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GLOBALIZATION, SOCIAL CONFLICT AND ECONOMIC GROWTH

By

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The Raúl Prebisch Lectures were instituted in 1982 by Mr. Gamani Corea, the then Secretary-General of UNCTAD, to honour Dr. Raúl Prebisch, UNCTAD's founding father and first Secretary-General.

1st lecture, 1982:	Dr. Raúl Prebisch
2nd lecture, 1983:	Mrs. Indira Gandhi, Prime Minister of India, during UNCTAD VI in Belgrade
3rd lecture, 1987:	Dr. Saburo Okita, Japan, during UNCTAD VII in Geneva
4th lecture, 1989:	Academician Abel G. Aganbegyan, a principal economic adviser of the former USSR, on the occasion of the 25th anniversary of UNCTAD in Geneva
5th lecture, 1992:	Delivered jointly by Dr. Bernard T. Chidzero, Senior Minister of Finance, Economic Planning and Development of Zimbabwe; Mr. Mischel Rocard, former Prime Minister of France; And Mr. Enrique Ilesias, President of the Inter-American Development bank, during UNCTAD VIII in Cartagena de Indias
6th lecture, 1994:	Professor John H. Dunning, Professor of International Business at the State University of New Jersey, on the occasion of UNCTAD's thirthieth anniversary, in Geneva
7th lecture, 1996:	Professor Jagdish Bhagwati, Arthur Lehman Professor of economics at Columbia University, New York, during UNCTAD IX in Midrand, South Africa

CONTENTS

Welcoming address by Mr. Rubens Ricupero
Secretary-General of UNCTAD

It is a great pleasure for me today to introduce Professor Dani Rodrik. I have been familiar with the thought and work of Professor Rodrik without knowing him personally, for some time, having read with great admiration and great profit his last book *Has Globalization Gone Too Far?* So it is a personal pleasure for me to welcome him back to UNCTAD. As you know, for some time in the past, I think for two years, he worked here, and he still keeps strong ties with our organisation.

This morning, Professor Rodrik is here to deliver the eighth Raúl Prebisch Lecture. Raúl Prebisch was the founding father of UNCTAD, a distinguished Argentinian economist who was more influential than anyone else in terms of shaping the thinking about economic development, not only in Latin America but also elsewhere in the world. He is also someone who, like UNCTAD, suffers from the defect of very frequently being misjudged, or judged only on the basis of a partial and superficial knowledge of his work. So, in trying to pay the homage that his memory deserves, we plan to make the Prebisch Lecture a regular feature of UNCTAD's activities. As part of this plan, we intend to publish all the texts of the Prebisch lectures, starting with today's text, to ensure wide circulation.

I would like to introduce to you the members of this podium. They are the President of UNCTAD IX, Mr. Alec Erwin, Minister of Trade and Industry of South Africa, M. Georges Queloz, Vice-President of the Conseil municipal de la Ville de Genève, Mr. Carlos Fortin, Deputy Secretary-General of UNCTAD, Professor Rodrik, and our very good friend, Mr. Yves Berthelot, who was for many years the Deputy Secretary-General at UNCTAD, and is now Executive Secretary of the United Nations' regional Economic Commission for Europe. He is also representing the Director-General of the Geneva Office of the United Nations, Mr. Vladimir Petrovsky, who is presently in New York.

Professor Dani Rodrik is Professor of International Political Economy at the John F. Kennedy School of Government, Harvard University. He is also a research associate of the National Bureau of Economic Research, research fellow of the Centre for Economic Policy Research in London, advisory committee member of the Institute for International Economics in Washington, programme associate of the Overseas Development Council, and advisory committee member of the Economic Research Forum for the Arab Countries, Iran and Turkey. He was previously professor of economics and international affairs at Columbia University, New York. He is joint editor of the *Journal of Policy Reform*, and an associate editor of *Journal of Economic Perspectives, Journal of Development Economics, European Economic Review, Review of Economics and Statistics*, and *Economics and Politics*. He has been the recipient of an NBER Olin Fellowship, a Hoover Institution National Fellowship, and a World Bank McNamara Fellowship. He has consulted for several international organizations and governments. He holds a Ph.D. in economics and an MBA from Princeton University, and an A.B.(summa cum laude) from Harvard University.

Professor Rodrik's research interests cover international economics, economic development and political economy. He has published widely on issues related to trade policy and economic reform in developing and transitional economies. His papers have appeared in many important journals on economics. His 1997 book *Has Globalization Gone Too Far?* was called "one of the most important economics books of the decade" in Business Week. He is also the co-author of Eastern Europe and the Soviet Union in the World Economy and co-editor of The Economics of Middle East Peace (1993). His most recent research is concerned with the consequences of international economic integration, the role of conflict-management institutions in determining economic performance, and the political economy of policy reform. He gave the Alfred Marshall Lecture of the European Economic Association in August 1996.

Professor Rodrik was born in Istanbul, Turkey, in 1957, and is a national of Turkey. He lives in Newton, Massachusetts.

The title of his lecture this morning is *"Globalization, Social Conflict and Economic Growth".* I welcome Professor Dani Rodrik and invite him to take the floor.

GLOBALIZATION, SOCIAL CONFLICT AND ECONOMIC GROWTH

INTRODUCTION

Let me begin with a confession: until about a month ago, when I began to prepare for this lecture, I had not read any of Raul Prebisch's writings. I was, of course, familiar with many of Prebisch's ideas-his intellectual leadership at ECLA and UNCTAD, the so-called Prebisch-Singer thesis on the deterioration of the terms of trade for primary products, and his advocacy of import protection as a way of speeding up industrialization. But like most development economists of my generation, I knew Prebisch second-hand and mostly as a label associated with a particular type of development strategy.

It is no secret that this development strategy--import substituting industrialization (ISI)--has now been out of favour for a while. By the late 1970s, neoclassical economists were pretty unanimous in their condemnation of the ISI strategy. And, about a decade later, policy makers all over the developing world had converged on the same verdict. Prebisch's name has become tainted by association with an apparently failed development strategy. Today's conventional wisdom reverses the logic of Prebisch's argument: those developing countries that took Prebisch's advice and withdrew from the world economy, the new consensus goes, eventually floundered, while those that embraced trade prospered beyond expectations.

Anyone who has read Prebisch more closely-and I am now happy to include myself in this company-would object that the usual characterization of Prebisch as an advocate of protection ignores a lot of subtleties. Prebisch did not favour indiscriminate protection. He anticipated his later critics by recognizing that trade protection on its own would not lead to increased productivity in manufactures, and that it might even resuit in the opposite[1])

But my difficulty with the conventional wisdom, as I just stated it, goes beyond the details. I believe the development community has internalized the wrong lessons from the experience of countries that adopted the ISI strategy in Latin America and elsewhere. The correct interpretation, I think, goes something like this.

