9

GLOBALIZATION AND THE LOGIC OF INTERNATIONAL COLLECTIVE ACTION: RE-EXAMINING THE BRETTON WOODS INSTITUTIONS

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1. INTRODUCTION

The Bretton Woods Institutions were established just over fifty years ago, at the conclusion of World War II and in the aftermath of the great depression, to aid in the reconstruction of Europe and to make it less likely that another global calamity such as the great depression would occur again. As an afterthought, the World Bank was also charged with promoting the development of the third world countries, most of which at that time remained under the yoke of colonialism.

Much has happened in the world since then. The cold war came and went. Colonialism has ended, but the end of colonialism has failed to bring with it prosperity to the ex-colonies as many had hoped. The dependence of so many countries on assistance from abroad—and the dependence of countries that have generally been doing well on external assistance in times of crisis—have brought worries of a new form of economic colonialism. Though different from nineteenth century colonialism, the new economic colonialism is perhaps equally insidious: the nascent democracies have economic policies dictated to them by the

international organizations, whose policies in turn are largely driven by the G-7, and some would say by financial interests in the 'G-1'.[1]

The global economy has changed dramatically as well. Trade has increased enormously as transportation and communications costs have decreased. Multinational firms have taken on an increasingly large role, both in disseminating technology, creating a global market place, and moving capital.[2] One of the primary rationales for the World Bank was to direct an official flow of capital to less developed countries, but in the early nineties, private flows increased enormously—six fold between 1996 and 1990. Though the global financial crisis demonstrated that private flows were highly unstable, their sheer magnitude came to dwarf official aid flows. In some circles, questions were raised about whether the World Bank was really needed. But a closer look at where the money went—disproportionately going to relatively few countries (almost none of it to Africa) and little of it going to such vital sectors as education and health—suggested to most observers that there was still a need for the World Bank. It did become clear that World Bank aid had to be more targeted, focusing on areas where the private sector was less likely to go. Increasing attention also focused on the role of the World Bank in expanding knowledge: facilitating the flow of knowledge and helping countries to design a policy environment that would attract capital was recognized to be every bit as important as, and an important complement to, the provision of capital.

Back in 1971, the fixed exchange rate system had been abandoned, raising questions at that time about the role of the International Monetary Fund. But the abandonment of the fixed exchange rate system did not mark an end to crises; rather, they seemed to become

both more frequent and of greater depth. Some argued that there was an even greater role for the IMF in this increasingly unstable global environment.

At the same time that the world was changing in so many ways, our understanding of the world was also changing. When the Bretton Woods institutions were founded, there was a less well developed theory of *collective action* that outlined the circumstances under which public, as opposed to private, action was desirable. There was, in particular, a less well developed theory of *market failure*, of the circumstances under which markets by themselves did not yield efficient (or otherwise desirable) outcomes. For Keynes and the other founders of the Bretton Woods institutions, the great depression was evidence itself that markets sometimes did not work well, and that there was a role for government intervention.

2. GLOBAL PUBLIC GOODS AND THE LOGIC OF COLLECTIVE ACTION

Today, we have a well developed theory of market failure. Market failure may occur when any of the following is present: *public goods*, items that are difficult to exclude people from enjoying and whose cost to an additional individual enjoying it is zero, or very low (such as a public park or the air we breathe); *externalities*, situations in which the action of an individual has repercussions on others for which the individual neither pays nor is compensated; *incomplete markets*, situations in which certain markets are absent, especially risk markets and markets for intertemporal trades; and *imperfect markets*, and especially *markets with imperfect competition*. Perfect competition is necessary (though not sufficient) to achieve economic efficiency. Yet there are a variety of circumstances in

which firms attempt to monopolize markets or otherwise restrain trade. The theory that shows free markets leading to efficiency also assumes that information and knowledge (e.g. about production processes) is fixed; yet today, the production and dissemination of information and knowledge is a central economic activity. In general, whenever information is imperfect (or markets incomplete) the economy is not Pareto efficient.

Perhaps the most important market failure is that occasionally the economy fails to use resources fully—and especially labour. Whether this should be treated as a separate market failure, or as a particularly dramatic manifestation of one or more of the other market failures, need not detain us here.

The various market imperfections interact: the costs associated with the production of information and knowledge often lead to imperfections of competition; that the returns to knowledge can almost never be perfectly appropriated implies that there are spillovers (externalities) associated with the generation of information and knowledge.

In addition to these circumstances in which markets fail to produce (Pareto) efficient outcomes, there may be a desire for collective action as a result of dissatisfaction with the distribution of income generated by market processes. Some individuals, for instance, may have an income so low that they cannot survive, and this may be viewed to be 'socially unacceptable.'

