Initiative *for* Policy Dialogue

Based at Columbia University

Working Paper Series

Post Washington Consensus Consensus

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Task Force on Governance of Globalization

If there is a consensus today about what strategies are most likely to promote the development of the poorest countries in the world, it is this: there is no consensus except that the Washington consensus did not provide the answer. Its recipes were neither necessary nor sufficient for successful growth, though each of its policies made sense for particular countries at particular times.

By the Washington consensus I mean, of course, the oversimplified rendition of what it was that the international financial institutions and the U.S. Treasury recommended, especially during the period of the eighties and early nineties, before they became such a subject of vilification in both the North and the South, not the more subtle work of John Williamson, who actually coined the term.[1] Whatever, its original content and intent, the term "Washington Consensus", ni the minds of most people around the world, has come to refer to development strategies focusing around privatization, liberalization, and macro-stability (meaning mostly price stability); , a set of policies predicated upon a strong faith – stronger than warranted --in unfettered markets and aimed at reducing, or even minimizing, the role of government.[2] That development strategy stands in marked contrast to the successful strategies pursued in East Asia, where the *development state* took an active role.

The post Washington consensus goes further in detailing the nature of the failures of the Washington consensus.[3] There was a failure in understanding economic structures within developing countries, in focusing on too narrow a set of objectives, and on too limited a set of instruments. For instance, markets by themselves do not produce efficient outcomes when technology is changing or when there is learning about markets; such dynamic processes are at the heart of development; and there are important externalities in such dynamic processes, giving rise to an important role for government. The successful East Asian countries recognized this role; the Washington consensus policies did not.

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[1] Williamson, J. [1990] "What Washington Means by Policy Reform," Chapter 2 in *Latin American Adjustment: How Much Has Happened?*, John Williamson (ed.), 1990, Washington: Institute for International Economics and Williamson, J. [1999] "What Should the Bank Think About the Washington Consensus," Background Paper to the World Bank's *World Development Report 2000*, July 1999.

[2] How the term "Washington Consensus" is widely understood is then an important difference between this paper and John Williamson's paper presented at the same conference --"A Short History of the Washington Consensus" – in which Williamson, referring to me, asserts that "when a serious economist attacks the Washington Consensus, the world at large interprets that as saying that he believes there is a serious intellectual case against disciplined macroeconomic policies, the use of markets, and trade liberalization…" At any rate, that is not my case against the Washington Consensus polices, as I understand the term to refer to and is evident from what follows in this paper. On the particular points raised by Williamson, my view is that the Washington Consensus has come to mean too much and too narrow a focus on price stability, and inadequate attention to the case for interventions in markets, including via trade policy. See for instance Williamson, J. [2004] "A Short History of the Washington Consensus," paper presented at Foundation CIDOB conference held in Barcelona in September 2004, "From the Washington Consensus towards a new Global Governance".

[3] See, for instance, Stiglitz, J. E. [1998] "More Instruments and Broader Goals: Moving Toward the Post-Washington Consensus," the 1998 WIDER Annual Lecture, Helsinki, January 1998, reprinted Chapter 1 in *The Rebel Within*, Ha-Joon Chang (ed.), London: Wimbledon Publishing Company, 2001, pp. 17-56. This paper extends and updates the arguments I made in that paper.

Similarly, little attention was placed on other distinctive attributes of developing countries, such as the prevalence of sharecropping contracts, which imposed, in effect, a tax rate on peasants of 50%--and in some cases of 66 2/3%, an order of magnitude greater than many of the others to which they directed their attention. While the international financial institutions talked a great deal about 'getting incentives right,' they never addressed this incentive problem.

While critics of the Washington consensus policies say that they relied too heavily on *market fundamentalism*, the belief that markets by themselves lead to economic efficiency and that economic policies should focus on efficiency—distributional concerns could and should be taken care of elsewhere in the political process—more moderate advocates of Washington consensus policies deny the charge. To a large extent, that debate, like the debate over the nomenclature 'the Washington consensus' itself, is beside the point. The policies pursued by the international financial institutions which came to be called the Washington consensus policies or neo-liberalism entailed a much more circumscribed role for the state than were embraced by most of the East Asian countries, a set of policies which (in another simplification) came to be called the development state.