- First, ISI worked rather well for a period of about two decades. It brought unprecedented economic growth to scores of countries in Latin America, the Middle East, and North Africa, and even to some in sub-Saharan Africa.

- Second, when the economies of these same countries began to fail apart in the second half of the 1970s, the reasons had very little to do with ISI policies *per se* or the extent of government interventions. Countries that weathered the storm were those in which governments undertook the appropriate <u>macro</u>economic adjustments (in the areas of fiscal, monetary and exchange-rate policy) rapidly and decisively.

- Third, and more fundamentally, success in adopting these macroeconomic adjustments was linked to deeper social determinants. It was the ability to manage the domestic social conflicts triggered by the turbulance of the world economy during the 1970s that made the difference between continued growth and economic collapse. Countries with deeper social divisions and weaker institutions of conflict management experienced greater economic deterioration in response to the external shocks of the 1970s.

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[1] He wrote***: "But protection by itself does not increase productivity. On the contrary, if excessive, it tends to weaken the incentive to produce"*** (Prebisch 1959, 259).

Each of these points has considerable empirical support, as we shall see. Taken together, they provide an interpretation of recent economic history that is at odds with much current thinking. By emphasizing the importance of social conflicts and institutions-at the expense of trade strategy and industrial policies-they also suggest quite a different perspective on development policy.

One of the implications is worth mentioning at the outset. If I am right, the main difference between Latin America, say, and East Asia was not that the former remained closed and isolated while the latter integrated itself with the world economy. The main difference was that the former did a much worse job of dealing with the turbulence emanating from the world economy. It is not openness '***per se***' that matters; it is how well you handle it.

Some numbers

We have reliable and comparable data on per capita GDP for most developing countries only since 1960. So I take the period 1960-1975 as the golden era of post-war growth. As Table 1 shows, more than 50 countries experienced growth of 3 per cent or more in GDP per capita during this period. The list includes the East Asian tigers, of course, but also ten countries in Central or South America (Barbados, Brazil, Panama, Ecuador, Dominican Republic, Mexico, Jamaica, Bolivia, Nicaragua, Costa Rica), seven in the Middle East and North Africa (Syria, Israel, Iran, Morocco, Tunisia, Turkey, Egypt), and even nine in sub-Saharan Africa (Gabon, Botswana, Lesotho, Swaziland, Nigeria, Togo, South Africa, United Republic of Tanzania, Côte d'Ivoire). The fastest growing country prior to 1975 is not Singapore or Republic of Korea, but Gabon! Botswana's growth rate in 1960-75 exceeds that of Hong Kong and Taiwan, Province of China.

Table 1: Per capita GDP Growth

Country/ Territory	1960-1975	1975-1989	Country/ Territory	1960-1975	1975-1989
Gabon	7.87%	-3.40%	Ireland	4.02%	2.70%
Singapore	7.40%	5.10%	Finland	3.99%	2.73%
Japan	7.05%	3.53%	**Thailand**	3.94%	4.72%
Rep. of Korea	6.47%	7.00%	Italy	3.89%	2.80%
Botswana	6.16%	6.17%	Turkey	3.85%	1.23%
Greece	6.15%	1.73%	Iceland	3.80%	2.54%
Hong Kong	6.12%	6.61%	Belgium	3.78%	2.08%
Lesotho	6.00%	2.15%	Norway	3.76%	2.77%
Taiwan, Prov. of China	5.86%	6.57%	France	3.73%	1.90%
Portugal	5.68%	2.59%	Austria	3.71 %	2.29%
Spain	5.66%	1.64%	Domncan Rep.	3.56%	1.14%
Spian Arab Rep.	5.61 %	0.30%	Canada	3.52%	2.57%
Malta	5.46%	5.39%	Togo	3.49%	0.22%
Yugoslavia	5.42%	1.04%	Netherlands	3.48%	1.35%
Israel	4.98%	1.25%	South Africa	3.39%	-0.39%
Swaziland	4.76%	-0.86%	Mexico	3.37%	0.76%
Barbados	4.60%	2.57%	Tanzania	3.37%	n.a.
Iran, Islamic Rep .	4.59%	-3.60%	Côte d'Ivoire	3.30%	-1.56%
Brazil	4.57%	1.27%	Jamaica	3.23%	-1.35%
Morocco	4.27%	2.20%	Bolivia	3.19%	, -0.77%
Malaysia	4.26%	3.82%	Nicaragua	3.11%	n.a.
Nigeria	4.15%	-2.41%	Costa Rica	3.05%	0.82%
Tunisia	4.14%	2.25%	Sweden	3.05%	1.45%
Panama	4.13%	-0.38%	Egypt	3.04%	2.93%
Ecuador	4.04%	0.48%	Papua New Guinea	3.02%	-1.27%

***Source*:** Penn World Tables. Only the nine countries (in bold face) had growth rates exceeding 3 per cent in 1960-75, and also in 1975-1980.

Table 1 also shows, however, that very few countries sustained their high growth rates after 1975. Of the 50 countries in the table with growth rates exceeding 3 per cent in 1960-75, only nin repeated the performance after 1975-leven countries in East and Southeast Asia, plus Botswana and Malta. Why did growth collapse in so many countries?

The question can be approached from a different angle, by looking at comparative evidence on productivity growth. Table 2, taken from Collins and Bosworth (1996), shows productivity performance in various regions during three periods: 1960-73, 1973-84, and 1984-94. Productivity is measured by total factor productivity growth, TFPG. Look first at the figures for 1960-73, which contain a striking finding. During this period both Latin America and the Middle East appear to have experienced higher rates of TFPG than East Asia. Annual average growth rates of total factor productivity during 1960-73 are 2.3 per cent and 1.8 per cent in the Middle East and Latin America, respectively, compared to 1.3 per cent in East Asia. The East Asian performance starts to look truly superlative only after 1973, when Latin America and the Middle East began to undergo regress in total factor productivity (as did sub-Saharan Africa).

Table 2: Economic performance by period and region
(annual average growth rates, in percentages)

	1960-1973		1973-1984		1984-1994	
	GDP per worker	TFP	GDP per worker	TFP	GDP per worker	TFP
East Asia (excluding China	4.2	1.3	4.0	0.5	4.4	1.6
Lat America	3.4	1.8	0.4	-1.1	0.1	-0.4
Middle East	4.7	2.3	0.5	-2.2	-1.1	-1.5
South Asia	1.8	0.1	2.5	1.2	2.7	1.5
Africa	1.9	0.3	-0.6	-2.0	-0.6	-0.4
Non-U.S. industrial Countries	4.8	2.2	1.8	0.2	1.7	0.7
U.S.	1.9	0.8	0.2	0. -5	0.9	0.7

Source : Collins and Bosworth (1996).

