

DEMOCRACY and
the FUTURE of the
WORLD ECONOMY

The Globalization Paradox



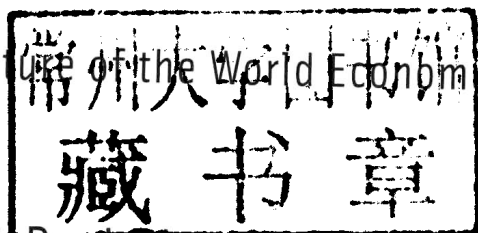
DANI RODRIK

Author of ONE ECONOMICS, MANY RECIPES



The Globalization Paradox

Democracy and the Future of the World Economy



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The
Globalization
Paradox

Also by Dani Rodrik

*One Economics, Many Recipes: Globalization, Institutions, and
Economic Growth*

Has Globalization Gone Too Far?

To Çetin Doğan

An extraordinary man whose dignity, fortitude, and resolve will prevail
over the great injustice he has been forced to endure.

INTRODUCTION

Recasting Globalization's Narrative

I published a little book early in 1997 called *Has Globalization Gone Too Far?* A few months later, the economies of Thailand, Indonesia, South Korea, and other countries in Southeast Asia stood in tatters, casualties of a massive international financial whiplash. These countries had been growing rapidly for decades and had become the darlings of the international financial community and development experts. But all of a sudden international banks and investors decided they were no longer safe places to leave their money in. A precipitous withdrawal of funds ensued, currencies took a nose-dive, corporations and banks found themselves bankrupt, and the economies of the region collapsed. Thus was born the Asian financial crisis, which spread first to Russia, then to Brazil, and eventually to Argentina, bringing down with it Long-Term Capital Management (LTCM), the formidable and much-admired hedge fund, along the way.

I might have congratulated myself for my prescience and timing. My book eventually became a top seller for its publisher, the Washington-based Institute for International Economics (IIE), in part, I suppose, because of the IIE's reputation as a staunch advocate for globalization. It was a kind of a Nixon-in-China effect. Skepticism about globalization was more interesting when it came

from a quarter where it was least expected. “A pro-globalization think tank publishes study by Harvard professor who warns globalization is not what it’s cracked up to be”—now that is something worth paying attention to!

Alas, I was far from getting it right. My book was oblivious to the crisis brewing in financial markets. In fact, not only had I not foreseen the coming storm, I had decided to leave financial globalization—the trillions of dollars in currencies, securities, derivatives, and other financial assets exchanged globally on a daily basis—out of the book altogether. Instead, I had focused on the difficulties that international trade in goods was generating in labor markets and for social policies. I worried that the boom in international commerce and outsourcing would exacerbate inequality, accentuate labor market risks, and erode the social compact within nations. These conflicts need to be managed, I argued, through more extensive social programs and better international rules. I had decided to write the book because my colleagues in the economics profession were pooh-poohing such concerns and missing an opportunity to engage productively in the public debate. I believe I was right at the time, and the economics profession as a whole has since moved much closer to the views I expressed then. But the downside of *financial* globalization? That was not on my radar screen at the time.

In the years that followed the Asian financial crisis, my research increasingly turned toward understanding how financial globalization worked (or didn’t). So when, ten years later, the International Monetary Fund asked me to prepare a study on this topic, I felt I was prepared. The article I wrote in 2007 with my co-author Arvind Subramanian was titled “Why Did Financial Globalization Disappoint?”¹ The promise of financial globalization was that it would help entrepreneurs raise funds and reallocate risk to more sophisticated investors better able to bear it. Developing nations would benefit the most, since they are cash-poor, subject to many shocks, and less able to diversify. That is not how things turned out.

The better performing countries—such as China—were not the countries receiving capital inflows but the ones that were *lending* to rich nations. Those who relied on international finance tended to do poorly. Our article tried to explain why unleashing global finance had not delivered the goods for the developing nations.

No sooner had we sent the article to the printer than the subprime mortgage crisis broke out and enveloped the United States. The housing bubble burst, prices of mortgage-backed assets collapsed, credit markets dried up, and within months Wall Street firms had committed collective suicide. The government had to step in, first in the United States and then in other advanced economies, with massive bailouts and takeovers of financial institutions. Financial globalization lay at the core of the crisis. The housing bubble and the huge edifice of risky derivatives it gave rise to were instigated by the excess saving of Asian nations and petrostates. That the crisis could spread so easily from Wall Street to other financial centers around the world was thanks to the comingling of balance sheets brought on by financial globalization. Once again, I had missed the bigger event unfolding just beyond the horizon.

