

The Overselling of Globalization: Truth and Consequences

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Volcker Award Lecture
Washington, D.C.
March 6, 2017

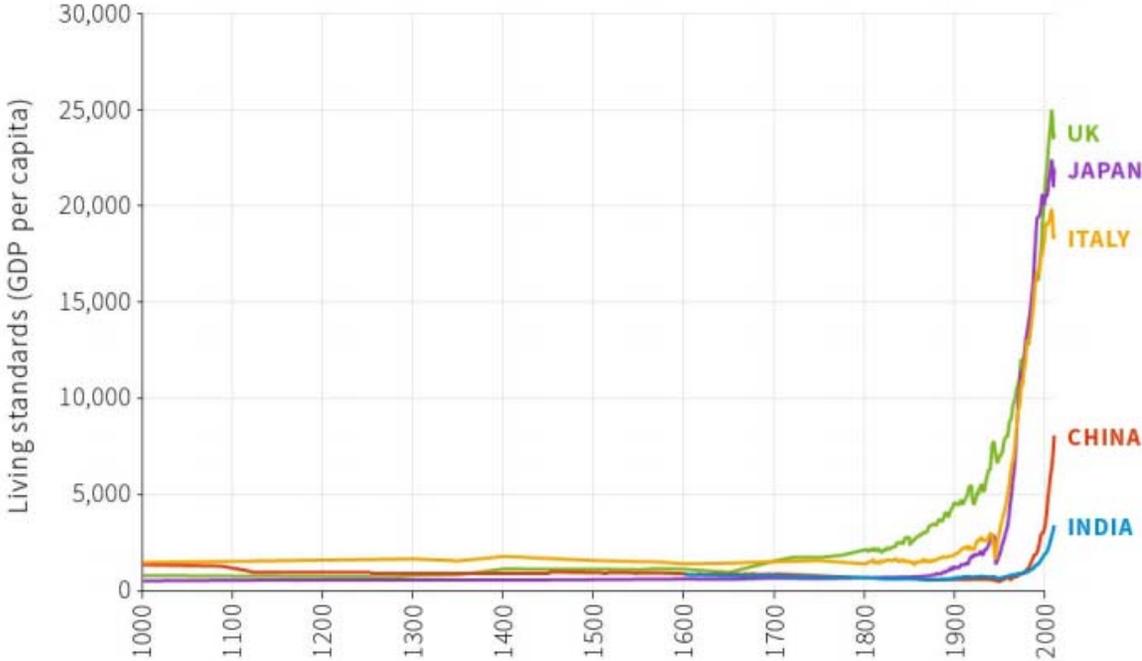
Key epistemological and moral question

- How do we know what we know?
- With what confidence do we hold our beliefs?
- What is our responsibility as public servants in conveying the “truth,” including our uncertainties and the limitations of our knowledge
 - Including the limitations of the models which we use to forecast the consequences of alternative policies
- Key: it is because of changes in belief systems associated with the enlightenment that our standards of living have risen so much
 - These belief systems are now under attack

I. On the importance of Creating a Learning Society

- The transformation to “learning societies” that occurred around 1800 for Western economies, and more recently for those in Asia, appears to have had a far, far greater impact on human well-being than improvements in allocative efficiency or resource accumulation.
 - For hundreds of years standards of living had remained essentially unchanged

