

A conversation with Joseph Stiglitz¹

Joseph Stiglitz launched his new book *Making Globalization Work* at the Saïd Business School on 4 September. In this interview with OES he explains how he thinks globalization should be governed, discusses policies for economic development, and suggests some directions for future research.

The governance of globalization

Oxonomics Editors (Ed): *Could you begin by outlining the main proposals of your new book and how they build on your arguments in Globalization and its Discontents?*

Joseph Stiglitz (JS): The simple thesis of *Globalization and its Discontents* was that there was a lot to be discontent with in globalization, and so there was some validity to the grievances raised by the protesters against globalization, such as at Seattle in December, 1999. In my earlier book, I looked at financial institutions – the International Monetary Fund (IMF) and the World Bank – and focused on three sets of issues: (1) Development; (2) Crises – very vivid at that time as it was just after the East Asia crisis; and (3) Transition from Communism to the market economy.

This book broadens the canvas and looks at a much wider range of issues: trade, intellectual property, natural resources, the environment and a broader spread of financial and debt issues.

Ed: *Some of the issues that have gained most prominence in the early press have been proposals for new institutions or at least significant reform of institutions, such as a global reserve system and new ways of dealing with environmental problems.*

JS: That's right, also a global bankruptcy regime and a proposal to promote competition at a global level.

Ed: *How can these institutions avoid the governance problems that you've identified, particularly in the IMF?*

JS: I spend some time talking about why the governance structures of these older institutions are flawed – there's a lack of democracy and accountability – and so the first answer is that, having learned from the mistakes of these institutions, to make sure that the new ones are more accountable and democratic.

But a lot of the reforms I talk about are reforms in practices rather than in creating new institutions. For instance, I recommend an extractive industries transparency initiative. You don't need new institutions for that. All you need to do is have an agreement that every expenditure that is tax deductible (e.g. to a foreign government, in payment say for its oil) is transparent.

Ed: *And you don't need a permanent bureaucracy to run that kind of initiative.*

JS: Exactly. In intellectual property, where I've strongly criticised the current patent regime, I put forward the proposal of a medical prize fund. So, for instance, a firm that creates a malaria vaccine gets a big prize. Well, here you need a limited bureaucracy, but the likelihood is that experts can agree which are the diseases that affect most people and are most aggravating to health. So you can reach a reasonable agreement without anything like full global government. In my book, I'm aware of the fact that we cannot get perfect institutions and suggest how we can get on with more limited international agreements.

Similarly, the reforms I propose to environmental policy are designed to work with the limitations of our current governance system. On global warming, I argue that one of the essential problems is to ensure compliance (in emission reductions) by the United States, and every other country. I suggest using the existing framework of trade sanctions. Those who say that you should not link trade and the environment are wrong. In an ideal world perhaps we maybe would not need to resort to trade sanctions, but this is one of the few incentives, though not a perfect one, that will have some effect on behaviour. Second, I argue for using a tax rather than the targets approach of the Kyoto protocol to control emissions because the degree of consensus required is much lower; the problem with targets is that you have to solve huge distributional questions as to how much greenhouse gas each country is allowed to emit.

¹ The interview was conducted on behalf of *Oxonomics* by Nicholas Fawcett, Dirk-Jan Omtzigt and Joe Perkins.

Ed: *And the taxes raised would then go to national governments?*

JS: That's right – we're just changing from a tax on good things such as work and saving to a tax on bad things such as carbon dioxide emissions. So it's designed to take into account the difficulty of reaching a global consensus, trying to minimise the scope for disagreement.

Ed: *Sir Nicholas Stern (2006) gave a talk along similar lines at the Economics department here recently.*

JS: We talked about this idea. What he emphasises is a third approach, standards for road vehicles for example, and I think that could work too.

