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THE WORLD BANK OF THE FUTURE

Abhijit V. Banerjee
Ruimin He

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Room E52-251
50 Memorial Drive
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THE WORLD BANK OF THE FUTURE

Abhijit V. Banerjee and Ruimin He

Department of Economics, M.I.T.

January, 2003

This paper argues that the prima facie evidence suggests that the World Bank is not particularly effective either in dealing with countries that default or in promoting countries, projects and ideas that are likely to do well. We argue that this is probably related to the fact that the Bank does not make adequate use of scientific evidence in its decision-making and suggest ways to improve matters.

Keywords: World Bank, Aid Effectiveness; Multi-lateral Lending

JEL Codes: O19, F33, F35

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1 We are grateful to Peter Diamond, Shanta Devarajan, Esther Duflo, Stan Fischer, Michael Kremer, Allan Meltzer and Nick Stern for their comments.
I. What can the World Bank do?

Even in today’s world of burgeoning private capital markets, there is much that an organization like the World Bank can contribute towards realizing the dream of a world without poverty. First, of course, there is emergency relief: At any point of time there are people in the world who are in the middle of an acute crisis and need emergency relief. While delivering relief effectively is not easy, there is broad agreement that it is a worthwhile goal. However the World Bank believes, rightly, that this is not enough. As we see it, there are at least three important ways it can contribute to the broader project:

1. Default Management: Optimal default management suggests that countries that have defaulted should be rationed in their access to credit, without being starved of the liquidity needed for successful restructuring. Individual lenders might either be too willing to lend compared to this optimal plan (because, say, post default, the country’s balance sheet looks much better) or too reluctant (because, an efficient restructuring benefits all potential lenders). An important potential role for multilateral lending institutions is to help the lenders coordinate and thereby maintain the right balance of incentives and liquidity. In practice, while the IMF handles the default itself, the eventual restructuring package typically includes the Bank and its sister organizations.

2. Promoting economic opportunities: In developing countries, economic opportunities often need to be created and/or promoted before the market can find its way to them. First because there are physical externalities between investments: The benefits from some investments (infrastructure, courts, etc.) are only realized after other complementary investments. Second, there are informational externalities: New countries and new

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2 As in Murphy, Shleifer and Vishny (1989).
projects are associated with uncertainty that gets partially resolved after the initial investments. The early investors are therefore doing other investors a favor and consequently, the market under-supplies such investment. Because the World Bank can afford to lose some money, it can internalize this externality. Moreover its country expertise might allow it to select better initial projects and thereby minimize risk.

3. Promoting Best Practice: It is not easy to be aware of the recent history of the world and hold that countries mostly pursue policies that best serve the majority. This is in part the way of political economy, but ignorance and ideology have also done their bit. The World Bank can do something about this: First, because it can get the necessary know-how. Second, because it can get country governments to listen to it, especially if it has subsidized loans to offer. And third, because country governments can use World Bank pressure as an excuse when dealing with the domestic supporters of the status quo.

II. How effective is the World Bank?

How well does the Bank do along these three important dimensions? There is a long and largely unresolved debate on whether multilateral lending (or aid) has any effect on overall growth, where assigning causality has been a persistent problem. We are interested in the narrower question of identifying specific channels of influence, where the causality issues are exaggerated by the lack of data. Our regressions results are therefore best seen as an attempt to check whether, prima facie, the conditional correlations in the data are consistent with the models we have suggested.

