# The Future of Capitalism

Dani Rodrik

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# Capitalism 1.0: the miracle of markets

- Insight: the market is the most creative and dynamic economic engine known to man
- Textbook renditions (still common) presume it requires a minimal state
  - National defense, protection of property rights, and the administration of justice
  - Not necessarily Adam Smith's own view
- Corresponds to the 19th century "liberal" view and today's libertarian vision

# Capitalism 2.0: the institutional underpinnings of markets

- Insight: markets are not self-creating, self-regulating, self-stabilizing, or self-legitimizing
- Therefore they need to be embedded in a wide range of institutions
  - Regulatory institutions, redistributive institutions, monetary and fiscal institutions, institutions of conflict management, …
- In practice: Keynes + the welfare state
- A national system of capitalism, not a global one
  - Bretton Woods made the system work by throwing lots of "sand in the wheels" of international commerce and finance
    - Capital controls plus a highly permissive GATT

# Capitalism 2.1: the roots of the crisis

- Two “neoliberal” blind spots:
  - Can push for rapid deep integration in world trade and finance, and let institutional underpinnings catch up later
  - Deep economic integration has no (or mostly benign) effects on national institutional arrangements
    - i.e., tax competition is good
- Policy agenda: financial globalization and “deep integration” under the WTO
- Results
  - Erosion of the legitimacy of the trade system
  - Financial crisis
    - Weak financial regulation + poorly managed interface of U.S. and Chinese style capitalisms (“global macro imbalances”)

# The fundamental problem of the world economy

- Imbalance between reach of markets (global) and scope of their governance (mostly national)
- What will capitalism 3.0 look like?
- Temptation: a global version of capitalism 2.0
  - Global regulation, global standards, global safety nets, etc.
- But impractical
  - Places too much faith on the supply of global “leadership” and willingness of countries to give up sovereignty
- And more importantly, undesirable
  - Diversity in national preferences and needs
    - E,g., trade-off between financial innovation and financial stability
    - E.g., developing countries’ need to promote structural transformation

# The political trilemma of the world economy

Deep globalization

Golden Straitjacket

Global governance

National self-determination

Democratic politics

Bretton Woods compromise

<u>Pick two, any two</u>

# Where globalization's constraints bite: advanced country examples

- Labor standards
  - Domestic labor laws protect workers from displacement through the hiring of child labor; should trade be allowed to contravene this norm?
- Environmental, health and safety standards
  - If European citizenry want to apply a higher precautionary standard than other countries, should trade rules prevent them?
- Regulatory spillovers
  - Should countries allow free trade in financial assets by default, even if these assets are poorly regulated by issuing jurisdictions (e.g., trade in CDOs)
- Regulatory "takings"
  - Should foreign firms in the U.S. receive greater protection from policy changes than domestic firms (as NAFTA and BITs may require)?
- Currency "manipulation"
  - Does it make sense that WTO rules permit countervailing for export duties, but not for undervalued currencies?

# Where globalization's constraints bite: advanced country examples

- Redistributive provision of social insurance
  - If taxation of capital and skilled professionals has historically helped fund social insurance programs, should their mobility be allowed to undercut this "social compact"?
- Trade versus technological change
  - Domestically, R&D and technological progress are highly regulated (e.g., human cloning); should trade, which is analogous to technological change, be left unregulated as a rule?

These are all normatively difficult questions, without clear-cut answers. And they increase in salience with services off-shoring.

Realism and practicality dictate that they will be resolved primarily at the national level, given the wide variety of standards and norms that prevail across the globe.

Yet the deep integration model is antithetical to the transaction costs that would arise thereby.

# Where globalization's constraints bite: developing country examples

- Trade regime
  - Agreements on subsidies, TRIMs, TRIPs, and other negotiations on services ➔ narrowing room for "industrial policies"
- International capital markets
  - Financial codes and standards ➔ no roles for development banking and credit market interventions
- Monetary rules
  - CB independence and "free floating" ➔ no role for exchange rate as developmental policy instrument
- FTAs and BITs
  - Further restrictions in all areas above

