Introduction*

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In discussions of inclusive, sustainable development, we hear a lot about stability and growth. These are certainly important, but there is a third variable that is also crucial and which must be carefully considered in any strategy for inclusive growth—inequality.

Why should we be interested in the issue of inequality? First, we have to recognize that the objective of growth should not be an increase in GDP, which I call "GDP fetishism." We do not seek growth for its own sake. We need growth because it is often—but not always—an ingredient in improved well-being. But GDP is not, in itself, a good measure of well-being. Nevertheless, policymakers, journalists, and even economists use it as a proxy for well-being all the time.

We need to improve our methods for quantifying well-being; until we do so, it will be hard to design policies that promote it. At the behest of French President Nicolas Sarkozy, I chaired the International Commission on the Measurement of Economic Performance and Social Progress, which consisted of an outstanding group of researchers who had done important work on various aspects of the issue. The outcome was a report we completed in 2010, published as "Mismeasuring Our Lives: Why GDP Doesn't Add Up" (Fitoussi, Sen, and Stiglitz, 2010). It explains why GDP does not reflect well-being and does not reflect sustainability—facts that the financial crisis of 2008 made so evident. Even in the absence of a crisis, though, GDP is inadequate because it does not describe what is happening to the lives of ordinary citizens. It does not measure security, and crucially, it does not measure inequality.

There was a time when it was easier to argue that a rising tide lifts all boats—in other words, when it seemed easier to argue for trickledown economics. The idea was that if we increased GDP per capita, regardless of the distributions of the gains, then everybody would benefit, even if some benefited more than others. We now know that that is just not true. Of course, there was never theory or empirical evidence that supported that view, but the crisis and the Great Recession it spawned have driven home the fallacy. For instance, recent U.S. data show that while GDP per capita has been going up year after year for a long time (with the exception of 2009), this has not been true for most Americans—the median

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household income in the United States in 2010 was lower than it was in 1997. Even before the crisis, it had not recovered to its 2000 levels,[1] and the current median income of a full-time male worker is the same as it was in 1978. So there has been stagnation for more than three decades for the average worker in the United States. What this makes clear is that GDP per capita can be going up but that the livelihoods of most citizens can still be going down. Any assessment of economic performance must focus on what is happening to the majority of citizens.

But there is another reason why we may be interested in inequality: Among its many deleterious effects is instability. This was one of the most important points raised at the IMF meetings in the spring of 2011, when IMF announced a new official concern with inequality because of its recognized link with instability, the prevention of which is one of the principal mandates of the IMF. As then managing director Dominique Strauss-Kahn put it, "Ultimately, employment and equity are building blocks of economic stability and prosperity, of political stability and peace. This goes to the heart of the IMF's mandate. It must be placed at the heart of the policy agenda".[2]

One of the reasons for this conclusion is found in another IMF study, which concluded: "We find that longer growth spells are robustly associated with more equality in the income distribution . . . Over longer horizons, reduced inequality and sustained growth may thus be two sides of the same coin" (Berg and Ostry, 2011).[3]

This recognition by the IMF of the link between inequality and stability is consistent with a growing understanding in economics of the connections between the two. Part of the reasoning behind this had been put clearly in the report of a UN commission of experts (United Nations, 2010) charged with analyzing the causes of the Great Recession and the remedies. They pointed out that since higher-income individuals consume more than lower-income individuals (the savings rate at the top is 15 to 25 percent, and the savings rate at the bottom is normally close to zero[4]), moving money from the bottom to the top lowers consumption. That lowers total demand. The result is that unless something else happens, total demand in the economy will be less than what the economy is capable of supplying—and that means that there will be unemployment. The way that the United States sustained growth before the crisis was to create a housing bubble through a combination of lax regulation and loose mon-

[1] For more information, see Table H-9 of the U.S. Census historical tables, available at http://www.census.gov/hhes/www/income/data/historical/household/index.html.

