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National Security Implications of Transnational Economic Activity

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EXECUTIVE SUMMARY

National Security Implications of Transnational Economic Activity

This paper discusses the impact of regional trading arrangements (RTA's), multinational corporations (MNC's), and transnational financial activity on U.S. national security. The National Security Strategy (January 1993) is used as the framework to define U.S. security interests and objectives. The size and importance of the U.S. economy to the world economy is recognized, as is the significance of global economic interdependence.

Each transnational economic activity is presented in turn. The nature and scope of the activity is explained followed by analysis of its potential contributions to U.S. national security. Issues associated with the activity are then presented. In those instances where recommendations or counterpoints to the issues are relevant they are also presented.

Three policy recommendations are made regarding the transnational economic activities analyzed.

- o The U.S. should encourage development of regional trading arrangements that comply with the GATT.
- o The U.S. should support international regulation of multinational corporation investment and taxation.
- o The U.S. must strengthen its national economy in order to be a world class player in transnational financial activity.

The paper concludes with a reminder of the power of transnational economic activity in today's economically interdependent world -- and a call for the U.S. to provide the economic leadership necessary to maintain economic order in the new world order.

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BIOGRAPHICAL DATA

Lieutenant Colonel Joseph B. Wismann,
United States Army

Lieutenant Colonel Wismann was commissioned as a U.S. Army Infantry Lieutenant following graduation from the United States Military Academy in 1972. He served in numerous company level and battalion staff positions in the 82d Airborne Division at Fort Bragg, NC; the 2d Infantry Division in Korea; and the 2d Ranger Battalion at Fort Lewis, WA. He has served with the 75th Ranger Regiment at Fort Benning, GA as the Regimental Supply Officer and as the 3d Ranger Battalion Operations Officer. Lieutenant Colonel Wismann holds a Master of Science degree in Contract and Acquisition Management and has served as a Contracting Officer at the U.S. Army Communications-Electronics Command, Fort Monmouth, NJ. Prior to his assignment as a student at the Industrial College of the Armed Forces in Washington, DC, Lieutenant Colonel Wismann commanded a Special Operations support battalion at Fort Bragg, NC.

The lessons from history are exceedingly clear regarding the relationship between a great nation's economic strength and its national security. Economic decline preceded or accompanied the decline of the Roman Empire, the Byzantine Empire, and the British Empire (Hines, 1989). Certainly, there were other, variable causes (military overextension, political deficiencies, social problems, and educational short comings) that contributed to the fading fortunes of these great powers (Kennedy, 1987), but lack of economic strength compared to their former selves, and especially compared to their rivals, was a common phenomenon. This is a sobering reality for the United States which faces a variety of negative economic indicators today.

- o The trade deficit has routinely been above \$100 billion annually since 1983, with 1991 being an exception at \$73.44 billion. The estimate for 1992 is that it will go up -- to \$91.09 billion (Associated Press, 1 December 1992).

- o The federal budget deficit will set a new record for 1992 -- \$290.2 billion. The Associated Press (29 October 1992) reports, "It was the 23rd consecutive year the government failed to balance its budget and brought the accumulated national debt to \$3.97 trillion."

- o Our national savings rate fell from its historic eight percent levels to only three percent during the 1980's. It seems to languish at the level -- depriving our economy of the capital needed to fuel our investments (Shultze, 1992).

o And the news gets worse with each passing month. In January 1992 the President estimated the 1996 budget deficit at \$181.3 billion. By August he revised it to \$217.7 billion while the Congressional Budget Office (CBO) provided its own estimate of \$254.0 billion. Finally, in January 1993, the Office of Management and Budget revised the figure upward once again to \$266.4 billion (Garrett and Murray, 12 January 1993 and Mufson, 11 January 1993).

Further, Paul Kennedy (1987) argues that "it has not been given to any one nation to remain permanently ahead of all the others." He asserts that "everything else being equal" (emphasis his) nations will tend to possess a degree of the world's wealth and power that is proportionate to their own natural elements of power (i.e., population, natural resources, and geography). Given this premise, he suggests that a "natural" level of world wealth and power for the United States might be on the order of 16 to 18 percent instead of the 40 percent the United States has grown used to since the close of World War II.

Nonetheless, Kennedy, Rosecrance, and Lamm (1987) each see the possibility that the United States can slow its rate of decline, or even reverse the trend, and remain the first among equals in a multipolar world. This can be done they argue, because everything else is not equal. This view is shared by many who are in a position to act on it.

Newly elected President Clinton clearly understands the relationship between economic well being and national security. He recognizes his administration's task to "Rebuild America's economic strength" as a key part of *national security* strategy. Additionally, his support for "free, fair, open, and expanding trade, including the GATT negotiations" is also included in his concept of national security (Clinton and Gore, 1992).

Likewise, The National Security Strategy of the United States (The White House, 1993) includes economic considerations as both means and ends in achieving national security. The National Security Strategy specifically identifies one distinctly economic security interest and objective.

An open international trading and economic system which benefits all participants. A global economic system which encourages the free movement of goods capital and labor is also one which best contributes to our prosperity and to that of others. Steady, non-inflationary economic growth will help reduce social and political tensions, thus contributing to global peace, and will also provide a means for ensuring the health of our environment (The White House, 1993).

Part IV of The National Security Strategy spells out "Our Economic Agenda."

It includes:

- o Convincing others that free trade offers greater prosperity than managed trade or protected markets;

- o Supporting market economies in all regions of the world;

- o Enhancing the effectiveness of the institutions, national and international, needed to sustain a global market economy...

