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ON THE PAPER BY PROFESSOR STIGLITZ

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It is a pleasure to comment on Professor Stiglitz' lecture. We have been friends and collaborators for over three decades; moreover, he always has something interesting to say. Today, he has made a number of characteristically astute observations on global economic governance. He has also made a number of rather loose observations. He is such a powerful and well known social thinker that I am going to take a stern line with him over some of the polemical remarks he has made this morning.

If you need groceries in New York, where Professor Stiglitz (Joe to all who have met him) now lives, you will want to go to a grocery store, the reason being that you will almost always find the items you seek on the shelves, even though you have not placed an order for them. This is an illustration of the "invisible hand". It exists. Joe was wrong to deny its existence. What he should have said instead is that the invisible hand cannot survive in as extensive a form as it does without an overarching institution of laws to support it. Since the State is needed to enforce the law, the invisible hand needs a visible hand to enable it to exist. When you go into a store and purchase a good, you are not sure of its quality. Most often, you do not even know the store keeper. Nevertheless, you make the purchase, and you make it on trust. You do that because you know you will have recourse to the law in case the good turns out to be spoilt, or in case it malfunctions. So, the market system would seem to require a reliable legal infrastructure (and thus the State) for its ability to function.

But the legal system is not the only mechanism that enables markets to function. In all societies, even in modern industrial societies, there is a parallel system that helps to ensure product quality, namely, the system that helps to create and maintain "reputation". Your store keeper sells you a good product not only because he fears you will take recourse to the law for redress in case the product is of poor quality (if nothing else, recourse to the law is time consuming), he also fears that he will tarnish his reputation if you go tell others that he has sold you a bad product. If his reputation falters, others will not go to his store and he will lose business. This possibility also deters him from selling you a shoddy product.

I am using "product quality" in sales as a metaphor for "contracts". By a contract I mean an agreement among people on the sharing of tasks and on the benefits that are expected from carrying out those tasks. If people are able to trust one another to fulfil their terms of a mutually beneficial agreement, they will have an incentive to enter into the agreement. Contrariwise, if they cannot trust one another, the agreement will not be entered into, and what would have been a mutually beneficial outcome will not come about. The issue is therefore one of trust. I can trust you to keep to your side of the agreement if I am sanguine that you will suffer sufficient losses should you break my trust. What I am suggesting here is that there are two means of making you suffer such losses: (1) the law and (2) withdrawal of future cooperation. The former involves the enforcement of agreements by a third party (e.g., the State), while the latter is mutual enforcement within a long-term relationship.

Thus, contrary to what Joe said, the invisible hand exists. However, it does not always work well: it frequently "trembles". There are two broad ways in which the invisible hand does not function well. First, the allocation of resources it helps to bring about is influenced by the endowments people have to begin with. If you own very few assets (and remember, assets include knowledge and skills), you will probably not end up with much under the invisible hand. So, the invisible hand cannot deliver equity. Secondly, the invisible hand can harbour "externalities". By an "externality" economists mean the effects that a transaction has on people who have not been a party to the negotiations that led to the transaction. In a pure market economy, primary education and public health measures, to take only two examples, involve externalities. If I become literate, I benefit, but so do others, because they can now communicate with me via non-oral channels. Similarly, if I am immunised against an infectious disease, I benefit, but so do others, because they are no longer in danger from me. That is why there can be an under-supply of goods and services conferring positive externalities. By the same token, there can be an over-supply of goods and services inflicting negative externalities (e.g., environmental pollution). I should add that market power (e.g. monopoly) gives rise to externalities. I should also add that market imperfections arising from imperfect and asymmetric information fall under the general rubric of externalities as well: imperfect and asymmetric information give rise to externalities. In short, externalities are a fundamental reason for market failure.

We may conclude that the State's overarching powers are needed not only to enable the invisible hand to function, but are needed so that the invisible hand functions well – redistributing purchasing power and helping to remove externalities.

In his paper Joe is concerned with the international arena. He notes that we lack the kind of overarching international authority that could help the invisible hand to function well in the way national governments in principle are able to. Implicit in Joe's view of the world is that until such international authority is created, it is the moral duty of rich and powerful countries to act in ways that are designed to help the world's disadvantaged. Very movingly, he cites the case of citizens in some of the world's poorest countries (the previous Zaire is Joe's example) who are forced by the world order to pay back to international lenders debts that were incurred by previous, brutal national governments, who had used the borrowed funds to purchase arms for use against those very citizens. To him, and to me, this simply cannot be morally defensible: such debt should be "forgiven", because it can hardly be claimed that those citizens had engaged in the borrowing.

In less malignant environments, governments do not kill their citizens to retain power, they merely loot them. For such cases there is the argument that even if 95 cents out of every dollar aid or loan is wasted, 5 cents do get spent on economic needs. Where then does one draw the line? If 5 cents of benefits per dollar of aid (or loan) is too little, would 10 cents suffice? And if not 10 cents, would 20 cents suffice? I guess the key question is what happens to the amount that is looted by the domestic government. Is it pocketed for grandiose lifestyles, or is it used to suppress the citizenry? I do not believe there is a satisfactory answer to the moral dilemma that Joe poses.

However, in focusing on extreme bad cases (even by the standards of modern African States, Mobuto's government in Zaire was an exception) Joe overlooks one general reason that has been advanced against debt forgiveness, namely, that it encourages bad borrowing. The insurance industry calls the ensuing problem one of "moral hazard". If someone is sanguine that he will not have to repay, he will borrow recklessly. In my judgment, there is a need to distinguish between the governed and those who govern. It is not unusual of concerned people in the North to identify poor countries with rulers in poor countries and the rulers in turn with the poor in those countries. If it is not possible to reach the poor, it may make perfect moral sense for foreign institutions to cease dealing with predatory States in poor countries.

This said, I have not understood Joe's complaints against the US Federal Reserve. It would appear that he wants the institution not only to be a central bank, but also an aid agency. The problem with the proposal is that if it is to be accountable, an agency established for a purpose must be given a clearly defined role and scope. It would be no good if the international community were to have established the World Bank, the International Monetary Fund, the United Nations Environment Programme, and the many other international agencies that exist today, and to have asked each to shoulder the world's problems. The organizations would not have been accountable, their duties being far too diffuse. The international community would have been faced with a massive amount of moral hazard. The organizations would have been guaranteed to perform dismally.

Decentralization requires not only that public organizations be set their own tasks, but also that they be given their own, clearly defined, objectives. To be sure, the objectives ought to be congruent with one another. But if the organizations are to be effective, their objectives need to be distinct. Plurality of measures arises from a need for effective decentralization. Some agency in the US government ought certainly to be concerned with world poverty and the plight of the poorest, but not the Federal Reserve.