

## The new mercantilist challenge

By Dani Rodrik

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The history of economics is largely a struggle between two opposing schools of thought, “liberalism” and “mercantilism.” Economic liberalism, with its emphasis on private entrepreneurship and free markets, is today’s dominant doctrine. But its intellectual victory has blinded us to the great appeal – and frequent success – of mercantilist practices. In fact, mercantilism remains alive and well, and its continuing conflict with liberalism is likely to be a major force shaping the future of the global economy.

Today, mercantilism is typically dismissed as an archaic and blatantly erroneous set of ideas about economic policy. And, in their heyday, mercantilists certainly did defend some very odd notions, chief among which was the view that national policy ought to be guided by the accumulation of precious metals – gold and silver.

Adam Smith’s 1776 treatise *The Wealth of Nations* masterfully demolished many of these ideas. Smith showed, in particular, that money should not be confused for wealth. As he put it, “the wealth of a country consists, not in its gold and silver only, but in its lands, houses, and consumable goods of all different kinds.”

But it is more accurate to think of mercantilism as a different way to organize the relationship between the state and the economy – a vision that holds no less relevance today than it did in the eighteenth century. Mercantilist theorists such as Thomas Mun were in fact strong proponents of capitalism; they just propounded a different model than liberalism.

The liberal model views the state as necessarily predatory and the private sector as inherently rent-seeking. So it advocates a strict separation between the state and private business. Mercantilism, by contrast, offers a cor-

poratist vision in which the state and private business are allies and cooperate in pursuit of common objectives, such as domestic economic growth or national power.

The mercantilist model can be derided as state capitalism or cronyism. But when it works, as it has so often in Asia, the model’s “government-business collaboration” or “pro-business state” quickly garners heavy praise. Lagging economies have not failed to notice that mercantilism can be their friend. Even in Britain, classical liberalism arrived only in the mid-nineteenth century – that is, *after* the country had become the world’s dominant industrial power.

A second difference between the two models lies in whether consumer or producer interests are privileged. For liberals, consumers are king. The ultimate objective of economic policy is to increase households’ consumption potential, which requires giving them unhindered access to the cheapest-possible goods and services.

Mercantilists, by contrast, emphasize the productive side of the economy. For them, a sound economy requires a sound production structure. And consumption needs to be underpinned by high employment at adequate wages.

These different models have predictable implications for international economic policies. The logic of the liberal approach is that the economic benefits of trade arise from imports: the cheaper the imports, the better, even if the result is a trade deficit. Mercantilists, however, view trade as a means of supporting domestic production and employment, and prefer to spur exports rather than imports.

Today’s China is the leading bearer of the mercantilist torch, though Chinese leaders

would never admit it – too much opprobrium still attaches to the term. Much of China’s economic miracle is the product of an activist government that has supported, stimulated, and openly subsidized industrial producers – both domestic and foreign.

Although China phased out many of its explicit export subsidies as a condition of membership in the World Trade Organization (which it joined in 2001), mercantilism’s support system remains largely in place. In particular, the government has managed the exchange rate to maintain manufacturers’ profitability, resulting in a sizable trade surplus (which has come down recently, but largely as a result of an economic slowdown). Moreover, export-oriented firms continue to benefit from a range of tax incentives.

From the liberal perspective, these export subsidies impoverish Chinese consumers while benefiting consumers in the rest of the world. A recent study by the economists Fabrice De-fever and Alejandro Riaño of the University of Nottingham puts the “losses” to China at around 3% of Chinese income, and gains to the rest of the world at around 1% of global income. From the mercantilist perspective, however, these are simply the costs of building a modern economy and setting the stage for long-term prosperity.

As the example of export subsidies shows, the two models can co-exist happily in the world economy. Liberals should be happy to have their consumption subsidized by mercantilists.

Indeed, that, in a nutshell, is the story of the last six decades: a succession of Asian countries managed to grow by leaps and bounds by applying different variants of mercantilism. Governments in rich countries for the most part looked the other way while Japan, South Korea, Taiwan, and China protected their home markets, appropriated “intellectual property,” subsidized their producers, and managed their currencies.

We have now reached the end of this happy coexistence. The liberal model has become severely tarnished, owing to the rise in inequality and the plight of the middle class in the West, together with the financial crisis that deregulation spawned. Medium-term growth prospects for the American and European economies range from moderate to bleak. Unemployment will remain a major headache and preoccupation for policymakers. So mercantilist pressures will likely intensify in the advanced countries.

As a result, the new economic environment will produce more tension than accommodation between countries pursuing liberal and mercantilist paths. It may also reignite long-dormant debates about the type of capitalism that produces the greatest prosperity.

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