- o Improve economic policies and performance among the major industrial countries to promote sustained economic growth...

- o Continue promoting global and regional trade liberalization...

- o Continue the cooperative effort with our allies and the international financial institutions to support the successful transformation of Eastern Europe and the former Soviet Union to market based economies integrated into the global market place...

- o Strengthen the international financial and economic institutions -- the World Bank, the IMF, the OECD, the GATT and the regional development bank...(The White House, 1993).

Transnational economic activities are potentially valuable tools in achieving the U.S. national security interests and objectives articulated by the President and The National Security Strategy. However, these activities are also capable of working to our detriment. This paper presents a sampling of the benefits and pitfalls associated with,

- o Regional Trading Arrangements,

- o Multinational Corporations, and

- o Transnational Financial Activity.

It is important to note that these transnational economic activities share a common characteristic with the U.S. economy that is of the utmost importance. Virtually all economic activity today takes place in the context of global economic interdependence. For instance, Reich (1992) points out that:

When an American buys a Pontiac Le Mans from General Motors...about \$3,000 goes to South Korea for routine labor and assembly operations, \$1,750 to Japan for advanced components...\$750 to West Germany for styling and design engineering, \$400 to Taiwan, Singapore and Japan for small components, \$250 to Britain for advertising and marketing services, and about \$50 to Ireland and Barbados for data processing.

What's more, the global cash flows are not solely associated with labor and services. Transnational investments by corporations link industries and investors in a global economy. Ford owns Britian's Jaguar. General Motors owns about 40 percent of Japan's Izuzu, about half of South Korea's Daewoo Motors, and about half of Sweden's Saab (Riech, 1992). Global and international mutual funds pool billions of dollars from individuals to invest in thousands of companies in dozens of

countries.

This interdependence is especially significant for the United States. Our economy represents approximately 23 percent of the gross world product. We are the world's largest importer and the world's largest exporter (Central Intelligence Agency, 1992). Thus, any adjustments made to the U.S. economy will impact around the world for better or for worse and these impacts will then be returned to us through interdependence. The diagram at Appendix 1 depicts the mechanism whereby weaknesses in the U.S. domestic economy are magnified by its interaction with the global economy.

Regional Trading Arrangements -- Good, Bad, or Innocuous

The purpose of regional trading arrangements (RTA's) is to achieve some degree of economic integration among the members. Bullen and Dameron (1992) have concisely stated the various forms that economic integration can take. Figure 1 summarizes their points pertinent to this discussion.

The awesome magnitude of the economies and resources associated with the RTA's in existence or contemplated today dictates that the United States consider them in a national security context. The chart at Appendix 2 presents this issue to demonstrate its significance. It is not intended to be definitive of all the existing or potential RTA's, or all of the factors pertinent to evaluating them. The point is that an RTA may have considerable means with which to accomplish its ends.

METHODS OF ECONOMIC INTEGRATION

TITLE	FEATURES	EXAMPLES
Free Trade Area	A. No import tariff or restrictions among members	o U.S.-Canada o European Free Trade Area
	B. Each country retain own tariffs against non-members	o Latin America Free Trade Association
Customs Union	A. As above	o West African Customs Union
	B. Common external tariff adopted against non-members	
Common Market	A. As above	o European Economic Community
	B. As above	
	C. Labor and Capital can move freely among members	
Economic Union	A. As above	o EC 92
	B. As above	
	C. As above	
	D. Harmonization of macro-economic polities to include currency and interest rates	
Total Economic Integration	A. As above	o United States
	B. As above	
	C. As above	
	D. As above	
	E. Supra-national authority makes decisions binding on all members	

Figure 1

In addition to having considerable natural, financial, and human resources at its command, a RTA tends to accentuate the various comparative economic advantages of its member nations and of its region. This characteristic can result in both trade creation and trade diversion. In other words, the low intra-RTA tariffs

...encourage one member to buy from another member goods that it would have made itself. This is good: comparative advantage at work. But an [RTA] can also divert trade, if one member buys imports from another that it previously bought from a supplier outside the [RTA]. This is bad: comparative advantage denied. Why? Because before the [RTA] was established, the two exporters faced the same tariff, so the importer chose its supplier on price and quality alone. With the [RTA] in place, the importer switched to the less efficient supplier. ("The Trouble With Regionalism," 27 June 1992).

Kravis (1968) points out that the EC has been able to move decisively toward self sufficiency and has attracted increasing amounts of American technology and capital while decreasing its dependence on American goods. He suggests that such economic power might be used for economic protectionism or to retaliate against non-member states for actions taken under the GATT. Aho and Ostry (1990) feel that bilateral trading arrangements, in particular, result in

- o Resentment -- by those not included,

- o Inefficiency -- by fragmenting the world market,

- o Bureaucracy -- to run the system, and

- o Stupid signals -- (i.e., protectionism) being sent and received.

On the other hand, RTA's have their fair share of champions. Krause (1968) argues that, in the case of a RTA involving a lesser developed country (LDC), the benefits of trade creation outweigh the concerns of trade diversion. He notes that a RTA will work better for the LDC if the RTA includes a developed country. The diversity of the developed country's economy will allow the LDC to obtain goods and services it might not otherwise be able to afford or get from another LDC. Additionally, the linkage of the LDC to a developed country will likely inspire development in the LDC by giving confidence to foreign investors.

The EC and the NAFTA will share similar advantages commonly sought by RTA's. Both will provide the world with access to large relatively affluent markets. Each will also provide access to lesser developed economies on its continent and hopefully provide the confidence to attract investment to them. Additionally, both RTA's anticipate greater employment and increased world competitiveness (Driscoll, 19 October 1992 and Bullen, 12 January 1993).