Optimal default management implies that overall credit access for the country should go down after a default, to preserve the incentives. However multilateral lending might go down after default but it might also go up, if the private market overreacts.
To see how default actually gets managed, we use the BIS-IMF-OECD-World Bank statistics on external debt.\(^4\) We define multilateral lending to include all loans from all continental Development Banks, the World Bank and the use of IMF credit.\(^5\) Default is measured by the country having signed an agreement with Paris Club creditors.\(^6\)

We regress Log[net stock of multilateral lending to a country in 2002] on Log[net stock of multilateral lending to a country in 1996], a dummy for having defaulted between 1990 and 1995, another for having defaulted between 1996 and 2002 and the interaction of the two. The results are shown in column 1 of Table 1. Both current and past default is positively correlated with World Bank lending but defaulting twice has a negative sign. When we run the same regression for market credit we find a very different pattern: current default has a negative correlation with lending while past default is not significant (column 2). As a result of the two countervailing effects, there is no correlation between total credit and current default, and a positive correlation with past default (column 3). Conditioning on a number of measures of the state of the economy in 1996 such as growth rates, inflation rates and change in openness over the 1990-96 period (from the Penn Tables, Heston et al., 2002), leaves the pattern of correlations unchanged (columns 4-6).\(^7\) The results are robust to the inclusion of the same controls in 2002 and a control for the budget deficit.

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\(^3\) This is the model of the Bank that Gilbert, Powell and Vines (2000) call the Knowledge Bank.

\(^4\) See http://www.oecd.org/dac/debt/.

\(^5\) Here we do not include the outstanding balance of Brady bonds in multilateral lending, but the results are the same if we do.


\(^7\) This, for example, makes it less likely that the default was already anticipated and captured by the 1996 loan amount.
Unfortunately at this point we do not have data to say what happens to interest rates, though clearly they do not go up enough to discourage extra borrowing. With this caveat, we can say that we found no evidence for effectiveness in default management.

If the World Bank is interested in promoting economic opportunities, its goal should be to target its loans towards countries and projects that are better than one would expect based on publicly available data. If it is interested in promoting best practice, it should give preference to countries and projects that best approximate best practice. Both the first, selection argument and the second, incentive argument, have the implication that multilateral lending should be positively correlated with country and project performance, controlling for observables such as default and the state of the economy.

To check this we first add to the loan regressions already discussed, the Bank’s evaluation of the quality of governance in different countries in 2001 and 1997. The recent Bank publication, *A Case for Aid: Building a Consensus for Development Assistance* explicitly claims that the Bank is now targeting countries with good governance. The results, reported in column 1 of Table 2, show that neither of the coefficients on the governance variables are even remotely significant, and one is actually negative. An alternative possibility is that the Bank is targeting excellence in project performance rather than governance. In Column 3, we add to this equation an average country measure constructed from the Bank’s own ratings of projects funded in the country. We include both the 1990-95 average and the 1999-2001 average. None of the four performance measures are significant and three out of four are negative. A final

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9 From the Operations Evaluation Department Annual Reports
test along these lines is to estimate the relation between World Bank lending and project performance for all the projects evaluated by the Operations Evaluation Department at the Bank. For these we estimate a relation between the amount committed by the Bank and its outcome rating, controlling for the sector, the country, the length of the project, the year when it was approved and the closing. The coefficient on the rating is negative (-5.5) but not significant (the t-statistic is -1.54). However when we replace the amount committed by the fraction of World Bank funds in total project cost, the coefficient is negative (-0.28) and highly significant (t-statistic of -3.27).

The results based on the project score have the problem that we only observe projects that were chosen, and therefore comparison between them understates the degree of selectivity exercised by the Bank. In other words, the Bank could still be discarding many very bad projects. Moreover, our analysis does not distinguish between IDA and IBRD lending and it is possible that IDA lending is more performance-sensitive than IBRD lending. To the extent that this adds measurement error to the independent variable, it will tend to make our results less significant. Note however that many of the coefficients are actually negative.

In A Case for Aid, the research staff in the Development Economics Vice Presidency of the Bank make a series of claims, based on cross-country evidence, about the high level of effectiveness of Official Development Assistance generally and World Bank lending in particular. While this is not the place to try to resolve the conflict between their claim and ours, note that our results only show that World Bank loans do not outperform what one would have predicted on the basis of the state of the economy.

