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The Globalisation Paradox
A discussion with Professor Dani Rodrik
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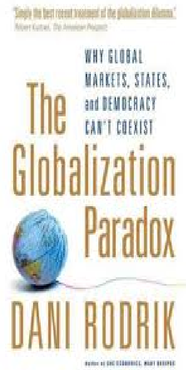
Dani Rodrik

Dani Rodrik is one of the world's leading economists. He is the Albert O. Hirschman Professor of Social Science at the Institute for Advanced Study in Princeton and is a leading scholar of globalisation and economic development. His 1997 book Has Globalization Gone Too Far? was called one of the decade's best economics books in Business Week. Rodrik's syndicated monthly columns for the Project Syndicate network are published in scores of newspapers around the world. His most recent book is The Globalization Paradox: Why Global Markets, States, and Democracy Can't Coexist.

About the book

"The Globalization Paradox: Why Global Markets, States, and Democracy Can't Coexist" provides an accessible account of the development of globalisation. It takes us from the trade in beaver fur in London's Garraway's coffee house in 1671, via the gold standard and the Bretton Woods regime to the challenges we face today. It provides the context for the trilemma that he set out in this presentation. He makes the case that the political classes have pushed the globalisation agenda too far at the expense of domestic considerations and suggests a smarter approach for the future.



The costs and benefits of globalisation continue to be hotly debated, with tax rules and transparency a key focus of the latest G8 summit. Professor Dani Rodrik discussed his views on the future of globalisation and its implications for nation states at a recent Schroders Secular Market Forum.

The onward march of globalisation can at times seem irreversible and unmanageable. While globalised trade has brought increased prosperity for many more people around the world, we are all familiar with its controversial aspects, such as multinationals using different jurisdictions to minimise their tax bills or outsourcing production to cheaper manufacturing centres. People may feel powerless to change such trends, but when the effects of globalisation become too damaging – as with the global financial crisis – we still turn to our national governments to rescue the situation.

Professor Rodrik's key theme was the tensions between the economic drive to globalise, the desire of countries to retain their individual sovereignty, and the need for democratic legitimacy. He made a compelling argument that it is possible to have any two of these, but that trying to have all three runs into problems of either economic failure or political illegitimacy. He terms this the 'trilemma' facing the world economy and made the case that difficult trade-offs will have to be made to ensure that globalisation can be sustained in an orderly manner. He also examined the history of globalisation to demonstrate how it has been attempted before, and considered the countries likely to be long-term winners and losers from globalisation.

> The world economy faces a 'trilemma' between the three competing demands of hyper-globalisation, national sovereignty and democratic legitimacy"

China – managed globalisation

Rodrik opened his talk with Milton Friedman's pencil analogy, which sets out the complex system necessary to draw together the different raw materials from around the world which go into making the humble pencil. The example demonstrates the role of free markets in inducing co-operation between people and countries in the creation of goods, for the benefit of consumers who can then buy cheap pencils. However, Rodrik noted that many of the pencils produced today will have been made in China, and that while this is partly due to market forces, it is also due to the decision by the Chinese government to develop a pencil industry. He explained that China's economic miracle and manufacturing success are in large part down to policies pursued by government in terms of restructuring the economy, state financing, providing subsidies and managing capital flows, etc. He added that "China has very effectively harnessed market forces, but combined them with determined government leadership and government intervention to ensure that globalisation would work to its benefit".

Although China has had great success in managing its entry into the global economy, Rodrik suggested that China's lack of democracy means it is likely to face other challenges as its economic growth slows. China's people may accept the autocratic political status quo while the economy is growing and they are sharing in the fruits of that growth, but slow or no growth is likely to prompt demands for political change.

How to respond to the challenges of globalisation?

Globalisation works best when it is not pushed too far, Rodrik argued, as this allows domestic authorities to retain adequate policymaking space. Hyper-globalisation, where the free market runs unchecked, will eventually create a crisis of legitimacy as it will undermine many of the things citizens expect their state to provide; such as regulations regarding finance or product safety, a fair tax regime, redistribution, and institutional practices such as employer-employee bargaining.

