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Globalization and the economic role of the state in the new millennium*

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This essay concerns the process of globalization, the integration of economies around the world which has put new demands on nation-states at the very same time that, in many ways, it has reduced their capacities to deal with those demands. The nation-state today is squeezed, on the one side, by the forces of global economics and, on the other side, by the political demands for devolution of power.

1. Introduction

This essay concerns the process of globalization, the integration of economies around the world which has put new demands on nation-states at the very same time that, in many ways, it has reduced their capacities to deal with those demands. The nation-state today is squeezed, on one side, by the forces of global economics and, on the other side, by the political demands for devolution of power.

1.1 An example: the constraints imposed by globalization on taxation and redistribution

An example of the constraints that have been imposed by globalization are the difficulties of taxation. With capital being movable from one jurisdiction to another, if one tries to impose a stronger taxation on capital, capital simply moves out. Ironically, just at the time that inequality has being growing—and it has grown enormously over the last twenty-five years—the ability to redistribute income through taxation of capital has been reduced enormously.

1.2 The contrast between nation-building 150 years ago and globalization today: the role of the visible hand

At the time that nation-states were being formed 150 years ago, communication and transportation costs were falling; it is these same forces that have given rise to the process of globalization. A government was in place that helped regulate these processes of nation-building, of building national economies. Professor Alfred Chandler of Harvard who described the process of nation-building in the United States talked about the ‘visible hand’ (Chandler, 1977). It was not the ‘invisible hand’, but the ‘visible hand’ that helped shape the process of nation-building.

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1.3 Global governance without global governance

Today, we have an analogous process of globalization, but we do not have global institutions that deal with its consequences. We have a system of global governance without global government. Worse still, just when the need for global institutions has never been greater, the confidence in the global institutions that do exist, like the International Monetary Fund (IMF) and the World Trade Organization, has never been less. There is a yawning gap between the demands placed on our international institutions and what those institutions can perform.

2. The failure of the reform of the international economic architecture

Since the East Asia crisis in 1997, there has been an enormous number of discussions on the reform of the global economic architecture, but almost nothing has happened. For those who have been participating in that process, this does not come as a surprise: the very parties that played a central role in the failures associated with the crisis have played a pivotal role in the reform discussions. To be sure, changes in international institutions will, under the best of circumstances, be difficult. But given the seeming momentum behind change, the fact that so little seems to have emerged is, to say the least, disappointing. But, in retrospect at least, it should now be clear why nothing has happened, and why little should have been expected to happen. To put it perhaps a little too bluntly, and oversimplified: it was because of the role of special interest groups, particularly in what I call the G1 (the United States).

2.1 An example: lack of transparency in the debate about transparency

A little episode helps demonstrate what I have in mind. At the beginning of the East Asia crisis, everybody talked about the importance of transparency. Transparency *is* a problem. There was a certain irony, though, in that the criticism was coming from the IMF, which is among the least transparent of all the international institutions, and from the US Treasury, which within the US government is the least transparent agency (apart from the CIA and the military). When I worked at the White House (as Chairman of the Council of Economic Advisers), the US Treasury used to fight hard to prevent us from finding out what it was doing. They viewed themselves as an independent part of government.

To return to the point: there was this enormous criticism of the lack of transparency in East Asia coming from the least transparent institutions. As the debate progressed, people, particularly in Asia, but also in Australia and in other places, started asking for a broad-based transparency. It does not do much good to know about some capital flows if we do not know about all capital flows. And all of a sudden, people realized that meant you have to find out about hedge funds and off-shore banking centers, and make them transparent. At that point, the US Treasury changed their tune. Larry Summers, who was soon to become Secretary of Treasury, started arguing about how too much transparency would have adverse effect on incentives to gather information. The whole debate about transparency was completely undermined, and that part of the process of reforming the global economic architecture came almost to a halt. While the outcome of those discussions was not to make hedge funds more transparent, they did make the role of special interests in driving US policies more transparent!

2.2 Small achievements versus big failures

I should be clear: some changes have been made in response to the global financial crisis and I do not want to underemphasize the value of that work. But it is not a change in the fundamental structure of the global economic architecture. We have to recognize that there have not been the kinds of reforms that would be required to substantially enhance global financial stability. As we have seen in the following years, financial instability is a fact of life. Each nation must learn to deal with the problems it confronts because of globalization. This is particularly important for the developing countries (that have been the center of my concern for the past few years), who both have the opportunity to benefit from globalization but also face the risk of being adversely affected by it.

3. The economic role of the state in light of the East Asia crisis

This is a good time to talk about the issue of the economic role of the state, because we stand at a crossroad where we can look back with some distance at the global economic crisis of 1997–98 and look forward to the changes in the economy and the role of government that are presented by the new economy and the new millennium. To understand why the 1997–98 crisis plays such an important role in thinking about these issues, one has to go back to the mindset of 1996 and early 1997. I remember myself, in speeches that I gave at that time, talking about capital flows from developed to less-developed countries having increased six-fold in six years: an amazing increase! There was a triumphant view of 'American-style' capitalism. There was the view that the business cycle had been repealed. After 200 years in which the market economies had fluctuated up and down, people thought this was the end of the business cycle. And all of a sudden all of this came to a crash, beginning in Thailand, and then in Indonesia, Korea, Russia, Brazil, now Argentina, Turkey, and we can go on.

3.1 How the East Asia crisis challenged triumphant capitalism

The debate about what caused the crisis was extremely heated, and for an obvious reason: in the most natural interpretation, the events challenged the orthodoxy that capitalism 'American style' was going to benefit everybody. But instead, the world seemed to come tumbling down. In fact, what the events did was to put what had happened from 1990 to 1996 in a broader historical context. There had been fluctuations in capitalism for 200 years. There had been real estate booms and busts in the United States, in Finland, in Sweden, in Norway. What happened in Thailand was very little different from the ordinary real estate boom and bust. Those who wanted to maintain the myth of the new, triumphant, American-style capitalism, wanted to make more of it than that. They wanted to reduce it to a problem *caused by bad policies in non-transparent countries that had really failed to adopt and adapt to American-style capitalism*; the problem, in this perspective, was not with capitalism, but with Thailand. But when Argentina, a country that had been described as the IMF's poster child, doing everything that IMF told it to do, had problems, then everybody recognized that the blame for the problems could not just be shifted to each country when it had its problems. There was something wrong with the *system*; something perhaps fundamental was defective. The 1997 crisis was so important because it required a re-examination of the nature of capitalism and reminded us that there were still some very significant risks. Globalization and market capitalism had the potential for enormous benefits, but also posed some serious risks.

