Also by Dani Rodrik

One Economics, Many Recipes: Globalization, Institutions, and Economic Growth

Has Globalization Gone Too Far?

The Globalization Paradox

Democracy and the Future of the World Economy

Dani Rodrik

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To Çetin Doğan

An extraordinary man whose dignity, fortitude, and resolve will prevail over the great injustice he has been forced to endure.

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INTRODUCTION

Recasting Globalization's Narrative

I published a little book early in 1997 called *Has Globalization Gone Too Far?* A few months later, the economies of Thailand, Indonesia, South Korea, and other countries in Southeast Asia stood in tatters, casualties of a massive international financial whiplash. These countries had been growing rapidly for decades and had become the darlings of the international financial community and development experts. But all of a sudden international banks and investors decided they were no longer safe places to leave their money in. A precipitous withdrawal of funds ensued, currencies took a nose-dive, corporations and banks found themselves bankrupt, and the economies of the region collapsed. Thus was born the Asian financial crisis, which spread first to Russia, then to Brazil, and eventually to Argentina, bringing down with it Long-Term Capital Management (LTCM), the formidable and much-admired hedge fund, along the way.

I might have congratulated myself for my prescience and timing. My book eventually became a top seller for its publisher, the Washington-based Institute for International Economics (IIE), in part, I suppose, because of the IIE's reputation as a staunch advocate for globalization. It was a kind of a Nixon-in-China effect. Skepticism about globalization was more interesting when it came

from a quarter where it was least expected. "A pro-globalization think tank publishes study by Harvard professor who warns globalization is not what it's cracked up to be"—now that is something worth paying attention to!

Alas, I was far from getting it right. My book was oblivious to the crisis brewing in financial markets. In fact, not only had I not foreseen the coming storm, I had decided to leave financial globalization—the trillions of dollars in currencies, securities, derivatives, and other financial assets exchanged globally on a daily basis—out of the book altogether. Instead, I had focused on the difficulties that international trade in goods was generating in labor markets and for social policies. I worried that the boom in international commerce and outsourcing would exacerbate inequality, accentuate labor market risks, and erode the social compact within nations. These conflicts need to be managed, I argued, through more extensive social programs and better international rules. I had decided to write the book because my colleagues in the economics profession were pooh-poohing such concerns and missing an opportunity to engage productively in the public debate. I believe I was right at the time, and the economics profession as a whole has since moved much closer to the views I expressed then. But the downside of *financial* globalization? That was not on my radar screen at the time.

In the years that followed the Asian financial crisis, my research increasingly turned toward understanding how financial globalization worked (or didn't). So when, ten years later, the International Monetary Fund asked me to prepare a study on this topic, I felt I was prepared. The article I wrote in 2007 with my co-author Arvind Subramanian was titled "Why Did Financial Globalization Disappoint?"[1] The promise of financial globalization was that it would help entrepreneurs raise funds and reallocate risk to more sophisticated investors better able to bear it. Developing nations would benefit the most, since they are cash-poor, subject to many shocks, and less able to diversify. That is not how things turned out.

The better performing countries—such as China—were not the countries receiving capital inflows but the ones that were *lending* to rich nations. Those who relied on international finance tended to do poorly. Our article tried to explain why unleashing global finance had not delivered the goods for the developing nations.

No sooner had we sent the article to the printer than the subprime mortgage crisis broke out and enveloped the United States. The housing bubble burst, prices of mortgage-backed assets collapsed, credit markets dried up, and within months Wall Street firms had committed collective suicide. The government had to step in, first in the United States and then in other advanced economies, with massive bailouts and takeovers of financial institutions. Financial globalization lay at the core of the crisis. The housing bubble and the huge edifice of risky derivatives it gave rise to were instigated by the excess saving of Asian nations and petrostates. That the crisis could spread so easily from Wall Street to other financial centers around the world was thanks to the commingling of balance sheets brought on by financial globalization. Once again, I had missed the bigger event unfolding just beyond the horizon.

I was hardly alone, of course. With very few exceptions economists were busy singing the praises of financial innovation instead of emphasizing the hazards created by the growth in what came to be known as the "shadow banking system," a hub of unregulated finance. Just as in the Asian financial crisis, they had overlooked the danger signs and ignored the risks.

Neither of the crises should have come as a total surprise. The Asian financial crisis was followed by reams of analysis which in the end all boiled down to this: it is dangerous for a government to try to hold on to the value of its currency when financial capital is free to move in and out of a country. You could not have been an economist in good standing and not have known this, well before the Thai baht took its plunge in August 1997. The subprime mortgage crisis has also generated a large literature, and in view of

its magnitude and momentous implications, surely much more will be written. But some of the key conclusions are not hard to foresee: markets are prone to bubbles, unregulated leverage creates systemic risk, lack of transparency undermines confidence, and early intervention is crucial when financial markets are going belly-up. Didn't we know all this from as long ago as the famous tulip mania of the seventeenth century?

These crises transpired not because they were unpredictable but because they were *unpredicted.* Economists (and those who listen to them) had become overconfident in their preferred narrative of the moment: markets are efficient, financial innovation transfers risk to those best able to bear it, self-regulation works best, and government intervention is ineffective and harmful. They forgot that there were many other storylines that led in radically different directions. Hubris creates blind spots. Even though I had been a critic of financial globalization, I was not immune from this. Along with the rest of the economics profession I too was ready to believe that prudential regulations and central bank policies had erected sufficiently strong barriers against financial panics and meltdowns in the advanced economies, and that the remaining problem was to bring similar arrangements to developing countries. My subplots may have been somewhat different, but I was following the same grand narrative.

Doubts All Around

When countries on the periphery of the global system such as Thailand and Indonesia are overcome by crisis, we blame them for their failures and their inability to adjust to the system's rigors. When countries at the center are similarly engulfed, we blame the system and say it's time to fix it. The great financial crisis of 2008 that brought down Wall Street and humbled the United States along with other major industrial nations has already ushered in

an era of newfound zeal for reform. It has raised serious questions about the sustainability of global capitalism, at least in the form that we have experienced in the last quarter century.

What might have prevented the financial crisis? Did the problem lie with unscrupulous mortgage lenders? Spendthrift borrowers? Faulty practices by credit rating agencies? Too much leverage on the part of financial institutions? The global savings glut? Too loose monetary policy by the Federal Reserve? Government guarantees for Fannie Mae and Freddie Mac? The U.S. Treasury's rescue of Bear Stearns and AIG? The U.S. Treasury's refusal to bail out Lehman Brothers? Greed? Moral hazard? Too little regulation? Too much regulation? The debate on these questions remains fierce and will no doubt continue for a long time.

In the bigger scheme of things, these questions interrogate mere details. More fundamentally, our basic narrative has lost its credibility and appeal. It will be quite some time before any policy maker can be persuaded that financial innovation is an overwhelming force for good, that financial markets are best policed through self-regulation, or that governments can expect to let large financial institutions pay for their own mistakes. We need a new narrative to shape the next stage of globalization. The more thoughtful that new narrative, the healthier our economies will be.

Global finance is not the only area that has run out of convincing story lines. In July 2008, as the subprime mortgage crisis was brewing, global negotiations aimed at reducing barriers to international trade collapsed amid much acrimony and finger-pointing. These talks, organized under the auspices of the World Trade Organization (WTO) and dubbed the "Doha Round," had been ongoing since 2001. For many anti-globalization groups, they had come to symbolize exploitation by multinational corporations of labor, poor farmers, and the environment. A frequent target of attack, in the end the talks were brought down for more mundane reasons. Developing countries led by India and China concluded that there was not enough on offer from the United States and

the European Union for them to dismantle their own industrial and agricultural tariffs. Even though efforts to revive the talks continue, the WTO seems to have run out of ideas to boost its legitimacy and make itself relevant once again.

The world's trade regime differs from its financial counterpart in one important respect. Corrosion in the system of trade relations does not produce a blowup from one day to the next. When nations find the rules too constraining and no longer appropriate to their needs, they find ways of flouting them. The effects tend to be more subtle and show up over time in a gradual retreat from the cornerstone principles of multilateralism and non-discrimination.

Developing nations have always complained that the system is biased against their interests since it is the big boys that make the rules. A motley collection of anarchists, environmentalists, union interests, and progressives have also occasionally made common cause in their opposition to globalization for obvious reasons. But the real big news in recent years is that the rich countries are no longer too happy with the rules either. The rather dramatic decline in support for economic globalization in major countries like the United States reflects this new trend. The proportion of respondents in an NBC/*Wall Street Journal* poll saying globalization has been good for the U.S. economy has fallen precipitously, from 42 percent in June 2007 to 25 percent in March 2008. And surprisingly, the dismay has also begun to show up in an expanding list of mainstream economists who now question globalization's supposedly unmitigated virtues.

So we have the late Paul Samuelson, the author of the postwar era's landmark economics textbook, reminding his fellow economists that China's gains in globalization may well come at the expense of the United States; Paul Krugman, the 2008 Nobelist in Economics, arguing that trade with low-income countries is no longer too small to have an effect on inequality in rich nations; Alan Blinder, a former U.S. Federal Reserve vice chairman, worrying that international outsourcing will cause unprecedented dislocations for the U.S. labor force; Martin Wolf, the *Financial Times* columnist and one of the most articulate advocates of globalization, expressing his disappointment with the way financial globalization has turned out; and Larry Summers, the Clinton administration's "Mr. Globalization" and economic adviser to President Barack Obama, musing about the dangers of a race to the bottom in national regulations and the need for international labor standards.

While these worries hardly amount to the full frontal attack mounted by the likes of Joseph Stiglitz, the Nobel Prize–winning economist, they still constitute a remarkable shift in the intellectual climate. Moreover, even those who have not lost heart often disagree vehemently about where they would like to see globalization go. For example, Jagdish Bhagwati, the distinguished free trader, and Fred Bergsten, the director of the pro-globalization Peterson Institute for International Economics, have both been on the front lines arguing that critics vastly exaggerate globalization's ills and underappreciate its benefits. But their debates on the merits of regional trade agreements—Bergsten for, Bhagwati against—are as heated as each one's disagreements with the authors mentioned above.

None of these economists is against globalization, of course. They do not want to reverse globalization, but to create new institutions and compensation mechanisms—at home or internationally—that will render globalization more effective, more fair, and more sustainable. Their policy proposals are often vague (when specified at all), and command little consensus. But confrontation over globalization has clearly moved well beyond the streets to the columns of the financial press and the rostrums of mainstream think tanks.

The intellectual consensus that sustains our current model of globalization had already begun to evaporate before the world economy became engulfed in the great financial crash of 2008.

Today, the self-assured attitude of globalization's cheerleaders has all but disappeared, replaced by doubts, questions, and skepticism.

An Alternative Narrative

The world has seen globalization collapse once already. The gold standard era—with its free trade and free capital mobility—came to an abrupt end in 1914 and could not be resuscitated after World War I. Could we witness a similar global economic breakdown in the years to come?

The question is not fanciful. Although economic globalization has enabled unprecedented levels of prosperity in advanced countries and has been a boon to hundreds of millions of poor workers in China and elsewhere in Asia, it rests on shaky pillars. Unlike national markets, which tend to be supported by domestic regulatory and political institutions, global markets are only "weakly embedded." There is no global antitrust authority, no global lender of last resort, no global regulator, no global safety net, and, of course, no global democracy. In other words, global markets suffer from weak governance, and are therefore prone to instability, inefficiency, and weak popular legitimacy.

This imbalance between the national scope of governments and the global nature of markets forms the soft underbelly of globalization. A healthy global economic system necessitates a delicate compromise between these two. Give too much power to governments, and you have protectionism and autarky. Give markets too much freedom, and you have an unstable world economy with little social and political support from those it is supposed to help.

The first three decades after 1945 were governed by the Bretton Woods compromise, named after the eponymous New Hampshire resort where American, British, and other policy makers from Allied nations gathered in 1944 to design the post–World

War II economic system. The Bretton Woods regime was a shallow multilateralism that permitted policy makers to focus on domestic social and employment needs while enabling global trade to recover and flourish. The genius of the system was that it achieved a balance that served multiple objectives admirably well. Some of the most egregious restrictions on trade flows were removed, while leaving governments free to run their own independent economic policies and to erect their preferred versions of the welfare state. Developing countries, for their part, were allowed to pursue their particular growth strategies with limited external restraint. International capital flows remained tightly circumscribed. The Bretton Woods compromise was a roaring success: the industrial countries recovered and became prosperous while most developing nations experienced unprecedented levels of economic growth. The world economy flourished as never before.

The Bretton Woods monetary regime eventually proved unsustainable as capital became internationally more mobile and as the oil shocks of the 1970s hit the advanced economies hard. This regime was superseded in the 1980s and 1990s by a more ambitious agenda of economic liberalization and deep integration—an effort to establish what we may call hyperglobalization. Trade agreements now extended beyond their traditional focus on import restrictions and impinged on domestic policies; controls on international capital markets were removed; and developing nations came under severe pressure to open their markets to foreign trade and investment. In effect, economic globalization became an end in itself.

In pushing the postwar globalization model beyond its limits, economists and policy makers overlooked what had been the secret of its original success. The result was a series of disappointments. Financial globalization ended up promulgating instability rather than higher investment and more rapid growth. Within countries, globalization generated inequality and insecurity instead of lifting all boats. There were stupendous successes in this period—China

and India in particular. But as we shall see, these were countries that chose to play the globalization game not by the new rules, but by Bretton Woods rules. Instead of opening themselves unconditionally to international trade and finance, they pursued mixed strategies with a heavy dose of state intervention to diversify their economies. Meanwhile countries that followed the more standard recipes—such as those in Latin America—languished. And thus globalization became a victim of its own earlier success.

Replacing our economic world on a safer footing requires a better understanding of the fragile balance between markets and governance. I will offer an alternative narrative in this book based on two simple ideas. First, markets and governments are complements, not substitutes. If you want more and better markets, you have to have more (and better) governance. Markets work best not where states are weakest, but where they are strong. Second, capitalism does not come with a unique model. Economic prosperity and stability can be achieved through different combinations of institutional arrangements in labor markets, finance, corporate governance, social welfare, and other areas. Nations are likely to—and indeed are entitled to—make varying choices among these arrangements depending on their needs and values.

Trite as they may sound as stated, these ideas have enormous implications for globalization and for democracy, and for how far we can take each in the presence of the other. Once you understand that markets require public institutions of governance and regulation in order to function well, and further, you accept that nations may have different preferences over the shape that those institutions and regulations should take, you have started to tell a story that leads you to radically different endings.

In particular, you begin to understand what I will call the fundamental political trilemma of the world economy: we cannot simultaneously pursue democracy, national determination, and economic globalization. If we want to push globalization further, we have to give up either the nation state or democratic politics.

If we want to maintain and deepen democracy, we have to choose between the nation state and international economic integration. And if we want to keep the nation state and self-determination, we have to choose between deepening democracy and deepening globalization. Our troubles have their roots in our reluctance to face up to these ineluctable choices.

Even though it is possible to advance both democracy and globalization, the trilemma suggests this requires the creation of a global political community that is vastly more ambitious than anything we have seen to date or are likely to experience soon. It would call for global rulemaking by democracy, supported by accountability mechanisms that go far beyond what we have at present. Democratic global governance of this sort is a chimera. There are too many differences among nation states, I shall argue, for their needs and preferences to be accommodated within common rules and institutions. Whatever global governance we can muster will support only a limited version of economic globalization. The great diversity that marks our current world renders hyperglobalization incompatible with democracy.

So we have to make some choices. Let me be clear about mine: democracy and national determination should trump hyperglobalization. *Democracies have the right to protect their social arrangements, and when this right clashes with the requirements of the global economy, it is the latter that should give way.*

You might think that this principle would be the end of globalization. Not so. I hope to convince you by the end of this book that reempowering national democracies will in fact place the world economy on a safer, healthier footing. And therein lies the ultimate paradox of globalization. A thin layer of international rules that leaves substantial room for maneuver by national governments is a *better* globalization. It can address globalization's ills while preserving its substantial economic benefits. We need smart globalization, not maximum globalization.

Economists Are Human, Too

Economists and policy advisers have exhibited myopia far too long toward the tensions and frailties that economic globalization generates. They have attributed every roadblock along the way to ignorance or, worse still, self-interested lobbying by protectionists of all kinds. They have paid insufficient attention to the legitimate clash among competing values and ideals that the single-minded pursuit of globalization accentuates. They have overlooked the link between well-functioning markets and purposeful state action. Their prescriptions have correspondingly done more harm than good at times. And they have missed countless opportunities to deploy the tools of their trade to better effect.

By necessity, then, this is also a book about economists and their ideas—about the tales they tell themselves and others. It explains how these tales have shaped our world, how they almost brought that world to an end, and how many of these economic ideas can now be used to erect a better global economic system. It is perhaps natural for an economist like me to think that ideas—and economists' ideas in particular—matter a whole lot. But I think it is hard to overstate the influence that these ideas have had in molding our understanding of the world around us, shaping the conversation among politicians and other decision makers, and constraining as well as expanding our choices. Political scientists, sociologists, historians, and others would no doubt claim equal credit for their professions. Policy choices are surely constrained by special interests and their political organization, by deeper societal trends, and by historical conditions. But by virtue of its technical wizardry and appearance of certitude, economic science has had the upper hand since at least the end of World War II. It has provided the language with which we discuss public policy and shaped the topology of our collective mental map. Keynes once famously said that "even the most practical man of affairs is usually in the thrall of the ideas of some long dead economist." I think he didn't put it nearly strongly enough. The ideas that have produced the policies of the last fifty years have emanated from economists who are (for the most part) very much alive.

Economists often get an unfair rap. They are perceived as market fundamentalists who care little about communities, social values, or public goals other than efficiency and economic growth. They promote material consumption, greed, and selfishness, it is said, over other ethical norms and socially cooperative behavior. The image of an economist most people carry in their head is that of Milton Friedman, preaching endlessly about the virtues of free markets and the perils of government intervention—in housing, education, health, employment, trade, and other areas. This is not an accurate picture at all. Economists use a variety of frameworks to analyze the world, some of which favor free markets and some of which don't. Much of economic research is in fact devoted to understanding the types of government intervention that can improve economic performance. Non-economic motives and socially cooperative behavior are increasingly part of what economists study.

