REIMAGINING THE GLOBAL ECONOMIC ORDER

Dani Rodrik[1]
January 2023

The post-1990s era of hyper-globalization is now commonly acknowledged to have come to an end. The Covid pandemic and Russia's war on Ukraine have relegated global markets to a secondary and at best supporting role behind other national objectives -- public health and national security, in particular. In fact, hyper-globalization had already been in retreat for a while, since the global financial crisis of 2007-2008. The share of trade in world GDP began to decline after 2007, as China's export-GDP ratio plummeted by a remarkable sixteen percentage points. Global value chains stopped spreading. International capital flows never recovered to their pre-2007 heights. And populist politicians openly hostile to globalization became much more powerful in the advanced economies.

All the talk about de-globalization should not blind us to the possibility that the present crisis may in fact produce a better globalization. But we must begin by diagnosing where we went wrong.

Hyper-globalization's contradictions

Hyper-globalization crumpled under its many contradictions. First, there was an economic tension between the gains from specialization and the gains from diversification. The principle of comparative advantage told countries they should specialize in what they were presently good at producing. But there was also a long line of developmental thinking that suggested governments should instead push their economies to produce what countries richer than them did. The result was a conflict between the interventionist policies of the most successful economies, notably China, and the "liberal" principles enshrined in the world trading system.

Second, hyper-globalization exacerbated distributional problems in many economies. Trade theory predicted that a substantial redistribution of income from trade's losers to its winners would be the inevitable flip side of the gains from trade. That is exactly what happened as many regions and groups of workers experienced income losses, with further negative consequences for social and health status. And as globalization deepened, redistribution loomed larger and larger in comparison to the net gains. Economists and technocrats who pooh-poohed the central logic of their discipline ended up undermining public confidence in it.

Third, hyper-globalization directly undermined democracy by eroding the accountability of public officials to their electorate. Reducing barriers to trade and financial globalization became code words for diluting decades-old domestic social bargains in social safety nets, industrial policy, labor markets, health and safety regulation, and macroeconomic stabilization. Calls to rewrite the rules of globalization were met with the retort that globalization was like a physical force, immutable and irresistible -- "the economic equivalent of a force of nature, like wind or water," as Bill Clinton put. To those who questioned the prevailing rules of globalization, British Prime Minister Tony Blair responded: "You might as well debate whether autumn should follow summer."

[1] Prepared for Omidyear Group. This piece draws heavily on my previous writings for *Project Syndicate* and in *Foreign Affairs* (September 2022).

Fourth, there was an inherent tension between national security and geopolitical competition, on the one hand, and international economic cooperation, on the other. The zero-sum logic of the former was antithetical to the positive-sum logic of the latter. With the rise of China as a geopolitical rival to the U.S., and Russia's invasion of Ukraine, strategic competition eventually reasserted itself over economics.

With hyper-globalization having collapsed, future scenarios for the world economy run the full gamut from the good and the bad to the ugly. The worst outcome would be nations (or groups of nations) retreating behind autarky, a la 1930s. A less bad, but still ugly, possibility is that international trade and finance will turn merely into weapons of geopolitics, with trade wars and economic sanctions looming large. The first of these scenarios seems unlikely -- as the world economy is more interdependent than ever and the economic costs of would be huge – but we certainly cannot rule out the second one.

But it is also possible to envisage a good scenario whereby we achieve a better balance between the prerogatives of the nation state and the requirements of an open economy. Such a rebalancing might enable inclusive prosperity at home and peace and security abroad.

Two essential prerequisites

A healthy world economy necessarily rests on healthy national economies. Hence policy makers need to prioritize mending the damage done to their economies and societies by hyper-globalization along with other market fundamentalist policies. This will require going back to the spirit of the Bretton Woods era, when the global economy was in the service of domestic economic and social goals – full employment, prosperity, and equity – rather than the other way around. Under hyper-globalization, policy makers inverted this logic, with the global economy becoming the end and domestic society the means, reversing the "embedded liberalism" compromise of the Bretton Woods period. International integration led to domestic disintegration.

