

# RETHINKING THE WORLD ECONOMY

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What a difference a year and a half has made to the world economy.

When the Bank of Thailand gave up on defending the *baht* on July 2nd, 1997, no one could have predicted the momentous consequences that would ensue from the collapse of a currency of which few people had ever heard. In the sixteen months that followed the Thai crisis, the “miracle” economies of East Asia collapsed, throwing tens of millions into poverty. Russia defaulted on its external obligations and turned to the communists. Pounded by capital outflows, Latin America has come perilously close to an East Asian-style disaster. Financial markets in the advanced industrial countries have been hammered as well, resulting in a significant slowdown in economic activity. All in all, the chain reaction that is still unfolding has brought the world economy to the worst impasse that it has faced in a long time, possibly since the 1930s.

The good news is that the short-run fix the world economy needs is pretty straightforward. The U.S. and Europe have to be ready to ease monetary conditions adequately. Japan needs real fiscal stimulus (no gimmicks this time around). Congress has to approve new funds for the International Monetary Fund (IMF). The IMF, in turn, has to look kindly on temporary capital controls in the countries that are otherwise following its recipes, so that they too can revive their economies. There are of course many things that could go wrong. Excessive concern for domestic price stability on the part of the Fed and the Bundesbank, political stalemate in Japan, an obstinate U.S. Congress, and a Treasury that is too enamored of free capital flows—not to mention a U.S. president embroiled in personal scandal—are some of the obvious difficulties. But applied with sufficient resolve, a few simple remedies would go far to boost market confidence and prevent a slide into global depression.

The bad news, however, is that policy makers are clueless when it comes to the deeper question of reforming the international economic system. Despite all the talk about building a new “international financial architecture,” proposals coming out of Washington remain remarkably timid. They center on greater disclosure and better dissemination of financial information, improved prudential regulation of financial intermediaries, and changes in IMF procedures that would enhance the effectiveness and transparency of that much-maligned institution. Ideas coming out of Europe—principally from Britain and France—have been more ambitious, but they are not likely to get far without U.S. backing. It is a good bet that the reforms under serious consideration will not prevent future crises. Nor will they restore sorely needed credibility and legitimacy to international economic arrangements.

There is a simple reason for the dearth of good ideas. Practically all discussion on institutional reform in the world economy is predicated on the premise that our objective is—or should be—a functioning *global* capitalist system. This approach takes it for granted that an integrated world market will deliver the goods as long as we can contain some of its excesses and imbalances. The policy challenge within this frame of reference

is: *how do we make the world safe for free trade in goods, services, and capital?*

There is no appropriate answer to this question because the idea of global capitalism is inherently impracticable. For reasons I will discuss below, we have never had a global capitalist system and are unlikely to have one anytime soon. Capitalism is, and will remain, a national phenomenon. Therefore, the real policy challenge is: *how do we make the world safe for different brands of national capitalism to prosper side by side?* In other words, how do we construct an international economic system that respects and best fulfills the aspirations of distinct national entities, including their desire for material advancement for which trade serves as a vehicle? This question yields answers that differ from those to the previous one. Until we make a conceptual leap and choose to address the second question instead of the first, we are not going to come to grips with the real issues and provide workable solutions to our global predicament.

## Back to the future

To understand why global capitalism is a Utopian notion, it helps to go back to a book by the anthropologist Karl Polanyi, first published in 1944 and called *The Great Transformation* (Boston: Beacon Press, 1957). Polanyi took issue with the idea of a self-regulating market, an idea that had taken hold under the classical liberalism of the nineteenth century. He argued that markets could not exist outside the web of social relations for long without tragic consequences. Indeed, he interpreted the turmoil of the interwar period and its aftermath—the collapse of the gold standard, the decline into protectionism and bilateralism, the rise of fascism and national socialism, and ultimately the Second World War—as the result of societies rising to protect themselves from the onslaught of the market.