RTA's Contribute to U.S. National Security

Clearly RTA's that comply with GATT facilitate U.S. national security objectives regarding the free movement of goods, capital, and labor. Specifically, U.S. commercial access to a region is of greater benefit than access to only a single country. Conversely, because the U.S. is part of a RTA (NAFTA), U.S. firms become more vulnerable to competition from within and outside the RTA. Therefore, our competitiveness (aggressiveness in seeking markets and meeting challenges in the North American market) and efficiency will be more important than ever. In other words, RTA's don't change our chances for success in this regard -- they just up the stakes.

RTA's will also prove useful in meeting our goals to support market economies in other regions and enhancing the effectiveness of the institutions that sustain the global economy. For instance, as the EC moves closer to the fruition of its EC 92 goals, nations in other regions will recognize both the threats and opportunities presented. If historical animosities can be put aside (admittedly a big "if"), they would be well advised to form RTA's. The NAFTA is a manifestation of this trend. And the National Security Strategy calls for it to continue.

Regionally, now that we have concluded the North American Free Trade Agreement, we should press ahead with the Enterprise for the Americas Initiative....We should also explore the possibility of arrangements

leading to free trade agreements with countries in other regions, such as Asia and Europe, where we have important interests (The White House, 1993).

RTA's enhance achievement of one non-economic national security interest as well. RTA's demand personal, political, and commercial interaction.

Cooperation and relationships enhance the functioning of the RTA. As the economic interdependence grows, regional stability is enhanced in a manner envisioned by our national security strategy.

- o **Global and regional stability which encourages peaceful change and progress... reducing sources of regional instability and violence...(The White House, 1993).**

Multinational Corporations -- Powerful and Motivated to Prosper

The sheer growth of our world population has placed such demands on our earth's resource system that economic and political interdependence have become facts of life. The multinational corporation has played a decisive role in creating interdependence. It is the main channel which products, goods, and services flow throughout the world. It also is the structural base on which the world economy operates (Morgan, 1977).

The impact of multinational corporations (MNC's) on the world economy and their potential to affect US national security interests can hardly be overstated. As

of 1990, MNC's numbered 35,000 with 147,000 foreign affiliates ("World Economy," 19 September 1992) and their foreign direct investments totaled \$225 billion ("UN Tallies Multinationals," 15 July 1992). The vast ability of a large MNC to produce goods and services; conduct research and development; generate capital; and employ people makes it more powerful in these regards than many "middle power" nations.

Why do companies become MNC's? Understanding the answer to this question will aid in understanding the issues associated with MNC's and their linkage with national security. Companies are motivated to expand operations to foreign countries for any one, or a combination of the reasons indicated below.

- o To secure access to raw materials

- o To take advantage of a favorable pricing of labor or capital

- o To avoid tariff or quota barriers and thereby retain market in the foreign country

- o To take advantage of increasing markets abroad--particularly when domestic markets are saturated or declining

- o To comply with foreign laws regarding local content for products sold in country or to enjoy patent protection in the foreign country.

Beneficial Aspects of MNC's

The MNC is a party to a complex set of political, economic, and social interactions. Some of the interactions are clearly beneficial while others are controversial. Aspects of MNC's that are generally regarded as beneficial to the advancement of economic development and standards of living throughout the world are a key part of our national security strategy.

MNC's are "engines of growth" for developing countries (LDC's) according to the newly created Transnational Corporations and Management Division of the UN Department of Economic and Social Development. MNC's are credited with,

- o providing investment and physical capital,
- o transferring [commercial] technology,
- o expanding trade opportunities,
- o supporting long term growth in developing countries,

- o stimulating local technology development, and

- o training unskilled workers ("World Investment Report 1992: TNC's are 'Engines of Growth,'" September 1992).

MNC's have a tendency to reduce international tensions and promote interdependence. Three factors contribute to their ability to do this.

- o MNC executives, of necessity, coordinate with high level government officials -- sometimes meeting routinely as is the case in Brazil (Smith, 15 June 1992).

- o MNC's cooperate with business and government in developing nations on joint ventures. This cooperation preserves the MNC's business position while contributing to the labor skills and capital position of the host country. Examples include GE's joint venture with former Brazilian rival Villares Group and IBM's cooperation with the same conglomerate (Smith, 15 June 1992).

- o MNC's, being multinational and having access to government, facilitate interdependence and standardization among nations because they are part of the web that binds the countries, regions, and world together. For instance, a recent UN report observes that increasing regionalization and globalization will cause

developing countries to develop their policies in the context of the policies of other nations and of multinational corporations ("Foreign Direct Investment, Privatization Considered by TNC Commission, September 1992).

Issues Regarding MNC's

The same MNC technology transfer that fuels the "engine of growth" in LDC's,

- o took 3.4 million jobs (primarily blue collar) away from the U.S. between 1977 and 1986,
- o cost the government about \$30 billion a year in lost tax revenue, and
- o contributed to U.S. domestic income spread as wealthy U.S. investors reaped dividends from overseas MNC operations while U.S. workers lost their jobs or were displaced to lower paying jobs (Epstein, Winter 1990-91).

There are, of course, other points of view regarding this issue. Robert Reich (1992) suggests that it may well be desirable to shift "high-volume, standardized production" to LDC's. This would tend to develop their economies as they provide goods in return for services provided by more developed countries. His argument is

well reasoned.

