

# Globalization's Wrong Turn

And How It Hurt America

Dani Rodrik

**G**lobalization is in trouble. A populist backlash, personified by U.S. President Donald Trump, is in full swing. A simmering trade war between China and the United States could easily boil over. Countries across Europe are shutting their borders to immigrants. Even globalization's biggest boosters now concede that it has produced lopsided benefits and that something will have to change.

Today's woes have their roots in the 1990s, when policymakers set the world on its current, hyperglobalist path, requiring domestic economies to be put in the service of the world economy instead of the other way around. In trade, the transformation was signaled by the creation of the World Trade Organization, in 1995. The WTO not only made it harder for countries to shield themselves from international competition but also reached into policy areas that international trade rules had not previously touched: agriculture, services, intellectual property, industrial policy, and health and sanitary regulations. Even more ambitious regional trade

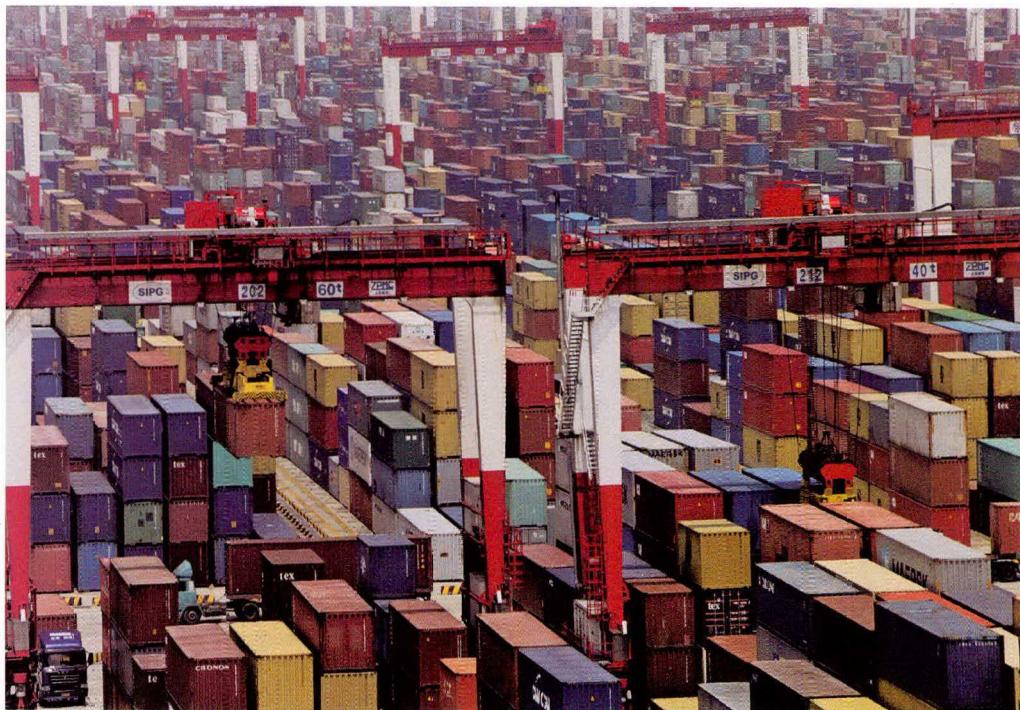
deals, such as the North American Free Trade Agreement, took off around the same time.

In finance, the change was marked by a fundamental shift in governments' attitudes away from managing capital flows and toward liberalization. Pushed by the United States and global organizations such as the International Monetary Fund and the Organization for Economic Cooperation and Development, countries freed up vast quantities of short-term finance to slosh across borders in search of higher returns.

At the time, these changes seemed to be based on sound economics. Openness to trade would lead economies to allocate their resources to where they would be the most productive. Capital would flow from the countries where it was plentiful to the countries where it was needed. More trade and freer finance would unleash private investment and fuel global economic growth. But these new arrangements came with risks that the hyperglobalists did not foresee, although economic theory could have predicted the downside to globalization just as well as it did the upside.

Increased trade with China and other low-wage countries accelerated the decline in manufacturing employment in the developed world, leaving many distressed communities behind. The financialization of the global economy produced the worst financial crisis since the Great Depression. And after the crash, international institutions promoted policies of austerity that made the damage even worse. More and more of what happened to ordinary people seemed the result of anonymous market forces or caused by distant decision-makers in foreign countries.

**DANI RODRIK** is Ford Foundation Professor of International Political Economy at the John F. Kennedy School of Government at Harvard University and President-Elect of the International Economic Association.



