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A Review of Joseph Stiglitz' "Globalization and Its Discontents"

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This book has already received wide attention. Its distinguished author has taught economics at Yale, Princeton, Oxford, Stanford, and now Columbia University. He shared the 2001 Nobel Prize in economics for his contributions to understanding the impact of asymmetric information on economic behavior and institutions. He served on President Clinton's Council of Economic Advisers, first as member, then as chairman, before moving in early 1997 to the World Bank as senior vice president and chief economist. Thus he had a ring-side seat among policy-makers during a significant decade which saw the completion of NAFTA and the Uruguay Round, the creation of the World Trade Organization, the transformation of former communist countries to market economies, rapid growth in the world's two most populous poor countries, and several serious financial crises.

Stiglitz reminds his readers again and again that the ultimate purpose of economic policy should be security and prosperity for all -- gainful employment, growth in income, adequate public services, especially health and education -- that foster individual well-being and facilitate further growth.

The author's has a good head on his shoulders and his heart is in the right place. Why then is this such an unsatisfactory book? Its title suggests it is about globalization -- which Stiglitz defines simply as the removal of barriers to free trade and the closer integration of national economies -- and many sensible things are said about it, in particular that the controversial issue is not globalization, which is all but inevitable and even desirable, but rather how it is managed.

The bulk of the book, however, is a diatribe against the International Monetary Fund (IMF) and secondarily its largest share-holder, the US Treasury Department. Somehow, the IMF got seriously under Stiglitz' skin during his stint in public service, and he developed a strong animus against it. Unfortunately, that animus pervades the book, and clouds Stiglitz' discussion of many important issues and events. In his view, the IMF is not only arrogant and secretive, but was more or less systematically wrong in its dealings both with developing countries and with former communist countries making the transition to market economies. Indeed, the IMF is blamed for many ills, ranging from increased AIDS in Thailand to collapse of the Russian economy. Some of the stories related by Stiglitz, if true, are appalling -- e.g., those concerning positions taken by the IMF in Ethiopia (foreign aid should not be considered a budgetary receipt, to be spent, but rather should be saved) and Morocco (a government agency should not be involved in the distribution of agricultural credit and seeds). Stiglitz' animus against the IMF, however, leads him too often to over-simplify the circumstances faced by policy-makers and to ignore the trade-offs and judgements they are often required to make. Substantively, the book focuses heavily on the Asian financial crisis of 1997 and on the transformation of the Russian economy, and the IMF's nefarious role in each. This review will cover Stiglitz' treatment of both episodes, which together provide the main (but not the sole) exhibits for his indictment of the IMF. But for some readers it may first be useful to say something about the IMF.

This institution, along with the World Bank and the General Agreement on Tariffs and Trade, was created immediately after the Second World War to provide a framework for international economic cooperation that would avoid another catastrophe like the Great Depression of the 1930s.

The stated purposes of the IMF are, inter alia, "to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income..." When it comes to IMF lending, it can do so temporarily "under adequate safeguards, thus providing [members] with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity." (Art.I, ii and v) The IMF was not established, as Stiglitz suggests, to help finance fiscal expansion in times of economic recession, but rather to help cover temporary shortfalls in international receipts, especially on trade in goods and services. Such shortfalls of course might arise from appropriately expansionary domestic fiscal policy. Above all, prosperity was not to be purchased at the expense of one's trading partners, e.g. through imposition of import restrictions or through competitive currency depreciation.

The original Bretton Woods system, as it was called (after a New Hampshire town where a key meeting occurred in 1944), envisioned fixed exchange rates among currencies, adjusted infrequently if necessary. This feature of the system disappeared in 1973 when the major currencies were allowed to float against one another. But most developing countries continued to manage their currencies heavily, often to the point of being indistinguishable from fixed exchange rates. The IMF made its last loans to rich countries (Britain and Italy) in 1976; but with the debt crises of the 1980s and transformation of former communist countries in the 1990s, the role of the IMF if anything has increased.

