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Lead Article on

Globalization Dilemmas & the Way out

Dani Rodrik

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Globalization Dilemmas & the Way Out

Dani Rodrik

The objective of international economic arrangements must be to attain the maximum amount of integration or the maximum thickness in economic transactions that are consistent with maintaining space for diversity in national institutions and the arrangements. The objective would be to create enough policy space to allow rich countries to rework their social compacts at home, poor countries to restructure and diversify their economies so that they can position themselves better to benefit from globalisation, and all nations, rich and poor alike, to establish financial systems and regulatory structures that are more attuned to their own needs. A better managed globalisation will be a better globalisation, argues the paper.

Dani Rodrik is Rafiq Hariri Professor of International Political Economy at John F. Kennedy School of Government, Harvard University. The first recipient of the prestigious A. O. Hirschman Award of the Social Science Research Council (New York) he authored many titles including the best sellers, *Has Globalization Gone Too Far (1997)* and *The Globalization Paradox (2011)*. This article is excerpted from his keynote address at the Bharat Ram Memorial Seminar held in New Delhi on 16 December, 2011.

Key Ideas

Let me start with some of the broad ideas before going on to what I call a fundamental political trilemma of the world economy. This will allow us to highlight some of the key tensions, particularly those between hyper-globalisation and democracy. The Euro Zone today demonstrates my arguments quite well.

The first key idea is that there is a natural limit to how far markets can extend themselves and that limit is defined by the scope of the workable regulations and governance that markets need. This is a corollary to Adam Smith's famous dictum that the division of labour is limited by the extent of the market. The corollary is that the market itself in turn is limited by the scope of workable regulations that non-market institutions need to extend to the same range that the markets are trying to cover.

The second idea relates to who or what provides or where do these institutions of regulation and governance come from? The main locus of legitimate governance today still remains the nation state. By legitimate locus I mean the answer to the following question: at what level does democratic deliberation rests for the most part? It is mostly at the level of the nation state and therefore, any notion of global governance or trans-national governance or any kind of mechanism of international governance or multi-lateralism that has significant institutions of democratic accountability and representativeness is still far off.

Third, there are legitimate differences across nation states on the shape these governance institutions ought to take. These differences arise from cultural differences. They arise also from the varying needs and preferences of different nation states and from the different levels of development in different countries.

None of these three ideas are particularly controversial when they are taken individually. Yet collectively they have implications which run counter to a lot of current thinking about how to address globalisation.

Global governance is fundamentally a fool's errand for good and substantive reasons.

We have to resign ourselves to a world where the governance of the world economy is bound to remain a patchwork, no matter how hard we push for global governance. Global governance is fundamentally a fool's errand for good and substantive reasons. The implication is that, once we internalise that idea, we have no other option but to understand that we need to moderate our ambitions with regard to economic globalisation or what I call hyper-globalisation, which is something that we actually cannot attain and any set of policies at the national or global level that are designed as if that is a worthy and feasible goal, is likely to bounce back with unexpected negative consequences.

When we get the balance wrong between institutions of governance and the reach of markets at the global level, we are going to run either into problems of legitimacy or problems of efficiency. When we push for global rules and global harmonisation too far without mechanisms of political accountability we are going to run into problems of inefficiency and instability. We then push global markets too far without corresponding rules.

Institutions of Capitalism

Adam Smith had a key insight in to the importance of markets and private initiative that market was the most creative and dynamic engine known to man and that this market required a very minimal state, providing very minimal functions. That markets required very thin level of governance has survived both in textbooks as well as in libertarian tradition that is still actually very strong in United States, which views markets as separate and disembodied from politics as long as the government simply protects property rights and undertakes national defence functions, nothing else is required for markets really to prosper.

In the Twentieth Century, we developed a much richer conception of the markets. We better understood that the markets need to be embedded in a much more complete, and stricter set of institutions and that the markets are not self-creating. Anything other than a village market requires investments in transport and logistics to create a market place whether electronic, virtual or real. Markets are not necessarily self-regulating either, thus requiring a whole panoply of regulatory institutions, from financial regulations to those relating to consumer safety and also competitive behaviour. Markets are not self-stabilising and therefore need monetary and fiscal institutions to stabilise them over time. Of course, markets are not self-legitimising and so we need institutions of social safety nets and social insurance. Ultimately we also need a political democracy to legitimise the working of markets which goes far beyond the original Smithian conception of a very thin state.