10 We have not yet managed to get hold of the 1996-98 numbers.
Success in promoting economic opportunities comes from getting the private sector to respond to the Bank’s promotion efforts. One test of this is to see if private sector lending to the country responds to the Bank’s evaluation of governance in the country, controlling for public information (default history, the state of the economy). This is a very weak requirement since we cannot be sure that the measure of governance that they are actually using comes from the Bank (commercial firms also provide measures). Column 2 in Table 2 reports that the governance measures are essentially uncorrelated with private lending. A more demanding requirement is to see if private sector lending responds to results of Bank projects (i.e., the average project score used above). Since we do not know how quickly the private sector responds to the information we include both the 1990-95 average and the 1999-2001 average. The results, shown in column 4, confirm the lack of correlation (one is positive and the other is negative, and the t-statistics are less than 1).

This evidence certainly does not rule out the possibility that the private sector does respond to a small fraction of highly successful bank projects. But it does question our confidence in the Bank’s ability to influence the private sector.

The final piece of evidence is on the Bank’s efforts to directly influence best practice through the advocacy of certain ideas in the annual World Development Report (WDR). We looked at the number of citations to the WDR and to certain key phrases in the WDR both in the academic press and on the web. The citations fall off very sharply after about the first two years since publication.
The WDR therefore does influence the public discourse, but only temporarily. It is possible that this is in the nature of the public discourse, but it does raise important concerns about the power of ideas in this context.

III. The World Bank of the Future: Towards Greater Effectiveness

While our results are not always easy to interpret, it is hard to point to a single piece of evidence that clearly signals effectiveness. With respect to the management of default, it does not look that there is effective coordination among the lenders. In part this might reflect the political compulsions to bail out private lenders. In part it may reflect genuine disagreements between the lenders (the Bank and the Fund, for example) about how much punishment is optimal. It remains however that incentives for potential defaulters are probably not what they should be and in the end, this hurts the borrowers.

Establishing a clear set of rules for dealing with default and enforcing them (including by punishing deviant lenders) is therefore vital. This is the natural preserve of the IMF: The Bank should accept the IMF’s lead, once they have agreed on the rules.

In trying to understand the Bank’s limitations in promoting economic opportunities and advocating best practice, we studied in some detail a recent Bank publication---Empowerment and Poverty Reduction: A Sourcebook. This is meant to provide a catalogue of what the Bank believes are the right strategies for poverty reduction. A subset of strategies recommended include: computer kiosks in villages; cell phones for rent in rural areas; scholarships targeted towards girls who go secondary school; schooling voucher programs for poor children; joint forest management programs; water users groups; citizen report cards for public services; participatory poverty assessments; internet access for tiny firms; land titling; micro-credit based on
group lending; and many others. While many of these are surely good ideas, the book does not tell us which of these have been subject to a randomized evaluation or even a non-randomized evaluation based on a convincing quasi-experimental design. In fact, to the best of our knowledge, only one of these strategies has been so evaluated in a LDC context---schooling vouchers for poor students---and that was because the Colombian voucher program had built-in random allocation. Yet it receives no more weight than any of the other programs. Moreover for many of the programs, the book makes no mention of rates of return, so it is not clear how one is to choose between them. Where the rates of return are mentioned, we are not told how these are calculated, and in particular, how they solve usual identification problems. And some of the programs, such as the Gyandoot program in Madhya Pradesh in India which provides computer kiosks in rural areas, are declared to be successes even while the text acknowledges that the computers often do not work and that they are all losing money (page 109).

Given this, one should not be too surprised if the Bank is not very successful in identifying good economic opportunities or if the private sector failed to follow its lead. And policy makers may be forgiven if they resist the Bank’s views on best practice.