The IMF is governed day to day by an Executive Board of 24 persons, 8 appointed by single countries, 16 representing coalitions of countries, with weighted voting. It has responsibility for "surveillance" of all its member countries on a routine (roughly annual) basis. But its major influence on national policy comes when a member country seeks to borrow above a certain scale. The borrower must present a "letter of intent" with respect to the policies it will pursue to eliminate the imbalance which led it to seek IMF help, and to permit repayment of the IMF loan, traditionally over a three to five year period, lengthened in special cases and, recently, more generally. This letter, technically from borrowing government to the IMF, is in fact usually negotiated with the IMF staff, and presents the (in)famous conditions imposed by the IMF in exchange for the loan. Note that the request comes at the initiative of the country that wants the loan. Over time, however, others have linked their willingness to provide funds, e.g. with respect to rescheduling of debt, to the presence of an IMF program. It increasingly became regarded as providing a "seal of approval" for the macroeconomic policies of the country, taken into account not just by debt reschedulers but also by foreign investors contemplating loans or other credits to the country, although the seal of approval is perhaps wearing thin after the experiences of the past five years, particularly in Russia (1998) and Argentina (2001).

### The Asian Financial Crisis

Stiglitz strongly indicts the IMF for the conditions it imposed in the Asian financial crises of 1997, involving, successively, Thailand, Indonesia, and South Korea (the Philippines is curiously omitted), and which Stiglitz (incorrectly, in my view) considers a single crisis. Concretely, the IMF drove those countries into economic depression by its insistence on high interest rates. Thailand and Korea eventually recovered, but only after steep declines in output. The Indonesian story is complicated by political developments -- the ouster of President Suharto -- that were triggered by the crisis and maybe even by the IMF program, but that were not of themselves undesirable for a thorough democrat such as Stiglitz, so the discussion concentrates on the first two countries, and on Malaysia, which eschewed an IMF program.

Basically Stiglitz' story is this: as a result of IMF-induced financial liberalization, Thailand ran into

serious financial difficulty, culminating in a sharp depreciation of Thailand's currency, the baht, in early July 1997. Thailand appealed to the IMF for financial support, which was granted in late August, on condition that Thailand tighten its fiscal and monetary policies and engage in some desirable but ill-advised reforms of the domestic financial system. [The IMF pledged \$3.9 billion, which was augmented by pledges of \$4 billion from the World Bank and Asian Development Bank and of \$12 billion from bilateral donors, mainly Japan but notably including, for the first time, China, for a total of \$20 billion.] The consequence was to permit foreign and rich Thai speculators to export capital at an unsustainably favorable exchange rate, while poor Thais were subjected austerly, higher unemployment, and an increase in poverty.

The preceding paragraph is slightly synthetic, in that while all statements can be found in the book, not all are applied specifically to Thailand. Indeed, one of the irritations of the book is that general claims are made which imply application to the country under discussion, without directly saying so. Stiglitz drifts from one generalization to another, leaving the reader to puzzle whether they apply in any particular instance.

Stiglitz' story of Thailand, sketched above, bears only a rough relationship to what actually happened. It is a "stylized" story, a technique used frequently by economists to make a point. But Stiglitz purports to be characterizing real events, and in this case it seriously distorts the truth, largely through selective omissions.

Here is a different, and more accurate, characterization of the same events: Thailand did indeed liberalize its financial system, internally and externally, possibly with IMF encouragement, although the process started in the early 1980s. That liberalization, however, included so-called offshore banking facilities licensed by Thailand, designed to attract foreign capital with the ostensible purpose of re-lending it abroad, or providing export credits, but used in fact, with the encouragement of Thai authorities, to channel funds into domestic loans in Thailand, including real estate loans.

During its routine surveillance of Thailand in July 1996, a full year before the foreign exchange crisis broke, the IMF team warned the Thai authorities -- admittedly in officialese, but unmistakably to anyone who can read it -- of the magnitude and short maturity of its external debt, of the weakness of its bank supervision, of the dangerously large size of its current account deficit (which would amount to nearly \$15 billion, 8 percent of GDP, during 1996), and of the relative inflexibility of its exchange rate policy (which had been unchanged near 25 baht per US dollar since 1987). The Thai authorities ignored the warnings.