The discussion of market failures has helped clarify the circumstances under which collective action *might* be desirable (I say might, because it has to be demonstrated that there is some form of collective action that can actually, or is likely to, improve upon the

market). Analyses over the past quarter of a century have also clarified *where* it is most appropriate for collective action to occur, i.e. at the local, national, or global level. Earlier literature focused on showing that there exist some public goods (or externalities) that affect only those living within a particular geographic area, and that these public goods and externalities should be handled by public bodies embracing that particular area. Such goods were referred to as *local public goods*. More recently, some economists have identified a set of public goods the benefits of which are not limited to a particular country, but are global in nature.[3] They are, quite naturally, referred to as *global public goods*. Six areas have been identified in particular: (i) global security; (ii) global economic stability; (iii) knowledge; (iv) global environment; (v) humanitarian assistance (e.g. for famines); and (vi) global health (especially contagious diseases). The provision of global public goods provides a central part of the logic of global collective action, but the rationale for global collective action goes further: potentially, it can address any of the market failures. Just as there are global public goods, there are global externalities. In the past sixty years, global institutions have been established to address, in part, each of the areas identified above. And many of the international institutions play a role in the provision of several of these public goods, or the regulation of several of the global externalities.

In this chapter, I want to explore the role of the Bretton Woods institutions from the perspective of global public goods and externalities.

2.1. The International Monetary Fund

I begin my discussion by focusing on the International Monetary Fund (IMF), simply because there was, in its establishment, a clear vision of a global market failure that it was supposed to address. The great depression was widely viewed as having resulted from, or at least been exacerbated by, negative interactions among countries. As each country's GDP fell, it cut back on its imports, and that reduced the demand for its neighbours' products, reducing its neighbours' (or trading partners') GDP. The depression itself was, of course, a manifestation of a massive market failure, but it did not provide the rationale for collective action at the global level. Each country had an incentive to undertake expansionary monetary and fiscal policies to restore its economy to full employment. It was when countries tried to restore their own economic strength at the expense of their trading partners' that collective action was needed.

Because, in the event of a global recession, some of the benefits of expansionary policies accrue to neighbours, if there is a cost to these expansionary policies (in terms of, say, a future debt burden), then countries will pursue expansionary policies less far than they should. There is thus a rationale for global collective action to induce each country to pursue expansionary policies further than it would pursue of its own accord.

These concerns were particularly paramount at the time of the founding of the IMF, when there were real worries that in the aftermath of the War, the world would return to a situation in which there was insufficient aggregate demand. In particular, people worried that some countries might try to pursue a mercantilist-style policy (though not necessarily with mercantilist methods) of running trade surpluses. Since the sum of the world

surpluses and deficits has to be zero, if some countries run surpluses, other countries are forced to run deficits, importing more than they are exporting, reducing those countries' aggregate demand from what it otherwise would have been, and thereby threatening those countries with a greater chance of unemployment.

The running of sustained surpluses by some countries forces sustained deficits on the rest of the world, thus imposing certain risks on them. Though 'crises' were perhaps less on their mind than they are today, the maintenance of surpluses by some countries over an extended period of time leads to indebtedness abroad that may be unsustainable. More precisely, high indebtedness leaves a country open to the risk of a sudden change of foreign investor sentiment about the credit worthiness of the country or the firms within the country. The resulting attempt to pull money out of the country (or the increase in interest rates intended to encourage money to stay in the country) can have enormous disruptive effects.

Policies such as fiscal expansion and choosing to run a trade surplus are both examples of activities with global externalities, and it would seem quite appropriate to create an international institution to help address these concerns. The argument for doing so is strengthened by another set of market failures (which arguably has been somewhat reduced over time)—that associated with the functioning of capital markets. Capital markets work far differently than the way they are depicted in simplistic models of perfect competition. For example, there may be credit rationing, and limitations in equity markets imply that there is far from perfect risk sharing. Research in the economics of information has laid out the theoretical reasons why we should expect such imperfections, and empirical research over the past two decades has provided ample documentation. The

macro-economic consequences are particularly important in developing countries. Many face credit rationing, at least at some times, and many countries seem to follow pro-cyclical fiscal policies, because in times of crises they cannot borrow, and accordingly have to cut back on expenditures (or risk costly inflationary pressures). Keynes worried that in many countries, monetary policy would be ineffective in stimulating aggregate demand, and countries with limited capital markets, and without access to international capital, might not be able to pursue expansionary fiscal policies. In recessions, countries faced *liquidity constraints*.

