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THE WORLD BANK AT THE MILLENNIUM*

Joseph E. Stiglitz

In the aftermath of World War II and in the wake of the Great Depression (surely one of the underlying causes of the war itself),[1] the countries of the world created three international institutions designed to facilitate economic cooperation: the General Agreement on Tariffs and Trade (GATT), the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD). GATT (which has since evolved into the World Trade Organisation) was to work on lowering trade barriers among nations and on preventing the beggar-thy-neighbour trade policies that were seen as a contributing factor to the breadth and depth of the Great Depression. The IMF was to provide liquidity and to sustain the international payments system (the gold standard that was reinstituted after the War). And the IBRD, known more generally as the World Bank, was primarily to facilitate the reconstruction of war-damaged Europe, and then to reach beyond that to aid in the development of what later became known as the Third World.[2]

It is now more than fifty years since the creation of these institutions. Over that half-century, they have evolved enormously, especially in response to changing economic circumstances and changing needs. The 1971 abandonment of the gold standard by the United States (and subsequently by the rest of the world) clearly necessitated a change in the functioning and perhaps in the very role of the IMF. The collapse of the Soviet Union posed a new set of challenges to the international institutions – namely facilitating the transition of the former Communist countries to a market economy. The fiftieth anniversary of the Bretton Woods institutions (IMF and World Bank) was marked by criticism from a vocal international group dedicated to the notion that 'Fifty Years Is Enough', reflecting a view among certain groups that these institutions had done as least as much or more harm than good. As the World Bank has

* The views presented here are solely those of the author and not those of any institution with which he is or has been affiliated. The author would like to acknowledge the helpful comments and assistance of Halsey Rogers and Maya Tudor.

[1] The link between economic well being and social and political stability had clearly been of concern to Keynes, one of the key founders of the Bretton Woods institutions. Recall his *The Economic Consequences of the Peace* (1920), in which with clairvoyant insight he saw the dangers of the adverse consequences of the reparations payments being imposed on Germany by the Versailles Treaty. We have, unfortunately, been reminded of this link over the past year. One of the most severe economic downturns of the postwar period is the depression that has fallen upon Indonesia, where output in 1998 is projected to be 16% below its 1997 level (which itself was dampened by the crisis which began in October 1997). It is somewhat ironic that the Indonesian depression was in no small measure caused by the social and political upheaval, itself induced in part by contractionary monetary and fiscal policies that had already reinforced the economic downturn that followed the currency and financial sector crises.

[2] The first 'development' loan was given to Belgium, to help the Congo. See Kapur *et al.* (1997), p. 98.

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worked over the past few years to redefine itself, that cry is heard much less often today. Similarly, in spite of considerable hesitancy and a lively debate over the IMF's role and competence, the U.S. Congress did increase its funding, perhaps in the recognition that if the IMF did not exist, it would have to be reinvented.

As the world moves into the next century, it is appropriate to re-examine how these institutions are and should be evolving. I shall focus my remarks especially on the World Bank, but I shall look at that institution through the broader perspective of the global economic architecture. And I shall look at these institutions through the lens of modern public finance, macroeconomics, and development theory.

1. Global Public Goods and the Theory of Market Failures

The Bretton Woods organisations are public institutions, designed to facilitate collective action at the global level. At the time the Bretton Woods institutions were founded, there was not as clear a concept of the role of collective action as there is today. Still, Keynes and his compatriots grasped the notion that there were imperfections of capital markets that might impede the flow of capital, say from more to less developed countries. Keynes and his contemporaries were keenly aware that market economies do not always work well—indeed, the Great Depression can be viewed as the most massive market failure that the world had experienced since the beginning of capitalism. He demonstrated how appropriate government intervention could help the economy pull out of an economic downturn. While at the time his ideas were viewed as radical, they were in a sense very conservative, for they maintained a faith in the market economy: beyond maintaining overall macroeconomic stability, government did not have to play any role in resource allocation. Thus, even at the founding of these institutions, there was a curious blend of a recognition of a massive market failure and a faith both in markets and government—or at least in the ability of government to effectively address the key market failures.

Since Keynes, the intellectual foundations of that belief have been subject to extensive scrutiny. Economic fluctuations in general (and the Great Depression in particular) are the tip of an iceberg, the most dramatic manifestations of the market failures that are pervasive in the economy.[3] But while we have come to recognise that markets are not generally even constrained Pareto-efficient,[4]

[3] For an articulation of this view, see Greenwald and Stiglitz (1987). While it was widely recognised that Samuelson's neoclassical synthesis, arguing that once macroeconomic problems were solved, markets provided an efficient resource allocation, lacked foundations, another strand of thought (real business cycle and new classical theory) tried to develop a consistent intellectual framework by arguing that markets worked efficiently all the time. To be sure, there were economic fluctuations, but these were the efficient market responses to external shocks. While employment did vary, it was only because individuals chose to enjoy more leisure at certain times (like recessions), in response to these changing economic circumstances.

[4] The general theorem is articulated in Greenwald and Stiglitz (1986), who show that when information is imperfect and markets incomplete—that is, essentially always—there exist interventions in the market which respect these limitations and which can make some individuals better off without making anyone else worse off.

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there has also grown a greater recognition of the limitations of government.[5] Government and markets are seen today more as complements, each providing a check on, and facilitating the functioning of, the other.[6] The recent failures in Russia have brought home forcefully the importance of the institutional infrastructure required to make markets work. This includes having appropriate legal and financial institutions, ensuring competition and contract enforcement, providing for bankruptcy, and enhancing the safety and soundness of banks. At the same time, public institutions have also made more extensive use of market mechanisms.

