

Review of Joseph E. Stiglitz's *Globalization and its Discontents*

(W.W. Norton, New York and London)

Joe Stiglitz has written an important book. It should be read by anyone interested in economic development, public policy in an era of globalization, and the political economy of decision making in international organizations. It is part memoir, part manifest, and part criticism of the International Monetary Fund (IMF). As a memoir, it is entertaining and informative. It tells the story of how Professor Stiglitz went to Washington, and did not like it there. He found out that politics was the main sport played inside the beltway, and that ideology was often more important than rigorous intellectual debate. Worse yet, he got little respect. People in high places did not always want to listen to him, and when they did, they often ignored his advice.

As a manifest, the book is powerful. One does not have to agree with everything Stiglitz has to say, to recognize that many of his ideas are important and deserve to be discussed seriously. As a result of the debate generated by the book, some policies that have become readily accepted in Washington are likely to be revised in the future.

The book is at its weakest when it comes to the criticism of the IMF. And this is not only because of *what* Stiglitz has to say; it is mostly because of *how* he says it. The tone is overly hostile and aggressive, and he misses no opportunity to insult the IMF staff. According to Stiglitz, "intellectual consistency has never been the hall-mark of the IMF," and the staff systematically practices "bad economics." His characterizations of IMF economists and policies are unfair and, in many cases, self-serving. I believe that the book would have been more effective had Stiglitz chosen a more temperate style.

1. The main argument

The main tenet of the book is simple, and goes something like this: pro-globalization policies have the potential of doing a lot of good, if undertaken properly and if

they incorporate the characteristics of each individual country. Countries should embrace globalization on their own terms, taking into account their own history, culture, and traditions. However, if poorly designed—or if a cookie-cutter approach is followed—pro-globalization policies are likely to be costly. They will increase instability, make countries more vulnerable to external shocks, reduce growth, and increase poverty.

The problem, according to Stiglitz, is that globalization has *not* been pushed carefully, or fairly. On the contrary, liberalization policies have been implemented too fast, in the wrong order, and often using inadequate—or plainly wrong—economic analysis. As a consequence, he argues, we now face terrible results, including increases in destitution and social conflict, and generalized frustration. The culprits are the IMF and its “market fundamentalists,” the “Washington Consensus,” and the US Treasury.

Stiglitz believes that in the early 1990s, the IMF, the World Bank and the US Treasury launched a conspiracy of sorts to run worldwide economic reform—this is the infamous “Washington Consensus.” This view, however, is overly simplistic and ignores the evolution of reform thinking during the last two decades. In the 1980s and early 1990s, policy makers in many developing nations were moving faster than the multilaterals or the Treasury. In Argentina, Chile, and Mexico, for example, the reforms were the result of a “national consensus” that was more imaginative, daring and far-reaching than anything bureaucrats in Washington were willing to accept at that time. It is well known, for example, that the IMF was initially critical of Chile’s social security reform, it opposed Argentina’s currency board, and it was highly skeptical of Mexico’s trade-opening strategy during the mid-1980s. If anything, the original emphasis on how to undertake economic reform came from a group of developing countries’ economists—many of them from Latin America—and not from the ranks of the multilaterals.

Three interrelated policy issues are at the center of Stiglitz’s criticism of globalization. (1) In designing reform packages during the 1990s, crucial aspects of the sequencing and pace of reform were ignored. As a result, in many countries, reform was implemented too fast—Stiglitz prefers gradualism—and in the wrong order. (2) Advocating (and imposing) capital account liberalization was a huge mistake. And (3), the IMF response to crises—and in particular to the East Asian crisis—was a disaster that made things worse rather than better. In particular, imposing fiscal austerity and raising interest rates were terrible mistakes that cost the East Asian countries several points in terms of growth. Not surprisingly, given his theoretical writings during the last 35 years, Stiglitz frames his criticism around the insights of the theory of asymmetric information.

Stiglitz claims that if things had been done differently, that is, if they had been done his way, the outcome in terms of social conditions would have been significantly better. At times, I found his arguments to be persuasive. At other times, however, I had trouble believing what I was reading, and I had to ask myself if he was being serious. This was the case, for example, when I read—in pp. 129 and 231—that the 2002 Argentine crisis could have been avoided by following a more *expansive* fiscal policy!

2. The sequencing and pace of reform and capital account liberalization

Stiglitz repeatedly argues that for economic liberalization to succeed, it is essential that reform be implemented at the right speed and in the right sequence (see, for example, pp. 73–78). This is a very important principle, and Stiglitz is right in emphasizing it. I believe that Stiglitz is particularly on target when he argues that opening the capital account too soon is likely to generate serious dislocations.

This emphasis on speed and sequencing is not new in policy discussions, however. In fact, since the beginning of the economics profession, it has been dealt with over and over again. Adam Smith, for example, argued in *The Wealth of Nations* that determining the appropriate sequencing was a difficult issue that involved, primarily, political considerations (see the Cannan Edition, Book IV, Chapter VII, Part III, p. 121). Moreover, Smith supported gradualism—just as Stiglitz does—on the grounds that cold-turkey liberalization would result in a significant increase in unemployment.

