

Panel Discussion— Promoting Better National Institutions: The Role of the IMF

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Remarks by Jeffrey A. Frankel

I. What Are “Institutions”?

What do we mean by institutions? The generality of the word cries out for a definition. But I am not going to attempt it. A narrow interpretation would consist of only specific legal bodies or procedural mechanisms. Examples include regulatory agencies, such as securities and exchange commissions, standards-setting bodies (e.g., for accounting), and what are sometimes called “commitment devices” (currency boards (CBs), guarantees of central bank independence, balanced budget amendments, the Stability and Growth Pact, etc.). A broad definition would include everything about a society that is more detailed than the basic theoretical model in a graduate economics textbook: from the existence of efficiency wages and a six-month gold futures market, to culture. The notion of institutional quality that has become common in the growth literature lies at an intermediate level of generality, and pertains to property rights and rule of law. I am happy to accept that usage. But, before I turn to it, I want to flag the wide variety of issues that could be termed institutional, and to observe that they may not necessarily all be correlated. For example, democracy is on many people’s list. But the commitment devices I named (currency boards, independent central banks, stability pact), are

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Table 1. Institutions Range Along Two Dimensions

		How sure are we that we know the right answer?			
		<i>Not Very</i>	<i>A Little</i>	<i>Fairly</i>	<i>Very</i>
How relevant is this issue to balance of payments problems?	<i>Not Relevant</i>	Religion	Capital punishment; drug policy	Democratic elections, labor rights	Human rights, environment
	<i>A Little</i>	Social capital	IPR rules; executive compensation	Competition policy; land tenure; legal systems	Poverty; education; military spending
	<i>Fairly</i>	How to close banks and dispose of NPLs; what are the best bankruptcy procedures	Standards for corporate governance; securities, accounting, bank regulation	Property rights; trade policy	Corruption, fiscal transparency
	<i>Very</i>	How to restore confidence in a crisis	Exchange rate regime; capital controls; PSI	Budget deficits	Monetary policy

distinctive for being institutions that prevent macroeconomic policy from being determined in “too democratic” a manner.

In Table 1, I have placed an array of what might be termed institutions, ranked across two dimensions: (i) How sure are we what the right answer is? and (ii) How clearly relevant are they to the business of the IMF, which I will interpret as countries’ balances of payments, and, to a lesser extent, economic growth. The bottom row is, and has always been, clearly within the purview of the IMF. Within the bottom row, I have put monetary policy in the far right, because we are pretty confident what is the relationship between money and the balance of payments, exchange rate, and inflation. I have chosen to put fiscal policy one column over, because there is some controversy and uncertainty regarding questions such as whether raising taxes to eliminate a budget deficit can be beneficial, and what effect fiscal expansion has on the overall balance of payments. I have put capital controls and the choice of exchange rate regime under “we have very little confidence what the right answer is,” even though we have a lot to say about it. And I have put “how to restore investor confidence during a balance of payments crisis” under “we basically have no idea.”

Now move to the top row, to illustrate the questions not relevant to the business of the IMF. At one end I have judged that we have no idea what is the right religion (if there is one), so that it is fortunate that this is clearly not relevant to the job of the Fund.¹ At the other end, I have judged that it is clear that protecting human rights and the environment are good goals, and that we have a fairly good idea how to go about them, but they are equally outside the purview of the IMF, even if it is sometimes

¹When I say “how sure are we about the right answer,” I don’t necessarily mean “how sure am I personally,” but more “how much agreement is there among informed opinion.”

hard to explain that to protesters. I have assigned labor rights a lower level of confidence than the environment, because I am not sure what I think of “right to work” laws, for example, or that I want to tell other countries at what age teenagers can start working or whether labor unions must be given the right to hold meetings on the company premises. Two years ago, I would have placed democratic elections in the far right, but after the recent elections in Mexico, the United States, Zimbabwe, Brazil, and Bahrain, I am no longer completely confident which electoral institutions translate into appropriate realization of the will of the people.

One could debate the precise placement in the table of many of these entries. But I mainly want to establish the simple idea that these issues can usefully be arranged along these two dimensions.

