

# The World Economy: The Way Forward

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# Where we are

- Slow growth—Great Malaise, New Mediocre
  - Not a crisis *yet*
  - But persistent moderately high unemployment in many countries (in some cases disguised), higher unemployment among youth and marginalized groups
  - Disproportionate share of slow growth going to a few at the top—growing inequality, wage stagnation
  - Even in countries with low “official” unemployment, raising questions of quality of job growth and disguised unemployment
- Mixed prospects—small probability of returning to robust growth, large probability of recession or worse
- Conflicting views about obvious instruments
  - Monetary policy has run its course
  - **Never very effective in deep downturns: the only effective instrument is fiscal policy**
  - Real problem **not** zero lower bound—slight lowering of interest rates (into negative territory) will not work
    - Experiments with negative interest rates unlikely to stimulate much, may have adverse side effects
  - QE increased inequality, and because of financial market imperfections/irrationalities may have led to mispricing of risk and other financial market distortions

- Worry that fiscal policy risks damaging build up of debts
  - View that fiscal stimuli in 2008/2009 didn't work is absolutely wrong
  - Reduced unemployment from what it otherwise would have been, prevented deeper recession, depression
  - In crisis, didn't have time to optimize spending—but even imperfect expenditures were better than alternative of massive idle resources and depressions
  - Worry about debts is fundamentally misplaced in balance sheet approach, where government spends money on productive investments
- Effectiveness of policies undermined by globalization—large spillovers to others, costs borne at home
  - But global coordination sufficiently weak to provide “superior” globally coordinated solutions

# Great malaise hides deeper problems on which there is being made remarkable little progress

- **Climate change**
- **Inequality**, large number of individuals in poverty
  - With many dimensions—inequality in wealth, health (in countries relying on private provision of health care), and access to justice
  - Hollowing out of the middle in advanced countries—and even in developing world
  - Problems especially severe for marginalized groups and (often) youth
- Deep **structural transformations** needed to achieve sustainable growth
- Deeper problems in market economies leading to **productivity slowdown**
  - Short termism in both private and public sector
  - Insufficient investment in basic research, and in many countries, infrastructure
  - Excessive financialization, part of process, part of cause
    - Opening up major gaps between wealth and capital
    - Capital output ratio in many countries going down even as wealth output ratio increases
  - Failures to adapt education system

# Diagnosis of the central problem

- **Lack of global aggregate demand**
- Combined with insufficient efforts in each country to support non-traded sectors
- Excessive reliance on debt, financialization
- More broadly, in large parts of advanced countries about a third of a century ago, there began a process of rewriting the rules of the market economy (redesigning tax structures, ill-thought out liberalization) that led to slower growth, more instability and more inequality—just the opposite of what was promised

# Remedies: Immediate issue—restoring global aggregate demand

- Setting a high price on carbon (following up on Paris) will induce investments to retrofit the global economy for climate change
- Development banks (like AIIB and NDB) can help recycle some of the surpluses and help meet deep investment needs, including infrastructure
- Increasing government spending, financed partially by taxes, will stimulate economy
  - Principle of balanced budget multiplier; with well designed taxes and expenditures, multiplier can be quite high
  - Appropriate accounting framework looks at both sides of the national balance sheet, not just at liabilities
    - Spending on education, health of young people are *investments* which improve asset side of balance sheet
    - So do investments in infrastructure and technology
  - Environmental taxes and land taxes will help restructure the economy to create sustainable growth
  - So will government expenditures to promote structural transformation and promote equality
  - Reformed tax structures (to eliminate corporate welfare, regressivity, distortions) can raise substantial revenue, improve economic performance, promoting sustainable and *inclusive* growth
- Other measures to increase equality will increase global aggregate demand
- A global reserve system will reduce need for demand-reducing build up of reserves

# Beyond *global* aggregate demand

- Especially as world moves to service sector economy, non-traded sector likely to be increasingly important
- Absence of *domestic* demand impairs supply
- Domestic demand is more than private *consumption*
  - Includes investment in environment, people, technology (closing the knowledge gap), infrastructure, making cities livable
- Much of this domestic demand will have to be *publicly financed*

# Need balanced approach to finance— debt vs. tax

- Will vary from country to country, depending on levels of debt and taxes, growth paths
- In *all* countries, raising environmental taxes (“charges”, including congestion fees), including carbon tax, would generate substantial revenues and improve economic performance
- In *virtually all* countries, raising taxes on land and other natural resources (“inelastically supplied”) would raise substantial revenues, increase growth (less diversion of savings to unproductive uses)
- Lowering taxes on corporations would *not* increase investment, since most investment is debt financed, and interest is tax deductible (lowering taxes raises *net* cost of capital, and thus discourages investment!)
- Balanced budget multiplier implies that raising taxes and spending in tandem stimulates economy
- Well designed taxes would also address key issues of inequality, instability, and environmental degradation
- Always need to keep balance sheet perspective