The problem is not that economists are high priests of free market fundamentalism, but that they suffer from the same heuristic biases as regular people. They tend to exhibit groupthink and overconfidence, relying excessively on those pieces of evidence that support their preferred narrative of the moment, while dismissing others that don't fit as neatly. They follow fads and fashion, promoting different sets of ideas at different times. They place too much weight on recent experience and too little weight on more distant history. They tend to overfocus on remedies that will address the last crisis, while paying insufficient attention to tensions that may result in the next. They tend to attribute dissenting views to ignorance or self-interest rather than genuine differences in evaluating the underlying circumstances. They are clannish, drawing a big distinction between who's in and who's out (i.e.,

card-carrying members of the profession versus the rest). As with all possessors of specialized knowledge, they tend to get arrogant when outsiders encroach upon their field. In other words, economists are human. They behave as humans do—not as the fictional hyperrational, social welfare–maximizing planners that their own models sometimes rely on.

But economists are not just any other group. They are the architects of the intellectual environment within which domestic and international policy making takes place. They command respect and are listened to—ironically the more so the worse the economic situation. When economists get things wrong, as they occasionally do, they can do real damage.

When they get things right, however, their contribution to human welfare is huge. Behind some of the greatest economic successes of our time—the reconstruction of global trade in the postwar period or the rise of China and India—lie simple but powerful ideas relentlessly driven home by economists: trade is better than self-sufficiency, incentives matter, markets are an engine of growth. As I will show, there is much in economics that can and should be celebrated.

So this is not a simple morality play about good guys and bad guys. I have as little patience for briefs that hold economists responsible for the world's various ills as I do for self-congratulatory accounts by market fundamentalists. I will neither denigrate economists' ideas, nor be a cheerleader for them. I will instead show how they have been used and misused at different times, and how we can build on them to construct a better form of globalization—one that is more consistent with the values and aspirations of different nations as well as more resilient. To date, economics has been two parts wonder drug and one part snake oil. I hope this book will help the reader tell the difference.

The Globalization Paradox

1

Of Markets and States

Globalization in History's Mirror

On November 17, 1671, the regulars at Garraway's coffeehouse, a popular hangout for London's shipowners, stockbrokers, and merchants, were greeted with an unusual announcement:

> On the fifth of December, ensuing, There Will Be Sold, in the Greate Hall of this Place, 3000 weight of Beaver Skins, comprised in thirty lotts, belonging to the Honourable, the Governour and Company of Merchants-Adventurers Trading into Hudson's Bay.

This sale of beaver fur was of more than passing interest to the clientele at Garraway's. Considered a source of the highest quality fur, beaver pelts were in great demand during the seventeenth century. Beaver was held in such high regard that in 1638 King Charles I had prohibited the use of any material other than beaver fur in hat making.

To the great consternation of the city's merchants, financiers, and nobility, London was a backwater where the fur trade was concerned. Most beaver fur originated from Russia and was sold through the Baltic and Black Sea ports to traders in major Conti-

nental cities such as Paris, Vienna, and Amsterdam. In addition, overhunting had resulted in a severe depletion of beaver stock and in high prices. London's wealthy had to content themselves with lower-quality fur that trickled in from the Continent or obtain their supplies directly from these cities at great expense. The public auction at Garraway's heralded a new era of plentiful, high-quality fur.[1]

How had the beaver furs found their way to Garraway's? Who or what was "the Governour and Company of Merchants-Adventurers Trading into Hudson's Bay"? There lies an interesting tale of globalization from another era.[2] This was a very different kind of globalization, to be sure. Yet look at it closely, and you learn quite a deal about what makes globalization possible—and what limits it.

The Age of Chartered Trading Companies

The series of events that landed the beaver furs at Garraway's had three unlikely protagonists. Two were brothers-in-law of French extraction with the colorful names of Pierre-Esprit Radisson and Médard Chouart, sieur des Groseilliers. Radisson and des Groseilliers were *coureurs des bois*, unauthorized adventurers and traders of furs in the northern reaches of Quebec in today's Canada. The French colonial regime in what was then called "New France" had established a profitable business buying beaver pelts from Native Americans. The natives would bring their supplies to trading posts established by the colonists and sell the beaver in exchange for firearms and brandy. In keeping with the economic philosophy of the day—mercantilism—this was all arranged as a monopoly, to generate the maximum profit for the French crown and its representatives.

Radisson and des Groseilliers's forays in the northern forests of the region, closer to the shores of Hudson's Bay, had led them to think they could greatly expand the existing supply of beaver furs by going deeper into the largely unexplored Native American territories. But the French colonial administration, too set in its established ways, would have none of it. The two adventurers were fined for trading without license and des Groseilliers landed in jail for a brief time.

Thwarted by their countrymen, the two brothers-in-law decided to change masters. In search of alternative sponsors, they traveled to London, where they were presented to King Charles II. Most important, they managed to attract the attention of Prince Rupert, the third protagonist of our story. Prince Rupert, born in Bohemia, was the nephew of Charles II and an adventurer of a different kind. He had fought in England, on the Continent, and in the Caribbean, and was also an amateur inventor and artist. Radisson and des Groseilliers's plan was to establish a sea route from England by traveling across the northern Atlantic into Hudson's Bay through the Hudson's Strait. This way they could bypass the French authorities and reach the Indian tribes directly from the north, an area as yet unclaimed by European governments. It was a risky and costly plan, for which they needed both royal protection and financial support. Prince Rupert was in a position to provide both.

On the morning of June 3, 1668, des Groseilliers set sail from London on the *Nonsuch*, a small vessel especially selected for its ability to travel inland, in a voyage financed by Prince Rupert and his entourage. He landed on the shores of Hudson's Bay four months later. (A second ship with Radisson on board had to return to England after encountering severe storms along the way.) Des Groseilliers and the crew wintered there, established contact with the Cree Indians, and returned to England in October 1669 on the *Nonsuch* with a good supply of beaver.[3]

Having demonstrated that their business plan worked, our three protagonists then did what anyone with a good head for business engaged in long-distance trade would have done at the time: lobby the king for monopoly rights. It didn't hurt of course that

Prince Rupert was family to Charles II. On May 2, 1670, the crown granted Prince Rupert and his partners a charter which established "the Governour and Company of Merchants-Adventurers Trading into Hudson's Bay." The company thereby created eventually came to be known as Hudson's Bay Company. It survives to this day as HBC, Canada's largest general retailer, which makes it also the world's oldest joint stock company.

The charter Charles II granted to Hudson's Bay Company is an extraordinary document that confers enormous powers on the company. The king begins by commending his "beloved cousin" Prince Rupert and his associates for having led the expedition to Hudson's Bay "at their own great cost" and for having discovered "considerable commodities," which will produce "great advantage to us and our Kingdom." He then grants sole trade and commerce of all those "seas, straits, bays, rivers, lakes, creeks, and sounds in whatsoever latitude they shall be" that lie within the entrance of Hudson's Strait, along with all the adjoining territory that does not already belong to another "Christian prince or state." But the charter does not stop there. Charles II then makes the company "the true and absolute lords and proprietors" of all the territories just described.[4]

In appreciation of the troubles that Prince Rupert and his associates (the "merchant-adventurers" who had risked their capital in the venture) had gone through, and in expectation of great benefits to the kingdom in the future, the company received not just monopoly trading privileges but also full property rights over the Hudson's Bay area. "Rupert's Land," an area covering all the rivers that drain into the Bay, came under the ownership of the company. The full dimensions of this territory weren't even known at the time since it hadn't been completely explored. It turned out that Charles II had just signed off a good chunk of today's Canada—an area that eventually would amount to roughly 40 percent of the country, or more than six times the size of France[5]—to a private company!

The king's charter made Hudson's Bay Company a government in all but name, administering a vast territory and ruling over the local Indians who had no choice in the matter. The company could fight wars, pass laws, and dispense justice. Needless to say, it was the sole arbiter of the fur trade in Rupert's Land, setting the conditions and prices of the exchange with the natives. In the nineteenth century, it even issued its own paper currency, which became legal tender in areas it controlled. The territorial control of the company did not end for some two hundred years, until 1870, at which point the company turned possession of Rupert's Land over to the Dominion of Canada in exchange for £300,000 ($34 million in today's money).[6]

The Canadian fur trade was comparatively small and the Hudson's Bay Company no more than a footnote in the extensive mercantile system of long-distance trade of the seventeenth and eighteenth centuries. The major trade routes lay elsewhere. There was of course the infamous Atlantic triangular trade, which carried slaves to the Americas in exchange for sugar, cotton, and tobacco (with the Europe-Africa leg providing an important connecting link). There was also the ever important trade with India and Southeast Asia, which could now bypass Venetian and Muslim intermediaries thanks to Vasco da Gama's passage of the Cape of Good Hope in 1497–98. In the three centuries following Columbus's and da Gama's discoveries, the world experienced a veritable boom in long-distance trade. According to one estimate, international trade rose at more than double the rate of world incomes in this period.[7]

The companies that made this trade possible were mostly chartered trading monopolies organized along lines similar to Hudson's Bay Company. Many have well-recognized names, such as the English East India Company and the Dutch East India Company, and many have left significant marks on history.

The most famous among them, the English East India Company, or the "Governor and Company of Merchants of London Trading

into the East Indies," as it was originally called, was chartered in 1600 as a joint stock company. Its monopoly covered trade with the Indian subcontinent and China (including opium trade). As with the Hudson's Bay Company, its powers extended considerably beyond trade. It had a standing army, could make war, enter into treaties, mint its currency, and administer justice. It expanded its control over India through a series of armed confrontations with the Mughal Empire and alliances with local rulers. The East India Company performed a vast range of public functions, including investments in transport, irrigation, and public education. It eventually became a tax collector as well, administering a land tax on the local population to supplement its trading profits. Even though the company lost its trading monopoly in India in 1813, it continued to rule for several decades. Finally, it was abolished as a result of the Indian Mutiny of 1858, at which time control of India passed directly to the British crown.

These companies had their own flags, armies, magistrates, and currencies. Meanwhile they paid dividends to their shareholders back home. That trade and rule were so closely entwined may seem like an anachronism to modern observers—the peculiar feature of an era whose misconceptions about economics have long been set straight. The dominant economic philosophy of the seventeenth century was mercantilism, which advocated a close alliance between the sovereign and commercial interests. In hindsight, mercantilists had some truly cranky ideas, such as the view that economic well-being sprang from accumulating silver and other precious metals. They thought free trade should be confined to raw materials and industry reserved for domestic producers through high import tariffs. But they also believed in capitalism (as we would call it today) and in exports, which set them light-years ahead of many of their contemporaries. While the Dutch and the English were scouring the ends of the world for raw materials and markets, the Ottomans and the Chinese—by far the more powerful entities—had both withdrawn into a doomed quest for self-sufficiency.[8] The mercantilists' narrative of

capitalism was based on the view that the state and commercial enterprise ought to serve the needs of each other. Economics was a tool of politics, and vice versa. International trade, in particular, had to be monopolized to exclude foreign powers and to reserve the benefits for the home country.

Today, we are likely to take our cue more from Adam Smith, whose *Wealth of Nations* (published in 1776) was a frontal attack on mercantilist thought and practice. Economic liberals, with Smith as their founding father, have a different narrative. They believe that economies flourish when markets are left free of state control. Competition, rather than monopoly, maximizes economic advantage. Protective barriers on trade—import tariffs and prohibitions—reduce competition and thus are a way of shooting oneself in the foot. State-business collaboration is just another name for corruption. Adam Smith did not deny that there was a role for government, but his vision was of a state restricted to national defense, protection of property rights, and administration of justice. In his view, mercantilism and the chartered monopolies were a drag on the development of national economies and of global commerce. According to this narrative, rapid economic growth and true globalization had to wait until the nineteenth century, when Adam Smith's ideas finally won the day.

This dichotomy between markets and states—between trade and rule—is false and hides more than it reveals. Market exchange, and especially long-distance trade, cannot exist without rules imposed from somewhere. The story of the Hudson's Bay Company reveals the close link between power and economic exchange in its naked simplicity. I want to trade with you, so you better play by my rules! We may think of later eras of globalization as more detached from state rules and power—and hence as more "pure." But that would be quite wrong. Power was exercised; just differently—and less obviously. Where there is globalization, there are rules. What they are, who imposes them, and how—those are the only real questions.

It is not that there are always malevolent powers lurking behind

markets and globalization. We can have better or worse rules. But we need to discard the idea that markets work best when they are left to their own devices. Markets necessarily require non-market institutions in order to function. Using the Nobel Prizewinner Doug North's pithy definition, these institutions supply the "rules of the game" for markets. Their presence in turn begs the questions of how they are designed and whose interests they serve. When we confront these questions head-on, instead of assuming them away, we get a better handle on how to design market-supporting institutions. We are also led to some uncomfortable thoughts on the limits of economic globalization.

But let's first return to our chartered companies to understand the role that statelike powers played in fostering long-distance trade.

What It Takes to Reap the Benefits of Trade

It is a simple principle that every child knows, and then relearns in college economics courses: there are gains from trade whenever you have something that I value more than you do. Recast as trade between different parts of the world, this quickly becomes a tale of comparative advantage. Whatever a country has plenty of can be exchanged for things that it lacks. Cree Indians along Hudson's Bay certainly had plenty of beaver. But they were short of blankets, kettles, and of course the rifles and brandy that they didn't even know they needed before they encountered white men. Given the high demand for beaver fur in Europe, the potential gains from intercontinental trade were huge.

In textbook renditions of trade, this would be just about the end of the story. In the real world, things are not that simple. Look at the obstacles that our triumvirate of heroes and their associates had to overcome. They had to engage in a dangerous venture—with risks to both purse and life—to reach the Indians through

a new, maritime route. They had to build and man trading posts along Hudson's Bay under severe weather conditions. They had to explore the areas inland and make connections with the Indians. They had to open and maintain channels of communication, build trust, and convince the Indians of their peaceful intentions. They had to do the "market research" to figure out what the Indians would buy in return for fur. Above all else, they had to provide a safe and secure environment within which trade could be carried out. That in turn required laws and regulations, backed up by force (if needed).

In other words, they had to invest in the infrastructure of trade—transport, logistics, communications, trust, law and order, contract enforcement—before trade could actually take place. Our "merchant-adventurers" *had* to carry out statelike functions, because trade would have been impossible in their absence.

The bargain that a sovereign struck with private companies under mercantilism was essentially this: You, the company, pay for the institutional infrastructure, and in return I will allow you to make monopoly profits from the resulting trade. This quid pro quo was well understood, and sometimes quite explicit. As early as 1468, the Portuguese granted Fernão Gomes a monopoly of trade with Africa for five years on the condition that "he extend the exploration of the coast southwards by one hundred leagues (a little over three hundred miles) each year."[9] In 1680, when the monopoly of the Royal African Company in Britain's slave trade was challenged, the advocates for the company defended it in terms that were quite explicit about the "public" functions performed by the enterprise: the slave trade required the construction of forts along the West African coast at an expense that was too great for private traders; the trade had to be defended from attacks by other nations; maintenance of forts and warships required exclusive control; private traders upset local rulers by attempting to enslave "all and sundry, even Negroes of high rank"; and so on.[10] Unfortunately for the company, these arguments did

not prevent the monopoly from being repealed in 1698. The slave trade was far too profitable for it to remain the exclusive preserve of a single company.

When the Hudson's Bay Company was charged by its opponents with underpaying American Indians for beaver pelts, it argued that those low prices were only fair given the difficulties of commerce in the North American wilds. It is true, the company said, that Indians were asked to pay high prices for English goods while being paid little for the furs. But this was common practice for "civilized traders all the world over, [when] dealing with ignorant and dependent tribes." After all, "the risks of life and limb and goods in remote regions are great, and great profits must be made to meet them."[11]

Ultimately, someone has to shoulder the responsibility for peace, security, and the framework of laws and regulations that makes trade possible. What distinguishes mercantilism from later versions of capitalism is that the job fell by and large on private entities. When private companies could no longer perform those tasks—either because they became too weak or competition from other nations undercut their rents—the crown had to intervene. Asked by a House of Commons committee in 1857 about the likely consequences of abolishing the special privileges of Hudson's Bay Company, a leading politician and former director of the company put it plainly: this would be of no consequence as long as "Canada shall bear the expense of governing [the territory ceded by the company] and maintaining a good police and preventing the introduction, so far as they can, of competition within the fur trade."[12] The company may not have been happy to see its monopoly go, but it could live with it as long as the prerequisites for doing business were henceforth to be supplied (and paid for) by the Canadian state.

The abolition of the East India Company following the Indian Mutiny of 1858, and its replacement by direct colonial rule from London, provides another perfect example of the transition. When the private firm and its armies were no longer up to the task, the sovereign had to step in with his own, more effective powers of persuasion.

Overcoming Transaction Costs

A contemporary economist would summarize the argument thus far by saying that the role played by the Hudson's Bay Company, the East India Company, and other chartered trading companies was to reduce the "transaction costs" in international trade to enable some degree of economic globalization. It is worth spending some time on this concept, as it holds the key to understanding globalization—what restricts or deepens it—and will recur throughout our discussion.

Economists like to think that the propensity to "truck, barter, and trade," in Adam Smith's evocative (but careful)[13] phrasing, is such an ingrained element of human nature that it makes "free trade" the natural order of things. They even have coined a general term for different types of friction that prevent mutually beneficial trade or render it more difficult: "transaction costs." Transaction costs are in fact rampant in the real world, and if we fail to see them all around us it is only because modern economies have developed so many effective institutional responses to overcome them.

