

PANEL ON GLOBALIZATION¹

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The discussion so far has been very interesting and I also will not be giving the PASS view, I will be giving my view. Let me begin with some preparatory remarks. First, this is, I think, a very big systemic failure that highlights broader problems with the economic system, it is not just a matter of a little plumbing failure that you correct, you call in a plumber, you change a few things, I think it is symptomatic of much deeper problems. The second observation is that we cannot, and we should not, think about just going back to the economic system as it was before the crisis, that there were fundamental problems before that and, among the problems, are things that have been already pointed out: the world economy was supported by excessive consumption by Americans and the world was characterized by global imbalances, the basic economic model in the long run was not sustainable, that has to do with the issue of global warming that was referred to, but also, in the short run, it was based on Americans, in the richest country in the world, consuming beyond their means, and that is what sustained the global economy.

It also illustrates, I think, deeper problems in the economic system. For instance, American financial markets, global financial markets, prided themselves on innovation but, mostly, innovation was directed at accounting arbitrage, regulatory arbitrage, and tax arbitrage. They were supposed to be managing risk, they created risk, they did not allocate capital wealth, they misallocated capital wealth. A small fraction of America's financial market was actually devoted to creating wealth, the part that was supporting venture capital, new investment, new firms, expansion, most of it was really a giant casino. And so, I think, in many of the discussions about regulation, what we will come back to, there was a fear that it would suppress innova-

¹ As delivered.

tion, but we have to realise that the innovation was not socially constructive. They talked about risk but they did not create products that enabled most Americans to manage the simple risk of staying in their homes. The result of that is that millions are being thrown out of their homes and losing with that their life savings. So, if we look at the social function which the financial system is supposed to perform, it did not do it. At the same time, a good financial system is supposed to be a small financial system, exposed to perform the tasks of risk management, capital allocation, transaction costs, at low cost. In the United States and some other countries the costs of the system were huge, a third or more of all corporate profits went to finance. It is supposed to be a means to an end, not an end in itself, but it became an end in itself. And you can see, for instance, the contrast between what was possible: on the basis of the new technologies that were referred to, we could have had a very efficient global electronic payment mechanism. We do not. We have a very expensive electronic payment mechanism in which the banking system skimmed off 1-2% of all transactions, it was really an outrage and they did it as a result of monopoly power.

There was also the fact that market mechanisms that we usually talk about, evolutionary forces, did not work in the way they were supposed to, it was not the best firms that survived, it was the most risk-taking. In fact, many firms said they had to undertake gambling because, if they did not, they could not survive. And that, I think, says something about the nature of the short-sightedness of market processes. Fifthly, it showed the corruption of the political process. There was, in a sense, a bipartisan buying of the political process by the financial markets, they succeeded first in buying deregulation, even though the risks were clearly pointed out, clearly discussed, and now they are buying a bank bailout of massive proportions. I think a very important comment was made about the magnitudes, not just the 700 billion dollars that is officially being spent, but the losses that are embedded in the Federal Reserve: the Central Bank has undertaken unprecedented kinds of activities taking on collateral and the estimates are that there will be large losses on these collateral of the kind that would normally not be accepted by a central bank.

The magnitudes of these transfers to the financial system are really so huge that we almost get numb to the numbers, it being an amount equal to almost all the foreign aid given by all the developed countries to all the developing countries over a period of a decade gives a sense of proportion. And let me emphasise, and if I have time I will come back to it, this was totally unnecessary, there were ways of restructuring the financial system

that did not require these massive bailouts. Simple debt to equity conversions playing by the rules of capitalism would have avoided this. It was simply a political buyout by the financial institutions that bought this massive redistribution of wealth. One of the reasons that I was very sensitive to this issue is that I have seen financial crises in developing countries all over the world and in each of these cases a very similar pattern occurs. Massive redistributions occur to the financial system under the guise of a crisis.

There is a final point that I think I should raise in this context, which is there is a massive moral failure on the part of our bankers and, to a lesser extent, on the part of our politicians. We use words like subprime mortgages that gives it a technical overtone but we should remember that the subprime mortgages were people, people were borrowing and the banks targeted the poorest Americans, and targeted Afro-Americans in particular, targeted them with deceptive practices to induce them to borrow beyond their means. They used securitisation to take these toxic assets, and the evolution from toxic to troubled assets under Paulson and to now Geithner calling them legacy assets should not distract us from the real moral character of what has occurred by our financial system, by our bankers. The politicians allowed it, we knew that there were predatory practices, predatory lending going on, usury, things that ought to be and, in the past, have been outlawed but, under the guise of deregulation, they were allowed and, again, the corrupt political practices allowed it. For instance, Dick Arney, number two in the Republican Party, is on the board of one of the most usurious firms that engages in these predatory lending practices, so we should be clear, there were links between politics and this kind of corruption.

These are some of the problems. Let me just share a view that I do not think that the spring sprouts do indicate that we are about to emerge from this crisis, I think it is going to be much harder, partly because we may be at the end of a freefall, and that is obviously good news, but remember that what sustained the American economy and the global economy was this consumption based on debt. America's savings rate was down to zero, people were borrowing, and that model of consumerism is not going to be resurrected very quickly. If savings even return to a more normal 4 or 5%, let alone the 6-7% that one might have expected, there will be weakness in the American economy and in the global economy.