Net capital inflows already ceased to cover the current account deficit in the summer of 1996; the exchange rate was maintained by drawing down official reserves, partly by commitments in the forward market, known to very few officials. Official interest rates were not increased, although money market rates rose. Thailand finally exhausted its official reserves in mid-1997, and the baht depreciated precipitously, to 36 per dollar by the end of September and 47 by the end of the year. It appreciated thereafter, reaching 36 by the end of 1998, from which it depreciated gradually and erratically. In late August 2002 it stood at 42. (The appreciation of the Korean won from its end-1997 low was even greater.) In what sense were the IMF-supported exchange rates "unsustainable"?

Note that the net capital inflow did not cover the current account deficit from summer 1996. This is a key point. Under such conditions, and with limited official reserves, a country must either borrow officially (e.g. from the IMF) or reduce its deficit. There are only two acceptable ways to accomplish the latter: depreciate the currency and/or contract aggregate demand. Usually both are necessary, because currency depreciation takes time to turn the deficit around by stimulating exports and discouraging imports. Direct import restrictions are ruled out by commitment to the IMF's basic

principles, cited above. In short, in these circumstances maintaining the *status quo ante* is not an option. The prescription of tightened fiscal and monetary conditions must be interpreted in light of this need to contract aggregate expenditure. Stiglitz to the contrary notwithstanding, the IMF usually urges often reluctant governments to depreciate their currencies, not support them at unsustainable levels. That was not necessary in the case of Thailand or Korea, since their currencies had already depreciated by more than enough during the early phase of the crisis.

Depreciation of the currency itself was deflationary in the short run, because of heavy indebtedness in foreign currency. A fine judgement is required, in a dynamic setting, concerning how much if any additional contractionary policy is required. Of course, to the extent temporary official borrowing is possible, the contraction can be mitigated, but not altogether avoided if the current account deficit is to be significantly reduced.

There was another concern: the export of capital by foreigners or residents would depreciate the currency even further. Stiglitz writes frequently and glibly about "international speculators." But what was the actual situation, again focussing on Thailand, although analogous comments could be made about Korea? First, foreign banks were not fully rolling over their short-term claims on Thai banks and firms, although according to balance of payments statistics only \$6 billion, less than ten percent of the amounts outstanding at the end of June, were withdrawn by the end of the year (more were withdrawn during 1998 and 1999). Second, Thais were buying foreign exchange to cover their heavy short-term obligations in dollars and yen, which in terms of baht were rising daily as the baht depreciated. They had erroneously counted on a stable exchange rate, were badly exposed in foreign currency debt, and were now hedging their obligations, not speculating. In fact, they were speculating *before* the crisis that the exchange rate would remain unchanged and they could borrow more cheaply abroad, although they may not have recognized it as speculation, given a decade of exchange rate stability.

Remarkably, net foreign purchases of Thai stocks continued throughout the second half of 1997 and winter of 1998. This is not the behavior of rapid turn-around foreign speculators, although there undoubtedly were some within the aggregated figures. In any case, those who liquidated on average lost money both on lower stock prices and on a weaker baht.

Stiglitz objects to massive IMF and IMF-related loans, pejoratively called bailouts, and asserts a proper prosperity-oriented program could have been achieved with far fewer funds. But he does not tell his readers how. As noted, the current account deficit was nearly \$15 billion in 1996 (Korea's was \$23 billion). The official support loans actually dispersed during the second half of 1997 were \$8.3 billion (Stiglitz fails to distinguish between contingent pledges, which are designed to assemble large visible support packages, and actual disbursements), of which \$2.4 billion was from the IMF. That was enough to cover half the 1996 deficit, plus a little. Could continued prosperity have been assured with a substantially smaller amount? I strongly doubt it, but would welcome learning the mechanism.