3.2 Conflicts over values and perspectives

It is also the case that the way in which the crisis was dealt with served to remind us of the deep divides in the values and perspectives among and across nations. To give you just a few examples: to save the creditors, to save the banks who had lent billions of dollars, the lives and livelihood of millions of people were put in jeopardy. Unemployment rates soared by factors of 5–10 in some countries. The seriousness of the recessions and depressions that resulted in East Asia are hard to fathom. It was the worst economic downturn since the Great Depression. Incomes fell by 20–30%, GDP fell by 15–20% in some countries. The IMF was supposedly created (under the inspiration of Keynes) to provide countries with the liquidity to finance fiscal expenditures to reduce the magnitude of economic downturns; yet it is clear that the policies that were imposed by the global institutions like the IMF exacerbated that downturn. Even the IMF now agrees that it imposed excessively contractionary fiscal policies. It was not as if we did not have the knowledge, as if we did not know how to counteract economic downturns. What was required was what we teachers of economics have been teaching our students in course after course in economics, all around the world, for more than half a century. And yet, decisions were made that were exactly the opposite of what we teach in our basic economics courses. For me, as an economist, it was, initially, very hard to understand. Eventually, I came to appreciate that, at least in part, the IMF had different objectives—they were not as concerned with maintaining the strength of the economies in the region as in preventing a default against Western banks.

Within a market economy, when a private person cannot pay a debt, bankruptcy laws deal with that problem. But the IMF and the US Treasury advised—insisted—countries not resort to bankruptcy as this would have been a violation of the sanctity of the credit contract. In order to preserve the credit contract, they were willing to tear up the social contract that binds people together, resulting in the kind of riots that took place in Indonesia. In December 1997, in a meeting in Kuala Lumpur, in which Michel Camdessus, former IMF Managing Director, and the finance ministers of the G20 were present, I forecast that if contractionary policies continued in the way that they were in Indonesia, a highly fractionated society, there would be social and political turmoil within half a year. It happened in five months. The point is that even if you had no compassion for the people who lost their jobs, for people whose wages were cut by 20%, it was bad economics, because with the social and political turmoil there was capital flight and social disruption, from which the economy is still recovering.

3.3 New perspectives on international governance

Thus, the global financial crisis served not only to expose the weaknesses in 'American-style' triumphant capitalism, but also to expose the problematic nature of the international institutions in charge of governing globalization. Issues of transparency were every bit as important for these international institutions as they were for the governments of the countries they were criticizing. Indeed, behind closed doors, it appeared that policies were adopted which were contrary to the very reason they were created—to enhance global economic stability and provide countries with the credit they need to *avoid* recessions—not to demand recessionary policies in return for aid. In fact, as people did research on this crisis, it became clear that the underlying source of the problem was the capital market liberalization which the IMF itself had foisted on these countries, as it had done around the world. Interestingly enough, today the IMF agrees that it made a mistake: excessively rapid capital market liberalization is dangerous for small, less-developed economies. But it recognized this only after the damage had been done. And the damage has been enormous. That their governance structures did not accord, in fundamental ways, with democratic principles had long been recognized—those who were most adversely affected by the crisis and the policies imposed by the IMF did not even have a seat at the table—but the global financial crisis made transparent the full consequences.

3.4 Lessons from the East Asia for the economic role of states

These events dramatically illustrate the risks that globalization poses to many economies. But the theme of this essay is the economic role of the state under globalization, and I want to return to that theme. The crisis was not produced by too large a government, but by government not doing the right thing. The existing process of global governance has some very major problems, and, given that we are not able to address them at a global level, these impose enormous burdens on the nation-state. Looking forward, the new economy and the changes in technology that have occurred in the last decade have had an enormous impact and will have even more enormous impacts, not only on the economies, but on the role of government. We are now at a crossroads, recognizing the mistakes and the problems of the past and looking forward to some very dramatic changes.

4. The third way

I would like to try to put into perspective the thinking today about the economic role of the state. There has been tremendous convergence about this from several perspectives.

On the one hand, fifty years ago, people talked about the power of the market, about the fact that the 'invisible hand' solved all problems.

4.1 The strengths and weaknesses of markets

Today, we are much more aware of the benefits from markets, but, at the same time, we are also more aware of market failures, of the pervasiveness of these market failures. These market failures are not just related to problems of the environment, problems of public goods, like national defense, areas where everybody recognizes a need for government. The research that I and others have done has highlighted that whenever markets are incomplete or information is imperfect, they do not work in the way that Adam Smith envisaged. In some sectors of the economy, like the financial sector, or the healthcare sector, these limitations are very important.

4.2 The strengths and weaknesses of collective action

On the one hand, we have become much more aware of the limitations in markets. On the other hand, we have also become much more aware of the limitations of collective action, of the difficulties government has in addressing many of these market failures. Some of these have been discussed extensively in the literature, such as the problems of 'red tape' and the difficulties of dealing with bureaucracy, or the problems of regulatory capture, that is to say, the fact that, quite often, the regulator itself is controlled by special interests, resulting in a government that, rather than serving the general interest, advances special interests. This is even true when we talk about nationalized enterprises. We used to talk about nationalization as a solution to the problem of ensuring that enterprises worked in the broader interests of society, but as Andreas Papandreou, a former prime minister of Greece, pointed out when he came into office, one of the major problems he was confronted with was the socialization of the national enterprises. He recognized that national enterprises were enterprises that were working for their own managers, for their own workers, but not for society more generally. He took up the burden of the socialization of national enterprises, and at the end even he recognized that he failed—the task was nigh impossible. These are well-known problems.

But we also have recognized that there are weaknesses in our democratic processes themselves. I have in mind not just the problems that occurred in the 2000 US presidential election in Florida, but more fundamental, more persistent problems having to do with voter registration and campaign financing, all of which result in voices of special interests being heard loudly and voices of some people, like the very poor, not being heard at all. We have to recognize that our democratic processes today are still imperfect. What we are working towards is better, more democratic processes. To give you an example, many governments today still do not have freedom of information acts, or right-to-know laws. The government treats the information that it has as if it were its own and not the people's. How can people participate in decision-making if they do not know what is going on? The notion of transparency that was raised in the crisis is really a very fundamental issue. We need to think about it in terms of our own societies, and in terms of the passage of freedom of information acts and making those acts actually work.

