

HOW CAN INTERNATIONAL FINANCIAL INSTITUTIONS FOSTER ECONOMIC GROWTH?  
WILLIAM EASTERLY  
Presented September 17, 2002

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In this presentation, renowned development scholar William Easterly kicked off the Bank's groundbreaking seminar series "New Ideas in Economic Policy and the Role of the IDB". The series is designed to introduce innovative and controversial ideas in development economics to the Bank's directors and management, including those that fly in the face of economic orthodoxy. Easterly began by debunking four myths of economic development and of IFI involvement in developing countries, explaining how adherence to these misperceptions accounted for most of the disappointing results of the past few decades. He then offered concrete suggestions on how to improve the status quo, both in terms of internal management and at the project level. A wide-ranging and lively Q&A session followed.

*The Myth of Benevolent Money.* The founding principle of many multilateral institutions was that merely filling the financing gap with aid and lending would boost investment, and therefore spur growth. Easterly challenged this belief, quoting Steven Landsburg's definition of the universal driving force of economic activity: "People respond to incentives, all the rest is commentary." If, for example, institutions such as the rule of law are weak, private businessmen whose ownership of profits is not protected will not have the incentive to invest. Foreign funding therefore too often drives consumption rather than investment. To put it bluntly, he stated, money can't buy you development. He illustrated this point using data to show the weak empirical links between growth and both investment and capital accumulation.

*The Myth of Benevolent Bureaucracy.* Questioning IFIs' longstanding practice of working through governments of recipient countries, Easterly pointed out that IFIs have long been victims of political naïveté in assuming that these governments sought economic growth and development. In fact, the time horizons facing political leaders are fairly short, and they often choose to merely redistribute available resources to interest groups inside the ruling coalition. Furthermore, some leaders may fear programs such as those involving education, as improved literacy could ultimately lead to challenges to their authority by a more informed populace.

Yet problems with bureaucracy are not limited to host country governments; Easterly lamented the mushrooming of the international aid bureaucracy, which has translated into unprecedented levels of resources, personnel, and areas of intervention. In terms of the ever-expanding and overly ambitious development agendas such as

those outlined in Monterrey and Johannesburg—encompassing everything from spoken word to gender equality—the price has been a loss of focus and effectiveness. IFIs do not appear to seek to minimize the costs of reaching the poor in order to help as many as possible, and the labyrinth of aid bureaucracies has made the process of appealing for help mind-bogglingly complex.

*The Myth of Benevolent Conditions.* By the 1980s IFIs had realized that domestic politics were causing impediments to growth. In order to alleviate this, they began imposing conditions on loans to foster “adjustment with growth” or structural adjustment. Again domestic political considerations in recipient countries predominated, and these funds were often used to dispense patronage to interest groups. The IFIs, as recipient countries were well aware, found themselves in a difficult spot, needing to issue new loans so that old loans could be serviced. Structural adjustment failed to either reform borrower countries or to prevent the collapse of growth that has occurred. The latest attempt to make governments benevolent is debt relief. Endorsed by prominent figures both in economics and other fields, debt relief involves the same efforts to impose conditions on borrower countries—this time in order to secure forgiveness for loans that cannot be repaid.

*The Myth of Benevolent Intervention.* When the failures of previous efforts became clearer, IFIs attempted to achieve better results through direct programming in a multitude of areas such as education, public administration, central bank reform and health. As with the others, this approach has foundered due to an inability to grasp and align incentives, maintains Easterly. Massive investments in schooling have not borne fruit because, for example, parents and students do not expect that the payoff will be a better paid, high skilled job, and because teachers are not sufficiently motivated. There is no “magic bullet” physical intervention that will spur growth, warns Easterly.

What *should* IFIs do now? Given the failings of conventional wisdom, Easterly called for a revolution in development thinking. First, IFIs should move away from traditional emphasis on the quantities of inputs in evaluating the impact of their programming, such as number of schools, miles of road, or amount of funds disbursed. This practice often leads to perverse incentives to skew results to fit the indicators, and does not give proper place to the intangibles such as institutions and incentives that are so critical for success. More pertinent measurements of effectiveness would entail the degree to which contracts are enforced, property rights are clear, and profits are protected, for example. Careful research to guide development project design should be undertaken in a decentralized way that comes from the countries themselves. Easterly

closed his presentation with a plea to continue striving to achieve growth and development on behalf of the millions of poor who struggle from day to day.

During the extended Q&A session that followed, Easterly and the participants debated whether IFIs were really too large, or if they were in fact too small to address the myriad of modern development problems. Easterly asserted that IFIs should focus on efficiency rather than size, and suggested that they create a corporate type of internal incentive structure wherein those designing and implementing projects would be penalized or rewarded depending upon results. Those results could be measured through methods such as randomized site visits and evaluations. He also proposed that increased competition among IFIs for donor funds would boost efficiency. One participant cautioned Easterly not to buy into the “Myth of Easy Solutions”, and that emphasis on the institutional environment and incentives may be yet another passing development fad. She doubted that lending institutions such as the IDB are really in a position to influence institutions. She also questioned Easterly’s assertion that politicians do not seek growth, since it is easier to buy support with increased resources. In response to a question about how the IFIs such as the IDB should approach Latin America in particular, Easterly responded that he would like to see less duplication of efforts and more competition—and therefore specialization—among IFIs and NGOs. For example, he envisioned the IDB essentially “taking over” in Latin America, with its extensive local knowledge and an obvious comparative advantage in the region over the World Bank and other organizations.

Approximately 45 people participated in this seminar.

*William Easterly is currently Senior Fellow at the Institute of International Economics and the Center of Global Development, as well as the author of the highly acclaimed and controversial book "The Quest for Growth." He also spent 16 years as a research economist at the World Bank.*