Polanyi's enduring insight is that markets are sustainable only to the extent that they are embedded in social and political institutions. These broader institutions serve three functions without which markets cannot survive: they *regulate, stabilize, and legitimate* market outcomes. As Adam Smith himself recognized, anti-competitive practices and con artists can easily disrupt markets in the absence of regulation. As John Maynard Keynes made us aware, markets suffer from boom-and-bust cycles and periods of unemployment in the absence of a stabilizer. And as every politician knows, the clamor for controls and restrictions overcome markets when markets produce outcomes that are not endowed with popular legitimacy. Markets are not self-regulating, self-stabilizing, and self-legitimizing. That is why every functioning society has regulatory bodies that set the rules of competition, monetary and fiscal institutions that perform stabilizing functions, and social insurance schemes, transfer policies, and other social arrangements that bring market outcomes into conformity with a society's preferences regarding the distribution of risks and rewards.

It is trite but true to say that none of these institutions exists at the global level. Had they existed, the ramifications of the Asian and Russian financial crises would not have been as serious: a global lender of last resort would have provided the liquidity needed to avert the global financial panic that ensued, and a global system of unemployment insurance would have taken care of the millions of Indonesians and others who were thrown out of work. The counterfactual clarifies a central point: global capitalism cannot exist short of some form of global government or global federalism.

The creation of supranational institutions that are adequate to the task would require not only a willingness to give up national sovereignty but a considerable degree of convergence in national preferences regarding what constitutes a desirable set of social arrangements. Neither of these is about to happen. For a second lesson of history is that there is no single blueprint for embedding a market economy in society. Today's advanced industrial nations are the product of models that, while successful, differ in significant respects. The United States, Germany, and Japan, to take three important examples, are alike in the emphasis they place on private property, the rule of law, and price stability. But these systems diverge greatly in their approach to social insurance, organization of labor markets, corporate governance, the regulation of product markets, redistributive taxation, and the intrusiveness of their governments in the economy more broadly. These and other nations have developed various styles of national capitalism arising out of disparate historical trajectories and different sets of norms. There are as many working models of successful capitalism as there are advanced industrial countries.

Typically, there are strong complementarities in the way that different elements of capitalist systems fit together. Certain aspects of Japanese society that seem inefficient to outside observers—such as the preference for mom-and-pop stores, extensive regulation of product markets, lifetime employment practices—are substitutes for the social insurance that would otherwise have to be provided (as it is in most European nations) by a welfare state. It is no coincidence that the United States has the world's freest product markets as well as its most vigilant anti-trust body; it is the latter that levels the playing field among competitors of varying strength, maintaining the efficacy and legitimacy of unbridled competition. Such complementarities mean that it is very difficult to alter national capitalist systems in a piecemeal fashion. Substantial changes come only in the aftermath of large dislocations, such as those created by the Great Depression or the Second World War. Hence we should not hold our breath for convergence among national institutions anytime soon. Nor, for that matter, should we view convergence as intrinsically desirable, since values and norms obviously differ across countries.

So it is futile to discuss international economic reform as if global capitalism exists or could be established in short order. The conundrum of those working within that conceptual realm is that they can offer either effective solutions or realistic ones, but not both. Hence official ideas coming out of Washington are perforce inadequate because they have to be politically realistic—that is, based on the reality that global federalism is not around the corner. More ambitious ideas, such as the creation of a global Fed, are technically superior, but utterly unrealistic in view of the way that the world is organized politically.

## **Creating breathing room for national capitalism**

What would an international system of national capitalisms look like? Here are some pointers:

- In common with today's regime, the system would adhere to multilateral procedures and the most-favored-nation principle. In particular, countries would not be able to play some trade partners off against others by discriminating amongst them.

- Second, the system would aim at low, but not necessarily zero levels of trade barriers in goods and services. Governments would not be required to reduce or eliminate controls on capital flows—especially the short-term kind. Neither would they be asked to harmonize behind-the-border policies in such areas as industrial regulation, taxation, labor rules, or environmental standards (except where there are clear cross-border spillovers, as in the case of acid rain and some other environmental problems).
- Third, and most significantly, the rules of the game would allow countries to reimpose restrictions at the border when not doing so would jeopardize a legitimate national objective. Concern for the environmental implications of certain kinds of trade, humanitarian objections to trading with a country that employs child labor, or adjustment difficulties in an industry faced with import competition might all constitute grounds for an opt-out of this kind. However, a government exercising this option would have to follow a set of guidelines that would be negotiated multilaterally and would specify the procedural requirements.

