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International Geopolitics and the Debate on the Existence of Strategic Sectors

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Summary

Various public policies in different states have historically been justified by alluding to the strategic nature of the economic sector they involve. Despite this, there is not always clarity regarding what criteria a sector of economic activity should meet in order to be considered strategic, nor is there a consensus definition of the term. Based on specific debates on public policies, this article seeks to discern the criteria underlying the designation of an economic sector as strategic and to elucidate its implications.

Keywords: strategic sector, public policies, security, economy.

Introduction

Strategic planning is a crucial phrase in the field of business management that, in the opinion of some gurus in the field, it would be better not to utter when talking about the State. A key author in this vein of business literature - no doubt - is Tsun Tzu. The implicit paradox becomes evident when we remember that the work for which Tsun Tzu is remembered is entitled "The Art of War", i.e., a state activity par excellence.

However, unlike - for example - game theory, where the word strategic has a precise meaning,[2] the use of the term in political discussions is often imprecise. In this context, the term suggests that the area of activity in question is of great importance to the state, whether for economic or security reasons. In other words, it becomes a surrogate for the perspective provided by realist international relations theory on state security.

That perspective is based on the conception of war contained in the above-quoted text of Tsun Tzu, according to which "The art of war is of vital importance for the State. It is a matter of life or death, a road that leads to security or ruin".[3] From the realist perspective, security policies are intended either to prevent war or, should one have to be faced, to achieve through it the political objectives of the state itself (which, in decreasing order of importance, are usually to guarantee its existence, its territorial integrity and its ability to make decisions autonomously).

Analysis

Given that guaranteeing the existence of the State is presented as a necessary condition for achieving any other end (such as achieving material well-being), security is by nature important, so that safeguarding it justifies the use of costly and exceptional means (such as the restriction of rights, among others). By associating the debate on the existence of strategic sectors or resources with this security perspective, the aim is to give them the sense of urgency that this would imply, as well as to justify the use of such onerous and unusual means. For example, during the COVID- 19 pandemic, Donald Trump defined himself as a war times president to explain the exceptional measures he adopted to deal with it,[4] by invoking the Defense Production Act (adopted in the 1950s during the Korean War) with the purpose of forcing the General Motors Company (GM) to supply clinical ventilators to the U.S. federal government.

In other words, Trump required a private company to manufacture goods that it did not produce, obliging it to produce them in a time, quantity and price established by the federal government, which would be the only buyer of those goods; something that, under normal conditions, would be incompatible with a market economy. The issue was already being negotiated between the federal government and GM, but, as Trump himself said, "Our negotiations with GM in terms of their ability to provide ventilators has been productive, but the fight against the virus is too urgent to allow the give and take of the procurement process to continue its natural course".[5]

As the above example suggests, even if there is no agreed definition of what defines a sector of the economy as strategic, it is not the case that this definition is entirely discretionary: even someone who does not accept the existence of strategic sectors, for example, could, at least in principle, agree that a pandemic poses a serious risk to the economy and public health of a State, and that this would merit the use of costly and exceptional means to deal with it.

Another similar example would be the argument used by another Republican government in the United States to justify state intervention in the economy to bail out private lenders with public funds during the 2008 financial crisis. In the words of then Treasury Secretary Henry Paulson, on the bailout of Fannie Mae and Freddie Mac, two entities dedicated to mortgage lending: "Fannie Mae and Freddie Mac are so big and are so intertwined with our financial system, that the breakdown of any of them would cause a big commotion in the financial markets in the country and around the world. This commotion would directly and adversely impact the wealth of homes (…). And this break would be prejudicial for the economic growth and job creation. That is why we are taking these actions today".[6]

In fact, the U.S. Treasury Secretary justified the bailout of private entities with public funds, arguing that the bankruptcy of these entities would have a systemic effect on both the U.S. and world economy. The systemic effect argument, however, ignored the problem of moral hazard. In that context, Lehman Brothers was allowed to fail because bailing it out would be tantamount to rewarding an investment bank whose conduct incurred in reckless risks, if not crime,[7] and would be tantamount to punishing investment banks that acted within the law and elementary standards of prudence. The fact that it was then decided to bail out the major investment banks with public funds was then tantamount to rewarding the behaviors that made the bailout necessary, making it more likely that they would be repeated in the future.