In the early 1980s, the World Bank became particularly interested in understanding issues related to sequencing and speed of reform. Papers were commissioned, conferences were organized, and different country experiences were explored. As a result of the discussion surrounding this work, a consensus of sorts developed on the sequencing and speed of reform. The most important elements of this consensus included: (1) trade liberalization should be gradual and buttressed with substantial foreign aid; (2) an effort should be made to minimize the unemployment consequences of reform; (3) in countries with very high inflation, fiscal imbalances should be dealt with very early on in the reform process; (4) financial reform requires the creation of modern supervisory and regulatory agencies; and (5), the capital account should be liberalized at the very end of the process, and only once the economy has been able to expand successfully its export sector. Of course, not everyone agreed with all of these recommendations, but most people did. In particular, people at the IMF did not object to these general principles. For example, Jacob Frenkel, who was to become the IMF's Economic Counselor, argued in a mid-1980s article in the *IMF Staff Papers* that the capital account should, indeed, be opened towards the end of the reform process.

Sometime during the early 1990s, this received wisdom on sequencing and speed began to be challenged. Increasingly, people in Washington began to call for simultaneous and very fast reforms. Many argued that politically, this was the only way to move forward. Otherwise, the argument went; reform opponents would successfully block liberalization efforts. I remember being introduced to this view by an economist turned politician, Vaclav Klaus. When I met him in Prague in 1991, he said: “Oh, you are the ‘sequencing’ professor. . .” and then he added, “you got it all wrong. There is not such a thing as an optimal sequence. We should do as much as we can, as fast as we can.” When I asked him what were the bases of his recommendation, he simply said, “politics, politics. . .” In the book, Stiglitz is critical of Klaus's “rapid and simultaneous” reform strategy, but his criticism fails to address the political economy concerns that at the time worried Klaus and other pioneer reformers in Central and Eastern Europe.

In 1992, and in response to what was perceived as US pressure to lift controls on international capital movements, Yung Chul Park from Korea University organized a conference on capital account liberalization. Most participants agreed that following an

appropriate sequencing was vital for the success of liberalization. There was also broad support for the idea that a premature opening of the capital account could entail serious danger for the country in question (see S. Edwards (Ed.). *Capital Controls, Exchange Rates and Monetary Policy in the World Economy*, Cambridge University Press, 1995). In a paper presented at this conference, Robert Mundell captured succinctly the views of most participants. The following quote is illustrative: “unfortunately. . .there are some negative externalities [of an early capital account liberalization]. One is that the borrowing goes into consumption rather than into investment, permitting the capital-importing country to live beyond its means. . .without any offset in future output with which to service the loans. Even if the liabilities are entirely in private hands, the government may feel compelled to transform the unrepayable debt into sovereign debt rather than allow execution of mortgages or other collateral” (p. 20).

At the 1992 Seoul conference on capital liberalization, one of the few dissenters was the late Manuel Guitian, then a senior official at the IMF, who argued in favor of moving quickly towards capital account convertibility. Yet, in stark contrast to Stiglitz’s characterization of the IMF leadership, there was no dogma or arrogance in Guitian’s position. He listened to others’ arguments, provided counter-arguments, and carefully listened to the counter counter-arguments. I believe that Guitian’s paper—suggestively titled “Capital Account Liberalization: Bringing Policy in Line with Reality”—is one of the first written pieces that documents the IMF’s change in views regarding sequencing and capital account convertibility. After discussing the evolution of international financial markets, and expressing reservations about the “capital-account-last” sequencing recommendation, Guitian summarized his views as follows: “There does not seem to be an a priori reason why the two accounts [current and capital] could not be opened up simultaneously. . .[A] strong case can be made in support of rapid and decisive liberalization in capital transactions” (pp. 85–86).

Starting in 1995, more and more countries began to relax their controls on capital mobility. In doing this, however, they tended to follow different strategies and paths. While some countries only relaxed bank lending, others only allowed long-term capital movements, and yet others—such as Chile—used market-based mechanisms to slow down the rate at which capital was flowing into the economy. Many countries, however, did not need any prodding from the IMF or the US to open their capital account. Indonesia and Mexico—just to mention two important cases—had a long tradition of free capital mobility, which preceded the events discussed in this book, and never had any intention of following a different policy.

But agreeing that sequencing is important is not the same as saying that capital controls should never be lifted. A difficult and important policy issue—and one that Stiglitz does not really tackle in this book—is how and when to remove impediments to capital flows. Recent research that uses new and improved measures on the degree of capital mobility suggests that a freer capital account has a positive effect on long run growth in countries that have surpassed a certain stage in the development process, and have strong institutions and domestic capital markets. Also, there is some evidence suggesting that price-based and transparent mechanisms, such as the flexible tax on short-term inflows used by Chile during much of the 1990s, work relatively well as a transitional device. It allows for some capital mobility and discourages short-term speculative monies; at the same time, it avoids arbitrary decisions by bureaucrats. However, as I have argued elsewhere, even Chile-style

capital controls have costs, and they did not spare Chile from contagion or macro instability during the second half of the 1990s.