To be sure, governments can make maters worse. No doubt, the Washington Consensus represented, in part, a reaction to the failures of the state in attempting to correct those of the market. But the pendulum swung too far in the other direction and for too long. The consensus policies often assumed the worst about the nature and capability of governments and made that one size fit all. That resulted in a strong bias against basing policy advice on an analysis of what interventions are appropriate in what contexts or to build the institutions or capacity of states to intervene effectively.

What is at issue then is not just the size of government, but its role—what activities should it undertake—and the balance between government and the market. The post Washington consensus recognizes that there is a role for a market; the question is, to what extent do the neo-liberals recognize that there is a role for the state, beyond the minimal role of enforcing contracts and property rights.

The intellectual foundations of the Washington consensus had been badly eroded even before the doctrines became widely accepted. The fundamental theorems of welfare economics provided the rigorous interpretation of Adam Smith's invisible hands, the conditions under which and the sense in which markets lead to efficient outcomes. There could be no externalities (no problems of air or water pollution), no public goods, no issues of learning, perfect capital markets—at least in the sense that there be no missing risk or intertemporal markets. If that was not bad enough, Greenwald and Stiglitz went further and showed that there had to be no imperfections of information, no changes in the information structure, no asymmetries of information.[4] These problems are serious in

[4] Stiglitz, J. E. and B. Greenwald [2003] *Towards a New Paradigm for Monetary Policy*, London: Cambridge University Press.

any economy, but are at the heart of development. *There is no theoretical underpinning to believe that in early stages of development, markets by themselves will lead to efficient outcomes.*

Historical experience—even before the Washington consensus was widely accepted—also provided little support. While there is an active debate about the particular role that each of the policies that each of the East Asian countries undertook, there is a clear link between the policies and the successes.[5] The township and village enterprises in china—publicly owned at the local level—were central to China's success in the 80s and early 90s. The individual responsibility system—which went far short of privatization of land—was responsible for the enormous increase in agriculture productivity. It is hard to conceive of Korea or Taiwan having become the industrial players of today without their having undertaken active industrial policies. All of the countries in East Asia had high savings rates, and it is at least plausible that the government policies designed to stimulate savings actually did what they were intended to do. While firms in the rest of the world complain about a shortage of capital, the governments of East Asia provided capital to those firms that were proving their mettle by exporting, especially in technology sectors where there were likely spillovers to the rest of the economy. To be sure, all of this could have been an accident; it is even possible that as some critics of these policies claim, the East Asian countries might have grown even faster in the absence of industrial policies. It is possible—but there is no reason to believe that that is the case, and the weight of the evidence points in the other directions.

If the success of East Asia suggests the desirability of a larger role for government in successful development than was traditionally emphasized in the Washington consensus policies, the failures in Sub-Saharan Africa and Latin America, have reinforced the doubts about the Washington consensus strategies.[6] Growth in Latin America during the 90s—the decade of reform —was just half of what it was in the 60s and 70s, the decades marked by the 'failed' policies of import substitution. Surely, there were problems with the import substitution strategy, and it would have had to evolve—as it did in East Asia—into a strategy based more on exports; but it was the debt crisis, not the shortcomings of the development strategy, that brought an end to the period of high growth. Success under reform was even more short lived—less than a decade—and the end of that success was directly related to the failures of the reform strategy, e.g. the openness of capital markets exposed the countries to the volatility of international capital markets, which had such adverse consequences in the global financial crisis of 1997-1998.

In Africa, the costs of a simple-minded belief in the magic of the market were palpable and huge. For example, policy conditionalities imposed on the countries of the region, too often focused much too narrowly on liberalization of agricultural prices without adequate

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[5] See for instance Wade, R. [2003] *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialization*. Princeton, NJ: Princeton University Press; *The East Asian Miracle: Economic Growth and Public Policy (World Bank Policy Research Reports)*. Washington, D.C.: World Bank Publications, 1993.

[6] Stiglitz J.E. [2002], *Reforming Reform: Towards a New Agenda for Latin America*, Prebisch Lecture, ECLAC, Santiago, Chile.

attention to the prerequisites to make that effective such as functioning markets for inputs and outputs, credit availability and infrastructure (especially roads); the insistence on static comparative advantage led to the fallacy of composition whereby increasing exports of commodities by many countries led to collapse in their prices; financial sector reforms were focused excessively on making interest rates market-determined in very thin and rudimentary markets leading often to prolonged periods of very high interest rates without improving the availability of credit.

