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Globalization and Its Discontents by Joseph Stiglitz
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Review Essay

The Globalization Wars

An Economist Reports From the Front Lines

Barry Eichengreen

Globalization and Its Discontents. BY JOSEPH STIGLITZ. New York: W. W. Norton, 2002, 282 pp. $24.95.

Joseph Stiglitz's memoirs of his years in Washington, D.C.—first as chair of President Bill Clinton's Council of Economic Advisers and then as chief economist at the World Bank—have the flavor of a morality play. Our goodhearted but slightly naive hero, on leave from Stanford University, sets out for the nation's capital to serve his country and improve the lot of the developing world. Once there he finds a morass of political opportunism, ideologically motivated decision-making, and bureaucratic inertia. Undeterred, he battles valiantly on behalf of impoverished nations against the unrelenting globalizers of the International Monetary Fund (IMF). As the tale unfolds, the reader waits with bated breath to learn whether the hero can save the world's poor from the consequences of bad economic advice.

Its melodramatic aspect notwithstanding, this book has a serious point. At its core is a withering critique of globalization, and of the role played by multilateral institutions and their principal shareholders in pressing developing countries to liberalize their economies. Too often, Stiglitz contends, those concerned with economic development have seen economic openness and liberalization as panaceas. He criticizes the Clinton Treasury Department for embracing this approach less because of its analytical merits than because it allowed the department to promote policies helpful to U.S. commercial and financial interests. Instead of progress, he argues, the result has all too often been devastation. Developing

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countries that have opened themselves to trade, deregulated their financial markets, and abruptly privatized national enterprise have experienced more economic and social disruption than growth. Foreign direct investment has destroyed potentially viable domestic companies. And liberalized international finance has made emerging-market economies more vulnerable to erratic shifts in investor sentiment without conferring any visible benefits.

Stiglitz's account also raises questions about the moral and professional obligations of economists in government and international organizations. Academics on leave, he argues, seduced by plush offices and first-class travel, may lose sight of their original motivation for public service—namely, to enlist science in the pursuit of human betterment. And international civil servants often have to choose between dissent and professional advancement. This is where tenure is valuable: if taking on the bureaucratic status quo gets a professor into political hot water, he or she can always retreat to the ivory tower.

But an official who publicly criticizes the policies of his or her agency without resigning in protest risks damaging its effectiveness. Doubts will arise about whether the members of its management team are on the same wavelength. Stiglitz's oft-reported criticisms of the Bretton Woods institutions were newsworthy precisely because he went public without resigning as the World Bank's chief economist and because they therefore raised questions about the competence of these agencies. To be sure, the author was less critical of his own employer than he was of the IMF, its sibling organization across 19th Street in Washington. But the multilateral institutions must work as a team to help financially distressed countries regain the confidence of the markets, which requires confidence in their own actions. Thus there is no finessing the point.

MR. STIGLITZ GOES TO WASHINGTON

These are the key issues posed by Stiglitz's entertaining, insightful, and well-written book. It is hard to think of anyone better placed to raise them, not just because of the author's practical experience but also because of his scholarly stature. Now at Columbia University, Stiglitz was prominent for his contributions to the economics of "asymmetric information" even before sharing the Nobel Prize in economics last year.

As the phrase implies, asymmetric information exists when one party to a transaction knows more about its characteristics than does the other. Among the theory's applications are some that yield important insights into the operation of financial markets. These show, among other things, that interest rates cannot always be counted on to balance the supply and demand for money and credit, that financial stress can undermine the stability of the economy as a whole, and that financial liberalization does not necessarily result in a more efficient and rational allocation of resources.

One suspects that Stiglitz's years of research not only shaped his analytical outlook but also gave him a stake in seeing his ideas taken up by policymakers. Thus when officials proposed at the 1997 IMF–World Bank meetings that the deregulation of international capital flows be made obligatory for IMF members, he vigorously dissented. It is similarly understandable that he reacted negatively when the IMF recommended interest-rate hikes to restore balance to the countries caught in the Asian financial crisis.

With the benefit of hindsight, most economists now agree that Stiglitz's warnings about the dangers of precipitous financial deregulation were on the mark. Indeed, the meeting in Hong Kong at which officials pushed for making the eventual deregulation of capital flows an obligation of IMF members actually took place after the outbreak of the Asian crisis, seemingly in disregard of that event. Stiglitz regards this poor timing as evidence that the IMF saw a liberalized financial system not as a means to development or stability but rather as an end in itself. (The alternative interpretation, it should be noted—that the proposal was driven by bureaucratic inertia—is scarcely more flattering.)