Groups of countries which are willing to go further than these, by implementing deeper cuts in trade barriers or by harmonizing domestic institutions for example, would be allowed to do so, provided they do not raise barriers against third countries.

If any of this sounds radical, consider the fact that the monetary/trade regime that formed in the immediate postwar period, and to which we owe our current prosperity, was founded on almost identical principles. Harry Dexter White and John Maynard Keynes, the architects of the Bretton Woods system, did not contemplate a regime whose main purpose was to maximize the international flow of goods and capital. Their objective was international economic stability. They sought a system that would prevent nations from exporting their economic difficulties to their trade partners and would avoid the problems of the interwar period: destabilizing capital flows, excessively volatile currencies, and an eventual descent into bilateralism and protectionism. For that purpose, they fixed exchange rates and left nations free to regulate capital flows.

In the trade arena, the GATT was concerned almost exclusively with policies at the border. In successive rounds of negotiations, trade officials brought down quantitative restrictions and tariffs on imports, and did so on a most-favored-nation basis. That is, all trade partners automatically became the beneficiaries of a barrier reduction negotiated with a particular partner. The rules frowned on quantitative restrictions, but not tariffs. Agriculture and textiles were effectively left out of these reductions. And a safeguard clause in the GATT permitted countries to raise tariffs temporarily when an increase in imports threatened to injure a domestic industry.

These international rules left enough space for national development efforts to proceed along successful but divergent paths. Western Europe chose to integrate within itself and to erect an extensive welfare state, with the share of government spending in national output doubling over a period of thirty years. Japan caught up with the West with its own distinctive brand of capitalism, combining a dynamic export sector with an inefficient and protected set of activities in services and agriculture. China began to grow by leaps and

bounds once it recognized the importance of private initiative, even though it flouted every other rule in the guidebook. Much of the rest of East Asia generated an economic miracle relying on industrial policies—such as quantitative restrictions, export subsidies, and domestic-content requirements—that have since been banned by the WTO. Until the late 1970s, scores of countries in Latin America, the Middle East, and even Africa generated economic growth rates that would have been unthinkable in an earlier era, and they did so under import-substitution policies that insulated their economies from the world economy.

What was radical, with hindsight, was the turn that events took during the 1980s. The Reagan and Thatcher “revolutions” presaged an era of market fundamentalism that went precisely counter to Polanyi’s central insight about the need to embed markets in social and political institutions. Market fundamentalism spawned a series of myths and half-truths: that freeing up international markets was a surest way to global prosperity (that is how Clinton put it recently); that foreign investment was key to expanding employment and spurring technological progress in “emerging” market economies; that free capital flows would allocate resources efficiently around the globe; that international financial markets would “discipline” governments to adopt more sound monetary and fiscal policies; that all countries were converging to a single brand of capitalism, patterned after the American model; and, perhaps most perniciously, that all of this could happen without significant inequities, economic instability, or disruptions to domestic social arrangements.

Neither history nor recent evidence provides much support for any of these propositions. Economists with no axe to grind will concede that the relationship between trade and foreign investment, on the one hand, and long-term economic growth, on the other, is a highly contingent one, dependent on many other mediating factors. With regard to capital flows, there is at least four centuries worth of accumulated evidence on their proclivity to manias, panics, and crashes. Far from imparting discipline, financial markets actually encourage irresponsibility on the part of borrowers (including governments) during the euphoric phases of these cycles. Moreover, there are no signs that the Europeans or the Japanese want significant changes in their social systems, much less to remake their societies in the image of the U.S.

No matter. Suddenly, the United States began to act as if the Japanese retail distribution system or its labor practices in the docks were a matter for bilateral negotiation, on the grounds that these *may* have had some trade impact. The World Trade Organization struck down U.S. import prohibitions enacted pursuant to its endangered species act because of concern that an open trading regime might otherwise be compromised. Emerging market economies like Mexico and South Korea were told to remove controls on international capital flows upon joining the OECD. Governments fell all over each other competing for and subsidizing foreign investors. Trade and foreign investment began to trump everything else.