If there were fruits of the Washington consensus, they are yet to be enjoyed, at least by the average citizens in many of the countries. Countries like Bolivia that were early followers are still asking; we have felt the pain, when do we get the gain. If the reforms exposed the countries to more risk, they evidently did not provide them with the strengths for a rapid recovery; in Latin America, as a whole, there followed almost half decade of declining per capita income.

As the failures—especially the crises, beginning with the Mexican crisis, then the East Asian crises, then the Russian crisis, then the Argentine crisis—made evident that all was not going well, the advocates of the Washington consensus successively tried to modify the prescription, coming up with various versions of the Washington consensus 'plus'. Mexico showed that even if a country got its own fiscal house in order and kept inflation in check, it could have a crisis. The problem, supposedly, was a lack of domestic savings. But when East Asian countries faced crisis—countries with the highest rates of savings in the world—a new explanation was sought. Now it was lack of transparency (they seemingly forgot that the last set of crises were in the Nordic countries, which were among the most transparent in the world.) weak financial institutions were to blame, but if such weak institutions were found in the United States and other advanced industrial countries, what hope did the developing countries have?. By this point, the IMF/US Treasury/Washington consensus[8] advice was ringing hollow: ex post, they could always find something that was wrong, and add something to the increasingly long laundry list of what countries should do.[9]

While the points were well taken—improvements in corporate governance and transparency would be of benefit—in the succeeding years, it has become increasingly evident that politics, rather than economic analysis, lay behind the framing of the agenda. For instance:

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[8] I deliberately drop the World Bank from the trilogy, because by this point, it had joined the critics on many of the elements of the Washington consensus.

[9] Jason Furman and I tried to do a somewhat serious job of ascertaining what might be meant by a country having policies or institutions that made it 'vulnerable' to a crisis, by looking across countries to see what, if any, characteristics were systematically associated with an increased likelihood of having a crisis. Not surprisingly, the East Asian countries that the IMF had suggested were particularly vulnerable do not appear to be so in our analysis. See Stiglitz, J.E. and J. Furman [1998] "Economic Crises: Evidence and Insights from East Asia," *Brookings Papers on Economic Activity*, 1998(2), pp. 1-114. (Presented at Brookings Panel on Economic Activity, Washington, September 3, 1998.)

- The IMF and the U.S. Treasury, while pushing the transparency agency, remained among the least transparent of public institutions.
- The US Treasury had even resisted reforms in the United States that would have improved transparency of America's accounting frameworks, e.g. related to stock options.
- The last set of countries to be afflicted by financial crises, in Scandinavia, were among the most transparent.
- When the debate about transparency turned to Western institutions, hedge funds and secret bank accounts, the US Treasury even began to argue against excessive transparency, and eventually vetoed (before 9/11) the OECD initiative on bank secrecy.
- While continuing, rightly, to inveigh against corruption, the developed countries have refused to take easy steps that would make such corruption more difficult, e.g. like allowing tax deductions only for those payments to governments that are 'published' (and adopting other measures of the extractive industries transparency initiative).
- IMF accounting practices continue to put a roadblock in the way of market based land redistribution.

While the IMF talked about the need for greater safety nets, it did not focus squarely on the factors that contributed to economic volatility—including capital market liberalization; it continued to advocate capital market liberalization, long after the adverse effects on stability became clear and as evidence mounted that it did not contribute to economic growth.[10] It continued to focus on the inadequacies in the developing countries, not in the Washington consensus policies; blame was squarely placed on the developing countries for their problems—especially related to lack of transparency and poor governance.

While the crises in countries that seemed to have followed the Washington consensus prescriptions, countries like Argentina that had received an A+ grade from the IMF (it's president, Menem, even having been paraded before the 1999 annual meeting as an exemplar of what other countries should do), a host of other problems were encountered: privatizations, for instance, marred by corruption, or of natural monopolies which led to higher prices for consumers as the monopoly power was exercised. Moreover, the objective of development was not, or should not have been, just an increase in GDP—putting aside for the moment the measurement problems associated with that measure; but rather sustainable increases in standards of living, and the promotion of democratic and equitable development.