I was hardly alone, of course. With very few exceptions economists were busy singing the praises of financial innovation instead of emphasizing the hazards created by the growth in what came to be known as the “shadow banking system,” a hub of unregulated finance. Just as in the Asian financial crisis, they had overlooked the danger signs and ignored the risks.

Neither of the crises should have come as a total surprise. The Asian financial crisis was followed by reams of analysis which in the end all boiled down to this: it is dangerous for a government to try to hold on to the value of its currency when financial capital is free to move in and out of a country. You could not have been an economist in good standing and not have known this, well before the Thai baht took its plunge in August 1997. The subprime mortgage crisis has also generated a large literature, and in view of

its magnitude and momentous implications, surely much more will be written. But some of the key conclusions are not hard to foresee: markets are prone to bubbles, unregulated leverage creates systemic risk, lack of transparency undermines confidence, and early intervention is crucial when financial markets are going belly-up. Didn't we know all this from as long ago as the famous tulip mania of the seventeenth century?

These crises transpired not because they were unpredictable but because they were *unpredicted*. Economists (and those who listen to them) had become overconfident in their preferred narrative of the moment: markets are efficient, financial innovation transfers risk to those best able to bear it, self-regulation works best, and government intervention is ineffective and harmful. They forgot that there were many other storylines that led in radically different directions. Hubris creates blind spots. Even though I had been a critic of financial globalization, I was not immune from this. Along with the rest of the economics profession I too was ready to believe that prudential regulations and central bank policies had erected sufficiently strong barriers against financial panics and meltdowns in the advanced economies, and that the remaining problem was to bring similar arrangements to developing countries. My subplots may have been somewhat different, but I was following the same grand narrative.

Doubts All Around

When countries on the periphery of the global system such as Thailand and Indonesia are overcome by crisis, we blame them for their failures and their inability to adjust to the system's rigors. When countries at the center are similarly engulfed, we blame the system and say it's time to fix it. The great financial crisis of 2008 that brought down Wall Street and humbled the United States along with other major industrial nations has already ushered in

an era of newfound zeal for reform. It has raised serious questions about the sustainability of global capitalism, at least in the form that we have experienced in the last quarter century.

What might have prevented the financial crisis? Did the problem lie with unscrupulous mortgage lenders? Spendthrift borrowers? Faulty practices by credit rating agencies? Too much leverage on the part of financial institutions? The global savings glut? Too loose monetary policy by the Federal Reserve? Government guarantees for Fannie Mae and Freddie Mac? The U.S. Treasury's rescue of Bear Stearns and AIG? The U.S. Treasury's refusal to bail out Lehman Brothers? Greed? Moral hazard? Too little regulation? Too much regulation? The debate on these questions remains fierce and will no doubt continue for a long time.

In the bigger scheme of things, these questions interrogate mere details. More fundamentally, our basic narrative has lost its credibility and appeal. It will be quite some time before any policy maker can be persuaded that financial innovation is an overwhelming force for good, that financial markets are best policed through self-regulation, or that governments can expect to let large financial institutions pay for their own mistakes. We need a new narrative to shape the next stage of globalization. The more thoughtful that new narrative, the healthier our economies will be.

Global finance is not the only area that has run out of convincing story lines. In July 2008, as the subprime mortgage crisis was brewing, global negotiations aimed at reducing barriers to international trade collapsed amid much acrimony and finger-pointing. These talks, organized under the auspices of the World Trade Organization (WTO) and dubbed the "Doha Round," had been ongoing since 2001. For many anti-globalization groups, they had come to symbolize exploitation by multinational corporations of labor, poor farmers, and the environment. A frequent target of attack, in the end the talks were brought down for more mundane reasons. Developing countries led by India and China concluded that there was not enough on offer from the United States and

the European Union for them to dismantle their own industrial and agricultural tariffs. Even though efforts to revive the talks continue, the WTO seems to have run out of ideas to boost its legitimacy and make itself relevant once again.