Global collective action might help relax those liquidity constraints, enabling countries to pursue more expansionary policies, with positive externalities to their trading partners. Because countries did not have sufficient incentives to pursue strong expansionary policies to the extent needed (or at least desirable) globally on their own, the international community needed to 'persuade' countries to be more expansionary than they otherwise would be. One way of doing so was to make access to the loans conditional on countries pursuing a sufficiently expansionary policy. Similarly, since running a trade surplus posed a negative externality on others, either surpluses should be taxed, or not running a surplus (or running a smaller surplus) should be made a condition for access to any liquidity provided by the international financial institutions.

Today, Keynes must be turning over in his grave! The major thrust of IMF conditionality is that countries cut back on their fiscal expenditures, increase taxes and reduce their trade deficits. The kinds of conditionalities that were implicit in the original rationale for the establishment of a collective global institution seem to have been turned on their head. Beggar-thy-neighbour policies have been replaced by even worse beggar-thyself policies,

in which each country to restore its trade balance is forced to cut back on its GDP. The resulting reduction in imports—other countries' exports—has exactly the same impact on them that the beggar-thy-neighbour policies had. Other countries do not care why their exports are no longer selling—whether it is competitive devaluations, tariffs or trade restrictions, or reduced GDP—all they know is that their exports have decreased. Arguably, IMF policies have thus served to exacerbate, rather than reduce, negative global externalities.

How could such a state of affairs have come about? There are several possible explanations. One is that the Fund has focused on another set of market failures or externalities. If countries follow imprudent macro-policies, they are more likely to have to default on their debts to the IMF, and the costs of non-repayment are borne by others. But this is an unconvincing explanation: the conditionalities imposed by the IMF go well beyond those that have a significant effect on the probability of repayment. Indeed, given the IMF's status as a senior creditor, the probability of default, at least in many cases, is so low that it can be ignored. If anything, the contractionary policies foisted on countries arguably actually impair their ability to repay.

At times the IMF has argued that it worries about contagion, that a fall in the exchange rate in one country can lead to a destabilization of exchange rates more generally. Though anecdotal in nature, the recent global crisis suggests that this explanation too is unpersuasive. Brazil's massive devaluation (which the IMF attempted to prevent) did not set off any significant 'contagion' effects. On the other hand, the IMF's attempts at stabilization in East Asia proved ineffective at containing the damage to the countries first affected. Indeed, one can argue that the policies imposed by the IMF actually exacerbated

global 'contagion' effects: their policies exacerbated economic downturns that had global effects, not only directly (through reduced imports) but indirectly, as commodity prices (e.g. for oil) plummeted. More generally, there is little theoretical basis either for the hypothesis that contagion (other than through trade effects) would be a serious problem without intervention (though to be sure it might produce momentary instability in markets—which can experience volatility for a myriad of causes) or that the IMF's interventions would be effective in stemming it.[4] The IMF has shown little ability to identify the correct equilibrium exchange rates—and thus to know whether there is a threat of overshooting. And the mistakes it has made on that count have had enormous costs to the affected countries. The notion of competitive devaluations, and the set of interventions designed to stop them, is more appropriate for a gold standard system than for a system of market determined flexible exchange rates.

There is another possible hypothesis: the IMF's governance structure makes it accountable to finance ministries and central banks, with close connections to the financial community. It would, accordingly, be unsurprising if the institution came to reflect the interests of that community. Forcing countries to eliminate trade deficits—encouraging them to run surpluses—may increase the probability of creditors' being repaid (regardless of whether the creditors engaged in due diligence when making the loans, and regardless of the adverse impact that the policy has on workers and others within the borrowing economy). The irony, of course, is that when contractionary policies are pursued in an inappropriate way, they may so weaken the economy that the probability of repayment will be reduced; in some cases, however, the IMF's provision of money *to the government* has encouraged, or at least enabled, the nationalization of private liabilities, thereby increasing, overall, the

probability of repayment of private debts. This process has occurred in numerous countries.

In this interpretation, the IMF has pursued the *collective interests* of a subset of the international community, rather than serving the broader collective interests for which it was originally created.[5] There are further examples that are consistent with this interpretation. The IMF has been a strong supporter of capital and financial market liberalization, paying insufficient attention to whether countries have the appropriate regulatory risk management, and risk absorption capacities in place. One could argue that international institutions should limit themselves to areas of global public goods and externalities. At the time the IMF pushed these policies of liberalization, there was little evidence that such policies had positive global externalities in general—though they might indeed bring benefits to the financial interests in the more advanced industrial countries. By contrast, there was evidence that they increased the risk of economic instability within countries adopting those policies—and if one worried about contagion (as the IMF allegedly did), it should have accordingly *opposed* those policies. More generally, there was no evidence that such liberalization increased economic growth or investment in developing countries, and some arguments were even put forward as to why they might have adverse effects.[6]

