Building Better Institutions

Rodrigo de Rato

It is a pleasure to be here today at the Cato Institute. I know that Cato believes in competition. Perhaps it is this spirit of competition that led you to schedule today's conference to coincide with the International Monetary Fund's research conference and steal the IMF's managing director and its current and past directors of research as participants. But while you have missed out on our research conference you will not miss out on our research: my talk today is based to a large extent on the findings of our latest World Economic Outlook, which conveniently has the theme "Building Institutions" [IMF 2005a].

My remarks address three questions. First, what have we learned about the importance of institutions in promoting economic development? Second, how we can accelerate the transition to better institutions? And, third, what reforms of international organizations, the IMF in particular, are needed to help this transition?

The Importance of Institutions

Let me begin with what we have learned about the importance of good institutions. By good institutions, I mean the adoption of policy frameworks in which there is acceptance of several broad principles:

- First, the private sector is recognized as the main actor on the economic stage, with the state stepping in to provide appropriate regulation of markets.
- Second, there is a commitment to protecting property rights and creating an environment where innovation can thrive.

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- Third, the rule of law prevails, and corruption is not tolerated in either the public or private arenas.
- And, fourth, there is a stable macroeconomic environment, reflected in low inflation and a sustainable fiscal position.

All this sounds to us today like common sense. But it is the evidence that has accumulated over the last few decades that has led to universal acceptance of these propositions. Forty years ago, with the Soviet Union still standing, many countries were tempted to give the state control over the commanding heights of the economy. That is not the case today.

It took a resurgence of interest among economists in the 1960s and 1970s to improve our understanding of how vested interests block economic growth. One of those economists was my colleague Anne Krueger who coined the term "rent seeking" in a famous paper published in 1974.

Attitudes toward corruption were also different then. In many countries, corruption was not just tolerated but almost welcomed as necessary to grease the wheels of commerce. Today, these same countries are engaged in a difficult but necessary battle to eliminate corruption.

Finally, the idea of seeking salvation through inflation has also been abandoned in recent decades. In the 1960s inflation was tolerated in the belief that it helped lower unemployment. Inflating one's way out of trouble was politically tempting for governments around the world and was regarded as imposing relatively few long-term economic costs. Indeed, as late as the early 1990s, annual inflation averaged more than 40 percent in Africa and more than 200 percent in Latin America, compared with the single-digit rates in both regions today. Clearly, attitudes and institutional frameworks have changed, as reflected in the sharp decline in inflation rates all over the globe and the independence of central banks.

It is not easy to quantify these changes in attitudes but it can be done. By combining information of the prevalence of the rule of law, the extent of regulatory burdens, the degree of corruption, the independence of central banks, and so on, one can create indexes of the quality of institutions. The work by IMF staff on the role of institutions relies quite heavily on these indexes, particularly the index of economic freedom published by the Fraser Institute in Canada in conjunction with the Cato Institute and other think tanks worldwide (see Gwartney and Lawson 2005).

How much does improving the quality of institutions contribute to economic development? The results of the IMF's research on this

question are quite striking. For instance, suppose that average institutional quality in Africa could be raised to the level currently prevailing in developing Asia. We estimate that this would be associated with almost a doubling of per capita GDP in Africa over the long term—that is, from about $800 to more than $1,400 a year. And, likewise, incomes in developing Asia would roughly double if their institutions could be strengthened to around the average of all countries [IMF 2005a].

It is not only developing countries that stand to gain from improving their institutions. Advanced nations too need to constantly mold their institutions to changing conditions, and they can learn from each other. One example is in the case of labor market institutions. In the 1960s, European unemployment rates were about 2 percent, much lower than that in the United States. This difference was a source of great discomfort to U.S. presidents and policymakers at that time.

Since then, of course, there has been a reversal of fortunes. While the United States has been able to maintain reasonably low average rates of unemployment, many countries in the euro area have been experiencing high and remarkably persistent unemployment rates since the mid-1970s. There is no doubt that the labor market institutions that Europe adopted—generous unemployment insurance, strict employment protection, and high labor taxation—have contributed to this state of affairs. There is a need for greater flexibility in labor markets than institutions in many European countries are able to deliver. Our staff's estimates suggest that the adoption of more flexible labor market institutions in the euro area would lead to a reduction in unemployment rates by about 3 percentage points and bring about output gains of more than 5 percent [IMF 2003].

