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Comments from the Editor

Tamir Agmon
Editor

A major development in the global economy is the movement from a global world that was characterized by investment flows from the developed North to the developing South to a global system of more equal players that exchange goods, services, and factors of production from the North to the South and from the South to the North. This change is evident by the rise of China, India, and other countries in what is called "emerging markets" as a source of investment flows and a basis for large multinational corporations. Another major development is the rise of private equity funds as a source of global growth where sector-specific capital that combines relational and organizational capital with financial capital, with labor, management, and physical capital provided by domestic firms in emerging markets. This change has an effect of the role of the US in international business.

These changes that are taking place in real time have a substantial effect on the way that we do research in international business. The traditional Industrial Organization model of the economics of international business that was introduced to the field by Caves, Kindleberger, and Hymer in the US in the 1960's and was further developed by Dunning, Buckley, and Casson in the UK in the 1970's is no longer appropriate. As Dunning wrote in an essay published in *AIB Insights* earlier, the world of international business is changing and therefore the research community of international business has to look for a new paradigm.

A good way to do it is to observe and analyze the new developments in the global market. Three studies that record and analyze such developments are reported in this issue of *AIB Insights*. Turkey is one of the most interesting emerging markets. The size of the country, its geopolitical location, the process of accession to the EU, and the cultural uniqueness of Turkey create an interesting location for investment. The US$20 billion investment of major global banks in the banking sector in Turkey in 2005–2006 is one expression of the accelerated globalization process in Turkey. The globalization of the Turkish economy is a major change agent for the country. One particular field where the old and the new interact is corporate governance. Professor Orbay provides a most interesting description and an analysis of the changes in corporate governance in the Turkish corporate sector and their relation to the globalization and the modernization processes in Turkey. Like in many other cases the problems in the Turkish corporate governance create problems but also opportunities for global investors. The foreign investment both in the Turkish corporate sector and in the banking sector provides a challenge to the domestic corporate sector, a challenge that according to Orbay may result in a stronger performance of the Turkish corporate sector.

The importance of high-risk capital in the form of venture capital and private equity funds is a well-known fact of the global market of today. As one of the managing partners of a major US-based private equity fund said: "Private equity funds are the MNEs of the 21st century." Import of high-risk sector-specific capital is the basis for new international business activities. Professor Messica describes the unprecedented growth of the high-tech sector in Israel in the period 1995–2003 as an example of how the combination of foreign high-risk sector-specific capital and domestic high-skilled labor generated a new comparative advantage for Israel. Messica's article is an example to the new role of small and peripheral countries as originators of international business activities.

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The emerging new form of international business does not rule out the role of the US as the main source of global investment, it changes the way it expresses itself. In a thought provoking article Professor Suk Kim revaluates the role of the US in the global economy against the rise of China as a global power. In a way Suk Kim's analysis is congruent with the analyses presented by Orbay and Messica. There is a change in the world. The way that international business expresses itself is changing, but the central role of globalization is as important as it has been in the past. The success of the international business of the second half of the 20th century is the reason for the changes that we observe at the beginning of the 21st century. The articles by Orbay, Messica, and Kim are evidence to this process.

Submission Information

- Submissions to *AIB Insights* can be sent at anytime to the editor.
- Submissions may be electronic, by fax, or by mail. Electronic submissions are preferred.
- Submissions will be reviewed by the Editor to ensure material is appropriate for *Insights*, then the advisory board will comment on submissions.
- For consideration for specific editions, submissions must reach the editor by the following dates:

1st Quarter:	December 15
2nd Quarter:	March 15
3rd Quarter:	June 15
4th Quarter:	September 15

- Articles should be approximately 2-3 printed pages.
- Exercises, simulations, and other material should include all the information needed for use in the classroom. Material submitted should not contravene any copyrights.
- Blunders should be based on real-world events and should be new — i.e., not previously published or disseminated in other media.

We look forward to your comments and submissions.

Globalization and Tradition in Corporate Governance in Turkey: Problems and Opportunities

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In a private interview, the general manager of a public company made a startling remark that reflects the dramatic changes faced by the corporate sector in Turkey. He said that:

> *Running this company used to be very straightforward. Customers had little choice and they were pretty much captive as long as they can afford the price. Things started to change in 2002. In 2003, the Board asked for an efficiency study, which I believe marks the first time ever that a concern about efficiency was uttered in a Board meeting.*

This rather dramatic change in the way of doing business in Turkey was a direct outcome of the process of globalization. As the same manager said:

> *Basically, the customers found alternatives in international suppliers. We have had to match world prices despite a small transportation advantage…. We found ourselves far from the efficient scale that international suppliers have achieved. How do we invest to get to efficient scale? Our market is not large enough and financing is difficult.*

The globalization of the corporate sector in Turkey brings about problems and opportunities. The problems reflect managerial weakness carried over through the corporate culture developed in an era of protectionism and from personal corporate governance of owner's control companies. The opportunities arise from the opening up of Turkish markets to international companies at an unprecedented level. These two factors together generate change processes that are reshaping corporate governance in Turkey.

From a Legacy of Protectionism and High Inflation to a Global and an Open Economy

Turkey was a closed economy until the 1980s. In the earlier years of the republic, the focus was on domestic capital accumulation and developing an industrial base. Private entrepreneurs were protected and pampered by the state. And this approach lingered until the late 90s.

This policy created rents for corporations and their stakeholders through public policies; effective management of companies was of second order importance. Board members were chosen to maintain good relationships with state officials. Management was evaluated on its ability to maintain and increase the rents.

From the perspective of owners, this culture has two important characteristics. First, efficient management of assets and costs were not the primary concern. Rents earned covered operational inefficiencies adequately. Second, capital owners became highly risk averse. High risk investments, such as research and development, were not considered

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seriously, as less risky investments provided sufficiently high returns.