Special interests in the advanced industrial countries interact with special interests in the developing countries, often to the detriment of the general interest. The IMF interacts with a country's finance ministry, which all too often largely reflects the interests of that country's financial community, or more broad élites. The interaction enhances the strength of the finance ministry—which is often already out of proportion. Critics are labelled as

populists, and other members of government are told that if they resist the demands of the finance ministry, it will jeopardize the Fund programme, forcing the country's budget into disarray, and risking the country's standing in international financial markets. Since typically only the finance ministry deals directly with the IMF, and the dealings are in secret, other ministries have to take the threats seriously: the IMF, in effect, enlarges the bargaining power of the finance ministry. To the extent that the agenda advanced by the finance ministry is in accord with broad national interests based on principles—such as sound budgeting—about which there is general consensus, this may be all to the good. To the extent that it advances special interests, the shift in bargaining power is far more dubious.

The changes in the world referred to in the beginning of this essay suggest a rationale for re-examining the role of the IMF as an institution providing global action directed at enhancing global stability. But as compelling as those changes are, arguably, the institution has not only failed to live up to its original mission but has actually undertaken counterproductive policies. That makes such a re-examination compelling. Our analysis suggests that the re-examination must be fundamental in nature, addressing not only what the institution does, but how it does it, its governance structure and its modes of operation. Otherwise, there is a real risk that what so often happens within national governments—that power is used not to advance general interests but to further special interests—will happen at the international level. One might argue that the problems at the international level are even more severe, for the electoral process provides at least a partial check on abuses of these powers within countries. The international financial institutions and the IMF in particular are sufficiently far removed from systems of direct electoral accountability that there is no effective check on abuses of this kind.

The absence of such direct accountability makes it necessary that other control mechanisms be put in place to ensure that broad, global international interests are promoted, rather than special interests of particular countries, or of particular groups within those countries. As I suggested, a change in the formal governance structure may be key. But there are other changes necessary in the *modes* of operation and the *span* of activities. The secrecy within which the IMF has traditional operated—including the absence of broad public debate in adopting IMF programmes, where in some cases not all the terms of the agreement are even made public—removes an important set of disciplines on the institution. (Back in Washington, there is no more love of openness and transparency than there is in the countries themselves.) This liberty—this absence of public scrutiny—has given it scope to undertake the policies that it has pursued.[7]

That there is no competition in the services it provides—it is a monopoly—enhances its powers. To be sure, it is difficult to conceive of there being competition for some of the services it provides—for instance, crisis lending. But one of the most important advances in the theory of industrial organization is the recognition that many of the old-style natural monopolies (industries in which competition is impractical) can be broken down, and there can be active competition in many of the key segments. While the World Bank and the Fund have both been strong advocates of competition and the industrial restructuring that has facilitated competition in these former natural monopolies, they have been less than enthusiastic in applying the lessons to themselves. (This is not surprising; most businesses argue for competition and no subsidies in general, but are quick to recognize the special circumstances in their own industries that warrant subsidies and limitations in competition.) In particular, bundled up with the provision of funds is the provision of advice, review of the performance of the economy as a whole and various segments of the

economy, and the collection of statistics. There can be far more effective competition in several segments. To be sure, there are economies of scope that provide a partial explanation of why these activities are bundled together—just as there are some economies of scope in some of the natural monopolies that have been broken up. But there is increasing recognition that the value of competition more than offsets the slight inefficiencies that might arise from the inability to exploit fully the economies of scope.

In particular, the Fund has resisted public debates concerning the efficacy and appropriateness of its policies; it has resisted the provision of alternative views. It has, for instance, resisted the notion that countries have outside 'counsel'—independent economists—in their negotiating team, and has discouraged governments from engaging in consultations with economists who oppose their views. During the Asian crisis, it even refused to engage in closed discussions with the World Bank and outside experts about the appropriateness of the policies. And while it made much to-do over its own retrospective of the policies, the Bank's analyses, which were more critical, were not only unwelcome, but US Treasury tried to suppress the Bank's normal dissemination programme for such studies (and partially succeeded). The US Treasury has played a key role in the formulation of these policies, so it is not surprising that it has been quite unenthusiastic about such public discussions. Given the dominant role it played in policy-making at the IMF, it worried that criticism of the IMF was tantamount to a criticism of Treasury. Treasury has even used the considerable political weight of the US to try to suppress such discussions when they arise from international institutions such as the World Bank or the Asian Development Bank. I believe that one of the global public goods is the promotion not just of development, but of *democratic* development, and the suppression of public debate on key issues of public policy undermines democracy.[8] In short, rather than

attempting to suppress alternative views, the Bank and the Fund should be encouraging them, and some of the assistance provided to developing countries by the international community should be devoted to establishing independent and competing sources of advice. Competition in the marketplace of ideas is every bit as important as competition in the marketplace for goods and services.