Ignoring the problems caused by globalisation is, therefore, not an option for policymakers. One solution could be to harmonise rules across countries, but this risks imposing ill-fitting rules on diverse countries and economies. Another option is to restrict the scope of globalisation, at the cost of giving up some of the gains from trade that globalisation makes possible.

> Globalisation works best when it is not pushed too far"

Learning from history

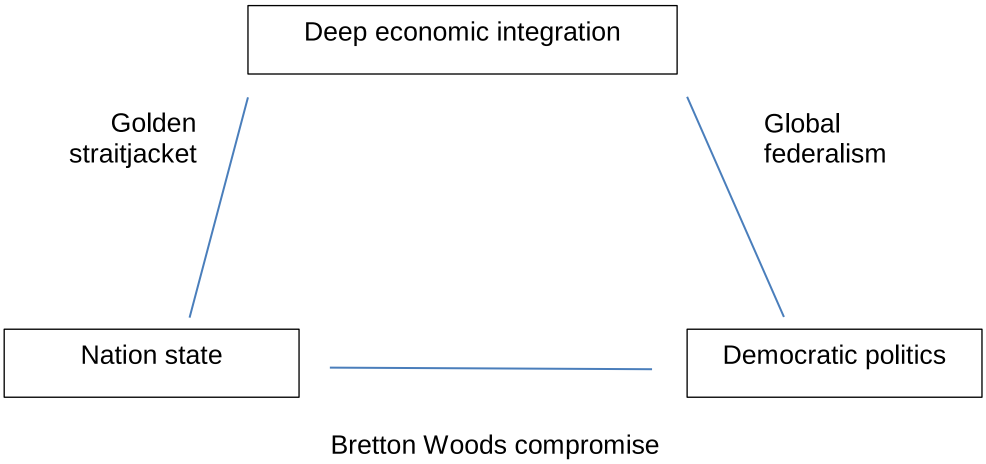
Rodrik explained that different countries have looked to history in order to formulate their response to the challenges presented by globalisation. Prior to the First World War, the gold standard system was the first attempt at a form of globalisation, creating a transnational set of rules that allowed for the free flow of capital and goods, but at the expense of limiting national governments' room for manoeuvre in developing their own policies. Such a regime can be termed a 'golden straitjacket', and Rodrik pointed out that this kind of system has historically not been compatible with the demands of democracy. In particular, he noted the ill-fated effort of Great Britain to return to the gold standard in the early 1930s, with the government finding that it was impossible to meet the increasing demands of the enlarged electorate and organised labour. Similarly, Argentina's pursuit of golden straitjacket policies in the 1990s came to grief amid mass public protests in 2001/02.

The second example he looked at was the post-war Bretton Woods system, which was more successful in maximising democratic legitimacy. Bretton Woods allowed space for the development of welfare states, for example, and for policymakers to undertake counter-cyclical measures when required. However, it was an explicitly incomplete version of globalisation with capital controls essential to its functioning. In addition, the accompanying GATT trade agreement allowed for only narrow trade liberalisation, covering solely manufacturing and developed markets.

The collapse of the Bretton Woods regime saw policymakers embark on an ambitious programme of economic liberalisation, with countries opening themselves up to international trade and finance. While beneficial for some, certain countries have fared much better than others in this environment. Rodrik argued that the example of

China shows that the most successful countries in the globalisation race are in fact the ones that have stuck closer to a Bretton Woods-style system, rather than those that opted for full openness under the World Trade Organisation regime.

Rodrik added that a third option for managing globalisation would be to establish a system of transnational governance, creating global institutions that would bypass national decisionmaking. As he acknowledged, such a strategy would require significant curbs on national self-determination and would limit the scope for individual countries to pursue diverse policies. There is also the danger that global institutions would be unaccountable, as democracy remains at a national level. Rodrik's own view is that democracy and national self-determination must prevail.



The example of the eurozone

The experience of the eurozone clearly demonstrates the difficulty in resolving the 'trilemma', as policymakers struggle to reconcile the demands of the single currency and single market with the need to maintain national sovereignty and democratic politics. While the financial integration of the eurozone proceeded rapidly, the development of institutions with the popularly-recognised mandate to oversee that integration lagged behind. When the eurozone crisis hit, those nascent institutions did not enjoy widely recognised legitimacy and national identity returned to the fore once more. Rodrik noted that 'lip service' is being paid to the idea of moving closer to the kind of fiscal and political union that will ensure the stability and democratic accountability of the currency union, but countries still prioritise maintaining their individual national sovereignty and keeping control of their own tax and spending plans.