The world's trade regime differs from its financial counterpart in one important respect. Corrosion in the system of trade relations does not produce a blowup from one day to the next. When nations find the rules too constraining and no longer appropriate to their needs, they find ways of flouting them. The effects tend to be more subtle and show up over time in a gradual retreat from the cornerstone principles of multilateralism and non-discrimination.

Developing nations have always complained that the system is biased against their interests since it is the big boys that make the rules. A motley collection of anarchists, environmentalists, union interests, and progressives have also occasionally made common cause in their opposition to globalization for obvious reasons. But the real big news in recent years is that the rich countries are no longer too happy with the rules either. The rather dramatic decline in support for economic globalization in major countries like the United States reflects this new trend. The proportion of respondents in an NBC/*Wall Street Journal* poll saying globalization has been good for the U.S. economy has fallen precipitously, from 42 percent in June 2007 to 25 percent in March 2008. And surprisingly, the dismay has also begun to show up in an expanding list of mainstream economists who now question globalization's supposedly unmitigated virtues.

So we have the late Paul Samuelson, the author of the postwar era's landmark economics textbook, reminding his fellow economists that China's gains in globalization may well come at the expense of the United States; Paul Krugman, the 2008 Nobel laureate in Economics, arguing that trade with low-income countries is no longer too small to have an effect on inequality in rich nations; Alan Blinder, a former U.S. Federal Reserve vice chairman, worry-

ing that international outsourcing will cause unprecedented dislocations for the U.S. labor force; Martin Wolf, the *Financial Times* columnist and one of the most articulate advocates of globalization, expressing his disappointment with the way financial globalization has turned out; and Larry Summers, the Clinton administration's "Mr. Globalization" and economic adviser to President Barack Obama, musing about the dangers of a race to the bottom in national regulations and the need for international labor standards.

While these worries hardly amount to the full frontal attack mounted by the likes of Joseph Stiglitz, the Nobel Prize-winning economist, they still constitute a remarkable shift in the intellectual climate. Moreover, even those who have not lost heart often disagree vehemently about where they would like to see globalization go. For example, Jagdish Bhagwati, the distinguished free trader, and Fred Bergsten, the director of the pro-globalization Peterson Institute for International Economics, have both been on the front lines arguing that critics vastly exaggerate globalization's ills and underappreciate its benefits. But their debates on the merits of regional trade agreements—Bergsten for, Bhagwati against—are as heated as each one's disagreements with the authors mentioned above.

None of these economists is against globalization, of course. They do not want to reverse globalization, but to create new institutions and compensation mechanisms—at home or internationally—that will render globalization more effective, more fair, and more sustainable. Their policy proposals are often vague (when specified at all), and command little consensus. But confrontation over globalization has clearly moved well beyond the streets to the columns of the financial press and the rostrums of mainstream think tanks.

The intellectual consensus that sustains our current model of globalization had already begun to evaporate before the world economy became engulfed in the great financial crash of 2008.

Today, the self-assured attitude of globalization's cheerleaders has all but disappeared, replaced by doubts, questions, and skepticism.

An Alternative Narrative

The world has seen globalization collapse once already. The gold standard era—with its free trade and free capital mobility—came to an abrupt end in 1914 and could not be resuscitated after World War I. Could we witness a similar global economic breakdown in the years to come?

The question is not fanciful. Although economic globalization has enabled unprecedented levels of prosperity in advanced countries and has been a boon to hundreds of millions of poor workers in China and elsewhere in Asia, it rests on shaky pillars. Unlike national markets, which tend to be supported by domestic regulatory and political institutions, global markets are only “weakly embedded.” There is no global antitrust authority, no global lender of last resort, no global regulator, no global safety net, and, of course, no global democracy. In other words, global markets suffer from weak governance, and are therefore prone to instability, inefficiency, and weak popular legitimacy.

This imbalance between the national scope of governments and the global nature of markets forms the soft underbelly of globalization. A healthy global economic system necessitates a delicate compromise between these two. Give too much power to governments, and you have protectionism and autarky. Give markets too much freedom, and you have an unstable world economy with little social and political support from those it is supposed to help.