One might worry that prioritizing domestic economic and social goals would undermine openness of the economy. In reality, shared prosperity makes societies more secure and more likely to countenance openness to foreigners and to the world. A key lesson of economic theory is that trade benefits the nation as a whole, but only as long as distributive concerns are addressed. It is in the self-interest of well-managed, well-ordered nations to be open. This is also the lesson of actual experience under Bretton Woods, which witnessed significant expansion of trade and long-term investment.

There is also a second important prerequisite for the good scenario. Nations must not to turn a legitimate quest for national security into aggression against others. For great powers, and the U.S. in particular, this means acknowledging multipolarity and abandoning the quest for global primacy. Washington tends to regard American predominance in global affairs as a natural and desirable state of things. In this view of the world, China's growing economy and advances in hi-tech are inherently and self-evidently a threat and everything turns into a zero-sum game. This mindset is both dangerous and unproductive. For one thing, it exacerbates the security dilemma. American policies designed to undermine China's hi-tech initiatives are likely to make China feel threatened and respond in ways that validate U.S. fears of Chinese expansionism. It also makes it harder to reap the mutual gains from cooperation in areas such as climate change and global public health, while acknowledging that there will be necessarily conflict in many others. As for Russia, the country may have had reasonable concerns against NATO expansion, but its war in Ukraine is a completely disproportionate response. It will likely leave Russia less secure and less prosperous in the longer run.

The Limits of Global Governance

Globalization requires rules. These rules are enforced either formally or informally, in the latter case through states internalizing shared norms of behavior. The key question that ought to determine whether a policy domain should be globalized is: does the domain in question necessitate global cooperation and coordination, or can we leave decision-making to national authorities without great cost to other nations? In view of the US-China geopolitical competition and the turn towards domestic priorities, the appetite for global cooperation will be in even shorter supply in the years ahead. This makes it all the more important that we focus on those areas where there is a genuine and significant need for global governance.

Nearly all domestic policies create some spillovers across the border for other nations. So we might be tempted to answer this question in favor of globalist outcomes in almost all instances. Since what we do at home affect others, shouldn't there be always some global rules that discipline national practices?

By this logic, there would be few policies that would be left strictly to national authorities. For example, our education policies shape our future comparative advantage, and hence the gains from trade of other nations. When we acquire a more skilled labor force, some of our trading partners may well end up worse off because their skill-intensive exports will face tougher competition. By the spillovers logic, education should not be left to national policy makers! Or to take perhaps an even more outlandish example, each nation's rules on highway speed limits should be subject to global discipline because these policies obviously influence the price of oil and hence the well-being of oil-exporting nations!

The reason that such examples don't seem to make such sense is that there is a contending logic that pushes in the other, anti-globalist direction. Nations each have different needs and circumstances, and national political authorities are, in principle, the best judge of how to respond to those. In other words, nations should be free to choose what is best for them. Such freedom can be valuable even when the argument for global coordination is otherwise unimpeachable.

Hence every globalization regime faces a central tradeoff. Global rules have the advantage that they can maximize global efficiency, reduce transaction costs across national borders, and allow nations to reap the gains from trade and benefits of scale. But they have the disadvantage of reducing policy autonomy, hence inhibiting policy diversity and experimentation at the national level. A well-designed globalization regime would pursue an appropriate mix of global efficiency and policy diversity, without seeking to maximize either.

In global economics, architects of the Bretton Woods regime got the balance mostly right. Having lived through the Gold Standard's eventful demise during the interwar period, John Maynard Keynes was keenly aware of the need to carve out space for national stabilization policies. He envisaged capital controls, to prevent disruptive speculative financial flows, to be an essential element of the post-war global economic system. In trade, the General Agreement on Tariffs and Trade similarly established a thin veneer of global rules, enabling a significant expansion of trade in manufactures while governments were left free to devise their own regulatory models.