In reality, Thailand's current account position improved quickly, following the economic contraction, and became a surplus by year end, which continued throughout 1998-2000. Clearly, in retrospect, Thailand overdid the contraction cum depreciation, and prosperity was unnecessarily sacrificed, as Stiglitz suggests. But the policy judgements required were more refined and subtle than he implies, and above all required quantitative comparisons among alternatives.

Stiglitz offers an unqualified criticism of high interest rates, and expresses puzzlement over the need for them by an institution dedicated to maintaining prosperity. Credit was contracted, and firms (including some export firms) were unable to expand. Other things equal, high interest rates are undesirable for growth-oriented economies. But other things were not equal. The currency was depreciating rapidly. Given the large current account deficit, the cessation of capital inflow, and the

desire of exposed debtors to hedge their foreign currency obligations, there was little to stop continuing depreciation. But that would increase the indebtedness, reckoned in baht. Indebted firms, and even the entire banking system, could be thrown into insolvency. The tight credit was designed to keep people from borrowing baht in order to buy foreign exchange, and thus to inhibit further depreciation. Combined with use of the official (IMF and related) support, that might stop the depreciation, and the high interest rates could be short-lived, doing little lasting damage. In short, the Thai authorities, and their IMF advisers, faced a Hobson's choice, requiring thoughtful comparison of two unattractive courses of action. For Stiglitz, the right answer is unambiguously clear -- avoid the high interest rates and let the currency go. He might have been right, but he simply asserts it, unpersuasively dismissing the dilemma in a short paragraph. And he surely would not be correct in all circumstances.

Stiglitz compares Malaysia approvingly with the other Asian countries. Malaysia, although affected by the crisis in Thailand, did not solicit IMF support, raised interest rates only modestly, and imposed controls on outflows of capital, albeit a year later and only briefly -- all without obviously worsening its economic recovery. What he does not tell his readers is that: (1) Thailand imposed capital controls in May, before the crisis, but they did not avert it; (2) Malaysia fixed its currency's exchange rate to the US dollar when it introduced capital controls, rather than continuing Stiglitz's preferred solution of floating; and (3) Singapore, Hong Kong, and Taiwan all raised their short-term interest rates sharply in the fall of 1997, even in the absence of an IMF program (indeed, the latter two entities are not members of the IMF), in order to discourage sales of their respective currencies, without the strong and prolonged contractions experienced by Thailand, Indonesia, and Korea. So temporarily high interest rates are not, after all, associated only with IMF programs, nor need they lead to severe economic contraction. Why did Stiglitz omit these important points? One can only assume because they would have blunted his strong anti-IMF message.

#### Russia and other Transition Economies

Stiglitz is similarly cavalier in his discussion of Russia and other countries "in transition" from central planning to market economies. He emphasizes the considerable deterioration of the Russian economy from 1989 to 1998 (an alleged deterioration which some specialists question), and blames it forthrightly on IMF advice and conditions. But the suggestion that the IMF could dictate policy to Russia during this period is, well, laughable. Of six stand-by agreements with the IMF, Russia violated the monetary and fiscal conditions in five of them, often egregiously. The IMF had little credibility in Russia, and both the Russians and the IMF knew it. There was strong political pressure, especially from the USA and Germany, not to let President Yeltsin down. Most of the content of the IMF programs was set by various Russian reformers, hoping to use the IMF agreement as leverage with the rest of the government and with the Russian legislature (Duma) -- a phenomenon not peculiar to Russia. The IMF probably did give some advice of doubtful merit -- transforming an economy from central planning to market was new territory for everyone, and, as one wag put it, one cannot discover the best path by reading "The Road to Socialism" backward. But the Russians made the key decisions.

Stiglitz' suggestion that Poland's economic performance was superior to Russia's because the Poles flouted the IMF's advice more often is again contrary to fact, according to a detailed study by R. Stone (Lending Credibility, 2002): Poland hewed more closely to the targets set in IMF programs than Russia ever did.