Let me just make a few remarks about the global response. One aspect of globalisation I talked about before is that economic globalisation has really outpaced the political globalisation, globalisation involves the fact that externalities of actions by one country affect others, America created these

toxic mortgages, it exported the deregulatory philosophy that persuaded others to be willing to buy these toxic mortgages and Americans are very thankful that the Europeans bought so many of our toxic mortgages because if you had not, America's downturn would be even worse, so we thank you. But the consequence is that now this economic downturn has spread. We have to recognise that the international institutions failed and that was not a surprise. The international institutions actually pushed the philosophies that caused the problem. The IMF pushed deregulation. The Financial Stability Forum did not really criticise the deregulatory framework. You have the IMF, one country, that had a veto power, so how are you going to have the source of the problem criticised by an organisation in which they have the veto power. Changing the name from Financial Stability Forum to Financial Stability Board, and having a few more countries on it, is not going to change the outcome. So I am not as optimistic that the initiatives taken at the G-20 meeting are adequate. I also want to raise the question that there are 192 countries in the world, 172 beyond G-20, and there is a certain lack of political legitimacy, I think, of an arbitrary self-selected group even if it does represent a large fraction of global GDP. We have created international institutions with some political legitimacy, the UN, and I would have preferred having this done within the context of the UN system, although there is obviously a need for an improvement in the way the UN system works. But still, moving from the G-8 to the G-20 was a big step forward of recognition that this is a global problem that cannot be handled by the old boys' club that had tried to handle these problems in the past.

Let me just make a couple of very specific remarks about some of the other proposals that went on in the G-20. One of them was a recognition that the developing countries are among those that are going to be most adversely affected and a resolution resolved to do something about it. Two problems: first of all, the money was going to be dispersed, or going to be dispersed mostly through the IMF. We have already talked about the problems of the IMF, the IMF does not have the confidence of many of the developing countries, some of them have said to me very explicitly that they would almost rather be on their deathbed before they will turn to the IMF. The second is that the countries with large amounts of liquid money do not want to turn it over to the IMF, because the IMF does not reflect their views, the values of countries in Asia and in the Middle East. The result of this is, for instance, that I know some African countries, some Asian countries, are going directly to particular donors, to China, to the Middle East, for funds rather than to the IMF and I think it would be much better to create a mul-

tilateral system that is effective. What we need to do is to create new lending facilities. But that is a second point. We do not want to create another debt crisis, we are just emerging from a problem of overburdened debt in the developing countries and so more of the money should be provided in the form of grants rather than debt.

One of the problems with the IMF is that it has associated giving money or lending money with counterproductive pro-cyclical conditions and we saw that in the East Asian crisis, in the Latin American crisis, and this is one of the reasons that countries are reluctant to turn to it. Our UN group is proposing the creation of a new emergency credit facility to try to help deal with the problem. One of the reasons for the global imbalances, in fact, is related to the way the IMF mismanaged the crisis a decade ago. Part of the reason, one of the responses to that mismanagement, very clear on the part of many of the developing countries, is that they decided to build up huge amounts of reserves. The Prime Minister of one of the countries told me he was in the Class of '97, he learned what happens if you do not have enough reserves, you lose your economic sovereignty, so the developing countries have built up trillions of dollars of reserves. Well, it is individually rational but it is an illustration of what is called the 'paradox of thrift'. As they were all saving, it contributed to the global imbalances and a global insufficiency of aggregate demand. This is one of the reasons, but only one of the reasons, why one of the most important recommendations of our UN group is the creation of a global reserve system. We are very interested that this idea has gotten some resonance from China, as was mentioned. The obvious reason why there is some resonance now, the dollar has been the reserve currency, the dollar is yielding very low returns and has a very high risk. The combination of low returns and high risk naturally leads people to say, let's have a different system. Whether we can get a global reserve system to work is another question, but I am actually very optimistic. Finally, let me mention one point that I think that, as one thinks about the failures of central banks, and it is hard not to think about central banks, they failed in several ways. One of the ways is that they did not perform their role as regulators, the important role of making sure that money is lent well, they did not focus on financial stability, they focused too much on inflation and we have now seen the consequence. But I do not think, I am not sure they should be blamed for having too low of an interest rate. The reason why I say that is, low interest rate should have been an opportunity. If the market is working well, you give people the market's low cost of capital, it could have been the basis of massive growth, it could have led to high investment

in real things that would have made the economy more prosperous. The problem was that markets did not work, they did not take the opportunity of low cost of capital, investing it well, rather they took the low cost of capital and used it to exploit poor Americans and the result of that is that we misallocated capital. So I think the burden of the complaint about the low cost of capital should be with the way the market used this opportunity or, I would say, misused or abused this opportunity and the failure of the regulators to stop these abuses. But having low cost of capital could have been, for instance, an opportunity to retrofit our economy, for the Green Economy, for the problems of global warming there are huge needs that our societies have and it is the failure to take advantage of those opportunities that is the question we ought to be thinking about.