3. Crisis management in East Asia

Stiglitz is particularly critical of the way in which the IMF handled the East Asian crisis. In his view, major mistakes included (1) closing down, in the middle of a financial panic, a number of banks in Indonesia; (2) bailing out private and mostly foreign creditors; (3) not allowing the imposition of capital controls on outflows; and (4) imposing tight fiscal policies and high interest rates. He claims that the experiences of China and India, two countries that did not suffer a crisis, and of Malaysia—which did not follow the IMF's advice, and recovered quickly—support his views. This argument is highly unpersuasive, however. Anyone mildly informed knows that there are many reasons why India and China have not faced a crisis, and attributing this to the presence of capital controls is overly simplistic, if not plainly wrong. The case of Malaysia is a bit more complicated. It has recovered fast—although not as fast as South Korea—but it is not clear if this recovery has been the result of the imposition of capital controls. What is clear, however, is that Malaysia surprised many observers by tightening controls only temporarily; after approximately a year, and once the economy had stabilized, the controls were lifted just as Dr. Mahatir had originally announced.

What makes Malaysia's case particularly interesting is that historically the temporary use of controls is quite unique. The historical norm is closer to what happened in Latin America during the 1980s debt crisis, when what was supposed to be a temporary tightening of controls, became a long-term feature of the regional economies. Moreover, in Latin America, the stricter controls on capital outflows did not encourage the restructuring of the domestic economies, nor did they result in orderly reforms. The opposite, in fact, happened. In country after country politicians experimented with populist policies that at the end of the road deepened the crisis.

Two of Stiglitz's criticisms are right on target: closing banks in the midst of a panic is a major mistake. Also, massive bailouts are costly and ineffective. A number of people have long recognized this, and the recent proposal by Anne Krueger, the IMF's First Deputy Managing Director, is a positive development in an effort to implement an effective standstills framework.

Stiglitz' most severe criticism refers to the IMF's fiscal and interest rate policies. He argues that the East Asian crisis called for *expansionary* and not, as the IMF insisted, *contractionary* fiscal policies. In his view, by imposing fiscal retrenchment, the IMF made a serious recession even deeper. Worse yet, the IMF-mandated increases in interest rates generated a string of bankruptcies that deepened the confidence crisis and further contributed to the slowdown. Stiglitz's position, however, does not have—at least, not yet—much empirical support, and fails to recognize how severe the situation had become by late 1997. These were not, as he argues, “severe downturns” that required textbook-type counter-cyclical fiscal policies; these were *major* currency crises. And a key feature of currency crises is that the public drastically reduces its demand for government securities and domestic money, turning to safer assets, especially foreign exchange. This

constrains what governments in crisis countries can do: with a declining demand for government securities—by both local and foreign investors—it is very difficult to run a more expansionary fiscal policy unless the deficit is monetized. Moreover, if the decline in the demand for domestic money is not brought to an end, the price of foreign exchange will jump drastically—greatly overshooting its equilibrium level—and inflation will increase significantly. If foreign currency denominated debt is high—as was the case in a number of the East Asian countries—the weakening of the currency will result in a significantly higher debt burden and further bankruptcies.

The first order of business in a major currency crisis is to re-establish confidence. While massive and recurrent bankruptcies do not contribute towards achieving this goal, neither do large deficits translated into money printing, or rapidly depreciating exchange rates. At the end of the road, the issue is one of trade-offs, and the key question is by how much to let the exchange rate depreciate, and by how much—and for how long—to increase interest rates. The answer depends in part on the government's objectives. If the authorities want to avoid default and runaway inflation—clear key objectives of every East Asian government—letting the exchange rate run amok is highly risky. Under most circumstances, pumping in liquidity when the demand for money is shrinking, and issuing government debt when government securities are being dumped, is unlikely to restore confidence or avoid an inflationary explosion.

4. Concluding remarks

I finish where I began: This is an important book that deserves to be read and discussed widely. At the end of the road, however, I was left with a sense of emptiness. I have no doubt that Stiglitz is sincere, and that he is truly pained by what he believes are major problems with globalization. However, he is also rather naïve. And it is this naivete, and not the stridency of the delivery, what at the end makes this book fail. Stiglitz has too much confidence on the ability of governments to do the right thing, and he exaggerates greatly the extent of market failures. The agenda should be to improve institutions and incentives; to promote competition and efficiency; to implement policies that raise productivity; to truly help the poor and the destitute; to put an end to corruption and abuse; and to make sure that globalization becomes a fair process, where the industrial countries also dismantle their protective barriers. The agenda should not be to bring back bureaucrats, xenophobic autocrats, and corrupt politicians to run the economy. We have been there, and it does not work.

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