The modern analysis of collective action thus *begins* with a discussion of market failures, but then moves on to consider whether public interventions can improve matters, and how those interventions can best be designed. It recognises the presence of agency problems in both the public and the private sector.[7]

We are concerned here with collective actions, and therefore with market failures, at the global level. Here, the concept of global public goods is essential. Following Samuelson's definition of the concept of public goods (in 1954), it became clear that the benefits of some public goods extended only within a limited geographic region. There thus developed a theory of *local public goods*.[8] More recently, it has become clear that there are public goods whose benefits extend well beyond national borders to the global level. These are *global public goods*.[9] Five major examples have been discussed in the literature: economic coordination, environment, knowledge, international security, and humanitarian assistance. Various international institutions have been created to facilitate collective action in each of these areas. As these five public goods overlap to some degree, not surprisingly, so do the mandates of the institutions, a theme to which I shall return later in this essay.

In analysing the evolving role of each of the Bretton Woods institutions, it is necessary to identify their core mission and the market and/or public failure that necessitates collective action at the global level. Why, for instance, might non-cooperative action lead to Pareto-inferior outcomes?

Answering the latter question might not be as easy as it seems. Standard neoclassical theory, for instance, argues that it is in the interests of each country to adopt a policy of free trade: what is sometimes referred to as a policy of unilateral disarmament is a Nash equilibrium. But there is considerable evidence that GATT and WTO have played a central role in moving the world towards a freer trade regime (though they have been more successful in reducing tariffs on manufacturing goods, of concern to more industrialised countries, than in removing trade barriers in agriculture, the comparative advantage of parts of the less developed world). To understand that role, one

[5] For a general articulation of this view, see Stiglitz (1989).
[6] This view has been put forward, e.g. by Hellman *et al.* (1997), Aoki *et al.* (1997) and World Bank (1997*c*).
[7] See Stiglitz (1991), Krueger (1987), Shleifer and Vishney (1994), Edlin and Stiglitz (1995).
[8] For early discussions, see, for instance, Tiebout (1956) and Stiglitz (1977 and 1983).
[9] See Stiglitz (1995) and the *Economic Report of the President* (1997) and Stiglitz (1999) UNDP paper.

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has to move beyond the neoclassical model. But once one does that, a concern for intellectual consistency should make one wary of returning to that same model in analysing trade policies more generally.

Understanding the non-cooperative equilibrium is important in identifying the kinds of interventions that are likely to be desirable at the international level. For instance, McKibbin (1988) concludes his analysis of the role of international macroeconomic coordination in a context in which countries face inflationary pressures by saying:

> A comparison of policies under cooperation and non-cooperation clearly shows that the non-cooperative equilibrium is contractionary relative to the cooperative equilibrium.

If that is correct, then international cooperative action should attempt to induce countries to take more expansionary policies than they would of their own accord.[10]

2. Core Mission

Today, the World Bank's core mission remains the promotion of economic growth and the eradication of poverty in the less developed countries. The instruments used to pursue that objective have changed over the years, to be sure. Over the Bank's history, the balance of its effort has shifted from large-scale, growth-oriented projects toward projects, programmes, and policy advice that more explicitly incorporate the poverty reduction goal. Individual projects remain the core of the Bank's work, and many of these projects have been shown to be quite successful at reducing poverty and its effects, whether by reducing severe malnutrition in Tamil Nadu, India or by helping spur a dramatic increase in girls' education in Bangladesh.[11]

But the Bank has learned over the years that successful projects are not enough: because of fungibility of funds, the net benefit from financing any individual project is in fact the net benefit of the *marginal* government project— whether Bank-supported or not. Recognition of that fact has led the Bank to an increased focus on whether, taken as a whole, the government's actions and the institutional environment support the goal of poverty reduction. Decisions on the *overall* lending portfolios for the poorer countries (those eligible for subsidised IDA loans) are increasingly based on indicators of macroeconomic and sectoral policies and institutions, as well as governance, because these variables are strong predictors of performance on poverty reduction. And poverty assessments now underlie virtually all of the periodic Country Assistance Strategies that guide our lending programme in each country. It is largely the increasing availability of poverty data, a result of

[10] Interestingly, this view seemed to predominate in the early days of the Bank, when the Bank's shareholders were reluctant to provide funds for Belgium, partly because of its exclusively *contractionary* monetary policy. See Kapur *et al.* (1997), p. 98.

[11] See World Bank (1999) for a detailed review of Bank efforts and performance on poverty reduction.

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household surveys often supported by the Bank, that has helped make that shift pos-sible.[12]

Even as the Bank has pursued and refined its mission of long-term economic development and poverty reduction however, it has increasingly focused on a multitude of other issues. It has become more involved in post-conflict situations, for example, helping countries recover as they emerge from years of civil war. And as the world has turned its attention to global environmental issues, the Bank has not only integrated these concerns into its development agenda (for example, through mandatory environmental assessments of its projects), but has actively promoted work on specific issues. For instance, the World Bank has addressed concerns about greenhouse gases through the Global Environment Facility[13] and through promoting 'carbon trading'.[14] At the same time, the Bank has also been involved in a number of 'bail-out' packages, which have had the effect of providing liquidity support to countries in crisis.

The core mission of IMF continues to be quite distinct: stabilisation, both of the monetary system and of the world economy in general. Like the World Bank, the Fund too has evolved over time, especially in its assistance to the countries in transition and to less developed countries, in its Enhanced Structural Adjustment Facility (ESAF) programme.

2.1. *Governance*

An understanding of the precise roles that these international economic institutions *ought* to play should reflect an understanding of the market failures that need addressing at an international level—a topic to which most of this essay is directed. But as a preface, let me note that to assess the *actual* functioning of these institutions and their ability to fulfill ideal roles, it is necessary to understand the governance of these institutions. As we noted, modern approaches to the economics of the public sector focus not only on market failures, but also on the capacity of political institutions to address those failures. While the Bretton Woods institutions are political institutions, they are not directly but indirectly accountable to the peoples of the world through the representatives of their governments (the executive directors). In fact, the institutions are not even directly accountable to the chief executives of their 'shareholder' countries:[15] the IMF is accountable to ministries of finance and central banks, while the World Bank is accountable to ministries

[12] In Africa, for example, virtually every country has by now carried out at least one such survey, and most have done so within the past five years (World Bank, 1999).