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[10] Finally, in March of 2003, even the IMF recognized these problems—almost six years after it had tried to change its charter to force developing countries to liberalize their capital markets. It remains uncertain, however, the extent to which these findings have altered the policy prescriptions that it gives at the country level. See, for instance, Prasad, E., Rogoff, K.,Wei, S., and Kose, A.M. [2003] "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," IMF Occasional Paper No. 220, September.

The issue of equity, in particular, often got short shrift. Is a society in which the vast majority of its citizens are becoming worse off –but in which a few at the top are doing so well that average incomes are rising—better off than one in which the vast majority are doing better? While there may be disagreements—and those at the very top may well stress that average income is the appropriate measure—the possibility that increases in GDP may not benefit most individuals means that we cannot simply ignore issues of distribution. Some economists argued that distribution concerns could be ignored because they believed in trickle down economics—somehow everybody would benefit; a rising tide would lift all boats. But the evidence against trickle down economics is now overwhelming, at least in the sense that an increase in average incomes is not sufficient to raise the incomes of the poor for quite prolonged periods. Some economists argued that distribution concerns could and *should* be ignored, because such concerns were outside the province of economics; economists should focus on efficiency and growth alone. Distribution was a matter for politics. The fundamental theorems of welfare economics gave economists some comfort, for those results suggested that one could separate out equity and efficiency concerns; any desired distribution of income could be achieved simply by a redistribution of initial endowments. But advances in economic theory (especially related to the economics of information) showed that that was simply not true; lump sum redistributions were not in general feasible, and efficiency and equity were inextricably interlinked.[11] Interestingly, several sources of these interlinkages (e.g. associated with agency problems) had been analyzed *in the context of developing countries* fifteen years *before* the formulation of the Washington consensus. [12] [13]

Ignoring distributional concerns meant that sometimes even improvements in efficiency were compromised For instance, land reform which would have reduced the scope for (and inefficiencies associated with) agency problems in tenancy would have simultaneously improved equity and efficiency. Sharecropping, a prevalent form of land tenancy in developing countries, results in an effective tax rate on some of the poorest people in the world of 50%--and in some cases of 66 2/3%. It is ironical that while the IMF and the advocates of the Washington Consensus often railed against the distortions arising from high tax rates, land reform, which should have been even more important, was seemingly not high on the agenda.

The Washington Consensus represented an advance in one respect over earlier approaches to development, which saw developed and less developed countries differing largely in their *resources*. That was why a 'bank' was put at the center of the world's

[11] See in particular the discussion in Stiglitz, J.E., *Whither Socialism?* [1994] Cambridge, MA: MIT Press.

[12] See, e.g. Stiglitz, J.E. [1974] "Alternative Theories of Wage Determination and Unemployment in L.D.C.'s: The Labor Turnover Model," *Quarterly Journal of Economics*, 88(2), May, 194-227. Subsequently published in *Development Economics*, 1, D. Lal (ed.), Elgar, 1992, 288-321.

[13] There are other connections. Capital constraints may limit access to education, implying that many individuals' full potential is never realized. See, e.g. Birdsall, N. [1999] "Education: The People's Asset" CSED Working Paper No. 5, September. Large inequalities may give rise to social tensions, and are even systematically associated with civil strife. See, e.g. Deininger, K. [2003] "Causes and Consequences of Civil Strife: Micro-Level Evidence from Uganda." World Bank Working Paper No. 3045, May. Also, civil strife has a very negative effect on growth.

efforts to promote development—it would make more resources available. Interestingly, the creation of the World Bank (as well as the IMF) reflected a recognition of the importance of market failures. If the neoclassical model *were* correct, the shortage of capital would be reflected in higher returns to capital, and private markets would ensure the flow of capital from the capital rich advanced industrial countries to the capital poor developing world. But particularly at the time of the founding of the World Bank, such flows were limited; and even in the temporary hey day of capital flows, the mid 90s, before the global financial crisis, the funds went mostly to a limited number of countries, and for limited types of investment. Many countries seemingly faced credit constraints.[14] (It was in this sense ironical that international institutions founded in recognition of a market failure should premise so much of their analysis on models which paid insufficient attention to these failures.)