*Trading up? Shipping containers in Shanghai, China, May 2012*

Politicians and policymakers downplayed these problems, denying that the new terms of the global economy entailed sacrificing sovereignty. Yet they seemed immobilized by these same forces. The center-right and the center-left disagreed not over the rules of the new world economy but over how they should accommodate their national economies to them. The right wanted to cut taxes and slash regulations; the left asked for more spending on education and public infrastructure. Both sides agreed that economies needed to be refashioned in the name of global competitiveness. Globalization, exclaimed U.S. President Bill Clinton, "is the economic equivalent of a force of nature, like wind or water." British Prime Minister Tony Blair mocked those who wanted to "debate globalization," saying, "you might as well debate whether autumn should follow summer."

Yet there was nothing inevitable about the path the world followed beginning in the 1990s. International institutions played their part, but hyperglobalization was more a state of mind than a genuine, immutable constraint on domestic policy. Before it came along, countries had experimented with two very different models of globalization: the gold standard and the Bretton Woods system. The new hyperglobalization was closer in spirit to the historically more distant and more intrusive gold standard. That is the source of many of today's problems. It is to the more flexible principles of Bretton Woods that today's policymakers should look if they are to craft a fairer and more sustainable global economy.

#### **THE GOLDEN STRAITJACKET**

For roughly 50 years before World War I, plus a brief revival during the interwar period, the gold standard set the rules of economic management. A government

on the gold standard had to fix the value of its national currency to the price of gold, maintain open borders to finance, and repay its external debts under all circumstances. If those rules meant the government had to impose what economists would today call austerity, so be it, however great the damage to domestic incomes and employment.

That willingness to impose economic pain meant it was no coincidence that the first self-consciously populist movement arose under the gold standard. At the tail end of the nineteenth century, the People's Party gave voice to distressed American farmers, who were suffering from high interest rates on their debt and declining prices for their crops. The solution was clear: easier credit, enabled by making the currency redeemable in silver as well as gold. If the government allowed anyone with silver bullion to convert it into currency at a set rate, the supply of money would increase, driving up prices and easing the burden of the farmers' debts. But the northeastern establishment and its backing for the gold standard stood in the way. Frustrations grew, and at the 1896 Democratic National Convention, William Jennings Bryan, a candidate for the presidential nomination, famously declared, "You shall not crucify mankind upon a cross of gold."

The gold standard survived the populist assault in the United States thanks in part to fortuitous discoveries of gold ore that eased credit conditions after the 1890s. Nearly four decades later, the gold standard would be brought down for good, this time by the United Kingdom, under the pressure of similar grievances. After effectively suspending the gold standard during World War I,

the United Kingdom returned to it in 1925 at its pre-war rate. But the British economy was only a shadow of its pre-war self, and four years later, the crash of 1929 pushed the country over the edge. Business and labor demanded lower interest rates, which, under the gold standard, would have sent capital fleeing abroad. This time, however, the British government chose the domestic economy over the global rules and abandoned the gold standard in 1931. Two years later, Franklin Roosevelt, the newly elected U.S. president, wisely followed suit. As economists now know, the sooner a country left the gold standard, the sooner it came out of the Great Depression.

The experience of the gold standard taught the architects of the postwar international economic system, chief among them the economist John Maynard Keynes, that keeping domestic economies on a tight leash to promote international trade and investment made the system more, not less, fragile. Accordingly, the international regime that the Allied countries crafted at the Bretton Woods conference, in 1944, gave governments plenty of room to set monetary and fiscal policy. Central to this system were the controls it put on international capital mobility. As Keynes emphasized, capital controls were not merely a temporary expedient until financial markets stabilized after the war; they were a "permanent arrangement." Each government fixed the value of its currency, but it could adjust that value when the economy ran up against the constraint of international finance. The Bretton Woods system was predicated on the belief that the best way to encourage international trade

and long-term investment was to enable national governments to manage their economies.

Bretton Woods covered only international monetary and financial arrangements. Rules for trade developed in a more ad hoc manner, under the auspices of the General Agreement on Tariffs and Trade (GATT). But the same philosophy applied. Countries were to open up their economies only to the extent that this did not upset domestic social and political bargains. Trade liberalization remained limited to lowering border restrictions—import quotas and tariffs—on manufactured goods and applied only to developed countries. Developing countries were essentially free to do what they wanted. And even developed countries had plenty of flexibility to protect sensitive sectors. When, in the early 1970s, a rapid rise in garment imports from developing countries threatened employment in the developed world, developed and developing nations negotiated a special regime that allowed the former to reimpose import quotas.

Compared with both the gold standard and the subsequent hyper-globalization, the Bretton Woods and GATT rules gave countries great freedom to choose the terms on which they would participate in the world economy. Advanced economies used that freedom to regulate and tax their economies as they wished and to build generous welfare states, unhindered by worries of global competitiveness or capital flight. Developing nations diversified their economies through trade restrictions and industrial policies.