The moral from these two tables is the following. Had the world come to an end sometime during the mid-1970s, ISI would not have had ended up with such a bad reputation, and the East Asian "miracle" would not occupy the central place in development thinking it occupies today. The puzzle is why so many economies that seemed to be doing well took the express train to hell after 1975.

Now, it is true that most of the countries that had embarked on ISI strategies in the 1960s became the casualties of the debt crisis and related macro syndromes. This is what makes the association between ISI strategies and growth collapses (the latter eventually being transformed into "low growth", once memories of the high growth period began to fade) plausible and compelling on the face of it. But there are severe problems with this interpretation. At a conceptual level, I have never seen a good argument about why a set of **microeconomic** policies, which the ISI policies were, should be necessarily and systematically associated with **macroeconomic** disequilibrium, which is what the debt crisis represented (see the discussion in Rodrik 1996). In any case, it is clear that there was nothing preordained about the debt crisis: some of the countries that adhered most rigidly to ISI policies-India being a chief example-were able to avoid protracted debt crises. As Table 2 shows, the only region of the world that experienced a significant rise in TFPG after 1973 was, in fact, South Asia (i.e., Bangladesh, India, Myanmar, Pakistan, and Sri Lanka), which is not exactly the region that comes to mind when one mentions "outward orientation".

Table 3: Determinations of the Debt Crisis, 1982

	Large external shock	Failure to adjust monetary and fiscal policy	Index of relative-price distortion
Troubled Countries			
Argentina	No	Yes	0.3054
Brazil	Yes	Yes	0.2019
Chile	Yes	Yes	0.4460
Costa Rica	No	Yes	0.2818
Cote d'ivoire	Yes	Yes	0.2438
Mexico	No	Yes	n.a.
Morocco	No	Yes	0.2675
Nigeria	No	Yes	0.2306
Unweighted Average			0.824
Moderately Troubled Countries			
Colombia	No	Yes	0.2744
Kenia	Yes	Yes	0.1218
Sri Lanka	Yes	No	0.8606
Unweighted Average			0.4189
Untroubled Countries			
Cameroon	Yes	No	0.2344
India	No	No	0.2620
Indonesia	No	No	0.4503
Republic of Korea	Yes	No	0.2128
Pakistan	No	No	0.3814
Thailand	Yes	No	n.a.
Turkey	No	No	n.a.
Unweighted Average			0.3082

Source: Little et al. (1993), Table 4.4, except for the relative-price distortion index which is taken from Easterly (1993). The latter indexis the variance of the log input prices (relative to US prices) across commodities, measured in 1980. See Easterly (1993) for the method of calculation and the justification for the index.

The point is made somewhat more systematically in Table 3, taken from Rodrik (1996) and based on information from Little et al. (1993) and Easterly (1993). The table evaluates the relevance of three types of potential explanations for whether a country succumbed to the 1982 debt crisis or not: (a) the presence of a significant external shock; (b) the quality of monetary and fiscal policies; and (c) the extent of microeconomic policy distortions. The results point unambiguously to macroeconomic policies as the chief culprit. All the countries that Little et al. (1993) classify as having been "troubled" are also classified as cases of "failure to adjust monetary and fiscal policy". None of the "untroubled" countries are similarly classified. With regard to price distortions, these were on average no higher (in fact somewhat lower) in the "troubled" countries than in the "untroubled" countries. Likewise, there is no clear-cut pattern where external shocks are concerned.

The bottom line is easily summarized. In those countries that experienced a debt crisis, the crisis was the product of monetary and fiscal policies that were incompatible with sustainable external balances; there was too little expenditure reducing and expenditure switching. Trade and industrial policies had very little to do with bringing the crisis on.

The deeper determinants

We have now pushed the puzzle one level deeper. Why did governments in some countries do the obvious thing of adjusting macroeconomic policies and devaluing their currency in a timely fashion while governments elsewhere did not?

Consider the experiences of three countries, all three of which were hit by sizeable terms-of-trade shocks during the mid- to late 1970s: the Republic of Korea, Turkey, and Brazil. Among them, the Republic of Korea suffered the greatest external shock, since trade constitutes a much larger share of national income there and the income loss associated with a rise in the price of imported oil was correspondingly larger in the Republic of Korea than in Brazil or Turkey. Yet the Republic of Korea grew even faster after 1975, while Turkey and Brazil both experienced an economic collapse.

At one level, there is no great mystery about these differing experiences. The Government of the Republic of Korea undertook a textbook adjustment in 1980 as soon as signs of a payments imbalance appeared. There was a devaluation, tightening of monetary policy, and a programme aimed at increasing energy efficiency in the economy. The result was a single year with moderate inflation and recession, and resumed growth thereafter (see Aghevli and Marquez-Ruarte 1985).

The Turkish response was quite different. A populist government reacted to the growing current-account deficit in the mid-1970s by going on an unsustainable external borrowing binge. Once foreign bank loans dried up in 1977-78 as a result of concerns about repayment capacity, fiscal and exchange-rate adjustments were delayed. Between 1978 and 1980, inflation rose and the economy went into a tailspin. Some semblance of macroeconomic balance was restored in 1980, but at the cost of huge distributional consequences brought about by changes in key relative prices (the real exchange rate, real wages, and the rural-urban terms of trade). These relative-price changes had the effect of transferring income from farmers and workers to the public sector (see Celasun and Rodrik 1989). They were greatly facilitated by military rule during 1980-83. These distributional shifts have in turn created a legacy of macroeconomic cycles in Turkey, with real wages going through periods of recovery followed by bust. Largely due to this legacy of instability, inflation has remained high since the early 1980s, and the Turkish economy has underperfomed relative to its potential.

In Brazil, widespread indexation prevented an adjustment in relative prices of the kind that eventually took place in Turkey. Even without formal indexation, strategic interaction among social groups resulting in wage-price rigidities appears to have made orthodox adjustment policies of demand restraint extremely costly in terms of output (Simonsen 1988). Consequently, fiscal and monetary restraint was tried only half-heartedly. The result was a succession of high-inflation plateaus: inflation jumped from 50 per cent per year to 100 per cent in 1979, 200 per cent in 1983, 400 per cent in 1987, 1,000 per cent in 1988, and more than 2,000 per cent in 1990. Each failed stabilization resulted in higher inflation rates than previously, until the "Real plan" Of 1994 finally brought price stabilit.