Economic development

Ed: *In your book you describe the economic development of certain regions across the world and highlight China as an example that is managing economic transition fairly well. How do you think they've managed this without democratic government?*

JS: China is very complex. They have some degree of participatory decision-making, especially at the local and provincial levels; it's not just a top-down system, with a small group making all decisions on their own, without consulting others. The lack of elective democracy means you don't have the kinds of checks and balances you find in some democracies, but the government does try to provide things for its people and get some kind of consensus behind its policies. And even in a democracy, you can still lack accountability; look at the United States, where you can have a lot of dissatisfaction – 70 per cent of Americans oppose the policies of Bush – but there's still a discussion about whether this will change the control of Congress.

Ed: *Do you think that democracy should be a condition before countries receive foreign aid or IMF loans, perhaps the only condition?*

JS: One of the reasons I object to conditionality of aid in general is that it undermines democracy; it delegates responsibility for shaping economic policies from their parliament to the World Bank and the IMF. I understand democratic governments saying that they do not want to support governments that have not been democratically elected. That's a coherent and consistent position. But if you focus on the issue of poverty, you might say that people in poor undemocratic countries are suffering from both a lack of democratic government and from poverty. Should we say that because they have not solved one problem we are going to make them suffer more on the other? I do think that there are some dictators that are particularly oppressive, and if one gives support to those

countries, it should be administered carefully to make sure it goes to the people and doesn't strengthen the dictatorship at all.

Ed: *One of the economic issues raised by Chinese growth that you point out is the absurdity of China saving lots of money in order to lend it to Americans to spend. What do you think can be done about this? Does China need a big currency revaluation?*

JS: A substantial revaluation will not solve the global imbalances. Three years ago, when America began to vociferously blame China for the global imbalances, China did not even have a multilateral trade surplus. It has a large trade surplus today, and that suggests that some exchange rate adjustment is required. But it's always difficult to read from current statistics the magnitude of the imbalances; for instance, if you're an exporter and you anticipate a revaluation, you might accelerate your pace of exports now. It's conceivable that some of the surplus is a result of anticipatory sales.

There's a problem with an exchange rate revaluation, which is that it would hit the poorest people in China hardest; the prices they receive would likely fall. So Lawrence Lau and I proposed an export tax instead (Lau and Stiglitz, 2005); this would reduce the imbalances without harming the rural poor. And it looks as though China is actually moving in that direction, not by actually imposing an export tax, but by reducing export tax rebates.

Ed: *What's the advantage of that kind of policy over direct subsidies for agriculture after a revaluation?*

JS: Underlying the problem are big agricultural subsidies in the developed world, which are really damaging for developing countries and their farmers, because they drive down global farmers. China's farmers are suffering from these subsidies, and a free exchange rate makes them suffer more. China could respond by subsidising their farmers. Like Gresham's Law: bad policy drives out good policy all around the world. Giving rich farmers subsidies in the advanced industrial countries is a bad policy. And it would be a mistake for China to follow that bad example. It would reduce money that they could use to sustain their growth, to create new jobs for the millions of new entrants into the labour force every year. That's one of the arguments, I think a very compelling argument, for an export tax rather than a revaluation. An export tax keeps the import price of food up, so farmers aren't hurt, and you have the advantage that you do the adjustment only on one side. Instead of costing you revenue, as an agriculture subsidy would, an export tax actually generates revenue. So if there is a lack of revenue, this is a much better way to deal with the problem.

Ed: *A lot of developing countries, and China is an obvious example, are quite wedded to fixed exchange rates. They're building up vast reserves and doing all they can to maintain a particular level. Is this misguided, or are there good reasons for it?*

JS: There are two different issues: one is stable exchange rates and the other is a fixed exchange rate. I think there are good reasons to control the movement of short-term capital in and out of the country, to help maintain stable exchange rates. Big exchange rate moves impose enormous amounts of risk on traders, and it's clear that exchange rates can vary all over the place without any relation to economic fundamentals. Now in a very open market like the United States you can't do much about that, but China is still at the stage where you can. And if you can do it at relatively little cost, it's clear that you should.