Think of all the things that we take for granted that are absolutely essential for trade to take place. There must be some way—a marketplace, bazaar, trade fair, an electronic exchange—to bring the two parties to a transaction together. There must be a modicum of peace and security for them to engage in trade without risk to life and liberty or concern for theft. There must be a common language for the parties to understand each other. In any form of exchange other than barter, there must be a trusted medium of exchange (a currency). All the relevant attributes of the good or

service being exchanged (for example, its durability and quality) must be fully observable. There must be sufficient trust between the two parties. The seller must have (and be able to demonstrate) clear property rights over the goods being sold and must have the ability to transfer these rights to the seller. Any contract that the two sides enter into must be enforceable in a court of law or through other arrangements. The parties must be able to take on future commitments ("I will pay you so much upon the delivery of . . . ") and do so credibly. There must be protection against third parties trying to block the exchange or impede it. I could keep going, but the point is probably clear.

Sometimes these requirements do not raise major hurdles for trade. If you have two cookies and I have two glasses of lemonade, we could easily carry out a trade that would leave both of us better off. At other times, the trade relies on an extensive network of institutional prerequisites. Apple and its subcontractors in China must necessarily operate in a contract-rich environment involving a long list of specific bilateral commitments. When Citigroup makes a loan to a firm in a developing nation, it relies on a combination of the borrower's reputation, the strength of laws in the host country, and the likelihood of international sanctions as a precondition for agreeing to the deal. When something goes wrong in these relationships—a Chinese subcontractor passes on the iPhone's proprietary designs to a competitor or Citigroup's borrower refuses to service his debt obligations—there may be precious little that the aggrieved parties can do. The fear that such things can and will go wrong acts as a considerable deterrent to the transactions in the first place. In economists' language, these are trades with potentially quite significant transaction costs.

Institutions—at least those that support markets—are social arrangements designed to reduce such transaction costs. These institutions come in three forms: long-term relationships based on reciprocity and trust; belief systems; and third-party enforcement.

The first of these generate cooperation through repeated interaction over time. For example, a supplier is deterred from cheating his customer because he worries that he would lose future business. The customer in turn chooses not to shortchange the supplier because it would be costly to switch suppliers and build a long-term relationship with a new firm. As the relationship builds, trust increases, and it becomes possible to contemplate larger ventures. These self-supporting processes do not rely on any formal legal structures or organizational backstops. They predominate in developing nations where such structures are weak.

Second, trade can be supported through belief systems or ideologies. The fruit seller doesn't sell a traveler rotten fruit because "that would simply be wrong." A country may choose not to raise tariffs or restrict capital flows because "that is not the way things are done." Perhaps these actors truly internalize the reasons for their actions. Perhaps they fear being ostracized by their communities—tribe, caste, religious group, ethnic group, or "community of nations," as the case may be—if they are seen to defy prevailing norms of good behavior. Wherever they may come from, widely held views on the appropriateness of different courses of actions may discipline parties to an exchange and support a level of honesty and cooperation that might be difficult to achieve otherwise.

Repeated interaction and community norms work best when markets are mostly local and small scale, when people do not move around much, and when the goods and services traded are simple, standardized, and don't have to travel over long distances. But as economies grow and geographical mobility increases, the need for clear and extensive rules and more reliable enforcement becomes paramount. The only countries that have managed to become rich under capitalism are those that have erected an extensive set of *formal* institutions that govern markets: tax systems that pay for public goods such as national defense and infrastructure, legal regimes that establish and protect property rights, courts that

enforce contracts, police forces to sanction violators, bureaucrats who design and administer economic regulations, central banks that ensure monetary and financial stability, and so on. In the language of the economist, these are institutions of "third-party enforcement." The rules of the game are enforced by a formal, typically governmental apparatus. You pay your taxes in part because you want better roads and schools, but I suspect you would pay a lot less if it weren't for the tax collector.

When we look at the size of the government across different societies, we uncover a rather amazing fact. With very few exceptions, the more developed an economy, the greater the share of its resources that is consumed by the public sector. Governments are bigger and stronger not in the world's poorest economies but in its most advanced economies. The correlation between government size and per capita income is remarkably tight. Rich countries have better functioning markets *and* larger governments when compared to poor ones. All this may be surprising at first sight, but the preceding discussion helps us understand what is going on. Markets are most developed and most effective in generating wealth when they are backed by solid governmental institutions. *Markets and states are complements*, not substitutes, as simplistic economic accounts would often have it.

Trade and Governments

This point was brought home to me in quite an unexpected way some years back. The government plays such a pervasive role in modern society that many social scientists, myself among them, find it impossible not to be obsessed by it. One day I was sitting in my office wondering why shrinking the public sector had proved so difficult despite the clamor for "small government" from conservative politicians when an article by the Yale political scientist David Cameron crossed my desk.[14]

Cameron was interested in the following question: Why had the public sector expanded so rapidly in the major advanced economies in the decades following World War II? Even though Cameron focused only on the post-1945 experience, this was in fact a trend that went further back in history. Around 1870, the share of government expenditures in the economies of today's advanced economies averaged around 11 percent. By 1920, this share had almost doubled, to 20 percent. It increased further, to 28 percent, in 1960. By the time of Cameron's study it stood at more than 40 percent, and has continued to rise since then.[15] The increase has not been uniform across different countries. Governments are considerably smaller today in the United States, Japan, and Australia (with expenditure shares below 35 percent) than they are in Sweden or The Netherlands (55–60 percent), with most of the other European countries in between. Cameron wanted to understand the sources of this difference.

His conclusion, based on a study of eighteen advanced nations, was that openness to international trade had been a major contributor. Governments had grown the largest in those economies that were the most exposed to international markets. Some countries are naturally more sheltered from the forces of international competition, either because they are large or because they are distant from their major trading partners. This is exactly the case of the small government economies on our list (the United States, Japan, and Australia). Small economies close to their trading partners, by contrast, engage in much more trade and have larger public sectors (such as in Sweden and The Netherlands).

This is a highly counterintuitive argument if you are used to thinking that markets can prosper only where the state does not intrude. I knew of course that more advanced economies have larger public sectors, but the Cameron claim was something else: he argued that the variation in the size of the public sector among equally rich economies could be explained by the importance of trade to their economies.

I must confess that I was suspicious about Cameron's result; economists tend to be a skeptical bunch, especially when faced with statistical work by other social scientists. My first reaction to the article was: this cannot be true. The sample is too small (only eighteen countries). The effect is driven by country size rather than exposure to international trade per se. There are many other confounding effects that the analysis has not taken into account. And so on.

I decided to check for myself. I downloaded some data and began to look at how government size lines up against economic openness. I first scrutinized the advanced countries that Cameron had focused on. I used different data sources and varying time periods, but to my surprise the Cameron result held up. Then I expanded the analysis to developing nations, looking at more than a hundred countries for which data were available. Again, the picture was the same. Finally, I tried to make the result disappear by controlling for everything that I could think of—country size, geography, demography, income level, urbanization, and many other factors besides. Whichever way I cut the data, I found a strong positive correlation between a nation's exposure to international trade and the size of its government.

Where was this correlation coming from? I considered many possible explanations, but none survived my battery of tests. In the end the evidence seemed to point strongly toward the social insurance motive. People demand compensation against risk when their economies are more exposed to international economic forces; and governments respond by erecting broader safety nets, either through social programs or through public employment (more typical in poor nations). This was essentially the same argument that Cameron had made, and it clearly went beyond the small set of rich countries he had considered. I had stumbled on one of the fundamental truths of economics that no one in graduate school had ever told me about: If you want markets to expand, you need governments to do the same.[16]

This need for expansion isn't just because governments are necessary to establish peace and security, protect property rights, enforce contracts, and manage the macroeconomy. It is also because they are needed to preserve the legitimacy of markets by protecting people from the risks and insecurities markets bring with them.

The recent subprime mortgage crisis and deep recession provide a good example. Why didn't the world economy fall off the same protectionist cliff that it did in the Great Depression of the 1930s? In the decades since, modern industrial societies have erected a wide array of social protections—unemployment compensation, adjustment assistance and other labor market interventions, health insurance, family support—that mitigate demand for cruder forms of protection such as sheltering the economy behind high tariff walls. The welfare state is the flip side of the open economy. Markets and states are complements in more ways than one.

Globalization's Love-and-Hate Relationship with the State

Now we can begin to appreciate how greatly international commerce differs from domestic economic transactions. If you and I are citizens of the same country, we operate under an identical set of legal rules and benefit from the public goods that our government provides. If we are citizens of different countries, none of this is necessarily true. There is no international entity that guarantees peace and safety, passes laws and enforces them, pays for public goods, or ensures economic stability and security. In view of the differences in culture and distances that separate nations, informal institutions such as reciprocity and norms typically do not induce much cooperation either. The market-supporting institutions that do exist are local and vary across nations. As a result, *international trade and finance entail inherently higher transaction costs than domestic exchanges.*

But there is more. The higher transaction costs are not just due to the absence of the requisite international institutions. Domestic arrangements geared to the needs of national markets also impede global commerce frequently. National rules inhibit globalization. The most obvious examples include government-imposed tariffs on trade or regulations that restrict international lending or borrowing. Whatever domestic purpose such restrictions may serve—social and political stability, encouragement of domestic entrepreneurship, or pure cronyism—they constitute clear transaction costs on international exchanges. The taxes that finance social safety nets and other public investments can also necessitate some restrictions on international exchange in order to prevent footloose professionals or capitalists from evading them.

In addition, many domestic regulations and standards discourage cross-border transactions, even when they are not primarily aimed at raising barriers to trade. Differences in national currencies, legal practices, banking regulations, labor market rules, food safety standards, and many other areas raise the costs of doing business internationally. "For us to remain competitive," Jeffrey Immelt, CEO of General Electric, complained in 2005, "we simply cannot navigate a regulatory maze that forces us to tweak and modulate every product and process to suit individual regulatory regimes at their whim."[17] Governments help reduce transaction costs within national boundaries, but they are a source of friction in trade *between* nations.

International markets operate outside the formal institutional framework of sovereign entities and therefore, absent special arrangements, are deprived of the support of those frameworks. Equally important, international markets operate across the institutional boundaries demarcating states and their jurisdictions. These two facts—the absence of an overall institutional framework for global markets and the tensions such markets generate between local institutions—are fundamental to understanding economic globalization. They help us think our way through the challenges of globalization and appreciate its limits. We return to them throughout the book.

Thus the difficulties the Hudson's Bay Company and its contemporaries faced while carrying out long-distance exchange were not specific to the seventeenth century or to trade in fur, spices, and other favored commodities of the time. International trade *is* different and requires special institutional arrangements. For all its faults, the chartered trading monopoly was a successful institutional innovation—aligned with the politics and economics of the time—that overcame many of the transaction costs specific to intercontinental trade. It spurred private entities to invest in knowledge, security, and contract enforcement, and thus made ongoing trade possible.

Of course, not all participants in the trade benefited equally. The prices received by the Cree Indians, for example, were unconscionably low.[18] The slave trade was an abomination. Over time, companies became more interested in maintaining their monopoly profits than in expanding trade networks. The co-dependence that developed between states and private companies helped neither the quality of governance nor economic performance over the long run. Adam Smith was right to question whether chartered monopolies contributed positively to the national balance sheet in the end. But as Smith's ideas gained ground and Britain and other leading powers dissolved the monopolies, the fundamental problem remained: how to render international trade and finance cheap and safe. The transaction costs inherent in the international economy would continue to haunt traders, financiers, and politicians.

Globalization's Conundrum

Markets have demanding prerequisites—and global markets even more so. Markets for basic foodstuffs, say, and other necessities,

can work pretty well on their own in small communities where people know each other and interact repetitively. A small cabal of businessmen and financiers can enforce trade and exchange when they share a common belief system. Anything bigger, more wide-ranging, and ultimately sustainable requires a large cast of supporting institutions: property rules to establish ownership, courts to enforce contracts, trading regulations to protect buyers and sellers, a police force to punish cheaters, macro-policy frameworks to manage and smooth the business cycle, prudential standards and supervision to maintain financial stability, a lender-of-last-resort to prevent financial panics, health, safety, labor, and environmental standards to ensure compliance with public norms, compensation schemes to placate the losers (when markets leave some in the cold, as they often do), social insurance to provide some insulation against market risks, and taxes to finance all these functions.

In short, markets are not self-creating, self-regulating, self-stabilizing, or self-legitimizing. Every well-functioning market economy blends state and market, laissez-faire and intervention. The precise mix depends on each nation's preferences, its international position, and its historical trajectory. But no country has figured out how to develop without placing substantial responsibilities on its public sector.

If states are indispensable to the operation of national markets, they are also the main obstacle to the establishment of global markets. As we will see, their practices are the very source of the transaction costs that globalization has to surmount. That is the central conundrum of globalization: can't do without states, can't do with them!

Hence global markets are doubly problematic: they lack the institutional underpinnings of national markets and they fall *between* existing institutional boundaries. This dual curse leaves economic globalization fragile and full of transaction costs, even in the absence of direct restrictions on trade and cross-border

finance. It renders the quest for a perfect globalization a fool's errand.

The mercantilists' chartered trading companies offered one solution to these dilemmas. Thanks to their statelike enforcement powers, these companies imposed their own rules over foreign populations in distant lands. However, they became less effective over time as they proved unable to handle restless local populations and the mercantilist narrative lost its appeal. The nineteenth century—the first era of true globalization—would have to rely on different mechanisms.

us a better appreciation of the role that anticipatory, forward-looking behavior by firms, workers, and consumers plays in shaping economic outcomes. The "efficient market hypothesis," built on the joint supposition of rational expectations *and* frictionless markets, taught us about the good that financial markets can do in the absence of transaction costs. These ideas made useful contributions to economics and to economic policy. But they did not upend everything we already knew. They simply gave us additional tools with which we could anticipate the economic consequences of different circumstances.

An honest practitioner of academic economics should respond with a blank stare when asked what the implications of his work are for policy. "That depends on so many other things," would be the appropriate answer. Frustrating perhaps for the student or the journalist, but correct nevertheless. When economists mistake academic fashions for the real thing, they do considerable damage. When the hedgehogs' highly stylized models become the basis for one grand narrative, the world needs to run for cover.

The antidote to these tendencies requires us to maintain a healthy skepticism toward the reigning economic fad of the day, to keep history's lessons alive, and to rely on local and experiential knowledge in addition to economic theory. The world is better served by syncretic economists and policy makers who can hold multiple ideas in their heads than by "one-handed" economists who promote one big idea regardless of context.[28]

Poor Countries in a Rich World

In the first lecture I give them, I confront my economic development students at Harvard with the following teaser: Would you rather be rich in a poor country or poor in a rich country?

The question typically leads at first to a lot of nervous shuffling in the seats and puzzled looks. So I clarify the question. I ask them to consider only their own consumption and not worry about the well-being of others in the society they choose. I then spell out what I mean by "rich" and "poor." I tell them that they should think of a rich person as someone in the top 10 percent of a country's income distribution while a poor person is in the bottom 10 percent. Similarly, a rich country is in the top decile of all countries ranked by average income per person while a poor country is in the bottom decile of that list. Now, I say, you are ready to answer the question. Which would you choose?

The students are graduate students and have been to developing countries, so they have all seen the flashy cars the wealthy drive and the mansions where they live. Most have little hesitation in responding that they'd rather be rich in a poor country.

That is the wrong answer. The correct answer is "Poor in a rich country"—and it's not even close. The average poor person in a rich country, according to my parameters, earns *three times more*

than the average rich person in the poor country ($9,400 versus $3,000, adjusted for differences in purchasing power across countries).[1] Disparities in other aspects of well-being, such as infant mortality, go the same way too. The poor in a rich country have it much, much better than the rich in the poor country.

Students get it wrong because they don't realize what a minute share of society those BMW-driving superrich represent—no larger perhaps than one hundredth of 1 percent of the total population. When we expand the numbers to cover the full top 10 percent of a typical poor country, we have come down to income levels that are a fraction of what most poor people in rich countries make. It is an easy mistake to make. I once had one of the world's foremost experts on economic development in the audience when I asked the question, and he gave the wrong answer too!

That it is far better to be poor in a rich country than rich in a poor country tells us something fundamental about today's global economy. Disparities in income (as well as health and other indicators of well-being) are much larger across nations than they are within nations. The country you are born in largely determines your life possibilities.

It wasn't always so. At the onset of the Industrial Revolution, the gap between the richest and poorest regions of the world was of the order of 2:1. Today, the same ratio stands at 20:1.[2] The gap between the richest and poorest *country* has risen to about 80:1. Over time, some parts of the world—Western Europe, America, and later East Asia—took off while the rest grew very slowly, when at all, and often lost ground after bursts of expansion. In the words of my Harvard colleague, Lant Pritchett, the global economy experienced "divergence, big time."[3]

By the middle of the twentieth century the world was divided between a small group of wealthy countries and a large number of others struggling under varying degrees of poverty. The next six decades witnessed extraordinary growth on a global scale. But except for a handful of countries, mostly in Asia, few poor countries were able to close the gap between them and the advanced countries in a sustained manner. Luckily, the successful countries (notably China) were home to hundreds of millions of very poor people, so the development record of the last few decades is in fact quite impressive. Other countries were unable to match this performance, ensuring that the chasm between rich and poor nations would widen to unprecedented depths.

Why so much poverty amidst plenty? What role did globalization play in the "great divergence"? What can countries do to redress poverty? These are the questions that this and the next chapter address.

Globalization and the Great Divergence

The proximate cause of poverty is low productivity. Poor people are poor because their labor enables them to produce too little to adequately feed and house themselves, let alone provide for other needs such as health and education. Low productivity in turn has diverse and multiple causes. It may be the result of lack of credit, which prevents producers from making the investments that would increase their output and hence incomes. It may be result of lack of access to new and better technologies. It may be due to lack of skills, knowledge, or job opportunities. It may be the consequence of small market size, which depresses the profitability of acquiring new equipment and technologies. Or it may be due to exploitative elites, typically in cahoots with the government, who block any improvement in economic conditions that would threaten their power. The ultimate reasons for poverty can be traced to one or more of these causes.

Globalization promises to give everyone access to markets, capital, and technology, and foster good governance. In other words, globalization has the potential to remove all of the deficiencies that create and sustain poverty. As such, globalization ought to be

a powerful engine for economic catch-up in the lagging regions of the world. And yet the last two centuries of globalization have witnessed massive economic divergence on a global scale. How is that possible?