II. Deep Sources of Growth

By now the empirical literature on determination of countries’ levels of income and growth rates² is so large that some have called for a halt. I disagree. I think we are still learning important things about why some economies perform better than others. Some of the relatively better established determinants are investment, education, trade, political stability, financial development, and economic freedom.³

Perhaps the most interesting part of the current debate on growth is: *what are the deeper determinants?* Yes, policies regarding taxes, government spending, and tariffs help determine investment, education, and trade. But what are the deeper determinants of those policies? A recent paper by Dani Rodrik and coauthors poses the question well.⁴ In their view, there seem to be three emerging theories: geography, openness, and institutions. Each theory can be captured by some standard measures; but each has serious endogeneity problems that must be addressed. (Table 2 illustrates.) Let us consider each in turn.

(1) By now “*geography*” has (belatedly) made its way deep into the literatures on trade and growth in many different ways. So it is important to clarify here what sort of geography we mean. We are talking about the natural climate, biology, and geology—especially differences between the *tropics* and *temperate* zones, such as the presence of malaria and other debilitating tropical diseases, length of the growing season, and other climate effects. The presence of malaria can be partly endogenous: it was stamped out in Panama and Singapore, despite their tropical locations, by superior technology and social organization. Such instrumental variables as latitude, percent of land in the tropics, or average temperature have been used to capture the exogenous component of theory number 1.⁵

(2) By *openness*, we mean international integration along several dimensions, but trade is the most important, and the most readily measured (ratio of trade to

²In a cross-country study that conditions on beginning of period income, one can interpret the equation equally well as determining the end of period level of income or the period growth rate.

³Barro (1991) started it all.

⁴Rodrik, Subramanian, and Trebbi (2002).

⁵Diamond (1997), Gallup, Sachs, and Messenger (1998), Hall and Jones (1999), and Sachs (2001). Rodrik, Subramanian, and Trebbi claim that institutions’ variables “knock out” tropical variables like latitude and malaria in regressions of income levels; but Sachs (2003) responds that malaria remains highly significant when instrumented by a carefully constructed measure of malaria ecology.

Table 2. Deep Determinants of Growth

Determinant	1. Tropical geography	2. Openness	3. Institutions
Measures	Malaria and other diseases; length of growing season	Trade/GDP, tariffs; FDI	Property rights, rule of law
Sample endogeneity problem	Suppression of malaria	Imported investment or luxury goods; endogenous tariffs	Regulation and tax systems develop with income
Exogenous instrumental variables	Distance from equator, tropical area; temperature, rainfall	Gravity model: including remoteness, landlockedness, linguistic and historical links	European settler mortality rates; extractive industries (plantation crops and mining)

Sources: Acemoglu, Johnson, and Robinson (2001, 2002), Acemoglu and others (2002), Easterly and Levine (2002), Engerman and Sokoloff (1997, 2002), Hall and Jones (1999), and Rodrik, Subramanian, and Trebbi (2002). Typical finding: *Institutions dominate*.

GDP). Trade and trade policies are both clearly endogenous. For this reason, Frankel and Romer (1999) proposed an instrumental variable for theory number 2: geographical suitability for trade as predicted by the gravity model, and it has been widely accepted. It includes such exogenous determinants of trade as remoteness from big trading partners, landlockedness, etc. New Zealand and Botswana are disadvantaged in trade; Belgium and Hong Kong are well situated.

(3) Finally, *institutions*. Rodrik, Subramanian, and Trebbi use as their measure of institutional quality an indicator of the rule of law and protection of property rights (taken from Kaufmann, Kraay, and Zoido-Lobaton, 2002). Acemoglu, Johnson, and Robinson (2001) use a measure of expropriation risk to investors. Acemoglu and others (2002) measure the quality of a country's "cluster of institutions" by the extent of constraints on the executive. The theory is that weak institutions lead to inequality, intermittent dictatorship, and lack of any constraints preventing elites and politicians from plundering the country.⁶