The U.S. has been a service based economy since 1910 and it appears that we will become even more so in the future. The service sector accounts for 76% of the work force; 68% of GNP; and 90% of new jobs. The manufacturing sector has never exceeded more than 30% of labor force employment (Bobie and Freeman, 1988). Therefore, we should not mourn too loudly the loss of these blue collar jobs. Instead, we should see to the employment of these workers in more productive (higher value added) jobs.

The behavior of MNC's as " corporate citizens" of this nation is also cause for concern. On a day-to-day basis, we should expect neither more nor less from MNC's than we do from any other corporation seeking to prosper.

In general, the tendency of the corporation is to maximize its freedom from all government control....The corporation will pit host against home governments in order to increase its capacity to grow and to maximize profits (Gilpin, 1975).

But how will MNC's perform during periods of national need or emergency? Historically, the evidence is mixed. In 1956 the U.S. was able to force the withdrawal of Britain and France from their Suez invasion by threatening to cut off oil supplies through U.S. based MNC's. On the other hand, during the 1973 Arab oil boycott,

American oil companies followed the dictates of the Arab states even to the extent of refusing to supply oil to the American military, thus jeopardizing U.S. military preparedness at a time of international crisis (Gilpin, 1975).

A snapshot of current MNC attitudes indicates that today's national strategic planners should also expect MNC patriotism to be an unknown.

One fourth of Levi Strauss's worldwide sales come from Europe, and the firm now regards itself as 'a European company with American roots'....Scores of other successful U.S. corporations in Europe think and act similarly... (Knight, et.al., 1992).

Further insight into the MNC good versus bad citizenship issue is provided by a brief examination of the government's problem of collecting taxes from them. As Susan Dentzer (30 November 1992) reports, many MNC's manipulate transfer prices and license fees to ensure that profits are shifted to the home country or to tax haven countries with lower tax rates.

President Clinton pledged that his administration would pay attention to this issue and collect as much as \$45 billion during his term. However, tax experts generally agree that \$12 billion to \$24 billion is a more realistic expectation. Regardless of the amount, this issue is valid and reflects negatively on the linkage of MNC's to U.S. national security.

However, the biggest problem associated with MNC's and national security is their impact on the balance of payments. This issue has been hotly debated for at least 20 years. In the mid-1970's it appeared as though the difference between U.S. based MNC exports and imports represented a net gain of about \$7 billion for the U.S. Nevertheless, labor argued that by moving operations overseas, MNC's were reducing U.S. jobs, increasing U.S. imports and decreasing U.S. exports. Management maintained that inputs to overseas operations required from the U.S. increased both U.S. jobs and U.S. exports.

In 1978 a study by the Brookings Institution concluded that the relationship between U.S. MNC overseas operations (U.S. foreign direct investment (USFDI)) and U.S. exports is "haphazard." The data analyzed suggests that initial or increased USFDI to an area with little or no previous investment will result in an increase in U.S. exports to that area. This is probably due to lack of local alternatives to support the new investment. Over time, the USFDI appears to become a substitute for U.S. exports as the local situation matures. The authors stress that the relationship of time to U.S. export decline varies from industry to industry and between firms within the same industry, as well as according to geographical region in which the investment is made. (Bergsten, Horst, and Moran, 1978).

The debate still rages. The Economic Report of the President 1992 argues that USFDI increases exports and should therefore be encouraged. U.S. exports of goods and services were relatively flat from 1980 to 1985. Only after a sharp rise in USFDI in 1985 did exports, particularly services, experience significant growth. This is consistent with the findings of the Brookings Institution study -- *increased* USFDI leads to *increased* exports. In many cases, the choice made by the U.S. based MNC is to either invest overseas or lose the market to foreign competition. Therefore, it is argued that the current free trade policy serves our national interests (Council of Economic Advisors (CEA), 1992). Thus, the free-trader's philosophy is reflected in national policy.

Official U.S. policy toward foreign investment...recognizes that unhindered international flows of capital are beneficial to home and host countries alike (CEA, 1992).

Gerald Epstein (Winter 1990-91) presents a thorough and forceful counter argument to this laissez faire policy regarding MNC induced international capital flow. He contends that --

- o U.S. based MNC's allowed facilities in the U.S. to deteriorate. The result has been a loss of competitiveness from factories in the U.S. which resulted in a decline of U.S. exports from a 17.1 percent world share in 1966 to an 11.7% world share 1986.

o U.S. based MNC's increased the competitiveness of their *foreign affiliates* by investing in modern facilities overseas. These foreign affiliates actually increased their share of the world export market from 8.0% in 1966 to 9.8% in 1986.

o Imports to the U.S. from U.S. based MNC's foreign affiliates "account for a substantial share of the U.S. trade imbalance not only with Taiwan and Singapore but also with Mexico, South Korea, and other newly industrializing countries."

o As U.S. based MNC's increase employment abroad, they tend to decrease employment in the U.S.

o MNC's have contributed to the federal budget deficit.

-- due to tax losses, as a result of jobs shifted overseas (discussed earlier) and

-- due to tax losses as a result of transfer pricing and other schemes to hide profits (discussed earlier).

The MNC Intersection with the National Security Strategy

The aspirations and methodologies of MNC's support U.S. national security interests and objectives. MNC's are,

...the contemporary world's foremost instruments of economic development. Through the transfer of American technology and the free enterprise tradition, they are helping to create the democratic and pluralistic world of the American liberal vision. They are the means to fulfill the American ideological commitment to a peaceful and interdependent world in which economic cooperation and growth would supplant the clash of national rivalries (Gilpin, 1975).