This question has preoccupied economists and policy makers for a very long time. The answers they have produced coalesce around two opposing narratives. One says the problem is "too little globalization," while the other blames "too much globalization." At different times in history, each of these narratives has found favor and they have experienced varying appeal in different parts of the world. But the debate on globalization and development ultimately always comes back to the conundrum framed by these competing narratives: If we want to increase our economic growth, should we throw ourselves open to the forces emanating from the world economy, or protect ourselves from them?

Unfortunately, neither of these two narratives offers much help in explaining why some countries have done better than others, and therefore neither is a very good guide for policy. The truth lies in an uncomfortable place, the middle. Globalization does greatly enhance the potential for economic growth, but the best way to take advantage of it is not to remove the transaction costs that block full integration to the maximum extent possible. A "thin" version of globalization, à la Bretton Woods, seems to work best. Consider a metaphor I once heard from a student from China (appropriately enough): keep the windows open, but don't forget the mosquito screen. This way you get the fresh air but you also keep the bugs away.

Globalization's Uneven Impact During the Nineteenth Century

The Industrial Revolution spread from England to the European Continent and to some of the lands of recent settlement (North America, Australia, and New Zealand), but did not go much

further. The world economy soon split between an increasingly industrial core and a largely raw materials–producing periphery. Globalization played the parts of both Dr. Jekyll and Mr. Hyde in this. It enabled new technologies to disseminate in areas with the requisite preconditions, but also entrenched and accentuated a long-term division between the core and the periphery.

Those parts of the world which proved receptive to the forces of the Industrial Revolution shared two advantages. They had a large enough stock of relatively educated and skilled workers that could fill up and run the new factories. They also had sufficiently good institutions—well-functioning legal systems, stable politics, and restraints on expropriations by the state—to generate incentives for private investment and market expansion. With these pre-conditions, much of Continental Europe was ready to absorb the new production techniques developed and applied in Britain. Chalk up one for globalization.

Elsewhere, industrialization depended on "importing" skills and institutions. Intercontinental labor mobility was a tremendous advantage here. Where Europeans settled en masse, they brought with them both the skills and the drive for more representative, market-friendly institutions that would promote economic activity alongside their interests. The consequences were disastrous for the native populations, who perished in large numbers courtesy of European aggression and germs. But the regions of the world that the economic historian Angus Maddison has called "Western offshoots"[4]—the United States, Canada, Australia, and New Zealand—were able to acquire the necessary prerequisites thanks to large immigrations. Supported also by sizable capital flows from Europe, these economies would eventually become part of the industrial "core." Chalk up two for globalization.

Colonization's impact on other parts of the world was quite different. When Europeans encountered inhospitable conditions that precluded their settlement in large numbers or began to exploit natural resources that required armies of manual work-

ers, they set up institutions that were quite different from those in the Western offshoots. These purely "extractive" institutions were designed to get the raw materials to the core as cheaply as possible. They entailed vast inequalities in wealth and power, with a narrow elite, typically white and European, dominating a vast number of natives or slaves. Colonies built on the extractive model did little to protect general property rights, support market development, or stimulate other kinds of economic activity. The plantation-based economies in the Caribbean and the mineral economies of Africa were typical examples. Studies by economists and economic historians have established that this early experience with institutional development—or lack thereof—has produced a debilitating effect on economies in Africa and Latin America that is still felt today.[5] Chalk up one *against* globalization.

Those regions of the world that avoided European colonization weren't exactly shielded from the adverse effects of globalization. The free trade treaties that European powers imposed on peripheral regions froze their initial comparative advantage in raw materials. Low tariffs combined with the decline in shipping costs exposed their textile and other nascent industrial activities to competition from Britain and decimated them. In the Ottoman Empire, for example, textile imports shot up to capture nearly 75 percent of the home market by the 1870s, up from a mere 3 percent in the 1820s.[6]

Once the lines were clearly drawn between industrializing and commodity-producing countries, there were strong economic dynamics that reinforced the demarcation. Globalization played a crucial role here by deepening the international division of labor. Commodity-based economies faced little incentive or opportunity to diversify. As transport costs fell during the nineteenth century and growth in the industrial core fed demand, these economies experienced commodity booms. This was very good for the small number of people who reaped the windfall from the mines and plantations that produced such commodities, but not very good

for manufacturing industries that were squeezed as a result.[7] International trade worked just as in textbook models: profits rose in economic activities in which countries had comparative advantage, but fell elsewhere.

International trade induced industrial countries to keep investing in skills, technology, and other drivers of economic growth. It also encouraged families to have fewer, better-educated children, in light of the high returns to skills that modern manufacturing industries brought. These effects were reversed in the developing countries of the periphery. Specialization in primary commodities did not encourage skill accumulation and delayed the reduction in fertility and population growth. Birth rates remained high in the developing world well into the twentieth century, unlike the industrialized countries, which experienced sharp declines in fertility toward the end of the nineteenth century. In the words of the economists Oded Galor and Andrew Mountford, commodity-exporting countries gave up productivity in exchange for population.[8]

The countries of the periphery not only failed to industrialize, they actually lost whatever industry they had. They *deindustrialized.* At the dawn of the Industrial Revolution, Asia and Latin America had levels of industrial activity roughly similar to Europe's. Europe experienced a nearly sixfold increase in these levels between 1750 and 1913. Asia and Latin America meanwhile witnessed a decline to less than a third of their initial level.[9] In 1900, developing nations produced only about half the quantity of manufactured goods that they did in 1830. As the economic historian Paul Bairoch, the source of these estimates, writes: "There cannot be any question but that the cause of de-industrialization in the Third World lay in the massive influx of European manufactured goods, especially textiles, on the markets of these countries."[10] Chalk up two against globalization.

The pre-1914 international division of labor did produce wealth in commodity-exporting countries. But just as in today's oil-rich

economies, the wealth was highly concentrated and ended up stifling institutional and productive development. Where independence had not yet arrived, it accrued to the metropolitan powers. Where it had, it went to a narrow group of domestic elites.

Argentina, to take the leading example, became one of the world's richest economies on the back of the produce of its fertile lowlands, its *pampas*. With its chic boulevards, polo clubs, grand opera house, Eton-educated children, and refined aristocracy, Buenos Aires could outdo any of the major European capitals. This wealth came at the expense of crippling future economic development. Exports of grains and livestock along with large infusions of British capital mainly benefited large landowners who had little interest in diversifying the economy or building better market-supporting institutions. The contrast with the United States is instructive. There Northern industrialists and Western farmers gained the upper hand over Southern plantation owners and fostered broader-based institutions and industrialization, on the back of high import tariffs.[11]

The Japanese Exception

So geography and natural endowments largely determined nations' economic fates under the first era of globalization. One major exception to this rule would ultimately become an inspiration to all commodity-dependent countries intent on breaking the curse. The exception was Japan, the only non-Western society to industrialize before 1914.

Japan had many of the features of the economies of the periphery. It exported primarily raw materials—raw silk, yarn, tea, fish—in exchange for manufactures, and this trade had boomed in the aftermath of the opening to free trade imposed by Commodore Perry in 1854. Left to its own devices, the economy would have likely followed the same path as so many others in the periphery. But Japan had an indigenous group of well-educated and patriotic businessmen and merchants, and even more important, a government, following the Meiji Restoration of 1868, that was single-mindedly focused on economic (and political) modernization. The government was little moved with the laissez-faire ideas prevailing among Western policy elites at the time. In a document that could be called the world's first development plan, Japanese officials made clear that the state had a significant role to play in developing the economy, even though its actions "might interfere with individual freedom and with the gains of speculators."[12]

Many of the reforms introduced by the Meiji bureaucrats were aimed at creating the infrastructure of a modern national economy: a unified currency, railroads, public education, banking laws, and other legislation. Considerable effort also went into what today would be called "industrial policy"—state initiatives targeted at promoting new industries. The Japanese government built and ran state-owned plants in a wide range of industries, including cotton textiles and shipbuilding. Even though many of these enterprises ended as failures, they produced important demonstration effects and trained many skilled artisans and managers who would subsequently ply their trade in private establishments. These enterprises were eventually privatized, enabling the private sector to build on the foundations established by the state. The government also paid to employ foreign technicians and technology in manufacturing industries and it financed training abroad for Japanese students. In addition, as Japan regained tariff autonomy from international treaties, the government raised import tariffs on many industrial products to encourage domestic production. These efforts paid off most remarkably in cotton textiles, where Japan established by 1914 a world-class industry that was able to displace British exports not just from the Japanese markets but from neighboring Asian markets as well.[13]

Japan's militarist and expansionist policies in the run-up to World War II tarred these accomplishments, but its achieve-

ments on the economic front demonstrated that an alternative path was available. It was possible to steer an economy away from its natural specialization in raw materials. Economic growth was achievable—even if a country started at the wrong end of the international division of labor—if you combined the efforts of a determined government with the energies of a vibrant private sector. The key was not more or less globalization, but just the right kind of globalization.

These lessons would be relearned in the decades that followed World War II.

The East Asian "Miracle"

One hundred years after the Meiji bureaucrats produced their first development plan, Japan was a major economic power with significant say in global institutions.[14] It had become the second largest shareholder in the World Bank, forcing the institution's management to pay more attention to its views. Masaki Shiratori, Japan's executive director at the World Bank, one of twenty-four country representatives who oversee the institution's operations, was growing increasingly uncomfortable with the policy advice the Bank gave to developing nations. He and his colleagues in Japan's powerful Ministry of Finance felt that this advice relied too much on the American preference for a free market model and underplayed the role of the state in promoting industrialization and development. In their view, the World Bank did not pay enough attention to the lessons of Japan's own development experience.[15]

The Japanese government pushed the Bank to prepare a study of the "Asian miracle," agreeing also to pay for the bulk of it. The miracle in question referred not only to Japan's experience but also to that of seven other East and Southeast Asian economies that had grown very rapidly since the early 1960s—South Korea,

Taiwan, Hong Kong, Singapore, Malaysia, Thailand, and Indonesia. All of these countries had benefited enormously from exports, and hence from globalization. But none, with the exception of the British colony of Hong Kong, came even close to being free market economies. The state had played an important guiding and coordinating role in all of them.

The World Bank's report was eventually released in 1993 with the title *The East Asian Miracle: Economic Growth and Public Policy*. Produced by a large team of economists and consultants, and encompassing nearly 400 pages of text, charts, and statistical analysis along with more than 40 background studies, it could lay claim to being the most authoritative analysis of the subject. But more than anything else, the report demonstrated the World Bank's inability to fashion a coherent account of how Asian nations had managed to grow so rapidly. There was too much state intervention in Asia for it not to have had some beneficial effect, yet the Bank did not want to suggest that state intervention works. Fixated on an absolute distinction between markets and state intervention, the Bank could not see how the two could mutually reinforce each other. The resulting report proceeded in a schizophrenic manner and presented a deeply contradictory argument.

The analysis of financial markets—drafted by Joe Stiglitz, well known for his skeptical views on financial liberalization—painted a positive picture of the Japanese and South Korean governments' controls: ceilings on interest rates, credit subsidies targeted at new industries, and restrictions on international capital flows. This part of the report accepted the Japanese argument that government-supported loans to industry had played a positive role in accelerating industrialization and growth. Yet in other chapters the line was that industrial policies—the promotion of specific industries through government inducements—had not worked and should not be advocated for other developing nations. Depending on which chapters you read, you would have come away with a very dif-

ferent view as to whether Asian countries had succeeded because of their governments' efforts to promote new industries or despite these efforts.[16]

Asia's economic experience violates stereotypes and yet offers something for everyone. In effect, it acts as a reflecting pool for the biases of the observer. If you think unleashing markets is the best way to foster economic development, you will find plenty of evidence for that. If you think markets need the firm commanding hand of the government, well, there is much evidence for that, too. Globalization as an engine for growth? East Asian countries are a case in point. Globalization needs to be tamed? Ditto. However, if you leave aside these stale arguments and listen to the real message that emanates from the success of the region, you find that what works is a combination of states and markets. Globalization is a tremendously positive force, but only if you are able to domesticate it to work for you rather than against you.

Consider two of the most successful countries of the region: South Korea and Taiwan. In the late 1950s, neither of these economies was much richer than the countries of sub-Saharan Africa. South Korea was mired in political instability and had virtually no industry, having lost whatever it had to the more developed North Korea. Taiwan too was a predominantly agricultural economy, with sugar and rice as its main exports. The transformation that the two economies began to experience in the early 1960s placed them on a path that would turn them into major industrial powers.

Their strategies in many ways mirrored Japan's. They required first a government that was single-mindedly focused on economic growth. Prior land reform in both countries had established some space for governments to act independently from landed elites. Both countries also possessed an overarching geopolitical motive. South Korea needed to grow so it could counter any possible threats from North Korea. Taiwan, having given up on the idea of reconquest of mainland China, wanted to forestall any possible challenge from the Communists. In many parts of the world, regional hostilities become an excuse for building a strong state at the expense of the economy; think, for example, of the Middle East. But the governments in South Korea and Taiwan understood that achieving their political and military goals required rapid economic growth as well. In particular, developing industrial capabilities and a strong manufactured exports base became the predominant objective of both governments' policies.

This objective was accomplished by unleashing the energies of private business. Even though both governments invested heavily in public enterprises during the 1960s, this investment was designed to facilitate private enterprise—by providing cheap inputs, for example—and not to supplant it. One plank of the strategy called for removing the obstacles to private investment that stifled many other low-income countries: excessive taxation, red tape and bureaucratic corruption, inadequate infrastructure, high inflation. These were improvements in what today would be called "investment climate."

Equally important were interventionist policies—government incentives designed to stimulate investments in modern manufactures. Both governments designated such industries as "priority sectors" and provided businesses with generous subsidies. In South Korea, these took the form largely of subsidized loans administered through the banking sector. In Taiwan, they came in the form of tax incentives for investments in designated sectors. In both countries, bureaucrats often played the role of midwife to new industries: they coordinated private firms' investments, supplied the inputs, twisted arms when needed, and provided sweeteners when necessary. Even though they removed some of the most egregious import restrictions, neither country exposed its nascent industries to much import competition until well into the 1980s. The domestic market was protected to enable the "infant" industries to make sufficient

profits. South Korea also discouraged multinational enterprises from coming in, which allowed maximum room for domestic firms to engage in technological learning.

While they enjoyed protection from international competition, these infant industries were goaded to export from day one. This was achieved by a combination of explicit export subsidies and intense pressure from bureaucrats to ensure export targets were met. In effect, private businesses were offered a quid pro quo: they would be the beneficiary of state largesse, but only so long as they exported, and did so in increasing amounts. If gaining a beachhead in international markets required loss-making prices early on, these could be recouped by the subsidies and profits on the home market. But, importantly, these policies gave private firms a strong incentive to improve their productivity so they could hold their own against established competitors abroad.[17]

We can see how this growth strategy offered something to satisfy all tastes. A macroeconomist could walk away with the conclusion that macroeconomic stability in the form of low inflation held the key. A labor economist could point to the importance of a relatively well educated labor force. A trade economist would note the high rates of protection, but take comfort from the fact that their trade-inhibiting effects were nullified by export subsidies that pushed the other way. A political economist would emphasize the role of the strong state and its "autonomy" from elites. The World Bank could emphasize the leading role that private investment and exports played. An interventionist could emphasize the heavy hand of the state in guiding private investment.

They would all be missing the big picture. Economic growth requires a pragmatic government willing to do whatever it takes to energize the private sector. It requires using markets and globalization strategically to diversify the domestic economy away from natural resources. The specific tools and instruments needed to achieve this can vary and will depend heavily on the context. Specific recipes for success do not travel well. It is the broad vision behind them that needs emulation.

These lessons were put to good use in the most astounding development success the world has ever known.

Marching to Its Own Drum: China and Globalization

The feat that China's economy pulled off would have been difficult to imagine had it not happened in front of our eyes. Since 1978, income per capita in China has grown at an average rate of 8.3 percent per annum—a rate that implies a doubling of incomes every nine years. Thanks to this rapid economic growth, half a billion people were lifted out of extreme poverty.[18] During the same period China transformed itself from near autarky to the most feared competitor on world markets. That this happened in a country with a complete lack of private property rights (until recently) and run by the Communist Party only deepens the mystery.

China's experience offers compelling evidence that globalization can be a great boon for poor nations. Yet it also presents the strongest argument against the reigning orthodoxy in globalization—emphasizing financial globalization and deep integration through the WTO. China's ability to shield itself from the global economy proved critical to its efforts to build a modern industrial base, which would be leveraged in turn through world markets.

China's big break came when Deng Xiaoping and other post-Mao leaders decided to trust markets instead of central planning. But their real genius lay in their recognition that the market-supporting institutions they built, most of which were sorely lacking at the time, would have to possess distinctly Chinese characteristics. Western economists would propose European- or American-style regulations to enforce contracts, protect property

rights, liberalize markets, and free up trade. These ideas faced huge practical difficulties and moreover violated, in many cases, official Party doctrine (as in the case of private property). Instead, the Chinese leaders pragmatically experimented with alternative institutional arrangements. No fewer than half of all national regulations in China in the early to mid-1980s had explicitly experimental status.[19] Through experimentation, China's policy makers sought to discover solutions that would overcome their constraints and be more suited to local conditions. China's institutional innovations proved remarkably successful. They effectively turned institutional weakness into an advantage.

China's economy was predominantly rural in 1978. A key problem Deng faced early on was how to energize farmers in an environment where prices and quantities were still determined by central planning. The state fixed all the prices and demanded that peasants deliver mandated quantities of grains to the government in accordance with the plan. Farmers were organized into communes and prohibited from selling any of their produce in private markets. The food that the state extracted from the countryside in this fashion was then rationed to workers in urban areas. The system ensured that workers would be fed at no cost to the government budget. The downside was that farmers had little incentive to increase production or make more efficient use of the land.

