

A global lesson in market failure; From U.S. homeowners to the world's poor, the pain is real

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The Globe and Mail (Canada)

July 8, 2008

The world has not been kind to neo-liberalism, that grab bag of ideas based on the fundamentalist notion that markets are self-correcting, allocate resources efficiently and serve the public interest well. It was this market fundamentalism that underlay Thatcherism, Reaganomics and the so-called "Washington Consensus" in favour of privatization, liberalization and independent central banks focusing single-mindedly on inflation.

For a quarter-century, there has been a contest among developing countries, and the losers are clear: Countries that pursued neo-liberal policies not only lost the growth sweepstakes; when they did grow, the benefits accrued disproportionately to those at the top.

Although neo-liberals do not want to admit it, their ideology also failed another test. No one can claim that financial markets did a stellar job in allocating resources in the late 1990s, with 97 per cent of investments in fibre optics taking years to see any light. But at least that mistake had an unintended benefit: As costs of communication were driven down, India and China became more integrated into the global economy.

But it is hard to see such benefits to the massive misallocation of resources to housing in the United States. The newly constructed homes built for families that could not afford them get trashed and gutted as millions of families are forced out of their homes. In some communities, government has finally stepped in - to remove the remains. In others, the blight spreads. So even those who have been model citizens, borrowing prudently and maintaining their homes, now find that markets have driven down the value of their homes beyond their worst nightmares.

To be sure, there were some short-term benefits from the excess investment in real estate: Some Americans (perhaps only for a few months) enjoyed the pleasures of home ownership and living in a bigger home than they otherwise would have. But at what a cost to themselves and the world economy! Millions will lose their life savings as they lose their homes. And the housing foreclosures have precipitated a global slowdown. There is an increasing consensus on the prognosis: This downturn will be prolonged and widespread.

Nor did markets prepare us well for soaring oil and food prices. Neither sector is an example of free-market economics, but that is partly the point: Free-market rhetoric has been used selectively - embraced when it serves special interests; discarded when it does not.

Perhaps one of the few virtues of George W. Bush's administration is that the gap between rhetoric and reality is narrower than it was under Ronald Reagan. For all Mr. Reagan's free-trade rhetoric, he freely imposed trade restrictions, including the notorious "voluntary" export restraints on automobiles.

Mr. Bush's policies have been worse, but the extent to which he has openly served America's military-industrial complex has been more naked. The only time that the Bush administration turned green was when it came to ethanol subsidies, whose environmental benefits are dubious. Distortions in the energy market (especially through the tax system) continue, and if Mr. Bush could have gotten away with it, matters would have been worse.

This mixture of free-market rhetoric and government intervention has worked particularly badly for developing countries. They were told to stop intervening in agriculture, thereby exposing their farmers to devastating competition from the United States and Europe. Their farmers might have been able to compete with American and European farmers, but they could not compete with American and European Union subsidies. Not surprisingly, investments in agriculture in developing countries faded, and a food gap widened.

Those who promulgated this mistaken advice do not have to worry about carrying malpractice insurance. The costs will be borne by those in developing countries, especially the poor. This year will see a large rise in poverty, especially if we measure it correctly.

Simply put, in a world of plenty, millions in the developing world still cannot afford minimum nutritional requirements. In many countries, increases in food and energy prices will have a particularly devastating effect on the poor, because they constitute a larger share of their expenditures.

The anger around the world is palpable. Speculators, not surprisingly, have borne more than a little of the wrath. The speculators argue: We are not the cause of the problem; we are simply engaged in "price discovery." In other words, discovering - a little late to do much about the problem this year - that there is scarcity.

But that answer is disingenuous. Expectations of rising and volatile prices encourage hundreds of millions of farmers to take precautions. They might make more money if they hoard a little of their grain today and sell it later; and if they do not, they won't be able to afford it if next year's crop is smaller than hoped. A little grain taken off the market by hundreds of millions of farmers around the world adds up.

Defenders of market fundamentalism want to shift the blame from market failure to government failure. One senior Chinese official was quoted as saying that the problem was that the U.S. government should have done more to help low-income Americans with their housing. I agree. But that does not change the facts: U.S. banks mismanaged risk on a colossal scale, with global consequences, while those running these institutions have walked away with billions of dollars in compensation.

Today, there is a mismatch between social and private returns. Unless they are closely aligned, the market system cannot work well.

Neo-liberal market fundamentalism was always a political doctrine serving certain interests. It was never supported by economic theory. Nor, it should now be clear, is it supported by historical experience. Learning this lesson may be the silver lining in the cloud now hanging over the global economy.