By the early 80s, however, it was recognized that projects were not enough. The Washington Consensus thus focused on *policies.* When the Washington policies failed, it was argued, as we have noted, that these policies needed to be supplemented with additional policies, the Washington consensus plus. What was added depended on the criticism that was being leveled, on the nature of the failure that was being recognized. When growth failed to materialize, 'second generation reforms, including competition polices to accompany privatizations of natural monopolies, were added. When problems of equity were noted, the plus included female education or improved safety nets.

When all of these versions of the Washington consensus plus too failed to do the trick, a new layer of reforms was added: one had to go beyond projects and policies to institutions, including *public institutions*, and their governance.

In some ways, this represented a more fundamental change in perspectives, but in other ways it was a continuation of the same mindset. Government had long been seen as the problem, markets as the solution. the questions should have been, what can we do to improve the efficiency of *both* markets and the government, what is the right balance between the market and government, and how should that balance change over time, as markets improve and the competencies of governments change. Rather than asking these questions, the Washington Consensus had ignored market failures, viewed government as the problem, and proposed massive scale backs in government. Belatedly, it recognized the need to improve government, and that many of the countries where development was not proceeding suffered not from too much government but from too little—the failed states. But there remained a lack of balance. For instance, rather than asking, could public pension systems be strengthened, attention continued to be placed on privatization; when the deficiencies in private pension schemes were noted (their higher administrative costs, problems of adverse selection, the failure to insulate old age pensioners against risks of market volatility or inflation, the difficulty of preventing fraud), the problems were ignored, or attempts were made to address the *market failures*, but it was simply assumed that it would be easier to make markets work than to make public institutions work.

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[14] See, e.g. Eaton, J. and Gerzovitz, M. [1981] "Debt with Potential Repudiation: Theoretical and Empirical Analysis," *Review of Economic Studies*, 48, 289-309.

Nor was the link between policies and institutions—or institutions and society—adequately recognized. Countries were told to have good institutions, examples of good institutions were exhibited, but there was little to say about how such institutions were to be created. It was easy to instruct countries on good policies—simply cut the budget deficit. But an injunction to have honest institutions didn't take one very far. Just as there was controversy about what was meant by good policies, so too there was controversy about what was meant by good institutions. Countries were told to be democratic, but there is no subject of greater concern to the citizens of most developing countries than their economic performance and they were told that one central ingredient, monetary policy, was too important to be trusted to democratic processes. As part of the conditionality imposed to get loans, countries were given short deadlines to reform social security programs or to privatize or change the charter of their central banks, to engage in reforms that the democracies of many advanced industrial countries had rejected. There was a failure to recognize that in issuing such demands, public institutions were put into an impossible bind: if they failed to comply, they lost credibility, as they were accused of not doing what was right for their country; if the acceded to the demands, they lost credibility, as they appeared to be simply following the orders of the new colonial masters. When the reforms failed to deliver on the promises—as happened in country after country—the governments again lost credibility. The weaknesses in public institutions were thus caused in part by the Washington institutions.

There were other important instances of policies interacting with institutions. High interest rate policies in Russia (and the failure to create viable financial institutions to supply credit to new and expanding enterprises) made asset stripping more attractive than wealth creation; and weakened support for the creation of the kind of rule of law that would have facilitated wealth creation.[15]

Thus, even as the Washington consensus began to expand the list of what was to be done, its perspectives remained too narrow. Broader goals and still more instruments were required. A more fundamental change in mindset was needed.

The problem was illustrated by the confusions too between ends and means. Privatization and liberalization were often taken as ends in themselves, rather than as means. In doing so, ultimate development objectives were compromised. The pursuit of rapid privatization in the former Soviet Union contributed to the enormous increase in inequality, compromising the legitimacy of private rights, at least those acquired in the privatization process, and perhaps even of the market system. Excessively tight monetary policy led to the growth of barter, equally undermining of market efficiency as inflation. Capital market liberalization did not lead to faster economic growth, but did lead to more instability.

[15] See, e.g. Hoff, K. and J.E. Stiglitz [2004] "After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-Communist Societies", *American Economic Review* 94 (3), June 2004, 753-763.