Another factor fueling this culture was the high-inflation environment in the 90s. In this period government bonds provided very high real returns. The government became the major financial intermediary where the corporate and the private sector invested their funds in governments' bonds, and raised funds for their investment from the government.

A quick look at the figures gives an idea of the distortion in the company operations. In 1997, of 206 non-financial companies traded in the IMKB (the Istanbul Stock Exchange), 33 reported interest income exceeding their operating income, 15 of which showed operating loss. For 83 companies, interest income made up more than 10% of their operating EBIT. The high return from financial investment of the corporate sector indicates the importance of the Turkish government as a financial intermediary and affects corporate governance in Turkey. Operational efficiency and cost control were not of primary concern.

The economic stability and the declining inflation following the 2001 crisis changed the rules of the game in the corporate sector in Turkey, and it led to opening up of the Turkish markets to international companies. Stability made the EU Customs Union agreements more effective and increased competition. Stability also had a positive effect on exchange rates' volatility. Therefore markups on imported goods were significantly reduced. In order to compete, Turkish companies had to focus on their core businesses and improve their operating efficiency to survive. This led to changes in corporate governance.

One of the important changes is the decline of the unrecorded economy. The prevalence of the unrecorded economy is a consequence of weak enforcement and a business culture. It is also the result of having one individual or a group of majority holders who control the company. This procedure makes market value irrelevant and makes international transactions unlikely. As the manager of the Mergers and Acquisitions department at TSKB[1] said:

> *Today, there is a lot of interest in Turkish assets from foreign investors. Because the risk associated with Turkey has been significantly reduced, these investors are willing to pay high prices for equity investments.… Many Turkish companies seek foreign partners for capital infusion and growth in international markets.… However, if all your transactions are not on the books, you will not even be able to talk to the investors.*

As in many developing countries, one of the most important structural weaknesses obstructing economic development is ineffective enforcement of laws and regulations. The Turkish judicial system has traditionally been complicated and slow, although some improvements have been implemented in the late 1990s.

An interesting example to enforcement problems is provided by the Capital Markets Board of Turkey (CMBT). The CMBT keeps a watch on market participants for compliance with the capital markets law. When a violation is detected, the CMBT may impose administrative fines or a suspension from trading. In some infractions the CMBT must file a case at the public prosecutor's office for commencing a judicial process. The CMBT reports that approximately 100 cases per year have been filed for prosecution between 2000 and 2003, however, only one case per year ended up with a verdict. The rest of the cases have either been dismissed, or are dragging through the court system.[2] The ineffective enforcement is the main reason behind the widespread unrecorded economy phenomena.

At the very basic level, when the rules are not properly enforced, it is not possible to develop a rule-based system, which is essential to the good governance of companies and a level playing field for all economic agents. The most important advantage of a rule-based system is that the environment becomes more predictable and, conse-

quently, perceived risks of doing business are much reduced.

Ineffective enforcement leads to ineffective financial contracting, a big deterrent for an efficient trade and the overall smooth running of the economy.

As a consequence of insufficient enforcement, what we observe today in Turkey is a widespread distrust of formal mechanisms. For example, joint ventures between companies or project-based partnerships between business people are very rare. Recently, in a press conference concerning the group of businesspeople preparing a joint bid in the privatization of Erdemir, Rifat Hisarciklioglu[3] remarked that "one of the goals of our venture is to provide a model of doing business in partnership, which, unfortunately is lacking in our business culture" (paraphrased).

Distrust of formal mechanisms feeds the culture of relationship-based interaction as a way of doing business. This is also apparent in the owner-manager structures within companies. We have already pointed out that lack of transparency hinders effective management. Furthermore, as the owners can not be entirely comfortable with employee contracts due to the enforceability question, they are very reluctant to empower managers adequately for the running of the company. The perception is that it would be extremely costly to remove a manager on a poor performance basis.

The most important conclusion we draw from this section is that, currently, a very large number of Turkish companies are beset with inefficient management carrying over from the earlier era of corporate governance and corporate culture. As a consequence, they experience problems in competing with more efficient international suppliers. The same feature, when coupled with a movement toward more modern corporate governance, is a source of competitive advantage for Turkish companies. The strength of Turkish companies, perhaps also partly because of direct owner involvement in management, is their dynamism and high degree of adaptability to different circumstances. Certainly, the extended period of crisis honed the survival instincts of these business people. It is our expectation that this dynamism will reshape corporate structures into forms that increase substantially the capacity to compete in the new environment.

THE STATE OF CORPORATE GOVERNANCE

The International Institute of Finance Task Force Report on Turkey provides a comprehensive report on corporate governance in Turkey4. The purpose of this part of the article is to discuss the main components of corporate governance as they relate to the globalization and the modernization of the Turkish corporate sector.

Ineffective enforcement leads to ineffective financial contracting, a big deterrent for an efficient trade and the overall smooth running of the economy.

Legal Framework and Institutions

The Turkish corporate governance regime is based on three pieces of legislation: the Commercial Code (CC), Capital Markets Law (CML) and Corporate Governance Principles published by the Capital Markets Board (CMB). The CC, a French-origin law, was enacted in 1956. The CML, enacted in 1981 and amended in 1999, is based on Anglo-Saxon laws. Both these laws are currently undergoing a major revision. In particular, the CC is being completely rewritten with a goal of aligning it with European Union requirements. The new versions are expected to mend important weaknesses of the governance regime.

The CMB's Corporate Governance Principles, published in 2003, provides guidelines for improving corporate governance within the established legal framework. These guidelines apply to listed corporations on a comply-or-explain basis. Starting in 2004, all listed corporations must set a

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corporate governance section in their annual reports, where they report how they comply with the Principles.

The IIF Task Force Report states that these three documents cover almost all of the key guidelines in the IIF Code.