Historical living standards



Source: INET

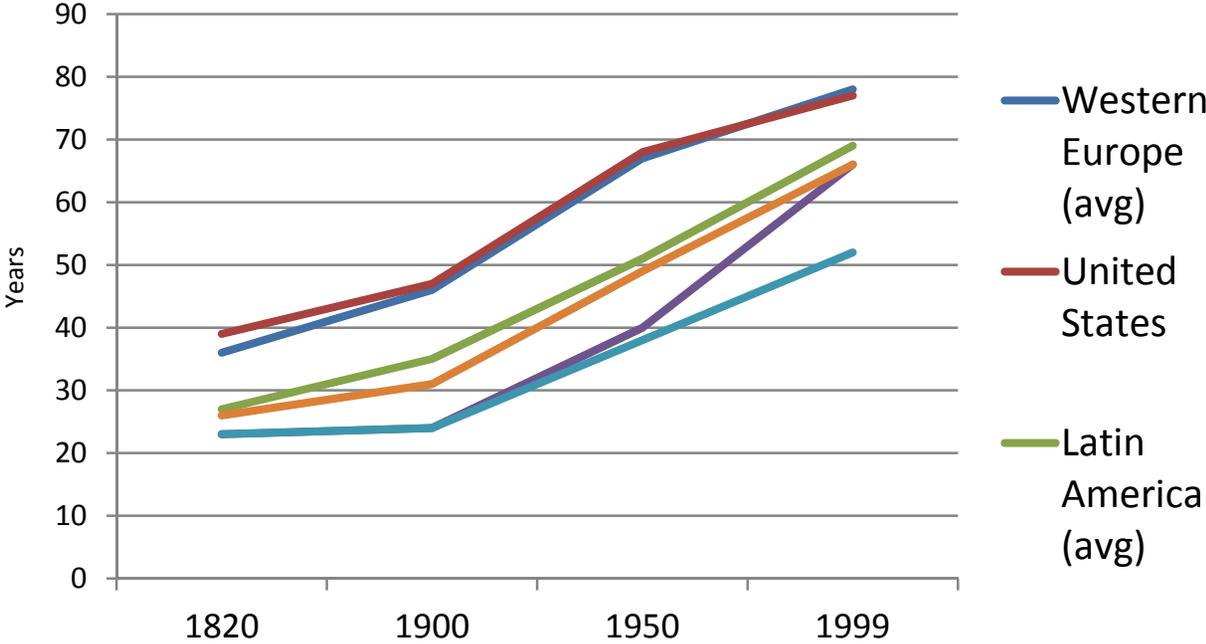
Real wages of craftsmen in London, 1200-2000



Figure 3. Real wages over seven centuries: craftsman (skilled worker) in London (1264-2001).

Source: INET

Improvements in life expectancy since 1820



Data are estimates from A. Maddison, 2001, "The World Economy: A Millennial Perspective," OECD.

What caused this seemingly sudden change?

- The enlightenment—A CHANGE IN MINDSET
 - Questioning authority
 - Recognizing change was possible
- The scientific method provided systemic way of figuring out how to improve productivity
 - Getting more outputs from given input
- THAT CHANGE IN MINDSET WAS ASSOCIATED WITH THE CREATION OF LIBERAL DEMOCRACIES
 - Undemocratic governments have succeeded in closing the knowledge gap
 - But can they do this on a sustained basis? Can they be knowledge leaders?
 - And typically associated with significant cross border flows, not just of ideas but of people

II. Free trade

- The desirability of free trade has been one of the longest and strongest held tenets of economics
 - Ricardo, Smith
 - Modern mathematical formulation: Samuelson (1938)
- Based on simple models
 - Comparative advantage
 - Advantages of specialization
- Benefits of trade: higher standards of living
 - Keeping the economy at full employment was the responsibility of monetary and fiscal authorities
 - We had the knowledge, tools, and will to do that

The selling—or overselling—of free trade

- But that was hard to explain
- So politicians told another story—often supported by economists
 - Trade creates jobs
 - But if exports create jobs, imports destroy jobs
 - If trade is relatively balanced, then since exports are capital intensive, trade agreements that leave trade balance roughly unchanged destroy jobs
 - Trade balance is determined by macro-economic fundamentals, gap between domestic savings and investment, only slightly affected by most trade agreements

The selling—or overselling—of free trade

- Real support for trade agreements came from special interests, who saw trade agreements as opportunity to *distort* economy in their favor and increase their profits (rents)
 - These were managed trade agreements, not free trade agreements
 - Managed for the interests of large corporations
 - Provisions went beyond trade to IPR and regulation
 - Special interests especially represented in these provisions
 - With distortions, ambiguous effect on welfare

The selling—or overselling—of free trade

- Consider TPP, sold as the most important trade agreement in history, embracing 44% of global trade
- Using standard models, government (optimistic) effect on GDP, when fully implemented (15 years), net effect miniscule (.15% of GDP)
 - Better models suggest effects even smaller, or negative
- But these calculations use GDP
 - GDP is not a good measure of well-being
 - International Commission on the Measurement of Economic Performance and Social Progress
- With broader measure of well-being, better models, benefits likely smaller, or more negative