A Western-trained economist would have recommended abolishing the plan and removing all price controls. Yet without the quotas, urban workers would be deprived of their cheap rations and the government of an important source of revenue. There would be masses of disgruntled workers in the cities and the government would have to resort to printing money, risking hyperinflation. The Chinese solution to this conundrum was to graft a market system *on top* of the plan. Communes were abolished and family farming restored; but land remained state property. Obligatory grain deliveries at controlled prices were also kept in place; but once farmers had fulfilled their state quota, they were

now free to sell their surplus at market-determined prices. This dual-track regime gave farmers market-based incentives and yet did not dispossess the state from its revenue or the urban workers from their cheap food.[20] Agricultural productivity rose sharply, setting off the first phase of China's post-1978 growth.

Another problem was how to provide a semblance of property rights when the state remained the ultimate owner of all property. Privatization would have been the conventional route, but it was ruled out by the Chinese Communist Party's ideology. Once again, it was an innovation that came to the rescue. Township and village enterprises (TVEs) proved remarkably adept at stimulating domestic private investment. They were owned not by private entities or the central government, but by local governments (townships or villages). TVEs produced virtually the full gamut of products, everything from consumer goods to capital goods, and spearheaded Chinese economic growth from the mid-1980s until the mid-1990s.

The key to their success was that local governments were keen to ensure the prosperity of TVEs as their equity stake generated substantial income for them. Local authorities gave private entrepreneurs considerable freedom and also protected them from challenge—most critically from the local Party bosses themselves. This offered a better deal to the entrepreneurs than having formal private ownership rights and then hoping that local courts—weak and corruptible as they were—would enforce those rights in the face of disputes. Many a former Socialist economy has painfully discovered that property rights reform often flounders because domestic courts are too fragile to enforce the new rules. As the Berkeley economist Yingyi Qian emphasizes, property rights were effectively more secure when backed up by partnerships with the local government than they would have been under a standard regime of private property rights.[21]

China's strategy to open its economy to the world also diverged from received theory. The standard list of recommendations for

countries pursuing this goal includes: dismantling quantitative restrictions on imports; reducing import tariffs and their dispersion; and making the currency convertible for trade transactions. Measured by these guidelines, China's policies suggest a country that messed up big time, not one that became a formidable competitive threat in world markets. In brief, China opened up very gradually, and significant reforms lagged behind growth (in exports and overall incomes) by at least a decade or more. While state trading monopolies were dismantled relatively early (starting in the late 1970s), what took their place was a complex and highly restrictive set of tariffs, non-tariff barriers, and licenses restricting imports. These were not substantially relaxed until the early 1990s.

The Chinese leadership resisted the conventional advice in opening their economy because removing barriers to trade would have forced many state enterprises to close without doing much to stimulate new investments in industrial activities. Employment and economic growth would have suffered, threatening social stability. The Chinese decided to experiment with alternative mechanisms that would not create too much pressure on existing industrial structures. In particular, they relied on Special Economic Zones (SEZs) to generate exports and attract foreign investment. Enterprises in these zones operated under different rules than those that applied in the rest of the country; they had access to better infrastructure and could import inputs duty-free. The SEZs generated incentives for export-oriented investments without pulling the rug from under state enterprises.

What fueled China's growth, along with these institutional innovations, was a dramatic productive transformation. The Chinese economy latched on to advanced, high-productivity products that no one would expect a poor, labor-abundant country like China to produce, let alone export. By the end of the 1990s, China's export portfolio resembled that of a country with an income-per-capita level at least *three times higher* than China's.[22]

This was the result not of natural, market-led processes but of a determined push by the Chinese government. Low labor costs did help China's export drive, but they don't tell the whole story. In areas such as consumer electronics and auto parts China made stupendous productivity gains, catching up with countries at much higher levels of income. Furthermore, China steadily moved away from being simply an assembler of components. Increasingly, production became integrated backwards and the supply chain moved from richer countries to China where the assembly was undertaken.

Foreign investors played a key role in the evolution of China's industries. They were the most productive among the firms, they were the source of technology, and they dominated exports. The SEZs where foreign producers could operate with good infrastructure and a minimum of hassles deserve considerable credit. But if China welcomed foreign companies, it always did so with the objective of fostering domestic capabilities.

The Chinese government used a number of policies to ensure that technology transfer would take place and strong domestic players would emerge. Early on, it relied predominantly on state-owned national champions. Later, the government used a variety of incentives and disincentives. In mobile phone and computer production, foreign investors were required to undertake joint ventures with domestic firms. In autos, the government required foreign car companies investing in the domestic market to achieve a relatively high level of Chinese content within a short period of time (typically 70 percent within three years).[23] This forced these companies to work closely with local suppliers to ensure that their technology and quality were up to par. Domestic markets were protected to attract investors seeking a large consumer base, in addition to those that looked for cost savings. Weak enforcement of intellectual protection laws enabled domestic producers to reverse engineer and imitate foreign technologies with little fear of prosecution. Cities and provinces were given substantial free-

doms to fashion their own policies of stimulation and support, which led to the creation of industrial clusters in Shanghai, Shenzhen, Hangzhou, and elsewhere.[24]

Many of the Chinese companies created through government efforts failed. Accounts of industrial policy in China point to the low productivity and low-technology absorption of many state enterprises and to the lack of coordination (across national ministries as well as across different levels of government) that characterizes Chinese policies.[25] But as in Japan a century earlier, state-led efforts played an important role in training workers and managers and in creating demonstration effects. Would China have been able to produce a company like Lenovo, which became large and profitable enough to purchase IBM's PC unit in 2004, without state support and financial assistance?

Moreover, as in other areas of policy, government attitudes were pragmatic and open to trying new approaches when old ones failed. A well-known case involves the early development of the color TV industry, which consisted in the 1980s of more than one hundred companies operating at short production runs and high cost. By the early 1990s, the industry had been consolidated thanks to the efforts of local governments and national leadership, which forced mergers and joint ventures with foreign firms. This policy reversal led to the emergence in quick order of a profitable, export-oriented industry.[26]

Many of these early policies would have run afoul of WTO rules that ban export subsidies and prohibit discrimination in favor of domestic firms—if China had been a member of the organization. Chinese policy makers were not constrained by any external rules in their conduct of trade and industrial policies and could act freely to promote industrialization. By the time China did join the WTO in 2001, it had created a strong industrial base, much of which did not need protection or nurturing. China substantially reduced its tariffs in preparation for WTO membership, bringing

them down from the high levels of the early 1990s (an average of around 40 percent) to single digits in 2001. Many other industrial policies were also phased out.

However, China was not yet ready to let the push and pull of global markets determine the fate of its industries. It began to rely increasingly on a competitive exchange rate to effectively subsidize these industries. By intervening in currency markets and keeping short-term capital flows out, the government prevented its currency (the renminbi) from appreciating, which would have been the natural consequence of China's rapid economic growth. Explicit industrial policies gave way to an implicit industrial policy conducted by way of currency policy. The renminbi has been undervalued by around 25 percent in recent years, implying an effective subsidy to export-oriented industries (and import-competing firms) of an equal magnitude.[27] Once again, China bent globalization's rules to its own requirements. Since floating currencies and free capital mobility would not have helped its economic development, China simply did without them. Its flouting of these "rules" would eventually become a serious source of conflict in its relationship with the United States. I will return to this conflict in chapter Twelve, as the growing role of China in the world economy renders its foreign economic policy one of the thorniest issues that the world will have to confront in years ahead.

In sum, Chinese policy makers maintained their maneuvering space and they exploited it skillfully. They gave markets and private incentives a much greater role, but did so in ways that were adapted to domestic economic realities and respected political and ideological constraints. The international rulebook was not suited to their needs, so their reforms necessarily took on unorthodox characteristics. They resisted international disciplines, and submitted to them only once their economy had become sufficiently strong. They would have found it very difficult to diversify out of agriculture and other traditional products otherwise. China (like

South Korea and Taiwan before it) played the globalization game by Bretton Woods rules rather than the post-1990 rules of deep integration.

The Diversification Imperative

You become what you produce. That is the inevitable fate of nations. Specialize in commodities and raw materials, and you will get stuck in the periphery of the world economy. You will remain hostage to fluctuations in world prices and suffer under the rule of a small group of domestic elites. If you can push your way into manufactures and other modern tradable products, you may pave a path toward convergence with the world's rich countries. You will have greater ability to withstand swings in world markets, and you will acquire the broad-based, representative institutions that a growing middle class demands instead of the repressive ones that elites need to hide behind.

Globalization accentuates the dilemma because it makes it easier for countries to fall into the commodities trap. The international division of labor makes it possible for you to produce little else besides commodities, if that is what you choose to do. You can always import the other stuff from the rich countries. At the same time, globalization also greatly increases the rewards of the alternative strategy, as the experiences of Japan, South Korea, Taiwan, and China amply show. A government committed to economic diversification and capable of energizing its private sector can spur growth rates that would have been unthinkable in a world untouched by globalization.

In principle, well-functioning markets—both domestic and global—should help countries move up the ladder from commodities to new industries without a push from the government. Many economists believe the transition doesn't need a helping hand beyond ensuring that markets do their job. But in practice

there are too many things that can go wrong. Learning new technologies and investing in new products is a difficult process that has many built-in obstacles if a country is not already predisposed toward it.

In particular, industrialization requires the development of social capabilities that are subject to significant economic spillovers—adapting foreign technologies to local conditions, acquiring skills, producing specialized inputs for production, coordinating complementary investments in diverse areas. In all of these cases, social benefits exceed the gains captured by the relevant private actors alone, producing what economists call "positive externalities." Markets are not very good at providing signals beyond short-term private profitability. Left to their own devices, they undersupply the incentives needed for productive upgrading. That is why, in the words of the Harvard Business School innovation expert Josh Lerner, "virtually every hub of cutting-edge entrepreneurial activity in the world today had its origins in proactive government intervention."[28]

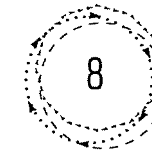
The benefits of globalization come to those who invest in domestic social capabilities. Those investments in turn require some degree of support for domestic firms—protective tariffs, subsidies, undervalued currencies, cheap funding, and other kinds of government assistance that increase the rewards for entering new lines of business without closing the economy to the outside world. If the rest of the world does not create high-productivity jobs for your workers, you have no choice but to create those jobs yourself. The deep integration model of globalization overlooks this imperative. By restricting in the name of freer trade the scope for industrial policies needed to restructure and diversify national economies, it undercuts globalization as a positive force for development.

It may seem like the ultimate paradox that reaping globalization's gains may require an increase rather than a decrease in international transaction costs, but the paradox is more apparent

than real. A complicated world requires foxlike policies. There is no more contradiction here than there is when we mount a screen on an open window; in a perfect world there would be no mosquitoes and no need for a screen.

Why have not more countries followed the East Asian examples? Why has it proved so difficult to emulate their strategies? Why do scores of countries in Africa and elsewhere remain mired in poverty, unable to make the transition to modern industries and services? Unfortunately, many of these countries have governments with little interest in real development. These governments are unlikely to unleash economic changes that threaten their hold on power.

Politics is only part of the answer. We cannot understand the disappointments of the rest of the world without giving economists their due. Economists have been responsible for the narratives that interpret developmental success and failure, narratives which in turn have guided policy in many parts of the world. Economists have been the ultimate arbiters of how those narratives would be shaped, which would survive, and how they would spread. As we shall see in the next chapter, they have not always got it right.



Trade Fundamentalism in the Tropics

In March 1960, James Meade, a Cambridge don and future Nobel Prize winner for his research in international economics, traveled to the British colony of Mauritius with a small team of economists. The island was getting ready for independence, which it would acquire in 1968. The British fretted about the country's prospects under self-rule, shorn of support from London. Meade, a left-leaning economist and admirer of Keynes, had been invited by the island's British governor to survey the economy and make proposals for its future development.

Meade stood for a practical, commonsense brand of economics, and his eventual recommendations would reflect this pragmatism. However, three decades after his trip to Mauritius, development economics was transformed beyond recognition and became dominated by a vision that elevated free markets and free trade above all else. The central insights of Meade and his contemporaries—the need to tailor reforms to local circumstances and for proactive government policies to stimulate structural transformation—were shunted aside. It is only recently that these older insights have been resuscitated and are being reincorporated into thinking on development strategy. This chapter recounts this strange tale of the loss and (partial) recovery of common sense.

The Unmaking of a Malthusian Nightmare

An island off the coast of Africa, Mauritius lies about 560 miles east of Madagascar. Its people are a mix of descendants from Africa (Creoles), India (Indo-Mauritians), France (Franco-Mauritians), and China (Sino-Mauritians)—a combination of ethnicities, languages, and religions that could be described as either "lively" or "explosive" depending on which side of the bed one got up in the morning. At the time of Meade's visit, the country was exceedingly poor. The economy wholly depended on sugar cultivation, which employed more than a third of the labor force and generated the country's sole export.

Moreover, the island confronted the threat of a population explosion. Thanks largely to the elimination of malaria under colonial public health policies, the population growth rate had risen from around 0.5 percent per annum in the immediate aftermath of World War II to closer to 3 percent by the time of Meade's visit. The island's population was projected to rise from 600,000 to 3 million by the end of the twentieth century. "This," Meade wrote at the time, "is a truly terrifying prospect."[1]

The problem, as Meade saw, was that a growing population would put pressure on the limited arable land that was available and drive living standards down. Sugar and other agricultural products would never be able to absorb the growing workforce. Emigration was at best a partial solution, and domestic investment was limited by the small scale of domestic saving. The island's ethnic and social divisions made an already difficult problem almost insoluble. "It would be difficult with present attitudes in Mauritius," noted Meade, "to conceive of a man with business acumen (who happened to be Chinese) managing a firm for which a wealthy person (who happened to be Indian) had provided the capital to exploit an imaginative idea of an engineer (who happened to be of European extraction)."[2]

Though pessimistic, Meade did not give up. The solution was to create a large number of employment opportunities in labor-intensive light industries. One plank of his proposed strategy called for restraining wage increases, to ensure there was no disincentive to the establishment of such industries. The other advocated a concerted government effort to stimulate the creation of new industries. Since the island had few industries, they would need to be started from scratch, and that required an active government.

Meade recommended the formation of an Industrial Development Board which, in consultation with the private sector, would seek new investment opportunities and grant tax holidays and other incentives to firms with the greatest prospect for job creation. He advocated the creation of industrial estates with adequate infrastructure that would lease factories and workshops to manufacturers at low cost. Meade understood that Mauritian producers could overcome the limitations of the small home market by exporting to the world—just as the East Asian Tigers were beginning to do. But he thought that these "infant industries" would need to be nurtured until they could compete on their own. He recommended moderately high import tariffs that would protect nascent industries from foreign competition.

For Meade, the key to Mauritius' future lay in economic diversification and the growth of new industries. The island did not have to remain a mono-crop economy: it could move into manufactures, relieving the population pressure on land and setting the stage for future growth. He also knew that this transformation would not be automatic; it required the helping hand of the government. Market forces would need to be supplemented by government programs aimed at stimulating the new industries. Industrial policy had to be part of the development strategy.

Despite its inauspicious beginnings, Mauritius would turn out to be one of Africa's few success stories. In time, textiles and clothing replaced sugar as the island's main exports. A vibrant political democracy was able to contain the ethnic tensions simmering just

below the surface. And the nightmare of population explosion never came to pass. Rapid economic growth not only created jobs, it also fed into fertility declines. The island's population stood at 1.2 million by the year 2000, a fraction of the 3 million that Meade had projected. The island became an upper-middle-income country, with an income level similar to that of Southeastern Europe.

The strategy that Meade devised had a lot to do with this success, although not all his recommendations were followed. In particular, successive Mauritian governments found it difficult to keep a lid on wages and instead chose to buy social peace through generous social programs and nationwide wage bargains that gave organized labor a strong voice at the negotiating table. But Meade's proposals on industrial promotion effectively became government policy over the subsequent decade. Domestic industry received significant incentives and trade protection, and by the end of the 1960s a substantial group of light-manufacturing producers oriented toward the home market had been created. Starting in 1970, the government began to promote export-oriented firms too, mainly in garments, under a very successful export-processing zone (EPZ) scheme, using tax incentives, import-duty exemptions, and weaker labor rules. Industrial activity was further stimulated through currency devaluations in the 1980s.

These two segments of industry—one oriented toward the home market and the other oriented toward export—co-existed for quite some time. As late as the early 1990s, Mauritius remained one of the world's most protected economies, despite a thriving EPZ and rapid export growth.[3] The protected sector did not perform as well as the EPZ; but, just as Meade had anticipated, it was an important incubator for entrepreneurship in modern industry. Indeed, the growth of the EPZ was fueled not simply by foreign investors and technology but also by domestic capital and entrepreneurship. Unlike similar zones in other countries, domestic investors and entrepreneurs participated substantially in the Mauritian EPZ.[4] That helps explain why it was so much more successful than copycats in other countries.

Today, Mauritius has an open economy with a strong manufacturing base, but it faces the challenges of the next stages of diversification. The garment sector can no longer propel the economy forward in view of rising domestic wages and competitive pressure from low-cost producers on the world market. Boosting growth requires a new strategy.

What would a modern-day James Meade recommend?

The Revisionists Take Over

Economists' views on development policy took a strange turn in the decades following Meade's report. During the 1950s and 1960s, most economists who studied the underdeveloped countries of the world, as they were then called, took it for granted that their infant industries needed nurturing and that government leadership played an important role. There was much, indeed excessive, skepticism about markets and the influence of the global economy. The leading development economists of the day, such as W. Arthur Lewis, Raul Prebisch, Paul Rosenstein-Rodan, and Albert Hirschman, had their debates, of course. But none would have endorsed the view that free trade and small government are the best way to promote economic growth and development.[5] The lessons of the Great Divergence during the nineteenth century—the division of the world between a rich industrial core and a poor commodity-producing periphery—were clear to all.

By the 1980s, the dominant view among North American development experts and their followers had changed dramatically. The state went from being a handmaiden of economic growth to the principal obstacle blocking it. The international division of labor was transformed from a threat to a savior. During the 1990s,

enthusiasm for free capital mobility was added to the package too, as we saw in an earlier chapter. This narrative infused development agencies such as the World Bank with a new sense of mission and reshaped the policy advice they dished out.