Stiglitz argues that the Russian financial crisis of August 1998 represented contagion from the East Asian crisis, via a sharp decline in oil prices, on which the Russian government depended heavily for revenue. That oil prices significantly fell is fact. That it can plausibly be attributed to the Asian crisis

is highly doubtful: reduced oil consumption in Southeast Asia, even when Korea is added, simply was not large enough to explain the drop. Japan's recession, which began before the Thai crisis erupted, was more significant, as was a mild US winter in 1998. But most important was the struggle for market share between Saudi Arabia and Venezuela, and Saudi Arabia's deliberate increase in oil production in early 1998 [ck] in order to "discipline" Venezuela and other oil producers. The Asian financial crisis simply cannot carry the weight Stiglitz gives it, and the Russian crisis must be regarded largely as a distinct, separate phenomenon.

Lower Russian revenue required even more borrowing to cover a rising budget deficit without cutting expenditures, and Russia had to pay higher interest rates to float the new (ruble-denominated) debt as well as replacing retiring debt.

Not surprisingly, Stiglitz is highly critical of the IMF's role in the Russian crisis. Again, he shows no awareness of the policy dilemmas involved. Paraphrasing, here is how one key Russian official posed the problem:

We became prisoners of our own policy. The government's anti-inflationary strategy was predicated on a stable ruble, as was the surge of foreign investment Russia had received between 1996 and 1998. Devaluing preemptively would simply have brought on the crisis it was intended to avert by destroying the value of the GKO [treasury bill] market, which was denominated in rubles. This, in turn, would wipe out the liquidity of the Russian banking system, make it impossible for the government to attract noninflationary finance, and lead to capital outflows. Even a small movement in this direction would shake the confidence of the market, frighten away foreign investors, and very likely bring about a collapse. Having come to this pass in the summer of 1998, there was no way to go but forward. (from R. Stone, p.154)

The Russian officials decided to gamble, and appealed once again for IMF support. The appeal was controversial within the IMF, but it decided to go ahead with a new program in July, apparently on the grounds that there was some chance it could succeed, whereas to deny it assured collapse of the Russian program, would undermine the new team of reform ministers, and might even jeopardize democracy in Russia. In the end, the gamble failed, but that is not the same as saying it was irrational or that in similar future circumstances it should not be tried again. The point here is not to resolve the issue, but to point out that policy-makers, both national and international, often need to make refined judgements in difficult circumstances. In Stiglitz' book, such policy dilemmas simply do not exist.

Stiglitz compares Russia unfavorably with China. However, he idealizes Chinese economic performance, while vilifying Russia's. Chinese will be astonished to learn here that they have created an effective social safety net, or that their banks provided substantial credits to new enterprises. He extols China for its gradualism, in contrast to Russia's "shock therapy." However, his starting points, 1978 and 1992, are arbitrary. China had its shock treatment, during the Cultural Revolution, which was designed to undermine the growing authority and arrogance of the bureaucrats, including Communist Party cadres, and it succeeded. That set the political stage for Deng Xiao Ping's economic reforms, which were admittedly undertaken experimentally and without overall design. Russia, in contrast, started in 1985 with gradual reform, and it simply did not work. Entrenched bureaucratic resistance was fierce even to the mild price reforms Gorbachev espoused, and by 1991 the shops were bare. Moreover, while Russia freed prices dramatically in early 1992, it did not carry out the full program advocated by the Russian reformers; it was stalled in mid-1992, and never fully recovered.

Stiglitz rightly urges the desirability of wide public support for drastic reforms, but he naively converts Russia's Communists in the Duma into social democrats, a loyal opposition. That may have

been true of some of them, and increasingly over time; but in 1992-93 Communist members of the Duma were trenchantly opposed to market-oriented reform, and used their parliamentary strength to block reforms and undermine the reformers in the government. This contrasts with Poland, Czechoslovakia, and Hungary, where there was general public consensus for becoming "normal" nations again, i.e. like western European countries.

Gradualism was initially tried not only in Russia, but also in Ukraine, Belarus, and several other former Soviet republics, with economic performance even worse than Russia's; while the Baltic states, especially Estonia, pushed ahead rapidly and performed better. In fact, Anders Aslund argues in his recent book that the faster reforms were undertaken, and the faster transition countries democratized, the better the economic performance. A gradual approach permitted the growth of rent-seeking by former Communist officials and others, and stalled both reforms and economic performance. Again, why these significant omissions in his characterization of the record in transforming countries, and his generalizations from that record?