Domestic autonomy from global economic pressures might sound like a

recipe for less globalization. But during the Bretton Woods era, the global economy was on a tear. Developed and developing economies alike grew at unprecedented rates. Trade and foreign direct investment expanded even faster, outpacing the growth of world GDP. The share of exports in global output more than tripled, from less than five percent in 1945 to 16 percent in 1981. This success was a remarkable validation of Keynes' idea that the global economy functions best when each government takes care of its own economy and society.

## **BACK TO THE SPIRIT OF THE GOLD STANDARD**

Ironically, the hyperglobalists used the very success of the Bretton Woods system to legitimize their own project to displace it. If the shallow Bretton Woods arrangements had done so much to lift world trade, investment, and living standards, they argued, imagine what deeper integration could achieve.

But in the process of constructing the new regime, the central lesson of the old one was forgotten. Globalization became the end, national economies the means. Economists and policymakers came to view every conceivable feature of domestic economies through the lens of global markets. Domestic regulations were either hidden trade barriers, to be negotiated away through trade agreements, or potential sources of trade competitiveness. The confidence of financial markets became the paramount measure of the success or failure of monetary and fiscal policy.

The premise of the Bretton Woods regime had been that the GATT and other international agreements would act as a counterweight to powerful

protectionists at home—labor unions and firms serving mainly the domestic market. By the 1990s, however, the balance of political power in rich countries had swung away from the protectionists toward exporter and investor lobbies.

The trade deals that emerged in the 1990s reflected the strength of those lobbies. The clearest illustration of that power came when international trade agreements incorporated domestic protections for intellectual property rights, the result of aggressive lobbying by pharmaceutical firms eager to capture profits by extending their monopoly power to foreign markets. To this day, Big Pharma is the single largest lobby behind trade deals. International investors also won special privileges in trade agreements, allowing them (and only them) to directly sue governments in international tribunals for alleged violations of their property rights. Big banks, with the power of the U.S. Treasury behind them, pushed countries to open up to international finance.

Those who lost out from hyper-globalization received little support. Many manufacturing-dependent communities in the United States saw their jobs shipped off to China and Mexico and suffered serious economic and social consequences, ranging from joblessness to epidemics of drug addiction. In principle, workers hurt by trade should have been compensated through the federal Trade Adjustment Assistance program, but politicians had no incentives to fund it adequately or to make sure it was working well.

Economists were brimming with confidence in the 1990s about globalization as an engine of growth. The game

was to encourage exports and attract foreign investment. Do that, and the gains would prove so large that everyone would eventually win. This technocratic consensus served to legitimize and further reinforce the power of globalizing corporate and financial special interests.

An important element of hyper-globalist triumphalism was the belief that countries with different economic and social models would ultimately converge, if not on identical models, at least on sufficiently similar market economy models. China's admission to the WTO, in particular, was predicated on the expectation in the West that the state would give up directing economic activity. The Chinese government, however, had different ideas. It saw little reason to move away from the kind of managed economy that had produced such miraculous results over the previous 40 years. Western investors' complaints that China was violating its WTO commitments and engaging in unfair economic practices fell on deaf ears. Regardless of the legal merits of each side's case, the deeper problem lay elsewhere: the new trade regime could not accommodate the full range of institutional diversity among the world's largest economies.

### A SANER GLOBALIZATION

Policymakers can no longer resuscitate the Bretton Woods system in all its details; the world can't (and shouldn't) go back to fixed exchange rates, pervasive capital controls, and high levels of trade protection. But policymakers can draw on its lessons to craft a new, healthier globalization.

Trump's in-your-face unilateralism is the wrong way forward. Politicians

should work to revive the multilateral trade regime's legitimacy rather than squelching it. The way to achieve that, however, is not to further open markets and tighten global rules on trade and investment. Barriers to trade in goods and many services are already quite low. The task is to ensure greater popular support for a world economy that is open in essential respects, even if it falls short of the hyperglobalist ideal.

Building that support will require new international norms that expand the space for governments to pursue domestic objectives. For rich countries, this will mean a system that allows them to reconstitute their domestic social contracts. The set of rules that permit countries to temporarily protect sensitive sectors from competition badly needs reform. For example, the WTO allows countries to impose temporary tariffs, known as antidumping duties, on imports being sold by a foreign company below cost that threaten to harm a domestic industry. The WTO should also let governments respond to so-called social dumping, the practice of countries violating workers' rights in order to keep wages low and attract production. An anti-social-dumping regime would permit countries to protect not merely industry profits but labor standards, too. For developing countries, the international rules should accommodate governments' need to restructure their economies to accelerate growth. The WTO should also loosen the rules on subsidies, investment, and intellectual property rights that constrain developing countries' ability to boost particular industries.

