

# The People's Professor

Prakash Loungani profiles

Joseph Stiglitz

“THE most misunderstood man in America”—that’s what *Newsweek* called Joseph Stiglitz in an article this year. The 2001 Nobel Laureate in economics “can’t get any respect at home,” the magazine said, adding that “in Washington he’s seen as just another economic critic and not always a welcome one.” Outside his native United States, Stiglitz gets quite a different reception—in many countries he is treated like an oracle. Luckily, jokes Stiglitz, he spends a fair bit of his time these days outside the United States: “My passport is so thick that sometimes I’m questioned about whether it’s real.”

Stiglitz isn’t surprised by his lack of popularity in Washington. He says it’s because he has always taken the side of the “little guy” against the financial elites and their champions. It’s the theme that runs through his life’s work. The academic work that earned

him his Nobel focused on cases where one side in a transaction had less information than the other, leading to market outcomes that were often patently unfair. When he dove into policymaking in the 1990s, first on President Clinton’s Council of Economic Advisers (CEA) and then as chief economist at the World Bank, he continued to take on “lawyers and investment bankers and economic superpowers” to defend the cause of the global citizen. As Jonathan Chait wrote in *The American Prospect* a decade ago, Stiglitz “remains a professor, not a player . . . . And yet, somehow, the issues he cares about most always make it onto the agenda.”

## Rabbi Joe

Stiglitz grew up in Gary, Indiana, the hometown of another economics Nobel Laureate, Paul Samuelson. His family provided him with an early education in doing the right thing. His mother taught in a public school,



a white teacher in a school with predominantly African-American kids. His father told him about the moral and legal importance of paying the household help's social security—Stiglitz says that listening to his father “saved me a lot of trouble when I was up for Senate confirmation” as CEA chairman. And he fondly remembers an uncle who, though a successful businessman, was critical of President Kennedy for being too anti-union.

A high school personality test suggested that Stiglitz would do well as a rabbi. He didn't go off in that direction, but at Amherst College, where he headed for his undergraduate studies, he quickly gained a reputation as a formidable debater and expositor. He also made a fateful decision to switch from physics to economics, a subject in which his prodigious talent soon became obvious. Barry Nalebuff, a Yale University professor and Stiglitz collaborator, says: “Like Rabbi Hillel, Joe can explain what you need to know about economics while standing on one foot; the rest is commentary.”

Realizing Stiglitz's potential, his professors encouraged him to leave Amherst after his third year and start graduate work elsewhere; they

were nevertheless devastated to see him go. “Frankly, seeing Stiglitz leave is like watching the disappearance of one's right arm,” one of them wrote. The Massachusetts Institute of Technology (MIT), however, was overjoyed to get him as a student. The institution's admissions committee sent his information to the economics department and asked what the amount of his stipend should be, listing choices ranging from no stipend to \$12,000. The professor assessing Stiglitz's application scribbled on the folder: “Offer him Department Head's salary.”

### **Paper chase**

A few weeks into his stay at MIT he had already produced his first academic paper. The 1965 paper—Stiglitz was 22 then—challenged Karl Marx's claim that European nations had needed colonies to provide a market for their excess production of goods at home. Stiglitz argued that the colonies were more important as an avenue for investment opportunities; without them, entrepreneurs would have run out of high-return opportunities at home. Colonization was a way of making the property rights associated with those foreign investments secure. And, more important, the colonizer could

shape the direction of the colony's investment so that it would not compete with its home industry—England, for instance, kept India from investing in textiles. It was an early indication of Stiglitz's sympathy for economically underprivileged nations—a cause that today has him railing against rich nations' agricultural subsidies to their rich farmers, which hold back competition from poorer farmers everywhere.

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In the 1960s, MIT was the center of a revolution in economics. “The department placed mathematics—not philosophy or ideology—at the heart of policy analysis,” says Stiglitz, but it sought to bring about “an interface of careful mathematical models and the practical problems of the economic world.” Stiglitz went on to excel at this work, so much so that MIT made him an offer right away on his graduation. The job came with strings attached, though. Stiglitz had to agree to sleep in an apartment instead of his office—MIT wanted to see a lease as proof that he had an apartment—and to start wearing shoes around the office. MIT was not able to retain Stiglitz for long—over the next two decades his wanderlust took him to Cambridge, Yale, Oxford, Stanford, and Princeton—but MIT was right about his potential. Stiglitz unleashed an intellectual effort that earned him the 1979 John Bates Clark medal—awarded to the most influential U.S. economist under the age of 40—and made him a shooin for a Nobel Prize.