The post-1990 push into hyper-globalization ignored the lessons of the earlier era. The World Trade Organization, established in 1994, and subsequent trade agreements pursued a model of "deep integration" under which domestic regulations (in health, environment, intellectual property, subsidies, industrial policies) were increasingly viewed as trade barriers, impeding global efficiency. The free flow of short-term capital became the rule, rather than the norm, imposing limits on countries' monetary, fiscal, and tax policies.

A little appreciated irony of the post-1990 arrangements is that their greatest beneficiary was China, a country that played the globalization game not by hyper-globalization rules, but by Bretton Woods rules. China actively managed its exchange rate, restricted capital flows, and deployed a wide range of subsidies and other industrial policy tools, while taking advantage of other countries' open markets, to engineer economic history's most impressive economic growth and poverty reduction experience.

<u>Where Global Governance is Really Needed</u>

Beyond this basic trade-off, there are two sets of circumstances under which the argument for global rules carries significant weight. In economists' technical jargon, these are "beggar-thy-neighbor" policies and "global public goods." I will use these terms here because they have clear analytical content and cover very specific conditions. They clearly demarcate areas where global rules are necessary from those where they are not.

Beggar-thy-neighbor policies refer to policies that provide benefits at home only to the extent that they impose costs on foreign countries. Note that it is not enough that there be harm for others. The domestic benefits must be the direct result of that harm. The classic case is the abuse of monopoly power on world markets through trade restrictions. For example, some years back China imposed export restrictions on rare earth elements, used in many electronics products such as mobile phones. China has a near-monopoly in the production of these minerals and the policy was clearly aimed at jacking up world prices.

Another illustration is undervaluing the value of the national currency to gain a competitive advantage and "export" unemployment to other countries. This practice, common during the Great Depression of the 1930s, is what prompted the British economist Joan Robinson to coin the term "beggar-thy-nation." A third example are "pure" tax havens – practices that shift paper profits without attracting real physical investment. Some small nations such as Bermuda or the Cayman Islands maintain very low corporate tax rates to attract corporate headquarters. This results in substantial tax losses for other, higher-tax jurisdictions.

Global public goods (or bads) refer to circumstances where benefits (or costs) of national action are shared equally by all nations. The clearest and most significant example is climate change. Whether greenhouse gases are produced in my country or yours makes no difference to global warming. If I impose carbon taxes in mine, you benefit as much as I do. Under these circumstances, individual nations are likely to under-invest substantially in providing for the collective good and have strong incentive to free ride on other nations' contributions -- sadly an all-too apparent reality in climate change. Many aspects of fighting health pandemics also have a global public good nature. Early-warning systems, information collection, development of vaccines and medicines provide benefits to all nations regardless of where the investments are made. Our common humanity means that basic human rights – freedom from discrimination and degrading treatment -- are yet another global public good.

These considerations clarify why climate change and global public health in particular call for globalizing policy. In these domains, moving beyond the nation state to develop global rules that allocate responsibilities and prerogatives is a worthwhile, if challenging objective. On the flip side, these principles reveal that the case for global regimes is much weaker in other domains. This is especially true for economic globalization. Much of the effort and political capital invested in recent decades in building global rules for the world economy cannot be justified on the basis of these first-order considerations.

This may be a surprising claim. In the vernacular of the financial press, business circles, and policy technocracy, the world economy is a “global commons” that necessitates global cooperation. But the metaphor is misleading for the most part. There are some exceptions to be sure, and I mentioned the most important ones previously. Abuse of national market power, competitive currency manipulation, and tax havens do need to be disciplined through global rules. But the vast majority of the problems we encounter in international economics derive neither from beggar-thy-neighbor policies nor from failures to provide for a global public good.

In economics, virtue is its own reward. The policies that expand the national economic pie also tend to be good for other nations. Openness to foreign trade and foreign investment, full-employment policies, price stability, appropriate prudential regulation of financial institutions, growth-promoting structural policies are all the cornerstones of a healthy global economy. Well governed nations do not need persuasion from other countries to pursue such policies, because they are even more essential for the home economy to function well. Take free trade. As economists delight in demonstrating to first-year students, the point of free trade is to expand <u>domestic</u> consumption possibilities; it is not to confer benefits to other nations. The same is true for openness to long-term capital flows, growth policies, or macroeconomic stability.