Institutions, much like malaria and trade, can be endogenous. Many institutions—such as the structure of financial markets, mechanisms of income redistribution and social safety nets, tax systems, and intellectual property rights (IPR) rules—tend to evolve in response to the level of income. Furthermore, where measures of institutional quality come from survey ratings, the responses may be influenced by ex post awareness of a country's level of economic performance. What is a good instrumental variable for institutions? Acemoglu, Johnson, and Robinson (2001) and Acemoglu and others (2002) introduce the mortality rates of colonial settlers. The theory is that, out of all the lands that Europeans colonized, only those where Europeans actually settled were given good European institutions. This theory is related to the idea of Engerman and Sokoloff (1997, 2002) that lands endowed with extractive industries and plantation crops (mining, sugar, cotton)

⁶A key early contribution was North (1994). This is by now a large literature. Other examples include Roll and Talbott (2001), for whom property rights is one of the most important variables.

developed institutions of slavery, inequality, class, dictatorship, and state control, whereas those climates suited to fishing and small farms (fruits and vegetables, grain, and livestock) developed institutions based on individualism, democracy, incentives, egalitarianism, and capitalism. In both papers above, Acemoglu and his coauthors chose their instrument on the reasoning that initial settler mortality rates determined whether Europeans subsequently settled in large numbers. The first item to point out to justify this otherwise idiosyncratic sounding instrumental variable is that there need not be a strong correlation between the diseases that killed settlers and the diseases that afflict natives, and that both are independent of the countries' geographical suitability for trade. The conclusion of Rodrik, Subramanian, and Trebbi is that institutions trump everything else—the effects of both tropical geography and trade pale in the blinding light of institutions. Nobody denies the important role of, say, macroeconomic stability; but the claim is that macroeconomic policies are merely the outcome of institutions. This is essentially the same result as found by Acemoglu and others (2002), Easterly and Levine (2002), and Hall and Jones (1999): institutions drive out the effect of policies, and geography matters primarily as a determinant of institutions.⁷

My own view is that some of the papers may overstate the effect of institutions by not conditioning on enough variables. Table 3 reports some recent results from Noguer and Siscart (2002), who condition on country size, and implement the gravity instrument with a comprehensive set of bilateral trade data. They find that, yes, institutions have a statistically significant effect on income per capita, but openness and tropical location retain their significant effects as well. Alcalá and Ciccone (2002) instrument for both trade and institutions and find that both significantly raise output per worker. Institutional quality works mainly via physical and human capital, while trade works through the efficiency of labor.

For the purposes of this panel, it doesn't matter much whether the effect of institutions is merely one of several important deep factors or if, as these papers seem to claim, it is the only important deep factor. Clearly institutions are important.

Financial sector institutions are particularly relevant for the IMF. Here the series of papers by La Porta and others (1998) shows the importance of such institutions as protection of shareholders rights, and the possibility that they are deeply rooted in history and culture. The relevancy of the variables explored by La Porta and others to the IMF's job is supported by the finding that they predict external crises in emerging markets, as in Mulder, Perrelli, and Rocha (2002).

The exogeneity issue is important, not just for econometrics, but also for the question of relevance for IMF strategy. An implication of this line of research is that it may be futile for the IMF to pressure a country into better economic policies, if those policies are dictated by deeply rooted institutions. Acemoglu and others conclude, "Distortionary macroeconomic policies are . . . part of the 'tools' that groups in power use in order to enrich themselves and to remain in power. But they are only one of many possible tools. . . . An interesting possibility implied by this perspective is a seesaw effect: preventing the use of a specific macro distortion will not necessarily cure the economic instability problems, since underlying

⁷Easterly and Levine just group openness together with other policies. Hall and Jones consider latitude a proxy for European institutions and don't distinguish the independent effect of tropical conditions.

Table 3. Effects of Trade, Tropics, and Institutions—Noguer-Siscart Estimates
(Dependent variable: log GDP per capita in 1985)

Trade Share (instrumented)	0.79** (0.33)	0.82** (0.37)	1.01** (0.41)
Log Population	-0.13** (0.06)	-0.04 (0.08)	-0.05 (0.09)
Log Area	0.24** (0.08)	0.12 (0.07)	0.23** (0.08)
Latitude	0.45 (0.23)		0.52 (0.31)
Tropics (share of population)	-1.83** (0.20)		-0.99** (0.30)
Distance to Equator		1.52** (0.65)	
Sub-Saharan Africa		-1.07** (0.27)	-0.67** (0.32)
East Asia		-0.10 (0.23)	-0.27 (0.25)
Latin America		0.42 (0.25)	0.51 (0.27)
Institutions	1.27** (0.40)	1.47** (0.49)	1.59** (0.42)
Sample Size	89	89	89
R ²	0.69	0.77	0.77
RMSE	0.61	0.53	0.54

Source: Noguer and Siscart (2002).