The beneficial aspects of MNC's make them powerful implementing instruments for that portion of President Clinton's national security strategy regarding use of "the power of *American values* in shaping the post-Cold War era" (Clinton and Gore, 1992). Likewise, MNC's contribute significantly to portions of our security concept articulated in The National Security Strategy. Specifically,

- o The vision of the world to which the United States aspires is one of freedom, respect for human rights, free markets, and the rule of law.

- o Global and regional stability which encourages peaceful change and progress...working to avoid conflict by reducing sources of regional instability and violence...

- o Convincing others that free trade offers greater prosperity than managed trade or protected markets;**

- o Supporting market economies in all regions of the world, and**

- o Enhancing the effectiveness of the institutions, national and international, needed to sustain a global market economy...**

- o Continue promoting global and regional trade liberalization (The White House, 1993).**

The issues associated with MNC's are significant to U.S. national security interests. Of the four issues considered, the question of MNC performance as citizens is certainly of immediate concern. The U.S. obviously should take strong action to prevent conduct which is inimical to its interests. But on the other hand, it is somewhat unrealistic to expect all MNC's to be super U.S. patriots -- or Canadian patriots, or French patriots. The MNC must try to survive international crises without harm to any of its international appendages. It requires the favor of each nation in order to do so. Therefore, the policy maker's best course is to expect MNC's to be neutral until such time as their survival is threatened.

The loss of manufacturing jobs and exports through MNC's shifting operations overseas has been addressed by several writers (see Reich, 1992; Clinton and Gore, 1992; and Epstein, Winter 1990-91). The consensus is that the solution must include,

- o increased infrastructure investment,

- o increased social investment to provide a well educated, disciplined workforce,

- o worker training to maintain productivity, and

- o expanded research and development conducted in the U.S.

These points are widely accepted, as evidenced by President Clinton's recent election. The current public debate is only in regard to who should pay for their implementation and how exactly to accomplish them.

The last two problems -- collecting taxes from MNC's and the effect of MNC's on the balance of payments -- have the same cause and solution. The cause is MNC capital flowing internationally more quickly than the government can scrutinize it.

How to maintain adequate levels of public and private investment and at the same time ensure rising wages and environmental standards in an age of global corporations and international capital mobility is the dominant question of the 1990s (Epstein, Winter 1990-91).

The solution is to get some control over the flow of capital. Don't let it flow unless specified standards are met.

...what is needed is a global regulatory framework for multinational corporations -- a set of common standards for labor rights, tax and wage rates, and environmental protection...(Epstein, Winter 1990-91).

This proposal is not new. The United Nations has had an on-off effort in this regard since the 1970s. Nonetheless, it is worthwhile to continue the effort. Recognizing that MNC's will act in their own financial best interest, the community of nations must establish protocols that marry those interests to the welfare of their citizens.

Transnational Financial Activity -- Paying the International Bills

Neither RTA's nor MNC's are alone in facilitating the movement of huge sums of money across borders and creating global economic interdependence. Consider, for instance, that

o over \$130 billion in foreign currencies are exchanged daily in New York financial markets (Shultze, 1992),

o the combined total of foreign bonds bought and sold by U.S. citizens and U.S. bonds bought and sold by foreigners exceeded \$1 trillion dollars in 1989 (Shultze, 1992),

o cross border lending rose from \$324 billion in 1980 to \$7.5 trillion in 1991 ("World Economy," 19 September 1992).

o the gross sales and purchases of bonds and equities with foreigners has skyrocketed for key industrialized countries.

Transnational Security Transactions as a Percent of GDP

<u>Country/Year</u>	<u>1970</u>	<u>1980</u>	<u>1990</u>
USA	3	9	93
W. Germany	3	8	58
Japan	2 (1975)	7	119
Great Britain	-	368 (1985)	690

("World Economy," 19 September 1992)

Figure 2

The balance of payments is the score sheet that nations use to track this massive transnational financial activity and to tell where they stand in regard to the global economy. The balance of payments indicates to what extent a nation is invested in the rest of the world and to what extent the rest of the world is invested in the nation. The significant (simplified) features of the balance of payments include,

- o the current account which nets imports and exports; travel and transportation; military transactions; and other government transactions to provide a balance on current account. It is the sum total of all the goods and services the nation has traded, given away, or received during the period.

- o the capital account which nets domestic government and civilian ownership of assets abroad and foreign government and civilian ownership of domestic assets.

Theoretically, the current account will balance with the capital account. That is, if a nation's imports exceed exports in the current account (and there are no other offsetting current account activities), then the capital account should reflect an equal inflow of capital that was (theoretically) used to purchase the imports. The numbers do not always balance exactly, but they are close enough to show trends.

The trend shown for the United States has reflected a growing balance of payments problem for about a decade.

Our net foreign investment position reached a peak of \$141 billion at the end of 1981. Then, in just four years, the result of 60 years of American overseas investment was undone. By the end of 1985...foreign assets in the United States exceeded American assets abroad by \$112 billion. By the end of 1989 the United States was probably \$650 billion in the red (Krugman, 1992).

There is some discrepancy regarding valuation of foreign assets held by U.S. citizens and corporations. For instance, Shultze (1992), states that "...by the end of 1990 America was a net debtor to the tune of \$360 billion. Regardless of these differences, there can be no doubt that we have a problem and that it is not trivial.

The genesis of the problem lies in three areas.