The danger is that you wind up with a misaligned exchange rate. The costs of misalignment depend on whether your currency is undervalued or overvalued. If you are undervalued, and people still want to buy your Yuan, it does not cost a lot to produce them. There are advantages of people selling Yuan for dollars, because it helps you export more, though I think China is coming to the end of this strategy. But trying to maintain an overvalued Yuan would be a disaster. It's not sustainable and it has a high cost. In the past, most of the literature criticising fixed exchange rates has been about countries like Argentina that have tried to maintain overvalued exchange rates, not countries like China that are trying to maintain a slightly undervalued rate. I think there is a big asymmetry between those two.

The theoretical background

Ed: *I wonder if we could broaden the perspective from this book to your research career as a whole. I wonder how you see your latest work as fitting into your earlier research in the areas of information, development and public economics. Do you see these as a seamless whole?*

JS: Yes, and many of the issues that I take up here are issues that I have written about over a very long time. The first paper I wrote on intellectual property was the first paper I gave to the American Economic Association meeting in 1969 (Domar and Stiglitz, 1969). Given the importance of innovation in our economy, it's clearly an issue which deserves considerable attention, and over the years, I've done a considerable amount of theoretical work on the issue (Dasgupta and Stiglitz, 1980). The first papers I wrote on natural resources were in the early 1970s (e.g. Stiglitz, 1974), and issues of correcting externalities and providing public goods are a key part of public economics (see Atkinson and Stiglitz, 1980). The idea of a corrective tax if you have an externality is a staple of that field.

Thinking about these things on a global scale is obviously somewhat different. But even that was something that I began looking at in my theoretical research many years ago. I think I credit myself with inventing the term 'global international public goods' back in the early nineties. Having done the theoretical work on local public goods (Stiglitz, 1977), public goods in an area smaller than the nation state, it was natural to think about global public goods, public goods on a supranational scale. A lot of what I write about in *Making Globalization Work* are applications of existing ideas in new arenas.

Ed: *Rereading Globalization and its Discontents, it seems that quite a lot of people working for the international institutions, especially the IMF, take a small section of economics and then apply it very literally. So they believe that all you need to know to make policy is Arrow-Debreu general equilibrium theory. Why do you think that a lot of the research by you and others on imperfect information and incomplete markets hasn't made it through into policy?*

JS: This is partially due to the process of self-selection. The IMF recruiters go to universities and hire people who believe in the IMF model. You would feel uncomfortable signing up to implement the IMF model if you believe it's badly flawed. And then you have this big divide in the economics profession between those who continue to use the Arrow-Debreu model as the basis of their analyses and those who don't. In macroeconomics, you find real business cycle theorists who try to explain the world without considering market failures. They claim that unemployment is just a response to productivity shocks, people temporarily deciding to consume more leisure, because it's more efficient to consume leisure when productivity is low. But in reality it's a big macroeconomic market failure, and it's traditionally the one that people are most worried about.

I think the mathematical formulation of rational expectations led to confusion here. People built more complex models of the economy with rational expectations and found different, non-Keynesian, results. So they thought the problem was that the results of Keynesian models were a result of making a wrong or flawed assumption about expectations – they were irrational: they mistakenly concluded that once we 'fixed' this mistake, involuntary unemployment just doesn't happen. But in fact what they did was take away *all* the other market imperfections as well. Here in Oxford, Peter Neary and I took a standard Keynesian macro model and introduced rational expectations, but kept, for instance, the assumption that wages were rigid (Neary and Stiglitz, 1983). We showed not only that one could get unemployment – even with rational expectations – but that government policy with rational expectations was even more effective than it was without. (That is, a dollar increase in government expendi-

tures led to a *larger* increase in GDP when expectations were rational than it did in the older theories which had assumed irrational expectations. Keynes' argument for the use of expansionary fiscal policy was strengthened by the assumption of rational expectations!).