[2] Dominique Strauss-Kahn, "The Global Jobs Crisis—Sustaining the Recovery through Employment and Equitable Growth," April 13, 2011, speech delivered in Washington, DC; available at http://www.imf.org/external/np/speeches/2011/041311.htm.

[3] Chapter 9 by the same authors in the present volume is based on (Berg and Ostry, 2011).

[4] For a discussion of savings rates before the recession, see Dynan and others (2004). The authors find savings rates varying from zero for the lowest quintile of the American income distribution to in excess of 25 percent for the top.

etary policy. It was inevitable that the bubble would eventually break, and it was inevitable that dire consequences would follow.[5]

Inequality can also have an effect on economic growth both directly and indirectly as a result of the instability that it helps foster, since instability for a variety of reasons can also affect economic growth. Space does not allow a discussion of all the channels through which inequality affects both instability and inequality—and there is considerable controversy about many of these channels. It is clear, though, that we need to understand the causes of the very large increases of inequality that have affected so many countries around the world, and we need to think about what we can do to reduce the sources of that inequality.

While markets are central to the determination of incomes and inequality, markets are shaped and affected by policies, including laws and regulations. Every aspect of policy has the potential for distributive consequences. Fiscal policy's distributive consequences should be obvious: Cutbacks in spending hurt those at the bottom or in the middle the most. But trade policy can have strong distributive consequences, too, particularly in the context of globalization. Jobs can be destroyed faster than they are created, and the resulting unemployment has both a direct effect on inequality and an indirect effect as it exerts downward pressure on wages. When we design policies for growth, is it pro-poor growth? There are policies that foster anti-poor growth, and there are policies that are more or less inclusive.

Earlier I noted the link between inequality and growth. If we think that inequality affects stability and growth, then we want to make sure that we are sensitive to the impacts of polices on inequality. But the relationship is two-sided: Those at the bottom typically suffer the most in a crisis.

Commodity price volatility is also related to inequality. Take, for example, agricultural or food price volatility. Because the poor spend a larger fraction of their income on food, this kind of volatility affects the poor more than it does other people. The poor have less of a buffer and thus have the harshest experience with the price volatility. They have less access to capital markets, less ability to borrow, and fewer savings. Average savings of those in the bottom half, even in a rich country like the United States, are close to zero, so volatility in their real incomes is felt immediately.

But there is also an indirect effect of this volatility. Commodity price volatility has macroeconomic effects on countries, and those macroeconomic effects lead governments to respond in ways that often exacerbate inequality. When prices go down, the government must often cut back on spending, and among the areas of spending that often get hit very badly is social spending. Also, many countries still have large fuel subsidies, and when fuel and energy prices go up, it eats into government budgets, leaving less for other aspects of growth and development expen-

[5] It should be clear that there were other ways by which the deficiency of aggregate demand arising from the growth in inequality could have been offset, such as more progressive taxation. But the increase in inequality itself gives rise to a politics that makes these alternatives more difficult.

ditures. In short, anybody concerned about inequality should be worried about the high level of commodity volatility that we have seen in recent years.

Food and commodity price volatility is particularly important in sub-Saharan Africa for two reasons. For one, there are more countries in that region that are dependent on natural resources. They constitute a large fraction of exports and a large fraction of government revenues in those countries. Second, many of those countries have very low incomes, so food and oil are a large fraction of their consumption baskets.

Even within countries, the effect of price volatility is uneven, which can put additional burdens on the government. For instance, high food prices may benefit the agricultural workers in the country, but urban workers suffer a great deal. Those who benefit do not automatically compensate those who lose, and it is left to the government to try to deal with those who lose and get revenues from somewhere else to make up for these increased expenditures. Commodity price volatility imposes real strains on government budgets.