4.3 The third way: between socialism and laissez-faire

Having recognized both the limitations of governments and the limitations of the market, there is now a movement around the world towards what is increasingly being called *the third way*, which lies between socialism and *laissez-faire*. There is a broad consensus that a free-market, *laissez-faire* approach does not work, and there is a broad consensus that socialism, with government domination of the economy, does not work either. But between these two extremes there is a very wide range. For instance, in the United States, the Democratic Party talks about 'new democrats' and the Republican Party talks about 'compassionate conservativism'—these both represent a third way; both parties are saying there is a need for market *and* a need for government. However, there still is a very marked difference between these two perspectives. To a large extent, the third way has come to dominate the political scene. But because there is not a single third way, but many *third ways,* there remains enormous scope for political discourse. We have put away the extremes—and that is an important step in the right direction. We are now looking at the choices inside the extremes, but there are enormous differences among these choices.

4.4 Principles of the third way

I would now like to try to highlight what I view as the way to think about choosing among the third ways.

Partnerships and complementarities between government and the private sector. First, in the past, we have thought too often of dividing society's activities into what should go in the public sector and what should go in the private sector. We divided society into public and private. On the contrary, one of the essential insights of the third way is that one should think about the public and private sectors in terms of *complementarity* and *partnership*. Take the example of the regulation of financial markets. Most of us agree that government should not be involved in allocating credit, of deciding who should get loans; that is probably not the government's comparative advantage. But there is another fundamental problem with government-allocated credit: in too many countries, the opportunities for corruption have not been resisted. (Outsiders find it difficult to ascertain whether an individual has been given a loan at an interest rate which does not fully reflect the actuarial risk.) On the other hand, we also recognize that an unregulated financial sector almost inevitably winds up with enormous problems of instability. Regulation in the United States began in 1863 in the middle of the Civil War. It was introduced, in part, because it was felt that after the Civil War it was important to have a strong nation, and without a strong national banking system the US could not have a strong national economy. Without strong regulation, banks often engage in 'insider lending' and other bad lending practices. Not only are resources wasted, but all too often the resulting weaknesses result in financial crises, with the public having to pick up the tab.

The general perspective which I want to emphasize is that the public and the private sectors should not be viewed as alternatives but as complements to each other. Finding the right balance is critical.

Social justice and democratic processes. There are two other aspects of the third way that are particularly stressed by what is often called the European democratic left: first, a commitment to social justice; and, second, a commitment to democratic processes. These two elements are actually interrelated in a number of different ways. First, the outcome of any process led by any political institution depends on governance, on the rules by which the institution is governed. Accordingly, the emphasis that is going to be placed on social justice in evaluating choices will itself depend on governance structures. Let me give you an example of what I have in mind. I apologize for repeatedly drawing upon the example of the IMF and East Asia crisis, but it is the one that I just lived through and it has had a very big effect on my own thinking on these subjects. It just 'happened' that the IMF was able to find $150 billion to bail out the banks but could not find $1 billion for food subsidies for the people who were thrown out of jobs. To me, that seems strange: $150 billion for the banks and not $1 billion for the people who were thrown out of jobs! Let us think for a moment about the governance of the IMF, the global institution that was responsible for those decisions. The voting rights in the IMF are allocated not by usual democratic principles but by economic power, and not by economic power as of today, but economic power as of 1944 (with some revisions since then). There is only one country in the world that has a veto power at the IMF, and it is the G1. In most of our democracies, we do not believe in property qualifications for voting. We do not believe that you need to own property in order to vote, even when voting affects economic issues. We do not allocate voting rights by dollars or lira; but when it comes to international institutions, we do. Moreover, consider a country like China: its IMF voting rights have not kept pace with the strength it has acquired in the global economy. Given the IMF's voting structure, its governance, is it a surprise that there has been such questioning of its legitimacy, especially within those countries that have inadequate representation? But its governance is even more problematic than that. Consider how decisions about economics are made in most of our democracies. Not only does the finance minister sit at the table, but so does a council of economic advisors, the minister of labor, the minister of trade, the minister of commerce; everybody sits around the table, even the minister of justice, because there are often anti-trust issues at stake. The treasury secretary would probably like to try to make all the decisions himself, but even if he were well intentioned, he is not allowed to do so. We believe that everybody should have a seat at the table.

But that is not the way that international financial institutions work: it is only the financial ministers and central bank governors who have a seat at the table. (I sometimes joke by saying that there is encouragement of a wide diversity of views, ranging all the way from the governors of the central banks to the ministers of finance.)

The outcomes, the policies pushed by the IMF and its modes of behavior, are precisely what any political scientist would predict, given the governance structure. And unless we change that governance structure, we will not get fundamentally different outcomes. All of this might not matter so much if the IMF were just concerned with technical issues, like the management of check clearing. But the policies that it pushes, that it insists are conditions for its loans, affect the livelihoods and lives of millions of people, workers and small businessmen, and not just those who are involved in international capital markets.

The close link between the decisions that are made and the processes by which those decisions are made is why it is so important to think together about social justice on the one hand, and democratic processes on the other. Unless we think very deeply about how we make a decision, as democracies, we will not change the outcomes of those decision processes. In the United States, for instance, unless we change the ways that campaigns are financed, we will change the outcomes: business will continue to exert undue influence.

There is a second link between democratic processes and social justice. Today we think about social justice not just in terms of equality of outcomes, but also in terms of equality of opportunity, equality of voice and participation in decision-making processes. When we think about what we mean by democracy in constructing our society, we should not think only about the results, but about the very processes by which those results come about.

Improving the public sector. I stressed before the limitations of government and the limitations of the market. Having understood the limitations of the market and of government, I believe that we can craft better policies and better institutions to give expression to our concerns about social justice and democratic processes. For instance, within government we can use market mechanisms more effectively. One of the most interesting parts of my stint as Chairman of the Council of Economic Advisors under President Clinton was my involvement in an exercise that we called 'reinventing government'. We sat down with each of the agencies, and we asked three questions: (i) Was there a role for government here? (ii) If there was a role, what was it? (iii) What is the best way of performing that role? Do current policies, practices and institutions reflect the roles that government *today* should be performing? We were, for instance, convinced that in many cases we could improve the efficiency and effectiveness of government through using market mechanisms in government, like auctions and competitive procurement processes. In a number of instances at least, by introducing these market mechanisms, we succeeded in making government more efficient and more responsive to those that they were trying to serve.

Differences among the third ways. These are all areas where I think there is a broad consensus in the United States both in the left and the right, and probably a broad consensus in Europe as well, although I think that some of these issues (e.g. concerning the efficiency of the public sector) have, until recently, not received the attention within

Europe that they have had in the US. There are still some very large differences both between compassionate conservativism and new democrats, and between perspectives in Europe and in the US. These differences relate to a number of factors. Partly they relate to judgments about the magnitude of market failures, and about the ability of government to address those market failures. But they also relate to values and principles. I find the high correlation between the judgments concerning the weaknesses of markets and the limitations of government and values striking. It turns out that people who worry more about social justice and inequality seem to have less faith in the market and more faith in government. And it turns out that those who do not care much about distribution always have a lot of confidence in the market and much less confidence in government. This is a correlation that underlies much of the debate.