These country stories underscore the importance of the manner in which different societies react to external shocks. In the Republic of Korea, adjustment was swift and somehow non-politicized. In Turkey, adjustment was delayed and when it eventually took place it was undertaken in a manner that imposed disproportionate costs on certain segments of society, undercutting the sustainability of macro balances in the longer run. In Brazil, strategic competition among different social groups gave prices a life of their own and rendered traditional remedies for excess demand costly and ineffective.

In short, social conflicts and their management -whether successful or not-played a key role in transmitting the effects of external shocks on to economic performance. I believe that this is a key insight about economic performance and the manner in which the global economy impinges on it. Societies that benefit the most from integration with the world economy are those that have the complementary institutions at home that manage and contain the conflicts that economic interdependence triggers.

Let me make this idea a bit more precise and empirical by drawing on one of my recent papers (Rodrik 1997). 1 argue in this paper that in societies where there are deep social cleavages. and the institutions of conflict management are weak, the economic costs of exogenous shocks--such as deteriorations in the terms of trade--are magnified by the distributional conflicts that are triggered. Such conflicts diminish the productivity with which a society's resources are utilized in a number of ways: by delaying needed adjustments in fiscal policies and key relative prices (such as the real exchange rate or real wages) and by diverting activities from the productive and entrepreneurial spheres to the political sphere. Heuristically, the idea can be summarized by the following formula:

$$?\text{growth} = -\text{ external shocks} \times \frac{\text{latent social conflict}}{\text{institutions of conflict management}}$$

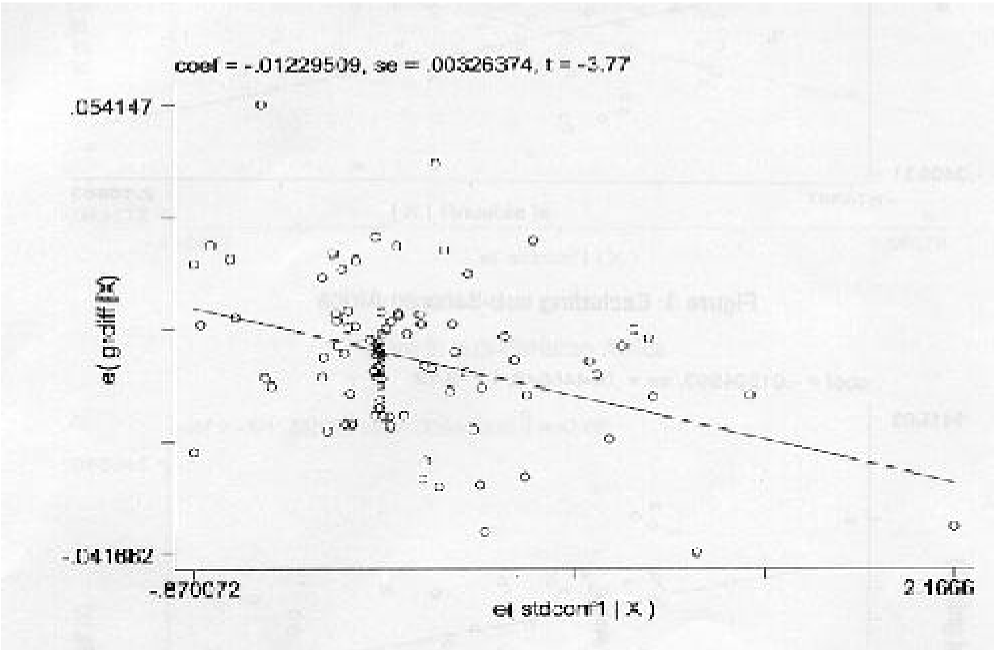
The effect of shocks on growth is larger the greater the latent social conflict in an economy and the weaker its institutions of conflict management.

The next step is to quantify this formula. In the paper I just mentioned, I use various proxies for the terms on the right-hand side of the equation. External shocks are measured by the income effects of the volatility of the external terms of trade. I proxy for "latent social conflict" by using measures of inequality, ethnic and linguistic fragmentation, and social (dis)trust. I proxy "institutions of conflict management" by using measures of democracy, quality of governmental institutions, and public spending on social insurance.

Let me focus here on one combination of proxies, which I call conflictl. This synthetic indicator is constructed in the spirit of the equation above, by multiplying three terms: (i) my measure of external shocks; (ii) an index of ethnic and linguistic fragmentation, to capture latent conflicts; and (iii) the inverse of an index of democracy, to capture the role of institutions (sources for all the data and methods of construction are discussed in Rodrik 1997). The result is then transformed into a standardized variable, so that a unit change in *conflict1*corresponds to a single standard deviation.

The figure 1 summarizes the main finding for a sample of 92 countries. The difference in growth rates between 1975-1989 and 1960-1975 is shown on the vertical axis, the while *conflict1* is the horizontal axis. (In both cases, the influence of other possible determinants of growth differentials has been partialed out.[2]). As the figure shows, there is quite a tight relationship between how high a country ranks on *conflict1and the* extent of growth collapse after 1975 (the t-statistic is –3.77). The estimated slope coefficient indicates that a one standard-deviation increase in *conflict1* is associated with a growth reduction of 1.2 percentage points. Hence our measure of (externally induced) social conflict does a very good job of discriminating between countries that managed to hold together after the mid-1970s and those that fell apart.

Figure 1: Social conflict and growth collapse



The next set of charts explores the same theme with a number of variations, to demonstrate that this result is not a fluke. Figure 2 excludes the richer countries from the sample, with the result that the slope coefficient increases in absolute value from –1.2 to –1.4 (and remains highly significant). Figure 3 excludes sub Saharan African countries to see if a few African countries with extreme values are driving the result: answer is decidedly no, since the estimated coefficient and its level of statistical significance are barely affected. Figure 4 and 5 show that the strong negative relationship hold in samples restricted to Latin American and sub-Saharan African countries, respectively.

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[2] The basic regression is one where the growth differential is regressed on a set of regional dummies for Latin America, East Asia, and sub-Saharan Africa as well as growth during 1960-1975 (the letter to account for convergence effects). The results are robust to the inclusion of other right-hand side variables. In particular, nothing changes if per capita GDP in 1975 is substituted for growth during 1960-1975 (see Rodrik 1997).