Even if one accepts that state intervention is necessary to prevent the systemic effect of a bankruptcy, one might question whether a substantial effort was not made to avoid moral hazard (i.e., to prevent a government decision from encouraging undesirable behavior in the future). In the 1990s, for example, Sweden rescued private banks with public funds, but at a cost to the shareholders and executives whose behavior led to their failure. At that time, the Swedish government acquired ownership of the banks at their market value, which - given their insolvency situation - was quite low; it then assumed the cost of the defaulted loans and recapitalized the banks with public funds in order to -Once their finances have been cleaned up, privatize them, thus recovering as much as possible of the public funds used for the bailout.

The point is that, even if one accepts that the bailout of private companies with public funds in the United States did not adequately deal with the problem of moral hazard, the argument that the State should try to avoid the systemic risk of the bankruptcy of private companies would still be valid. It is only one step from there to arguing that those companies -whose bankruptcy could pose a systemic risk- constitute a strategic sector of the economy.

However, the controversy as to whether or not strategic sectors exist is not only due to the conceptual imprecision with which they are defined, but also to the role of the State in the economy, and there are four debates on the subject. The first of these debates is the one we have already outlined: should the State intervene to prevent, with public funds, the bankruptcy of private companies because of their allegedly strategic nature? To what has been said I would only add that there have been different answers to that question, as in the case of Iceland, which "unlike other western economies, the Islandic government let its three main banks go bankrupt (…) and then went after the irresponsible bankers".[8]

The second debate about the role of the state in the economy to which the controversy over the existence of strategic sectors is related is that of ownership. A common assumption is that, if a particular sector is particularly important to a country's economy or security, perhaps the state should exercise ownership on it. It is no coincidence, for example, that in 2005 the three largest companies in the world hydrocarbon sector were owned by developing or post-communist states: Aramco (Saudi Arabia), Gasprom (Russia), and the National Iranian Oil Company (Iran).

However, it was Margaret Thatcher's conservative government in the United Kingdom that changed the nature of this debate by considering that a sector of the economy could be strategic without having to be owned by the State. On the one hand, she allowed foreign capital to participate in privatized companies, even in sectors of particular relevance to her country's economy or security. On the other hand, however, it created the so-called golden actions as a special regulatory mechanism. These actions endowed the British state with a veto right over certain corporate decisions (essentially in matters related to ownership, such as capital increase, acquisition or merger with other companies). In some cases, the purpose of these golden actions was clear: to prevent companies producing cutting-edge technology in the military field from being acquired by states considered hostile, or by companies from other countries competing with British companies.

The third debate on the role of the State in the economy related to the controversy surrounding the existence of strategic sectors has to do with the so-called industrial policies. That is, should the State have public policies that benefit a particular sector because of its importance (presumed or real) for the economy or security of a country? We are talking about policies such as granting preferential credits, subsidies, tax or tariff exemptions, or export and investment controls. For example, the South Korean government decided that the country's economic development should be based on the export of high value-added industrial products. This led to the implementation of industrial policies designed to achieve that end, but there was nothing natural about setting that goal, since it was an eminently political decision.

Nor was it natural to opt for such policies to achieve this; for example, while in South Korea the state first protected and then promoted private enterprises owned by Korean citizens, in other countries similar objectives were pursued through the expropriation of private enterprises, or by releasing - to a greater extent - the allocation of resources to market forces. The latter, however, did not prevent those states from choosing their own favorites. In the case of Peru, a supporter of the market economy such as Carlos Boloña, in his role as minister, had no problem in allocating public resources to prevent the bankruptcy of private banks, explaining his behavior based on the so-called systemic risk mentioned above.