For the moment then, the eurozone is pursuing the policies of the golden straitjacket, with Brussels and Berlin effectively taking policymaking away from countries such as Greece and dictating to them the terms on which they may remain in the eurozone. Rodrik questioned whether this strategy is ultimately sustainable as it risks creating social unrest which could lead to a country exiting the eurozone anyway, particularly when following the policies laid down by Brussels seems to lead to further economic decline. He added too that it appears to be fear of the unknown that is currently holding the eurozone together, but that one cannot trust this to prevail indefinitely. In his view, countries such as Greece or Spain are likely to suffer another two or three years of economic decline if they remain within the current system, but he argued that if they were to leave the euro – and make the right decisions on matters such as devaluation and capital controls – then they could begin to turn their economies around in about a year.

> Democracy and national self-determination should trump hyper-globalisation"

Winners and losers in the global economy

Rodrik said it is hard to be optimistic about the future of the world economy given the headwinds it currently faces. However, he believes there are likely to be very highly differentiated outcomes around the world. There are four key characteristics likely to ensure a country's relative success in the globalised economy, in Rodrik's view.

- Firstly he mentioned low debt levels (with private debt just as important as public debt), given that high debt intensifies redistributive conflicts, crowds out investment, reduces the scope for counter-cyclical fiscal policy, eventually requires higher taxation, and leaves domestic policymaking hostage to financial markets.

- Secondly, he sees those countries with large internal markets as better positioned than those with high external imbalances, as trade imbalances are a source of instability and export-led growth appears less achievable than before.

- Thirdly, Rodrik cited a robust democracy as a key characteristic for success because it works as a stable mechanism for conflict management.

- The fourth requirement is for sound relations between government and business, with on-going collaboration to identify opportunities and obstacles, develop new technology and diversify into new industries.

Rodrik noted that a key challenge for the global economy is that so few countries satisfy all of these requirements, but some countries will be in a better position than others. He named Brazil, India and South Korea as countries likely to be relative winners. In contrast, he sees China and Turkey, with their high external imbalances (albeit in opposite directions), as relative losers.

> Most of the things we need for globalisation to work well are things countries need to do for their own good"

The future for globalisation: the good, the bad and the ugly

- The 'good' outcome, according to Rodrik, would be for the trade-offs between globalisation, national sovereignty and democratic legitimacy to be recognised explicitly. In his view, this could allow development of a managed form of globalisation in which a better balance is struck between the prerogative of nation states and international rule. He added that "what doesn't work is trying to go around governments in announcing global rules that don't fit very well, or are ineffective, or run into problems of implementation".

- A 'bad' scenario, Rodrik said, would be if policymakers continue to avoid confronting the 'trilemma' and tried to maintain business as usual, relying on inadequate improvements to global governance and coordination.

- The 'ugly' scenario would be an abrupt end to globalisation and a return instead to the protectionism of the 1930s. However, Rodrik sees this outcome as unlikely, given that mainstream political and economic thought is much more in favour of open markets than it was in the early 20th century. The damage done by the Smoot-Hawley Tariff Act of 1930, which sent global trade into steep decline, is one of the enduring lessons of the Great Depression. In addition, there are now many more barriers to the unravelling of the global system. However, if policymakers pursue the 'bad' scenario and try to muddle through then they could paradoxically render this 'ugly' outcome more likely.

The paradox in action

Lastly, Rodrik made the point that sometimes there is too much emphasis on the need for co-operation at a global level, and that most of the things we need for globalisation to work well are things countries need to do for their own good. He gave the examples of Canada and Sweden as countries that are very open to the global economy in terms of trade and immigration, but which have not tried to integrate themselves in the way that the eurozone has tried to do. Both Sweden and Canada maintain their independent fiscal policy, their own monetary policy and their own banking rules. Rodrik said the two countries show that "you can have a lot of globalisation, but you still have to have your shock absorbers".

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