

Review of Joseph Stiglitz, *Globalization and its Discontents* (New York: W.W. Norton & Company, 2002).

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April 2002**

In a classic melodrama, our valiant hero does battle with a dastardly villain to save the damsel in distress. Many members of my generation will have first been exposed to the genre via their Saturday morning cartoons. In the prototypical formulation, the good-hearted but naive hero, Dudley Do-Right, astride his faithful horse, Horse, struggles with the black-caped, mustache-twirling, cold-hearted villain, Snidely Whiplash, who has tied the innocent Nell to the railroad tracks. Overcoming a series of obstacles, some of his own making, Dudley just rescues Nell from the wheels of the oncoming train, following which the credits roll.

Joseph Stiglitz's memoirs of his years in Washington, D.C., first as member and chair of President Clinton's Council of Economic Advisors and then as chief economist and vice president of the World Bank, follow these classic lines. Our good-hearted but naive hero, on leave from Stanford University, does battle with the black-caped, mustache-twirling, cold-hearted management and staff of the International Monetary Fund, who have tied the developing world to the tracks of globalization. Do-right -- err, Stiglitz -- seeks to rescue the damsel before she is flattened by this runaway train.

Its melodramatic aspect notwithstanding, this book has a serious point. At its core is a withering critique of globalization and of the role of the multilateral institutions and their principal shareholders, notably the United States, in pressing developing countries to liberalize their economies. Openness and liberalization, the author contends, have too often been seen as

panaceas by those concerned with economic development. He criticizes the Clinton Treasury for allowing itself to become converted to this strategy less by its analytical merits than its convenience, insofar as it allowed Treasury to advocate policies supportive of U.S. commercial and financial interests.

The results, Stiglitz contends, have often been devastating for developing countries. Opening trade, deregulating financial markets, and privatizing enterprise abruptly rather than gradually have delivered more economic and social disruption than stimulus to growth. Foreign direct investment has destroyed potentially viable domestic enterprises. Liberalizing international financial transactions has heightened the vulnerability of emerging economies 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, 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. Moreover, international civil servants may have to choose between dissent and professional advancement. Those who blow the intellectual whistle run the risk of losing the perks and prerequisites of their appointments. This is where tenure is handy: if dissenting from the organizational status quo gets the professor on leave into political hot water, he can always retreat to the ivory tower.

But an official who publicly criticizes the policies of his 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 public criticisms of the Bretton Woods institutions will be familiar to readers of the financial press. They were newsworthy precisely

because he went public without resigning as vice president of the World Bank and because they therefore raised questions about the competence of these agencies. To be sure, the author was critical less of his own employer than of the International Monetary Fund, its sister organization across 19th Street. 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.

These are the issues posed by Professor Stiglitz's entertaining, analytical, and well-written book. It is hard to think of anyone better placed to raise them, owing not just to the author's practical experience but also to his scholarly renown. Now on the faculty of Columbia University, Stiglitz was prominent for his contributions to the economics of asymmetric information even before being awarded the Nobel Prize Economics last year together with George Akerlof and Michael Spence. Asymmetric information, as the term implies, exists when some parties to a transaction know more about its characteristics than those on the other side of the market. As the Nobel press release put it, Stiglitz's path-breaking research showed that "asymmetric information can provide the key to understanding many observed market phenomena..." Although the applications are too numerous to name, among them are a number of important insights into the operation of financial markets. These showed, among other things, that interest rates cannot always be counted on to equilibrate the supply and demand for money and credit, that financial stress can have major macroeconomic costs, and that financial liberalization need not lead to an efficient allocation of resources.

One suspects that years of research not only shaped Professor Stiglitz's analytical outlook but also gave him a stake in seeing his ideas taken up by policy makers. Thus, he reacted

strongly when he saw the International Monetary Fund preaching the gospel of financial liberalization and heard proposals at the 1997 IMF-World Bank meetings in Hong Kong that capital account liberalization should be made an obligation of IMF members. It is similarly understandable that he should have dissented when the IMF recommended interest rate hikes to restore balance in the Asian crisis countries.

With benefit of hindsight, it is now widely agreed that Stiglitz's warnings of the dangers of precipitous capital account liberalization were on the mark. The Hong Kong meeting at which officials discussed making capital account convertibility an obligation of IMF members actually took place after the outbreak of the Asian crisis, seemingly in disregard of that event. For Stiglitz, this is prima facie evidence that the IMF saw a liberalized financial system as an end in itself. The alternative interpretation, emphasizing bureaucratic inertia, is scarcely more flattering to the institution.