Undoubtedly, this is a highly topical debate due to recent decisions by some of the world's leading states. For example, the supply chain of an iPhone involves companies from different countries, from those that provide inputs to those that design the product, including those that assemble it. Until a few years ago, these chains were established mainly -although not exclusively- on the basis of economic efficiency; in other words, whoever was able to offer a better product, or a lower price would become a link in the chain. But because of the disruptions in supply chains due to the pandemic and the war in Ukraine, the governments of the world's major economies are increasingly subordinating efficiency as a criterion in favor of more resilient supply chains that are less dependent on political rivals.

Suddenly, for example, the fact that Taiwan accounts for around 90% of the world's production of advanced microprocessors (those of nine nanometers or less) becomes a political vulnerability in the event that these supplies are stopped as a result of the conflict between the People's Republic of China and the United States over Taiwan. Also of concern is the fact that, according to a report by the International Energy Agency,[9] China concentrates a large proportion of the international capacity to process and refine the so-called rare lands (a crucial input for the development of renewable energies).

What China, the United States and the states of the European Union do - more often than not - is to adopt industrial policies that achieve three ends: to produce domestically part of what was previously imported, to diversify the sources of supply of those components that are not feasible to produce domestically (so as not to depend on a single source), and to reduce dependence on rival states (as in the case of European imports of Russian gas and oil). As mentioned above, this implies the adoption of industrial policies in favor of national companies or States that are not considered to be a source of economic or political risk (for example, the main beneficiary of such policies in Latin America would be Mexico, which has borders and a free trade agreement with the United States, is integrated into supply chains that supply that country, and is not considered a political rival). In other words, we are talking about policies that deliberately introduce distortions in international markets in order to make supply chains more resilient and less dependent on political rivals, but at the cost of being less efficient in economic terms.

Judging from past experience, such policies entail certain risks. The main one is that, when applied by all major economies simultaneously, they may fail to achieve their initial purpose or do so at an exorbitant economic cost. For example, during the Great Depression most major economies tried to compensate for weak domestic demand by exporting to their trading partners. To do so, they resorted to policies such as devaluing their currency (to make their exports more competitive) or adopting protectionist measures (to make their trading partners' exports less competitive). However, since they all adopted the same measures, they neutralized each other, which did not have the desired effect and worsened the international recession (an experience that explains the Bretton Woods agreements after World War II to promote cooperation even in times of crisis).

Currently, the Inflation Reduction Act passed by the U.S. government could have similar consequences.[10] In order to reduce the environmental impact of economic growth, the U.S. government provides incentives for its industry to transition to renewable energy and cleaner technologies through the Inflation Reduction Act. The Inflation Reduction Act contains two types of incentives that even countries allied with the United States see as a source of unfair competition. On the one hand, it provides subsidies and tax exemptions to producers and consumers (it contemplates, for example, a tax credit of up to US$7,500 for the purchase of an electric car). On the other hand, companies would only have access to these benefits if at least part of their production processes are carried out in the United

States or in countries that have free trade agreements with the United States (which excludes the European Union, the United Kingdom and China, among others).

Evidence that these benefits are perceived as a source of unfair competition in the European Union, is the joint pronouncement of the German and French governments entitled "For a European Green Industrial Policy, a French-German contribution".[11] In this pronouncement, both governments maintain that "the existing rules for state help may become more agile in the transformation technologies area"[12] (i.e., those that would enable the transition to environmentally sustainable growth). Lest there be any doubt as to what this implies, they add that "we propose permitting experimentation with focalized subsidies and tax exonerations".[13] They further propose to use EU trade policy to "preserve the common market of the distortions that come particularly from countries that aren't market economies and ensure an equal playing field".[14] Although the emphasis is on the People's Republic of China (under the euphemism of countries that are not market economies), evidence that this proposal also targets the United States is the fact that, shortly after releasing that document, the finance ministers of Germany and France traveled to Washington to discuss the implications of the Inflation Reduction Act. Not for nothing did the German news agency DW headline its report on the subject, "France and Germany travel to the U.S. to avoid a trade war".[15]