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In practice, during much of the Twentieth Century and certainly after World War II, the practical realisation of this conception of embedded markets took the form of combining Keynesian ideas about macro-economic management and the welfare state, providing extensive forms of social insurance and safety nets in much of the developing world and elsewhere as well through the extensive industry policies and restructuring of the economies. This combination of the welfare state and the industry policy was the practical expression of these ideas.

Bretton Woods System

During the Bretton Woods era when this set of ideas came to a fruition, the kind of world economy we had was the one that was based largely on national systems of capitalism and not a global one. In fact, the Bretton Woods system made the whole economy work by throwing lots of sand in the wheels of both international commerce and finance. On the side of international finance we had the capital controls. On the side of international trade we had very thin set of rules that kept a lot of global commerce outside the domain of global or multi-lateral discipline.

After the 1980's, we began to push for a somewhat different conception. The key idea here was of full-fledged globalisation or what I call hyper-globalisation that required elimination of transaction costs on international trade and finance and that went beyond simply reducing import tariffs or eliminating capital controls at the border. It meant reforming the domestic regulatory apparatus such that the differences across countries would not in themselves impede global trade and finance. It meant the agenda under the World Trade Organisation being pushed for regulatory harmonisation in a lot of areas. It also meant financial globalisation where everything was done to ensure the free, unimpeded flow of capital across the borders.

Now the flaw of the system was that it did not provide sufficiently strong global governance mechanisms to support international commerce and finance while at the same time weakening the very national institutions of governance that previously had ensured that the spread or the growth of domestic or national markets could provide for the prosperity for all. The consequence of this was the very syndrome associated with the last two decades; malfunctioning by both the economic as well as the political institutions. One way to put all these ideas on a historical frame is to highlight the kind of dilemma that we face today, the political trilemma of the world economy.

Talking historically, the period of the Gold Standard of the 19th century or roughly the period froml880 until about the First World War was a system where we tried to combine a very open world economy with the system that was in fact a patchwork in terms of governance and where the basic unit was still individual countries and the nation states. Certainly national sovereignty reigned supreme but the manner in which the Gold Standard and its rules played out was that individual countries had very little space within which to carry out their economic policies. In fact, there was not even a conception of what domestic economic sovereignty really meant. This was, of course before Keynes.

We have learnt from history that this kind of a model is fundamentally not compatible with democracy because the narrowing of domestic political and economic sovereignty or domestic economic policy space restricts the options too much to be really compatible with democracy. Of course, there is historically the big transition from the Gold Standard. Great Britain went off it in 1931. In Britain a lot of political forces then exerted pressure on the government to reflate the economy while the rules of the Gold Standard required to keep very high interest rates. Ultimately, the domestic political forces won and Britain had to get off Gold in response essentially to mass politics.

Hyper-Globalization

What I mean by hyper-globalisation is a global market that is as integrated as a national market is. It means a world economy where national borders are not associated with any transaction costs on international trade and finance.

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What does that actually mean for individual nation states? It means that nation states are unable to impose restrictions at the borders such as import tariffs, import restrictions, capital controls. There is more; nation states must also harmonise domestic legal and regulatory regimes with the global ones to minimise transaction costs that might arise from jurisdictional discontinuities like different bank regulations, different consumer safety regulations and so forth. It must also be the case that nation states are credibly pre-committing not to deviate from those harmonised regimes. Logically, therefore, the only manner in which we can attain hyper-globalisation is by restricting the scope of domestic policy in this way.

Such narrowing of policy space conflicts with the conventional conceptions of democracy. There are less ambitious forms of globalisation that may in fact be compatible with and actually enhance democracy. That is precisely the kind of globalisation and not hyper-globalisation that we need to push for.

Bretton Woods Compromise

Post World War II the Bretton Wood regime picked a very different system. Taking off from the interpretation of Keynes and others as to what had gone wrong during the War II period, the Bretton Woods regime explicitly designed rules that left significant policy space for individual countries. This was meant to open up the space for individual governments so that they could practice Keynesian demand management policies. They could erect their own social safety nets and welfare states and they had enough economic policy space to conduct restructuring policies and industrial policies and that is what we mean by the Bretton Wood compromise. It explicitly left out any attempt at trying to move towards hyper-globalisation or achieve economic globalisation beyond a certain level. This was an explicitly incomplete globalisation. Keynes famously said in 1945 that capital controls as part of the Britain Woods regime were not meant to be simply a temporary expedient. They were permanently an integral part of the regime because he understood that, for the healthy functioning of domestic economic management, countries needed certain amount of insulation from the vagaries of short-term international finance and trade regime. The GATT regime actually worked out a similar arrangement in trade, given the various exceptions that were called for in agriculture, services and even within manufacturing, for textiles and clothing as trade in those areas encroached on the domestic social and political bargains. This was a vision that explicitly kept hyper-globalisation at bay.