- o U.S. taxpayers preferred consumption over saving during the 1980s. Consumption, as a percentage of disposable income, rose from an average of 89.6 in 1970 to 93.1 in the latter half of the decade (Epstein, Winter 1990-91). Savings declined from 8.2% of national income in 1959-1980 to 4.2% in 1981-1988, and to just 3.0% in 1989-1990 (Shultze, 1992). The net effect of increased consumption was to draw down the current account as more imports were consumed. The decline in savings deprived domestic markets of capital to

loan for business investment and government consumption.

- o The Government spent more than it collected in tax revenues. The budget deficit averaged \$147.6 billion per year during the period 1980-1989 (Baumol and Blinder, 1991). Since domestic savings were not available to draw upon, government expenditure was financed by foreign borrowing. Foreign ownership of U.S. Government debt increased from 7% in 1970 to 17% in 1988 and was at 16% in 1991 (Epstein, Winter 1990-91). This increased the capital account to balance the decrease in the current account.

- o Similarly, domestic investment, lacking national savings to draw upon, has been increasingly financed by foreign investment. Shultze (1992) points out that during the period 1959-1980 foreign borrowing and investment accounted for only .5% of domestic investment. In 1989-1990 foreign borrowing accounted for 1.9 percent of domestic investment. This action also increased the capital account balance.

Both Krugman (1992) and Shultze (1992) point out several implications of net debtor status.

- o The U.S. will owe interest, dividends, and rents to foreign investors. This drain on our resources totaled \$38 billion in 1990 for government bond interest

alone (Shultze, 1992).

- o The U.S. may be exposed to future domestic financial crises (i.e., interest rate fluctuations and recessions) as a result of foreign investor loss of confidence -- a run on the dollar.

- o Indebtedness could compromise our national sovereignty -- or at least add a new consideration to our decision making processes.

- o Risks of a trade war are increased as U.S. citizens become less tolerant of the foreign investment and more cognizant of the trade deficit.

National Security Implications of Transnational Financial Activity

There are several aspects of transnational financial activity that are significant to a security planner.

- o The international capital flows are now amazingly fast and flexible. Computer links and 24 hour investing capabilities have contributed to the ease with which money crosses national borders.

o The fabulous amounts of money involved have enormous potential to serve our purposes or thwart them.

o Getting into trouble (i.e., deficits, debt) can happen very quickly. Getting out of trouble takes longer.

o Any significant adjustments made to the nation's financial activities will have international repercussions due to the interdependence of the global economy.

The operative national security interest in regard to transnational financial activity is "to promote sustained global economic growth" (The White House, 1993). To achieve that end we must reverse the upward trends in our budget deficit and resultant trade deficit. However, these "twin deficits" should not be attacked directly -- or at least not attacked too strongly if attacked directly. Excessive or misdirected zeal in budget deficit reduction could cause a flight from the dollar (the very risk such action is trying avoid) as foreign investors see cuts in U.S. public investment which cause ". . . the steady erosion of the country's productive base. . ." (Epstein, Winter 1990-91). Additionally, Krugman (1992) points out that severe cuts in spending could trigger a recession due to the decrease in demand for domestic products.

To achieve deficit reduction without crisis, Epstein (Winter 1990-91) favors budget cuts in economically unproductive areas (such as defense) and regulation of the international flow of capital through MNC's. He is particularly concerned that MNC's might take advantage of the lower interest rates resulting from government budget deficit reduction to borrow money in the U.S. for investment overseas.

Krugman (1992) believes that ". . . the root cause of the trade deficits of the 1980's was America's low national savings rate. . . ." Further, he feels that ". . . cutting the Federal deficit is the only reliable tool we have to [raise national savings]." To accomplish this, he recommends a two-faceted effort. First we should switch demand from foreign to domestic goods reducing the value of the dollar or imposing tariffs or quotas. Second we should reduce total demand so that switching does not cause inflation.

Recommendations -- How to Capitalize on Transnational Economic Activity for National Security Purposes

The United States should encourage development of regional trading arrangements that comply with the GATT. RTA's tend to contribute to regional stability -- trading partners are less likely to fight. Decreased regional tensions are a cost avoidance for the world powers (i.e., the U.S. or U.N.) that would likely bear the cost of restoring stability.

RTA's can also promote multilateral trade liberalization by setting the example for other nations and setting precedents for the GATT (Schott, May 1989). Additionally, those RTA's that include LDC's enhance the economic development of the LDC's. The resultant growth in gross world product and standard of living is a further stabilizing influence.

It is important that the U.S. insist on GATT compliance. The large and more self-sufficient a RTA is -- the less willing it may be to comply with multilateral trading arrangements. The repeated violation of the GATT by the EC's agricultural policy is an example of this problem (The Economist, 31 October 1992). To avoid world economic disintegration, GATT compliance is a necessity.

The United States should support international regulation of multinational corporation investment and taxation. Recent MNC investment in the U.S. has typically not been "quality investment" -- capital investment in new plant and equipment. "In 1989, for example, foreign companies spent \$64 billion to acquire U.S. companies, but only \$9 billion to establish new ones" (Epstein, Winter 1990-91). Further, corporate investment in human capital has been less than encouraging. It has tapered off from an annual growth rate of 15 percent during the 1970's to less than 1.5 percent in 1989 (Reich, 1992). Meanwhile, MNC's are granted local subsidies and tax breaks to attract them to a locale. Once they are established, the federal government has difficulty collecting what taxes are, in fact, owed.

An international regimen that eliminated tax havens and standardized tax treatment for MNC's would go a long way toward "leveling the playing field" for communities and nations struggling to develop human capital. Right now the field seems tilted in favor of MNC's that profit from the U.S. without investing to make it better.