Figure 2: Countries with 1975 GDP per capita, $5000 (in 1985 dollars)

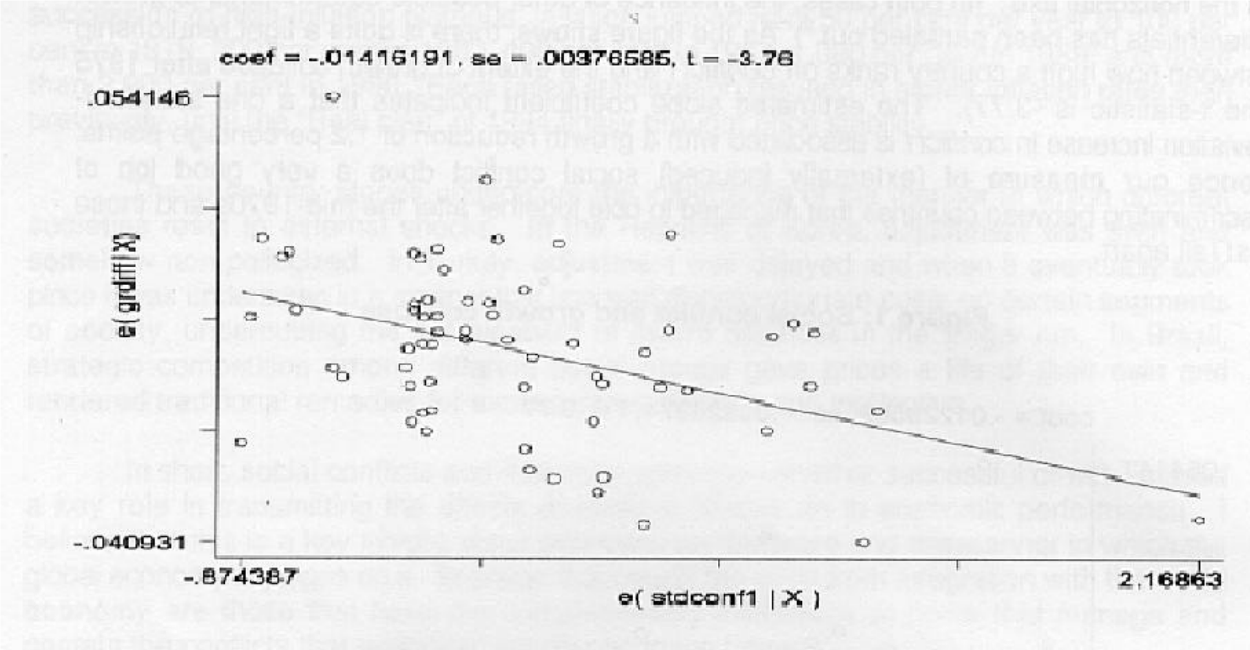


Figure 3: Excluding sub-Saharan Africa

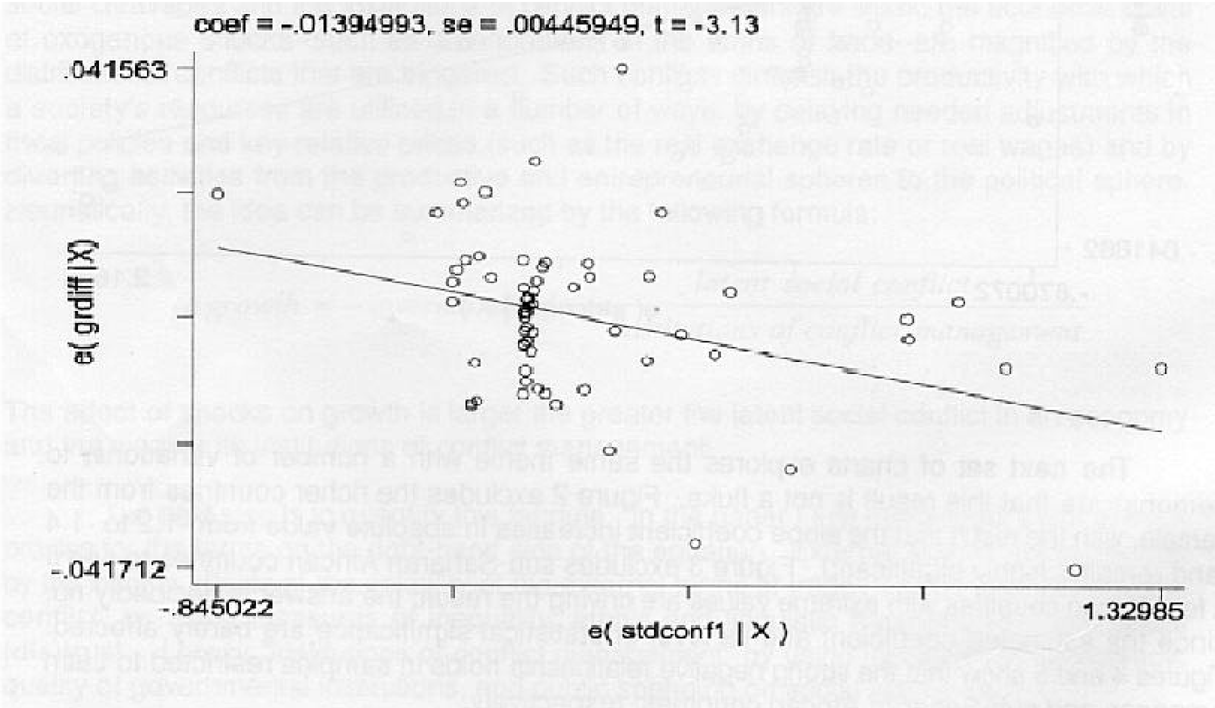


Figure 4: Latin America

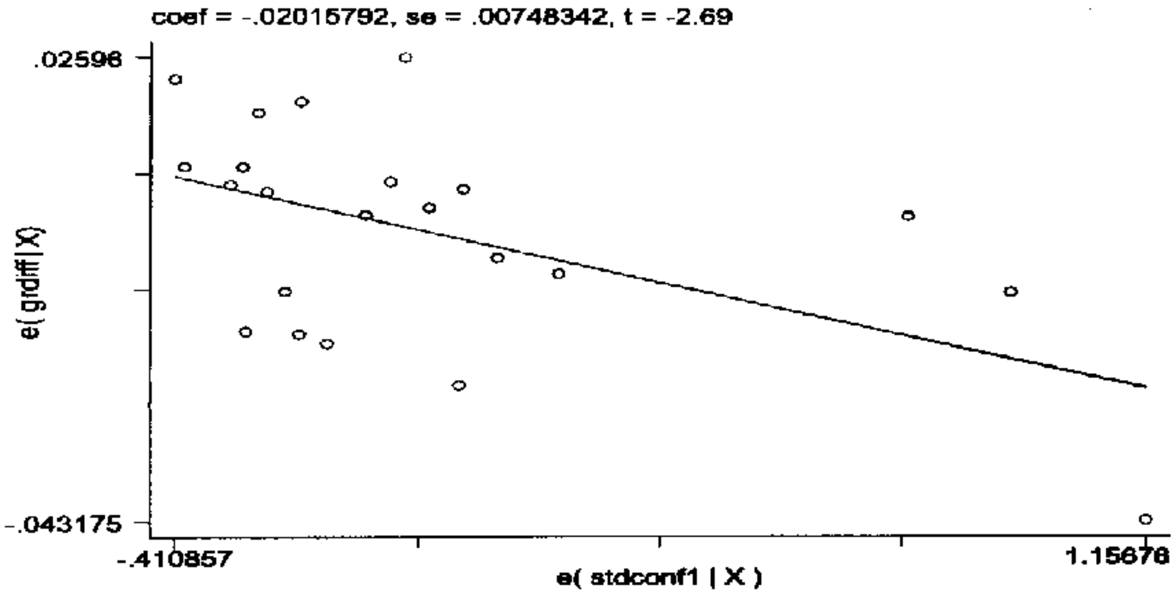
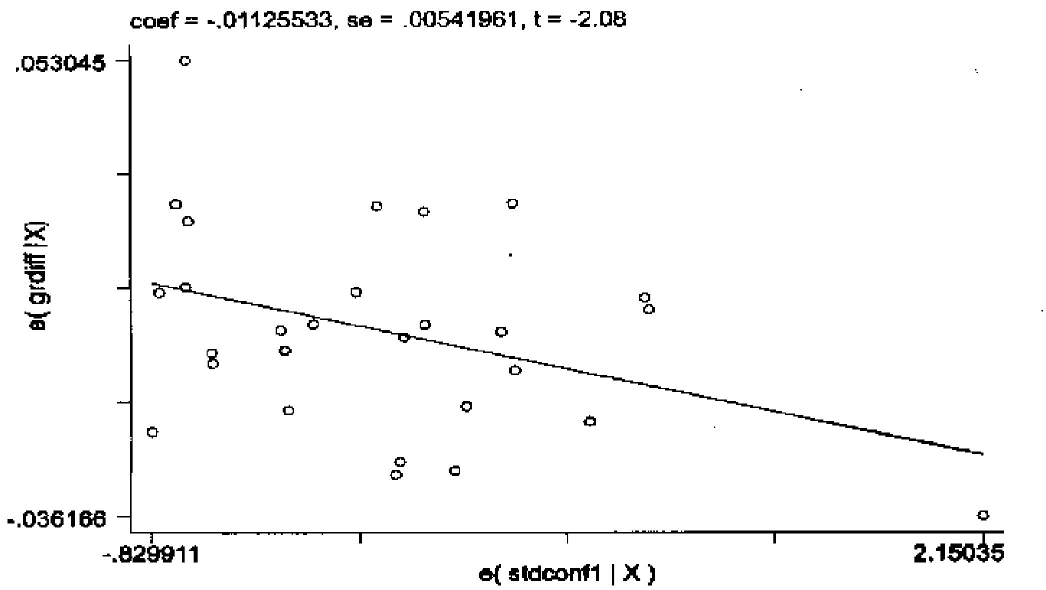


Figure 5: sub-Saharan Africa



Finally, in figure 6, I use a different measure of social conflict *(conflict3)*, which departs from the previous one in to respects: income inequality during the 1970s is substituted for ethnolinguistic fragmentation and an index of the quality of governmental institutions is substituted for democracy. Once again, we discover a tight relationship between our measure and growth differentials, although the estimated slope coefficient is somewhat smaller at –0.7

The bottom line is that this broader respective contributes substantially to an understanding of growth collapse that was the common fate of so many countries after the 1970s. Countries that experienced the sharpest drop in GDP growth after 1975 were those with divided societies and weaks institutions of conflict management. The severity of the external shocks themselves is distinctly secondary as a determinant of cross-country differences in growth across periods.

