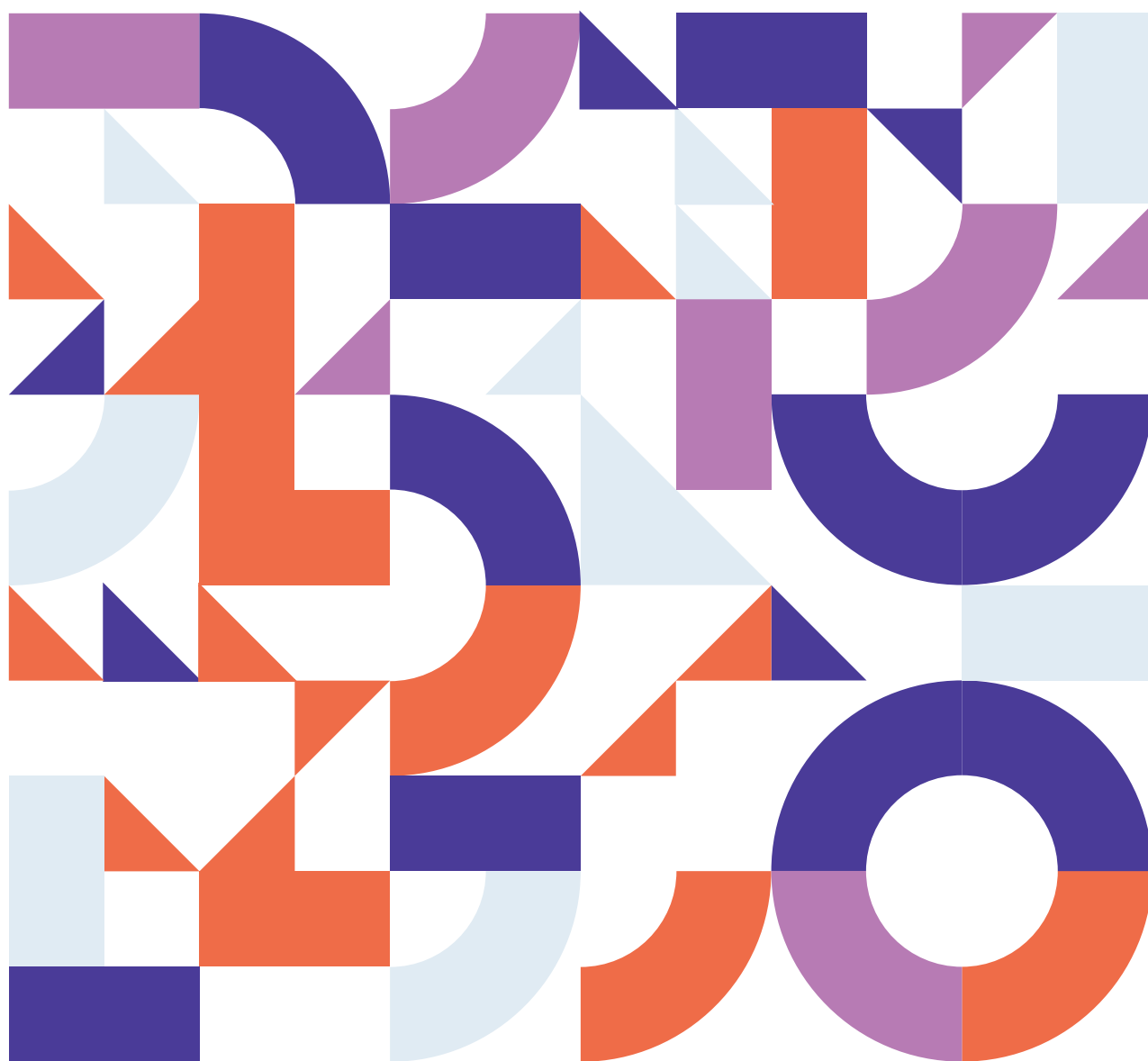


Economics of the interregnum

WORKING PAPER - MARCH 2022



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Economics of the interregnum

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The original premise of this intervention was to analyze Europe and the pandemic, but events always take over and so it is necessary to cover Europe, the pandemic, and the Ukraine invasion and try to put these in a broader perspective. Europe has shown an enormous and impressive solidarity in responding both to the pandemic and to the Ukrainian crisis. The speed, flexibility, and commitment responding to those two crises have been extremely impressive. There are many strengths, but being an academic, I can't help but to also point out things that also should have been done¹.