An early version of the revisionist package was codified in the so-called "Washington Consensus." Coined in 1989 by the economist John Williamson, the term originally referred to some of the common elements in the reforms that Latin American countries had embarked on at the time. Williamson's original list contained ten distinct reforms, with a heavy emphasis on deregulation, trade and financial liberalization, privatization, avoidance of currency overvaluation, and fiscal discipline. Over time, the "Washington Consensus" was transformed into a more doctrinaire approach, a mantra for the über-liberalizers. Even though Williamson was a skeptic on financial globalization, to his great chagrin capital market liberalization was soon folded into the package as well.[6]

By the mid-1990s, few people remembered specific items on Williamson's original list, but everyone knew the moniker referred to an agenda that could be summarized in three words: stabilize, liberalize, and privatize. Williamson himself, a moderate economist, would become the target of much abuse as the originator of this "neoliberal dogma." In my own travels in developing countries during the 1990s, I was struck by the ideological fervor with which policy makers, especially those in Latin America, had embraced this agenda as the only path to economic salvation. What in East Asia remained a pragmatic respect for the power of price incentives and of world markets had been transmogrified into a religion of sorts.

The Big Fix

Ultimately, the Washington Consensus derived its appeal from a simple narrative about the power of globalization to lift developing nations out of poverty. But rather than promote the mixed, pragmatic strategies that China and others had employed in order to develop domestic industrial capabilities, advocates of this narrative stressed the role of openness to the global economy. Poor countries remain poor, they argued, because they have small domestic markets riddled with inefficiencies created by government restrictions on trade. Let these countries open themselves up to international trade and investment, the thinking went, and a rising tide of trade will pull them up from poverty. What was at stake was no longer some relatively minor efficiency gains—the standard argument for gains from trade—but a rapid convergence with the standards of living in the rich countries.

The apotheosis of this movement arrived in an article published in 1995 by the prominent economist Jeffrey Sachs and a co-author, Andrew Warner, both of them at Harvard at the time.[7] A long and elaborate piece, it was full of details on economic reform in the developing nations and the historical evolution of globalization. But the heart of the article was a statistical analysis with a striking finding. Sachs and Warner divided countries into two groups: those that were open to international trade and those that were closed. Their central result was that countries in the first group grew 2.45 percentage points faster over the longer term (in per capita terms) than those in the second. This is a remarkably large number. It meant that a developing country that was growing, say, at 2 percent per annum, could more than double its growth rate simply by opening itself to international trade.

Equally striking, the Sachs-Warner analysis implied that you could reap these benefits regardless of how poor your domestic policies were or how large your other disadvantages. A lousy government, say, or an ill-educated labor force, were of little significance. You could be extremely poor and have few industries, but those factors didn't matter either. Lowering barriers to trade alone would spur growth.[8]

These results depended crucially on the method Sachs and War-

ner had employed to classify countries as "open" and "closed."[9] For example, rapidly growing countries such as South Korea, Taiwan, Indonesia, and Mauritius were treated as open even though they had maintained high barriers on imports into the 1980s and had reduced these barriers only after they had acquired significant manufacturing capabilities. Sachs himself seemed to have a much more nuanced view, placing greater emphasis on the importance of promoting manufactured exports than on trade liberalization itself.[10] That, however, was not the focus of the statistical analysis. The message that technocrats and policy makers found in the research was loud and clear: If you want to catch up with the living standards of the advanced nations, there exists no instrument more potent than reducing your import tariffs and relaxing other restrictions on trade.[11]

So complete was the conversion that it became difficult to understand why the earlier generation of economists had been so skeptical of trade and so welcoming of government intervention. In an article celebrating the new consensus, Anne Krueger, one of its principal architects, would wonder how the principle of comparative advantage could have been so "blithely abandoned." "With hindsight," she wrote, "it is almost incredible that such a high fraction of economists could have deviated so far from the basic principles of international trade."[12] No leading Western economist in good professional standing during the eighties and nineties would dream of coming up with a plan like James Meade's; he would be considered a protectionist crank if he did.

The Sachs-Warner study and others, many of them carried out at the World Bank, became powerful artillery in the campaign by development agencies and technocrats to reshape development strategies. They fueled an obsessive drive for globalization on the part of developing country policy makers. The new consensus turned foreign trade and investment into the ultimate yardsticks for judging the adequacy of domestic economic and social policies—a key deformation produced by the quest for hyperglobalization. The best argument for addressing any domestic ill—whether crime, corruption, poor infrastructure, or low skills—was that it forestalled integration with the world economy.[13] Just mention "foreign investor sentiment" or "competitiveness in world markets," and policy makers would snap to attention. The pursuit of globalization became a substitute for development strategy, an end in itself, rather than an opportunity to be exploited strategically.

There were skeptical voices within academia, but few were interested in taking on this globalization mania in the real world. Many economists would say in private that the studies attributing such large growth effects to open trade lacked credibility. But they didn't want to appear to condone protectionism. The revisionists may have greatly exaggerated the growth-boosting effects of trade liberalization, but so what? Perhaps development strategies came to revolve too much around trade policies and trade agreements, but again, what's the big deal? Any move in the direction of open trade policies had to be a good thing.

When I presented a critique of the Sachs-Warner research and other similar work in front of a group of academics in 2000, the reception was emblematic. A prominent economist interrupted me to ask: "Why are you doing this?" I was stumped. Economists are a contentious lot, and I was used to having my methods or evidence questioned, but I had not encountered such incredulity before. The idea of free trade as an engine of growth had become such a sacred cow that someone who revisited the evidence needed to have his motives questioned.[14]

When Facts Are Not What They Seem

Trade fundamentalism appealed to many because the postwar evidence superficially seemed to bear it out. The phenomenal rise of South Korea, Taiwan, and other East and Southeast Asian

nations on world markets had buried the idea, common in the 1950s and 1960s, that nascent industrial firms in poor nations wouldn't respond to trade incentives or would remain too weak to prosper in global markets. Meade himself had been overly pessimistic about Mauritius' export prospects. But the revisionists went much farther. They interpreted the East Asian experience as a triumph of markets over government and of free trade over controlled trade. Rampant state interventions were either overlooked or finessed as mutually offsetting, resulting in outcomes similar to what markets, left to their own devices, would have produced.[15] As a last resort, revisionists argued that East Asian economies would have grown even more rapidly in the absence of government interventions. We saw the difficulties this perspective ran into when we encountered the World Bank's report on *The East Asian Miracle* in the previous chapter.

The misdiagnosis of the experience of countries such as Brazil, Mexico, and Turkey, which had followed more inward-looking strategies, was equally problematic. Unlike East Asian countries or Mauritius, these countries had made little effort to push their firms to export, relying mostly on the domestic market to fuel growth. They had maintained highly restrictive trade regimes well into the 1980s. This was the strategy of "import-substituting industrialization" (ISI), and it had become the dominant model in Latin America, the Middle East, Africa, and parts of Asia (especially India) since the 1930s and following independence. As the name suggests, the strategy focused on replacing previously imported goods—initially simple consumer goods, but eventually more sophisticated capital goods as well—by domestic production. This goal was to be achieved through an array of government interventions, in the form of import protection, credit subsidies, tax incentives, and public investment. The strategy placed little emphasis or confidence in the ability of domestic firms to export and compete on world markets.

The revisionists painted a grim picture of ISI's record. By failing

to take advantage of world markets and giving the state too large a role, they argued, these countries had severely handicapped their development. Once again, this depiction overshot the mark. To be sure, it was easy to dig up horror stories about the excesses of protectionism and state intervention. In some cases, trade barriers had distorted investment incentives so much that private entrepreneurs had found it profitable to set up plants where the cost of the inputs they were using exceeded the value of what they were producing.[16] Some countries, notably Argentina and India, did perform poorly.

Nonetheless, the overall record of ISI was in fact rather impressive. Brazil, Mexico, Turkey, and scores of other developing nations in Latin America, the Middle East, and Africa experienced faster rates of economic growth under ISI than at any other time in their economic history. Latin America grew at an annual average rate exceeding 2.5 percent per capita between 1945 and the early 1980s—a pace that far exceeds what the region has registered since 1990 (1.9 percent).[17] Two dozen countries in post-independence sub-Saharan Africa also grew quite rapidly until the mid- to late 1970s.

Industrialization drove this performance. ISI countries experienced rapid productivity growth as their economies diversified away from traditional agriculture into manufacturing activities. As surprising as it may seem, our best studies indicate that during the sixties and seventies economywide productivity grew more rapidly in import-substituting Latin America than it did in export-oriented East Asia.[18] Latin America's economies expanded at a slower clip than East Asia's not because they experienced slower technological progress but because they invested a lower share of their national income. Latin America has yet to reproduce such rates of productivity gain despite (or perhaps because of) two decades of economic liberalization and rapid integration into the world economy. To their credit, some of the ISI countries, notably Brazil, turned toward world markets during the seventies on the

back of this industrialization. Even where ISI underperformed, it often bequeathed industrial capacities that would later prove very helpful. In India, for example, highly protected firms in pharmaceuticals, auto parts, and basic metals eventually became world-class players, and engineers employed in state-owned electronics companies formed the backbone of many of the IT firms that sprang up in Bangalore, India's answer to Silicon Valley.[19]

ISI acquired its bad reputation in part because it was associated with the debt crisis that engulfed Latin America in 1982. Revisionists viewed the crisis as a byproduct of ISI: an overextended state had produced large fiscal and external imbalances, while the incapacity to generate export revenues had made adjustment to the sudden stop in capital inflows that much more difficult. This oft-repeated narrative has major flaws.

Some of the most ardent champions of ISI managed in fact to avoid getting embroiled in a debt crisis. Think of India. India's policies had a major impact on the locus of economic activity, but they did not wreak havoc on macroeconomic balances—the balance between income and expenditures—or on external finances. And when fiscal expansion in the late 1980s threatened a Latin American–style crisis, Indian policy makers were quick to adjust macropolicies, unlike their Latin American counterparts. There is nothing in ISI that makes a foreign debt crisis more likely.

Outward orientation does nothing to make such crises less likely, either. The Asian financial crisis in 1997 and the Argentinean crisis in 2001–02 took place in economies that had given up on ISI policies—East Asia in the 1960s and Argentina in the 1990s—and, by the time of their crises, were highly open to international trade. Yet openness did little to protect the affected countries from the whiplash they suffered. As we have seen, financial crises have their own dynamic and don't particularly discriminate among countries with different trade strategies.

In Search of a Post–Washington Consensus Consensus

Today, the Washington Consensus is a "damaged brand," as John Williamson conceded as early as 2002.[20] Its disrepute comes not only from the ideological opposition it has engendered from the political left, but, more fundamentally, from its disappointing economic record. In their 1995 article, Sachs and Warner had written that "we find no cases to support the frequent worry that a country might open and yet fail to grow."[21] Even if their claim was true at the time, subsequent evidence clearly contradicted the assertion. The countries in Latin America and elsewhere that jettisoned ISI in favor of the Washington Consensus ended up, for the most part, with considerably lower rates of growth. Considering how misguided ISI policies seem by today's standards, this was quite an embarrassment for the proponents of the Washington Consensus. It would take a lot of explaining to square the disappointing outcomes with the revisionist narrative.[22] Jeffrey Sachs himself soon abandoned any pretense that trade openness alone can yield rapid growth or, for that matter, that it is even a major force. As he spent more time in Africa, he would increasingly focus on domestic constraints on development: low levels of education, poor health standards, dismal agricultural productivity, and inadequate investment in public infrastructure.[23]

The failure of the Washington Consensus left economists with a conundrum. Repudiating the specific reforms on the agenda was not an attractive option. Trade liberalization, deregulation, privatization, and the other reforms still seemed eminently reasonable: they would make poor nations' policies look more like those of the advanced market economies. An explicit rejection of these reforms would have forced economists to abandon some of their most fundamental tenets. The problem with the Washington Consensus had to lie elsewhere.

The rehabilitation took the form of retaining the Washington

Consensus but expanding it to include a wide range of additional reforms. There was nothing wrong with the Washington Consensus itself; it just had not been ambitious enough. The failure showed, the new story line went, that much more profound institutional reforms were needed to ensure the Washington Consensus would produce the advertised results. The actual reforms undertaken have been uneven and incomplete, an IMF report complained in 2005: "More progress was made with measures that had low upfront costs, such as privatization, relative to reforms that promised greater long-term benefits, such as improving macroeconomic and labor market institutions, and strengthening legal and judicial systems."[24] Anne Krueger captured the verdict in the title of a 2004 speech: "Meant Well, Tried Little, Failed Much."[25]

Developing countries had to work harder; so the thinking went. It wasn't enough to slash import tariffs and eliminate barriers to trade; open trade policies had to be underpinned by extensive reforms in public administration, by labor market "flexibility," and by international trade agreements. Macroeconomic stability had to be cemented by reforming fiscal institutions, giving central banks independence, and of course by better politics. Property rights required extensive reforms in governance and legal regimes. Free capital flows added their own long list of regulatory, supervisory, and macroeconomic prerequisites. Policy makers received a veritable laundry list of reforms, many of which required institutional changes that had taken developed countries decades, if not centuries, to accomplish.

The new reforms were called "second-generation reforms," to distinguish them from the earlier, simpler commandments. These would eventually morph into an impossibly broad and ambitious agenda under the general heading of "governance reforms." This open-ended agenda offered little help to policy makers in the developing world. Telling poor countries in Africa or Latin America that they should set their sights on the institutions of the United States or Sweden is like telling them that the only way to develop

is to become developed. This is hardly useful policy advice; but it made for excellent cover when the advice went awry. As one proponent of trade reform would put it: "Of course, openness to trade is not by itself sufficient to promote growth—macroeconomic and political stability *and other policies* are needed as well" (emphasis mine).[26] In the end there is always something that the recipient of the advice can be faulted for not having done properly.

While the World Bank and most development economists focused on augmenting and enlarging the Washington Consensus, other efforts centered on the United Nations took a different tack. The UN Millennium Project, led by Jeffrey Sachs, explicitly rejected the Washington Consensus and recommended large-scale public investments in health and infrastructure for Africa, financed by foreign aid. The UN Millennium Development Goals, a blueprint agreed to by the world's nations in 2000, set concrete targets to be achieved by 2015, including halving extreme poverty (defined as incomes below $1 a day), stopping the spread of HIV/AIDS, and providing universal access to primary education.

In contrast to these holistic approaches encompassing a very long list of reforms, others attempted to come up with a new big fix. The hedgehogs' big idea this time was not trade; it had to be something else. But the reasoning took a similar form: "Poor countries are poor primarily because they lack X: give them X and we will have solved the problem of world poverty." For the Peruvian economist and activist Hernando de Soto, X was formal titles to property. Give poor people a piece of paper which gives them legal ownership rights over their house or their land, he thought, and you will turn them into entrepreneurs and successful capitalists.[27] For the Bangladeshi economist and banker Muhammad Yunus, X was credit. Give each entrepreneur a small loan (a "microcredit"), he argued, and you will unleash a process of growth and development from below.[28] Both of these ideas inspired active movements and found large numbers of practitioners worldwide.

Despite their obvious differences, what all of these strategies

presume is that all developing countries suffer from the same ailments and require broadly similar treatment, and that we know enough about the nature of the remedies to mount a bold, ambitious, and often costly effort to eradicate world poverty. None of this need be true. After all, governmental and international efforts to spur development have failed more often than they have succeeded. A much less confident perspective might posit that we have little clue about what works in different settings or why.

William Easterly, the former World Banker and foreign aid foe, has taken this line of thought to its most extreme form. Trying to force development from above by applying some grand scheme dreamt up in the halls of academe or the corridors of Washington, Easterly would argue, is simply futile.[29] Development experts have nothing useful to tell policy makers, except possibly how to avoid gross errors. The best we can do is ensure that an overconfident and overintrusive state does not stay in the way of development bubbling up from below.

In a world where globalization can just as easily condemn you to dependence on exports of commodities as it fosters rapid growth through industrialization, the wait for development to take place on its own could take a very long time. Easterly's argument counsels despair rather than hope. Fortunately, though, there is a middle way.

Different Strokes for Different Folks

When I visited a Latin American country a few years back, a proud economics minister told me that his government had already completed all the second-generation reforms, and that they were now embarking on "third-generation reforms." The economy had been opened to trade and capital flows, markets deregulated, public enterprises privatized, and macroeconomic imbalances eliminated. The tax regime, banking regulations, social security institutions, fiscal rules, and judicial system had all been reformed in line with "best-practice" standards. Labor markets were as "flexible"—that is, free of regulations—as they come. Yet the economy was barely growing. What was the problem? Was it that all the necessary reforms had not yet been implemented, or was it something more fundamental about the development strategy in place?

The difficulty that this country confronted typifies the shortcomings of the laundry list approach to reform. The agenda presumes that all developing nations suffer from the same problems, and that all of the problems are equally important. It is a ready-made, undifferentiated program that fails to target an economy's most severe bottlenecks. At best, it forces policy makers to spread themselves too thin in pursuit of a very ambitious set of reforms. At worst, it can backfire when otherwise well-intentioned reforms end up aggravating problems elsewhere in the economy.

Once we begin to think in terms of specific bottlenecks and their relative importance, we are in fact on our way to a more effective strategy for growth, one that is based on the fox's more grounded approach. Suppose you have an old clunker of a car that no longer drives. Sprucing it up with new fenders, different headlights, a shinier coat of paint, and a more powerful engine may make it look like a better car. But it is not clear that these improvements will make it go. A far better strategy would be to try to identify the immediate source of the trouble. If the problem is a flat tire, replace the tire and then drive on. If the problem is with the ignition system, then fix the ignition. Eventually, the car will need new headlights and a fresh coat of paint, and possibly even a new engine. But you can get a lot more mileage out of the car, at less cost, if you tackle one problem at a time instead of attempting a long list of renovations suggested by a mechanic who has not even examined the car.