If the Bank has to be more effective in its two promotion roles, it has to move to a much more scientific process for the selection of projects and ideas. If something has to get the Bank’s imprimatur, the expectation should be that there is a clear and well-understood theory behind it, and that it has been subjected to multiple randomized evaluations, to ensure both internal and external validity. If governments are reluctant to

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12 A Case for Aid, takes a similar cavalier approach to project appraisal.
13 It is not that successful projects cannot lose money: But when it is said that they are losing money because the computers often do not work and there is not enough demand, one must wonder.
randomize, the Bank can collaborate with NGOs. Success in these evaluations does not need to be judged by a uniform standard across countries---even a little bit of success may be valuable where nothing works. But the standard should be explicit and determined ex ante. The process of trial and error should be made relatively public, as a way of resisting political interference. Finally, where randomization is physically impossible (say the bank needs to decide whether to push for the abolition of power subsidies), the rule should be to stay away unless the theoretical case and the available high quality non-experimental evidence is exceptionally compelling.

This could mean that for some time the Bank will have more money than it needs to finance specific initiatives---though going to global scale on all the programs where there already is strong experimental support (de-worming, vitamin A supplements, etc.) need not be cheap. There is however always relief work, which might include broad budgetary support to bankrupt governments (subject to what we say above about default management)---if only to protect the programs for the poor from being cut. It may be justifiable to use the resulting leverage to eliminate policy distortions in the country, but only if the case for intervention is exceptionally strong. And even in such cases, a clear separation between with budgetary support negotiations and the recommendations of the Bank for long-term development, must be institutionalized.

Effective promotion may also require the Bank to signal its commitment to an idea by putting its own money at risk of default. In this sense, moving completely to grant financing, as recommended by the International Financial Advisory Commission (Meltzer Commission) report, may be counter-productive. On the other hand, since
NGOs may be more willing to try out new ideas than governments, the Bank should have a grant fund that can be used to finance these efforts.

The Bank is attracting a lot of unwelcome attention these days. A Bank that resists advocating what it cannot prove will soon stop being the prime target of the Seattle crowd. It would live quietly in the shadows, doing its best, doing good.

References


Heston, Alan, Robert Summers and Bettina Aten, Penn World Table Version 6.1, Center for International Comparisons at the University of Pennsylvania (CICUP), October 2002


Table 1: OLS Regressions of Log of Stock of loans in 2002

<table>
<thead>
<tr>
<th>Variable</th>
<th>World Bank (1)</th>
<th>Market (2)</th>
<th>Total (3)</th>
<th>World Bank (4)</th>
<th>Market (5)</th>
<th>Total (6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>log(LOANS) (1996)</td>
<td>0.8776* [0.05]</td>
<td>0.7804* [0.03]</td>
<td>0.8061* [0.04]</td>
<td>0.9091* [0.04]</td>
<td>0.7717* [0.03]</td>
<td>0.8472* [0.02]</td>
</tr>
<tr>
<td>DEFAULT? (1996-2002)</td>
<td>0.4765* [0.1]</td>
<td>-0.6879* [0.2]</td>
<td>-0.0845 [0.1]</td>
<td>0.6669* [0.2]</td>
<td>-0.3263 [0.2]</td>
<td>0.1300 [0.2]</td>
</tr>
<tr>
<td>DEFAULT? (1990-1995)</td>
<td>0.4709* [0.2]</td>
<td>0.1905 [0.2]</td>
<td>0.2238* [0.1]</td>
<td>0.4876* [0.2]</td>
<td>0.3318* [0.1]</td>
<td>0.2587* [0.1]</td>
</tr>
<tr>
<td>INTERACT</td>
<td>-0.6980* [0.2]</td>
<td>0.0596 [0.3]</td>
<td>-0.3097* [0.2]</td>
<td>-0.7627* [0.2]</td>
<td>-0.3334 [0.3]</td>
<td>-0.4412* [0.2]</td>
</tr>
<tr>
<td>Past Controls?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.86</td>
<td>0.89</td>
<td>0.89</td>
<td>0.89</td>
<td>0.90</td>
<td>0.93</td>
</tr>
<tr>
<td>$n$</td>
<td>144</td>
<td>163</td>
<td>170</td>
<td>103</td>
<td>107</td>
<td>108</td>
</tr>
</tbody>
</table>

Notes – Robust standard errors are in parentheses. *Significantly different from 0 at the 10-percent level.