Another practice that undermines democracy is the imposition of 'conditionality' on a country. Countries are forced to accept a wide array of conditions in order to receive assistance. Many of the conditions have nothing to do with the crisis at hand; some even go into areas that are highly political in nature. Few of the conditions are directly related to the fiduciary responsibility of a lender to ensure a high likelihood of repayment. In some cases, in fact, the policies, by pushing a country into deep recession, may actually reduce the probability of repayment.[9]

When an institution (in this case, the IMF) has a monopoly or market power in one area, without enforced competition (in this case, in the marketplace of ideas), it can leverage its monopoly power in that area to extend it to another. Its market power in the realm of crisis lending enables it to leverage its power to impose conditions that extend well beyond those directly germane to the crisis.

The IMF's market power, however, is even greater than might be indicated by its role in crisis lending. The consequences of the IMF denouncing a country's economic policy is not just that the country will lose funding from the IMF, but will also lose funding from other public and private sources. The IMF has managed to persuade other public

authorities to make their lending to a given country (partially or totally) contingent on the Fund's approval of that country's macro-economic policies.

In some cases, the Fund has suspended programmes to a country not because the country's macro-performance is weak, but for other reasons. Ethiopia is a case in point, where the Fund's programme was suspended even though that country had no inflation, and by most economists' reckoning, was pursuing good fiscal policies, with expenditures limited to tax revenues and foreign aid receipts. The IMF was pushing reforms in Ethiopia's financial market that many economists argued were inappropriate for a country at that stage of development. (As an example, in Kenya, financial market liberalization had led to an increase in interest rates paid by borrowers, not a decrease as had been predicted.) The failure of the policies to achieve the predicted effects did not impede the Fund from pushing them, but these failures played an important role in the Ethiopian government's resistance—it did not want its already desperately poor farmers to be further impoverished as a result of higher borrowing costs.[10]

That the Fund can have such a powerful effect on other suppliers of funds gives the Fund enormous power, of course. It is a kind of leverage that every monopolist seeks, but few achieve. In other arenas, enormous thought has been put into the question of how to reduce that kind of power. One way is to force competition in areas where that is possible—as in the area of advice—and the other way is to restrict its activities in other areas that may enhance its power.

For instance, the Fund is engaged in 'surveillance,' an annual review of economies' performance. The surveillance represents an example of 'mission creep.' The Article 4

reviews are named after the section of the IMF's Articles of Agreement that mandates supervision by the Fund of member countries' exchange rate policies to ensure that countries are complying with the Article 1. Today, that particular topic is a minuscule part of the overall review. If the Fund is to carry out its stabilization mission, it must monitor countries, but the annual review is an inefficient way of gathering the relevant information. Too many resources are allocated to countries such as the United States where the probability of a crisis is very low and where the value added by the review to information available elsewhere is almost surely zero. (My own experience while I was chairman of the Council of Economic Advisers was that the review added nothing to our understanding of the economy. Its assessments lacked the depth of insight that was available from a multitude of other sources, and its policy recommendations were often misguided.) By the same token, more resources could have been added to learning about and monitoring countries that were more likely to have crises. The surveillance function could easily be performed by others at least as effectively, for example by regional or other groupings of countries (such as is currently done by the OECD) through processes of peer monitoring.

One could argue that the data gathering services provided by a variety of international organizations, including the UN, the World Bank, and the IMF represents an international public good. Such data can be viewed as part of 'knowledge' and is thus clearly a global public good, one that, in turn, contributes to other global public goods, such as improved international economic stability. But a general principle that has emerged from observing data collection activities within governments is that there are real dangers when these activities are entrusted to an operating agency; conflicts of interest too easily arise.[11] That is why many countries have established independent central statistical organizations.

In the case of the IMF, these concerns take on a concrete manifestation: its growth projections of countries with IMF programmes do not represent the best estimate of the future course of the economy, but are the numbers negotiated in the midst of the implementation of an IMF programme. All too often, there are significant gaps between those numbers and reality. An IMF programme, to hang together, must show, for instance, a certain level of tax revenues, that would in turn require a certain rate of growth. If the most accurate growth projection entailed a smaller growth projection, the deficit would be too large to be 'acceptable.' The Fund, rather than showing flexibility in what is acceptable as a budget deficit, has demonstrated at least in some instances more flexibility in what is accepted as a reasonable estimate of growth.

Separating out the surveillance and data collection functions from the Fund would potentially not only increase the efficacy with which these functions are performed, but also reduce the monopoly power of the IMF.

I have argued in this section that there is an argument for international collective action in enhancing global economic stability, but the IMF, the institution created for that purpose, has often not only failed in advancing that objective, but may have been counterproductive—and acted in ways that undermine other basic global values such as democracy. I have also suggested that what is required is basic reforms in accountability and in some of its basic modes of operation, for instance, its degree of openness and transparency.