The cumulative effect of decisions of this type has been exactly what Polanyi would have predicted: market instability and the steady erosion of the public legitimacy of the international economic system. The ongoing financial crisis has brought the issues to a head, forcing all concerned to take a much more cautious view of the freedom to trade paper assets across national borders. But the problems of the world economy transcend the arcane world of international finance. The IMF, WTO, and NAFTA had become dirty acronyms evoking deep hostility in many quarters—including the labor and

environmental movements, the NGO community, and many parts of the developing world—long before the baht was devalued in July 1997. President Clinton’s inability to wrest trade negotiating authority from Congress and the failure to complete the Multilateral Agreement on Investment (MAI), a charter that would uphold the rights of foreign investors, were symptomatic. The global economy was developing a crisis of legitimacy even before financial excess caused it to crash. It helps to understand why: we took market fundamentalism, which is silly enough at the national level, and extended it to the international economy, which is utter folly.

## A slippery slope?

The principal objection to an international economic system of the type I have proposed is the slippery slope. Without sufficient international discipline, the conventional argument goes, there is a serious risk that governments will slide back into protectionism, of the visible or disguised kind. In particular, broadening the existing safeguards agreement to allow nations to opt-out under a wider range of circumstances (moral, humanitarian, environmental) could weaken the international rules so much as to render them ineffective.

There may be a slippery slope in international economic relations, but the logic needs to be turned on its head. When governments are confronted with inflexible rules that conflict with domestic requirements, they find ways to flout the rules. And because systematic flouting of the rules ultimately corrodes the system, it is far better to provide well-designed, internationally sanctioned escape clauses than to allow a complete free-for-all. Had the IMF come up with intelligent advice on capital controls—rather than treating them as taboo—Malaysia might well have chosen more appropriate interventions over complete financial autarky.

The existing safeguards agreement of the WTO provides a good example of the unintended consequences of imposing unrealistic disciplines. Because the agreement is so restricted in scope—requiring an import surge, a demonstration that imports are the source of “injury” to a domestic industry, and compensation for affected trade partners—governments rarely turn to it. Instead, they resort to anti-dumping duties, the rules for which are significantly more flexible. For example, twelve U.S. steel companies recently petitioned the government for anti-dumping duties on imports from Russia, Brazil, and Japan. But, as any trade economist will point out, anti-dumping is a terrible way of regulating international trade. It penalizes normal competitive behavior that is not prohibited in any domestic setting (such as pricing below unit cost during market downturns). As a result, the use of anti-dumping as the safeguard mechanism of choice has done much more damage to the trading system than a broad but well-designed escape clause would have done.

The slippery slope argument also significantly underestimates human ingenuity in designing institutions that foreclose unwanted options—in this case, disguised protection. The reason why anti-dumping works the way it does in the United States is that it is a system *designed* to provide protection. The procedural rules are biased in that direction, and facilitate the plaintiff’s case by excluding considerations of economic efficiency or of the losses that would be incurred by those who are users of the imports in question. A more desirable set of procedures, balancing the interests of the plaintiffs against the

interests of those who would be hurt by trade restrictions, would not be tremendously difficult to set up. (I have discussed some of the details in my *Has Globalization Gone To Far?* Institute for International Economics, Washington, DC, pp. 83-85.) Compared to a system of inflexible rules, the outcomes may be more messy and unpredictable. But they would be more consistent with national aspirations and carry greater legitimacy.

### **A regime of rules or of free trade?**

A free trade regime and a rule-based multilateral regime are not one and the same thing. It is the latter that deserves first priority at the moment. Any set of ground rules for the world economy that is predicated on the Holy Grail of *global* capitalism, as a regime of complete free trade would be, is bound to disappoint badly. It is far more productive to strive for something that has worked very well in the past and remains attainable: a regime of peaceful coexistence among national capitalisms.

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