The selling—or overselling—of free trade

- Role of economists as public servants and public intellectuals
- Seemingly ignored many of these “details”
- Ignored—or paid too little attention to—questions that advances in economic science were raising about trade agreements
- Based both on theory and historical experience
 - Limitations of standard models
- And ignored—or paid too little attention to—distributive consequences
 - Perhaps following dictum of Robert Lucas: nothing [is] as “poisonous” to sound economics as focusing on income inequality

III. Overestimating aggregate gains: The True Jobs Story

- Jobs are often destroyed in import competing sectors and in non-traded goods sectors than jobs are created in export sectors
 - Especially when financial sector is not well-functioning
 - Especially when there is an overall insufficiency of aggregate demand
 - This was what I saw as Chief Economist of the World Bank (and described in *Globalization and its Discontents*)
 - This is what has been documented to have happened in US in recent years
 - Areas producing goods competing with those where there was a surge of imports from China have lower wages and more unemployment
 - Whole communities affected, as property values decrease and those in non-traded sectors serving traded goods sector affected
 - Lowering of property values inhibited creation of new small businesses, especially with dysfunctional financial markets

IV. Undermining confidence in elites

- Disparity between the “promised” jobs story and real jobs story undermined confidence in elites
- Good jobs performance after NAFTA quickly forgotten with poor jobs performance after 2000
- Major structural changes associated with globalization—without appropriate assistance in making necessary resource reallocations—had the effect of shifting the Phillips Curve
- little comfort to know that on the other side of the world, many people have never seen it so good.
 - contrast is likely to fuel the view that the gains of those elsewhere have been at their expense.
 - reinforces a zero-sum view of the world, where one country’s gain is another’s loss.

Reality: Most Americans have not been doing well

- Bottom 90% have seen their income stagnate for a third of a century
- Median male real income *of a full time worker* (i.e. if he can get a job) lower than 42 years ago
- Stress, insecurity, and income inequality showing up in life expectancy
 - For first time in 2015, life expectancy of Americans began to decline

Paradox

- Globalization was supposed to increase well-being of *everyone*
 - Rising tide lifts all boats (trickle-down economics)
- So too for technological progress
- Gives little comfort to those in the middle who have seen their incomes stagnate to say that only part of their suffering is due to globalization, that most of the decline of the middle class is due to technological change.
- Globalization particularly paradoxical
 - Told that to compete, have to accept wages cuts and cuts in government services
 - How does that add up to an increase in living standards

V. Overestimating aggregate gains: Much was missing from the models

- Assumptions of standard model were wrong—sufficiently wrong that they led to wrong conclusions
- Problem not just with assumptions concerning employment
- Opening of trade may **increase risk**
 - Problem sufficiently serious that under plausible assumptions, free trade (without good risk markets) may lower well-being of everyone
 - Free trade is Pareto Inferior (Newbery-Stiglitz, 1984)
- **Imperfect competition**
 - May provide more scope for monopsony/monopoly—exercise of market power
- Standard model ignores *dynamics of comparative advantage*, learning
 - Korea would not be where it is today had it not intervened in trade
 - Infant *economy* argument for protection (Greenwald-Stiglitz, 2006)

VI. Trade liberalization has large distributive effects

- Standard discussions overestimated aggregate benefits, ignored or underestimated distributive effects
- A more balanced accounting would have noted that *without government assistance* most individuals may be worse off
- Some conservatives argue that redistributions and assistance are costly (deadweight loss) and/or ineffective
 - Implication: Trade liberalization is not a Pareto Improvement
 - Have to weigh losses of losers and gains of winners
 - Losers were at the bottom and middle, winners at the top
 - Managed (free) trade agreements also introduced distortions
 - Net calculus: Likely that trade agreement was welfare decreasing *unless one took no or little note of distributive consequences*

Standard argument

- Winner could compensate the losers
 - Not that they did
 - And they typically didn't
- Distributive effects were large
 - Samuelson-Stolper/factor price equalization effects
 - Changed bargaining power
 - Impacts of budgetary cuts (tax cuts) allegedly to enhance competition
- Just at time when government spending was *more needed*
 - Scope for government action was seemingly more constrained
 - Globalization provided new ways to avoid and evade taxes
 - Which some of our most innovative firms took full advantage of
 - Globalization's rules did nothing about this

Has relative silence on these consequences undermined confidence in elites?