In Turkey modern capital markets have only a 20-year history, although the history of equity trading goes back to the turn of the last century. The CMB was established in 1981 with the enactment of the CML, and the Istanbul Stock Exchange (ISE) started equity trading in 1986. Figure 1 shows the brief history of the exchange with the main ISE index and trading volume. The history is marked with three major crises in 1994, 1998 and 2001. While 2000 started as spectacular year for the market, the index started sliding in the second half of the year in expectation of a currency crisis in 2001.

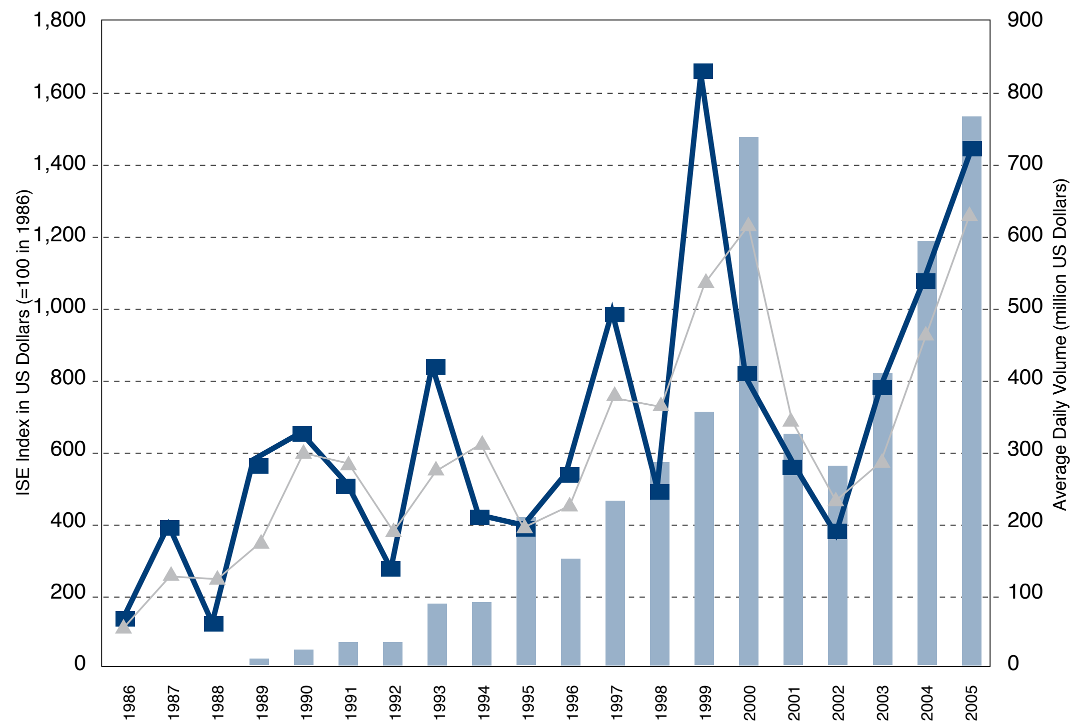


Figure 1. 20-year history of Istanbul Stock Exchange. *Bars show average daily trading volume (right axis) while lines indicate ISE100 index in US$ at year end (square markers) and average of beginning and ending index values (triangle markers).*

Prior to 1990, trading was insignificant. Since 1990, ISE has shown a strong overall growth, but also very high volatility reflecting the period of economic turbulence. In the last 15 years, average annual return was 30% in US$, with a standard deviation of 90%.

Similar to several other medium income countries, the ISE is not a very developed equity market. As of September 2005, market capitalization has reached $130 billion. This represents 30-35% of GDP, well below OECD average of 135%. Equity shares of only 264 companies are traded, together with shares of 10 real-estate investment funds and 25 mutual funds. The list of public companies includes only one-fifth of the largest 500 companies. In addition to the equity market, the ISE is also the secondary market for government and corporate bonds, though the latter does not exist at the moment. A separate exchange for derivative securities, located in Izmir, was established in 2004.

Ownership Structures

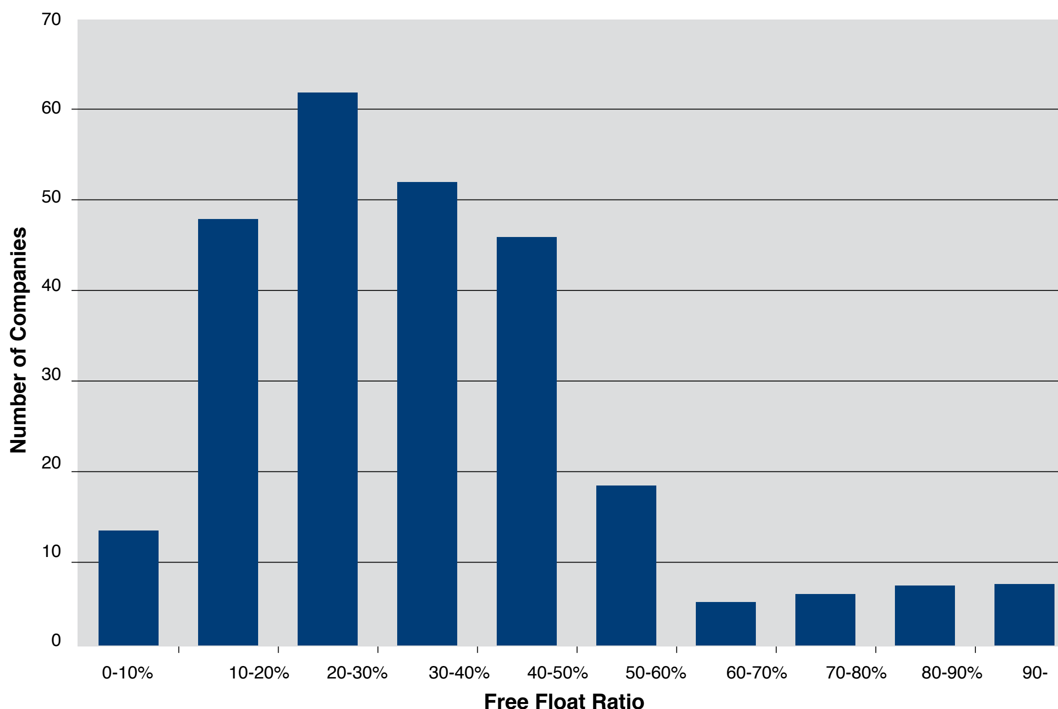
The ownership structures of Turkish companies can be characterized as highly concentrated. Yurtoglu reports that families control 80% of public companies with an average voting block of 67%. In half of these companies, the majority owner is a holding company controlled by the family. For the remaining 20% of the companies, the majority block is again 67% on average, though the owners are institutions without family control.