So it is with growth strategies, too. Poor countries suffer from multiple shortcomings, but not all of them need to be addressed at the same time for their economies to enjoy rapid growth for a

while. The trick is to identify the most binding constraints that prevent entrepreneurs from investing in the modern industries and services that fuel economic growth. The most pressing problem could be a shortage of finance. It could be government practices (such as high taxes or corruption) that depress private profits. It could be high inflation or public debt that increases risk. Or it could be learning spillovers associated with infant industries that prevent private entrepreneurs from reaping the full social value of their investments.[30]

Each one of these constraints, as well as an almost endless number of others that might exist, will call for a different approach. For example, if the chief constraint is that trade restrictions have cut off the private sector from imported inputs and technologies, trade opening would clearly be a priority. If, on the other hand, the problem is macroeconomic instability fed by large fiscal deficits, a conventional stabilization program (consisting of government expenditure cuts and tax increases) will do wonders for growth even in the absence of trade opening or large-scale institutional reform. In this instance, cuts in import tariffs may actually make things worse by aggravating the fiscal deficit. Similarly, if the main constraint lies in inadequate entrepreneurial incentives because much of the benefit of investments in technology spills over to other firms, some kind of incentive package for the private sector may be required. Moves toward trade liberalization would threaten to aggravate the underlying problem in this last instance by depressing profitability in industry even further.

These examples illustrate how policies that would normally be desirable in well-functioning advanced market economies can produce perverse effects in the second-best environment of developing nations. International capital flows is an important area where such effects have played out. Leaving aside financial crises for a moment, a large capital inflow is a great idea when the most severe obstacle blocking domestic investment is insufficient credit. But when investment is constrained primarily by low profitability,

which is the situation in many, if not most, emerging economies, a capital inflow aggravates the problem instead of making it better. It makes dollars plentiful and their price low, reducing the competitiveness of domestic industries on global markets.[31] In a second-best world, increasing transaction costs on international finance may make sense.

There are diverse ways in which a particular constraint can be lifted, some more attuned to domestic circumstances than others. If you want to increase the economy's outward orientation, this can be achieved via export subsidies (as in South Korea and Taiwan), via an export-processing zone (as in Mauritius), via Special Economic Zones (as in China)—or via free trade (as in Hong Kong) for that matter. Domestic industries can be promoted through subsidized credit (South Korea), tax incentives (Taiwan), or trade protection (Brazil, Mexico, and Turkey). Property rights can be enhanced by importing and adapting foreign legal codes (as in Japan during the Meiji Restoration) or by developing domestic variants (as in China and Vietnam). Countries need room to experiment with alternative, often unorthodox arrangements. Whether you choose to fix your car's flat tire by replacing it or by patching it up depends on whether you have a spare in the trunk or there is a garage nearby.

Governments do not need to do a whole lot to unleash rapid growth—at least for a while—as long as the little they do lifts the most binding constraints they face. India's remarkable economic performance in recent years provides a perfect example. The mythology around India's economic miracle holds that India took off after a wave of economic liberalization that started in 1991. In fact, India's growth acceleration took place a decade earlier, in the early 1980s, with tentative and relatively minor reforms aimed at reversing the long-held anti-business attitudes of the Indian state. The Congress Party under Indira Gandhi and (after her death in 1984) Rajiv Gandhi began to woo private business and the industrial establishment, in large part to neutralize the perceived politi-

cal threat from the private-sector-oriented Janata Party which had trounced Congress in the 1977 election.[32]

This attitudinal change and concomitant small adjustments on the part of the central government—such as the reduction in some business taxes and the easing of access to imported inputs—had remarkably powerful effects on economic activity. India's growth rate, which many observers had considered immutably fixed, more than doubled, from less than 2 percent (in per capita terms) to closer to 4 percent during the 1980s.[33] Yet few of the obstacles in the standard litany of what holds India back had been removed. Bureaucratic inefficiency and red tape were still a nightmare, trade barriers remained high, and the infrastructure was in very poor shape.

When a country lies so much below its potential, it doesn't require much to unleash economic growth. And so it was with India, which had accumulated some significant strengths during long decades of repression of much private-sector activity. Once India's private sector was unleashed, previous investments in industry and technical education paid off. India would eventually open up its economy; but unlike Latin America it did so cautiously, gradually, and more than a decade after the pickup in growth.

A constraint will cede its place to others once it is successfully lifted. A selective approach therefore requires being ready to address the next set of constraints. It requires flexible policies and willingness to change course as circumstances demand. Countries that have grown in a sustained fashion are those where this strategy has been applied consistently over the longer run. China once again provides the leading example. Chinese policy reformers employed a strategic and sequential approach that targeted one set of supply-side constraints after another. They started out in agriculture in the late seventies, moved to industry in the eighties, then to foreign trade in the nineties, and are now struggling with the finance sector. China's leaders have not yet furnished the complete institutional underpinnings for a modern market economy. Most conspicuously missing are representative political institutions. In the meantime at least they have turned their country from a basket case into a middle-income economy and have lifted half a billion people from extreme poverty.

How ironic and sad, then, that globalization's rules have evolved to make it more difficult, rather than easier, for other countries to emulate the success of countries like Mauritius, South Korea, Taiwan, India, and China. The rules of the WTO, the practices of the IMF, and the recommendations of Western policy advisers have had the collective effect of shrinking the policy space within which similar homegrown, sequential approaches could be devised and implemented—all in the name of spreading the benefits of globalization.

The South African Predicament

Nearly half a century after Meade's visit to Mauritius, a group of colleagues and I were invited by South Africa's finance minister at the time, Trevor Manuel, to provide assistance on the country's growth strategy. Manuel, a former resistance leader, was largely self-taught in economics, but he was so well versed in the economics literature that he could cite my latest papers within days of them being posted online. He knew that South Africa was underperforming relative to other nations and to its own potential.

South Africa in 2005 looked of course very different from Mauritius in 1960. A middle-income country with a fairly diversified economy, it was highly integrated with world markets and had a sophisticated financial sector. But the central challenge South Africa confronted was the same: where would the jobs needed to employ the large surplus of low-skilled workers come from?

South Africa had undergone a remarkable political and economic transformation since its democratic transition in 1994. Following the end of white minority rule, it had managed to avoid

a descent into acrimonious recrimination, endless redistribution, and populism that would have decimated the economy and turned the country into a sham democracy. The African National Congress government had managed to create a stable, peaceful, and racially balanced political regime with an exemplary record of civil liberties and political freedoms. Economic policy had also been prudent and cautious, following the general dictates prevailing during the 1990s. The economy was opened to trade and capital flows. The government pursued cautious fiscal policies. An independent central bank focused on fighting inflation.

If the world were fair, political restraint and economic rectitude of this magnitude would have produced a booming South African economy operating at full employment. Unfortunately, growth had been measly since 1994, at less than 2 percent per year per capita; private investment had remained low; and most important, unemployment had risen to 26 percent. Counting discouraged workers, the unemployment rate stood closer to 40 percent. These are some of the highest unemployment rates ever recorded. As would be expected, unemployment was heavily concentrated among the young, unskilled, and black population.

The economy had not been able to generate enough work at reasonable wages for the large number of job seekers, both new entrants into the labor market and workers released from shrinking sectors (mining and agriculture). The mismatch between a slow rise in labor demand and a rapid rise in labor supply meant one of two things: either wages would fall to rock-bottom levels, or there would be high unemployment. The South African government had chosen unemployment, but had also instituted a relatively generous system of public financial assistance to prop up the living standards of the poor and unemployed.

Going forward, the only way to create well-paying jobs for the unemployed was to significantly expand manufacturing production. Agriculture and mining were unlikely to revive, and service industries such as finance (which had been doing reasonably well) employed mostly skilled workers. This in turn required increasing the profitability of manufacturing in South Africa, which would stimulate private investment in the sector. Ultimately, the solution had to match the one that Meade had advocated for Mauritius.[34]

South Africa had to meet this challenge in a world where the rules of the game were quite different. China's rise as a low-cost exporter had made competing in manufactures much more difficult. South Africa's import tariffs had been slashed and international agreements made it difficult or impossible to raise them significantly. Even though the government subsidized certain manufacturing industries, such as autos, these programs were already pushing the boundaries of WTO law. And the country's independent central bank and liberal regime of capital flows made it impossible to contemplate a devaluation of the currency (the rand) to provide manufactured exports a boost in profitability.

In the end, my colleagues and I recommended an eclectic mix of policies. We advocated a tighter fiscal policy that would leave room for the central bank to reduce interest rates and let the rand depreciate. We proposed a temporary jobs subsidy to reduce the cost to employers of hiring young school-leavers. And we recommended a new approach to industrial policy which we thought would be more effective, more market-friendly, and less likely to be challenged in the WTO.

The traditional approach to industrial policy consists of a list of sectors to be promoted along with a list of instruments for promotion (for example, tariff protection, tax rebates, R&D subsidies, cheap credit, industrial zones). Our approach, by contrast, was process-oriented. It focused on repositioning existing institutions—such as the Department of Trade and Industry or the Industrial Development Corporation—into foci of business-government dialogue. The dialogue would seek to identify bottlenecks and opportunities in industrial activities, few of which could be known beforehand, and to respond quickly and with a variety of policies to the prospects that the dialogue identified.[35]

Would these proposals help? It is difficult to know. No doubt some would fail, and others would need revision before they became fully effective. What matters ultimately is having a government that understands the nature of the challenge and is willing to try different solutions to overcome it. By 2009, South Africa had elected a new president, Jacob Zuma, and installed a new government. Government officials were warning about the risk of deindustrialization and talking about industrial policy as the central plank of South Africa's response to the global financial crisis.[36]

A New Narrative for Development

As early as 1791, Alexander Hamilton had argued that those who believed that modern industries would develop on their own, without support from government, were mistaken.[37] There were too many obstacles, not the least competition from more advanced nations, for these industries to arise spontaneously and naturally in the United States. Hamilton argued equally strongly against those who thought government efforts would necessarily make things worse rather than better. It wasn't a matter of whether the government should intervene, but of how.

Trade fundamentalists overlooked the insights of Hamilton and of countless other economists since. They fundamentally misunderstood the nature of the challenges faced by developing nations. Economic growth and development are possible only through the accumulation of capabilities over time, in areas ranging from skills and technologies to public institutions. Globalization on its own does not generate these capabilities; it simply allows nations to leverage better those that they already possess. That is why the world's successful globalizers—East Asian nations in our times—enhance their domestic productive capacities before they lay themselves bare to the gales of international competition.

That industrial policy, in whatever guise, is once again considered acceptable, and indeed necessary, speaks volumes about how far we have retreated from the trade fundamentalism of the 1990s. But it is too early to declare victory. The precepts of trade fundamentalism remain ingrained in WTO rules and in the practices of other multilateral institutions, as well as in the consciousness of too many technocrats and policy makers.

This reflects in large part the absence of an alternative narrative that has sufficient appeal. The older, second-best tradition of thinking on development strategy, closer to the fox's approach than the hedgehog's, got the essentials right, but it looks worn and jaded. Reinvigorating it requires recalibrating the balance between states and markets while retaining its essence.

out should pay a fee." "But this will make it more costly for us to trade," the fishermen objected. "Yes, indeed," the shaman replied. "But it will also reduce overfishing and make up for the loss in contributions at the feasts. And it won't cut off trade altogether," he added, pointing with his head to the villagers who wanted to block the road.

The villagers agreed that this was a reasonable solution. They walked out of the meeting satisfied. Harmony was restored to the village.

And everyone lived happily ever after.

NOTES

Introduction

1 This article was eventually published in 2009. See Dani Rodrik and Arvind Subramanian, "Why Did Financial Globalization Disappoint?" *IMF Staff Papers*, vol. 56, no. 1 (March 2009), pp. 112–38.

1. Of Markets and States

1 For the early history of what became known as the Hudson's Bay Company, see Beckles Willson, *The Great Company* (Toronto: Copp, Clark Company, 1899).

2 The Garraway's coffeehouse was itself the product of globalization, of course, coffee having made its way from the Near East to Europe during the sixteenth century. Coffeehouses spread like mushrooms in England during the second half of the seventeenth century and became popular gathering places for social and business purposes. See Deborah Hale, "The London Coffee House: A Social Institution" (April 2003), available online at http://www.rakehell.com/article.php?id=206. A fictionalized but highly informative account of the coffee trade during the seventeenth century, centered on Amsterdam, is provided in David Liss, *The Coffee Trader* (New York: Random House, 2003).

3 The online Canadian Encyclopedia is a good source on the voyage of the *Nonsuch* and other information related to Hudson's Bay Company. See http://www.thecanadianencyclopedia.com/index.cfm?PgNm=ArchivedFeatures&Params=A256.

4 The full text of the charter is available at http://www.solon.org/

Constitutions/Canada/English/PreConfederation/hbc_charter_1670.html.

5 Peter C. Newman, *Empire of the Bay: An Illustrated History of the Hudson's Bay Company* (New York: Viking/Madison Press, 1989), p. 39.

6 Converted to 2009 U.S. dollars with help from Lawrence H. Officer, "Five Ways to Compute the Relative Value of a UK Pound Amount, 1830 to Present," MeasuringWorth, 2008. http://www.measuringworth.com/ukcompare/.

7 One percent versus 0.4 percent per annum, respectively. See Kevin H. O'Rourke and Jeffrey G. Williamson, "After Columbus: Explaining Europe's Overseas Trade Boom, 1500–1800," *Journal of Economic History*, vol. 62, no. 2 (June 2002), pp. 417–55.

8 Following Zeng He's famous voyages to East Africa in the early fifteenth century, the Chinese emperors inexplicably banned such intercontinental expeditions.

9 Ronald Findlay and Kevin H. O'Rourke, *Power and Plenty: Trade, War, and the World Economy in the Second Millennium* (Princeton and Oxford: Princeton University Press, 2007), p. 146.

10 This summary of their argument is taken from Eric Williams, *From Columbus to Castro: The History of the Caribbean 1492–1969* (New York: Random House, 1984), pp. 138–39.

11 George Bryce, *The Remarkable History of the Hudson's Bay Company*, 3rd ed. (London: Sampson Low, Marston & Co., 1910), pp. 22–23.

12 Quoted in Newman, *Empire of the Bay*, p. 165.

13 The actual quote is: "This division of labour, from which so many advantages are derived, is not originally the effect of any human wisdom, which foresees and intends that general opulence to which it gives occasion. It is the necessary, though very slow and gradual consequence of a certain propensity in human nature which has in view no such extensive utility; the propensity to truck, barter, and exchange one thing for another"—Adam Smith, *An Enquiry into the Nature and Causes of the Wealth of Nations* (1776), Bk. I, chap. 2.

14 See David R. Cameron, "The Expansion of the Public Economy: A Comparative Analysis," *American Political Science Review*, vol. 72, no. 4 (December 1978), pp. 1243–61.

15 Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: A Global Perspective* (Cambridge: Cambridge University Press, 2000), chap. 1.

16 Dani Rodrik, "Why Do More Open Economies Have Bigger Governments?" *Journal of Political Economy*, vol. 106, no. 5 (October 1998), pp. 997–1032. For an update on these findings, see Giuseppe Bertola and Anna Lo Prete, "Openness, Financial Markets, and Policies: Cross-Country and Dynamic Patterns," Unpublished paper, University of Torino, November 2008.

17 Jeffrey Immelt, "A Consistent Policy on Cleaner Energy," *Financial Times*, June 29, 2005, quoted in Daniel W. Drezner, *All Politics Is Global: Explaining International Regulatory Regimes* (Princeton: Princeton University Press, 2007), p. 44.

18 Some idea about the terms of trade offered to the Indians can be obtained by noting that in one year (1676) the value of merchandise exported from England by the Hudson's Bay Company was a mere £650 compared to £19,000 for the value of the furs imported—Willson, *The Great Company*, p. 215. Even with transport and other costs, this enabled a hefty profit for the company.

2. The Rise and Fall of the First Great Globalization

1 See Kevin H. O'Rourke and Jeffrey G. Williamson, "Once More: When Did Globalisation Begin?" *European Review of Economic History*, 8 (2004), pp. 109–17, for estimates of the growth rate of world trade during different historical eras.

2 John Morley, *The Life of Richard Cobden* (London: T. Fisher Unwin, 1905), p. 711. Quoted in the Wikipedia entry http://en.wikipedia.org/wiki/Cobden-Chevalier_Treaty.

3 The indispensable source on nineteenth-century tariff history is Paul Bairoch, "European Trade Policy, 1815–1914," in Peter Mathias and Sydney Pollard, eds., *The Cambridge Economic History of Europe*, Vol. 8: *The Industrial Economies: The Development of Economic and Social Policies* (Cambridge: Cambridge University Press, 1989), pp. 11–161.

4 Ibid., p. 138.

5 Southern interests had managed to insert a clause in the U.S. Constitution that prohibits the taxation of exports. They had failed to anticipate the "Lerner theorem," posited by the late economist Abba Lerner, which states that import tariffs are identical to export taxes with respect to their economic consequences.

6 Robert O. Keohane, "Associative American Development, 1776–1861: Economic Development and Political Disintegration," in John G. Ruggie, ed., *The Antinomies of Interdependence* (New York: Columbia University Press, 1983), p. 48.

7 One relevant comparison is provided by the experience of Latin America, whose economies remained dependent on large-scale plantation agriculture and authoritarian control mechanisms over the local popu-

25 Johnson and I had often taken stands on the opposite sides of the argument, while remaining friends and respectful of each other's views. Johnson had been critical of my argument that capital controls had helped Malaysia avoid an even worse downturn during the Asian financial crisis. When my skeptical views on financial globalization appeared in the financial press, Johnson was quick with his letters to the editor taking me and my co-author to task for underselling the benefits of free capital flows and for overlooking the "collateral benefits" argument in their favor. These letters, one in *The Economist* and the other in the *Financial Times*, are reproduced on the IMF Web site at http://www.imf.org/external/np/vc/2008/030608.htm and http://www.imf.org/external/np/vc/2008/050108.htm. As late as October 2007, Johnson was reluctant, as the chief economist of the IMF, to recommend stronger financial regulation because he thought it was unclear whether the problems in financial markets required more or *less* regulation. See Transcript of a Press Briefing by Simon Johnson, Economic Counsellor and Director of the IMF's Research Department, on the Analytic Chapters of the World Economic Outlook, Washington, DC, October 10, 2007 (http://www.imf.org/external/np/tr/2007/tr071010.htm).