[13] Which helps pay for incremental costs associated with environmentally beneficial projects.

[14] It has been exploring the creation of a Prototype Carbon Fund (PCF), which would facilitate carbon trading at the global level under the Clean Development Mechanism and could be expanded to incorporate trading in emission permits.

[15] Voting rights in these international institutions are markedly different from in the United Nations, where, in the General Assembly, each country gets a single vote, regardless of its size. In the IMF and the World Bank, voting rights are proportional to the contributions of the countries that support those institutions, which, in turn, are related to their GDP. Thus, the United States has the largest 'vote'.

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of finance and either aid agencies (in the case of donor countries) or economic ministries (in the case of recipient countries). Democratic accountability has been further weakened as central banks have increasingly succeeded in achieving greater independence, often with the encouragement of the IMF itself.[16]

The World Bank's broad mission of promoting development requires it to work actively with a large number of ministries in each developing country—on environment, labour markets, health, education, judicial systems. This in turn necessitates it taking into account a wide range of perspectives. This has become even more true in recent years, as views of development have changed from a more narrow focus on solving certain technical problems, like lowering tariffs, to a broader one of the transformation of society.[17] In response, the World Bank has attempted to engage not only all of these ministries, but also civil society (which in many cases has proven to be an important agent for change).

Differences in governance structures and in borrowing-country counterparts clearly affect the policy prescriptions offered by the two institutions. Different agencies (and the constituencies they represent, or with which they are most closely affiliated) have different priorities, and those priorities will show up most glaringly when it becomes necessary to make hard choices. Central bankers focus predominantly on stabilisation, or even more narrowly on containing inflation, arguing that such policies are a precondition for growth. By contrast, development ministries—not to mention environment and labour ministries—typically focus on the country's longer-term development, broader quality-of-life issues, impacts of policies on workers, and more broadly, issues of equity and sustainability. What is important is ensuring that any major policy shift be preceded by a full discussion that draws on all of these diverse viewpoints.[18]

2.2. *Special Interests vs. National Interests*

When I served as Chairman of the Council of Economic Advisers, it was clear that different agencies in the government serve (and see as their mission

[16] My point here is not to discuss whether there might be advantages that result from independence to offset the presumed disadvantage arising from weaker democratic accountability, but only to focus on some of the *consequences*. Note, however, that while there is some argument that independence leads to better performance of economies in terms of certain intermediate variables (like inflation), there is no evidence that in terms of the variables of ultimate concern, output and real incomes, and their growth variability, that performance is superior. See Alesina and Summers (1993). And even in terms of the former, questions have been raised. Stiglitz (1998*f*). Some countries, like India, without independence, but a strong anti-inflation consensus, have pursued low inflation policies. On the other hand, independence of the central bank in Russia has enabled it to pursue a more inflationary policy than the government might have desired. Independence in countries without democratic institutions raises further problems: Had the Indonesians been persuaded to have an independent central bank during the Suharto era, the transition to a more democratically accountable regime might have been even more difficult.

[17] For articulations of these views, see Wolfensohn's address to the Annual Meetings of the World Bank and IMF (Wolfensohn, 1998) and my Prebisch lecture at UNCTAD (Stiglitz, 1998*b*).

[18] The section below on 'Overlapping Jurisdictions' will elaborate on this point.

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serving) different constituencies. Indeed, only at the very top is there typically much focus on the *national interest*. Special interests are so powerful that even near-Pareto-efficient improvements are frequently blocked.[19] Democratic processes within countries resolve these conflicts, attempting to find policies that accommodate different interests and thereby reach broad consensus. Without such consensus, policies will often not be sustainable. They will be undone with the next change of political winds and, even while they are in effect, they will not yield full benefits simply because of the uncertainty that arises from political vicissitudes.

It should not be surprising then that any international economic agency reporting to central banks and finance ministries reflects the views and interests of those agencies and their constituencies more than it does the views and interests of others. Many central banks do not seek to achieve equitable representation on their boards, and while they may claim that they bear in mind the overall economic interests of the country, they may face tradeoffs in which different groups bear the risks and reap the benefits associated with different policies. Labour unions, financial institutions, and business firms may all look at those tradeoffs differently (in American parlance, workers, Main Street, and Wall Street may each have different views). Indeed, even technical matters—probability judgments—that cannot be cleanly separated out as forming Bayesian probabilities requires the specification of a loss function, and each group has a different loss function.[20]

There are thus real risks associated with delegating excessive power to international economic agencies, and a real challenge involved in making these institutions take positions that are more reflective of stances that might have evolved if they were indeed more democratically accountable. Essential to this democratic accountability is increased transparency and increased public discussion of the positions and policies of these institutions. The World Bank is committed to pursuing policies of increased transparency and public dialogue, not only within the developing countries with which it deals, but also in its own operations.

Agency problems arise at several levels. Not only may an institution not serve the *general interest* and weigh the welfare or perspectives of certain groups more than others, but the institution can actually become an interest group itself, concerned with maintaining its position and enhancing its power. This problem becomes particularly alarming when the power and prestige of an international organisation is pitted against the weak position of a developing country that is appealing to the international community in a time of crisis. Like any prudent lender, international institutions have an obligation to see that their funds are not squandered and will be repaid. Usually, repayment is not so much at issue as enforcing international codes of conduct: democracies do not like to see international institutions, which they created and support, being used to prop up corrupt regimes that immiserate their citizens. But in

[19] Stiglitz (1997*b*).
[20] Stiglitz (1998*f, g*).