Complex pyramidal structures are frequent, although there is a trend towards simplification of these pyramids. Through these structures, families maintain control with a much higher fraction of voting rights than cash-flow rights. For the family-controlled companies, families claim, on average, 51% of cash flow rights compared to 67% of voting rights. For the median company, the ratio of voting rights to cash flow rights is 1.12, though the mean is much higher (5.3).

Even for public companies, the fraction of shares traded is quite low. Figure 2 shows the distribution of the free float ratio for the 264 corporations traded on the ISE. In this group, the average flotation ratio is 35.7%. Weighted by market capitalization, this ratio drops to 30.5%, indicating that firms with higher market capitalization have somewhat lower flotation ratios.

Recently, the ISE board has taken steps to increase the flotation ratio of listed companies and thereby depth of trading. All companies with market capitalization less then 20 million YTL are required to increase their flotation ratio to 25% by June 2007. Otherwise, these companies will be delisted from the primary market. This change represents an improvement through elimination of illiquid issues.

Figure 2. Distribution of flotation ratios of public corporations.



Despite concentrated ownership, there is a widespread use of multiple class shares. Company articles of association may assign various types of privileges to different classes.

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Share Class	Equity Capital Ratio	Cash Flow Rights	Voting Rights	Other Privileges
A	26%	54%	41%	Two votes per share Nominates 4 of 7 board members Nominates 2 of 3 audit committee members
B	25%	36%	20%	Nominates 1 of 7 board members
C	49%	10%	39%	Nominates 2 of 7 board members

Table 1. Share classes and privileges in Adana Cement

According to the CMB survey in 2004, 42% of public companies have share classes with the privilege of nominating board members, which is the most commonly used privilege. Other observed privileges are voting rights (21%) and the nomination of audit committee members (18%). As an example, Table 1 displays share classes in Adana Çimento, a cement company. Adana is a rare case where shares in all three classes are traded in the ISE. Typically, shares in privileged classes are not floated.

Board Structure

While there is no systematic research on corporate boards in Turkey, the CMB survey of 2004 reports that, among public companies:

- 78% have non-executive board members,
- 26% reported appointments of independent board members, however, the CMB report questions whether these members conform to the definition of independence given in principles,
- 9% have a formal corporate governance committee,
- 4% remunerate board members on the basis of performance.

In general, boards are composed of representatives of controlling families, who are typically family members. Occasionally, professionals are appointed as board members to utilize their expertise. Most commonly, executive powers are delegated to a board committee (executive committee), chaired by a family member. Although general managers are appointed, and sometimes even called CEO, their executive powers are limited and controlled closely by the chair of the executive committee.

At present, independence of boards is largely a myth in the Turkish reality. The board decisions are generally imposed by the chairman of the board. Anecdotal evidence suggest that even in many of the largest companies, board meetings can be devoid of substantial discussion and not go beyond fulfilling formal requirements.

Transparency

Turkey has shown significant progress lately in the transparency and disclosure area. Prior to 2004, the Turkish national accounting system held the distinction of being the one with the highest number of discrepancies with international standards among OECD countries. In particular, lack of inflation accounting and lack of consolidation practice significantly lowered the information content of financial reports.

Starting in 2005, adherence to International Financial Reporting Standards (IFRS) became mandatory for public companies. A law enacted in 2003 allows for inflation accounting for both reporting and taxation purposes. Complementing these significant improvements, the CMB decrees mandate reporting of ownership details and related-party transactions.

A recent study conducted jointly by Standard & Poor's and Sabanci University evaluated the disclosure practices of 52 public companies, to compare with S&P's studies in other countries[5]. The results, shown in the table on page 9, place Turkey between Latin America and Asia Pacific. However,

	Composite Score	Ownership Structure	Financial Disclosure	Board Related Disclosure	Number of companies
U.K.	70	54	81	70	124
Europe	51	41	69	41	227
U.S.	70	52	77	78	500
Japan	61	70	76	37	150
Asia-Pacific	48	41	60	42	99
Latin America	31	28	58	18	89
Emerging Asia	40	39	54	27	253
Turkey	41	39	64	20	52

Table 2. Comparison of Transparency and Disclosure Scores (sources: *S&P's Transparency and Disclosure Study, 2002 and S&P/CGFT Transparency and Disclosure Survey-Turkey)*

this comparison may be somewhat out of date. The Turkish study was based on the 2003 annual reports whereas, for example, the Latin America study was conducted in 2001. Thus, the progress in this time period was not taken into account. On the other hand, new disclosure requirements, especially Corporate Governance Principles disclosure compliance reporting, are expected to cause a jump in the Turkish scores.

Concluding Remarks

In the period following the 2001 crisis, Turkey has demonstrated its vast potential. Much of this potential has realized through global investment and global involvement. A sound corporate governance is a necessary condition for this process to continue. A governance deficiency as the one experienced during the decade preceding the crisis will bring an inevitable collapse that may be even more deeply damaging and therefore much more difficult to overcome. Hence the crucial importance of sound governance. Moreover, it is not sufficient today to achieve or even maintain stability. What is imperative now for a country like Turkey is achieving sustainable high growth in the fiercely competitive environment of the global knowledge economy. For Turkey, perceiving fully and progressing definitively toward this objective has become even more critical now as the accession negotiations with the EU and hence a very critical period of continuous and further transformations has started. This process and its objectives require high levels of productivity enhancing, knowledge-intensive investments. This can only take place in an environment and with the instruments of highest quality governance both at the public and private level. The set of most critical factors in this general context include: the need to decrease the discretionary element in regulation and endow the latter with sufficient competence; transformation toward more effective corporate governance in the corporate sector and in the public sector; and the creation of a credible and accessible financial information base. By accomplishing these goals, the corporate sector in Turkey will become an equal partner in the new global economy.

