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Institutional Arrangements and Economic Growth

Ladies and Gentlemen,

Dear colleagues,

It is a great pleasure for me to take part in this session on the interactions between institutional arrangements and economic growth. According to the typology developed by Arvind Subramanian and Dani Rodrick, the scope of analysis is wide, as it encompasses market creating institutions, which safeguard property rights and ensure that contracts are enforced, market legitimizing institutions, which provide social welfare and insurance, organise redistribution and manage conflict, and market regulating and stabilising institutions.

This scope of analysis is obviously very important and a large body of recent empirical studies supports the theory, developed in particular by Douglass North, a Noble Prize Laureate in Economics, that institutions are vital for economic growth and that differences in the quality of these institutions contribute to explaining development gaps on account of their effect on the functioning of markets. On the product market, they may determine the degree of competitive pressure and innovation efforts. On the labour market, they may influence reorganisations as well as inflows and outflows. Via financial markets, they have an impact on capital allocation and the financing of investment and growth.

It is therefore not surprising that the role of institutions is prominent in the analysis of the causes of the financial crisis and of its extremely high cost in terms of economic growth and in the lessons that are being drawn from the recent disruptions of the financial system. The G20 Heads of State and Government have included their reform among the actions to be taken to reach the objective they set themselves at the Pittsburgh Summit of restoring strong, sustainable and balanced growth.

Discussions on the scope and terms of this reform are already well underway and I would just like to make a few comments on:

1- The most important reforms
2- The conditions that need to be met to ensure their success
3- The scope and the limitations of the reforms being carried out in Europe

As a central banker and given my speaking time, I will principally comment on the reforms to be conducted relative to the institutions in charge of regulating and stabilising markets.

1. Prioritizing important reforms

1.1. To promote the definition and implementation of crisis prevention and management tools in an economic and financial system characterised by growing interdependencies between its players, the G20 Heads of State and Government rightly stressed, both at the London and Pittsburgh summits, the importance of carrying out institutional reforms that would meet the following three objectives:

- strengthen the multilateral bodies charged with the definition of financial regulations and the macroprudential supervision of the financial system

- set up in the framework of the G20 a multilateral surveillance and coordination mechanism of macroeconomic policies
- enhance the legitimacy, the role and the resources of institutions such as the IMF, which play a pivotal role in the international financial architecture.

1.2. However, the objective of restoring strong, sustainable and balanced growth should also lead to institutional changes at the national level. Naturally, these changes should aim at incorporating into the regulatory frameworks the macroprudential supervision of the national financial system, the importance of which has clearly been brought to the fore by the crisis. They should also, in the light of the current discussions on the consequences of the crisis for long-term growth prospects, aim at reforming institutions that are a source of rigidity in the functioning of the labour, product and services markets and are thus likely to hamper the growth potential of economies.

1.3. Is it possible to define a priori a target and a reference strategy for conducting these reforms, irrespective of the level of development of a particular economy? I will not try and settle this old debate here. I would only like to point out that the influence that institutions have on the functioning of markets also depends on other factors, such as the timeframe considered and the shocks that affect the economy.

1.4. As regards the labour market for instance, it is generally acknowledged that rigid institutions have a negative impact in the long term. In the short term, however, the strong rigidities in redundancy rules result in a smaller decline in employment and, consequently, a smaller increase in unemployment when economic conditions deteriorate. Similarly, these same rigidities lead to a more moderate increase in employment and a slighter decrease in unemployment when conditions improve.

1.5. Academic research also shows that the impact of institutions may depend on the shocks that affect the economy. The same institutions may be equipped for dealing with certain shocks and not with others[1]. Sargent and Ljungqvist, for example, show that when human capital is stable (low degree of depreciation, this is typically the case before the 1970s), the European welfare system is conducive to low unemployment. In a different technological context, these same institutions contribute to a surge in unemployment.

1.6. From these observations, it can be concluded that the desirable institutions are significantly influenced by contextual specificities. This would explain why some developing countries have achieved good results in terms of growth, by combining conventional and unconventional institutional policies, like in China for example. However, research and experience have shown the importance of at least having institutions that safeguard property rights and the enforcement of contracts, on which the very existence of markets depends, and institutions that contribute to ensuring their stability, such as independent central banks. In addition, the crisis raises the question of the sustainability for global economic growth and the reduction of development gaps of overly different choices in terms of institutions designed to ensure market stability. Recent experience shows that the asymmetries that stem from these differences in terms of financial system development, contribution of exports to growth and levels of social welfare and insurance, fuel imbalances in demand, savings and investment that may lead to major systemic crises.

[1] [Blanchard and Wolfers (2000), Sargent and Ljungqvist (1998, 2007)]

2. The conditions for success

2.1. The impetus and support provided by the G20 Heads of State and Government represent a key factor for the success of the institutional reforms launched at the international level. However, to be effective, these reforms will require strong coordination within the international financial institutions, greater interinstitutional cooperation between the IMF, the Financial Stability Council, the World Bank, the BIS and the international standard-setting committees, and a strong discipline in the implementation at the national level of the recommendations issued at the international level.

