Institutions and Economic Development

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Summary

- Institutions—the rules of the game in economic, political and social interactions (North, 1990)—affect <u>long-run</u> development outcomes:
  - Growth
  - Macroeconomic stability
- But this has led to growth strategies, focusing on institutional and governance reform ("Washington Consensus Plus")
- And inadequate attention to: what if scope for institutional reform in the short to medium run is limited? The Case of Financial Globalization
- Need more modesty and realism on the former, and more seriousness and creativity on the latter

Introduction and Definition

- Institutions:
  - are humanly devised
  - set constraints
  - shape incentives

- Different ways of slicing institutions
  - Political/economic
  - Broad/narrow
  - Formal/informal

Introduction and (Functional) Definition

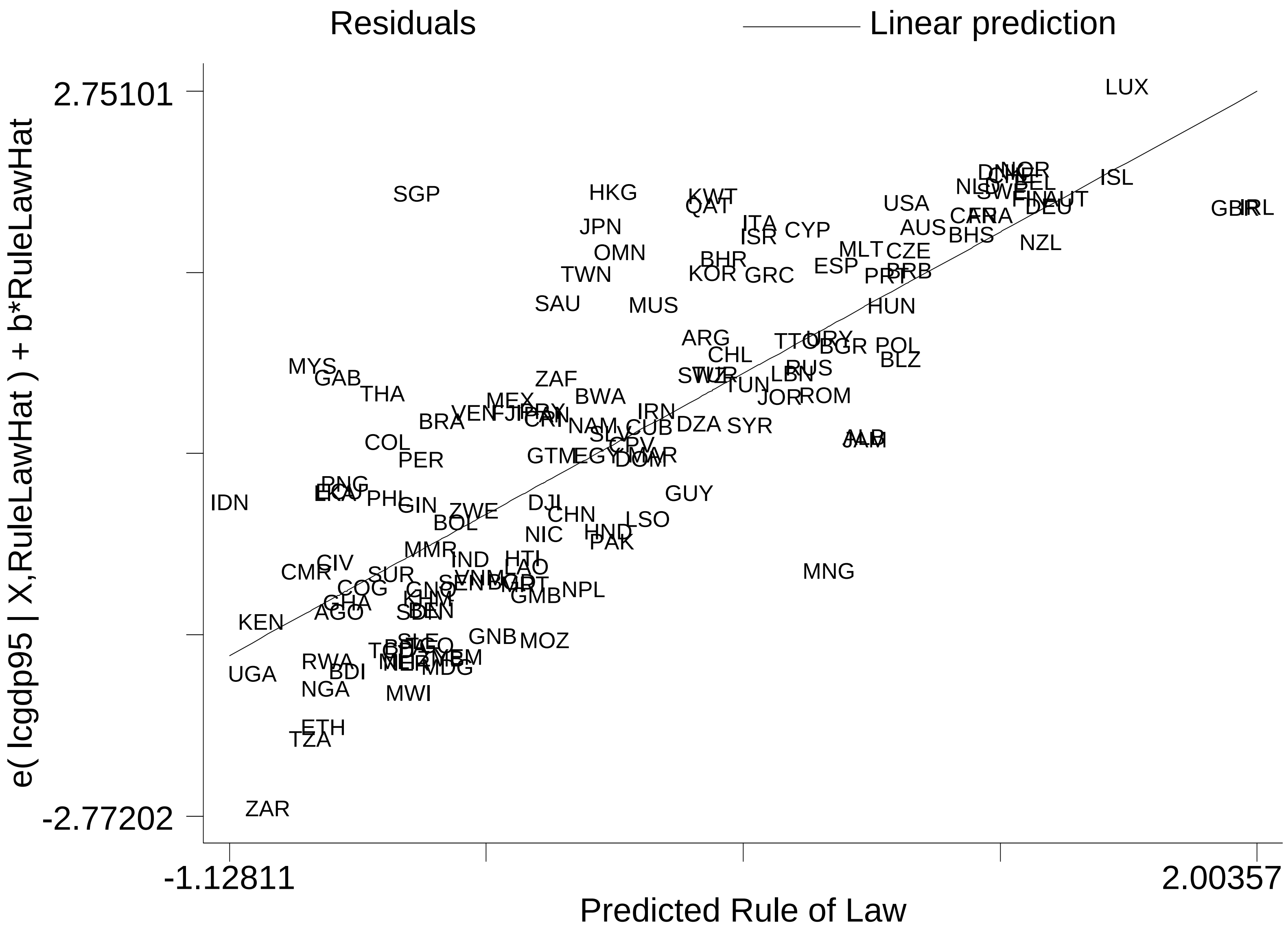
- Market-creating
  - Order/rule of law (Hobbesian state)
  - Property rights protection ; Contract enforcement
- Market-legitimizing
  - Social protection and insurance
  - Democracy
- Market-substituting/regulating
  - Market failures (anti-monopoly; finance)
  - Essential services (health, education)
- Market-stabilizing
  - Central banks; financial regulation
  - Fiscal rules
- The Crisis and institutions: Coupled economies, decoupled debate