There is an interesting debate about whether the problems of the IMF arise because of lack of political accountability, or from too much political interference. Some, such as De

Gregorio *et al.* (1999) argue for reforms that are in the opposite direction from those I have been arguing for, that the IMF should be made more independent, less politically accountable. They rightly see that many of the key failures are associated with interventions, especially by the Americans and French—the former pushing loans to Russia, for instance, the latter to Zaire and Francophone West Africa, against the better judgement of the staff. But pretending that the IMF is simply a technocratic body, helping the country adopt Pareto dominant policies, is simply wrong. There are key trade-offs, issues that should be resolved in the political process, and the IMF staff has repeatedly shown a failure to appreciate the distinction between providing advice concerning the set of 'Pareto optimal policies' and forcing a particular set of policies, a particular choice on the Pareto frontier, that reflects the interests of particular groups within society. (The trade-offs are particularly significant when there is uncertainty about the consequences of policies—which there always are, but that the Fund often fails to recognize publicly. Different policies entail different groups bearing risks.) Thus, letting the staff loose with even less political accountability could well make the problems identified earlier worse. I would argue that more direct public accountability holds open the promise of checking the kind of direct interference that has been the source of so much failure. It is at least conceivable that loans to Mobutu might not have proceeded if there had been a public debate exposing the corruption, noting that the funds were more likely to enrich Mobutu than the people of the country, who would be left with increased debt and little to show for it. Perhaps the loan would have gone forward anyway—a clear testimony to the importance of geo-political considerations in the cold war period—but at least there would be little pretence about what the money was for.

In the end, the most important reforms—and the hardest to achieve—will be in governance: to whom the IMF is *directly* accountable. Governance affects organizational behaviour. To be sure, in some sense, the IMF is accountable to its member countries. But any observer of political processes know that different agencies within a government reflect more closely different interests within the polity: finance ministries reflect the interests of the financial community far more than they do the interests of labour, to say the least. That the IMF is accountable to finance ministers and central bank governors (many of whom themselves are not directly accountable)[12] undoubtedly has an effect on the IMF, and especially the policies that it advocates. It is more than likely that the IMF would have been far more concerned about the effects of its policies on unemployment and wages if it reported directly to labour ministers!

If the IMF were only a 'club' of central bankers, facilitating the clearing of checks, for instance, all of this would make little difference. But the policies of the IMF have profound effects on every aspect of the economy—and hence the lack of representativeness, both *across* countries and *within* countries, undermines the legitimacy of the institution, especially calling into questions policies that go beyond, or are contrary to, its original mandate.

I am, however, not completely sanguine about the reforms discussed so far fully addressing the concerns raised earlier and ensuring that the institution really does pursue global economic stability in ways that reflect broad global interests. Further reforms will be needed in its modes of operation, with perhaps further restraints on the kinds of actions it can take. An important step in the right direction will be to require *ex ante* assessments of the likely impact of a programme, not only on inflation and the exchange rate, but also

on poverty, growth, and unemployment, and periodic reviews by independent outsider commissions not only of the accuracy of those assessments, but also of the overall effectiveness of crisis prevention and management policies.[13]

2.2. The World Bank

The fifth global public good described earlier, the provision of international humanitarian assistance, provides the rationale for the World Bank's mission of helping developing countries grow faster and eradicate their poverty. Originally, it saw its mission as addressing a market failure—the imperfections in capital markets that impede the flow of capital from developed to less developed countries. Standard theories at the time suggested that what caused lack of development was a shortage of capital. Lower capital-labour ratios in poor countries *should* have resulted in high returns, which *should* have, with well-functioning capital markets, led to a flow of capital from the developed to the less developed countries. But that was not happening. Now we recognize that what separates developed from less developed countries is not just a disparity in capital, but gaps in knowledge; and one of the functions of the World Bank is to reduce those gaps.[14]

The World Bank also sees as one of its functions the production and dissemination of knowledge about development and about the kinds of policies and institutions that are most conducive to development. Knowledge, policies, and institutions can all be thought of as complements to capital. Increases in knowledge or improvements in institutions and policies can raise the marginal productivity of capital, increasing not only the effectiveness of aid, but also inducing a flow of private capital.

Research in the economics of information over the past quarter of century has helped us understand why capital markets are often imperfect: why, for instance, there is likely to be rationing, or why equity markets typically provide only limited opportunities for firms to divest themselves of risk. Just because flows of capital from the developed to the less developed countries have increased so much over the past decade, we should not be lulled into thinking that there are no capital market imperfections, and that therefore there is no role of the World Bank in providing capital. We already noted that most developing countries still do not have ready access to capital especially for funds that can be used broadly, say for health or education. Not only might they have to pay very high interest rates, they may actually face credit rationing. And when the economy goes into a recession, and they need funds to finance a fiscal deficit to help restore the economy's strength, private lenders are likely to retract rather than extend lending—flows are all too often pro-cyclical.