### Back to the IMF

In summary, this book is largely a hatchet job on the IMF. The IMF often deserves criticism, but to be helpful, that criticism should be meticulous, taking into account the actual circumstances, economic structure, and near-term outlook of each case. Stiglitz' criticisms fall short in this regard. His dissatisfaction with the IMF is clear; what coherent and potentially efficacious advice he would have given is not.

Stiglitz however is onto something when he surmises that the IMF has subtly shifted its focus over time, from the basic economics of preserving or restoring prosperity to an emphasis on financial rectitude as that is defined in financial markets. This may be due in part to efforts to help rebuild "confidence" in financial markets following crises in order to discourage further withdrawal of private capital and/or to encourage new lending, in countries where that is relevant. If so, this approach is likely to be a fundamental error, or at least needs to be questioned. We have no persuasive evidence from recent decades that foreign private financial capital, as opposed to foreign direct investment, contributes to economic growth; and to the extent it deepens financial crises, it may detract from growth. But Stiglitz is simply wrong to suggest that this shift in orientation is due to many IMF employees being drawn from the financial sector; most are promoted from within the IMF itself, and senior positions are generally filled by national civil servants or academics. And it is simply scurrilous to suggest that former Deputy Managing Director Stanley Fischer's policy positions were determined by his angling for a job at Citibank.

A related area where the IMF needs to be pressed hard is its crusade against inflation. Hyperinflation can be severely damaging to economy and society, but there is no evidence that moderate inflation hurts economic performance. On the contrary, so long as it is under control, inflation in the low double digits can help economic development in countries with poorly developed financial markets -- as it probably did Korea and Colombia in the 1970s. Inflation is a tax on money balances, and it is a tax that is probably fairer and easier to collect than many other taxes in developing countries. Yet the IMF developed a passion against inflation, similar to the passion that enshrined price stability as the primary objective of the European Central Bank in the Maastricht Treaty that created the euro. Perhaps the source was the same European financial officials, given European dominance of the Executive Board (eight of 24 EDs are European, nine counting the Russian) and monopoly over the Managing Directorship, although the United States certainly has not resisted it. Yet the IMF Articles speak of prosperity, not price stability. Runaway inflation can be damaging to prosperity, but moderate,

controlled inflation has a potential developmental role.

Another area where the IMF should be questioned hard is the level of microeconomic detail it frequently requires in framing a stabilization program. As noted, this detail is sometimes requested by foreign economic officials, hoping to invoke IMF authority to press their agendas for reform on reluctant colleagues. Sometimes it has arisen from experience-based mistrust of national officials to carry out general commitments. But it sometimes takes the IMF well beyond its technical competence, absolves national authorities from taking responsibility for their actions, intrudes into areas of domestic political sensitivity, and frequently is unnecessary to carry out the basic purposes of the IMF, to help countries through payments crises. I am also dubious of the current fashion, to have the IMF focus on poverty reduction. That is an appropriate assignment for the world bank and aid agencies, not for an institution whose main charge is macroeconomic stabilization and payments equilibrium.

Many of the comments here may seem like niggling details. But the difference between science and opinion is precisely attention to relevant details. Generalizations are necessary, but they must be scrupulously consistent with relevant details; otherwise they are merely unsupported opinion. Stiglitz was apparently deeply offended by the IMF, and this book is his retribution. Unfortunately, it is unpersuasive (which is not the same as saying it is always wrong), and unhappily in it Stiglitz displays some of the arrogance of which he is so critical in the IMF. Policy-making involves choices among alternatives, sometimes unpalatable alternatives, and requires careful, often quantitative cost-benefit analysis among the the alternatives that are feasible. Stiglitz fails to provide the feasible alternatives, which is too bad.

The IMF needs constructive external criticism. Stiglitz has both the intellectual equipment and the experience to provide it. He missed a major opportunity, and thereby has left the important task to others.