There is a key caveat in the previous paragraph, and it shows up in the phrase “well governed.” Incompetence or the power of special interests frequently push governments to make mistakes that are costly to their economies, and hence to others’ as well. Trade barriers or subsidies may redistribute income to politically well-connected firms or sectors. Regulators may err in allowing banks to take excessive risks, increasing the likelihood of financial crises. Failures of this sort are common enough. But they do not arise from weak global governance. They are the product of bad <u>local</u> governance. The costs – to consumers, taxpayers, financial stability – are borne primarily at home.

It is possible that global rules might enhance national governance in some instances. Global information sharing, transparency norms, and rules that promote evidence-based decision making cannot hurt. But there cannot be a presumption that globalizing policy regimes will reliably prevent domestic policy mistakes. Global rules can be hijacked by special interests just as easily as domestic policies can, to overturn social contracts or arrangements in the broader public interest. Perhaps the clearest example of this is how big pharma has managed to rewrite global rules on patents to preserve and increase monopoly profits. It is no secret that the agenda of hyper-globalization has been set by multinational corporations and big banks, with labor, environmental and civil society groups typically on the defensive. Instead of targeting genuine domestic governance failures, global economic rules have been designed for the most part to privilege one set of distributive interests over others. The recent history economic globalization provides ample reason for global rules to be restricted to clear-cut instances of beggar-thy-neighbor and global public goods.

<u>A Meta-Regime for Global Order</u>

With these considerations as background, it is possible to envisage a thinner form of globalization that enables countries to reap most of the benefits from trade and encourages the provision of global public goods, while also leaving adequate space for governments to address their domestic economic, social, political, and national-security priorities. In a recent piece, Steve Walt and I have outlined a meta-regime for global order with that objective. The regime makes a distinction between four categories of policies: (i) prohibited actions; (ii) negotiations and mutual adjustments; (iii) independent actions; (iv) multilateral governance. To participate in it, states would agree on the desirability of this four-fold classification of policies, without having to agree in advance on which actions or issues belong in each category or on specific policy outcomes. The meta-regime presumes little agreement at the outset but might allow increasing cooperation over time as a result of transparency, mutual reason-giving, and trust-building.

Consider how this framework might be applied in one contentious policy domain: competition in high-tech industries. As China's high-tech industries have developed, U.S. and European policy-makers have become concerned not only about the commercial consequences but also the national security implications. Our meta-regime would allow Western nations considerable latitude in limiting Chinese firms' activities or presence within their own countries, largely on national security grounds. But it would also limit attempts to undermine Chinese industries through deliberate international restrictions.

For example, as the Chinese company Huawei has become a dominant force in global 5G networks, U.S. and European policymakers have grown concerned not only about the commercial consequences but also the national security implications, because Huawei is believed to have close ties to the Chinese security establishment. But the hardline response by the United States—which has sought to cripple Huawei's international activities and pressured U.S. telecom operators not to do business with it—is unproductive and has ratcheted up tensions. The recent, much broader restrictions on advanced semiconductors are even more extreme.

In fact, there are more effective strategies for dealing with tech conflicts such as Huawei. In contrast to the United States, the British government negotiated an arrangement with Huawei under which the company's products in the British telecoms market undergo an annual security evaluation. The evaluations are conducted by the Huawei Cyber Security Evaluation Centre (HCSEC), whose governing board includes a Huawei representative along with senior officials from the British government and telecom sector. If the annual evaluation finds areas of concern, it must make them public and state its rationale. Thus, the 2019 HCSEC report found that Huawei's software and cybersecurity system posed risks to British operators and would require significant adjustments to address these risks. In July 2020, the United Kingdom decided to ban Huawei from its 5G network.