Institutions and Long-Run Income

- *Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.* Adam Smith, Wealth of Nations

- Institutions are a key determinant of long-run income level (Acemoglu, Johnson and Robinson, 2001; Rodrik, Subramanian and Trebbi, 2004)

Institutions and Long-Run Income



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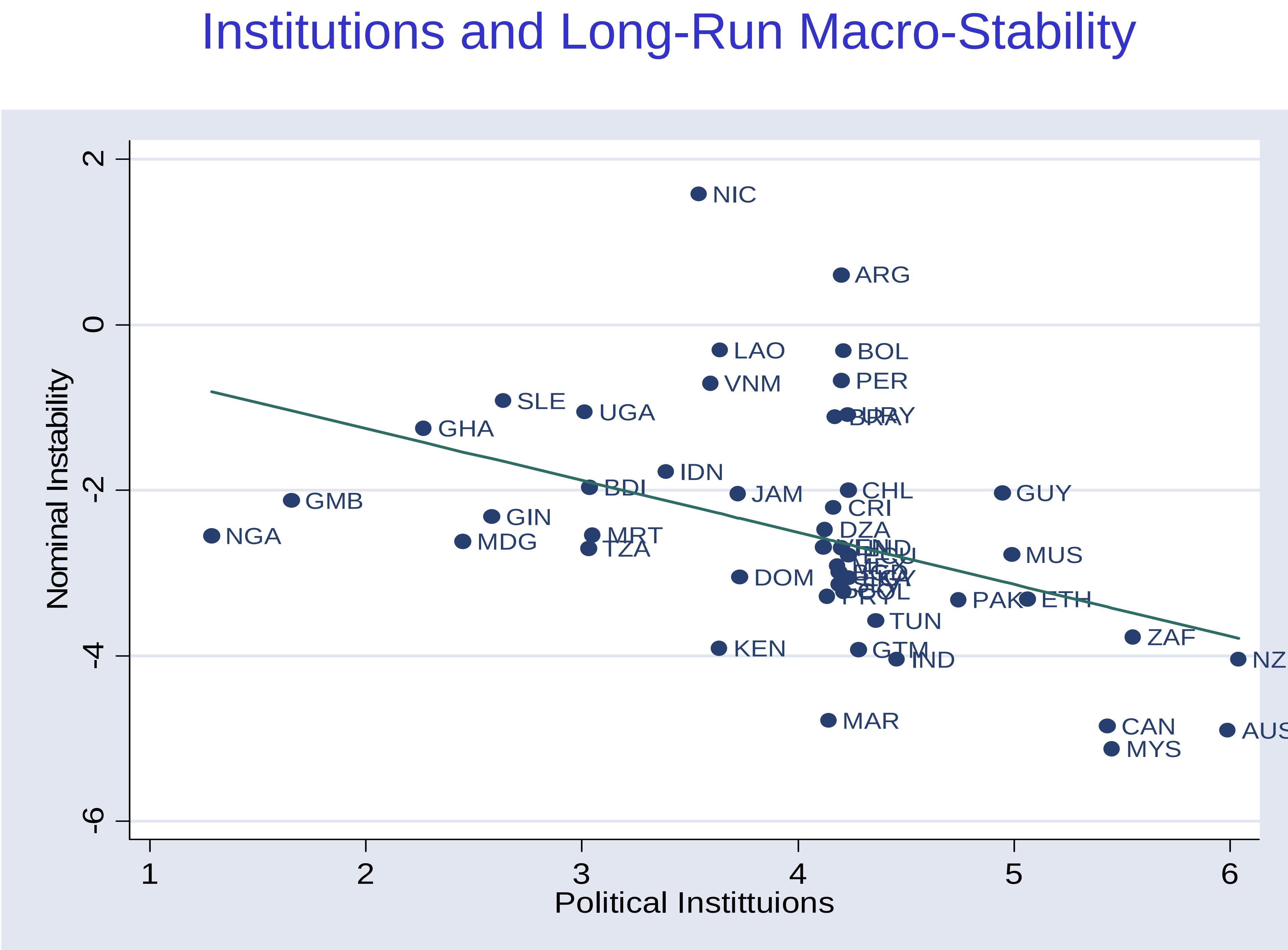
Institutions and Long-Run Macro-Stability