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both cases, there are elements of judgment calls—what reforms are necessary to ensure, or increase the likelihood of recovery? What reforms could be postponed? What reforms should be postponed?[21] Where does one cross the line, with both the reforms themselves and the manner in which they are forced upon the country, undermining democratic processes and ideals?[22]

Asymmetries of information make it difficult to curtail agency problems. When a particular prescription fails, the doctor always has an incentive to suggest that it was the patients' fault for not following the prescription precisely. One sometimes hears the defence of failed policies that 'the policies were correct, but the implementation was faulty'. But modern medicine has taken upon itself recognition of these 'implementation' problems. Doctors are aware of human fallibility, of systematic problems—such as patients' inability to follow a difficult regimen over a long period of time—and have worked out ways that enhance the likelihood of success (for example, by looking for pills that need to be taken less often). To suggest that the policy of financial or capital market liberalisation would have worked, if only the government had had adequate regulatory institutions, misses the point that few developing countries have such institutions and that those weaknesses should have been addressed prior to the deregulation. To put it another way, consider a traffic analogy. When a single car has an accident on the road, one is inclined to blame the driver or his car; when there a dozens of accidents at the same spot however, the presumption changes. It is likely that something is wrong with the design of the road. The fact that there have been, by some reckonings, financial crises in 100 countries in the past quarter-century suggests that there are systematic problems.[23]

My point here is not an exegesis of the most recent set of crises, or even more broadly, of the policies which might have led to them. Rather, my intent is to point out that those who advocated those policies have an incentive to

[21] For instance, consider what would have happened if the United States had undertaken a thorough reform of its preferential taxation of real estate and its misguided agricultural policies in the midst of the S&L crisis in 1989. Clearly, these were distortionary policies that not only interfered with the overall efficiency of the economy, but also were directly related to the real estate boom at the root of the crisis. Yet had those policies been reformed during the crisis, the collapse of a small but important segment of the U.S. financial system would have overtaken the entire system. As a result, one effect of that collapse—the recession of 1991–2—would almost undoubtedly been far more severe. Timing of reforms is critical, and the midst of a crisis was clearly the wrong time for those reforms.

[22] Feldstein (1998) argues that many of the conditions imposed on Korea by the IMF in the bailout of December 1997 crossed that line. For instance, whether or the extent to which the Central Bank should be independent, and whether its exclusive mandate should be the maintenance of price stability, are hotly contested propositions even among economists. They are ultimately political decisions. Indeed, in the United States, when Senator Mack proposed changing the charter of the Federal Reserve Board from its current broad mandate, which includes 'maximum employment, stable prices, and moderate long-term interest rates' (Board of Governors, 1994) to an exclusive focus on price stability, I and others in the Clinton Administration had little trouble convincing the President that, should the Senator pursue in advocating this change, the issue should be made a central one in the upcoming election. The threat sufficed to bury the proposal. Korea did not have a history of inflation, such as might warrant inclusion of such a major political reform as a condition for receiving assistance.

[23] Caprio and Klingebiel (1997). For more extensive discussion of these issues, see World Bank (1998*b*) and Furman and Stiglitz (1998).

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defend them as appropriate, as well as an incentive to argue that any apparent failures are the fault not of the policies, but of those who implemented them.[24] It is important to recognise these potentially perverse incentives, for they suggest that the policy framework generally, and the policy prescriptions individually, may be maintained longer than the 'evidence' would suggest is reasonable.[25]

2.3. *Transparency*

Public scrutiny serves a useful function in limiting the distortions and abuses that arise from agency problems at every level. Such public scrutiny is especially important for the international financial institutions, for several reasons. First, in the services they provide, these institutions are monopolists or near-monopolists. Market discipline thus cannot provide its usual check. Even if an institution developed a bad reputation and was often thought to misdiagnose problems, it might be turned to in a time of crisis simply because it was the only game in town. Second, the natural asymmetries of information are large: few outside the institutions and the affected governments[26] have the up-to-the minute knowledge required to assess the accuracy of the diagnosis or the likelihood of success of the therapy. Third, the magnitude of the asymmetries of information is endogenous. There is an especial danger: the institutions recognise their 'market power' in the flow of information, and there will therefore be strong pressures on and within the various international agencies to 'collude' to restrict the flow of information, and in particular, information that might be interpreted as critical of one another.[27] (Indeed, as in other arenas, collusion is facilitated by the need for cooperation and by procedures designed to check some of the natural rivalries that might exist between the organisations.) Finally, as we have noted, the governance structure is such that there is not broad-based accountability.

Natural proclivities for secrecy[28] in the public sector generally are only reinforced by the cultures of the governing ministries and the markets from which they draw many of their key personnel. Central banks have had a long tradition of secrecy, which is only now slowly changing. In financial markets,

[24] See Stiglitz (1998*d*).

[25] The tendency of managers with failing projects to delay abandoning them has long been noted in the organisational literature, which has referred to the phenomenon as 'escalating commitment'. The phenomenon appeared puzzling to economists, who repeated the maxim that bygones should be treated as bygones: previous investments should be treated as sunk costs. At each moment, the issue should be, what is the best policy going forward. But the economists' naïve reasoning ignored the agency problem: the manager's personal reputation was at stake. See Jensen and Meckling (1976) and Staw (1981).

[26] One other group typically does have considerable knowledge—the lenders who are part of the bail-out—but they have obvious vested interests.

[27] What may be at stake is not so much the reputation of the institution or agency as a whole, but of particular individuals who have been influential in making the decisions. These individuals have, of course, an incentive to make it seem that what is at stake is not their own personal reputation, but that of the institution.

[28] See Stiglitz (1998*a*) for a discussion of some of the incentives for secrecy at play within public agencies, and the conflict between public and private interests.

