult, long-term learning curves. It asserts control via government ownership over its most critical commercial enterprises, while subsidizing their expansion and growth well beyond its geographic borders. In short, state capitalism is more strategic than capitalism; it is more strategic like chess and less like checkers.

The Results of State Capitalism

Whether state capitalism as an economic model is sustainable is very much in question and hotly debated. But in the short run, it has yielded impressive results. Nonetheless, many argue (and they may be right) that the perils of an overreliance on production versus consumption, the inability of the state to pick winners over losers, as well as the demand for personal liberties, social and environmental reforms will one day combine to expose the limits of state capitalism.

Only time will tell if that will be the case. In the interim, however, an important question needs to be asked: What international economic policy challenges does state capitalism pose for countries whose economies are largely market-based and feature a far more limited role for government?

In the past, the economy of the Soviet Union did not interface with the United States or Europe the way China's economy does today. Even during the height of state involvement in Western Europe, the state rarely put the private sector in competition with state enterprises. State enterprises were government-granted monopolies that left little room for the private sector to compete. Furthermore, these monopolies strictly operated domestically and were not capitalized or encouraged to operate abroad.

Yet, today, state capitalism with its state-owned enterprises and associated national champions offers unique challenges to trade, investment and competition norms. The first such policy calibration occurred during the run-up to the recent global financial collapse. While global imbalances and sovereign debt are current concerns, just a few years ago it was sovereign wealth funds.

The mass accumulation of capital wealth by countries largely in the Middle East and Asia left much of the developed world and its economies in the awkward position of actively courting sovereign wealth fund investment, at the same time grappling with potential corporate governance concerns. These concerns stemmed from the umbilical tethers between the funds themselves and their foreign government owners, as well as the political fallout that these funds were causing by investing in often semisensitive industries.

As the global financial crisis unfolded, the problem of state capitalism became more acute as governments felt more comfortable exercising their leverage to promote state objectives and advance national power. Industrial policies such as China's "indigenous innovation" movement (essentially requiring the transfer of technology into China prior to allowing foreign investment to take place) and export subsidies and financing (such as those being challenged in the WTO aircraft disputes) began to take center stage. Ditto for targeted research and development funding, the control and hording of natural resources (as in the case of rare earths), and claims of maintaining "national economic security" (as in the case of Canada's use of a "net-benefit" test in BHP's attempt to acquire the Potash Corporation of Saskatchewan).

This is not to say that these are legitimate tools for promoting growth and maintaining macroeconomic control, but it does suggest that countries are more willing to entertain such market-distorting practices in the face of perceived discredited market mechanisms, gaps in the rules that govern the global economy, and more challenging global economic conditions.

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