- *"It has long been obvious that the roots of inflation ..lie deep in the social and political structure in general and in social and political conflict and conflict management in particular*." (Hirschman, 1985)

- Inflation's proximate causes (excessive increase in money supply) distinct from the "deeper" social causes (Milton Friedman in Seldon, 1975).

- Nearly all nominal pathologies (inflation, exchange rate instability, fiscal procyclicality, fiscal volatility; original sin) may have deep institutional causes (Acemoglu, Johnson et. al. 2004; Satyanath and Subramanian, 2008).



Institutions and Long-Run Macro-Stability
Nominal Instability
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Strong Institutions and Growth Strategy

- But “improve institutions” does not make for a growth strategy for a new “Washington Consensus . Why?

- 1. Good institutions neither necessary nor sufficient for growth over shorter horizons
  - Strong performers with weak institutions in recent history (China, Bangladesh, Vietnam, Lao PDR) and in earlier episodes (Singapore, Taiwan, Malaysia, Indonesia)

  - Weak performers with strong institutions (South Africa)

Sustained Growth Transitions Do not Require Strong Institutions

Sustained Growers and the Initial Quality of Institutions					
			Political Institutions	Economic Institutions	Economic Institutions
	Year T	Real Per Capita GDP Growth (Constant 2000, WDI)	Constraint on the Executive 1/	Control of Corruption 2/	Degree of Administrative Efficiency 3/
Chile	1986	4.4	1.0	3.8	80
China,P.R.: Mainland	1978	8.5	3.0	2.0	n.a.
Dominican Republic	1969	3.2	3.0	3.3	10
Egypt	1976	3.4	3.0	2.1	80
Indonesia	1967	4.2	2.0	3.0	10
Korea	1962	5.8	1.0	5.0	40
Malaysia	1970	4.1	3.0	4.0	n.a.
Singapore	1969	5.5	3.0	4.0	n.a.
Taiwan Province of China	1961	6.8	2.0	4.0	80
Thailand	1960	4.6	1.0	3.0	40
Tunisia	1968	3.3	1.0	3.0	80
Vietnam	1985	4.9	3.0	3.0	40
Average	...	4.9	**2.2**	**3.4**	**51.1**

Source: Johnson, Ostry and Subramanian (2010).

1/ Data refer to the period T. Score ranges from 1 to 7. The higher the score the more the constraints on the executive.