The lessons of the pandemic

Responding to the remark made that Eurobonds should have been issued during the eurozone crisis: this has now been done in response to the pandemic, and is essential for the stability, the long-term performance of Europe and the eurozone. Some parts of the response can be criticized: The money should have been directed more to grants and the total amount should have been larger. One of the reasons why the U.S. economy has had a stronger recovery is that there was more stimulus. Most importantly, Eurobonds could have been used as an opportunity to develop a Europe-wide tax system to repay the Eurobonds.

There are many areas that need a European tax system. In France there was discussion of a digital tax, but there needs to be a European-wide digital tax. It is concerning that in the new tax agreement there is – irrationally – a proscription of those kinds of taxes. There should have been a commonwealth tax. There is still much inequality in Europe, and one problem is that people can move from one place in Europe to another and escape taxes. There are some well-known examples in France, and this could have been an opportunity for a common income tax.

In the founding of Europe, there was worry about cross-border externalities. What would happen if some country had deficits when managing its fiscal affairs? What would be the macroeconomic implications for other countries?

1 — A first version of this text was presented by Joseph Stiglitz at the conference on the future of Europe organised by the French Court of Auditors on 15 March 2022..

That turned out not to be the important externality or an important problem. What has turned out to be an important problem is tax competition. The fact is that a few countries – Ireland and Luxembourg, for example – have found this very comfortable, basically robbing their neighbors by becoming low-tax jurisdictions, and at some point, this issue will have to be addressed.

A second aspect of the response to the pandemic that was very impressive was Next Gen EU. Although President Biden had the right concept with Build Back Better, he hasn't been able to get it passed. Where Europe has done a better job than America was that the money spent to help recover the economy did double, triple, or quadruple duty. The basic precept of economics is to say: when money is scarce, resources are scarce. That money had to not only help recover the economy, but address the inequality crisis, the climate crisis, and all the other problems that our societies face. That was really the idea in both Next Generation Programme and Build Back Better. It is very clear that, after the pandemic, Europe and the U.S. do not want to go back to the world as it was in September 2019. Spending all that money could actually help move our societies in a different direction.

An example of how successful the U.S. has been in one year with the American Rescue Plan, and of the failure of making it permanent, are the provisions directed at childhood poverty. In a rich country like the U.S., it seems criminal that 20% of children grow up in poverty. In one year under President Biden that number was divided in half, from 20% to 10%. That shows it could have been done earlier. We took the opportunity of the crisis to address a long-standing problem in the country. Unfortunately, politics in the U.S. are ugly and, in consequence, Republicans now want to put more children back into poverty, so this was only a temporary victory.

The third aspect is the quality of the response and, especially in the U.S., recognizing that there is a healthcare problem, which is a distinction between Europe and the U.S. Whereas the U.S. spends much more on healthcare - close to 20 % of GDP on healthcare - France spends about 11%. And yet, health statistics are much worse in the U.S.: life expectancy is lower; morbidity is higher; all indicators of health are worse. This is partly because there is not a good public healthcare system. The U.S. does not recognize something that is in the UN charter: that the right to healthcare is a basic human right. I could tell a story of when one of the presidents of France came to visit Columbia University in the middle of the debate over Obamacare. One of the students asked, "What is your view on Obamacare?" His answer was very diplomatic; he said, "You know, I don't get involved in the internal affairs of America, I don't want to give an opinion. But I simply don't understand how you can have a healthcare system that doesn't recognize the right of healthcare to everybody." He recognized that there was something very strange about America's healthcare system in that we don't recognize the right to healthcare access.