The high volatility of commodity prices is one factor contributing to the natural resource curse, the fact that resource-rich, commodity-dependent countries have not grown as well as others. But another striking feature of the natural resource–cursed countries is they often have more inequality. This is a paradox because one would think that with all the revenue coming in, which is inelastically supplied, it should be easier to engage in redistribution. If we tax rich individuals, they might decide to work less, and therefore, there is a limit on the taxes that we can impose on labor for redistribution. But if one taxes oil, oil will not decide to disappear. Oil is there. Natural resources are there. (Obviously you have to compensate people for extracting the resources, but the rents currently in the oil markets are enormous, as they are for a lot of the other natural resources, so one could increase the taxes on natural resource rents a great deal without adverse consequences; they are not going to disappear.) Given the magnitude of the rents that are available in these societies for redistribution, one would think that there would be more of it, more equality, and more spending on social areas; but in fact, these countries are characterized by more inequality.

Commodity price volatility does present a special set of problems for inclusive growth, and that is why it is important for us to discuss them. This is especially so because the problems of lack of growth, pervasive instability, and persistent inequality can be exacerbated by policy. It is important also to consider the origins of high commodity price volatility, although space does not allow us to do so in great detail here. But whatever the source of the volatility, policy can exacerbate the effects.

For instance, fiscal policies and monetary policies that are procyclical can exacerbate the macroeconomic fluctuations arising from highly volatile commodity prices. Inflation targeting, as it is normally formulated, is procyclical. It exacerbates these problems. In the aftermath of the 2008 crisis, many policymakers are discussing whether countries should continue with inflation targeting, which is a bit surprising. I would have thought that one of the big lessons of this crisis is that inflation targeting did not do what it was supposed to do. Many people thought that inflation targeting was necessary and almost sufficient for economic stability, but clearly even though monetary policy may have played a role in keeping inflation low and stable, low and stable inflation did not lead, as predicted, to high and stable growth; it did not protect Europe and the United States from the huge crash. In fact, the models that are used to argue for inflation targeting focused on effects that were really of second, third, *n*th order of importance. The models focused on the relative price distortions that arise in the presence of inflation; that is, that relative prices can get out of line, which distorts the economy.

But the fact is that the losses from the output gap that resulted from the financial collapse were a magnitude greater than these inflation-related dead weight losses. The quantitative magnitude of the effects that are usually linked to inflation are really not very important. The losses from the gap between the economy's potential and its actual output as a result of the crisis, on the other hand, are in the trillions of dollars. The focus on inflation targeting was misguided and a distraction from the really important issues. There was an interesting meeting at the IMF in the spring of 2011 that brought together many academic experts and policymakers.[6] The meeting highlighted a broad consensus that we need to move beyond the preoccupation with inflation targeting. Not that one should forget about inflation—when it gets out of control one has to worry about it. But inflation must not be our only concern. Financial stability, even for central bankers, is something that is equally, or more, important. And in most countries today, inflation has been low to moderate and relatively stable.

Inflation targeting has another danger—it can contribute to inequality. Because inequality can contribute to instability, there is an indirect channel by which inflation targeting may contribute to the weaknesses in the economy. And the link is pretty clear. Think about a small African country where the source of inflation is imported food and oil. Raising interest rates is not going to have any consequences on global prices of food or global prices of oil, so raising interest rates is not going to change that. So how can one dampen inflation in these circumstances? The only way to do it is to cause massive unemployment among those workers within the country, adding insult to injury. Workers are already suffering from high food prices and from high energy prices. Now, they are going to suffer from high unemployment, too. Obviously, this should be politically unacceptable, but it also should be economically unacceptable. It increases inequality, real inequality, because it is the workers who will suffer the most.

Globalization and inequality are also strongly linked. Some of the most obvious connections are in trade policy, arising from unfair and poorly designed trade agreements that have allowed, for instance, the continuation of agricultural subsidies, such as for cotton. The United States subsidizes 25,000 rich cotton farmers to the tune of billions of dollars a year, thereby depressing cotton prices. Without those subsidies, American farmers would not be exporting cotton, but because of them, the United States is one of the largest cotton exporters. The depressed

[6] Proceedings from that conference were published by the IMF in 2012, in a volume called *In the Wake of the Crisis*.

global prices, in turn, depress incomes of cotton farmers in sub-Saharan Africa and increase poverty among the poorest people in Africa.