26 Tim Fernholz, "The Unlikely Revolutionary," *The American Prospect*, online, April 22, 2009 (http://www.prospect.org/cs/articles?article=the_unlikely_revolutionary).

27 A number of good articles and books have recently underscored this point. See in particular Barry Eichengreen, "The Last Temptation of Risk," *The National Interest*, April 30, 2009; John Cassidy, *How Markets Fail: The Logic of Economic Calamities* (New York: Farrar, Straus & Giroux, 2009); and Yves Smith, *ECONned: How Unenlightened Self Interest Undermined Democracy and Corrupted Capitalism* (New York: Palgrave/Macmillan, 2010).

28 In February 2010, the IMF published a little-noticed policy note which contained a remarkable admission. Under certain conditions, the IMF's economists wrote, capital controls are "justified" to deal with capital inflows. So the IMF too has come a long way from its enthusiastic embrace of finance fetishism during the 1990s. Perhaps the foxes are winning after all. See Jonathan D. Ostry, et al., "Capital Inflows: The Role of Controls," IMF Staff Position Note, February 19, 2010.

7. Poor Countries in a Rich World

1 These figures are in 1994 dollars. Here is how they are arrived at. The median "poor" country has a per capita income of $868 and an income share for the top decile of 35 percent. Therefore the average income of a rich person in a poor country is 10 × 868 × 0.35 = $3,039. The median "rich" country has a per capita income of $34,767 and an income share for the bottom decile of 2.7 percent. Therefore the average income of a poor person in a rich society is 10 × 34,767 × 0.027 = $9,387.

2 Angus Maddison, *Growth and Interaction in the World Economy: The Roots of Modernity* (Washington, DC: American Enterprise Institute, 2004), Table 2.

3 Lant Pritchett. "Divergence, Big Time" *Journal of Economic Perspectives*, vol. 11, no. 3 (Summer 1997), pp. 3–17.

4 Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: OECD Development Centre, 2001).

5 Daron Acemoglu, Simon Johnson, and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review*, vol. 91, no. 5 (December 2001), pp. 1369–1401. See also Stanley L. Engerman and Kenneth L. Sokoloff, "Factor Endowments, Institutions and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States," in Stephen Huber, ed., *How Latin America Fell Behind* (Stanford, CA: Stanford University Press, 1997).

6 Şevket Pamuk and Jeffrey G. Williamson, "Ottoman De-Industrialization 1800–1913: Assessing the Shock, Its Impact, and the Response," National Bureau of Economic Research, Working Paper 14763, March 2009.

7 Jeffrey G. Williamson, "Globalization and Under-development in the Pre-Modern Third World," The Luca d'Agliano Lecture, Turin, Italy, March 31, 2006.

8 Oded Galor and Andrew Mountford, "Trading Population for Productivity: Theory and Evidence," *Review of Economic Studies*, vol. 75, no. 4 (October 2008), pp. 1143–1179.

9 I am referring here to manufacturing output levels in per capita terms.

10 Paul Bairoch, "International Industrialization Levels from 1750 to 1980," *Journal of European Economic History*, 11 (Spring 1982), pp. 269–310.

11 The tale of the contrasting paths of Argentina and the United States is told in Alan Beattie, *False Economy: A Surprising Economic History of the World* (New York: Riverhead Books, 2009), chap. 1.

12 Ichirou Inukai and Arlon R. Tussing, "Kogyo Iken: Japan's Ten Year Plan, 1884," *Economic Development and Cultural Change*, vol. 16, no. 1 (October 1967), p. 53.

13 For varying accounts of the role played by the state and private industry in the takeoff of cotton spinning in Japan, see W. Miles Fletcher, "The Japan Spinners Association: Creating Industrial Policy in Meiji Japan,"

Journal of Japanese Studies, vol. 22, no. 1 (Winter 1996), pp. 49–75, and Gary Saxonhouse, "A Tale of Japanese Technological Diffusion in the Meiji Period," *Journal of Economic History*, vol. 34, no. 1 (March 1974), pp. 149–65.

14 *Japan as Number One: Lessons for America*, the title of a bestselling book of the 1980s, captures well the aura of its manufacturing prowess at the time—Ezra F. Vogel, *Japan as Number One: Lessons for America* (Cambridge, MA: Harvard University Press, 1979).

15 The story of Japan's drive to get the World Bank to pay more attention to the Japanese model is told in Robert Wade, "Japan, the World Bank, and the Art of Paradigm Maintenance: *The East Asian Miracle* in Political Perspective," *New Left Review*, 217 (May–June 1996), pp. 3–36.

16 My views on the report were written up in Dani Rodrik, "King Kong Meets Godzilla: The World Bank and the East Asian Miracle," in Albert Fishlow, et al., *Miracle or Design? Lessons from the East Asian Experience*, Overseas Development Council, Policy Essay No. 11, Washington, DC, 1994.

17 My interpretation of these two countries' takeoff is in Dani Rodrik, "Getting Interventions Right: How South Korea and Taiwan Grew Rich," *Economic Policy*, 20 (1995), pp. 55–107. The two best books on the subject remain Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization* (Princeton: Princeton University Press, 1990), and Alice H. Amsden, *Asia's Next Giant: South Korea and Late Industrialization* (New York: Oxford University Press, 1989).

18 See Shaohua Chen and Martin Ravallion, "China Is Poorer Than We Thought, But No Less Successful in the Fight Against Poverty," World Bank, Policy Research Working Paper No. 4621, Washington, DC, May 2008.

19 Sebastian Heilmann, "Policy Experimentation in China's Economic Rise," *Studies in Comparative International Development*, vol. 43, no. 1 (Spring 2008), pp. 1–26.

20 Lawrence J. Lau, Yingyi Qian, and Gerard Roland, "Reform Without Losers: An Interpretation of China's Dual-Track Approach to Transition," *Journal of Political Economy*, vol. 108, no. 1 (February 2000), pp. 120–43.

21 Yingyi Qian, "How Reform Worked in China," in Dani Rodrik, ed., *In Search of Prosperity: Analytic Narratives of Economic Growth* (Princeton: Princeton University Press, 2003).

22 Dani Rodrik, "What's So Special About China's Exports?" *China & World Economy*, vol. 14. no. 5 (September–October 2006), pp. 1–19.

23 John Sutton, "The Auto-Component Supply Chain in China and India: A Benchmarking Study," Unpublished paper, London School of Economics, 2005.

24 Jean-François Huchet characterizes China's policies as of the mid-1990s thus: "China's technological acquisition strategy is clear: It allows foreign firms access to the domestic market in exchange for technology transfer through joint production or joint ventures"—Huchet, "The China Circle and Technological Development in the Chinese Electronics Industry," in Barry Naughton, ed., *The China Circle: Economics and Electronics in the PRC, Taiwan, and Hong Kong* (Washington, DC: Brookings Institution Press, 1997), p. 270.

25 See ibid., and Kenneth L. Kraemer and Jason Dedrick, "Creating a Computer Industry Giant: China's Industrial Policies and Outcomes in the 1990s," Center for Research on Information Technology and Organizations, UC Irvine, 2001.

26 Dic Lo and Thomas M. H. Chan, "Machinery and China's Nexus of Foreign Trade and Economic Growth," *Journal of International Development*, vol. 10, no. 6 (1998), pp. 733–49.

27 See Dani Rodrik, "The Real Exchange Rate and Economic Growth," *Brookings Papers on Economic Activity*, 2 (2008).

28 Josh Lerner, *Boulevard of Broken Dreams: Why Public Efforts to Boost Entrepreneurship and Venture Capital Have Failed—and What to Do About It* (Princeton: Princeton University Press, 2009), p. 42. Lerner documents the role of public funding and military contracts in helping Silicon Valley get started, providing a useful counterweight to the mythology that the high-tech start-ups around Stanford University were the product of free markets alone.

8. Trade Fundamentalism in the Tropics

1 James E. Meade, *The Economic and Social Structure of Mauritius* (London: Methuen & Co., 1961), p. 3.

2 Ibid., p. 26.

3 Arvind Subramanian, *Trade and Trade Policies in Eastern and Southern Africa*, International Monetary Fund, Occasional Paper 196, Washington, DC, 2001.

4 See Arvind Subramanian and Devesh Roy, "Who Can Explain the Mauritian Miracle? Meade, Romer, Sachs, or Rodrik?" in Rodrik, ed., *In Search of Prosperity: Analytic Narratives on Economic Growth*, p. 228. For case studies of partnerships between domestic groups and foreign investors, see R. Lamusse, "Mauritius," in Samuel M. Wangwe, ed., *Exporting Africa: Technology, Trade, and Industrialization in Sub-Saharan Africa*

(London and New York: UNU/INTECH Studies in Technology and Development, Routledge, 1995), chap. 12.

5 There were a few exceptions, of course. Peter T. Bauer was the leading contrarian, arguing for a small state. See Bauer, *Economic Analysis and Policy in Under-developed Countries* (Cambridge: Cambridge University Press, 1957).

6 For John Williamson's own account of how the Washington Consensus was developed and of its evolution over time, see Williamson, "A Short History of the Washington Consensus," Peterson Institute for International Economics, Washington, DC, September 2004, available online at http://www.iie.com/publications/papers/williamson0904-2.pdf.

7 Jeffrey D. Sachs and Andrew M. Warner, "Economic Reform and the Process of Global Integration," *Brookings Papers on Economic Activity*, 1 (1995), pp. 1–95.

8 "We therefore argue against the notion of a low-income 'development trap' since open trade policies (and correlated market policies) are available to even the poorest countries," Sachs and Warner wrote (ibid., p. 52, n. 73).

9 My own critique of the Sachs and Warner study can be found in Francisco Rodríguez and Dani Rodrik, "Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence," in Bernanke and Rogoff, eds., *Macroeconomics Annual 2000*.

10 This interpretation is based on a number of conversations I had with Sachs subsequently.

11 What Sachs and Warner considered "open" policies on import tariffs and quotas were in fact remarkably protective by today's standard—so protective that few countries were classified as "closed" on account of their import tariffs or quantitative restrictions on imports. The real work in the classification was done by two other indicators: the black market premium for foreign currency, a measure of macroeconomic imbalance more than anything else, and an indicator for the presence of state monopoly in exports, the coverage of which was restricted to African countries. See Rodríguez and Rodrik, "Trade Policy and Economic Growth," for details.

12 Anne O. Krueger, "Trade Policy and Economic Development: How We Learn," *American Economic Review*, vol. 87, no. 1 (March 1997), p. 11.

13 So a senior U.S. Treasury economist could admonish the Mexican government to work harder to bring crime levels down, "because such high levels of crime and violence may drive foreign investors away." See Dani Rodrik, "Trading in Illusions," *Foreign Policy* (March–April 2001), p. 55.

14 The paper I was presenting was Rodríguez and Rodrik, "Trade Policy and Economic Growth." Subsequent research by others has shown that tariffs on manufactures or on high-skill products can indeed promote economic growth. See Sybille Lehmann and Kevin H. O'Rourke, "The Structure of Protection and Growth in the Late 19th Century," *Review of Economics and Statistics* (forthcoming); and Nathan Nunn and Daniel Trefler, "The Structure of Tariffs and Long-Term Growth," *American Economic Journal—Macroeconomics* (forthcoming).

15 For example, it was common to argue that East Asian export subsidies simply offset the effects of import protection, resulting in near–free trade conditions. Similarly, price "distortions" in East Asia and elsewhere were rarely directly compared. If they were, it would be obvious that East Asian governments had not been on the side of angels. One of the bibles of the revisionists, a book project undertaken for the OECD, calculated an index of price distortion for a number of countries so as to compare their trade regimes in an objective manner. Among the countries included were Taiwan, the archetypal outward-oriented country, and Mexico, a leading case of inward-looking development. When one looks at the evidence in the OECD study closely, one finds that the average level of intervention in manufacturing seems to have been higher in Taiwan than it was in Mexico. See Ian M. D. Little, Tibor Scitovsky, and Maurice Scott, *Industry and Trade in Some Developing Countries* (London: Oxford University Press, 1970), Table 5.2.

16 When both inputs and outputs are valued at world prices. This is called "producing negative value added."

17 Enrique Cardenas, Jose Antonio Ocampo, and Rosemary Thorp, *An Economic History of Twentieth-Century Latin America*, Vol. 3: *Industrialization and the State in Latin America: The Postwar Years* (London: Palgrave, 2000), p. 16. The post-1990 growth rate comes from the World Bank's World Development Indicators online database.

18 See Barry P. Bosworth and Susan M. Collins, "The Empirics of Growth: An Update," *Brookings Papers on Economic Activity*, 2 (2003), Table 1.

19 Kalpana Kochhar, et al., "India's Pattern of Development: What Happened, What Follows?" *Journal of Monetary Economics*, vol. 53, no. 5 (July 2006), pp. 981–1019.

20 John Williamson, "Did the Washington Consensus Fail?" Outline of Speech at the Center for Strategic and International Studies, Washington, DC, November 6, 2002, online at http://www.iie.com/publications/papers/paper.cfm?ResearchID=488. The term "damaged brand" was used in Moisés Naím, "Washington Consensus: A Damaged Brand," *Financial Times*, October 28, 2002. British prime minister Gordon Brown officially pronounced the death of the Washington Consensus in early 2009.

21 Sachs and Warner, "Economic Reform," p. 44.

22 See Dani Rodrik, "Growth Strategies," in Philippe Aghion and Steven Durlauf, eds., *Handbook of Economic Growth*, Vol. 1A (Amsterdam: North-Holland, 2005).

23 Jeffrey Sachs's more recent worldview is captured in Jeffrey D. Sachs, et al., "Ending Africa's Poverty Trap," *Brookings Papers on Economic Activity*, 1 (2004).

24 Anoop Singh, et al., *Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience Since the Early 1990s*, IMF Occasional Paper, Washington, DC, February 2005, p. xiv.

25 Anne O. Krueger, "Meant Well, Tried Little, Failed Much: Policy Reforms in Emerging Market Economies," Remarks at the Roundtable Lecture at the Economic Honors Society, New York University, New York, March 23, 2004.

26 Arvind Panagariya, "Think Again—International Trade," *Foreign Policy* (November–December 2003).

27 Hernando de Soto, *The Mystery of Capital* (New York: Basic Books, 2000).

28 Muhammad Yunus, *Banker to the Poor: Micro-Lending and the Battle Against World Poverty* (New York: Public Affairs, 2003).

29 William Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (New York: Penguin, 2006).

30 This approach, called "the Growth Diagnostics framework," was developed by Ricardo Hausmann, Andres Velasco, and myself. It was subsequently applied to a large number of different settings. See Hausmann, Rodrik, and Velasco, "Growth Diagnostics," in Joseph Stiglitz and Narcis Serra, eds., *The Washington Consensus Reconsidered: Towards a New Global Governance* (New York: Oxford University Press, 2008). Some of the country applications can be found online at http://ksghome.harvard.edu/~drodrik/Growth_Diagnostics_Index.html.

31 In other words, it leads to overvaluation of the home currency. See Rodrik and Subramanian, "Why Did Financial Globalization Disappoint?" pp. 112–38.

32 Atul Kohli, "Politics of Economic Liberalization in India," *World Development*, vol. 17, no. 3 (1989), pp. 305–28.

33 Dani Rodrik and Arvind Subramanian, "From 'Hindu Growth' to Productivity Surge: The Mystery of the Indian Growth Transition," *IMF Staff Papers*, vol. 52, no. 2 (2005).

34 The project was led by my Harvard colleague Ricardo Hausmann. For background and discussion on South Africa's problems, see Dani Rodrik, "Understanding South Africa's Economic Puzzles," *Economics of Transition*, vol. 16, no. 4 (2008), pp. 769–97. The full set of papers prepared for this project can be found in http://www.cid.harvard.edu/southafrica/.

35 For further elaboration, see Ricardo Hausmann, Dani Rodrik, and Charles F. Sabel, "Reconfiguring Industrial Policy: A Framework with an Application to South Africa," Center for International Development, Working Paper No. 168, Harvard University, May 2008. We may have exaggerated the novelty of our ideas. Meade himself was quite clear about the importance of the government–private-sector dialogue. The Industrial Development Corporation that he recommended was designed in part to stimulate the kind of strategic collaboration we had in mind for South Africa—See Meade, *The Economic and Social Structure of Mauritius*, p. 30.

36 See the speech by Rob Davies, minister of trade and industry, Budget Vote Address in Parliament delivered in Cape Town on June 30, 2009; available online at http://www.politicsweb.co.za/politicsweb/view/politicsweb/en/page71656?oid=134655&sn=Detail.

37 Alexander Hamilton, *Report on Manufactures*, Communication to the House of Representatives, December 5, 1791.

9. The Political Trilemma of the World Economy

1 See the interview with Domingo Cavallo at http://www.pbs.org/wgbh/commandingheights/shared/pdf/int_domingocavallo.pdf.

2 This account draws on Dani Rodrik, "Reform in Argentina, Take Two: Trade Rout," *The New Republic*, January 14, 2002, pp. 13–15.

3 Cavallo would later argue that the true culprit was loose fiscal policy in the years preceding the crisis. See the interview cited in note 1. From a narrow economic perspective, he may well be right. With enough fiscal austerity, price deflation, and belt-tightening, the Argentine economy would have been able to service external debts and maintain financial market confidence. The question is whether this is a sensible way to run an economy. Is it reasonable, or even desirable, to expect that the political system will deliver these drastic measures when needed (that is, when times are already tough) just to satisfy foreign creditors?

4 Thomas L. Friedman, *The Lexus and the Olive Tree* (New York: Anchor Books, 2000), pp. 104–06.

5 In a famous decision issued in 1905 (*Lochner v. New York*), the U.S. Supreme Court struck down a New York State law restricting the maximum hours of work for bakery employees. The New York statute was