A list of the most influential articles in economics has six papers by Stiglitz, an honor that he shares with only two others, Robert Barro (see *F&D*, September 2007) and Eugene Fama. A common theme in his papers is the difficulty in getting markets to function properly when information is costly to acquire or when the parties involved in a transaction are not equally informed.

In a 1981 paper with Andrew Weiss, Stiglitz gave a powerful demonstration of how credit markets could malfunction when this was the case. In the textbook model of credit markets, interest rates work to bring about balance between supply and demand; if there is too much demand for credit relative to supply, interest rates rise to cut off the demand of some of the borrowers. But what if lenders don't know which of their borrowers will work hard at their projects and repay the loan and which are going to shirk and simply hope that good fortune will enable them to pay off the loan? If there is excess demand for credit, raising the interest rate discourages the hard-working borrowers but not those who are intending to take a gamble with the loan. So, far from restoring balance

between supply and demand as in the textbook model, the rise in the interest rate actually ends up tilting the composition of borrowers toward the undesirable type. Nalebuff says the Stiglitz-Weiss paper shows that “who you end up lending money to or what they do with that loan changes with the interest rate you charge . . . . Or, as Groucho Marx might have said: ‘I wouldn’t want to lend money to anyone who would borrow at that interest rate.’” The Stiglitz-Weiss paper helped develop a more realistic description of credit markets by showing why lenders might engage in credit rationing (i.e., limit the volume of loans) rather than raise the interest rate.

In other papers, Stiglitz showed that such information gaps could also plague labor markets. In the textbook model, the wage rate is the lever that eliminates unemployment by moving up or down as needed to balance out the demand and supply of labor. But, just as in the credit market, there are informational deficiencies. Employers often lack accurate information about which of their workers will give the proverbial 110 percent to their job and which are inclined to shirk. They could of course monitor their employees to determine who’s been working hard and who’s been merely saying so. But such monitoring is costly in terms of the employer’s time and can lower employee morale.

Employers, Stiglitz argued, are therefore likely to use the wage rate as a tool to separate workers from shirkers. They may offer a wage higher than the going market rate as an incentive to induce hard work from those who are willing and able to supply it. Paying a wage higher than the competition means that the good workers have something to lose if their jobs are terminated; they thus have an incentive to work hard. But with wages set above a competitive level, the wage rate no longer acts a lever to eliminate unemployment. In fact, as Stiglitz demonstrated in a 1984 paper with Carl Shapiro, unemployment is necessary as a “disciplining device” to keep workers from shirking.

Stiglitz also questioned how well stock markets could work when their information was costly to acquire. A tenet of the textbook model of stock markets is that stock prices accurately reflect all publicly available information. But in a 1980 paper with Sandy Grossman, Stiglitz presented a paradox. If prices reflect all the market information perfectly, then no one should bother to collect information because they can get it for free from the prices. But if no one bothers to collect information, then prices reveal no information. “The paradox lays the basis for the argument that imperfect information is likely to be the rule, rather than the exception,” says Nalebuff.

Throughout his career, Stiglitz has written more than 600 articles—his CV runs to 60 pages—with over 100 coauthors. Nobel Laureate and *New York Times* columnist Paul Krugman says Stiglitz is “an insanely great economist—almost every time you dig into some sub-field of economics . . . you find that much of the work rests on a seminal Stiglitz paper.”

### **Turbulent academic**

In 1993, Stiglitz abandoned his comfortable perch in academia for the rough-and-tumble of the policy world. He became a member of Clinton’s CEA and later its chairman. Alan Blinder,

a Princeton professor and a fellow CEA member, describes it as “a gutsy move for a purely academic superstar.” Stiglitz was instrumental in pushing through several initiatives, including persuading a somewhat reluctant U.S. Treasury to issue inflation-indexed government debt. But Chait wrote in *The American Prospect* that Stiglitz’s style of argument—making his case publicly even after losing internal debates on issues—led to wintry relationships with other presidential advisors, such as Larry Summers. Blinder says politely that “Joe’s behavior . . . might perhaps be considered a little quixotic.”

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This style grew even more pronounced after Stiglitz moved in 1997 from the White House to become World Bank chief economist. He was critical of the economic advice to the transition economies to carry out a speedy move to markets and capitalism. Stiglitz favored a much more gradual move, with legal and institutional reforms needed to support a market economy preceding the transition to markets. Kenneth Rogoff, a Harvard professor and former chief economist of the IMF, doubts that Stiglitz’s approach would have succeeded. He says it is “unlikely that market institutions could have been developed in a laboratory setting and without actually starting the messy transition to the market.” Rogoff adds that because the institutions underpinning communism had collapsed, “some new institutions had to be created quickly,” and it is inevitable that mistakes were made in this haste. But “institutions take a long time to nurture and the ones that are there today, however imperfect, might well not be there if the effort had not been started” immediately when communism fell.