Endnotes

1. TSKB (Türkiye Sınai Kalkınma Bankası) is a state-controlled investment bank.

2. A special problem for CMBT cases is that the capital markets law and the corporate law have conflicting clauses in their current versions. These conflicts cause unpredictability of judicial outcome. (Both laws are being rewritten as of October 2005.)

3. Rifat Hisarciklioglu is the chairman of Turkish Union of Chambers and Commodity Exchanges (TOBB). He facilitated the joint venture of approximately 15 different companies that participated in the privatization of Erdemir, the largest iron and steel mill in Turkey, which has considerable market power.

4. *Corporate Governance in Turkey*, IIF Task Force Report, 2005. Other sources are Ararat and Ugur (2004, 2005).

5. Transparency and Disclosure Survey-Turkey, S&P and CGFT

Capital Imports, Innovation Finance and New Comparative Advantage in Small Countries

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Innovation is an important driver for national growth and value in many small countries. Growth in such countries is necessarily associated with exports and other international business activities. Capital imports have always played an important role in the development of export in small and developing countries. In the development economic analyses (that have dealt primarily with Latin America) in the 1960s, the focus was on the accumulation of physical capital through foreign direct investment (FDI) as was accounted for by Balassa (1965). In today's global high-technology sector we observe a process in which the flow of sector-specific capital – such as the type of high-risk capital that is provided by venture capital (VC) funds – partially displaces the traditional FDI as source for exports-generating capital.

Comparative advantage depends on factor intensity. In some small countries it is the combination of a specific production factor that is augmented by a second, additional, factor that may, together, generate the necessary factor intensity which will lead to a new comparative advantage. The development of a comparative advantage in the high-technology sector (Hi-Tech) sector in Israel is a case in point. The development of such a comparative advantage is evident from the sharp growth in the Israeli exports of Hi-Tech goods and services and seems to debunk traditional international trade theory. Israel is a small peripheral country that did not develop meaningful international activity prior to 1995 despite its high level of higher education. Yet, over a short time, in 1995–2000, Israel has developed a significant comparative advantage in the global Hi-Tech sector that mostly originated from the start up of young, innovative technological companies. The extent of this global comparative advantage can be evaluated by Balassa's Revealed Comparative Advantage (RCA) index that calculates the ratio of a country's exports (as percentage of the global exports) to its relative size in terms of world GDP.

Over the past fifteen years the Israeli Hi-Tech industry went through a double transformation; its center of gravity shifted from military/defense-orientated products to commercial products for the civilian market and from governmental funding for corporate manufacturing and R&D to VC-backed ventures. This shift was initiated by a government program called Yozma (in Hebrew "Yozma" means "Initiative") that was comprised of two major features: relying on the private market and focusing on foreign high-risk capital. Yozma was a fund of funds that triggered the Israeli venture capital industry by active promotion of the establishment of ten local VC funds and through joint-venture policy for these funds with American as well as other international venture capital funds.

The budget commitment of the Israeli government was relatively small, $100 million, but significant enough to kick off the process. For perspective, the US venture capital industry managed roughly $7.5 billion in 1994. The outcome of the Yozma program was overwhelming, as is illustrated by the table on page 11.

During 1995–2005 the Israeli government invested roughly $3 billion in its local Hi-Tech through a variety of support programs. At the same time the Israeli VC industry imported and invested about $11 billion of sector-specific, high-risk capital, primarily from the US. This huge capital import paid off. Over 1998–2003 the Israeli

Outcome of the Yozma Program (1994–2004)

Total Investment	# VC funds	Invested ventured	Survived (2004)	Employees (2004)	Total exports	Tax Return (2004)
$100M	10	168	103	6,000	$1.2B	$100M

information and communication technology (ICT) sector has grown by 50%. The contribution of the ICT sector to the Israeli economy has grown from 8.8% in 1998 to 12.4% in 2003, and its annual exports almost doubled from $6.6 billion to $10.8 billion. The number of employees at the Israeli ICT sector has grown by 60% from 100,000 to 160,000.

This accomplishment was made possible by importing high-risk capital from the US, as well as other developed capital markets, and was matched locally by the vigorous generation of intellectual property (IP) and the existence of high-skilled labor. What are the financial prerequisites for such an immense capital import of high-risk capital to take place? This question takes us back to basics. Much like any local firm that seeks to operate in the global markets, any country that strives to set up a successful Hi-Tech sector faces entry barriers. These barriers are proportional to the size of the relevant sector (e.g., telecom, semiconductors, or biotech and medical instrumentation) and the competitive investments that are made by other countries. It is quite often that these barriers are relatively higher for smaller and more peripheral countries. For example, it is evidently clear that only a small number of countries can enter the lucrative semiconductor fabrication industry due to the multi-billion dollar investments that are required. Therefore these required investments, as well as the required intangible assets such as IP and the like, form an insurmountable barrier for small countries such as Israel. Retrospectively the main contribution of the Yozma program was to open the door for a flow of foreign sector-specific capital to Israel. It is this foreign VC that allowed Israel to overcome the entry barriers of the global Hi-Tech sector and that bought it the entry ticket to this global market.

The Israeli government, through the Yozma program, accomplished the import of high-risk, sector-specific capital to Israel, bridging the gap between local optimist entrepreneurs and risk-averse foreign investors through the formation of a financial intermediation mechanism in the form of local VC funds having foreign professional investors (Coval and Thakor, 2005).