# Key role of China

- China has been major source of increases in global demand, especially since the global financial crisis
  - Effects are felt directly, and indirectly, through effects, e.g. on Latin America and Africa
- Europe and the US will not be able to offset the effects of the slowdown in China
  - Especially given the problems posed by the Eurozone in Europe
  - It is not so much the slowdown per se, but the shifting of the center of gravity of the Chinese economy to the domestic economy from the rest of the World. It is inevitable as the Chinese economy grows bigger and bigger.
- Many of key issues facing China are similar to those facing rest of world

# Supply side vs. demand side reforms

- In the absence of adequate demand, supply side reforms will increase unemployment, not promote growth
  - Moving people from low productivity sector to zero productivity unemployment
  - Supply does *not* create its own demand
  - Indeed, supply side reforms can weaken demand and lead to lower GDP
  - But well designed demand policies can increase supply/productivity, can increase GDP today and potential growth rates
- Backward looking supply side reforms also will not work
  - Reducing excess housing capacity in the US (empty homes in Nevada desert) would not have helped US recovery
  - Destroying excess chip capacity in Korean crisis (1998) would have impeded its recovery
    - Ignored option value
  - Arguments often made by those wishing a reduction in competition
    - “national champions” = oligopolies
    - Special concern—state capitalism

# Failure of Supply side measures

- Many other ineffective (or counterproductive) supply side measures
  - Lowering corporate income tax
    - Lowering taxes on corporations that invest and create jobs and increasing it on corporations that don't incentivize investment and job creation
  - Financial market deregulation
- Supply side measures in US (and other countries) in early 1980s failed
  - Didn't live up to promise of increasing tax revenues—actually fell
  - Didn't live up to promise of increasing growth—actually fell
    - Savings rate fell
      - Same effect seen in more recent tax cuts in beginning of 2000s
    - Labor force participation fell
  - Worries about impact on inequality more than justified—have reached new heights

# Supply side measures that would work

Often working in conjunction with “demand”

- Increased investment in technology
  - Especially important as one creating an innovation economy and a learning society
- Increased investment in people—creating a healthier and more productive labor force
- Industrial policies which help restructure the economy, moving from old sectors to new
  - Markets don't make these transformation well on their own
- Competition policies—preventing the agglomeration of economic power
  - Monopolies restrict output
- Financial market reform
  - Not just prevent financial sector from imposing harms
  - Encouraging it to do what it is supposed to do, intermediate, private finance, especially for small and medium sized enterprises
  - Encouraging equity rather than debt
- Regulations on product quality and safety
  - Lack of confidence in products reducing domestic demand

# The world has lost its way

- Too often ideology has dominated pragmatism
  - “Seek truth from facts”
- Need for *balance*, with particular attention to the circumstances of the moment
  - Between supply and demand
    - At moment, shortage of global aggregate demand, and in most countries, shortage of domestic demand
    - Lack of demand impairs future productivity growth
    - Well designed demand policies will improve supply
    - Poorly designed supply policies will decrease demand
  - Between the public and private sectors
    - Most of key problems today need public action
      - Environment, inequality, instability, creating livable cities, health, education, research (especially basic) , economic restructuring
    - Remembering “third sector”—variety of alternative institutional arrangements
      - One of most successful US sectors—and source of private sector growth—is not-for-profit higher education

# The need for balance

- Among different groups in society
  - In too many countries growth has not been balanced, has not been inclusive
  - Reducing both demand and supply
- Between short and long run
  - Markets characterized by excessive short termism
- “Crossing river by feeling the stones”
  - Shock therapy didn’t work
  - But those who didn’t change also didn’t progress

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- Restore the balance that has been lost
- The New Mediocre, the Great Malaise, Secular Stagnation are not inevitable
  - They are the result of failed policies
- In an increasingly integrated world, the *best* way forward would entail global cooperation in restoring balance and increasing aggregate demand
  - Combined with cooperation, for instance, in the provision of global public goods—research, global warming
  - Achieving that cooperation has proven difficult
  - China's leadership in G-20 may be part of way forward
- But even lacking that cooperation, there is much that each country can do to strengthen demand and improve productivity within its own borders
  - With significant spill-overs to others