Furthermore, once latent social conflict and the quality of conflict management institutions are taken into account, we find the various measures of the government policy at the out set of the crisis, such as openness to trade or the size of the public sector, contribute practically nothing to explaining economic performance after 1975 (relative to the earlier period). This is shown in Figures 7-9. Each of these figures depicts the <u>additional</u> explanatory power of a specific candidate explanation for the growth collapse, after social conflict is controlled (by including conflict1 in the regression). The three candidates shown are government consumption levels in 1975 (Figure 7), openness to trade (measured by the share of trade in GDP in 1970-1974, Figure 8), and the debt-exports ratio in 1975 (Figure 9). In one of these cases is there a statistically significant (partial) association with the growth collapse after 1975. By contrast, the estimated coefficient on *conflict1* is robust to the inclusion of these additional variables on the right-hand side.

Figure 6: Using an alternative measure of social conflict

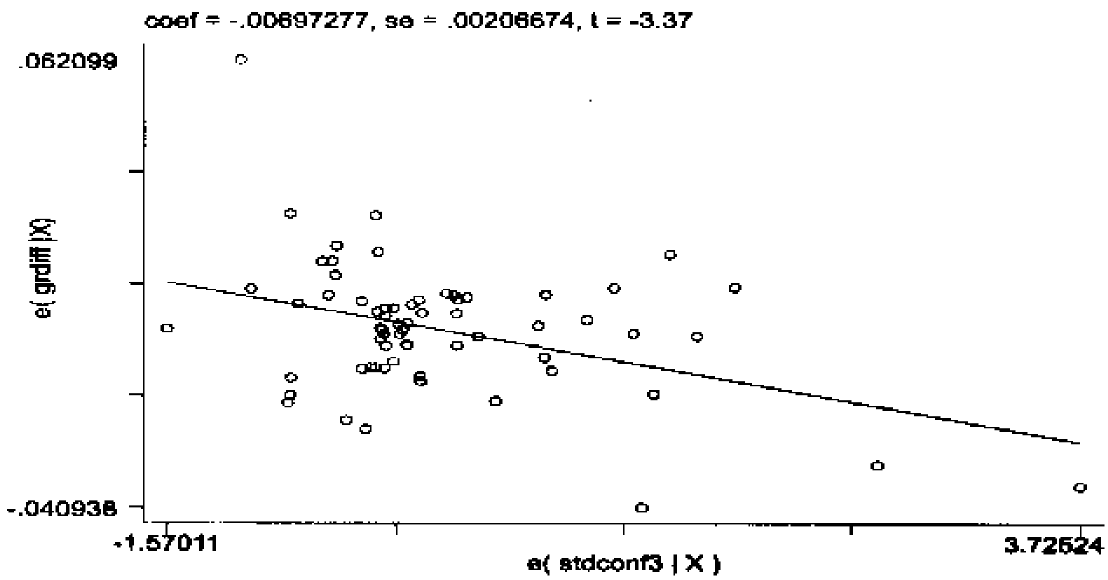


Figure 7: Government consumption levels in 1975 as a determinant of growth collapse