If China and the United States are to resolve their trade conflict, they need to

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acknowledge that the differences between their economies are not going away. The Chinese economic miracle was built on industrial and financial policies that violated key tenets of the new hyperglobalist regime: subsidies for preferred industries, requirements that foreign companies transfer technology to domestic firms if they wanted to operate in China, pervasive state ownership, and currency controls. The Chinese government is not going to abandon such policies now. What U.S. companies see as the theft of intellectual property is a time-honored practice, in which a young United States itself engaged back when it was playing catch-up with industrializing England in the nineteenth century. For its part, China must realize that the United States and European countries have legitimate reasons to protect their social contracts and homegrown technologies from Chinese practices. Taking a page from the U.S.-Soviet relationship during the Cold War, China and the United States should aim for peaceful coexistence rather than convergence.

In international finance, countries should reinstate the norm that domestic governments get to control the cross-border mobility of capital, especially of the short-term kind. The rules should prioritize the integrity of domestic macroeconomic policies, tax systems, and financial regulations over free capital flows. The International Monetary Fund has already reversed its categorical opposition to capital controls, but governments and international institutions should do more to legitimize their use. For example, governments can make their domestic economies more stable by using “coun-

tercyclical capital regulation,” that is, restricting capital inflows when the economy is running hot and taxing outflows during a downturn. Governments should also crack down on tax evasion by the wealthy by establishing a global financial registry that would record the residence and nationality of shareholders and the actual owners of financial assets.

Left to its own devices, globalization always creates winners and losers. A key principle for a new globalization should be that changes in its rules must produce benefits for all rather than the few. Economic theory contributes an important idea here. It suggests that the scope for compensating the losers is much greater when the barrier being reduced is high to begin with. From this perspective, whittling away at the remaining, mostly minor restrictions on trade in goods or financial assets does not make much sense. Countries should focus instead on freeing up cross-border labor mobility, where the barriers are far greater. Indeed, labor markets are the area that offers the strongest economic case for deepening globalization. Expanding temporary work visa programs, especially for low-skilled workers, in advanced economies would be one way to go.

Proposing greater globalization of labor markets might seem to fly in the face of the usual concern that increased competition from foreign workers will harm low-skilled workers in advanced economies. And it may well be a political nonstarter in the United States and western Europe right now. If governments aren’t proposing to compensate those who lose out, they should take this concern seriously. But the potential

economic gains are huge: even a small increase in cross-border labor mobility would produce global economic gains that would dwarf those from the completion of the entire current, long-stalled round of multilateral trade negotiations. That means there's plenty of scope for compensating the losers—for example, by taxing increased cross-border labor flows and spending the proceeds directly on labor-market assistance programs.

In general, global governance should be light and flexible, allowing governments to choose their own methods of regulation. Countries trade not to confer benefits on others but because trade creates gains at home. When those gains are distributed fairly throughout the domestic economy, countries don't need external rules to enforce openness; they'll choose it of their own accord.

A lighter touch may even help globalization. After all, trade expanded faster relative to global output during the three and a half decades of the Bretton Woods regime than it has since 1990, even excluding the slowdown following the 2008 global financial crisis. Countries should pursue international agreements to constrain domestic policy only when they're needed to tackle genuine beggar-thy-neighbor problems, such as corporate tax havens, economic cartels, and policies that keep one's currency artificially cheap.

The current system of international rules tries to rein in many economic policies that don't represent true beggar-thy-neighbor problems. Consider bans on genetically modified organisms, agricultural subsidies, industrial policies, and overly lax financial regulation. Each of these policies could well harm

other countries, but the domestic economy in question will pay the bulk of the economic cost. Governments adopt such policies presumably because they think the social and political benefits are worth the price tag. In any individual case, a government might well be wrong. But international institutions aren't likely to be better judges of the tradeoffs—and even when they're right, their decisions will lack democratic legitimacy.

The push into hyperglobalization since the 1990s has led to much greater levels of international economic integration. At the same time, it has produced domestic disintegration. As professional, corporate, and financial elites have connected with their peers all over the globe, they have grown more distant from their compatriots at home. Today's populist backlash is a symptom of that fragmentation.

The bulk of the work needed to mend domestic economic and political systems has to be done at home. Closing the economic and social gaps widened by hyperglobalization will require restoring primacy to the domestic sphere in the policy hierarchy and demoting the international. The greatest contribution the world economy can make to this project is to enable, rather than encumber, that correction.❸

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