5. Two general principles: the virtues of competition and no subsidies

There are two almost universally agreed upon general principles that I first noticed when I was at the Council of Economic Advisors, but then saw repeatedly while I was at the World Bank. The first was that everybody believes in no subsidies, everybody agrees that subsidies are bad, *except for their own sector*. The second is that competition is good, that it is the force of competition that makes markets work wonderfully, *except in their own sector*; in their own sector they talk about destructive competition that interferes with stability. (There is a third principle that I will not discuss here: everyone agrees that transparency and openness are good, *except in their own arena*.)

5.1 An example: creating a global aluminum cartel

Let me illustrate these principles in terms of two examples that I had to deal with in the last ten years. On the competition side, I can draw upon an example involving US Treasury Secretary, Paul O'Neill. He comes from the business community—he was chairman and Chief Executive Officer of Alcoa, a leading producer of aluminum and aluminum products, and like everybody else in the business community believes in markets and competition. In 1993, the price of aluminum started to plummet. There were three reasons for this: one was a global slow-down; commodity prices tend to be very sensitive to a global slow-down, and the price of commodities like aluminum almost always falls. The second reason was linked to Coca-Cola, and more generally to soft-drink cans. A new technology was invented that allowed production of tin cans with 10% less aluminum. One of the major uses of aluminum is in soft-drink cans. (In the United States, there is a tradition among young males that when they finish drinking a coke or a beer, they squeeze the can to demonstrate their strength. In 1993 there was a strong increase in the strength of the American male. They could squeeze these cans much more forcefully. What they did not know was that the cans were actually thinner. The *apparent* new-found strength made them feel good, and may have contributed to the confidence in the US economy. But the thinner cans contributed at the same time to the downfall in the price of aluminum.) The third reason was the end of the Soviet empire, which brought cuts in defense expenditures. Since one of the big uses of aluminum is making airplanes, although it was great news for the West that Russia had stopped building airplanes that might have been used to drop bombs on the West, it was bad news for Alcoa because it meant that there was more aluminum coming into the markets in the West. We all agreed that Russia should become a market economy. Russians were not going to be able to sell their cars to America or Europe—their cars could not compete with those made in Japan, Germany or the United States. One thing they could produce, that could easily be sold on the market, was aluminum. They tried to sell it in the West.

As I saw the price of aluminum sinking, I thought, 'In a few months Alcoa will be here in the White House asking for something.' And even faster than I had anticipated, there they were: Paul O'Neill was at our doorstep. His proposal was simple but daring: a global aluminum cartel to keep Russian aluminum out of the United States. It put me in a very difficult position, because I was scheduled to visit Russia to talk about free market economics to Mr Guidar, the First Deputy Prime Minister of Russia, in charge of economics. Guidar started our conversation by talking about hypocrisy—he argued that Russia was not dumping, and he was right. The United States had talked about Russia becoming a market economy, but as soon as it could produce something that could compete, the US government was being brought in to squeeze Russia out of the market. I could not defend what the United States was doing. One of the most exciting economic sub-cabinet meetings during my years at the White House occurred over this issue. In the end I succeeded in convincing almost everybody that cartels are bad things, and that we had to open our markets to Russian aluminum. The Russian reformers were very critical of a cartel, for they knew that such a cartel, by re-establishing quotas, would be a setback for their reform and a victory for the old guard. But people in the old Ministry of Trade and Industry were happy with cartel quotas—it was, after all, what they were familiar with; indeed, they wondered why there had ever been a move to prices and free markets in the first place. While I was getting phone calls from the Russian reformers pleading not to go ahead with the cartel, the US State Department was talking to their old friends in the old-line ministries, who encouraged them to go ahead with the cartel. The combination of State Department support and pressure from US special interests—the aluminum industry—was unbeatable: it led to the formation of a global cartel. At the end of the meeting, the assistant attorney-general for antitrust, furious at this clear violation of the principles of competition, put the participants in the meeting on notice that she might have to subpoena them for collusion in violation of the antitrust laws. Although she never followed through on her threat, she was right—there had been a real collusion, protected by the umbrella of government, to restrict competition. Even those of us who were highly critical of the action did not anticipate the full nature of the disaster, because we did not fully appreciate the Mafia capitalism that we were helping create in Russia as we helped establish the cartel with its monopoly rents. Blood flowed in the struggle to gain control of these monopoly rents, and today, an aluminum monopoly is emerging within Russia.

A general lesson to be drawn from this example is that the state can be an important force in maintaining competition, but the state can also be used to restrict competition; and who gets a seat at the table, who is entitled to decision-making power, makes a very big difference. The consumers, for instance, did not have a seat at the table. That is why the governance process is so important.

5.2 Corporate welfare: a second example

The second example illustrates the second of the three principles I enunciated earlier (competition in every sector except one's own; no subsidies in any sector, except one's own; and transparency in every sector except one's own). Wall Street has been among the most adamant devotees to these principles. In the midst of the debate in the United States on welfare reform, some of us said we had to look at corporate welfare. How could we cut back on welfare to the poor, without cutting back on welfare to the rich, and to large corporations? But cutbacks in corporate welfare were of considerable interest to the US Treasury; indeed, they got very upset when we talked about corporate welfare. They thought such talk was 'anti-business', reminiscent of the language of class warfare. I viewed the issues as simply reflecting principles of equity and economics: over the preceding years we had seen billions and billions of dollars spent on bail-outs (including the massive bail-outs of the savings and loan associations), a multiple of the magnitude of expenditures on welfare for the poor. The same US Treasury that supported billions of dollars for bail-outs in East Asia—bail-outs that proved ineffective in stabilizing exchange rates or resuscitating the economies—opposed miniscule programs to help resuscitate the dilapidated schools in America's inner cities.