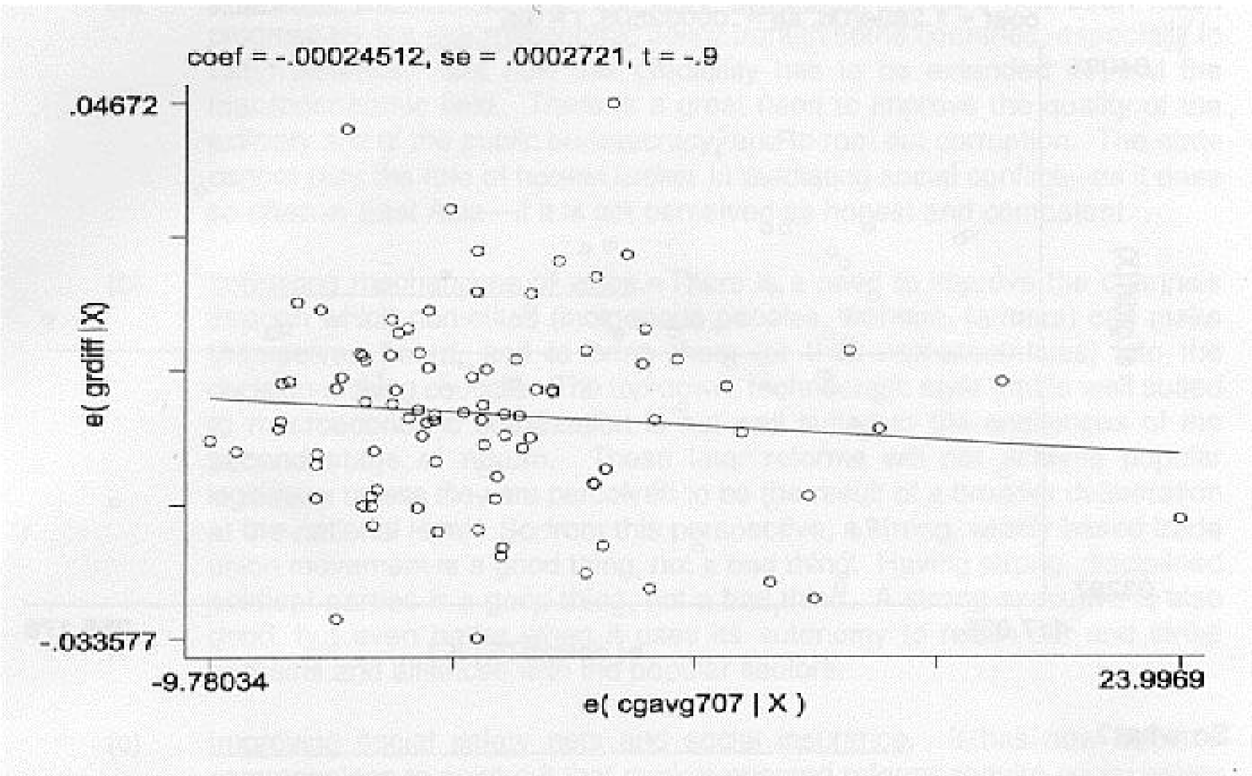


Figure 8: Openness to trade in 1970-1974 a a determinant of growth collapse

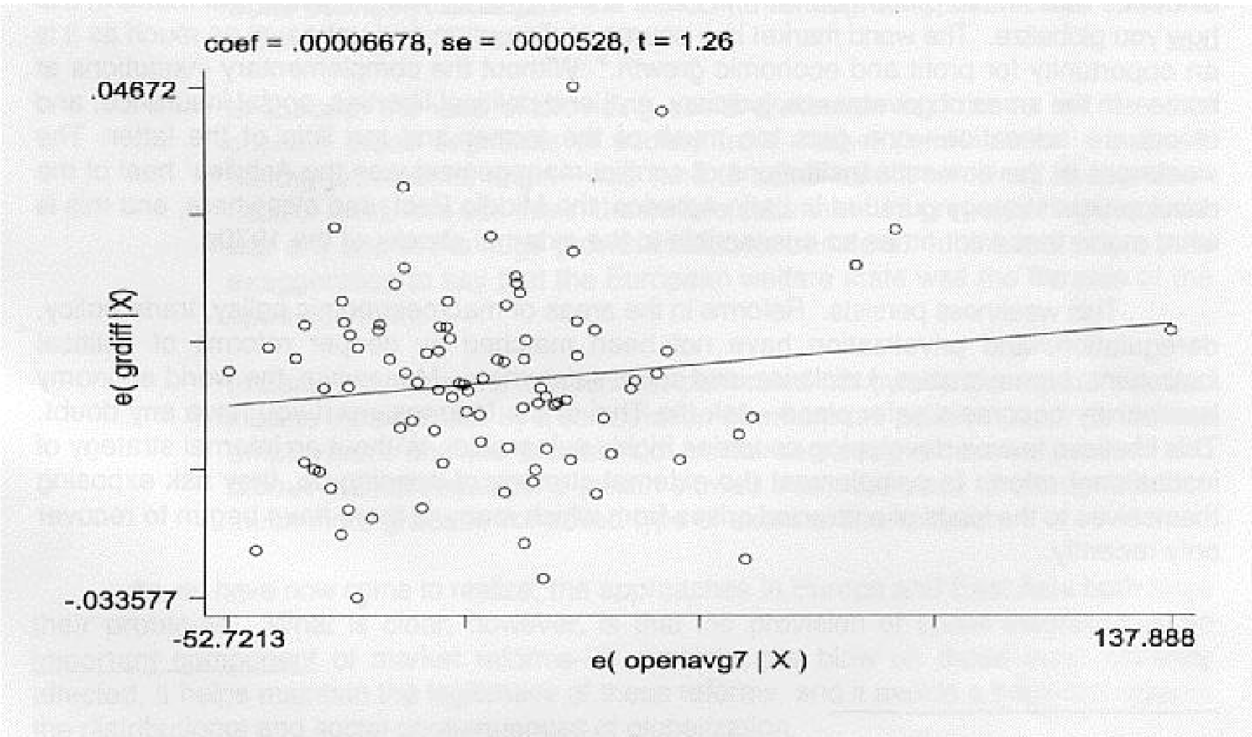
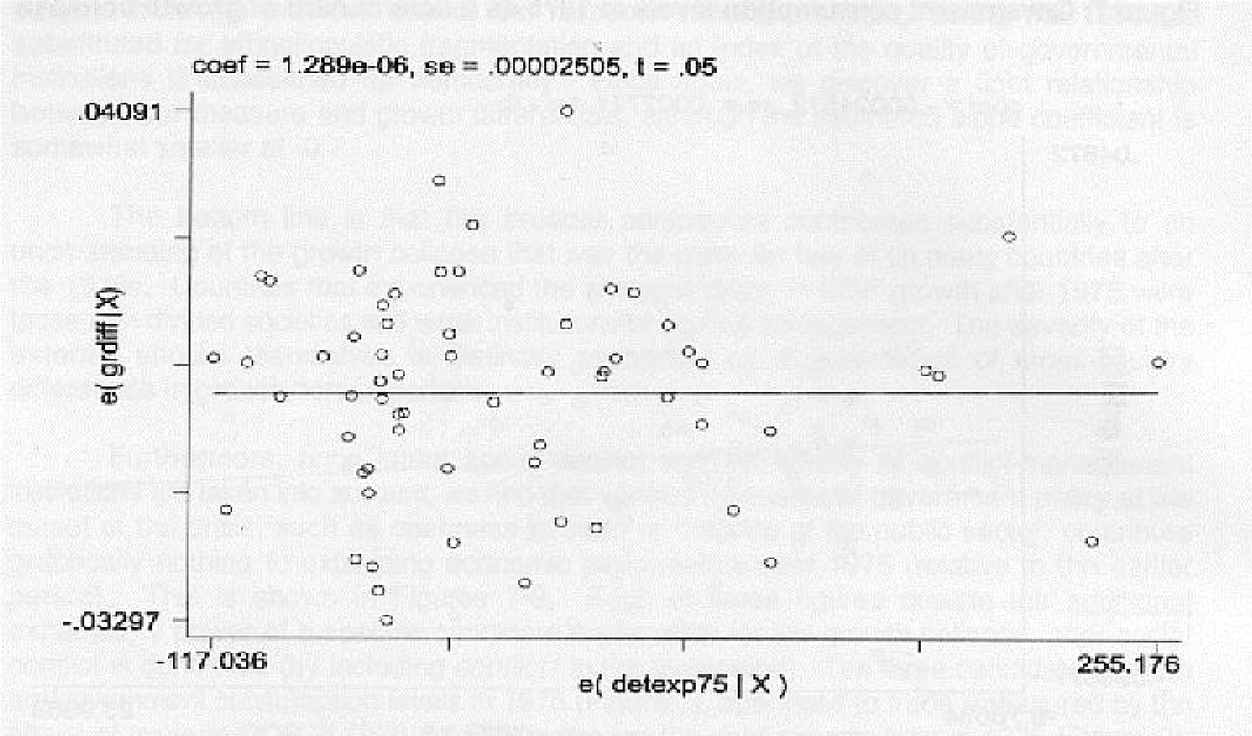