# Guidelines for (global) capitalism 3.0

- Markets need to be deeply embedded in systems of governance in order to work well
- Democratic governance and political communities are organized largely within nation states, and are likely to remain so in the immediate future.
  - With few exceptions: EU perhaps?
- There is no “one way”: institutional designs that underpin market economies will differ according to domestic preferences and needs
- Countries have the right to protect their own social arrangements and institutions
  - But not to impose them on others
- The objective of international economic arrangements must be to attain the maximum “thickness” in economic transactions (in trade and investment flows) that is consistent with maintaining space for diversity in national institutional arrangements.
  - Enable like-minded countries to deep integrate
  - When deep integration is not feasible or desirable, rely on traffic rules to manage interface among national institutional arrangements
- Non-democratic countries pose special difficulties for this architecture (since it cannot be presumed that their choices reflect the needs of their citizenry) and therefore may be subject to less permissive rules.

# New traffic rules

- To manage the interface between national regulatory settings and social orders
- Creation of policy space to allow:
  - rich nations to provide social insurance, address concerns about labor, environmental, health, and safety consequences of trade, and shorten the “chain of delegation”
  - poor nations to position themselves better for globalization through economic restructuring
  - all nations to create financial systems and regulatory structures more attuned to their own conditions and needs

# What might such traffic rules look like?

An illustration from trade: generalizing the WTO safeguards/escape-clause approach

- Allows countries to re-impose tariffs under certain circumstances
- Principle behind safeguards: negotiated opt-outs, with procedural constraints, better than disorganized opt-outs
- Restricted at present to very limited circumstances
  - An import surge, causally linked to "injury" to domestic industry; must be applied on MFN basis; must be temporary; requires compensation
- Can be broadened to wider set of circumstances in which the legitimacy of trade is at issue
  - Subject to transparency, accountability and other institutional and procedural prerequisites
    - Which, in particular, provide standing to beneficiaries of trade
- A "development box" for developing countries
  - Recognition that structural transformation requires subsidies and other currently prohibited practices
- Exchange of policy space instead of market access
- Risk of slippery slope?
  - Limited if experience with anti-dumping is a guide

# What might such traffic rules look like?

An illustration from finance: a nationally-based, but globally consistent regime of regulation

- Recognize that the governance of financial markets will be done mainly at the national, not international level
- Recognize that different countries/regions will make different regulatory choices
- Recognize that there will be strong pressures towards regulatory arbitrage when national regulatory arrangements vary
- Recognize that governments have the right to interfere in cross-border financial flows to prevent undermining of domestic regulations
  - Analogy with “harmful” tax competition
- Recognize that the resulting financial segmentation is the necessary price to pay for financial stability
- If the experience of the last quarter century is a guide, we should not exaggerate the economic costs of a certain amount of financial de-globalization

# Final word: the future of globalization

- The worst possible outcome: a return to the 1930s
  - But 1930s-style increases in barriers to trade and investment remain unlikely
    - We have learned something in the meantime!
  - unless the U.S. succumbs into an even deeper recession
  - and/or the transition to a new global regime is badly mismanaged
- A mistake of the opposite kind: an ambitious effort to take economic globalization to the next level
  - Major global initiatives in financial regulation, supervision, and institution-building
    - i.e., a global regulator, or the IMF as a true ILLR
  - A return to a “deep integration” agenda in world trade
  - The problem:
    - greatly underestimates (and misunderstands) the political and institutional underpinnings of deep integration
    - assumes too much about the supply of global leadership and willingness of major countries to surrender national sovereignty
    - so leaves us defenseless vis-à-vis instability and backlash, and sets us up for failure

# Final word: the future of globalization

- A preferable scenario: an intermediate level of globalization
  - Somewhat like a return to the "spirit" of the Bretton Woods years
    - recreating "embedded liberalism"
  - A retreat from the gung-ho globalization of the post-1990 years, which was marked by attempts at deep integration
    - beyond-the-border "trade liberalization" measures under the WTO
    - post-1990 financial globalization and free capital mobility as the norm
  - But not from globalization per se
    - Trade restrictions remain low-to-moderate at worst, and capital controls are mainly prudential rather than punitive
    - Remember: considerable increase in the volume of trade and investment in the 1960s and 1970s
  - Key: willingness to allow much greater domestic "policy space" when there is conflict between domestic requirements and international integration
  - This model economizes on the supply of global leadership/cooperation, without necessarily sacrificing the many good things (e.g., growth) that comes with globalization