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knowledge may be the key not only to power, but, more importantly, to money—the real currency of the realm. There are those who argue that public discussions will roil the market; yet there have been no studies demonstrating this and no evidence that the policies of more complete disclosure, such as those recently instituted by the Bank of England, have had any adverse effects on market stability. Moreover, even if there were a conflict or tradeoff between openness and democratic accountability on the one hand and a slight increase in market volatility on the other, it is not apparent to me that such a conflict should be automatically resolved in favour of the markets. Recent emphases on the importance of transparency suggest that there is a widespread belief that greater transparency will actually enhance the functioning of the markets.[29] In general, I suspect that markets respond more readily to fundamentals than to the pronouncements of international bureaucrats, and an increased flow of information should reduce the importance of any particular piece of information. Specifically, it is especially hard to believe that analyses of actions taken in the beginning of a crisis would have much impact weeks later. The standards of disclosure should be at least up to those of the Freedom of Information Acts of the countries with the greatest degree of democratic accountability, with confidentiality exceptions spelled out clearly, and with public debate on these exceptions.

2.4. *Organisational Checks*

While the most important check on agency problems is that provided by public scrutiny, well-managed organisations, aware of these difficulties, can and do design complementary internal checks. The World Bank has several. One of the functions of the Development Economics Center (which is also responsible for conducting research) is to comment on the policies and practices being pursued by the Bank's operations. What is their development impact? To what extent are funds fungible? To what extent does the loan change the way resources are being allocated? Can the project be designed in a way that enables us to extract broadly applicable lessons? Will the country be better off after the loan, enough better off to compensate for the greater burden of debt?

Another group, the Operations Evaluation Department, is devoted to evaluating the Bank's projects. This group reports directly to the Board, and in that way obviates some of the agency problems that would arise if it reported to the Bank's management, whose performance it judges.

The Bank also relies heavily on outsiders—for example, through peer review of its research proposals, an Inspection Panel which independently evaluates whether the Bank has abided by its own chartered policies and procedures, and so forth.

[29] It is of course, possible that there may be some hypocrisy in these stances. For a more extended discussion of the relationship between transparency and economic performance, and a discussion of the political economy of transparency, see World Bank (1997*c*), Kaufmann *et al.* (1998) and Furman and Stiglitz (1998).

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The questions posed by these various groups are often uncomfortable, but the internal scrutiny serves the organisation, and development more broadly, well.

3. Adapting to a Changing World

While the broad mandate of the World Bank has not changed in recent decades, the way in which it works to accomplish that mandate has changed. In this part of the paper, I want to trace out how changes in the global economy, as well as new perspectives on development, have led to changes in both what the Bank does and how it does it.

3.1. *New Views of Development*

Views about development have changed in the Bank, as they have in the development community more broadly. Today, there is a concern about broader objectives, entailing more instruments, than was the case earlier.[30]Development is concerned not only with increasing GDP, but also with raising living standards more broadly. It is concerned with democratic, equitable, and sustainable development.[31] Development is seen as a transformation of society: a dual economy is not a developed economy, and many of the earlier strategies did little to promote this broader transformation of society. It is true that earlier strategies diverged markedly in their views concerning the role of the state: they varied from the planning approaches that characterised development strategies within the Bank while Hollis Chenery served as Chief Economist, to the focus on trade liberalisation and privatisation in the years in which Anne Krueger served in that same capacity, and later to the emphasis on macro-stability as a series of macroeconomists held the position. What all of these approaches had in common was a belief that solving certain technical problems to achieve a more efficient allocation of resources was the key to successful development.[32] But successful development requires not only addressing these technical issues, but a transformation that puts educational and political development at its centre.

Indeed, there has been considerable questioning of earlier strategies even in their more narrow definitions. While the development strategies of the last twenty years have focused on market-based reforms,[33] they have often failed to

[30] See Stiglitz (1998*d*).

[31] This broader agenda often brings the Bank beyond the traditional domains of economic analysis. There has been some concern whether in doing so the Bank is going beyond its charter, which proscribed it from entering into politics. But it has increasingly become recognised that issues like corruption, transparency and democratic processes have profound effects both on development and poverty. See, for instance, Knack and Keefer (1997), Sen (1997) and World Bank (1997*a*).

[32] For a brief discussion of these different positions, see Stiglitz, (1997*a*).

[33] It is clear that the prescriptions that came to be called the Washington Consensus are not sufficient for development, since many countries that followed the precepts have still failed to achieve even moderate levels of growth. Beyond this, there is even a question whether they are necessary for successful development. China, which is by all accounts the most successful of the low-income countries

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establish the institutional infrastructure required to make markets work. Economic theory emphasised that to make markets work, both the competition and the incentives provided by private property are necessary. The emphasis on one over the other was not based on any body of theory or evidence. The contrast between the experiences of China and Russia has raised questions about the reform strategy emphasising privatisation over competition: China focused on competition, and saw its per capita GDP increase almost eight-fold in two decades; Russia ignored competition policy, and, even after privatisations and other reforms that were supposed to improve efficiency, saw its output decline markedly. Moreover, privatisations in many countries that did not accompany those changes with effective regulatory and competition policies showed that while private monopolies could more efficiently exploit consumers than could the public monopolies they were replacing, privatisation did not necessarily lead to either lower prices or much greater market access. East Asia demonstrated that successful development was possible, but its leading economies adopted economic policies that differed in several key respects from the orthodoxy often advocated by the international financial institutions.[34] And the East Asia crisis has reinforced the message that weak financial institutions can be as disruptive to macroeconomic stability as can high levels of inflation.