There are other examples. One way that globalization contributes to inequality arises from the fact that we have had asymmetric globalization (liberalization). We have liberalized capital markets but not labor markets, which means that capital can move all over the world much more freely than labor. This increases the bargaining power of capital relative to labor, which lowers wages relative to what they otherwise would be and increases inequality. It also puts pressure on countries to lower their taxes on capital, reducing the scope for redistributive taxation. Trade agreements and trade policy can be problematic in other ways. They often restrict the ability of countries to try to manage the risks that they face, including volatility in commodity prices. For instance, Colombia introduced a variable-rate tariff in recognition of the fact that international prices are very unstable. It wanted to stabilize incomes of those inside the country so that they would be insulated a little bit from the high volatility in international prices. But the United States put pressure on Colombia not to have these variable rate tariffs—it did not like the system.

Another example is that an important aspect of trade liberalization policy in recent years has been the elimination of quotas in a process that is called "tariffication." But actually moving from quotas to tariffs can expose countries to more instability. Quotas are a way that a country can insulate itself to some extent from the volatility in international markets. If we had perfect risk markets, this would not make any difference. But we do not have good risk markets, especially in developing countries and especially in the least developed countries. So this is another example where international agreements focused on the wrong models. By relying on flawed assumptions, international agreements have thus contributed to increase the vulnerability of the poorest in the least developed countries to the global volatility that has become so important.[7]

There are other aspects of globalization having to do with the globalization of international financial markets that have important consequences for stability and inequality. One is capital market liberalization. Should countries open up themselves to the destabilizing short-term flows of the capital market? This is in many ways very different from openness to foreign direct investment (FDI). China, for instance, has long been open to FDI and has been the largest recipient ofFDI, with tens of billions of dollars coming into the country. For China, it has been an important way of getting access to international markets, access to technology, training, and so forth. But that is very different from the short-term capital flows that can come in and out of a country overnight. Those short-term capital flows were at the center of the East Asia crisis 13 years ago.

It should be clear too that these short-term flows, while they increase instability, do not in general lead to fast growth. One cannot build factories on money

[7] See Dasgupta and Stiglitz (1977). Newbery and Stiglitz (1984) show that, in fact, in the absence of good insurance markets, trade liberalization may make everyone worse off. Similarly, capital market liberalization may increase volatility (Stiglitz, 2008).

that can come in and out overnight. It does not lead to real development. Short-term speculative capital focuses on short-term opportunities, not the long-term growth that is at the center of development.

There is also a wide recognition that in general, more extensive capital market integration played an important role of the spread of the crisis in the United States to the rest of the world. This was a crisis that began in the United States and very quickly spread through several channels. One of the channels was this stronger capital and financial market integration. One of the broad lessons that emerged from the financial crisis was that we need to have well-regulated financial markets: A major source of the crisis was inadequate regulation. The core of the problem was that banks did not manage risk very well. They did not allocate capital very well. But this kind of problem has occurred over and over again in the history of capitalism. After the Great Depression, however, we put in regulations that worked. There was a long period of stability until about 1980, when we started removing those regulations. Then the banks went back to the way they behaved normally and we started getting more and more volatility and more frequent crises.

One aspect of regulation is regulation of cross-border capital flows. A lot of the instability facing developing countries comes from unstable cross-border capital flows. Countries need to protect themselves against these destabilizing short-term capital flows. Again, the people who tend to be hurt the most and have the least resilience to these downturns are the poorest. Capital market liberalization thus contributes to the creation of inequality through the crises that it brings about. This points to another failing of GDP—that it does not measure security. When I was at the World Bank, there was a study done called "The Voices of the Poor." We interviewed 10,000 poor people, asking them what most contributed to the unpleasantness of poverty. One obvious answer was the lack of income, but there were two other important things as well. One of them was lack of security.