5.3 Improving the public and private sectors and the role of values

To return to my central theme: there are some general principles that should help inform us in making choices among the alternative *third* ways. Each country must make assessments both about the nature of market failures and the nature of the limitations of its government and political processes, and must come to judgments not only about the strengths and weaknesses of the public and private sectors, but also about how and how easily they might be improved. When pressed, many on the right will admit that there are market failures, but not only do they put greater stress on the government failures, they express great confidence that market mechanisms can be improved, and little confidence that the deficiencies in public processes can be remedied. But having said this, I cannot underestimate the importance of values—both conceptions of social justice and democratic processes and the importance that is ascribed to them. It is differences in values which, as much as anything else, drives the assessments of the relative strengths of the public and private sectors. As a political economist, I must add, these differences in values reflect to some degree differences in interests; those who wish to *conserve* existing power structures and degrees of inequality, who benefit from that, are more likely to stress the limitations of government, though in practice, when it serves their interests, they turn to it for assistance, as I pointed out earlier in the discussion of corporate welfare. Those who see themselves left behind by market processes working on their own naturally turn to collective action, to political processes, to remedy their situation.

What is at stake, it must be remembered, is more than a matter of economic efficiency. It is not just a question of which *choices*, which among the third ways, leads to higher GDP. It is even more than a matter of the distribution of income, how GDP is divided among the citizens of a country. It is a matter of what kind of society we wish to live in, and to pass on to future generations. Necessarily, that is a question which must be approached *collectively*. The decision to rely on market forces is, in itself, a political action; and indeed, since no society has a policy of relying solely on market forces, every society is constantly engaging in a debate on the extent to which to rely on market forces, when to intervene, how to govern these forces. No society can walk away from these choices.

I have been talking about general principles but these very general principles get translated into very specific policies. I want to emphasize that this is not just an area of philosophy, to be debated among academics. The perspectives influence how we approach each of the major issues facing our society.

6. The role of the state in retirement security[1]

One of the most important issues facing any society is the issue of retirement security. The first objective of an old age retirement system is, of course, to provide income security for the entire population for their retirement. How well it does this is the most important criteria by which one can judge the adequacy of the system. In addition, of course, there are some other criteria: (i) efficiency, which means we seek a system that promotes saving, that does not have an adverse effect on labour supply, and has low transaction costs; (ii) fairness and equity, to ensure that the poorest people in society have a basic minimum standard of income while in retirement. In developing countries there is a further objective, as the social insurance system can play a role in the development of capital markets. An important point of departure is to recognize that there will inevitably be an important role for government in the old age retirement system. Whether that role is a role of running a public system or of regulating a private system, the fact is that there will be a role. The key issue then is, what is the appropriate role for the government to play that best meets the objectives and criteria described above.

One argument reinforcing the necessity of a role for the state in a system that provides for security for people in their old age is providing security against the risk of inflation. There is no private insurance system, no private annuity system, in almost any country around the world that provides security against this risk. When I was Chairman of the Council of Economic Advisors we spent some time analyzing whether there were

[1]Much of this section is derived from 'Rethinking pension reform: ten myths about social security systems' and 'Introduction' with Peter Orszag, in Holman and Stiglitz (2001: 17–56).

alternatives to provide for security against inflation, for instance investment in stocks, or in bonds, or a combination of those. There was no single measure or combination of measures that would provide for adequate insurance against the risk of inflation, at least as it has been in the past. Recognizing that the private sector has, at the current time, not provided adequate mechanisms for achieving old age security, and that there will be a role for government, the question should be, how do we improve the public provision, not just whether it is possible to replace the public sector with the private system.[2]

[2]Recent discussions of reforming social security have focused on a three-pillar approach—a first pillar, publicly provided, providing the basic level of support; the third a voluntary private sector. Debate has centred around the second pillar, often characterized as mandatory, but unlike the first pillar, there is no redistribution. Most proposals call for this pillar being privately managed but publicly regulated, and to be a defined contribution system. In a broader view, the second pillar could be either publicly or privately managed, and could have insurance components, such as insurance against inflation, that make it little different from an (actuarially fair) defined benefit program. Among the key policy questions then are (i) who should run the second pillar; (ii) how much 'insurance' should be embedded within it; (iii) what should be the right mix between the first, second and third pillars; and (iv) how do we manage the transition to having a system in which the second pillar plays a greater role?

As far as the engineering of the transition itself is concerned, one of the advantages of a growing economy is that one can succeed in the transition by scaling down the relative size of the public pillar but actually scaling up its absolute size. If you have a basic pension program and if you allow it to grow in benefits but not to the same extent as the growth in GDP, then the relative size of it will diminish even if its absolute size will increase. The problems of transition are, accordingly, much less important than some of the discussions have suggested.

I should also note that the debate about the extent to which the private and the public systems are substitutes has been a little bit exaggerated. Some of the research in the United States has suggested that in fact there is perhaps less substitutability and more complementarity between the two.

Finally, elsewhere, I have questioned the dominant presumption in the World Bank and elsewhere that the second pillar should be privately managed. A government-run program has some marked advantages over a private system, e.g. in reducing transactions costs (often related to selling costs) and problems of adverse selection. Still, I think there is a role for the private system. It does not, however, arise from a desire to minimize risk with diversification, because, at least for those at the bottom of the income distribution, the public pillar will continue to dominate the private one. Nor am I persuaded by arguments that the private system allows for more choice about risk-taking: if you consider choice of that kind as important, you can build that within the public pillar, allowing, for instance, some choice between a bond fund and a equity fund. But a good reason to have a private third pillar is that different people have different preferences. Some people want to work hard when they are young and have a good retirement and other people prefer to enjoy life. There is room for choice and those who want to have more income in their retirement should have a third pillar to reflect that. The final and most persuasive argument for enhancing the role of the private sector has to do with the nature of capitalism. A lot of the funds that are going to venture capital, to new enterprises, are coming out of the private pension funds, and that involves people making choices of allocations of investment. I think that the government can invest in equities, but I feel a lot more secure with the government investing in equities through indexed funds, without deciding which are the good investments and the bad ones. Privately managed pillars provide for this allocation of capital. But we should not underestimate the problems: unless there is adequate security provided in the first pillar, the inevitable volatility of prices and returns to private investments will entail bail-outs in one form or the other; and the anticipation of these

6.1 The success of public programs

That having been said, let me make three other observations. The first is that an appropriately designed public system can meet all the objectives that I described at the beginning. The US system surely does a *reasonable* job in meeting all the objectives, and the mild reforms that are on the table could achieve all the objectives. The US system has very low transaction costs, there is no evidence of significant adverse effects on labor supply or on savings, and it does provide a very strong level of old age security of income. In fact, over the last thirty years the number of old people in poverty has been reduced dramatically, so much so that today the fraction of the aged population in poverty is lower than that for the population as a whole. In terms of providing a basic level of old age security and reducing old age poverty, the US system is working quite well. There are, to be sure, a few problems (as there are with any program of such breadth and magnitude) and I will come back to these, but they can be addressed within the public system. A criticism heard sometimes against the US system and other public systems is that they do not get as high a return as it is possible to get elsewhere. There are two responses to that criticism.