The Israeli experience teaches us that there are few major prerequisites that are required for a small country to generate a new comparative advantage in the global Hi-Tech sector. These are:

1. Importing sector-specific capital from wherever it is available.
2. Adopting a portfolio approach (Yozma was a fund of funds) to reduce variety of intangible transactions costs (e.g., IP rights, credibility, management practices, ethics, cultural differences).
3. Setting up the proper corporate governance, financial, legal, and accounting infrastructure that is congruent with the operational methods of venture capital funds and their investors (i.e., financial institutions in the US and other developed countries).

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Which Country Will Be the World Economic Leader in the Next Generation: The United States or China? And the North Korean Factor

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A growing body of literature indicates that the balance of power may shift from the West to the East as China rises and the United States declines. The sum total of America's global interests and obligations is nowadays far larger than the country's power to defend them all simultaneously. In this respect, the problems the United States confronts are almost identical with those of previous imperial powers, such as Britain, France, Spain, and the Soviet Union. If we accept an American decline for a moment, China is the only country that has the economic potential to challenge the United States for the global economic leadership in the next generation. There have been two great shifts in global power over the past 400 years. The first was the rise of Europe, which around the 17th century became the richest, most enterprising, and most ambitious part of the world. The second was the rise of the United States in the late 19th and early 20th centuries, when it became the single most powerful country in the world, the globe's decisive player in economics and politics. For centuries, the rest of the world was a stage for the ambitions and interests of the West's great powers. China's rise, along with those of Japan and Korea, represents the third great shift in global power, the rise of East Asia.[1] However, this paper argues why the United States will continue to maintain the world's economic leadership in the next generation and beyond. In addition, this paper also discusses the importance of multilateral actions on world affairs with respect to the North Korean nuclear standoff.

Is There Another Wave of American Decline?

The collapse of the Soviet Union in 1991, along with the unusually strong performance of both the U.S. economy and its stock market during the 1990s, elevated the United States to an unsurpassed level of economic, military, and cultural power. However, in the early 2000s, the United States has faced its sixth wave of decline since the 1950s, a phenomenon largely triggered by its external economic problems and the September 11, 2001 attacks against the World Trade Center in New York and the Pentagon in Washington, D.C. The first wave occurred in 1957 and 1958, when the Soviet Union launched the Sputnik, the first manned satellite. The second wave came at the end of the 1960s, when President Nixon began to prepare Americans for a multipolar world because American decline economically and militarily was inevitable. The third wave followed immediately after the OPEC oil embargo in 1973 and the dramatic increase in oil prices. The fourth wave took place in the later 1970s, because of the Vietnam War, the Watergate scandal, the continued development of Soviet nuclear forces, and the expansion of Soviet power in a half-dozen countries, such as Angola. The fifth wave happened in the late 1980s, largely due to U.S. foreign debt as well as financial threats from Japan.

Every single empire and great nation of history has been destroyed or greatly diminished in world influence. Why should we assume that the United States, today's great nation, could defeat the pattern of history? If we assume an American decline for a moment, China seems likely to emerge as a great power, which might end the dominance of the United States in the game of influence on world affairs. We can base the current wave of decline on three bodies of evidence: (1) mounting U.S. budget and trade deficits, (2) economic and military threats from China, and (3) a growing

world resistance to American unilateral actions. Let us examine, however, these three bodies of evidence, along with other arguments, before we willingly accept such a gloomy conclusion.

Fading America and Emerging China

Is the United States really passing its baton in the race for world economic leadership to China? Is there anything special about China? Oded Shenkar[2] argues that the rise of China in the early 21st century is distinctive and has more in common with the rise of the United States in the 20th century than with the advance of other countries such as Japan. We can find several compelling arguments that such a switch is already under way. For in almost every dimension—population, the numbers of engineers and scientists, trade, international reserves, investment, gross national product, and many other areas—China's activity will challenge that of the United States. At present, China has the world's largest population, graduates the world's largest number of engineers and scientists every year, enjoys the world's largest current account surplus, has the world's largest reserves of foreign exchange and gold, is the world's largest recipient of foreign direct investment, has the largest standing army in the world, and commands the world's second-largest economy in purchasing power parity (PPP).

Table 1 underscores a new reality. The United States is the largest net debtor nation in the world, while Japan is the largest net creditor nation and China is one of the major net creditor nations. For the United States on the one hand and Japan on the other hand, over the same period, a largely reciprocal relationship is evident. Growth in the net international investment position of the United States has coincided with the rapid increase of Japan's net investment position since 1990. China is emerging as a major net creditor nation and can become one of the world's largest net creditor nations quickly because the country holds the word's largest reserves of foreign exchange and gold. History shows that no country has managed to be a great power and a great debtor at the same time. Spain in the 16th century and England in the 19th century lost stature as world leaders when their status moved from creditor to debtor.

Table 1: Net Overseas Investment (in billions of U.S. dollars)

Year	United States	Japan	China
1988	15	292	–
1989	-77	294	–
1990	-211	329	–
1991	–263	384	–
1993	–180	612	–
1995	–423	812	–
1997	–1,066	959	–
1999	–1,037	829	–
2001	–2,340	1,360	–
2003	–2,340	1,614	–
2004	–2,449	1,784	120
2005	–2,546	1,532	287

Source: *The International Monetary Fund, Balance of Payments Statistics Yearbook, various issues.*

U.S. Foreign Debt

As recently as 1983, the United States was the world's largest net creditor nation. In just a few years, it then took an opposite role, becoming the world's biggest net debtor nation. What are the major causes of the U.S. foreign debt? Mounting budget and trade deficits have been primarily responsible for the U.S. foreign debt of the 1980s and beyond. The tax cut of 1981, which many regarded as the biggest in U.S. history, reduced revenue growth. The military buildup in the same year, again regarded as the largest in U.S. history, caused federal outlays to rise suddenly. Critics charge that "Bush I repeated Reagan's performance and turned the national debt upward again."