- Those who believed in well-functioning markets—among the strongest advocates of globalization—never talked about key implication, factor price equalization theorem
 - With well-functioning markets, wages of unskilled workers in US would converge to those in emerging markets

VII. New Protectionism not the answer

- Just as globalization may have led to net job losses and stress to communities and individuals, so too for deglobalization
- We have created a world in which firms believed borders didn't matter
- Created global supply chains
 - Now everyone is on notice: borders do matter
 - Consequences even if Trump does not follow through on threats
 - Damage will be long lasting
- Recreating new supply chains will take time, increase costs
- Again, job losses will take place faster than job gains
- New protectionism sets in motion a negative sum game

New Protectionism: Breaking the Rule of Law

- America's success is based on the strength of its *rule of law*
- New protectionism violates basic principles of the rule of law
- If society (government) wants individuals or firms to act in a particular way, it passes laws and regulations
 - To incentivize desired behavior
 - To discourage and proscribe undesirable behavior
- It does not pick out for attack particular firms or individuals
 - That is the way of despots and demagogues
- Undermining the rule of law will lower growth both in the short run and the long
 - Make the US a less attractive place to invest
 - Introduce large new uncertainties

New protectionism will not work

- Can't go back to world before Reagan
 - Global employment in manufacturing is decreasing
 - With natural entry of emerging markets, they will get a larger share of this global employment
 - We will only recapture jobs by converting manufacturing into poorly paid jobs (as we have done in the auto sector)
 - Even if we bring back output, it will be capital intensive: different skills, different people—and not many jobs
- Reagan style voluntary export restraints won't work: China is not Japan

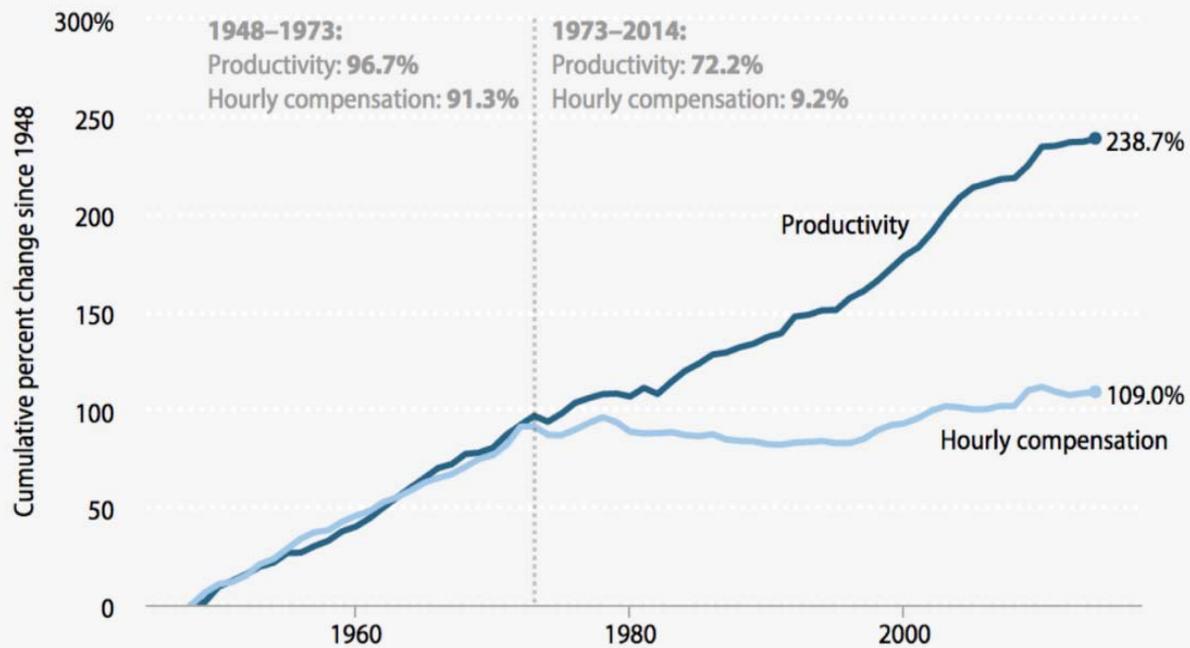
New Protection will lead to lower standards of living