Building Better Institutions

If institutions are so important for growth, it is natural to ask if they can be changed and how? This brings me to the second question I posed at the outset: How can we accelerate the transition to better institutions?

Often there is pessimism about the ability to change institutions. It is said that institutions are largely the result of a country's history and culture, and are therefore almost impossible to change quickly. But the evidence shows that rapid institutional improvement is indeed possible. Research reported in our *World Economic Outlook* (IMF 2005a) documents 65 transitions to better economic institutions in developing countries in the last three decades. Encouragingly, about

one quarter of these transitions have occurred in Africa, demonstrating that progress is possible even in the poorest countries. And these transitions have led to significant increases in growth.

Many different institutional forms can deliver good outcomes. Consequently, reform efforts need to be country specific and recognize that the appropriate design of institutions may change over time. For instance, China benefited from the creation of township and village enterprises as a transitional institution toward full-fledged private ownership. In contrast, many Central and Eastern European countries found it possible to adopt complete private ownership from the very onset of reforms.

What factors accelerate the pace of institutional improvement? One important factor is greater openness to international trade. By fostering greater competition, openness to foreign trade reduces the power of vested interests opposed to reform. But international trade is not the only external factor that can spur institutional progress. It can also be through the use of external anchors, including multinational agreements and constraints. A clear example of this is the European Union accession process, which encouraged institutional reform in Central and Eastern Europe. Likewise, membership in the World Trade Organization has contributed to reform efforts in China and elsewhere.

Another factor is the quality of the country's neighborhood. Countries are more likely to experience institutional development if their neighbors have higher institutional quality. Now what policy implications can we draw from this finding? People can move in and out of neighborhoods, capital can move in search of higher returns, but countries cannot relocate to a better region. Nevertheless, countries in a region can get together and make an attempt to improve the quality of their neighborhood. Regional arrangements to monitor and strengthen institutions can create a virtuous cycle of institutional development in a neighborhood. An example is the New Partnership for Africa's Development (NEPAD). It has a Peer Review Mechanism, which—if used actively—could be an effective way to diagnose common institutional weaknesses, and devise and monitor improvements.

Finally, greater transparency spurs institutional development. This should come as no surprise: Transparency helps identify the presence of economic rents in an economy and increases the penalty for rent extraction. In this context, we should be encouraged by the greater attention now being given to transparency. Let me offer three examples.

First, transparency is particularly critical in countries with large natural-resource wealth. The presence of a "pot of gold" can often

have a corrosive effect on institutions by encouraging rent seeking and corrupt behavior. To counter these tendencies, the United Kingdom launched, in 2002, the Extractive Industry Transparency Initiative. This initiative has been helpful in encouraging governments and companies operating in extractive industries to disclose revenues and payments.

Second, the IMF, the World Bank, and other international agencies now often make their support to countries conditional on steps to improve transparency. International support to Uganda for instance was tied to the implementation of public expenditure tracking surveys. This requirement reduced the leakage of per student grants to schools from 90 percent to about 20 percent [IMF 2005a]. Uganda has since adopted the use of such tracking surveys in several other sectors, and the practice has spread to other countries, including Zambia and Peru.

Third, the World Bank, Transparency International (TI), and other organizations have been effective in raising awareness of the level of corruption in various countries. TI's Corruption Perception Index (CPI) has been particularly useful. While levels of corruption remain distressingly high among developing countries, it is encouraging that there are exceptions and that countries are making efforts to battle corruption. Within Africa, TI found that perceptions of corruption are quite low in a number of countries, including Botswana, Tunisia, South Africa, Namibia, and Mauritius. Another positive development is that some countries, despite their still-high CPI, have shown improvements [Transparency International 2005].

Better Monetary Institutions: The Role of Inflation Targeting

Let me turn now to the topic of building better *monetary* institutions—in particular, the increasing use of inflation targeting. New Zealand was the first industrialized country to adopt inflation targeting in the early 1990s, followed by Canada, the United Kingdom, and Sweden. Today some 21 countries can be called "inflation targeters," and only 8 of them belong to the group of industrialized countries. Many other countries are considering inflation targeting.