Some elements of an emerging consensus

So far, I have described several elements of an emerging consensus – or at least, a broadly shared view – about the inadequacies of the Washington consensus.

Pushing the analysis back one step further, there is also a consensus about two of the underlying problems: excessive belief in market fundamentalism; and international economic institutions which have created unfair rules of the game and which have foisted the failed policies, particularly on developing countries which are dependent on them and donors for assistance. While many of the policies of the developing countries have themselves contributed to their own failure, the difficulties of development need to be recognized: tilting the playing board against them makes their task all the more difficult, even for an honest and committed government.

I have written extensively elsewhere on what accounted for these failures, the role of honest differences in economic analysis, in the interpretation of statistical evidence and the historical experiences, versus the role of ideology and special interests. In recent years, the economics profession has paid more attention to institutions, the incentives confronting the institutions and those within the institutions, and the relationships between governance, organization design, and organization behavior. Such analyses have provided insights into the behavior of the IMF and the WTO.[16] Of concern is not only what has been done, but what has not been done—for instance, the failure to address the problems posed by the international reserve system, sovereign defaults, and the inadequacy of system of sharing the risks of interest rate and exchange rate fluctuations between developed and less developed countries.

There are several more elements of a post-Washington consensus. The first is that a successful development strategy cannot be arrived at simply within the confines of Washington. It will have to involve those in the developing world in an important and meaningful way.

The second is that one size fits all policies are doomed to failure. Policies that work in one country may not work in others. Indeed, even as the contrast between the success of the East Asian economies—which did *not* follow the Washington consensus—and those that did becomes increasingly clear, there remains the question, to what extent can the policies which worked so well there be *transferred* to other countries.

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[16] See for instance, Stiglitz, J. E. [2001] "The Role of International Financial Institutions in the Current Global Economy," Chapter 5 in *The Rebel Within*, Ha-Joon Chang (ed.), London: Wimbledon Publishing Company, 2001, pp. 172-193. (Originally Address to the Chicago Council on Foreign Relations, Chicago, February 27, 1998.)

[17] Finally, in March of 2003, even the IMF recognized these problems—almost six years after it had tried to change its charter to force developing countries to liberalize their capital markets. It remains uncertain, however, the extent to which these findings have altered the policy prescriptions that it gives at the country level. See, for instance, Prasad, E., Rogoff, K.,Wei, S., and Kose, A.M. [2003] "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence," IMF Occasional Paper No. 220, September.

A third is that there are some areas in which economic science has not yet provided sufficient evidence, sufficiently strong theory, or empirical evidence, to result in a broad consensus about what countries should do. There may be a broad consensus against 'excessive protectionism' that only serves the interests of special interests; but there is no consensus that rapid liberalization, especially in a country with high unemployment, will lead to faster economic growth. It may only lead to more unemployment. The usual argument that liberalization frees resources to move from unproductive protected sectors into more productive export sectors is unconvincing, when there are ample unutilized resources already available. In these cases, there is an emerging consensus: countries should be given scope to experiment, to use their own judgment, to explore what might work best for them.

Though it may not be possible to formulate simple prescriptions applicable to all countries, there may still be some principles, and a range of instruments, to be adapted to the circumstances of each country. This conference provides us an opportunity to explore some of the possible principles, some of the possible reforms, both in the policies pursued by individual countries and by the global community.

As we approach each of the questions, I hope that we can do so without resorting to the clichés, the conventional wisdoms that are so often not well grounded either in theory or evidence, that have dominated discussions in these areas for so long.

We shall be addressing two broad sets of issues: First, What can each country, on its own, do to enhance sustainable, stable, equitable, and democratic development? As the developing countries approach this problem, they must take the world as it is, with the inequities in the global trading system and the instabilities in the global financial system. But that brings us to the second question: How should the global economic architecture be changed, to make the global economy more stable, to promote equity among countries, and to enhance the ability of developing countries to pursue their objectives—and especially the goals of sustainable, stable, equitable and democratic development? While we cannot, in the short space of the next two days, even touch upon all the facets of this question, we can discuss, or at least touch upon, a few of the central reforms, including, or especially, reforms in global governance.

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