In addition to the risk of initiating a trade conflict with its own allies, it prohibits any company in the world from exporting to China advanced microprocessors or the means and technology to produce them, if they contain intellectual property or components from U.S. companies.[16] In other words, in addition to implementing policies that provide U.S. companies with a competitive advantage over those of its allies, it requires the latter to stop doing business with a country whose imports represent about 50% of world trade in certain types of microprocessors (or the components to produce them). Although in the short-term companies headquartered in these countries cannot but implement these sanctions, it is to be expected that, in the long term, they will try to produce the same goods without U.S. technology or components to circumvent the effect of the sanctions and continue to trade with China. In fact, there is a precedent in the satellite industry. After the United States introduced export controls to China in 1999, European companies began designing satellites free of U.S. components to evade the effect of those sanctions and continue to trade with China.

Finally, the fourth debate on the role of the State in the economy related to the controversy surrounding the existence of strategic sectors is related to the previous one, insofar as the presumption that the State should promote or protect these sectors could imply the adoption of protectionist trade policies. Self-sufficiency in qualified strategic resources has historically been considered a desirable goal from a geopolitical perspective. If this is not possible, at least dependence on potential rivals as sources of supply should be avoided (this is the reason why Chile, during the government of Augusto Pinochet, preferred to import energy from East Asia rather than from Argentina, a neighboring state with which it had border disputes). In turn, the quest for self-sufficiency often had the counterpart of denying access to those resources to potential rivals, all of which increases the likelihood of armed conflict between two states. As early as 1939, Eugene Staley warned of the risks involved in protectionist trade policies. According to him, if the countries that control most of the resources in the world did not maintain economic relations with the rest, they would be "sowing the seeds of unrest and war. Above all, they create a powerful imperialism dynamic. When the economic walls go up along the political borders, it forces the possession of the territory to coincide with the economic opportunities”.[17]

In other words, in an international economy with significant trade restrictions, those states whose growth depends on access to natural resources that they do not possess might seek them through military means. In contrast, in an open international economy such natural resources could be accessed through trade. The contrast between the expansionist behavior of the Japanese state before World War II and its peaceful conduct after the end of that war can serve as an example of this.

However, at the time of the COVID-19 pandemic, most international powers banned or restricted the export of medical equipment (such as mechanical ventilators) or medicinal products (such as diagnostic tests), and then monopolized the supply of vaccines in its initial stage. In addition, the vast majority of developed countries opposed in the World Trade Organization (WTO) the proposal by India and South Africa to temporarily exempt developing countries from complying with patent rights, given the health emergency; a proposal that was covered by changes made to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).[18]

Likewise, when the outbreak of war in Ukraine temporarily restricted the world supply of food and fertilizers, states such as India restricted their own exports of such goods in anticipation of possible international shortages. In other words, the supply of the goods described, which under normal conditions is abundant and accessible through international trade, was suddenly restricted by political decision under critical and exceptional conditions (such as a war or a pandemic). This is further proof that, whether or not they use the term, the States that act in this way consider the goods involved to be strategic (i.e., of superlative importance, at least during such conjunctures, for their security or their economy).

Conclusions

Although there is no objective and uncontroversial definition of the phrase strategic sector, this does not imply that, in the process of making decisions on specific public policies, essential criteria have not been put forward on the basis of which to justify those decisions; that is, it is possible to present more or less persuasive arguments in favor of certain decisions. However, insofar as these decisions seek to achieve certain policy objectives and these are by nature controversial (both because of their normative content and because they compete for resources with other possible political objectives), it is never licit under a democratic regime to subtract the designation of an economic sector as strategic from public debate.

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Endnotes:

[1] The author has published a similar article through the Center for Strategic Studies of the Peruvian Army.

[2] In game theory, an interaction between actors is strategic when the achievement of the ends pursued by each of them, through that interaction, depends in part on the actions that would be carried out by other actors who, it is presumed, are rational and act in their own interest. In this context, it is necessary to foresee or even induce the actions of these other actors so that they are compatible with the achievement of our goals.

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