Thus, the broadening of objectives and instruments has necessitated both developing new competencies and re-examining old strategies. What separates more developed from less developed countries is not only a scarcity of capital, but a disparity in knowledge. Bridging the knowledge gap has thus become central to the Bank's strategy (World Bank, 1998*a*, *b*). Less developed countries differ from more developed countries in part because their market institutions that work less effectively. Development strategies must be based on an understanding of why markets do not function well. And while they should work to enhance the effectiveness of market institutions, public policy will be badly misguided if it does not take into account the limitations of markets. Government plays a vital role in providing the underlying institutional infrastructure required to make markets work well. Thus, increasing the effectiveness of the state at the same time that one focuses attention on its basic roles is central to development strategies.[35] All of these changes are based on advances in understanding of economics, including the revolutionary changes presented by information economics and the integration of modern finance into the main corpus of economic thought.

and which accounted in aggregate for two-thirds of the entire increase in incomes among the low-income countries between 1978 and 1995, did not follow many of the key precepts of the Washington consensus. For further discussion on the Washington Consensus, see Williamson (1990). Throughout this paper, I have in mind a somewhat different conception of the Washington consensus than the one originally outlined by my colleague John Williamson (1990), who coined the term. As Williamson (1997) himself notes, the term has evolved over time to signify a set of 'neoliberal' policy *prescriptions*, rather than the more descriptive usage that he originally intended in discussing reforms undertaken by Latin American economies in the 1980s.

[34] See World Bank (1993) and Stiglitz (1996).

[35] See World Bank (1997*a*, 1998*b*).

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3.2. *Changing Markets*

Changes in the world we deal with have also forced changes in what the Bank does and how it does it. In particular, globalisation—the marked expansion in global markets for goods and capital—has had a profound effect on the World Bank and other international institutions associated with global economic policy. We noted that the World Bank was founded partly on the presumption that capital markets are imperfect, and that without the role of government, there would be insufficient flows of capital from the more to the less developed countries. The World Bank borrowed in international capital markets and relent the money to needy member countries. The high credit rating of the World Bank enabled these countries to tap into the global capital markets at more favourable terms than they could on their own. Presumably, either there were market irrationalities that led private lenders to charge excessively high interest rates, or else the World Bank was more effective in enforcing contracts than were private lenders (or both). In either case, the World Bank represented an improvement in the functioning of capital markets.

The huge increase in the flow of private capital to emerging markets – with long-term flows increasing from less than $50 billion in 1990 to almost $250 billion in 1996 and $290 billion in 1997 – raised the spectre that these capital market imperfections might have been overcome. Indeed, by early 1997 many countries had access at terms comparable to those offered by the World Bank. Even then, however, it was clear that there were large gaps: most low-income countries, especially in Africa, did not have access to international capital markets; funds flowed freely only to a few select countries.[36] And funds were not going to all sectors, but went disproportionately to finance infrastructure projects from which cost recovery was possible. Other sectors that were equally important for successful development, such as health and education, received almost no private funds.

Within the World Bank, this changing marketplace led to a redirection of lending, to those sectors and those countries that did not have easy access to the market—that is, wherever the impediments to the flow of capital seemed to remain important. The Bank increasingly asked itself how could it work more effectively to complement the market, for example by offering credit guarantees that would leverage its limited resources. In recent months, it has been involved in several such credit enhancements.[37] The Bank is in effect testing whether the Modigliani-Miller theorem applies to these transactions, by assessing whether its actions have indeed reduced the market imperfections or have simply led to a repackaging of the risk.

The events of 1997 and 1998 raised, however, some profound questions about some of these large private capital flows. The instability of the flows imposed enormous costs on the recipient countries. While foreign direct

[36] While South Asia and Sub-Saharan Africa together received only 6% of FDI and 12% of the aggregate net resource flows to all developing countries, the East Asia region received 44% of FDI and 34% of the aggregate net resource flows. See World Bank (1998*e*).

[37] Examples from 1998 include credit guarantees for a repo facility in Argentina and for a power plant in Thailand.

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investment remained relatively stable, the reversals of short-term flows were both sudden and enormous (amounting in East Asia to over 10% of GDP). At a time when countercyclical investment would have been desirable, private finance for infrastructure projects was cancelled. There thus appeared to be a continuing countercyclical role for the Bank even in this area and in those countries where the private sector had been of increasing importance. The experience in this and previous crises showed that in periods not only of crisis, but also of economic slowdown, the net flow of private funds may quickly be withdrawn from developing countries, often exacerbating their economic weaknesses. The international institutions have a clear role to play in offsetting these destabilising forces of private capital markets.

Changes in global capital markets and changes in views of development interacted to lead to a shift in the focus of activities within the bank. While the Bank has continued to be a major source of capital (with outstanding loans totaling $106 billion in 1998, plus an additional $51 billion committed but not yet disbursed),[38] it has increasingly thought of itself as a Knowledge Bank.[39] Knowledge, it will be recalled, is one of the central international public goods. The accumulation, processing, and dissemination of knowledge in development, as well as working more broadly to close the knowledge gap, is the special responsibility of the World Bank.

The two activities of the Bank are complementary. Knowledge, particularly knowledge about the institutions and policies that make market economies work better, leads to higher returns and better allocation of capital. Recent research at the World Bank[40] has shown that in countries pursuing sound economic policies and good economic institutions—more than half of the developing countries, encompassing a much larger share of the population—development assistance is highly effective in promoting growth. Receiving assistance equal to 1% of GDP increases growth by 0.5%, reduces poverty by 1%, and increases private capital flows by 1.9% of GDP.

The World Bank has a role to play in providing such advice that extends beyond the public-good nature of knowledge. It is, and is widely perceived to be, an honest broker.[41] There is always a concern that there may be a conflict of interest in the private provision of such information—that a private consulting firm may recommend, for instance, provisions of a telecom bill that benefit the firm's other consulting clients more than they do the country itself.

[38] See World Bank (1998*c*).