Directions for future research

Ed: *One final question. What do you think are the most interesting areas for young economists to research at the moment? Where do you think the interesting questions lie?*

JS: I think that very broadly the analysis of models with perfect information and perfect markets, including the real business cycle model, has reached diminishing returns. Given that it does not provide a good description of the world, there is very little value from further research on that model, in which there has been enormous investment of intellectual resources. There has, perhaps, been some interesting progress in techniques, but regrettably on a model that is irrelevant. Correspondingly, there has been enormous underinvestment in a whole variety of issues, models dealing with a variety of market imperfections. For instance, the impact of taxation in a world with credit rationing, imperfect equity markets, and governance problems arising from the separation of ownership and control. Behavioral responses to taxation under such conditions are likely to be markedly different (from those in the standard neoclassical model), just to give one example. It seems to me that almost everything that has been done in a perfect market general equilibrium model needs to be redone in these other models.

Ed: *Your 1986 paper with Bruce Greenwald starts to do this; have a general equilibrium framework but introduce imperfections. But naturally you deal with one imperfection at a time. It would be nice if you could have an integrated framework with a lot of imperfections interacting with each other.*

JS: Even in areas of economics of information, I find it striking how little has been done. The interactions (e.g. between adverse selection and moral hazard effects, or between one moral hazard problem and another) often turn out to be critical. For instance, if you start to ask the question 'Why don't I offer a guarantee to my employer that I will be a good worker?' The employer is worried about your moral hazard problem, so you offer him a guarantee. But you are then worried about the employer's moral hazard problem – he might cheat you by claiming you are a bad worker when in fact you are good. I call that a double moral hazard problem: an example of a very strong interaction which drives a lot of behaviour.

Another major area that is underdeveloped is the economics of innovation. Of course, over the past half century, there has been considerable work, including work

by Arrow, Uzawa, Shell, Nordhaus, Phelps, Atkinson, Kaldor, and myself in the 1960s. Then there was some further work by people like Mansfield, Dasgupta, myself, and many others in the late 1970s and early 1980s. Some of these ideas have been rediscovered, and elaborated on more recently. But we need more work, especially thinking about how people get ideas.

Finally, people are beginning to work on the interplay between politics and economics in a much more sophisticated way. For example, going back to my earlier point, how might the Republicans still win in the next election even though 70 per cent oppose Bush? How do we use modern industrial organisation concepts to try to analyse imperfect competition in political processes? Another example: I've just finished a paper where we ask, not what is the optimal policy given that a government is going to be permanently in place, but what is the optimal policy under contestable democracy? You know that the opposition party will seize control – win the elections – at some future date with some probability. So knowing that you don't control policy over the indefinite future, what is the optimal thing that you should do today? It's a very complicated stochastic game, but we have modelled that, at least for one class of policies. This is another area where almost no work has been done. As a third example, Karla Hoff and I have recently looked at the transition towards a market economy in Russia, where we modelled the simultaneous decisions of creating the rule of law and choosing whether to strip assets or to build wealth (Hoff and Stiglitz, 2004, 2005). We then analyse how policies affect the political and economic equilibrium simultaneously.

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Professor Stiglitz was awarded the Nobel Prize in economics in 2001 for his analyses of markets with asymmetric information. A graduate of Amherst College, he received his PhD from MIT in 1967, became a full professor at Yale in 1970, and in 1979 was awarded the John Bates Clark Medal. He has taught at Princeton, Stanford, MIT and was the Drummond Professor and a fellow of All Souls College, Oxford. He is now University Professor at Columbia University in New York. Professor Stiglitz was a member of the Council of Economic Advisers from 1993–95, during the Clinton administration, and served as CEA chairman from 1995–97. He then became Chief Economist and Senior Vice-President of the World Bank from 1997–2000.

His recent books include *Globalization and Its Discontents*, *The Roaring Nineties*, and *Fair Trade for All*, with Andrew Charlton. His latest book is *Making Globalization Work*.