- Won't even lead to lower trade deficits
 - That's determined by macro-economics: domestic savings, investment
 - Administration's budget will lead to larger trade deficits, loss of manufacturing jobs
- Equilibrating: increase in the value of the dollar
 - With significantly adverse effects on emerging markets
 - The effects of which may ricochet back to US
- All of this will lead to lower living standards—especially for those that have already been suffering so much
 - High costs of the things they buy
 - Even possibly higher unemployment
 - Even possibly lower investment
 - Greater uncertainty—about the emerging geo-economic and geo-political order
 - Higher interest rates
- Net effect: even greater inequality

VII. There is a way to respond

- Analyzing fundamental causes of increase in inequality and why globalization may have not worked for most citizens
 - Need to address broader issues
 - But also pay attention to particular issues associated with globalization
- Recognize that conflict is not so much between workers in developing and developed countries, but between abuses of corporate power and interests of ordinary citizens
 - Major change in inequality associated with rising gap between growth in productivity and growth in wages

Disconnect between productivity and a typical worker's compensation, 1948–2014



Note: Data are for average hourly compensation of production/nonsupervisory workers in the private sector and net productivity of the total economy. "Net productivity" is the growth of output of goods and services minus depreciation per hour worked.

Source: EPI analysis of data from the BEA and BLS (see technical appendix for more detailed information)

Improving market incomes

- Rewriting the rules
 - Curbing market power, abuses of corporate governance, making financial sector perform functions it's suppose to perform
 - Strengthening unions/workers bargaining rights
- Reducing the intergenerational transmission of advantage and disadvantage
 - Public education—including pre-school and universal access to colleges
 - Estate taxes
- Need to run economy more tightly
 - Gains from lower unemployment far outweigh risks of moderate inflation
 - Only way to bring in marginalized into economy

Improving equality of after tax distribution of income

- Substituting progressive taxation for current system of regressive taxation
 - Actually make corporations and individuals pay taxes that they owe
 - Global minimum corporate income tax
 - Formulaic approach to corporate income tax—ending abuses of transfer price system
 - Carrying out other parts of successful government program will require more revenues
 - Stronger earned income tax credit
- Need to run economy more tightly
 - Gains from lower unemployment far outweigh risks of moderate inflation
 - Only way to bring in marginalized into economy
- Fed policies need to be oriented towards increasing the flow of credit, especially to SMEs, preventing abuses of financial sector, and preventing instability (costs borne disproportionately by poor)
 - Most of new regulation aimed at preventing financial sector from doing what it shouldn't
 - More attention on getting the financial sector to do what it should

Helping economy adjust to new economy

- Moving from manufacturing to a service sector economy
 - Markets don't do such transformations well on their own
 - Great Depression striking example
 - Trying to recapture manufacturing is largely a will-of-the-wisp
 - Enormous benefits from creating a learning economy and society (*Creating a Learning Society: A New Approach to Growth, Development, and Social Progress*, Columbia University Press, May 2014. Reader's Edition published June 2014.)
 - Education and retraining program—can work *if there are jobs*
 - Shift government expenditures towards the sectors that one thinks of as those of the future

Social insurance

- **Protection without protectionism** (*The Quest for Security: Protection without Protectionism and the Challenge of Global Governance*, Joseph E. Stiglitz and Mary Kaldor, eds., New York: Columbia University Press, 2013.)
 - **Market provides inadequate insurance for many risks—that's why we have social insurance**
 - Provide greater protection both for workers and **communities** that are adversely affected, perhaps through some form of insurance against shocks.

Reducing trade deficit

- Would strengthen aggregate demand, help moderate the transition
- New Protectionism won't work
- Need to change underlying macro-economics
 - Encourage domestic savings, especially through programs that “nudge” individuals to save for the future, by having retirement programs with high savings rates
 - Create a global reserve currency
 - Implement the “Buffett Plan” for trade chits

VIII. Responsibility of public servants and public intellectuals

- Our first professional responsibility is to the *public* and to *knowledge*
 - Accurately reflecting what we know and what we don't know
 - With all the uncertainties, limitations
 - These professional responsibilities should be overriding
- It is for others to engage in persuasion
- When the two get mixed together, our credibility—and that of our whole system of knowledge—is undermined
- Too many economists didn't take fully on board the uncertainties concerning the size of the aggregate benefits and the almost certainties concerning the adverse distribution consequences
- We—our profession and our society—are now paying a high price for these failures