Observers believe that the two huge U.S. deficits are unsustainable and thus will eventually ruin the U.S. economy. In addition, the spending boom has generated record trade deficits that grow at a rate of $70 billion a month. To finance trade deficits, the United States has been forced to borrow approximately $5 billion every working day, most of which comes from foreign investors. Japanese, Chinese, and other foreign investors continue to fund the U.S. economy even today, but nobody thinks that this kind of inflow can be sustained indefinitely as the fear of war and terrorism mounts, a change that may boost the inflation rate and hurt corporate profits, the U.S. dollar, and investment returns. This financial reversal would also bring about the collapse of the U.S. security policy and its calculated strategy of world pacification. More specifically, the U.S. foreign debt

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could create a number of serious problems: lower living standards, policy constraints, and reduced international influence.

Solutions at Hand

Although the massive influx of foreign funds has largely gone for private consumption and military spending, a substantial portion of the U.S. foreign debt has gone for investment. Prospects for domestic investment have been sufficiently bright to make investment in the United States more attractive than investments elsewhere. U.S. banks and other entities have decided to invest less abroad and more in the United States, and foreigners have decided to do the same. Thus, it should be regarded as a sign of U.S. strength and Chinese weakness that the Chinese find it more attractive to invest in the United States than in China or any other country.

In the November 6, 2006 U.S. elections, the Democrats picked up enough seats to gain control of both the House and the Senate. In their victory news conference on November 11, 2006, congressional Democrats pledged to work with President Bush when they assumed control of the Houses and the Senate in January 2007, but everybody knew that disagreement on U.S. trade policy and tax policy could be assured. The Democrats' stance against free trade and huge tax cuts for wealthy people helped to build the party's success at the polls and could tip the balance on trade and tax matters. Through tight control on spending, promotion of economic growth, and revenue enhancements, the budget deficit can decrease to a level at which it does not pose a threat to long-term economic growth. Furthermore, the Democratic Congress has made it clear that it will not make the huge tax cut of the early 2000s permanent. The 2007 CIA World Factbook shows that the U.S. federal debt as a percentage of GDP is the third lowest among the G-7 countries (the United Kingdom with 42.2 percent, Canada with 64.5 percent, the United States with 64.7 percent, France with 64.7 percent, Germany with 66.8 percent, Italy with 107.8 percent, and Japan with 176.2 percent).

The U.S. trade deficit is likely to reverse soon, because the Democrats control both Houses and the current huge U.S. trade deficit cannot be sustained indefinitely. In 2006, the United States recorded a record trade deficit with China of $232 billion, 28 percent of its record total imbalance. On March 30, 2007, the Bush administration said that it would reverse more than 20 years of U.S. policy and impose steep penalties on Chinese goods, on the ground that China provides its exporters with too many state subsidies.[3] This step reflects the shift in trade politics since the Democrats took control of Congress in November 2006. Such tariffs on Chinese goods, pressure on China to revalue its currency, and other actions are likely to reduce the U.S. trade deficit with China substantially. It will reduce further if the national debt reduces, manufacturing productivity increases, the U.S. dollar depreciates, and the U.S. government applies pressure to open up Chinese and other foreign markets.

The Declining U.S. Economic Share

Some skeptics insist that America's economy is shrinking relative to others, and they have a valid point to make. For a time in the 1950s, the United States produced about 50 percent of the gross world product (GWP), a far larger proportion than now. However, such a situation was clearly a temporary product of World War II, because Japan and Europe were still devastated by the after-effects of the war. By the mid-1960s, with the world fully recovered, the United States accounted for somewhere between 25 and 30 percent of the GWP and has consistently remained at that level ever since; the U.S. share of the GWP stood at 28.33 percent in 2006. In short, if leadership means having 50 percent of the world's economic activity, American leadership disappeared long ago. If leadership means 25 percent of the world product, American leadership looks quite secure.

China and the United States are among the most productive economies in the world. China's economy has grown at an average rate of 8.92 percent per annum for the past ten years, from 1996 to 2006, while the U.S. economy has grown at an average rate of 3.2 percent per annum over the same period. With average growth rates of 8 percent for China and 3 percent for the United States, China should have overtaken the United States as the world's largest economy in PPP by 2012 (see Panel A in Table 2).

Economically, America remains the world's largest producer; this pattern is unlikely to change drastically in the future. As shown in Panel B in Table 2, at the current exchange rate, China's economy will equal America's in 2041, which means that it will take 35 years for China to catch up with America in terms of the nominal GDP. It is important to note that the United States can sustain an average annual growth rate of 3 percent indefinitely, while it is highly unlikely for China to sustain an average annual growth rate of 8 percent over the long term. Even if China's GDP equals that of America in 2041, its per capita income is likely to be several times lower than America's due to China's larger population. The United States has the largest and most technologically powerful economy in the world, with a per capita GDP of $44,300 at the current exchange rate. On the other hand,

Table 2: The Gross Domestic Product of the United States and China (in trillions of U.S. dollars)

Year	United States	China
Panel A: Gross Domestic Product in purchasing power parity with annual growth rates of 3 percent for the United States and 8 percent for China		
2006	12.98	10.00
2009	14.19	12.60
2012	15.50	15.87
Panel B: Gross Domestic Product at the current exchange rate with annual growth rates of 3 percent for the United States and 8 percent for China		
2006	13.22	2.51
2016	17.77	5.42
2026	23.87	11.69
2036	32.08	25.26
2041	37.19	37.11

Notes: *1. The 2006 figures are those from the CIA World Factbook, March 27, 2007.*
2. Other year figures are the author's projections.