Stiglitz's critique of the IMF's advice on how to contain the crisis remains more controversial. Just as academics do not enjoy all the perks of officials, officials do not have the intellectual luxury of academics. They lack time to reflect. They must decide before the markets reopen at the beginning of the week whether to lend or to recommend increases in interest rates. They must rely on back-of-the-envelope calculations. Complex models that are the subject of scholarly controversy necessarily carry less weight in the board room than the seminar room. They tend to influence policy only when supported by extensive experience and only when their implications fit easily onto the back of an envelope.

While there is a growing body of empirical work applying the insights of information economics, evidence continues to lag theory. Convincing tests are difficult to devise because

investigators must make indirect inferences about something that is not directly observable, namely, the information available to market participants. Indirect inferences hinge on ancillary assumptions whose validity inevitably becomes the subject of debate. Stiglitz's own study of the Asian financial crisis, coauthored with Jason Furman, contained an analysis of the impact of interest rate hikes on exchange rates, which purported to show that higher interest rates actually weakened exchange rates by causing deep distress among banks and firms with heavy loads of short-term debt, rather than strengthening them as the IMF's simple textbook models led it to expect. This analysis did not entirely convince the skeptics. Economists continue to dispute the impact of interest rates on exchange rates in times of crises. It is fair to say that there is still nothing resembling a consensus reading of the evidence.

It is not as if IMF staff and management, many of whom also earned PhD's in economics from leading institutions of higher learning, were oblivious of these risks. They understood that higher interest rates would cause distress for banks and firms and that the adverse impact on investor confidence could, in theory, swamp any tendency for higher money-market yields to attract back flight capital. But they questioned whether what could be true in theory would in fact be true in practice. They feared that not raising interest rates and failing to lure back flight capital could have led to a weaker exchange rate, causing even more severe distress for banks and firms with financial liabilities denominated in dollars. IMF officials saw raising interest rates as risky, in other words, but they saw not raising them as worse.

Here Stiglitz acknowledges the critic's obligation to offer an alternative. He recommends restrictions on the freedom of residents and nonresidents to withdraw money from banks and to take funds out of the country. Such controls, he argues, can prevent a panic from doing

irreparable damage to financial markets, and they need not diminish a country's growth prospects. Controls worked well in Malaysia, he argues, when that country's prime minister, Mahathir bin Mohamad, imposed them in 1998. This assessment is controversial. It will be even more so now that Argentina's application of the remedy has had no obvious palliative effects and if anything has only made that country's crisis worse.

Indeed, repeated recourse to controls, rather than preventing crises, may only increase their frequency. If investors know that the authorities will reimpose controls at the first sign of trouble, any minor up-tick in volatility may then prompt a rush for the exits. Stiglitz is not oblivious to this critique. 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 liberalizing capital flows in the first place, arguing that neither theory nor evidence suggests that the benefits of such liberalization exceed the costs.

This advice is problematic if one believes that financial liberalization is important for financial development. Deep and liquid financial markets do not materialize out of thin air. Markets must be allowed to operate in order to acquire depth and liquidity. Only by competing against and emulating foreign rivals will banks and corporations learn to utilize the hedging instruments needed to protect against financial volatility. This is the basis for the argument that competition, to be 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 other distortions are present. There is no guarantee that

financial liberalization will enhance economic efficiency. Nor does privatization guarantee competition. Privatization without regulatory oversight will only create rents and inefficiencies. In countries lacking adequate competition policies, privatization may allow a few former state enterprises to dominate the economy. It will create an oligarchic elite that opposes the emergence of competitive markets. Privatization in such circumstances is a fertile seed bed for corruption.

That Stiglitz should display these concerns is not surprising. They were themes of his Wicksell Lectures (published in 1994 as *Whither Socialism?*) which can be read as a warning against precipitous privatizations like Russia's scheme of loans for shares. The partisans of the Washington consensus, he writes here, overlooked the importance of economic and corporate governance. They underestimated the difficulty of building institutions. They 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 be socially acceptable if they are to endure. Sustainable development thus requires not just liberalization and privatization but also initiatives to insure that all of society shares in the benefits. Stiglitz argues that the IMF has failed to heed the consequences of its advice for social and political stability. By insisting that governments privatize quickly, it has neglected the impact on the distribution of income and wealth. By demanding austerity at the same time it insists on liberalization and external opening, it disregards basic social needs. By forcing elected officials to abrogate their contract with society

in the name of fiscal balance, it has undermined the legitimacy of governments and the very process of globalization and market liberalization to which it attaches such value.