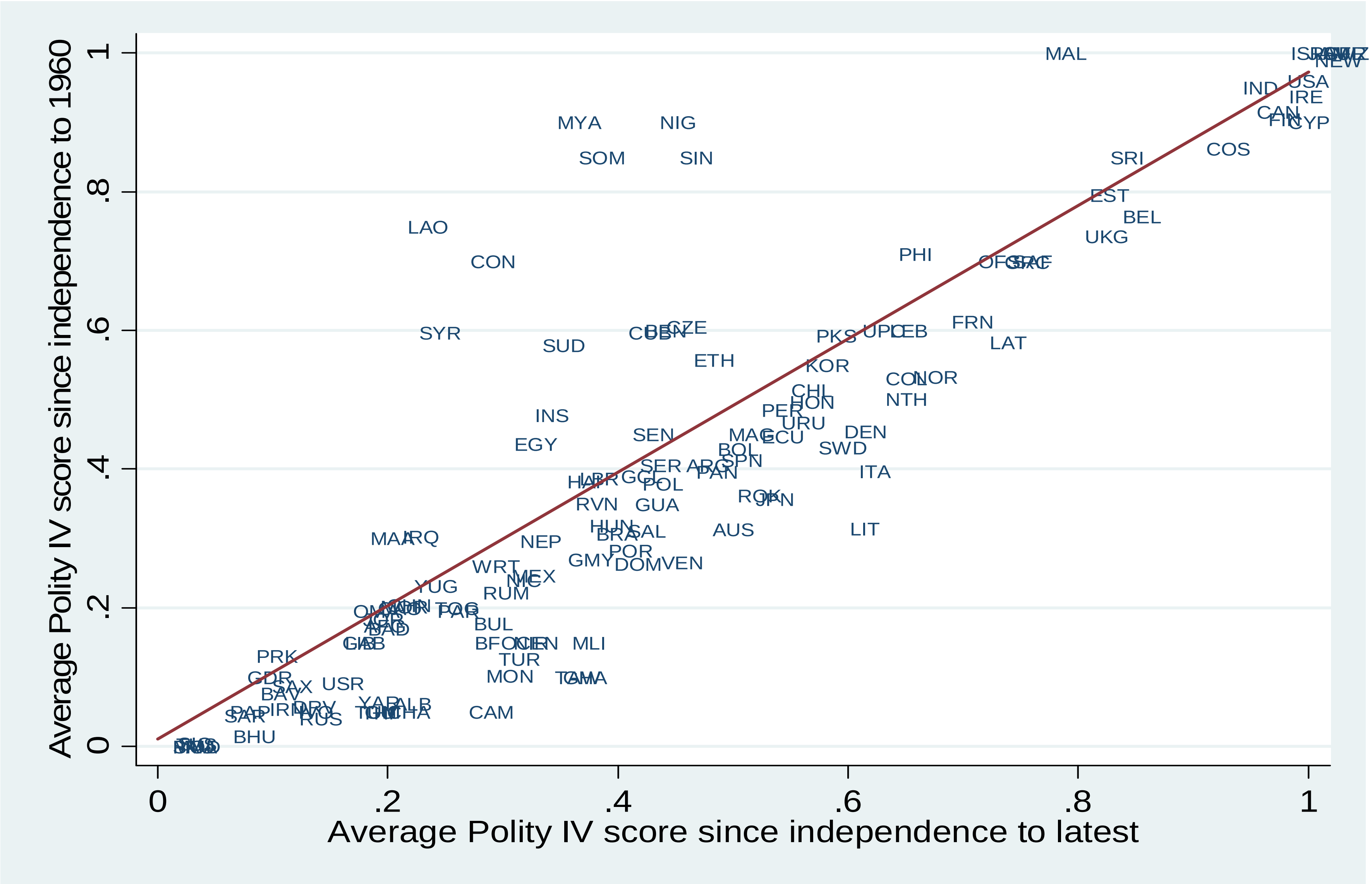
2/ Data refer to the mid-1990s (1996). Score ranges from 1 to 6. The higher the score the less the corruption.

3/ Data are from Adelman and Morris (1971) and refer to the period 1958-63. Score ranges from 0-100

Strong Institutions and Growth Strategy (contd.)

- 2. Uncertainty of action and consequence
  - – Which institutions and how? Bureaucracy, legal system, corruption
  - – Form versus function?
    - Good function but form: http://www.youtube.com/watch?v=eC4BN9kInXg
    - Good form but poor function: http://www.youtube.com/watch?v=H2JFL1Sk21Y
  - – See-saw effect: Changing institutions or policies may have limited impact because of policy substitution (e,g. anti-corruption bodies; controlling inflation via independent central banks may just lead to other forms of re-distribution—fiscal)
- 3. Feasibility of change: Institutions have historical roots and represent distribution of political and economic power and hence persistent (financial sector regulation in the US)

Institutions are Persistent



Institutions do Change

- Persistence is not immutability

- Institutions do change and some are even the consequence of “agency” and policy choice: Mexico and WTO/NAFTA

- But most of the big institutional changes are due to war, internal conflict, political upheavals, and technological shocks because persistent changes have to affect the underlying distribution of economic and political power in societies