During the financial crisis of 1997–98, Stiglitz publicly criticized the programs put together by the IMF and the governments of some Asian countries. Stiglitz argued that raising interest rates to defend the currencies in these countries was counterproductive: the high interest rates reduced confidence in the economy by increasing loan defaults and corporate bankruptcies. Not everyone agreed with Stiglitz. The late MIT economist Rudiger Dornbusch defended the high-interest-rate strategy as essential to restoring confidence, adding that “no finance minister will opt for the Stiglitz Clinic of Alternative Medicine. They [will] have the ambulance rush them to the IMF.” J. Bradford DeLong, a noted macroeconomist at the University of California, Berkeley, wrote that following “Stiglitz’s prescriptions [to] lend more with fewer conditions and have the government print more money to keep interest rates low . . . would have been overwhelmingly

likely . . . to end in hyperinflation or in a much larger-scale financial crisis as the falling value of the currency eliminated every firm's and bank's ability to repay its hard [foreign] currency debt."

After exiting the World Bank in 1999, Stiglitz repaired to Columbia University and wrote what became a best-selling book titled *Globalization and Its Discontents*. Many reviewers of the book noted that its narrative power came from having a clear villain: the IMF. The book's references to the IMF—almost all critical—totaled 340. Tom Dawson, the IMF's external relations head at the time, quipped: "That works out to over one alleged mistake committed by the IMF per page. You'd think by sheer accident we'd have gotten a couple of things right."

### "The game isn't over"

Stiglitz does think the IMF got some things right in the financial crisis of 2007–08: "The IMF is much better than it was in the past, absolutely. It has changed in many ways, and I think everybody needs to recognize it," he told *The Miami Herald* this year. At the annual meetings of the IMF and the World Bank in Istanbul, Stiglitz commended the IMF's support for a global fiscal stimulus and its view that there would be costs to an early withdrawal of the stimulus. "It's a repositioning of the IMF from what it has been historically," he told *The Wall Street Journal*.

Stiglitz sees the fallout from the financial crisis as vindicating his academic work and what he has been saying in policy circles for decades. In papers written in the mid-1980s with his Columbia colleague Bruce Greenwald, Stiglitz described how changes in financial and credit conditions are important in the propagation of the business cycle. U.S. Federal Reserve Board Chairman Ben Bernanke said in a July 2007 speech that the work of Stiglitz and others "gave economists the tools to think about the central role of financial markets in the real economy" and led to a better understanding of how "extreme disruptions of the normal functioning of financial markets . . . seem often to have a significant impact on the real economy," as happened, for instance, during the Great Depression.

Only a month after that speech, Bernanke and policymakers around the globe became engaged in fighting a financial crisis whose effects on the economy threatened to rival those of the Great Depression. The crisis has led to calls for reforms, including curbs on bankers' pay and more regulation of derivatives markets. To Stiglitz, an important reform would be to bring back the 1933 Glass-Steagall Act, which had separated commercial and investment banks. He had fought against repeal of the act in 1999, fearing that it would lead to the kind of financial meltdown that occurred in 2007–08. "When repeal of Glass-Steagall brought commercial and investment banks together, the investment-bank culture came out on top," Stiglitz wrote.

Despite the financial crisis, Stiglitz remains optimistic about the future of markets and capitalism. In contrast to "the 19th century owner-operated capitalism, in the 21st century capitalism will be operated by the people," he says. But

to make it a success, people have to be more economically literate and there has to be greater civic participation in economic policymaking. With these goals in mind, Stiglitz founded the Initiative for Policy Dialogue (IPD) in 2000—a global network of economists, political scientists, and policymakers that studies complex economic issues and provides policy alternatives to countries. IPD also conducts workshops to enable the media and civil society to participate effectively in policy circles. Dawson applauded the effort: "It's a tough business—you almost have to be a Bono to have an impact on policy."

Indeed, to reach wider audiences, Stiglitz has branched out into film with a documentary called *Around the World with Joseph Stiglitz* about how the fruits of capitalism can be shared more equally. Will it give filmmaker Michael Moore a run for his money? "No," laughs Stiglitz, "I think Moore is very effective," but "frustration doesn't do any good."

Unlike Moore, Stiglitz says he hasn't lost his "Midwestern optimism" that things improve over the long run. Many people, he says, express their dismay to him that, with the financial crisis barely over, the bankers and their boosters seem to be back calling the shots. But if genuine reform of the financial system is not undertaken, "there is a reasonable risk of another crisis within 10–15 years, and the likelihood that the banks will win the next round is lower." Every crisis provides "an impetus for deeper democratic reform. The game isn't over." ■

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