The reason that so many Americans have died – the largest number in any country – is the weaknesses in the healthcare system. Covid-19 was not an equal-access virus, it went after those in poor health. Because of the poor healthcare system there were many more people in that state. The other thing that came out of the pandemic was the recognition that public health is a public good; that we all profit from having a healthy society.

A critical and polarizing issue in the U.S. – and to a lesser extent in Europe – is that many Americans have taken the view that to be asked to be vaccinated or to be asked to wear a mask is an infringement on their freedom and their liberty in the same way as being asked not to carry a gun is an infringement of their liberty. What one has to understand is that one person’s freedom is another person’s “unfreedom”: if you carry a gun and you kill someone you take away their right to live, which is a more fundamental right than the right to carry a gun. If you don’t wear a mask it increases the probability that someone else gets the disease and dies. The right not to wear a mask is infringing on someone else’s right, which is a more fundamental right: the right to live. In that way the pandemic has provided an important lesson in how we as a society have to work together.

A fourth, and very strong, aspect of Europe’s response to the pandemic was that it was at the forefront of the global economic response. The magnitude of the response to help revive the economy in the U.S. and in Europe was previously stated but developing countries and emerging markets simply did not have the resources to do the same. The U.S. spent 25% of GDP, some countries spent more, Europe a little bit less. These were unprecedented amounts that were impressive responses to the crisis. However, developing countries and emerging markets could only spend a fraction of that.

Europe was at the forefront of working with the IMF to ensure that more money was made available. There were \$650 billions of special drawing rights (SDRs) that went to all the countries in the world to address the economic fallout from the pandemic. It was disappointing that in the U.S., President Trump vetoed this initiative that cost the American taxpayer essentially nothing. Europe continued to push it and finally, under President Biden, \$650 billion was issued. To date this money has not been recycled enough. SDRs are issued to countries whether they are rich or poor and that money needs to be recycled from the countries that do not need the IMF money to those that do. Europe has done a much better job of recycling than many other places. The U.S. has not yet agreed to this and there will be discussions next month in Washington at the IMF meeting. It is very clear that there won’t be a global recovery until there’s a recovery essentially everywhere and in many countries, we are about to see a debt crisis, especially from high oil costs and high interest rates, which will threaten the global recovery.

The flaws in our response

While we can celebrate these achievements, there are some disappointments and I hope that civil society will continue to agitate to make sure that these things happen.

The most significant disappointment was the failure to adopt the intellectual property waiver for the Covid-19 vaccine. It became very clear at the beginning of the pandemic that, as the WHO put it, no one in the world is safe until everyone is safe. As long as the disease is present anywhere in the world, there is a chance of a more fatal, more infectious, or vaccine-resistant mutation emerging. It was foolish not to do everything possible to assure that everybody in the world was vaccinated. We should celebrate the achievement because public investment in basic research and science as well as partnership between the public and the private sector allowed us to develop a vaccine in record

time. But we could have produced not only the billions of doses that were needed in advanced countries, but we could also have produced the billions more that were needed in developing countries and emerging markets. We did not do that, and this should be recognized as a major organizational and institutional failure.

Restrictions on intellectual property rights are meant to incentivize research, but in the midst of a pandemic it is imperative that a vaccine be distributed to everybody in the world. When the WTO was founded, there was an agreement on intellectual property with a provision allowing for the issue of compulsory licenses. This meant there was no change in the underlying principles of intellectual property. Civil society in the U.S. succeeded in persuading President Biden to support the vaccine IPR waiver, but the drug companies did not want it. It has mainly been Germany, with a few other European countries, that have remained the barrier to getting the waiver of intellectual property. There have been an enormous number of deaths, and even larger numbers of people who have gotten the disease because of the failure to enact the waiver when it was first proposed in October of 2020.