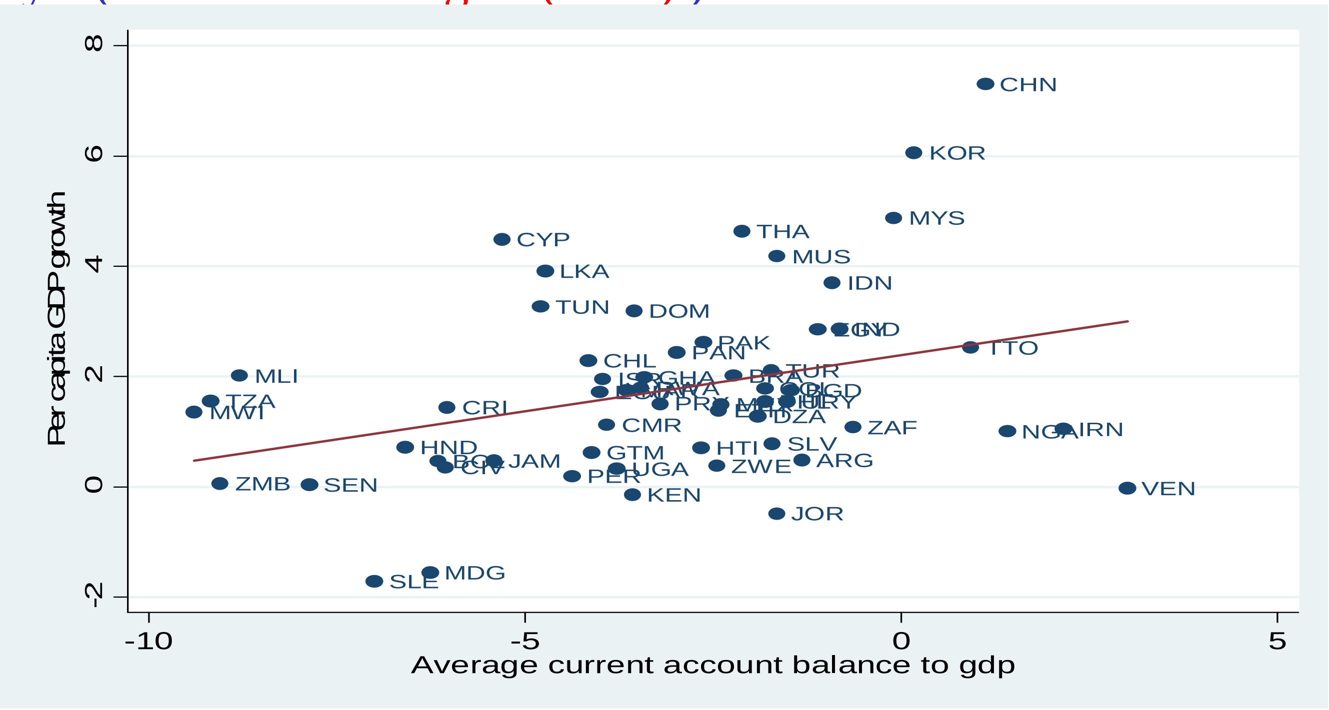
- Need modesty and realism for any agenda of institutional reform

The IMF and Case of Financial Globalization

- Pre-Asian Financial Crisis: Strong push for capital account liberalization

- The evidence: Financial globalization, especially non-FDI flows, has no effect on long run economic growth (Kose, Rogoff et. al. 2006) or possibly even negative Prasad, Rajan and Subramanian, 2008 and Gourinchas and Jeanne, 2007)

- "Periods of high international capital mobility have repeatedly produced international banking crises, not only famously as they did in the 1990s, but historically." (Reinhart and Rogoff (2008))



The IMF and Case of Financial Globalization

- Post-Asian Financial Crisis: From aggressive advocacy <u>not</u> to "caution about foreign capital" but to "do the complementary institutional reform" to benefit from financial globalization.

- Complementary institutional reform: legal system; corporate governance etc etc.

- Condition of underdevelopment is limited ability to do these reforms. What if "complementary institutional reform" cannot be easily implemented?

- Under what circumstances is it desirable to limit capital inflows? Best ways of achieving it? Price-based or quantity-based measures? to limit such flows? Which flows—debt or portfolio? Over what duration are limits most effective? When should they be withdrawn?

- We know little about these questions because of the easy and convenient but misleading invocation of "improve institutions" mantra. Eastern Europe in 2008 may be the consequence

Lessons

- Good and insightful academic research can easily lead to false turns and misleading policy prescriptions

- Developing countries don't need the advice of "improve institutions" but more guidance on "What if we cannot do so?"

- Global financial crisis has highlighted need to take the latter question seriously

- We will know IMF and others are taking it seriously when we see IMF providing sensible advice on counter-cyclical management of capital flows