In most developing countries, there is no adequate insurance to mitigate the risks they confront. In fact, even in many developed countries, insurance markets are far from perfect, but in developing countries the lack of insurance is even worse and there are none of the buffers, none of the safety nets that people can fall back on either in the public sector, the private sector, or the nongovernmental sector. So that is why it is a special responsibility for developing countries to try to protect themselves against instability, and that is why policies like capital market liberalization need to be looked at very carefully—they can expose countries to greater instability.

Financial market liberalization is a final area in which globalization may be having an adverse effect on the poor and on inequality. Financial market liberalization entails opening countries up to international banks and other financial institutions. With financial market liberalization, in many countries, international banks have bought domestic banks and/or have come in on their own. Very often, they displace domestic banks. Depositors see the international banks as safer than domestic banks. It is not always clear why, and it is not necessarily because the banks know how to manage risk better—the crisis should have raised an important question; that is, whether, for instance, Citibank was safer than the local bank, as many people once assumed. Perhaps there was confidence that the U.S. government would bail out Citibank should it run into trouble—which, of course, was what happened. But for whatever the reason, the evidence is that many depositors feel that way.

How depositors allocate their funds is important because it affects access to credit. Banking is about lending, or should be about lending. It should not be about speculation, and it should not be about all the other activities that some of the banks have become involved in. The core function of banking is providing funds to firms to do investing, and this is especially true in developing countries. The funds provided by banks are particularly important for small- and medium-sized enterprises. The function of allocating capital to small and medium-sized enterprises (SMEs) is very information intensive. Domestic banks (and other financial institutions) tend to have an informational advantage over international banks. The latter often focus their lending activities to the government, multinational enterprises, and large domestic firms. The implication is that as depository funds shift out of domestic banks, the domestic banks have to get funding from other sources, which are typically less stable, and/or cut back in their lending. The result of all this is that there is less lending to SMEs and the lending that there is can be less stable. This is of particular concern because the SMEs in any country are the source of job creation. So financial market liberalization can weaken the labor market, with an adverse effect on workers and inequality. There can also be adverse macro-economic effects on growth and stability.

There are a few concluding points. First, it is imperative that we focus more on the effects on inequality of policies both at the national level and the global level. The effect of policies on inequality is important in its own right, but it is also important because an increase in inequality can lead to social, political, and economic instability and indirectly lead to lower growth (appropriately measured). Second, volatility itself has a very high cost, so it is important to try to do what we can not only to reduce it, but also to manage that volatility, so that its economic and social consequences are mitigated and so that problems in one country (or one region in a country) do not spread to others. Third, there are some policies such as inflation targeting, financial market liberalization, and capital market liberalization that may actually increase economic instability and societal inequality and indirectly and directly lower economic growth. While there is not yet consensus on these issues among economists, the crisis of 2008 has at least undermined the opposing consensus that such policies facilitated growth and stability. Further research will be required to better elucidate the circumstances in which adverse effects are more likely to arise.

Finally, there is a range of policies that actually can encourage equality and reduce instability. Some of these have been curtailed by global agreements, and we have to make sure that those restrictions are removed from international agreements. There is thus a wide agenda ahead if we want to promote inclusive growth in the face of the high level of volatility in the price of commodities, which are so important to so many developing countries.

The final thought is the following: There has been insufficient attention to the distributive consequences of various policies, including those that I have discussed here, and the distributive consequences of volatility. These distributive consequences, while they may not show up in representative agent macroeconomic models (so they simply have nothing to say about inequality), are vitally important. They affect macroeconomic behavior. They affect how a policy affects most citizens of a country. They affect social and economic stability and sustainability. These distributive consequences should not be ignored in our analyses.

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