Figure 9 : Debt-exports ratio in 1975 as a determinant of growth collapse



So what?

Understanding what went wrong in the past is important retrospectively. But it is perhaps even more important prospectively, as we prepare for the future. And this is where we join the debate on globalization. For the main message that I take from the kind of evidence that I have presented here is that it is not whether you globalize that matters, it is how you globalize. The world market is a source of disruption and upheaval as such as it is an opportunity for profit and economic growth[3]. Without the complementary institutions at home –in areas f governance, judiciary, civil and political liberties, social insurance, and of course education-one gets too much of the former and too little of the latter. The weakness of the domestic institutions of conflict management was the Achilles' heel of the development strategy pursued in Latin America, the Middle East, and elsewhere, and this is what made these countries so susceptible to the external shocks on the 1970s.

This weakness persists. Reforms in the areas of the macroeconomic policy, trade policy, deregulation, and privatisation have not been matched by deeper reforms of political institutions, bureaucracies, judiciaries, and social safety nets. Meanwhile, the world economy has hardly become a safer place-ask the Thai or the Indonesians if you have any doubt. This I believe leaves developing countries highly vulnerable. Without an internal strategy of institutional reform to complement the external strategy of opening up, they risk exposing themselves to the kinds of protracted crises from which many of them have begun to recover only recently.

[3] There is a large and growing literature on the impact of globalization on industrialized and developing countries, focusing primarily on the adverse distributional effects. UNCTAD's *Trade and Development Report 1997* is among the most pessimistic. For other perspectives, see Lawrence (1996) and Rodrik (1997b). The same issues were also treated insightfully in Bhagwati's 1996 Prebisch Lecture. See Bhagwati (1997).

There are at least three components of such a strategy

(a) **Improving the credibility of the state apparatus** There has been much progress on the macroeconomic policy front in some countries, especially in Latin America. But now this credibility has to be extended beyond the macroeconomic field. There is a great need to improve the quality of the judiciary and of the public bureaucracy, and to root out corruption. The state cannot play the role of honest broker in mediating social conflict-as it does so often in East Asia-if it is not perceived as honest and competent.

(b) **Improving mechanisms of voice**. There is a need to improve the channels through which non-elites (indigenous peoples, workers, farmers) can make themselves heard, and to bring them (or their representatives) into the decision-making councils. The top-down, technocratic style that is well suited to macroeconomic stabilization is not well suited to the challenges of the second stage of reform. These later reforms will not achieve popular legitimacy unless they are perceived to be the result of a broader deliberation at the national level. So from this perspective, a strong, widely based trade union movement is a good thing, not a bad thing. Having strong, disciplined political parties is a good thing, not a bad thing. A strong executive is also good, but even better when it uses its autonomy to reach out and strike bargains and alliances with the popular sectors.

(c) **Improving social safety ne ts and social insurance**. It has now become commonplace to point out that market-oriented reforms require social safety nets to prevent people from falling through the cracks. But I don't think it is sufficiently appreciated what an important role social insurance played in those countries that were the most successful in integrating themselves into the world economy in the post-war period (or reintegrating themselves as in the case of Western Europe).

- In Europe, the idea of providing social protection in order to insulate and cushion broad segments of society from market risks--particularly those having an external origin-was (and to some extent remains) an ingrained habit of mind. We see this in the welfare state that has grown during the post war era and in the huge growth in income transfers. I think it is only a mild exaggeration to say that the European welfare state was the flip side of the open economy.
- In East Asia, the same function was performed not by social programmes and income transfers, but by a combination of enterprise policies (such as lifetime employment and the provision of social services), extensive product and labour market regulations (which slowed down the pace of change), and a much more gradual, controlled type of external liberalization.

As we have now come to realize, the approaches in Europe and East Asia both have their problems. What is clear, however, is that the provision of social insurance is an important component nent of market reforms-it cushions the blow on those most severely affected, it helps maintain the legitimacy of these reforms, and it avoids a backlash against the distributional and social consequences of globalization.

Obviously, there is no how-to manual on accomplishing these things. Much more thought and a fair bit of institutional innovation is needed. What is key, however, is to recognize that globalization requires strong institutions at home (of the type I just sketched out). In the absence of such institutions, globalization is likely to foster domestic social conflicts which are damaging not only in their own right, but are also detrimental to economic growth in the long run.

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