There is thus a role for international financial institutions in general, and the World Bank in particular, in providing capital to the developing world. The benefits may be more related to *access* in bad times (though not necessarily just times of crisis), than to reduced borrowing *costs*. (The lower interest rates on IFI loans do not necessarily translate into lower costs overall. Since IFI loans have seniority over other debts, more IFI borrowing to some extent decreases the ability to repay other debts, and thus other creditors demand a higher interest rate to compensate for their higher risk.)

It is likely that capital markets for middle income countries will continue to improve, and it is conceivable that, accordingly, the role of the World Bank in providing capital to those countries may diminish. But there is often a linkage between the transfer of knowledge

and the provision of credit, especially when the capital is provided to finance particular projects. It appears that this is at least one of the reasons that China, which is sitting on huge amounts of reserves that earn lower interest rates than what it has to pay to the World Bank on its loans, continues to be among the Bank's largest borrowers. For the middle-income countries, the World Bank acts much like a credit cooperative. Indeed, the Bank actually earns a profit on its middle income lending, part of which goes to cross-subsidize lending to lower income countries. If, in the future, it turns out that improvements in capital markets effectively eliminate the value of the credit enhancement provided by the 'credit cooperative', and the Bank is unable to deliver non-lending (knowledge) services 'that are valued, then middle income lending will, over time, diminish.[15]

3. INTERACTIONS AMONG GLOBAL PUBLIC GOODS

While the international financial institutions naturally focus on issues of *economic* global public goods and externalities, there are important interactions between these global public goods and other public goods and externalities. For instance, there is a clear relationship between economic stability and global security issues. Policies that increase unemployment or dramatically lower real incomes can and often have led to civil unrest, ethnic conflict, and strife not only within countries but among them. The policies pursued in Indonesia, including the elimination of the food and fuel subsidies just as incomes were plummeting and unemployment soaring, predictably led to riots that not only caused enormous bloodshed but further undermined the economy. The IMF has, at other times, strongly urged Jordan to remove food subsidies at a pace that the government felt might have led to riots there. Jordan's government managed to resist the IMF pressure; had it not,

and had the government's worries materialized, Middle East security could have clearly been jeopardized.

High interest rate policies and scarcity of credit in Indonesia and elsewhere have contributed to faster exhaustion of natural resources. Cutting down forests is an easy way of raising cash. Thus, there can be marked environmental consequences of economic policies. At the same time, putting in place good environmental policies may be costly, and when the benefits are a global public good (such as reduced atmospheric concentrations of greenhouse gases), it is appropriate that those most able to bear the costs of providing for these global public goods should do so. The Global Environmental Facility administered by the World Bank provides some funds, but clearly more funds are needed. The Bank has been using some of its 'leverage' to advance better environmental policies, for example by encouraging the elimination of energy subsidies, an action that would both improve the environment and economic performance.

Similarly, World Bank health programmes can not only be of enormous benefit to the people in the country, but can also reduce the global threat of contagious diseases. In that way, the World Bank contributes to another one of the global public goods.

4. CONCLUSIONS

The recognition that there are global public goods and global externalities, requiring collective action at the global level, represents a major change in thinking. Research has demonstrated the difficulties *within countries* of collective action. Markets by themselves

are powerful, but important and extensive market failures provide scope for collective action. Unfortunately, that collective action does not always work as we would hope. Agency problems are pervasive. Public bodies are sometimes captured by special interest groups, and politicians sometimes pursue agendas of their own. Limited competition in the provision of public goods has adverse effects on efficiency and effectiveness.

To date, unfortunately, collective action at the international level has not been subjected to the same kind of analytic scrutiny that has occurred at the national and local level. This chapter is intended to be an initial contribution, identifying the *objectives* (the rationales for global collective action). It also begins to assess whether policies have been well directed at achieving those objectives, or, as so often happens at the national level, they more accurately reflect the interests of the bureaucrats that run international institutions or the special interests that they serve.

More broadly, at the international level, collective action is, if anything, even more difficult. The international community, having recognized the need for collective action, has been struggling with the problem of global governance without global government. In some arenas there has been more reliance on consensus; in other arenas, there has been more delegation to specialized bodies, supposedly run by 'experts,' with little direct accountability.