The Ukrainian disruption

On the issue of the Ukraine war, it is totally inconceivable to have a land war in Europe in the 21st century. Europe's response has been impressive in its solidarity, even from more illiberal countries like Hungary. Countries that have expressed an admiration for a dictator like Putin have supported Europe's actions. This solidarity speaks well for Europe's future.

I have asked myself what an economics professor can add to the discussion of complex political and strategic issues? There are at least three topics that should be considered.

The first is the question that I faced 25 years ago when I was on the Council of Economic Advisors to President Clinton: Will sanctions work? There is a long history of sanctions in places like South Africa, Southern Rhodesia, or Myanmar. The answer is: sometimes. Often it takes a long time. South Africa took a very long time. But out of those experiences are some lessons to be learned on what can make sanctions more likely to be effective. For sanctions to be effective, they have to be universal, as strong as possible, and they have to have asymmetric effects. That is to say the effects on the country being sanctioned have to be greater than the effects on the county imposing the sanctions. In the current context it seems that there is a good likelihood of success.

The strength of the response throughout the U.S., Europe, and the Western world has been extremely effective. And the breadth of the sanctions covers the financial sector, every aspect of critical trade, and the possibility of taking away the WTO provision of "most favored nation". Finally, the particular position the West has vis-à-vis Russia is important to consider. Most people don't realize how small the Russian economy has become. Some people view the situation as two nearly equal superpowers, but in terms of size, the Russian economy is small. Depending on how you measure, it is the size of the Netherlands or Spain. These are not tiny, but they are a fraction of Europe, let alone of Europe and the U.S. combined.

Moreover, Russia has a natural resource-based economy with 70% or more of its exports being natural resources. Its economy is not widely diversified and is very dependent on global supply chains. There is significant asymmetry between Europe and the U.S., and Russia. We have other sources of energy, other sources of food, we make the most important inputs that go into our output, we have diversified industry, and so the possibility of very large asymmetric effects is very strong. This is particularly the case with Russia's financial sector, which has become interdependent with the West. Almost any financial system has fragility, and if it is suddenly cut off from its financial counterparts, there can be tremors and the system may be broken.

The limits of sanctions

There are some limits though of the effectiveness of sanctions. The first and most important is China. As stated, sanctions only work if they're universal. We've created global supply chains and China is a key piece in this global supply chain. If China decided to circumvent the sanctions that the U.S. and Europe are imposing, the impact of the sanctions would be very limited. That is why the U.S. has made it clear – and Europe should, in a diplomatic way, make it clear – that there would be strong consequences to China for circumventing the sanctions. It is not in China's interest to be on the wrong side. Russia is a small economy and therefore the benefits of having Russia as sole trading partner are such that China would clearly not want that to happen.

The second important caveat to the effectiveness of the sanctions has to do with Russia's main exports: natural resources, in particular oil and gas. Germany, and Europe more broadly, made a great mistake in becoming dependent on Russian gas. Russia is not a stable trading partner. It is not a stable political entity to be dependent on. Gas is different from oil because alternative supplies of gas are less quickly replaced. Economists talk about market failure here, which was that the risk of being dependent on Russian gas was not priced into the market. When, in using Russian gas, Germany went for the cheapest source of energy, the price didn't reflect the cost of carbon or of risk. Europe is now experiencing that cost.

Looking at it from the other side of the Atlantic, there also seemed to be a kind of corruption with the chancellor of Germany being instrumental in this dependence by becoming chairman of Gazprom. This does not look good from the point of view of democratic politics and there should have been more sensitivity to what that would look like.