Ultimately, HCSEC may have had less to do with the British ban than direct U.S. pressure, but it still illustrates the possibility of a more transparent and less contentious approach. The technical reasoning on which a national-security determination has been made can be seen and evaluated by all parties, including domestic firms with a commercial stake in Huawei's investments, the Chinese government, and Huawei itself. This feature alone can help build trust as each party develops a fuller understanding of the other's motives and actions. Transparency also makes it more difficult for home governments to invoke national security concerns as a cover for purely protectionist commercial considerations. And it may facilitate negotiating over time mutually beneficial bargains.

Nonetheless, most actions in hi-tech are likely to end up in our third category, where states take unilateral measures to protect themselves. Here, our framework requires the responses to be proportionate to actual or potential harms rather than as a means to gain strategic advantage. The Trump administration violated this principle by barring U.S. corporations from exporting microchips and other components to Huawei and its suppliers, regardless of where they operated or the purposes for which their products were used. Instead of seeking to protect the United States from espionage or some sort of cyberattack, the clear intention was to deliver a fatal blow to Huawei by starving it of essential inputs.

Moreover, the U.S. campaign has had serious economic repercussions for other countries. Many low-income countries in Africa have benefited from Huawei's relatively inexpensive equipment. Since U.S. policy has important implications for these countries, Washington should have engaged in a multilateral process that acknowledged the costs that cracking down on Huawei would inflict on others—an approach that would have conserved global goodwill at little cost to U.S. national security.

President Biden's recent policy on U.S. semiconductor sales to China -- a vast array of new restrictions on the sale of advanced technologies to Chinese firms -- raise these problems to an altogether new level. Biden has gone much further than Donald Trump, who had targeted individual companies. The new measures are astounding in their ambition, aiming at nothing less than preventing the rise of China as a high-tech power. Edward Luce of the Financial Times calls it "a full-blown economic war on China." Gregory C. Allen of the Center for Strategic and International Studies calls it "a new U.S. policy of actively strangling large segments of the Chinese technology industry—strangling with an intent to kill."

In this case, the U.S. response amounts to doubling down on U.S. primacy instead of accommodating to the realities of a post-unipolar world. The Biden administration has given up on making a distinction between technologies that directly help the Chinese military (and hence might pose a threat to U.S. allies) and commercial technologies (which might produce economic benefits not just to China but others as well, not least American firms). The U.S. has now crossed a line, with momentous implications. Such a broad-brush approach by the U.S., even if partially justified by the intertwined nature of the commercial and military sectors in China, raises significant dangers of its own. China will justifiably treat this as an aggressive move and will find ways to retaliate, raising tensions and heightening mutual fears even further.

Great powers (and indeed all nations) look out for their interests and protect their national security, taking counter-measures against other powers as necessary. But a secure, prosperous, and stable world order requires that these responses be well-calibrated, meaning that they have to be clearly linked to the damage inflicted by the other side's policies and intended solely to mitigate their negative effects. They should not be taken for the express purpose of punishing the other side or weakening it in the long run. Biden's export controls on high-tech does not pass this test.

A Thinner but Better Globalization

The retreat from hyper-globalization can lead us down the path of trade wars and rising ethno-nationalism, damaging economic prospects for all. But it need not do so. It is possible to envisage a more sensible, less intrusive model of economic globalization that focuses on areas where international cooperation truly pays off – global public health, international environmental agreements, global tax havens and other beggar-thy-neighbor policies -- but otherwise leaves nations unencumbered to prioritize their economic and social problems at home. Such a global order would not be inimical to the expansion of world trade and investment. It might even facilitate it insofar as it opens up space for restoring domestic social bargains in the advanced economies and crafting appropriate growth strategies in the developing world.

Such a good outcome, however, looks more and more remote by the day, as nations choose to over-react to geopolitical concerns. Until recently, we made the error of letting international banks and corporations write the rules of globalization. We now run the risk of handing the same privilege to the national security establishments of great powers. In the earlier era, it was our domestic social fabric and politics that paid the cost. Today, we are risking global peace as well.