The two arenas in which global collective action has been most advanced—reflecting their importance—relate to international economic and political stability. In this chapter, I have tried to argue that while there is a real rationale for collective action, the actions undertaken by the IMF have arguably not been well directed at *correcting* the market

failure. In some cases, it may actually have exacerbated the problems. I have speculated about why that might be the case, and have proposed reforms that might go some way toward making it more likely that its policies will not only be more effective, but more directed at correcting global economic market failures.

NOTES

[1] The G-1 is the euphemism for the largest shareholder in both of the Bretton Woods institutions, the United States, which actually has veto power in the many decisions of the IMF that require a super-majority vote.

[2] See World Bank (1998a).

[3] See, for example, Stiglitz (1995).

[4] See, e.g. Furman and Stiglitz (1998) and Stiglitz (1998).

[5] It should be clear: many of the policies advocated by the IMF are those about which there is a broad agreement among economists and that are almost surely in the broad national interest. The issue is that the IMF sometimes—often—goes well beyond these policies.

[6] For a review of these arguments, see Stiglitz (1996); and Hellmann, Murdock, and Stiglitz (2000).

[7] The IMF often tries to shift blame—it is perfectly willing to disclose more, but can only do so with the agreement of the country. There are some instances in which there are good reasons for maintaining some degree of secrecy: an analysis of a banking system that shows that it is about to collapse would precipitate a run—precisely the event that the authorities are trying to avoid. But these instances are more the exception than the rule. The IMF has shown little hesitation in imposing conditions on countries that go well beyond the situation or crisis that is its immediate concern. Is there a reason that it could not require much broader transparency as a condition of funds—thus removing one of its major excuses for non-disclosure, at least with regard to countries receiving assistance?

[8] Some argue that my raising the issue of democracy is beside the point: the Articles of Agreement of the Fund and the Bank explicitly preclude the institutions' engaging in political matters—and the focus on economics rather than politics has in fact been one of the great sources of strength of the Bretton Woods

institutions. While this may be true, two points should be made in reply: first, what I am discussing here is not the imposition of political conditionality, but the recognition that the way that the Fund interacts with the country affects political processes—it affects whether democratic processes are strengthened or weakened. The way it operates should take these consequences into account. Secondly, in fact the Fund (and the Bank) always enter into political arenas; indeed, one of my criticisms is that they do so more than is necessary for the accomplishment of their economic objectives. I have already referred to the fact that the conditions imposed in times of crisis reach out into political areas. (See also, Feldstein 1998). Judgements about whether to privatize public pension systems, or attempt to improve the performance of the public programmes, rest largely on political economy arguments. More broadly, political judgments are pervasive in Fund programmes.

[9] There is also considerable evidence that conditionality is actually ineffective in achieving 'better' policies. See, e.g. World Bank (1998b). For a fuller discussion of the role, effectiveness, and consequences of conditionality, see Collier (1999).

[10] Other, more nefarious, reasons have been suggested for the suspension of the IMF programme. Ethiopia repaid a high interest loan to an American bank early, without asking 'permission' of the IMF. Some suspected that it was no surprise that the U.S. was particularly critical of this action (though few disagreed that it was a reasonable action, in terms of strengthening the country's financial position—what it was earning on the reserves used to repay the loan was far less than what it ended up paying to the American bank).

[11] Even when the agency does not act badly, the suspicion that it might adversely affects credibility. Thus, in the mid 1990s, in the United States, there was a major debate about biases in the consumer price index (CPI). Spearheaded by a bi-partisan Congressional commission chaired by the former chairman of the Council of Economic Advisers, Michael Boskin, a consensus developed that the CPI overstated the rate of inflation by between 1 and 2 percentage points a year—a significant amount. The discrepancy had implications for a variety of areas, including judgments about the seriousness of inflation and the indexing of social security payments and wages with cost of living increases. Determination of the CPI is entrusted to the Department of Labor, which has close ties to the labor movement. Unions were concerned that a downward revision of the CPI would adversely affect workers. When the Department of Labor resisted making changes in the CPI (at least at the speed that critics of the index thought desirable), some attributed it to general bureaucratic conservatism, but others saw a conflict of interest.

[12] And indeed, one of the main items in the IMF agenda in recent years has been to increase the independence of the central banks—making themselves accountable to those who are even less democratically accountable.

[13] For more extensive discussions of the kinds of reforms that might be desirable, see Independent Task Force (1999), Meltzer Commission (2000), and Overseas Development Council (2000).

[14] For a discussion of these issues, see World Bank (1998c).

[15] Thus, I disagree with the Meltzer Commission report's recommendation that the World Bank withdraw completely from middle income lending. There is a small implicit subsidy (associated with the credit enhancement provided by the Bank's original capital contributions and the potential further backing of the 'shareholders' should that prove insufficient), but, taking account of the cross-subsidy to low income countries, possibly the net effect is a tax on middle income lending.

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