The first three decades after 1945 were governed by the Bretton Woods compromise, named after the eponymous New Hampshire resort where American, British, and other policy makers from Allied nations gathered in 1944 to design the post-World

War II economic system. The Bretton Woods regime was a shallow multilateralism that permitted policy makers to focus on domestic social and employment needs while enabling global trade to recover and flourish. The genius of the system was that it achieved a balance that served multiple objectives admirably well. Some of the most egregious restrictions on trade flows were removed, while leaving governments free to run their own independent economic policies and to erect their preferred versions of the welfare state. Developing countries, for their part, were allowed to pursue their particular growth strategies with limited external restraint. International capital flows remained tightly circumscribed. The Bretton Woods compromise was a roaring success: the industrial countries recovered and became prosperous while most developing nations experienced unprecedented levels of economic growth. The world economy flourished as never before.

The Bretton Woods monetary regime eventually proved unsustainable as capital became internationally more mobile and as the oil shocks of the 1970s hit the advanced economies hard. This regime was superseded in the 1980s and 1990s by a more ambitious agenda of economic liberalization and deep integration—an effort to establish what we may call hyperglobalization. Trade agreements now extended beyond their traditional focus on import restrictions and impinged on domestic policies; controls on international capital markets were removed; and developing nations came under severe pressure to open their markets to foreign trade and investment. In effect, economic globalization became an end in itself.

In pushing the postwar globalization model beyond its limits, economists and policy makers overlooked what had been the secret of its original success. The result was a series of disappointments. Financial globalization ended up promulgating instability rather than higher investment and more rapid growth. Within countries, globalization generated inequality and insecurity instead of lifting all boats. There were stupendous successes in this period—China

and India in particular. But as we shall see, these were countries that chose to play the globalization game not by the new rules, but by Bretton Woods rules. Instead of opening themselves unconditionally to international trade and finance, they pursued mixed strategies with a heavy dose of state intervention to diversify their economies. Meanwhile countries that followed the more standard recipes—such as those in Latin America—languished. And thus globalization became a victim of its own earlier success.

Replacing our economic world on a safer footing requires a better understanding of the fragile balance between markets and governance. I will offer an alternative narrative in this book based on two simple ideas. First, markets and governments are complements, not substitutes. If you want more and better markets, you have to have more (and better) governance. Markets work best not where states are weakest, but where they are strong. Second, capitalism does not come with a unique model. Economic prosperity and stability can be achieved through different combinations of institutional arrangements in labor markets, finance, corporate governance, social welfare, and other areas. Nations are likely to—and indeed are entitled to—make varying choices among these arrangements depending on their needs and values.

Trite as they may sound as stated, these ideas have enormous implications for globalization and for democracy, and for how far we can take each in the presence of the other. Once you understand that markets require public institutions of governance and regulation in order to function well, and further, you accept that nations may have different preferences over the shape that those institutions and regulations should take, you have started to tell a story that leads you to radically different endings.

In particular, you begin to understand what I will call the fundamental political trilemma of the world economy: we cannot simultaneously pursue democracy, national determination, and economic globalization. If we want to push globalization further, we have to give up either the nation state or democratic politics.

If we want to maintain and deepen democracy, we have to choose between the nation state and international economic integration. And if we want to keep the nation state and self-determination, we have to choose between deepening democracy and deepening globalization. Our troubles have their roots in our reluctance to face up to these ineluctable choices.

Even though it is possible to advance both democracy and globalization, the trilemma suggests this requires the creation of a global political community that is vastly more ambitious than anything we have seen to date or are likely to experience soon. It would call for global rulemaking by democracy, supported by accountability mechanisms that go far beyond what we have at present. Democratic global governance of this sort is a chimera. There are too many differences among nation states, I shall argue, for their needs and preferences to be accommodated within common rules and institutions. Whatever global governance we can muster will support only a limited version of economic globalization. The great diversity that marks our current world renders hyperglobalization incompatible with democracy.

So we have to make some choices. Let me be clear about mine: democracy and national determination should trump hyperglobalization. *Democracies have the right to protect their social arrangements, and when this right clashes with the requirements of the global economy, it is the latter that should give way.*

You might think that this principle would be the end of globalization. Not so. I hope to convince you by the end of this book that reempowering national democracies will in fact place the world economy on a safer, healthier footing. And therein lies the ultimate paradox of globalization. A thin layer of international rules that leaves substantial room for maneuver by national governments is a *better* globalization. It can address globalization's ills while preserving its substantial economic benefits. We need smart globalization, not maximum globalization.