The third problem to having effective sanctions relates to the point of sanctions having a higher cost on the sanctioned country. Right now, one of the costs that the U.S. and Europe are facing is inflation, which is happening because of supply side interruptions associated with the pandemic. The question is how this inflation is viewed. Many in the press have been writing that this is the highest inflation in forty years, as if it is the end of the world. It must be very clear that the inflation we had forty years ago was much higher. It was well over 10%, and in some countries as high as 15%, which is very different from today. I believe that current inflation is a temporary supply side interruption that may take a longer time to deal with, particularly with the energy and food interruptions of the war. There are a variety of reasons that I am less worried about inflation,

but it is still a political problem that needs to be addressed. There are three or four things that must be done. Unfortunately, the oil and gas companies are engaged in what can only be called “war-profiteering”. It must be made clear that there should be no price gouging and no war-profiteering. Their profits are rising enormously because they own the reserves. The big oil companies are not buying oil from other companies, but the value of their reserves has increased. The cost of production has not gone up drastically, so they are mostly taking advantage of the shortage of gas and oil; it is part of the market adjustment. In the short run there is relatively little ability to adjust, so they are enjoying those higher prices. Bills have been introduced in the U.S. by Ro Khanna in the House of Representatives and Sherrod Brown in the Senate to limit price gouging and institute a windfall-profit tax against companies that engage in this behavior. I have suggested that some of this profit or new tax revenue can be used to help those who are adversely affected by inflation to offset their increased heating or gasoline costs.

Third is recognizing that this is a common problem, and some countries are more likely to be affected than others. There ought to be sharing within Europe and between Europe and the U.S. as well as recognizing that there are going to be costs of the war in Ukraine. It is important to have solidarity when one fights together so that the costs are shared.

Economists often have something to say about Russia’s failed transition from communism to a market economy. It must be recognized that it was not a successful transition, and it needs to be asked why. Part of it has to do with the shock therapy, the Washington consensus policies, and the neoliberal doctrines that guided that transition. There should have been more emphasis on democracy and civil society. Had that been done – while not certain – there would have been the possibility for Russia to have taken a different course. The U.S. also has to recognize its failures here as there was corruption in the assistance provided to Russia by the U.S. government.

Another aspect that economists talk about is the role of information and disinformation. I received the Nobel Prize in the Economics of Information for research dealing with how people have different information. We did not focus on the problem of people deliberately engaging in misinformation, which has been a critical problem. There is a whole class of digital harms, such as incitement, or the anti-vaxx movement that has impeded vaccination. One of the main questions is whether this can be controlled within a democratic framework, and I believe disinformation can be at least better controlled. One of the important initiatives that Europe is moving towards under the French presidency is the DMA and the DSA regulation, which will allow Europe to take a leading role in regulation and set the global agenda.

To conclude, there is a moral responsibility to do everything possible to help Ukraine. Under the Budapest Memorandum, when Ukraine gave up its nuclear weapons, we made a commitment to stand by Ukraine and we need to live up to that. The pandemic has been a defining moment to realize the absolutely essential nature of state and collective action. The invasion puts an end to the view that this is the end of history. It was Fukuyama’s view that the fall of the iron curtain was the end of history, that we would all converge into liberal democracies and free market economies. That looks very naive as we are about to engage in a new Cold War, and we need to think about what life is going to

be like after that. We must also reflect deeply on the wave of nationalism and populism that is rising around the world. In France and the U.S. it is more than economics. Economists want to explain everything through economics, but economics does play a very important role and there has been a failure to ensure shared prosperity. Deindustrialization was not well managed and there are large portions of our population whose incomes have stagnated for forty years.

Most importantly, this battle in Ukraine should be seen as part of a wider war. Many of the points mentioned are the fruit of the ideas and ideals of the Enlightenment, of which this institution is part. These are checks and balances, the rule of law, science, progress, social organization, that enable cooperation on a scale that is necessary for the 21st century. It is the source of our well-being and the reason why our standards of living are so much higher than they were two centuries ago.

It seems unthinkable that these Enlightenment ideals would be questioned and re-litigated in the way they are today. We must recognize that so much of our well-being, so much of what we take for granted, so much of our standard of living is due to these ideas and ideals and we will have to fight for them. This battle in Ukraine is part of that battle and the battle for democracy is part of that battle.