Recent research by the IMF assesses how inflation targeting has worked in emerging markets by comparing the performance of those targeters with a peer group of nontargeters. In addition to the data on inflation and other indicators, the assessment was based on a detailed survey of 31 central banks [IMF 2005a]. The study found that inflation targeting in nonindustrialized countries was associated

with a 5 percentage point reduction in average inflation. There was also less volatility in inflation: the standard deviation of inflation was reduced by more than 3.5 percentage points. Those benefits were realized without any adverse effects on growth. In addition, not only was inflation less volatile under inflation targeting, but so were interest rates, exchange rates, and international reserves.

Equally important, it does not appear necessary to meet a stringent set of preconditions before adopting inflation targeting. This evidence runs counter to the view that inflation targeting is impractical for many countries because it requires a level of sophistication, a set of preconditions that they simply do not have. Our survey of central banks showed that before the adoption of inflation targeting, all but two of the emerging market prospective adopters were less than half way on the path toward ideal conditions. Mexico and South Africa were just about half way. However, conditions improved dramatically in all countries in the years following the adoption of inflation targeting. Thus, it appears that as long as a country has the commitment and ability to continue reforming after the adoption of inflation targeting, it can succeed. In other words, many countries learn to implement inflation targeting on the job.

Admittedly, inflation targeting is still a very new monetary policy framework and any assessment of its performance has to be considered preliminary. How the framework copes under pressure, such as the kind being exerted at present by the run-up in oil prices, will provide additional evidence of its effectiveness. Nevertheless, based on the evidence to date, inflation targeting appears to be a promising institutional framework that delivers low and stable inflation.

Reforming International Institutions: The IMF's Medium-Term Strategy

Thus far I have focused primarily on improvements in country-level or regional institutions. But international organizations, including the IMF, also need to improve their performance and effectiveness. That is why I recently proposed a medium-term strategy for the IMF [IMF 2005b]. Implementing this strategy would, I believe, help address the third issue I posed at the outset: How can the IMF accelerate the transition to better institutions, particularly in low-income countries?

I am aware that some observers are of the opinion that the IMF ought to get out of the business of supporting low-income countries and turn over those responsibilities to the World Bank. Such a view,

however, ignores the fact that the Fund can help promote the independence of central banks, strengthen monetary authorities' capacity to regulate banks, and improve tax administration and the budgetary process. All these are crucial institutional aspects of the reform process in these countries, and areas in which the technical assistance offered by the IMF makes an important contribution.

Low-income countries often also need sustained financial support from the Fund, which we provide on concessional terms through our Poverty Reduction and Growth Facility (PRGF). In fact, we have only recently taken some initiatives to tailor our lending arrangements to the evolving needs of low-income countries. We are in the process of expanding the scope of the PRGF to provide occasional access to concessional financing for countries to overcome the adverse effects of specific shocks. And for countries that need a signal of the IMF's assessment of their policies more than they do access to our credit, we established a new Policy Support Instrument. Nigeria has already taken advantage of this new instrument.

But while I do not believe in abandoning our work in developing countries, I would agree that our work there could be improved in a number of respects. First, I am concerned that the Fund's work on low-income countries is overloaded with procedures that absorb substantial resources but yield questionable gains. Our work must be streamlined. Second, there may be scope for changes in the allocation of work between the IMF and the World Bank in our efforts to assist low-income countries. Third, our Article IV consultation provides a well-established mechanism for regular consultation with our member countries. This surveillance work would be more effective if we could make better use of our wealth of cross-country experience to tell countries more clearly how to improve their economic policy frameworks and institutions.

Conclusion

There is consensus today on the importance of institutions in fostering economic development and also a fair bit of agreement on the needed set of institutions. What policymakers want to know is how they can actually go about improving the quality of their institutions. The IMF research that I summarized here offers hope. Improvements in the quality of institutions are taking place and often they are taking place in the poorest of countries. What hastens the pace of this improvement is often an external force of some kind—it can be the pull of wanting to join a body like the EU, it can be peer pressure from neighboring countries, it can be the "demonstration effect" of

seeing what has worked elsewhere. The IMF, with the unique cross-country overview that our surveillance provides, along with the extensive research we undertake, can contribute to this process by identifying and encouraging the adoption of best practices. I am committed to ensuring that the IMF does its job in this regard.

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