[39] See World Bank president James Wolfensohn's 1996 address to the Bank/Fund Annual Meetings in Washington (Wolfensohn, 1996). For a more extended discussion of the concept of knowledge as an international public good, and the role of the World Bank as a Knowledge Bank, see World Bank (1998*b*) and Stiglitz (1998*c*) and the references cited there.

[40] World Bank (1998*a*).

[41] In fulfilling this role, its multinational nature is important. It does not, for instance, represent the interests of the telecommunications company of any particular country.

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3.3. *Dealing with the Country*

The changing, broader view of development has necessitated a change in the way in which the Bank interacts with developing-country borrowers. In the past, international agencies typically insisted on a large list of 'conditions' in return for the provision of funds. On the one hand, these conditions could be thought of as part of the loan contract, just as a private lender imposes conditions the use of funds and covenants that restrict more generally the behaviour of the borrower. But the conditionalities imposed often were quite broad. This was especially true of the structural adjustment loans, which provided funds for overall budgetary and balance of payments support rather than for the financing of a particular project. The conditions negotiated with the country often entailed trade liberalisation, privatisation, and macroeconomic stability—all the elements that were central to the Washington consensus reforms. There has been an extensive discussion of this conditionality: whether the mandated reforms were the right reforms, whether they were introduced at the right pace and with the right sequencing, whether reformers paid adequate attention to the more difficult reforms associated with establishing the institutional infrastructure of a market economy, whether the reforms themselves went beyond issues of economics into politics,[42] and whether the imposition of so many conditions,[43] seemingly without prioritisation, tended to weaken country focus.[44] But these questions are not my concern here. There is a more fundamental issue: was imposing conditionality an effective way of changing policies? There is increasing evidence that it was not—good policies cannot be bought, at least in a sustainable way.[45] Equally critically, there is a concern that the way that the changes were effected undermined democratic processes.

As we go forward, the Bank will increasingly work with each borrowing country to develop a broad development strategy. Like a corporate strategy, it would serve as a vision of where the economy is going and what needs to be done to get there. The Bank would then ascertain where within that strategy it has a role. The focus of the Bank will be on capacity-building and consensus-building: helping the country develop the capacity (including think tanks and research institutions) to formulate its own development strategy and democratic institutions to arrive at a national consensus about those strategies.

Our approach has changed along with our understanding. In recent years, the Bank has increasingly recognised that funds are largely fungible, and that the limited funds it has available cannot by themselves make much of a dent on development. As a result, the Bank has focused increasingly on using its funds as 'leverage'. It does this in various ways: financing projects that can be

[42] See, for instance, Feldstein (1997).
[43] On this point, see, for instance, Sachs (1996). Overloading the agenda is of especial concern in those countries with limited institutional capacities. Indeed, there have been complaints that the inordinate amount of time that key government officials have had to spend negotiating these conditionalities reduced the amount of time they had available for engaging in constructive development efforts.
[44] See in particular, Stiglitz (1998*e*).
[45] World Bank (1998*a*).

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scaled up, so that the learning from successful projects can be transferred both within and between countries; using financing to help create an environment which attracts private capital; and helping to assess the overall expenditure programme and development strategy of the country, rather than just individual projects.

4. Overlapping Jurisdictions

The recent crises have brought to the fore the overlaps in the mandates of various international institutions, and especially of the World Bank and the International Monetary Fund, as illustrated by the call for the Bank to help provide liquidity support. Issues of overlapping jurisdictions have long been a source of concern—and indeed seemed to have been a worry even at the time that the institutions were created, when some suggested that the duties of the Bank and the Fund should be assigned to a single institution.[46]

Before describing the framework within which the two institutions seek to work together, let me say that such overlapping of jurisdictions does not bother me: the two institutions have different mandates, different foci, and different structures of governance. The Bank, as I have noted, focuses on long-run development, the Fund on stabilisation. Given these differences, it is not surprising that occasionally there may be major differences in views concerning economic policy. What may be good for stabilisation today may hinder long-term development. The design of economic policy represents a balancing of concerns, and it is up to the country to make the political decisions about how the various risks are to be balanced. These are not just technical matters to be left to international bureaucrats, as competent as they may be. And it is important that there be more than one source of opinion, of information, of advice. The benefits of a diversity of viewpoints outweigh the costs of the occasional confusion they engender. Resolving—not suppressing—conflicting views is an essential part of democratic processes. These alternative sources of information provide an important check, especially given the lack of direct democratic accountability.

The recent crises in Asia and elsewhere serve as a pointed reminder of the importance of this kind of dialogue. Clearly, the policy responses to those crises had huge distributional consequences. The countries could have adopted other policies that, if not Pareto-dominating, at least would have imposed less risks on some groups (though perhaps more on others) than did the policies that actually were undertaken. Such tradeoffs are again political; economic advisers should simply provide the information about the nature of the tradeoffs and the risks.[47] This is especially true in those arenas where there is not agreement among economists about the consequences of particular policies. There were many economists who warned, for instance, of the dangers of excessively rapid financial market liberalisation in countries that

[46] Mason (1973).
[47] This viewpoint was put forward forcefully by John Neville Keynes more than eighty years ago. See Keynes (1917).

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lacked the appropriate regulatory structures. In retrospect, there is now a growing consensus that that advice should have been heeded. Should the countries have been confronted with these alternative views, leaving it up to them to make the decision, rather than imposing such reforms as a condition for receiving aid?

An essential part of the transformation that is called development or modernisation is the spread of scientific reasoning—which distinguishes between evidence and ideology and which recognises the limitations of our knowledge and the high degree of uncertainty associated with many of our beliefs. Pretending that there is certainty where there is none is not only dangerous, but may itself set back the development agenda.

