

2001 Economics Nobel Laureate Professor Joseph Stiglitz
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Thank you very much for the opportunity to address you about the *Prospects of the world economy for 2008 and the challenges for Latin America and Peru*.

Latin America, in general, and Peru in particular, has experienced significant improvements in its prosperity in recent years. These advances are especially welcome after the tragic decade of the eighties, the lost decade of the nineties, and even the first years of the present decade. Such prosperity originates mainly, though not exclusively, in the high prices fetched by commodities, a consequence in turn of world growth. Although China's growth has played a fundamental role in this evolution, so has growth in the United States and, in the last year, also in the European Union and Japan, where signs of recovery are manifest. Likewise, India and other developing nations have grown at an accelerated pace. Even Africa, which saw its per capita income fall during the past 20 years, has also started growing again.

These events have created optimism about the global economy and the benefits of globalization. However, the next one or two years will be particularly difficult for developing nations. We have already started to notice some of the less agreeable aspects of globalization, arising out of the imperfections in the United States financial markets, which have started to have major repercussions. This shows in a dramatic way the nature of globalization: As the world becomes increasingly integrated, disturbances in one portion of the global economy have repercussions everywhere else.

We can draw many lessons for economic theory and policy from what is happening in the United States. The future evolution of events in the US is important not only because of the relevance of those events for the short term economic policies of Peru and Latin America, but also because they pose a number of theoretical questions which underscore the role of economic research in public policy making.

America's weakening economy

In terms of the prospects for the world economy, the outlook of the American economy stands out as a main concern. The US has experienced economic growth for six consecutive years. However, this growth has been built on a house of cards, or a mountain of debt, to be more precise, both Federal and household debt. This type of growth is not sustainable, and we are starting to see the consequences.

After describing what I think is the fundamental reason why the prospect of US economic growth is so weak, I will discuss the channels and mechanisms through which Latin America, including Peru, and other developing countries will be hurt by America's economic slowdown.

The portion of the problem in the United States that has received the greatest attention is the subprime mortgage crisis. Americans (especially poorer Americans) have been borrowing more than they can repay. They assumed the price of their homes would continue to rise. This meant the more they borrowed, the more they made in capital gains. But the prices could not continue to go up forever, for very simple reasons that people failed to realize. Today most Americans are in worse financial and economic condition than seven years ago, and most Americans' real income is lower today than it was eight years ago. It is true for those at the bottom, but it is also true for those in the middle. As real incomes dropped, it was obvious the price of most houses could not continue to rise (unless interest rates fell).

In the last two or three years, while house prices were rising, people were taking money out of their houses by refinancing their mortgages; they were using this money to pay for their consumption. It is this growth of consumer demand that has sustained the United States economy. Some figures show that the sizes of these withdrawals from the real estate industry in the last three years were between US\$600 million and almost one billion a year. This consumption demand offset the adverse effects of the war and the associated increase in the price of oil. Americans were spending hundreds of billions more on imports—money that was spent on imported oil was money that was not available to be spent at home. Were it not for these mortgage equity withdrawals, the weaknesses in the economy would have been apparent.

Hundreds of thousands of households have begun to default on their mortgages in the hundreds of thousands, and as housing prices fall, more defaults are likely. Some 5% of mortgages are expected to be in default within the next year, but if prices fall in the way expected, a quarter of all mortgages may be “underwater,” that is the value of the mortgage will exceed the value of the house. Balance sheets of banks and other financial institutions are being impaired—but of equal concern, they simply don’t know how badly off they are likely to be. And if they don’t know the state of their own balance sheets, they know even less about those to whom they might lend. The outcome of this development has been a credit crunch.

Moreover, the “game” that sustained the economy is now over: with falling prices, mortgage equity withdrawals will, at the very least, be greatly reduced.

The Bush administration may have been duped by its own rhetoric. They may have actually thought that the 2001 and 2003 tax cuts had put the country on a sound economic trajectory. If there were problems, they hoped that they would only appear after the November, 2008 elections.

The Administration has, unfortunately, agreed only to a very limited response, that would allow a small fraction of the homeowners to refinance their loans and thus stop the problem from growing. But this solution does not address the fundamental economic problem, namely that these loans are larger than people’s ability to repay them. Nor does it address the problem of the nearly 2 million people who may lose their homes this year.

Although this crisis has had serious consequences for the people who may lose their savings and homes, my basic concern revolves around the macroeconomics of this financial disaster. Such a high debt burden has a negative macroeconomic effect. Savings of American households in the last two years have been close to zero and in some quarters even negative. However, against the backdrop of shrinking credit, the savings rate of American households is expected to rise to 4% or 6% a year. American families will have to cut their consumption, which will reduce aggregate demand and in

turn will slow down growth in the US. If this happens quickly, the US economy will move into a recession. If it happens slowly, the slowdown will be longer.

