The Globalization Paradox

WHY GLOBAL MARKETS, STATES, and DEMOCRACY CAN'T COEXIST

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Author of ONE ECONOMICS, MANY RECIPES

The Globalization Paradox

Also by Dani Rodrik

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

Has Globalization Gone Too Far?

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Why Global Markets, States, and Democracy Can't Coexist

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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

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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 Continental 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.