Internationally standardized requirements to reinvest a specified percentage of profits made in the host country would also help to maintain productivity growth through investment. MNC investments in human and physical capital above the minimum levels specified could be incentivized by use of tax credits.

The United States must strengthen its national economy in order to be a world class player in transnational financial activity. The first and most important action in this regard is to organize the Economic Security Council (Clinton and Gore, 1992). The need to elevate economic policy considerations to a highly visible level has long been recognized. Several previous attempts to organize a council such as this were less than successful because (among other reasons) the importance of the nation's economic health was eclipsed by so many other crises during the cold war (Hines, 1989). Not so now. Now, the nation's economic health *is* the recognized crisis. The Economic Security Council (recently changed to National Economic Council) should begin without delay to coordinate synergistic national economic policies on issues such as those presented in this paper.

Budget deficit reduction is also a "must do" item. Government spending on economically nonproductive programs must be minimized consistent with minimum national security and minimum social welfare requirements. Paul Krugman's recommendation (previously presented) to switch demand from foreign to domestic goods by use of tariffs or quotas and devaluation of the dollar should be carefully reviewed and gingerly implemented lest it spark retaliatory action.

Budget deficit reduction is also an important contributor to restoring national savings -- which is the third must do item for the U.S. to regain control of its economy. National saving fell from its 1959-80 level of 8.2 percent of national income to only 3.0 percent in 1989-90. Government budget deficit spending during the 1980's was a key contributor to the fall (Shultze, 1992). Charles Shultze (1992) provides a brief analysis of the quantifiable factors that impact the nation's requirement to save. His conclusion is that our national savings rate should be about 7 percent of national income for the decade of the 1990's.

In addition to deficit reduction, the government can take other actions to help restore national savings. Specifically, these actions are directed at the private savings component (households plus business savings) of national savings. Detailed discussion of these areas is beyond the scope of this paper. However, formulation of a coordinated policy regarding the impact on national savings of the areas indicted below might well be within the purview of the National Economic

Council. Specifically, the government should address

- o Taxation of savings versus consumption,
- o Social security programs that discourage savings, and
- o Bank deregulation to increase incentives and safety for private savers.

Finally, to ensure the long term economic well being of the nation, the rate of productivity growth must be improved from its current 1 percent to the 2 to 3 percent range. Increased national savings will certainly contribute to this by easing capital formation. Additionally, tax credits for capital investments will help direct savings toward investment in plant and equipment. But there is more important capital investment that must be made -- investment in human capital. Improved education for school children and employee continuing education programs will lead to long term productivity growth.

The level of skills and education one has virtually defines one's standard of living. So it is with nations as well. The world has become more "hi-tech" and nations whose workers possess only lower order skills will be doomed to low income. More importantly, workers must accept the fact that the *pace* of change will dictate retraining probably more than once during a 30 year work life.

President Clinton has proposed that employers set aside 1 1/2 percent of payroll for worker education and training (Clinton and Gore, 1992). If this is too much or too little we can adjust it later. What is most important is that we start a program such as he has proposed without delay.

Improvement in our secondary school education is also of paramount importance. John Bishop of Cornell University estimates that, as a result of poor secondary education, the nation will lose about \$250 billion in GNP in the year 2000 that it might have earned had our workforce been of better intellectual quality (Shultze, 1992). Obviously, we need to improve the technical skills education of our future citizens. But I think that is equally important that "life skills" be taught in the schools. Too many of our youngsters do not receive an adequate education in this regard at home. I recommend that all high school students receive training in three key subjects that will enhance the individual's ability to establish and perpetuate a prosperous family. They are:

- o Personal and Family Financial Planning,

- o Parenting-Its Duties, Its Costs, and Its Rewards, and

- o United States Civics

Conclusions -- Government's Job Is More Complex

Three attributes of the transnational economic activities (TNEA's) discussed here are important to the national security planner.

- o They're big and they're powerful. All three TNEA's involve sums of money or trade control issues that could have at least a measurable impact on the economic well being of the U.S. They cannot be ignored.

- o They are related. MNC's benefit greatly by the formation of RTA's. MNC's are also a prime source of transnational financial activity. RTA's expedite transnational financial activity.