Inadequate Monetary and Fiscal Responses

Keynesian economics has already taught us how to respond to the prospect of a slowdown using monetary and fiscal tools. The problem is that it does not seem these instruments will or can be used effectively by this Administration. As for monetary policy, in more normal times, reducing interest rates would spur investment, which would stimulate economic growth. But Keynes emphasized monetary policies are relatively ineffective during recessions. It is like pushing on a string. Indeed, even in the past five years, monetary policy has worked mostly by encouraging people to borrow against their homes so they can consume more. As I have noted, with housing prices falling, this gambit is not likely to work now.

But there is an additional reason that monetary policy may not work. Typically, monetary authorities only controlled the interest rate at which government can borrow short term, the so called T-bill rate, but the Central Bank (the Fed) does not control the long term rates, including mortgage rates. Nor does it control the interest rates that are paid by companies. Now, financial markets are very concerned about inflation. As interest rates are lowered to get the economy moving again, concern about inflation will rise, and the consequence will be that medium and long term rates may not fall in tandem with decreases in the short term rate. In fact, they may even rise.

The options are also limited for fiscal policy. The problem is the United States has already had very large tax cuts in 2001 and 2003, but they were intended mostly to reduce the tax burden of rich Americans. As a consequence, these tax cuts did not provide a significant stimulus to the economy, and for that reason the onus of stimulating aggregate demand fell on monetary policy. Interest rates fell to 1%. But even that, by itself, did not suffice. Lax regulations and a flood of liquidity were required to keep the American economy going.

(Subsequent to delivering this talk, the Bush Administration and Congress agreed to a \$150 billion fiscal stimulus package. It was too little, too late, and not well designed. It

did not, for instance, maximize the “bang for the buck,” the amount of stimulation that the American economy gets for each dollar of spending. It focused on tax cuts, but because so many Americans are so indebted, they may use at least a portion of their money to pay back their debts—or to hold in reserve, knowing that with the credit crunch, access to credit may be difficult in the coming months. But even if it does stimulate consumption, it simply exacerbates one of America’s major structural problems—too much consumption, too little savings.)

For all of these reasons, the United States faces a negative economic outlook. Because the US economy is the world’s largest, the repercussions will be felt around the globe through several channels which I will describe very briefly. I will then talk about a couple of factors that could make these problems even worse and also about one element that could help absorb the shock.

The Global Impacts of America’s slowdown

The two main channels, as in the case of other globalization-linked financial crises, are financial and trade. In financial markets there are “supply” (credit availability) effects and price (interest rate) effects. When a major financial disruption occurs, the global risk premium rises, and developing countries suffer most because they are generally considered to have the riskiest markets. Developing countries that incurred debt, even those with very open economies, see their financial markets start to decline and credit rates rise. In sum, the supply of credit to developing countries shrinks, and the price at which credit that is available increases.

Trade is the second major channel. Global growth has expanded exports and commodity prices have increased markedly because their demand is relatively inelastic. When demand rises, prices rise significantly. This is a source of substantial profits to exporters of these products, but, of course, it has the exact opposite effect on importers. However, depending on the exporting countries’ financial condition, a global slow down would imply the risk of downward pressures on prices of some of these commodities.

To make matters worse, there is also the problem of higher food and energy prices. In fact, recent months have seen protests and demonstrations worldwide triggered by the incredibly rapid increase of some food prices. This is a particularly serious issue in developing countries, where food and energy make up a very large portion of their basic consumption baskets. What we see then is that inflation will rise more steeply in developing countries than in developed ones, but this is not due to less effective economic policies in developing countries or because they made mistakes. In a global market, food and energy prices are fixed globally. This has major implications for the design of policy responses.

Let me explain briefly why food prices are rising so quickly. We know the price of energy follows (in part) fluctuations in supply and demand, which is affected, for instance, by global growth on the one hand and the war in Iraq on the other. One of the reasons that the price of oil has risen so much since the start of the Iraq War is that the low cost providers are in the Middle East and the war has brought a new level of instability and insecurity to that region. Dramatic changes in technology are taking place, which have resulted in the food and energy markets becoming interwoven, through biofuels. In some areas in Brazil, the price of land has doubled because the environment is perfectly suited to grow sugar cane, a raw material used to make ethanol, and it is practically equivalent to finding oil on your property. (From the perspective of US trade policy Brazilian ethanol is so much more efficient than US ethanol, which is made from corn, that the US had to slap a 50 cent tax on every gallon of Brazilian ethanol. Additionally, the US subsidizes each gallon of its own ethanol to the tune of 50 cents a gallon, so there is a one dollar gap between prices.)

Land is being shifted from the production of food to the production of energy; the pace of the shift has been rapid both because of soaring energy prices and because of mandates and subsidies for renewable energy sources, including bio-fuels. This means that if the price of energy remains high, the price of food will also remain high—and even if the price of energy declines somewhat, the price of food may remain high if the bio-fuel subsidies and mandates remain in place. Thus, for developing countries, even when sound economic policies are put into practice, inflation has increased. The question is then, how are they going to respond? What is clear is that the old prescriptions—including the currently fashionable inflation targeting policies—will not

work. Raising interest rates will not bring down the price of energy and food, as these are set globally. Overall inflation would only be brought down by causing such a massive recession that wages and the price of non-trade goods fell so much as to offset the rising energy and food prices. The cure would be worse than the disease. These policies are a recipe for stagflation—that unpleasant combination of inflation and economic stagnation.