Bretton Woods regime explicitly designed rules that left significant policy space for individual countries.

After the 1980's, particularly after 1990, we have been pushing for hyper-globalisation which has created failures of deep legitimacy where global rules went too far. The key example of this is the World Trade Organisation which economists and trade lawyers think is the greatest construction of the last 30 years. Probably it may be the least popular international organisation if you ask the person on the street. Problems of legitimacy on the one hand and issues of inadequate regulation on the other were in fact of those who did not go far enough in the area international finance.

In principle, we can imagine a third alternative to complete the trilemma by posing the question: why not dispense with the nation state? Logically we can envisage a democratic, globally accountable representative system of governance at the global level and thus we can combine global markets and global governance along democratic lines. This, of course, would require significant restraint on the national self-determination because the political space would be moving from the level of the nation state. It would move trans-nationally to the level somewhat above the nation state.

The Case of European Union

The experience of the European Union, the failure of Euro zone in particular, gives us some pause to consider the limits that are broader than a regional entity, but this way of characterising our options is what the political trilemma of the world economy is. It basically says, between hyper-globalisation, national sovereignty and democratic politics we can have at the most two out of the three. To put it in terms of trade-offs, if we are moving in the direction of hyper-globalisation, we have to sacrifice either national sovereignty or sacrifice democracy, or both. We cannot keep all these values at once and a lot of our problems derive from the unwillingness or inability to internalise these constraints that economics and politics impose on us.

The experience of the European Union, the failure of Euro zone in particular, gives us some pause to consider the limits that are broader than a regional entity.

The case of European Union is very interesting because it is probably the part of the world which came as close to something like a global governance, but only at the regional level because, after all, the European Union was an attempt to create a broad range of institutions that would underpin a single European market in labour, commodities, services, finance and capital. There would also be democracy. In fact, the European Union created a very impressive set of institutional achievements. Europeans directly elected European Parliament, European Commission, European Council and the European Court of Justice, which actually can tell nation states that their laws violate European rules. There is the *Acquis communitaire* (EU's regulations) which by now cover a very wide range of areas, from housing standards to environmental standards. On top of everything else, the Euro Zone implies a common monetary regime, a common monetary policy and a single central bank.

All of these still turn out to have been quite incomplete, which is why the European Union was very badly exposed to the crisis. Ultimately, what the Euro Zone had created was a system where increasingly policy was being made at the centre, at the level of the European Union, but politics was still very much at the level of individual nation states. This is what Viven Schmidt of Boston University has called the problem of having policy without politics at the Union and politics without policy at the level of nation states. The fact is that national governments do not have room to choose their policies. All the important regulations are being taken at the level of the region but there is not really the effect of the political community that governs the system at all.

Euro Zone- USA Comparison

Just to drive the point home as to how that institutional incompleteness has played itself out, let us just compare the Euro Zone for a minute with the United States. Think of California, a part of the US, which shares a common currency with the rest of the US just as Greece and Ireland do within the Euro Zone. What happens if the state of California becomes insolvent? The way the things work out is very different from the way the things work out when the Greek Government becomes insolvent. What happens is that a resident of California now automatically gets welfare checks and other incomes directly from Washington.

Borrowers in California do not get automatically shut out of credit markets if they have a healthy balance sheet so they are not tarred by the sovereign risk of the California state government the same way that Greek borrowers or Greek banks are tarred by the sovereign rating of their own government. The Federal Reserve stands ready to act as an automatic lender of last resort to any Californian bank. Californian interests are represented directly in Washington because Californians can elect representatives and senators to go and push for their interests in Washington DC. Of course, Californians can move much more easily to seek jobs in the rest of the United States without facing cultural and language barriers like the Greeks would in the European Union.

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On the other side, there is no expectation that Washington DC will come necessarily to the help of the California state government. In fact Californian residents are being directly helped from Washington so that the centre does not necessarily have to come to the help of any individual borrowers such as the State of California.

The residents of California are part of the political community and governance structure of Washington and in return California has given up its sovereignty and has adopted Federal laws and regulations. Much of the economic policy moves directly up to the level of Washington. None of these things is true in the Euro Zone, which is what creates the problem that at the moment Greece runs into. If Greece goes into a sovereign crisis, it does not have the ability to pull itself out because Greek residents do not get the kind of help or do not have the safety valves that the Californians have. If Greece goes out of the Euro Zone then the next must be Portugal, Ireland or Italy. The spillovers, the contagion or the possibility of self-fulfilling panics are all there because of the lack of existence of the other institutions that the United States as a Federal Republic has managed to build over a period of a century or more.