Stiglitz's critique of the IMF recommendation that crisis-stricken countries raise interest rates so as to restore monetary balance, however, remains more controversial. Stiglitz's own work after the crisis seemed to demonstrate that rather than strengthening exchange rates, as the IMF's simple textbook models predicted, higher interest rates weakened them (by placing pressure on banks and firms with heavy loads of short-term debt). But for various reasons not all the skeptics were convinced, and no professional consensus exists on this point even now.

Just as academics do not enjoy all the perks of officials, so officials do not have the intellectual luxury of academics. They must decide before the markets reopen whether to lend money or to recommend increases in interest rates, and they have to rely on back-of-the-envelope calculations, not complex and controversial models that reek of the lamp. The IMF's managers, who also have Ph.D.'s in economics from the best universities, understood that higher interest rates would place pressure on debt-laden banks and firms. And they understood that the resulting adverse impact on investor confidence could, in theory, cancel out any chance that the higher interest rates would bring back capital that had been pulled out. But they questioned whether what was true in theory would be true in practice. They feared that not raising interest rates (and thereby failing to lure back foreign capital) could lead to a weaker exchange rate, causing even more severe distress for banks and firms with debts denominated in U.S. dollars. In short, they were not oblivious to the risks Stiglitz highlights, but they felt that the other risks were even greater.

CAPITAL CONTROL GANG

Acknowledging the critic's obligation to offer an alternative, Stiglitz suggests that the IMF should have recommended restrictions on the freedom of residents and nonresidents to withdraw money from banks and to take funds out of a crisis country. Such controls, he claims, can prevent a panic from doing irreparable damage to financial markets and need not diminish a country's growth prospects. As evidence, he cites the case of Malaysia, arguing that controls worked well there when Prime Minister Mahathir bin Mohamad imposed them in 1998.

This assessment is controversial, however, and will be even more so now that Argentina's application of the remedy has had no palliative effects—if anything it has only made that country's crisis worse. Indeed, rather than preventing crises, repeated recourse to capital controls may only increase their frequency. If investors know that the authorities will reimpose controls at the first sign of trouble, any minor uptick in volatility may prompt a rush for the exits.

Stiglitz is hardly unaware of this critique, and he does not suggest that countries liberalizing financial markets should restore controls at the first sign of trouble. Rather, he urges governments to think twice about deregulating capital flows in the first place, arguing that neither theory nor experience suggests that the benefits of such liberalization exceed the costs.

But such advice is problematic if one believes that financial liberalization is important for financial development. Financial markets do not materialize out of thin air. Markets must be allowed to operate to acquire depth and liquidity. Only by competing against and copying foreign rivals will banks and corporations learn to protect themselves against financial volatility. This is the basis for the argument that competition—achieved by liberalizing prices, privatizing public enterprise, and opening the economy to international transactions—is a key ingredient of economic and financial development.

Stiglitz's counterargument is that deregulation will not promote financial development when information is asymmetric and competition is inadequate. There is no guarantee that financial liberalization will enhance economic efficiency, nor that privatization will guarantee competition. Privatization without adequate regulatory oversight, for example, may allow a few formerly state-owned enterprises to dominate the economy. It will spur corruption and create an oligarchic elite that opposes the emergence of competitive markets.

That Stiglitz should display these concerns is not surprising. They were themes of his Wicksell lectures at the Stockholm School of Economics, published in 1994 as *Whither Socialism?* Those lectures can be read as a warning against precipitous privatizations such as those that were carried out in Russia. The partisans of the pro-liberalization "Washington consensus," he continues to stress, overlooked the importance of economic and corporate governance, underestimated the difficulty of building institutions, and forgot that many countries lack the sophisticated public administrations needed to ensure adequate competition. A Californian still recovering from the botched deregulation of his state's electricity market feels the author's pain.

But liberalization and market opening must be more than economically efficient, Stiglitz goes on to observe—their consequences must also be socially acceptable if they are to endure. Sustainable development thus requires not just liberalization and privatization but also initiatives to ensure that all of society shares in the benefits. The IMF, he argues, has failed to heed the consequences of its own advice for social and political stability. By insisting that governments privatize quickly, it neglects the negative impact on the distribution of wealth. By demanding austerity while insisting on liberalization, it disregards basic social needs. And by forcing elected officials to violate their social contract with their citizens in the name of fiscal balance, it undermines the legitimacy of governments and the very process of market liberalization to which it attaches such value.