The Bank and the Fund have on several occasions worked toward an accord that delineates more clearly their areas of responsibility. Given the Fund's focus on stabilisation, it is natural that it has taken a large responsibility for macroeconomic issues; given the Bank's responsibility for development, it is natural that it should take primary responsibility for structural or microeconomic issues. But the delineation is far from sharp. Issues of macroeconomics and microeconomics are intertwined, as evidenced so clearly in the most recent crisis. It was weak financial institutions and lack of transparency[48]—structural issues lying within the Bank's domain of responsibility—that were assigned much of the blame for the crisis and that underlay the macroeconomic weaknesses.

But it is not only at the onset of the crisis that structural issues have macroeconomic consequences: the pace and design of corporate and financial restructuring has strong aggregate consequences. A policy of forcing countries to meet excessively stringent capital adequacy standards in too short a period of time may lead to a credit crunch that undermines the economic recovery, and—by increasing the incidence of bankruptcy—may actually be self-defeating. At the same time, the conduct of macro policy clearly affects the ability to pursue structural reform: the difficulties of restructuring weak financial institutions in the midst of depression, when firms are going bankrupt by the droves, should be apparent.

Thus, the two institutions, although they differ in their areas of focus and core missions, have important areas of overlapping concern where cooperative action is required. However, the two institutions do not always speak with one voice, which is not surprising given the differences in mandates and governance structure discussed earlier. To some, this is disturbing: there is presumably only one truth, and the international institutions should be leading the less developed countries toward that truth! But to me, open discussion when there is a lack of agreement seems healthy. We should not pretend that there is more certainty about the policies being advocated than the evidence warrants, and disagreements between the institutions reflect both differences in interpretations of the evidence (including differences in models) and differences in objectives.

[48] Though there is some controversy even over this diagnosis. See Furman and Stiglitz (1998).

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Ultimately, if we believe in democratic processes, the countries must make the decisions for themselves, and the responsibility of economic advisers is only to apprise them of prevailing views concerning those consequences. We do a disservice in pretending that there is more consensus on these matters than there actually is. Moreover, given the weaknesses in the checks on the international institutions, whether through market discipline or direct democratic governance, it is all the more important that different voices be heard. To be sure, the different voices may give rise to a vigorous democratic debate, which may be uncomfortable to those wishing to ensure that their views prevail, but that is one of the 'prices' we pay for democracy.

More recently, the Bank has been called upon to participate in a large number of bailout programmes. While the Bank's charter clearly provides for extending emergency assistance—there is a consensus that such lending poses the danger of diverting the Bank from its core mission.[49] The main reason it has been called upon in these circumstances seems to be that the crisis countries have needed more funding than is available through the IMF. But if the international community believes that liquidity support through bailout packages is effective and desirable, there seems a compelling case that the community should provide sufficient financing to the institution responsible for carrying out this mandate—rather than diverting the funds and focus of other institutions away from their core missions. Still, in supporting the packages in East Asia, the Bank has worked hard to ensure that its support is directed at areas within its central mandate: helping these countries' long-term growth and development strategies and trying to limit the soaring poverty that has accompanied the economic collapses. Thus, while the Fund has tried to encourage short-term borrowing for adjustment and recovery, the Bank has designed its lending programme for a long-term engagement with the country, because it recognises that, for instance, corporate and financial restructuring cannot be done overnight. The Bank has focused on these restructuring issues, as well as issues of corporate and public governance and the development of stronger safety nets. In Thailand, where weaknesses in infrastructure and education were apparent as impediments to its long-term growth even before the crisis, the Bank has continued to support programmes in these areas. While the Bank's programmes in these countries lie well within its core mission, it has responded to the crisis by designing programmes and providing funds far more rapidly than would normally be the case.

5. Concluding Comments

The past fifty years has shown that development is possible, but not inevitable. If development were easy, there would have been more success stories. As the world enters the next millennium, the challenges facing the World Bank, in its core mission of promoting growth and reducing poverty, remain as great as

[49] See, for example, James Wolfensohn's address to the 1998 Annual Meetings of the Bank and Fund (Wolfensohn, 1998).

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ever. While there has been great progress in reducing poverty, continuing population growth makes the struggle an uphill one: there are now more people living in poverty than there were fifty years ago.[50] East Asia shows both the potential for success and the fragility of that success. While in the 1970s, it is estimated that 6 out of 10 East Asians lived in absolute poverty (defined as income of under US$1 per day), by the mid-1990s, that number had been reduced to 2 out of 10. But as a result of the recent crisis, the World Bank estimates that the number of people living in poverty in the region will double, from 30 million to 60 million.[51]

The Bank will thus have a mission well into the coming millennium. This would be true even if capital market imperfections were eliminated and capital and financial markets behaved far more stably than they have over the course of the previous two centuries. To be sure, what the Bank does and how it does it will undoubtedly evolve with the continuing changes in the global environment and in our understanding of development—that is, both our views of its objectives and our beliefs about how they can most effectively be accomplished. We have, for instance, learned much from the experiences in reform, from both successes and failures. There is a greater recognition of the importance of the institutional infrastructure that is required to make markets work, of the importance of competition, of the key role that governments play, and of the necessity of strengthening the capacity of governments to perform those roles. Deficiencies in the models of the economy which underlay much past advice have become apparent, and new and more appropriate models have been developed; hopefully, the advice proffered will reflect these new perspectives.

That there will be further evolution in the way that the Bank approaches its core mission seems clear, as greater clarity is achieved on the market failures that give rise to a need for public action and on public failures and the ways to mitigate them.

Over the long run, the success of the Bank will depend on its ability to maintain its focus on the broader role of international institutions: addressing the needs for collective action at a global level.

The World Bank

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[50] While the percentage of the world's population living in absolute poverty (under US$1 per day) has generally declined since the 1970s, the absolute number of poor has risen.

[51] See World Bank (1998*d*).

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