The impression left by this discussion is that the IMF is blissfully unaware of the importance of the social and political sustainability of its policies. While this critique may have contained more than a kernel of truth once upon a time, it is no longer accurate. Hard experience has taught the Fund that reforms that do not produce growth will not be sustainable. Moreover, 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 view tends to be that immediate macroeconomic stabilization and the elimination of structural distortions that interfere with the efficiency of the market mechanism are essential for growth. The institution's critics, including the author of the present book, question whether programs that entail such radical dislocations are politically sustainable.

The Fund, 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 from the present point of view is that it was precisely its growing awareness of the need to consider the social and political sustainability of its policies -- something of which Stiglitz argues it was unaware -- that led the Fund 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 Fund has sought to restart growth in crisis countries may be right or wrong. But it is simply not true that the Fund has been oblivious of the importance of growth for the sustainability of its policies.

Stiglitz criticizes IMF conditionality for emphasizing the structural weaknesses of emerging market economies, thereby inadvertently undermining investor confidence. But a politically and economically sustainable solution to the financial problems of a crisis country requires putting it back on the path to growth. This means recapitalizing the banking system so that lending can start up again, and reforming prudential supervision and regulation so that similar problems will not recur. It means following special bankruptcy procedures to clear away the overhang of nonperforming corporate debts so that firms can start investing again. While Stiglitz appreciates the need for these and other structural responses to financial crises, his doubts about the IMF's competency leads him to oppose including them as conditions in its lending packages. But by advocating the abandonment of IMF structural conditionality, as opposed to streamlining and focusing it, he risks throwing the baby out with the bath water.

Stiglitz's doubts about the IMF's competence in such matters are rooted in the fact that its management and staff are trained in the techniques of macroeconomic and financial analysis, not in the sociology and politics of economic development. Stiglitz 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 Fund refused to even discuss the merits of its recommendations despite the joint responsibility of the two organizations for carrying them out. One can imagine how this rankled, especially given the author's experience in the Clinton White House, where the Council of Economic Advisors, the traditional repository of economic expertise, came to be increasingly marginalized by the lawyers and financiers of the National Economic Council.

But, notwithstanding some passing criticisms of the NEC, it is the IMF that is Stiglitz's

doppelganger. While characterizing the World Bank a “learning organization,” he describes the IMF as learning impaired. IMF economists, as he portrays them, blindly subscribe to the fundamentalist ideology that the markets know right. The IMF does not brook dissent; its organizational culture encourages staff to mechanically think in terms of the “financial programming model” taught in training seminars, a model in which monetary and fiscal policies are tightened or loosened to balance supply and demand and there is no role for asymmetric information. The Fund does not heed criticism from outside or engage in public debate.

Here I must confess to not being an entirely disinterested observer. I spent the year of the Asian crisis as an advisor 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 the cause and what was the effect. The impression I gleaned, for what it is worth, is that the IMF is not immune to self-reflection and organizational adaptation. The Fund has acknowledged that its advice to Asian countries to tighten their budgetary policies was, at best, excessive. It has admitted that the way it handled the banking crisis in Indonesia, recommending selective bank closures rather than the wholesale reorganization of the system, aggravated the panic. It has acknowledged that the conditions it attached to its programs were too numerous and detailed. Its creation of an International Capital Markets Department and a Capital Markets Consultative Group are further indications that it has learned from its inability to foresee how quickly the Asian crisis would spread and from its failure to anticipate how financial markets would react to its interventions. These are not obviously the actions of an organization unwilling to acknowledge its mistakes or to adapt its behavior.

Stiglitz is skeptical that these changes will suffice to transform the IMF into a learning

organization. He argues that the Fund 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. IMF policy toward Asia was ill advised because Fund economists, operating in an intellectual isolation chamber, mechanically applied old models to new problems. They applied a model appropriate for the Latin American debt crisis of the 1980s, where the problems had been excess demand and chronic inflation and the corresponding solutions were to cut public spending and tighten monetary policy, to the Asian crisis of the 1990s, where the problems -- unstable capital flows and an arbitrary loss of investor confidence -- were of an entirely different sort.