6.2 Refutation of critics: are returns in public systems really low?

The first is that if you believe in efficient markets, which most advocates of privatization seem to do, then in fact the system in United States is efficient: it does provide high *risk-adjusted* returns. The returns are those of an investment in treasury bills; to be sure, treasury bills yield a lower return than equities, but, *in an efficient market*, the difference simply reflects a difference in risk. Of course, if you believe that equity markets do not work efficiently, then you might be able to get higher risk-adjusted returns by investing in equities. But if so, you have to accept that there is inefficiency in the financial market and that inefficiency should be in itself a source of concern. It is very hard to argue both that the markets are efficient and that one can get higher returns by investing in equities.

Moreover, if you believe that you could get higher returns by investing in equities, then in fact you should argue that the public old age pension fund should invest in equities. In the United States all the funds are invested in treasury bills, but there is a proposal, made by President Clinton, at the suggestion of the Council of Economic Advisors, that a fraction of the funds, perhaps a third, could be invested in equities. The big advantage of having public investment in equities as opposed to individual separate accounts in the private sector is that the downside risk can be better managed through a public program than through individual accounts. Those who believe that you can do better investing in equities should recognize that this can be better accomplished through a public program. In particular, indexed funds eliminate the problem of selecting which

bail-outs will lead to distorted investment decisions (the well-known moral hazard problem). Hence, the ability of a private component of the social insurance program to contribute to the economy's long run economic performance requires the establishment of a truly adequate public first pillar.

fund to invest in—there is very strong evidence that indexed funds do as well as any managed funds, and there is no evidence that small, individual investors can 'allocate' their investments better than indexed funds. The key remaining issue, then, is transaction costs, and here public programs (perhaps involving private subcontracting) in the United States have a strong track record—their transaction costs are low. Indeed, their track record looks particularly good in comparison with private programs, such as in the United Kingdom. In sum, well-designed public systems are working well in terms of the basic objectives of the old age pension program.

6.3 The failures of public systems

The second observation is that it is true that there are, around the world, many badly designed programs, not only involving high transaction costs but also large deficits. But the fact that there are some badly designed programs does not mean that we need to reject public programs. The report *Averting the Old Age Crisis* issued by the World Bank (1994) was based on the political statement that what you see in the average or worst cases is what is going to happen everywhere. But there is no reason for that to be the case, and evidence in the United States and in a number of other countries shows that you can have a good publicly managed system. To argue for the abandonment of the public approach in, say, developing countries is to argue, in effect, that there are some characteristics of those economies which make it unlikely, if not impossible, to establish a good public program.

6.4 The failures of private programs

That brings me to the third problem: among private programs around the world, there are few, if any, examples of good systems in which the private sector is at the center. Those advocating a movement to the private are really advocating a movement into the unknown. In an article with Peter Orszag,[3] we referred to a study that had been done in the United Kingdom, which has often been identified as having a good program. Yet the benefits the old-aged were receiving were reduced by about 40% as a result of transaction costs. That is an enormous loss. In that sense a more efficient public program can provide much better old age security.

Let us take another example. There was a lot of enthusiasm for the Chilean system in a period when people were investing in the equity market, and the stock market was booming. People saw their accounts going up year after year. But then came 1997. The stock market crashed and people did not feel so enthusiastic about the program. People started recognizing that in fact the transaction costs, though high in the United Kingdom, were even higher in Chile, which is what one would expect, given the differing states of development of their capital markets.

6.5 Rethinking the role of the state and the private sector

These two examples have helped motivate rethinking the role of the state in the pro-

[3]See note 1 above.

vision of old age security in developing countries. In countries with very thin capital markets it is not possible both to invest in your own country and to provide for secure old age retirement. By investing in US equities, Chile would gain a much greater stability because the volatility in the United States, which is very high, is still much lower than in Chile. But many people in Chile do not think that it is good for Chilean development for their savings to be invested in the United States. There is a real trade-off between old-age security and savings that will be used to promote the development of the developing countries. Further, and relatedly, if individuals invest in highly volatile stocks, or even in stocks that are not so highly volatile, and it turns out at the time of retirement that the benefits are not enough to sustain a minimum standard of living, there would inevitably be a bail-out from the public sector. In a sense, what we cannot walk away from is the fact that in a private system, the public is underwriting individual speculations in the stock market. There is a public insurance that is not visible when things are going well and the returns are high, but which will almost be inevitable when the market is down. The likelihood of a bail-out, and the consequent moral hazard problem, simply cannot be ignored.

There is an irony in the asymmetry of the inferences concerning past experiences of the advocates of a private sector program. When these bad experiences within the private program are noted, they argue that the problems can be fixed. They cannot even cite a 'best practices' example which other countries can emulate. When the bad experiences within the public system are noted, they argue that the problems cannot be fixed, even though there are 'best practice' examples showing that they can be.

6.6 Further criticisms of public programs: monopoly

Before leaving the issue of the role of the state in old age security, there are two further problems raised by some people concerning public pension schemes: *funding* and *monopoly*. Let us consider the issue of monopoly first. People find it very disturbing that there should be a monopoly. We believe in competition, in markets, in choice in other areas; why in this area should we have a different idea? Few would argue against there being some substantial scope for choice, and the kind of multiple-pillar system with a public and a private component that has increasingly become accepted as a basic framework provides such choice, in the third (purely private) pillar. There is also broad acceptance that there needs to be a first pillar, providing a basic level of support for the aged, and that within that public pillar, there is little scope for choice. Hence, the issue is not whether there should or should not be choice; rather the issue is the relative size of these different pillars.

The need for a compulsory program: adverse selection. Extreme advocates of privatization might dissent from this broad consensus. They ask, why should there be a public program at all, a public 'first pillar', with a government monopoly with limited choice?

There are three answers. The first one involves the problem of adverse selection. Insurance markets, as any private market in which there are problems of information, are affected by adverse selection. Everybody would want to provide insurance for the risks that are good (i.e. low). In the case of annuity markets (pensions are annuities), the good risks are people who are going to die young. What you would do if you ran a private annuity program would be to work very hard to find out who are the smokers, and the people who drink a lot. You would try to encourage them to buy your annuities, and to discourage the people who do not smoke or do not work very hard, such as university professors. Thus, the first problem with a basic system that is intended to cover everybody is adverse selection: each firm tries to shed the bad risks, and retain only the good risks. The screening/selection process can be very costly and distortionary.