2.2. In this respect, I would like to stress the following two points:

- First, as regards macroeconomic policy coordination, the *Framework for Strong, Sustainable and Balanced Growth*, which was adopted in principle at the Pittsburgh Summit and which is due to be fleshed out by the G20 Ministers of Finance and Governors at their next meeting in November, is expected to play an important role.
- Second, as regards coordination for the strengthening of financial system regulation, the commitments made to implement Basel II by 2011 should be properly carried out and the major projects that have been identified as essential should be pursued and completed. These include, in particular, the overhaul in 2010 of capital requirements to improve their quantity and quality, the convergence of accounting standards by June 2011 and the debate on a leverage ratio, which should only be introduced as a supplementary tool if it is comparable across financial centres.

2.3. At the national level, the conditions for success of the institutional reforms are certainly more complex. They depend on the combination of several factors: structural factors with social, political and cultural dimensions specific to each country and cyclical factors that may be relatively transitory

2.4. Economic literature, for instance, particularly highlights the strong influence of legal traditions on the institutional architecture and the importance of regulatory law, by making a distinction, for example, between common law countries and civil law countries. In common law countries, institutions are more of a contractual nature and judges have greater discretionary powers in the resolution of conflicts. In civil law countries, decisions are, to a larger extent, governed by stricter legal codes.

2.5. A country's legal tradition could have an effect on the institutions' ability to adapt to economic changes. Their adaptability is often deemed to be stronger in common law countries.

2.6. However, the fact that a country has a long-standing institutional culture does not necessarily lead to inflexible institutions. Thus, over the past two decades, some research[2] concludes that market rigidities have, on average, increased in common law countries and decreased in civil law countries, reflecting a certain convergence. In addition, I am of the view that in common law countries, the relative weakness of written regulations leads to an inflation in the size of contracts, with adverse consequences in terms of cost of transactions and legal certainty.

2.7. Useful lessons may also be drawn from the reforms carried out in different countries. A recent study by the OECD shows that the reforms for which the

[2] [Danielle Venn (2009)]

government has a clear electoral mandate are those which are the most likely to succeed. This is borne out by the fact that these reforms are preceded by a lengthy communication campaign emphasising the costs that would result from a status quo. Governmental cohesion and the involvement of social partners in the implementation of these reforms are also key ingredients for success.

3. The scope and the limitations of the reforms being carried out in Europe

3.1. In Europe, the crisis has given considerable impetus to institutional changes mainly in the field of financial system regulation in order, in particular, to integrate macroprudential supervision into the public supervisory architecture. However, this integration raises several important questions as to its implementation:

- First, what body should be charged with macroprudential supervision? Should this body be independent or not?
- Second, how should the macroprudential assessment be transmitted to the microprudential regulatory and supervisory authorities to make sure it results in appropriate measures?

In the European Union, these issues are complicated by the need to ensure a robust and integrated framework for all EU countries.

3.2. On the first point, the EU has decided to entrust macroprudential supervision to a European Systemic Risk Council (ESRC), in which central banks will play a prominent role. There are indeed very good reasons to entrust this responsibility principally to central banks: they have an advantage in terms of information and an incentive to act as macroprudential supervision tends to reduce the burden on monetary policy and as they need the financial system to function smoothly in order to ensure an effective transmission of monetary policy to the real economy.

3.3. On the second point, the stance taken by the EU is to entrust the ESRC with the task of providing warning of systemic risks and making recommendations. The recommendations of the ESRC will not be legally binding, but given the moral authority of its members and the obligation for recipients to react, they should naturally lead to the implementation of the necessary corrective measures. On this basis, a draft regulation of the European Parliament and of the Council is currently under discussion. It should result in the implementation of a new operational framework in 2010.

3.4. However, the institutional reforms that should contribute to limiting the impact of major shocks, like those that have recently affected our economic and financial systems on our growth potential, have made less progress. Nevertheless, in the framework of the Lisbon strategy, introduced in 2000 and relaunched in 2005, significant efforts have been made and need to be further developed to reach ambitious goals in terms of employment rates and research and development. In particular reaching these objectives implies that public finances be consolidated, in an in-depth manner given that the crisis has made considerable inroads into public finances. It also requires better regulations, adequate social and tax systems, improved education and training and tighter competition.

In conclusion, I would like to stress that in the strategy that we should adopt to restore strong, sustainable and more balanced growth, it is necessary to reform a certain number of our institutions at the national and international levels. We should welcome the fact that considerable efforts have already been made in this respect. One of the most encouraging signs is that the G20 has been entrusted with the leadership of the governance of the global economic and financial system. It is important that these efforts do not slacken as economic and financial activity returns to normalcy.