But it is not clear, contrary to what the author implies, that the World Bank is an appropriate model for reforming the multilateral financial institutions. The Bank is not exactly renowned for its efficiency. The tendency for departments to pursue their own agendas notoriously undermines the coherence of its programs. Nor is public dissent necessarily welcome -- just ask Bill Easterly, now of the independent Center for Global Development.

It would be interesting to know more about how the author assesses the IMF's recent proposal for changing the way emerging market crises are managed. The Fund's first deputy managing director, Anne Krueger, also on leave from Stanford University, as fate would have it, proposed in November a new mechanism for the orderly resolution of financial crises. Under its provisions, the IMF could aid a crisis country by declaring a standstill on payments. It would give sanction to the use of capital and exchange controls, as Stiglitz suggests. It would then coordinate restructuring negotiations, specifying the parameters of an acceptable restructuring, helping to appoint an independent tribunal to adjudicate disputes among the creditors, and

allowing a qualified majority vote by those creditors to bind in any dissenting investors, a scheme not unlike the "Super Chapter 11" that Stiglitz proposes for resolving crises in emerging markets. In the final pages of his book the author makes favorable reference to this proposal. It is not clear, in other words, that the recent record is consistent with Stiglitz's characterization of the IMF and its management as learning impaired.

Stiglitz's remaining recommendations focus on the need for greater transparency and better governance of the international financial institutions. The IMF has already moved in the direction of greater transparency. How much further it can move is questionable. Not only is the Fund in the business of restoring confidence, which lends a certain delicacy to its deliberations, but it is a trusted advisor to governments. If everything that is shared with the IMF immediately becomes public, governments will hesitate to reveal sensitive information. If every warning issued by the Fund similarly becomes public, it runs the risk of precipitating precisely the crises that it is in the business of averting. These dilemmas are familiar to the author, who knows more about information economics than anyone on the planet. One wishes that he had gone beyond the case for more information disclosure to tell us exactly how much information is optimal in this case.

No doubt he would have acknowledged the validity of arguments for holding at least some sensitive policy discussions behind closed doors. Why then is he so critical of the secrecy that shrouds IMF decision making? At the root of his objections is the fact that transparency is the only mechanism holding those responsible for IMF policies accountable to their constituencies in program countries. Only if IMF decisions are taken in the light of day, in other words, will there be any assurance that they are not being driven by the self interest of the

creditor countries that are the Fund's principal shareholders, as opposed to the global good.

The other obvious mechanism for ensuring accountability, namely, voting rights in the Executive Board, does little to confer legitimacy on the IMF in the developing world. The advanced-industrial countries are disproportionately favored by the Fund's voting formula. The United States controls the single largest block of votes. This, combined with the secrecy surrounding its deliberations, enables the U.S. government to use the IMF as an instrument of its foreign policy, generally at the expense, Stiglitz argues, of developing countries.

Stiglitz therefore recommends overhauling voting shares in the Bank and Fund along with the procedures whereby the heads of these organizations are appointed. These agents of globalization, he warns, are experiencing a crisis of legitimacy. Only by giving greater weight to the views of the countries most directly affected by their actions, he argues, can their legitimacy be restored. Absent mechanisms for ensuring that emerging markets have proportionate say, the rules and procedures by which the global economy is governed will not be regarded as fair and just.

Here, again, the author makes an important point. Still, one suspects that effective reform is more complex than Professor Stiglitz suggests in his more populist moments. The issue is not simply the veto position of the United States or ensuring that voting shares are proportional to countries' weights in the world economy. Rather, the problem is the politicization of the IMF's economic advice, both real and imagined, reflecting the mixed motives of its principal shareholders.

Nor is the issue simply the balance between debtors and creditors. Indeed, there is a huge moral hazard problem in shifting that balance -- in letting debtors become their own bankers and

their own bankruptcy judges. This issue rarely surfaces in public, but it is what is at the back of many people's minds when the issue of reforming IMF governance comes around.

My own preferred solution would be 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 governments. This 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.

Professor Stiglitz's book makes a compelling case that simple-minded economic doctrine, inadequately tailored to the realities of developing countries, can do more damage 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 high-powered intellects among us have only begun to think about it.

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