The need for a compulsory public program: redistribution. The second reason for the basic public pension program is the need for some redistribution. Society does not want old people to live below the poverty level, no matter what their income is while working. People are not going to engage voluntarily in redistribution. Redistribution can be thought of as part of what is sometimes referred to as social solidarity; but it has to be compulsory for obvious reasons: if everybody has a choice, those with higher incomes would clearly try to avoid bearing the burden of the redistributive transfers. If there is to be meaningful redistribution, there must be compulsory participation.[4]

The need for a public program: risk. The third reason is one to which I have already alluded: to have an old age insurance that provides for good security one has to have insurance against the risks of inflation, of bankruptcy of the private company from which one has obtained insurance, and against other risks that private companies do not or cannot adequately provide for. That is why there needs to be a public program.

The disadvantages of competition: transaction costs. That having been said, one can still achieve efficiency in the public sector by designing programs that reflect the advantages of the competition without the disadvantages. But before coming to that, I wish to make two more remarks about the disadvantages of the competition inherent in a private market system. Private systems, as we have noted, have entailed high transaction costs. The advantage of choosing among securities has a cost, which could be very significant, because the private firms spend enormous amounts trying to persuade individuals to enroll in their program. These marketing costs can be very high.

Uninformed consumers. What is very difficult to take into account is the fact that most individuals in our society still remain very uninformed investors. Studies have been done in the United States, which is probably one of the more sophisticated investor markets, to try to ascertain whether people know the difference between stocks and bonds, between short-term bonds and long-term bonds. Over 50% do not seem to know the difference between stocks and bonds. It is very hard to understand how they can make good investment decisions if they do not know the difference between a stock and a bond. Given our lack of information, private companies are going to spend

[4]To be sure, this begs the question of whether the entire burden of redistribution should be left to the tax and general welfare systems. But there are arguments why at least some redistribution should be conducted through the pension program. See Stiglitz (1999).

enormous amounts of money trying to convince people that their particular product is better. The less scrupulous will try to exploit this consumer ignorance. The firms that succeed in the market may not be those that are most efficient, in standard economic terms, but most effective and least scrupulous in exploiting investor ignorance. They can do so in a whole variety of ways, some of which are honest and some of which are dishonest. Inevitably, there will be demands for regulation, to prohibit at least the most egregious practices. But such regulation will not be easy. At a seminar at the World Bank on pension reform, we invited a representative from the US Securities and Exchanges Commission, and to our question regarding the Commission's ability to regulate these problems, she responded negatively. In effect, she said,

> We can regulate against outright fraud, we can protect investors against some abusive practices but we cannot provide the kind of regulatory structure that would be required to address the real concerns of protecting investors, especially those who are not well informed, that one would inevitably face in designing a private social insurance system for retirement appropriate for providing old age security.

These are some of the problems that one would encounter within a private system. Of course, there is enormous pressure for a private system. The amounts that are transaction costs from the point of view of consumers or investors are incomes from the point of view of the financial community. Those of us who are concerned about consumers and old people dislike transaction costs, but people in the financial community like them; they constitute that sector's income and profits.

Using competitive mechanisms to design a more efficient public system. Can we design a public system that systematically and with some assurance leads to efficiency in general, and low transaction costs in particular? There are two possible alternatives. One of them is called bench-mark competition. We know how much the transaction cost should be in an efficiently run system. We know, for instance, how much it costs to run a portfolio in the most efficient system, as we have competition in portfolio management, and we can use that information to establish bench-marks. We can use bench-mark competition to provide guidelines about how well the public sector is working. Some people have even advocated the use of competition for the management of transaction services within the public sector. On the side of portfolio management, the current US system entails investment in US government securities, with essentially no transaction costs. Assume, as noted above, the United States decided to move part of its portfolio into equities. We know how much it should cost to manage portfolios of indexed funds; we know how to reduce transaction costs to a very low amount: there are some funds in the United States, like Vanguard, that have brought the cost of managing a stock portfolio down to about nine basis points, while many mutual funds are charging 100–200 basis points. If the public sector cannot guarantee low transaction costs in portfolio management, one can put this part of its activities out for competition. More generally, one can have competition in the provision of transaction services, in the various parts of the public system, without having competition in the system as a whole. This is an example of how we can use market mechanisms within the public sector to increase its efficiency.

6.7 The role of pre-funding

One of the criticisms of public programs is that all too often they are pay-as-you go, rather than prefunded. But the issue of funding is completely separable from the issue of management. One can have public pre-funded programs.

Different systems are appropriate for different countries. More generally, different economies, facing different situations, need different kinds of systems: the role of pre-funding and of fully funded systems could differ in different economies. I argue quite strongly that in the case of developing economies that do not yet have a social insurance system and are just starting, particularly when they have a dire need for capital, having a fully funded system makes a great deal of sense. For an economy that already has a pay-as-you-go system, the transition to a fully funded system could pose very serious problems.

Much of the discussion regarding private versus public systems, fully funded versus pay-as-you-go, has been very misleading. The advocates of fully funded private systems often give a distorted view of the relative merits, underestimating the transition costs, the risks and the transaction costs. They have assumed that there is a more informed investor than in fact there is, and they have exaggerated the returns that are likely to be obtained in a private system. For instance, the numbers Feldstein and Ranguelova (1998) have used as returns on equities are not credible: if they could really guarantee the returns they assume, I would gladly give them my money to invest. Moreover, whatever return one could guarantee private investors, surely the government, with its highly diversified portfolio and lower transactions costs, also could attain.

Reforming the US system. As I said, different countries need different systems and one needs to adjust the system to the particular context of the economy, paying special attention to demography. I do not claim to know enough about the Italian situation to suggest what should be done there, but I have studied the US system quite extensively and I have come very strongly to the conviction that for the United States, minor reforms to the current system of pay-as-you-go would achieve all the objectives that I stated in the beginning. Let me briefly describe the two minor reforms that I believe are needed. The major problem confronting the US system is the fact that the system will run into financial problems some time in the next century. If the boom that has occurred in the last five years, with productivity growth of 4% or more, continues, the financial position will be markedly different, and more positive. If the surplus projections are accurate, then in fact the social insurance system will also be in a much better situation than was previously thought to be the case. My own view is that the United States needs to make adjustments, e.g. in the retirement age, and in the cost of living indexes (which almost surely overstate the rate of inflation). Relatively minor adjustments in those directions would put the US system basically in fiscal balance. The partial privatization proposal that President George W. Bush proposes would actually undermine the fiscal viability of the current US system and will present serious problems in the first third of this century, because that proposal will take part of the revenues that are needed to provide balance and turn them over to the private sector. That will leave a huge hole in the system. Moreover, the proposal does not really adequately address either the issues of transaction costs or the regulatory issues that I described earlier.