The good news in this discouraging situation may come from India and China. These two countries are home to two billion people and are growing at impressive rates. China has grown at an average of 10% during the last 30 years. India has been growing at 5 or 6% for a quarter century, and in the last two years it grew at a rate of 8 and 9%. Forecasts suggest that even if their growth moderates slightly as a result of the global slowdown, it will still remain very robust.

The economies in Latin America have been growing strongly too in the last few years—but at least partially because of strong commodity prices. But even with these high commodity prices, growth in this region compares unfavourably to that in East Asia and India. The question is why Latin American countries cannot grow at those rates, and my answer is that there is absolutely no reason why they could not grow at those rates, if the right policies are put in place.

Responding to the global slowdown

I want to spend a few final minutes talking briefly about the strategies needed to respond to the global slowdown. There are three things I would like to highlight. First, it is important to diversify production in order to avoid damage caused by the volatility of commodity prices. Next, Latin American markets need to escape dependence on the US market. After the East Asian crisis in 1997, Korea fundamentally changed its economic strategy. Before, most of its exports were directed at the United States market, but then they realized that was a very risky strategy. Now approximately half of their exports go to China and other Asian countries. This means that they are much better protected against the volatility of the United States economy. And, as I already said, the good news is that China and India will continue to grow, perhaps not as strongly as today, but they will continue to enjoy robust and sustained growth.

The third element is that we have to give a very important role to identifying not only the opportunities but also the risks that will come with the Free Trade Agreement with the United States. One research goal should be to determine what has happened in other countries in order to learn from their experiences and not run into the same problems. Mexico is an excellent case study. Ten years have passed since NAFTA was signed, and, at least by some accounts, real wages are lower and rural poverty has increased since the beginning of the Agreement. Rural poverty has increased. Furthermore, disparities between Mexico and the United States have increased.

There are a number of reasons for these disappointing outcomes. We have to understand better the reasons for these failures to find ways to respond to these problems that may arise in coming years.

One of the reasons that poverty may have increased is that trickle down economics does not work. Even if the country as a whole benefits, it does not mean that all the citizens within the country benefit.

Likewise, we have to understand that what we call a “free trade agreement” is only free in name. It is a Washington tradition to give laws names that are exactly the opposite of what they intend, so when they talk about a free trade agreement, what they really have in mind is a managed trade agreement. If it were a truly free trade agreement, it would be a short document eliminating all tariffs, non-tariff trade barriers, and subsidies on a specific timeline. But if you look closely at any of these agreements, you will see hundreds and hundreds of pages with complicated provisions.

A final major lesson from NAFTA is that Mexico thought trade would solve its economic problems. Instead, NAFTA reduced Mexico’s tariff-based revenues, and they were unable to create other sources of revenue. Fiscal revenues dropped, and as a consequence the government could not invest as much in education, technology, or infrastructure. While Mexico bet on trade as a solution to its problems, China built an integrated development strategy which included heavy emphasis on education, technology, and infrastructure. In 10 years, the advantages Mexico gained from NAFTA

were erased by the advantages China built by strengthening its economic fundamentals. Trade helps, but it does not solve all problems.

I would like to conclude with two general remarks. The first is that the objective of development is *not* to maximize GDP. The focus should be on sustainable and equitable increases in living standards. GDP is not a good indicator of societal well-being; it does not even measure the average income of the citizens of the country. GDP could be going up, yet the incomes of the citizens of the country could be going down. Average incomes could be going up, yet most citizens could be worse off—as is the case in the U.S. in recent years. A country could experience rapid growth, as measured by GDP, but that growth could be based on borrowing, which may not be sustainable—a lesson that Argentina learned in earlier years of this decade and that America has begun to learn this year. We need alternative, and better, measures of economic performance and social progress.

My final comment underscores the importance of evidence and science-based policy research in all economies. Economic policy decisions typically result in winners and losers. Obviously, the winners are motivated to enlist support for the policies that allow them to continue to win. They look for arguments that support their positions and appeal to simplistic “theories.” By the same token, vested interests look for arguments to defend their privileges. The doctrines of privatization and liberalization, so often associated with “neoliberalism” and “market fundamentalism” exemplify these notions: there have been winners and losers; the winners have appealed to simplistic ideas about market economics—ideas such as free markets lead, as if by an invisible hand, to the well-being of all. Economic theory—as well as historical experience and detailed statistical studies—have shown that success requires a balance between markets and government. America’s problems today derive, in part, from inadequate regulation.

The critical need for evidence and science-based policy research is why this type of Consortium that brings a range of research think tanks under a plural umbrella is important in challenging some of these assumptions and in devising alternative policy frameworks appropriate to the conditions and circumstances of Peru. It is these alternative policies that will do much to further the achievement of democratic, sustainable and equitable growth for Peru. Thank you.