Golden Straight Jacket Dilemma

In terms of applying the dilemma to the Euro Zone, what countries like Greece or Italy increasingly find themselves in is basically under the golden straight jacket where even a fiscal compact is simply going to mean the imposition of rules from the stronger countries like Germany on the weaker countries; rules made without the kind of democratic apparatus that normally we associate fiscal policy with. The alternative would have been to make a big leap towards a truly political Europe; it is obviously a much more ambitious one.

Ultimately the question for Europe is whether it is going to be feasible to restrain democratic politics to the extent of the level of nation states and if not, do we need other options? The third option here is the Euro Zone's break-up, with Greece and possibly others going away and reintroducing the domestic currency. That Europe is in a much more advanced state of hyper-globalisation makes it rather clear that these trade-offs do exist.

Europe needs either more political union if it wants a single market or less economic union if it is unable to achieve political integration.

Broadly speaking, Europe needs either more political union if it wants a single market or less economic union if it is unable to achieve political integration. The only other option which is where they are caught right now is to significantly restrain the working of democratic mechanisms.

Democracy Enhancing Globalization

Democracies have various mechanisms for restricting the autonomy or the policy space of decision makers. For example, democratically elected parliaments delegate power to independent or quasi independent autonomous bodies and lot of regulatory bodies are of that kind. Central banks are often similarly independent and there are various kinds of checks and balances in constitutional democracies. Similarly, globalisation can make it easier for national democracies to attain the goals that they pursue even if it comes at the expense of some restrictions in terms of autonomy.

The friction arises only when globalisation restricts the articulation and pursuit of domestic goals in ways that conflict with standard understanding of what democratic delegation is. Certainly some forms of delegation can be highly undemocratic such as when the national parliament delegates to the executive, and the executive delegates to the World Trade Organisation, which in-turn delegates to a bunch of Judges and then there might be a chain with too many links. The problem arises when globalisation entails restrictions on domestic policy space without compensating expansion of democratic space at the regional or global level. Then we do not get a voice in the rule making at transnational level while our voice in policy making at the domestic level is being restricted.

There are various ways in which globalisation can enhance democracy. There is a useful article by three political scientists, Keohane, Macedo and Moravcsik, which called this democracy enhancing multi-lateralism. They talk about how globalisation can enhance democracy by offsetting factions. If we have special interest lobbies that are very powerful domestically, the forces of globalisation can offset them by protecting minority rights or by enhancing the quality of democratic deliberation. However, just because globalisation can enhance democracy does not mean that it always does so and in fact there are many ways in which rather than offsetting factions, globalisation can privilege factions. Anti-dumping rules, for example, augment protectionist interests. Rules on intellectual property rights and copyrights which privilege pharmaceuticals companies and Disney Company are another case in point.

Similarly, there are many ways in which globalisation actually harms rather than enhancing the quality of democratic deliberation. For example, large-scale agreements under the aegis of the WTO or the IMF are often simply voted up or down in parliaments without any discussion whatsoever, simply because they are international agreements.

There are versions of globalisation that could enhance the working of democracy. Thus there is an important difference in principle and substance between the pursuit of what I have called hyper-globalisation, which would justify all external restrictions on domestic policy space so as to minimise transaction costs associated with national borders, and what now can be called after Keohane et al. 'democracy enhancing globalisation', which would impose only those, mostly procedural restrictions such as transparency, accountability, representativeness, use of scientific evidence and so forth.

We are moving into a phase of the world economy where national sovereignty is going to become much more important than before.

We are moving into a phase of the world economy where national sovereignty is going to become much more important than before. That is not only because some of the traditional multilateral powers are declining but also because of the rising powers like China and India which traditionally have put extremely strong emphasis on national sovereignty. This is not a bad thing because the global economy can actually function pretty well in a world where most countries are actually following their own national interest. Sometimes we make the mistake of thinking of the world economy as a global commons but, in fact, countries follow open trade and open finance policies because it is a good thing for themselves.

Nobody follows liberal trade and financial policies so as to provide benefits to the rest of the world. We do it because it is good for us. So in principle, if all countries are following their own national, domestic interest then we end up with a pretty open world economy as a matter of course. So when nation states have policy room, the outcome need not be a slippery slope to protectionism. This is not to say that democratic politics do not mal-function. We are very well aware of that in India how democracies can malfunction. But when democracies malfunction, it is the domestics who pay the bulk of the costs. For example, agriculture subsidies (or agricultural protectionism as is the case in India) generate costs for the rest of the world but the bulk of the costs is really paid by the domestic tax payers and domestic consumers. So improved domestic deliberation at home is likely to be a much more useful leverage and much more powerful than external constraints, given that ultimately the costs of that policy are borne at home and the benefits of good policy would also be disproportionately at home.