It is important to develop a social insurance system that reflects our views of social justice and that takes into account individual responsibility and choice. For the United States and for many other industrialized countries, the appropriate course is reforming the existing system, increasing fiscal balance and addressing some of the particular design features that bring inefficiencies, and sometimes inequities, into the system. But I would argue that it is much easier to make these reforms than to redesign and provide a private system that would meet the objectives that I set out at the beginning.

Going forward, there are other, more important reforms that should be on our agenda. One reform that we ought to be discussing in the coming decade, as soon as we get the current pension reform in place, is the building of an integrated social insurance system that brings together not only retirement, but also unemployment insurance, healthcare and a broad array of other social insurance needs.

7. Other dimensions to the third way and the economic role of the state

I have perhaps dwelled too long on this example, but I have done so because it nicely illustrates the controversies involved in the choices facing the third way. Everyone agrees that there is a role for the state in providing old age security. Everyone agrees that there is a role for the private sector. But they do not agree about what constitutes the right mix. Hidden in the debate are a host of issues— judgments about markets and how they work, judgments about government and how it works, and judgments about how markets and governments can be improved—as well as conflicting values. And while much of the debate proceeds as if all participants have nothing but the general interest at heart, it is apparent that here, as elsewhere, special interests are at play.

7.1 Competition policy

Coming back to other areas, competition policy remains a subject of great concern. Again, everyone recognizes that there is a role for government. The huge price-fixing conspiracies that have been uncovered in the last eight years show that there is still a need for active law enforcement. But there are those who are less worried than I am about monopolization and the abuses of market power. It was only with the Clinton administration that there was a resolve to go after predatory pricing, say in the airline industry, and the predatory practices of Microsoft. What happens to Microsoft, in particular, could have a very big impact on the 'new economy', and more broadly, on the structure of the global economy for decades to come.

7.2 Regulatory policy and regulatory loopholes

Another example where there are competing interpretations of the third way, of what should be the role of government, concerns financial market regulation. Again, everyone recognizes that there is a need for government regulation; there are few advocates today of free banking. But there are those who wish to go as far as they can in stripping away regulations, regardless of the cost. In the United States, we saw the consequences in the form of the savings and loans débâcle, but the global financial crisis is now widely recognized to have been a consequence, at least in part, of misguided deregulation efforts. The question should have been: what is the *right* regulatory structure, not what is the *minimal* regulatory structure.

Offshore banking centers present a particularly vexing issue. Why do they exist? Is there something about an island that makes it more suitable for banking? Do the breezes that waft through the islands make bankers more able to engage in their banking functions? I have not been able to understand why islands are particularly good for banking.

Joking aside, we all know the reasons for offshore banking. It is a way of avoiding taxes and regulations. But why have taxes and regulations, if at the same time you open up these loopholes for people to avoid these taxes and regulations? We all know the answer to that question too. These are not loopholes left by mistake. These are loopholes that are put there for specific reasons, at the behest of special interests. Our commitment to addressing those problems depends on your views of democratic processes and social justice. If we have government run by and for special interests, these loopholes will remain.

7.3 The environment

There are other examples where visions of the third way differ markedly: for instance, on the environment. Today, everyone recognizes the need for governments to protect the environment. But some take this obligation—a form of intertemporal social justice—more seriously than others. Do we need to put our emphasis on conserving the use of oil-based energy, or do we want to expose Arctic wildlife to risks that could destroy the environment? We have recently seen what oil is doing to one of the most important environmental preserves of the world, the Galapagos Islands. Do we want that to happen in the Arctic?

7.4 Macro-economic policy and the independence of central banks

One last topic that helps illustrate the general principle that while there is now a consensus on behalf of an important role for the government, there is not a consensus either about that role, or about the importance of democratic processes and social justice. At least since Keynes, there is almost universal agreement that a central responsibility of government is maintaining macro-economic stability. Markets, as wonderful as they may be, are not 'self-adjusting' in ways that ensure either full employment or price stability. That having been said, two questions remain hotly debated: what should be the objective of monetary policy, and how accountable should those responsible for monetary policy be through democratic processes? In the United States, monetary policy has three objectives: controlling inflation, maintaining full employment and promoting growth. In many parts of the world, countries have been persuaded that the objective of monetary policy is just controlling inflation, with no concern about employment or growth. In some quarters, it has become accepted that this is good *economic* policy. But in fact, there is no economics behind this; this is politics. A single-minded focus on inflation may lead to lower rates of inflation (it would be a strong rebuke to monetary policy if it did not), but it does not necessarily lead to higher employment or long-term growth—to better performance in the *real* variables. Lower inflation may, to be sure, benefit creditors; but if the lower inflation is obtained at the expense of higher unemployment, the benefits to the creditors come at the expense of workers.

The necessity of an independent central bank that is not democratically accountable has also become part of the mantra in many parts of the world. There is no issue of more concern to the people in most of the world than their jobs, and monetary policy has a very large effect on that. Why is it that, on the one hand, we tell countries democracy is very important, but on the other hand, when it comes to the most issues that are most important to them, jobs and employment, we say: this is too important to be entrusted to democratic processes; you should have an independent central bank?

My own view is that the degree of independence is something which democracies should debate. In some countries a more independent central bank is a good idea, while other countries do not need an independent central bank. India has had a very stable macro-policy, without inflation, and has not had an independent central bank. Russia today has an independent central bank that is being used to transfer billions of dollars out of the country into the hands of the oligarchs. For Russia, independence has not provided a solution to its problems.

The important points that I want to make is that the issue of independence itself should be part of the democratic debate, as should the issue of what should be the objective of monetary policy. What is at issue are matters of social justice and democratic processes.[5]

8. Concluding remarks

I have tried to convince you today that while we all accept *the third way*, between socialism and *laissez-faire*, while we all recognize that there is a role for government—and an important one at that—*and* a role for markets, there remain some very important issues in dispute. Those of us who are committed to the principles of demo-

[5]In particular, an independent central bank focusing on controlling inflation should not be imposed on countries as part of conditionality of assistance, as the IMF has repeatedly done.

cratic processes and social justice are committed to seeing those principles translated into economic policies that will make a real difference to people's lives. There is an economic theory, an empirical basis, a scientific basis behind policies calling for more than a minimalist role for government. For too long the ideology of the right has driven the definition of the appropriate economic role of the state. The time has now come to try to formulate some alternative visions of the economic role of the state in this century, visions based on the use of economic science, but motivated by a commitment to social justice and democracy.

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