THE DEVELOPMENT GAME

The impression left by Stiglitz's discussion is that the IMF is blissfully unaware of the importance of the social and political sustainability of its policies. Although this critique may have once contained a kernel of truth, it is no longer accurate. Hard experience has taught the IMF that reforms that do not produce growth will not be politically sustainable. Even a country with seemingly stable finances may experience a political and economic crisis if growth peters out and hardships mount, as was so visibly the case in Argentina last year.

The real question, then, is not whether shared growth should be a priority, but how best to achieve it. The IMF tends to view two steps as essential: immediate inflation stabilization and the elimination of structural barriers to market efficiency. The institution's critics, including Stiglitz, question whether programs that entail such radical dislocations are politically sustainable.

The IMF, of course, is a latecomer to the development game. For a long time it concentrated on the monetary, fiscal, and exchange-rate policies that were central to its mandate of preserving balance-of-payments stability. The irony here is that it was precisely its growing concern for the social and political sustainability of policies that led the IMF to devote more attention to the prospects for growth, and hence the need for structural reforms. Stiglitz's criticisms of the particular ways in which the IMF has sought to restart growth in crisis countries may be right or wrong, but his charge that it has been oblivious to the importance of growth for the sustainability of its policies is simply not true.

Stiglitz criticizes the IMF's practice of making its loans conditional on structural economic reforms in emerging-market economies. In his view, its conditions emphasize their structural weaknesses, thereby inadvertently undermining investor confidence. But a politically and economically sustainable solution to the financial problems of a crisis country requires putting the country back on the path of growth. This means recapitalizing the banking system so that lending can start up again, and reforming regulatory oversight so that similar problems will not recur. It means developing bankruptcy procedures capable of clearing away the burden of nonperforming corporate debts so that firms can start investing again. Stiglitz appreciates the need for these and other structural responses to financial crises, but his doubts about the IMF's competence lead him to reject them as conditions in its lending packages. By advocating that conditionality be abandoned rather than streamlined or more focused, however, he risks throwing the baby out with the bath water.

Stiglitz's doubts about the IMF's capabilities in such matters stem from the fact that its staff members are trained in the techniques of macroeconomic and financial analysis, not the sociology and politics of economic development. He describes how World Bank economists (the putative experts on such questions) were increasingly relegated to carrying the IMF's baggage. He reports how on more than one occasion the IMF refused even to discuss the merits of its recommendations with World Bank officials, even though the two organizations had joint responsibility for carrying them out. One can imagine how this rankled, especially given the author's prior experience in the Clinton White House, where the Council of Economic Advisers, the traditional repository of economic expertise, was increasingly marginalized by the lawyers and financiers of the National Economic Council.

But notwithstanding some passing discussion of life in the executive branch, Stiglitz focuses his book on the problems and prospects of international institutions. He characterizes the World Bank as a "learning organization" but describes the IMF as learning impaired. He portrays the IMF as subscribing blindly to the fundamentalist ideology that the markets know best and as not brooking dissent or engaging in public debate. As he sees it, the IMF encourages its staff to think mechanically in terms of the "financial programming model" taught in training seminars—a model in which monetary and fiscal policies are shifted to balance supply and demand and in which there is no role for asymmetric information. IMF policies were ill advised, he argues, because IMF economists, operating in an intellectual isolation chamber, mechanically applied a model appropriate for the Latin American debt crisis of the 1980s to the Asian crisis of the 1990s—and are unlikely to be more creative next time around unless things change dramatically.

Here I must confess to being a not entirely disinterested observer: I spent the year of the Asian crisis as an adviser at the IMF. I arrived on the day of Thailand's devaluation and left on the day of Russia's default. Readers will judge for themselves what was cause and what was effect. The impression I gleaned, for what it is worth, is that the IMF is not immune to self-criticism. It has acknowledged that its advice that Asian countries tighten up their budgets was, at best, excessive. It has admitted that its handling of the banking crisis in Indonesia, when it recommended selective bank closures rather than the wholesale reorganization of the system, aggravated the panic. It has accepted that the conditions it attached to its programs were too numerous and too detailed. The IMF has learned from its failure to foresee how quickly the Asian crisis would spread and from its inability to anticipate how financial markets would react to its interventions. As a result, it has created a new department to focus specifically on capital markets. These are not the actions of an organization unwilling to acknowledge its mistakes or change its behavior. Stiglitz himself, moreover, has a kind word in his final pages for the recent proposal by Anne Krueger, the IMF's first deputy managing director, to create a new mechanism for handling sovereign debt crises—an example of just the sort of fresh thinking he claims is unlikely to emerge from that organization.