Agenda for Global Negotiations

What would these imply for an agenda for global negotiations? First, multilateral institutions ought to focus on global rules that enhance the quality of domestic calibration. This is to be distinguished from global rule making which too often focuses instead on harmonising policies and regulations based on their substance. The key principle here would be to insist on some global procedural norms associated with high-quality democratic deliberation, such as transparency, accountability, representativeness, use of scientific or economic evidence. Domestic policy should be made subject to those procedural safeguards without taking a position as to what the outcome of those rules ought to be, i.e., what capital adequacy standards ought to be, what product safety rules ought to be in different countries etc. This is a very different way of thinking about what multi-lateral regimes should do. This approach would actually legitimise national differences in regulatory structures subject to procedural safeguards that ensure high quality deliberation.

Multilateral institutions ought to focus on global rules that enhance the quality of domestic calibration.

Some existing agreements have a bit of that flavour such as the SPS agreement in World Trade Organisation, which call for the use of scientific evidence. In practice, even that argument has fallen short by not giving enough room for democracies to make their own mistakes which they ought to be allowed to do. Many other WTO agreements are based on models of harmonisation and still others such as the anti-dumping regime are simply poorly designed to empower wrong or narrow set of interests.

It should also be possible to deal with macro-economic imbalances. The global economy is not a global commons in the sense that if all countries follow their national interests, we get a fairly open world economy because openness is in the domestic interest. There is one major exception that if countries believe that it is in their interest to run large trade surpluses then they impose large costs on other countries. This is an area, therefore, where global coordination and global governance can be of critical importance. In the context of China's current account surplus this is an issue that the world economy has to deal with. An important caveat should be added here: until now, the rest of the world and the United States in particular, has simply been telling China that they have to find a way of reducing their current account surplus and to appreciate their currency more rapidly without paying sufficient attention to that China also has very valid and real employment and social concerns. Therefore, ultimately, if the rest of the world wants more rapid renminbi appreciation, it ought to be willing to provide China with an insurance policy in the form of looking the other way if China has to employ sectoral or micro-economic or trade policies in order to bail out or protect certain tradable sectors that might suffer large job losses or dislocations as a result of a rapid appreciation of its own currency. So if the world community wants greater discipline over macro/currency policies in China, it also has to be willing to provide it with less discipline over micro industrial or sectoral policies. The costs imposed on other countries would not be necessarily as severe as with mercantilist currency or trade imbalance policies.

We cannot talk about where the big gains are in the world economy without also mentioning labour mobility because we have talked about globalisation. This is one area where globalisation is the least advanced. The labour regime today globally is where the trade regime was back in 1950 when certainly the smart thing to do was to dismantle the patchwork of quantitative restrictions and very high barriers to trade in goods. Where the greatest economic gains exist today for global cooperation is in the area of liberalising labour flows not globally, not entirely, not by very large amount but even marginally. Even a small increase in temporary work visa would yield net gains that are several times those from completing for example, the Doha Round today.

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The gains are not huge in Doha anymore. There are similarly no big gains from harmonising financial regulations, where the danger would be a movement towards lowest common denominator or inappropriate standards. In both areas, we need to focus much more on domestic regulatory standards and then find ways of preventing across country arbitrage or cross border capital flows that tend to undermine standards in the higher-standard countries.

New Set of Traffic Rules

What I have been calling for can be called a new set of traffic rules for the world economy. These are rules that are based on the understanding that countries actually have the right to protect their own social arrangements and institutions but not to impose them on others. We need to moderate our ambitions to economic globalisation. The objective of international economic arrangements must be to attain the maximum amount of integration or the maximum thickness in economic transactions that are consistent with maintaining space for diversity in national institutions and the arrangements. In a way, this entails a return at least to the spirit of the Bretton Woods system. The objective would be to create enough policy space to allow rich countries to rework their social compacts at home, poor countries to restructure and diversify their economies so that they can position themselves better to benefit from globalisation, and all nations, rich and poor alike, to establish financial systems and regulatory structures that are more attuned to their own needs.

A better managed globalisation will be a better globalisation.

The ultimate paradox of globalisation is that a system that moves in this direction may look like it is retreating from economic globalisation, but will actually provide a much more healthy foundation for a global economy. A better managed globalisation will be a better globalisation.