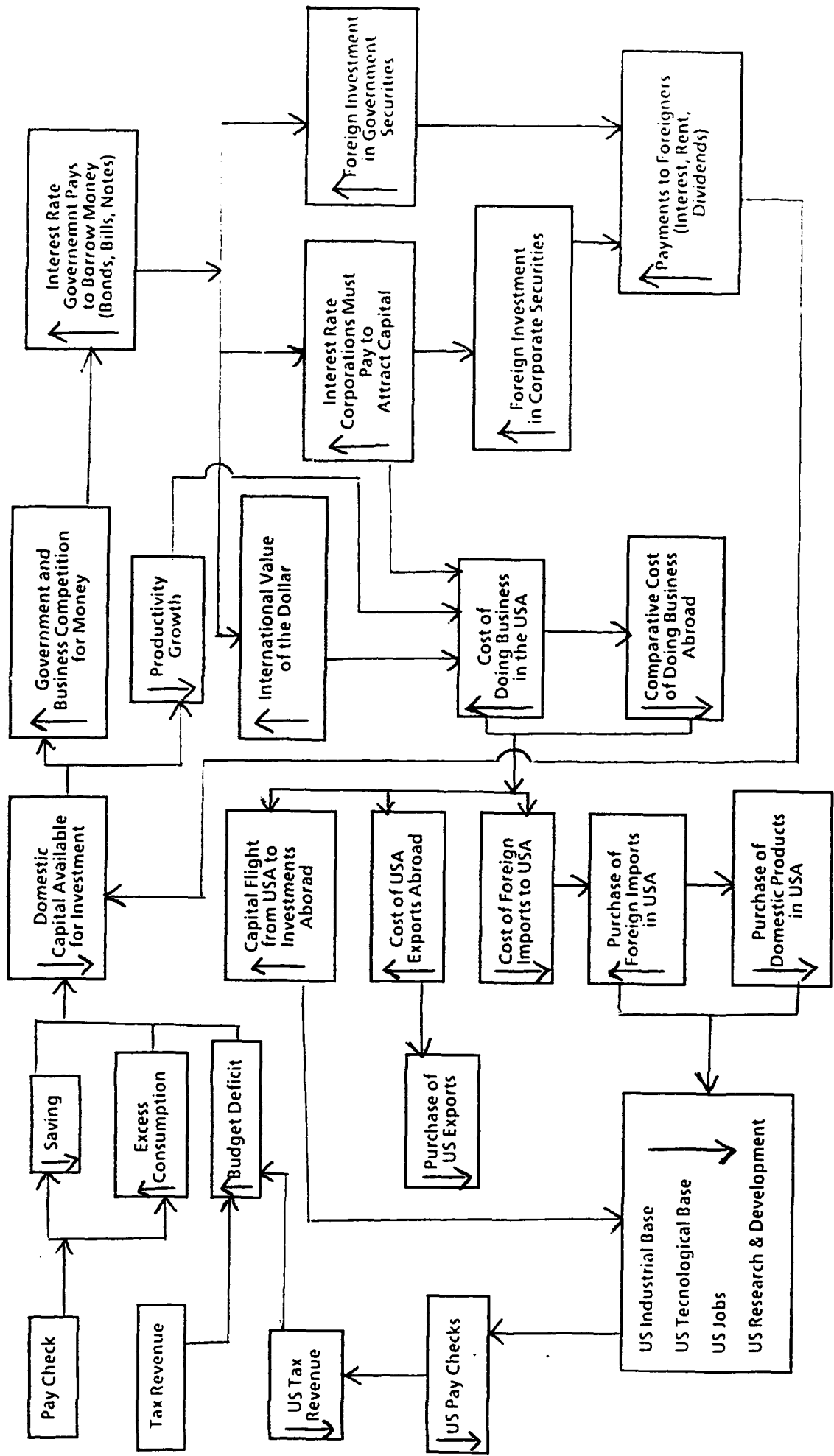
- o They are beyond the control of any single government. These TNEA's are going to occur whether or not the U.S. is a participant. Any single handed effort by any nation to control these activities will be futile.

Despite the powerful transnational economic forces which impact national political and economic well being in an interdependent world, national government retains many, if not most, of its traditional purposes. To fulfill the roles expected of it, the U.S. Government must influence these TNEA's to serve the national security interests and objectives. This calls for international leadership. To assume

a position of leadership, the U.S. must be economically strong -- not subject to the confidence, or lack of confidence, of foreign investors.

It is in the best interest of the United States and the world that the United States lead the economy of the new world order. The other national contenders to world economic leadership -- Japan and Germany -- are not trusted by the family of nations to assume such a powerful role. Regional trading arrangements may also compete for economic leadership in the new world order. However, inter-regional competition would be as likely to decrease gross world product as to improve world welfare. Only the United States enjoys the requisite combination of stability, economic capability, and international trust necessary to lead the world toward economic and political freedom. After 200 years of democratic tradition and international generosity, the United States once again finds itself in the same position it held in Abraham Lincoln's view -- the last, best hope of earth.

Appendix 1
U.S. Domestic and Global Economic Interaction



Appendix 2

RELATIVITY DATA FOR EXISTING AND POTENTIAL RTA'S

RTA	<u>Population</u>		<u>GDP</u>		<u>Export</u>		<u>Imports</u>	
	Actual	% of World	Value	% of World	Value	% of World	Value	% of World
North American Free Trade Assn (NAFTA)-Existing RTA o USA o Mexico o Canada	374M	6.8	\$6.5T	26.0	\$580B	17.0	\$645B	19.0
European Community (EC)-Existing RTA o Belgium o Denmark o France o Germany o Greece o Ireland o Italy o Luxembourg o Portugal o Netherlands o Spain o UK	347M	6.3	\$5.6T	22.4	\$1,330B	40.0	\$1,460B	41.0
ASEAN Free Trade Assn (AFTA)-Existing RTA o Philippines o Brunei o Singapore o Indonesia o Thailand o Malaysia	342M	6.2	.35T	1.5	\$157B	5.0	\$179B	5.0
Asia Pacific Economic Cooperation (APEC)-Potential RTA AFTA plus o Australia o Canada o China o Hong Kong o Japan o S. Korea o Taiwan o US o New Zealand	1,710M*	31.0	\$4T*	16.0	\$774B*	23.0	\$707B*	20.0
Tumen River Area Development Program -Potential RTA o China o Russia o Mongolia o Japan o N. Korea o S. Korea	1,512M	27.4	\$5.7T	23.0	\$519B	15.0	\$428B	12.0

* Quantities for US and Canada have been excluded -- they would not likely be included in this potential RTA.

Data was compiled from The World Fact Book 1991 and The World Fact Book 1992. Some data is based on a reasonable estimate. For instance, the Soviet Union GDP for 1992 was not available so the GNP for 1991 was used. Additionally, some nations' data was presented as GNP, others as GDP. I made no distinction for this chart. Information regarding the Tumen River Development Program was taken from Kaye (16 January 1992).

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