China faces a variety of problems to sustain its fast economic growth. Measured on a current exchange basis, in 2006 China stood as the fourth-largest economy in the world after the United States, Japan, and Germany, but in per capita terms ($1,900), the country is still a lower middle-income country

Unilateral Actions

The United States should aim to work with other nations on global problems whenever possible, because emerging powers—either singly or in coalition—will increasingly constrain U.S. options regionally and limit its strategic influence.[4] When President Bush took office on January 25, 2000, his aides assured the allies that America was a team player and would practice "multilateralism." However, Bush opposed a considerable number of multilateral treaties and agreements within six months of taking office. For example, the administration had pulled out of the Kyoto Protocol on global warming, announced its intention to withdraw from the Antiballistic Missile Treaty, stated its opposition to the Comprehensive Test Ban Treaty and the International Criminal Court signed by Clinton, backed away from establishing a body to verify the 1972 Biological Weapons Convention, and watered down a small arms control pact.[5]

Consequently, Bush encountered hostility from U.S. allies in Europe, Asia, and other parts of the world as the United States shifted its foreign policy from multilateralism under the Clinton administration to unilateralism under the Bush administration. The U.S. invasion of Iraq in March 2003 without U.N. support isolated the country even further from the rest of the world. The threat of terrorism is merely the most alarming example of why the United States must seek constructive relations with nations weak and strong. Critics charge that international crises, such as arms conflicts in Iraq, Iran, and North Korea, are simultaneously "the natural consequences of Bush's unilateralism, his militaristic new doctrine of preemption, and his insistence on expanding a justified war against al Qaeda to a misconstrued axis of evil."[6]

The North Korean Nuclear Standoff and Multilaterism

The United States and North Korea reached the Agreed Framework in October 1994, in which North Korea pledged to abandon its nuclear ambitions in return for the construction of two light-water reactors and 500,000 tons of fuel oil each year until the reactors were completed. However, this deal collapsed in October 2002, after North Korea admitted that the U.S. evidence about its secret nuclear weapons program was correct. On September 19, 2005, the six nations (China, Japan, Russia, North Korea, South Korea and the United States) reached a six-point agreement called the "Joint Statement," at the fourth round of talks in Beijing on North Korea's nuclear program. However, the six-party talks have gone nowhere since then, because in November 2005 the U.S. Department of Treasury designated Banco Delta Asia (BDA), a bank in Macau at which North Korean entities maintained accounts, as a "primary money laundering concern" and proposed rules to restrict U.S. financial institutions from engaging in financial transactions with it. Nevertheless, on February 13, 2007, the six parties conducted the fifth round of six-party talks and agreed to "Initial Actions for the Implementation of the Joint Statement," a reference to the September 19, 2005 Joint Statement. Will this new pact hold? Some experts think this new deal may stick for three major reasons. First, after the North Korean nuclear test in October 2006, the United States had no other alternative but to reach an agreement. Second, this accord would neutralize a number of increasingly stringent economic sanctions and restrictions against North Korea imposed by the United States, its allies, and the United Nations in recent years. More importantly, all these six-party talks have been held in Beijing under Chinese

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sponsorship, and China has been the increasingly reluctant patron of North Korea.

The United States should reject multilateral initiatives that are recipes for inaction, that promote the self-interest of others, or that are contrary to our values. In general, however, American foreign policy in a global information age should have a general preference for multilateralism. If the multilateral denucleariztion agreement of February 13, 2007 is successfully implemented, there is a good chance that the United States will return to multilateralism on negotiations for important global issues. The Iraq war has taught the United States that America's position of unchallenged dominance on world affairs might end, as America continues to rely on unilateral actions to resolve its conflict with other countries.

Has China Paid Its Dues to Be First?

Certainly, China is a strong country, with the world's largest army and a huge trade surplus, saving more than it spends, and investing excess money abroad. The flow of Chinese cash into the United States has helped fuel U.S. economic expansion in recent years and has enabled the United States to become an engine of world economic growth. China can no longer be ignored in important issues, such as negotiations on global trade and arms conflicts. However, it is unlikely that China will soon replace the United States as the international leader for economics and other global issues, because it takes more than money and the size of the active armed forces to be first.

Oddly enough, China's advantage in international finance does not seem that obvious. Beijing lags far behind London, New York, Frankfurt, Tokyo, and other major cities in terms of offshore banking centers, new financial instruments, or freedom from regulation. The United States still plays the largest role at multinational institutions such as the World Bank and the International Monetary Fund. Moreover, no country can be great without abundant natural resources. China has too few natural resources to be an enduring power. It is true that the U.S. advantage in technology over other countries has narrowed since the end of World War II. Although Japan, Europe, and even China have caught up with the United States in many old technologies, they are struggling and will continue to struggle to pass the United States in the new growth industries of the 2000s and beyond—computer software, genetic engineering, exotic material manufacturing, space technology, and others.

Conclusion

The ultimate test of a superpower depends on its ability to renew its power. American competition, mobility, and immigration are its engines of renewal, thereby enabling the United States to meet this test to a far greater extent than any other country. These characteristics are the main sources of American strength. In China, on the other hand, an authoritarian political system, a government-directed capitalism, and a centralized economic system spur its export drive, but such a social structure combined with a growing economy could be prone to collusion, corruption, and stagnation.

A true superpower does not draw all of its power from a single source, such as money, market share, military strength, or masses. Power—the elements that enable a nation to influence events in a fashion favorable to its own interests—derives from many sources. Seizaburo Sato, a foreign-policy advisor to former Japanese Prime Minister Nakasone, said that the greatness of a power is measured by four things: wealth, military strength, political ideas and the will to impose them, and a culture that appeals to other people and can influence them; the United States is the only superpower on all four counts.[7] In comparison to other major countries, the United States indeed ranks extremely high in almost all the major sources of national power: population size and education, natural resources, political stability, ideological appeal, diplomatic alliances, military strength, and technological achievement. The United States is, consequently, able to sustain reverses in any one arena while maintaining the overall influence stemming from other sources. At present, no country can mount a multidimensional challenge to the United States, and no country seems likely to be able to do so in the near future. Thus, just like the 20th century was the American century, the 21st century will be the American century.

Endnotes

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