In general, however, Stiglitz remains a skeptic. He argues that the IMF needs to develop a culture of openness that encourages debate, dissent, and learning—one that facilitates the acceptance of new ideas and the recognition of new problems. He holds up the World Bank as an example of what he would like to see. But contrary to what Stiglitz implies, it is not clear that the IMF's sibling organization is an appropriate model for reforming the multilateral financial institutions. The bank is not exactly renowned for its efficiency. The tendency for its departments to pursue their own agendas notoriously undermines the coherence of its programs. And it does not necessarily welcome public dissent—just ask former World Bank economist William Easterly, now of the Center for Global Development.

OPEN-DOOR POLICY?

Stiglitz's remaining recommendations focus on the need for greater transparency and better governance of the international financial institutions. But the IMF has already moved in the direction of greater transparency, and how much further it can go is questionable. Not only is the IMF in the business of restoring confidence, which lends a certain delicacy to its deliberations, but it is a trusted adviser to governments. If everything that is shared with the IMF immediately becomes public, governments will hesitate to reveal sensitive information. Similarly, if every warning issued by the fund becomes public, it runs the risk of precipitating precisely the crises that it seeks to avert. These dilemmas are familiar to Stiglitz, who knows more about information economics than anyone on the planet. One wishes, therefore, that he had not only made the case for more disclosure but also told us precisely how much disclosure is healthy.

Stiglitz would undoubtedly acknowledge the need to hold at least some sensitive policy discussions behind closed doors. Thus, his insistence on the need for greater transparency must have another basis: namely, that transparency is the only way to hold the IMF accountable to the countries whose fates it determines. Only if IMF decisions are taken in the light of day will there be any assurance that they are being driven not by the interests of the creditor countries that are the fund's principal shareholders but by the global good. The other obvious mechanism for ensuring accountability—voting rights on the Executive Board—does little to confer legitimacy on the IMF in the developing world. Rich countries are disproportionately favored by the fund's voting formula, with the United States controlling the single largest block of votes. This dominance, combined with the secrecy of IMF deliberations, enables the U.S. government to use the fund as an instrument of its own foreign policy—generally at the expense, Stiglitz argues, of developing countries.

Stiglitz therefore recommends overhauling voting shares in the World Bank and the IMF, along with the procedures for appointing the heads of these organizations. These agents of globalization, he warns, are experiencing a crisis of legitimacy. They can shore up their reputations only by giving greater weight to the countries most directly affected by their actions. Absent mechanisms for ensuring that developing countries have a proportionate say, the rules and procedures that govern the global economy will not be regarded as fair and just.

Like many other points in the book, this one is important. Still, one suspects that effective reform is more complex than Stiglitz suggests in his more populist moments. The issue is not simply the veto position of the United States or ensuring that developing countries are accorded votes proportional to their place in the global economy. Nor is the issue simply the balance between debtors and creditors. Indeed, there is a huge problem of moral hazard in shifting that balance—that is, in letting debtors become their own bankers and their own bankruptcy judges. This issue rarely surfaces in public, but it lurks in the background of any discussion of IMF reform.

The real problem is the politicization, both real and imagined, of the IMF's economic advice, reflecting the mixed motives of its principal shareholders. My own preferred solution, therefore, would be to try to depoliticize the IMF. Following the model of an independent central bank, the fund's executive directors could be appointed to long terms in office (giving them effective job security) and then prohibited from taking politically motivated instructions from their home governments. This solution would address the objection that the IMF is simply an instrument of U.S. foreign policy, which is what gives rise to the complaint that the fund's decisions are being driven by illegitimate political considerations. Not everyone will agree with this approach, but there clearly is a need to think harder about the governance of the Bretton Woods institutions.

Stiglitz's book makes a compelling case that simple-minded economic doctrine, inadequately tailored to the realities of developing countries, can do more harm than good, and that the subtleties of economic theory are actually quite important for sound policy advice. But simplistic political advice—give developing countries more voice and the institutions of global governance will be rendered more legitimate and efficient—is equally problematic. Political reform is as subtle and complex as economic reform. Evidently, the best minds among us have only begun to think about it.