Notes: A constant was included in the regressions but not reported. Robust standard errors, including adjustment for constructed regressors, appear in parentheses. ** indicates statistical significance at 95-percent level.

institutional problems may manifest themselves in the use of some other tool by politicians and elites to achieve their objectives.” They give the example of tools used by the coastal elite in Ghana to maintain their power at the expense of cocoa farmers in the interior, through such policies as an overvalued exchange rate and the cocoa marketing board. If the IMF succeeds in preventing Ghana from having an overvalued exchange rate, the elite instead suppresses the price of cocoa paid to farmers in other ways.

“Is European settlement destiny?” Rodrik, Subramanian, and Trebbi, make the point that even though settler mortality is a good instrument for institutions, institutions can be determined by many other things as well and have been even in the past, and so there is no reason why they can’t be changed in the future. Acemoglu, and others do not disagree, having no wish to be predestinationists.

The point is important. The identification of an exogenous instrument that works historically should not stop one from working for beneficial changes in a country's institutions that depart from geographic and historic destiny. Similarly, even when one has to take institutions as given, one should be aware of the wider context but shouldn't refrain from working for beneficial changes in policy.

III. The Role of the IMF

The subtitle of this panel discussion is "The Role of the IMF." I see the issue of institutions coming up under four headings of IMF activities: technical assistance, the new FSAP and ROSC activities, program conditionality, and the question of prolonged use of Fund resources.

Technical assistance to national governments is clearly relevant, such as help building better national statistical systems or the work of the IMF Institute. The Financial Sector Assessment Program (FSAP) helps countries develop better institutions for regulating banks and other financial markets. I gather that it now goes beyond general "capacity building," and that FSAP missions typically visit just before Article IV missions, so that the results can be discussed at that time, and incorporated in the Article IV report, and sometimes in subsequent IMF programs as well. The same is true of Reports on Observance of Standards and Codes (ROSC) missions as well, especially regarding fiscal transparency.⁸

Let us go directly to the issue of structural conditionality of IMF programs, wherein lies the heart of the debate. During the course of the 1990s there was an expansion in coverage or scope of IMF conditionality, from macroeconomic policies in the last row of the table, to structural policies, which, roughly speaking, is the second to last row. Perhaps in the "heat of action" during the East Asia crisis there was an expansion into such areas as competition policy, which are now reverting to World Bank responsibility. Currently the IMF devotes attention and resources to financial sector institutional issues, in particular.

The expansion of IMF conditionality beyond macroeconomic policy has been widely attacked as an example of mission creep.⁹ My own view is that this expansion has been appropriate. Briefly speaking, even if you don't buy the argument that structural flaws such as crony capitalism were the cause of the East Asia crisis, it seems clear that the IMF could not put a lot of money into Indonesia without taking steps to make sure that the money wouldn't "end up in Swiss bank accounts." Investor confidence was not going to be restored unless President Suharto signaled in a serious way a change in regime away from enrichment of his family and toward an economic system that would remain workable in the future. As international economic integration increases, the tension between regulation

⁸"Report of the Managing Director to the International Monetary and Financial Committee: The Fund's Crisis Prevention Initiatives," 2001.

⁹Of course the critique that the IMF overreached by getting into issues such as the Indonesian clove monopoly, and should instead "stick to its macroeconomic knitting," contradicts the critique that it applies a cookie cutter approach to all countries and neglects the issue of poverty. "Frankel's Law" is that for every critique of the Fund that sounds plausible and devastating, there exists an equally plausible and devastating-sounding critique that is its diametric opposite. Frankel and Roubini (2003), Section 3.1.5.

and national sovereignty increases, and an optimal trade-off for multilateral governance probably entails giving up a little of each, rather than hugging either corner of no regulation or no sovereignty.

This doesn't mean we are ready for the IMF to dictate countries' domestic policies on human rights or the environment. That would be too serious a violation of national sovereignty, and in any case these areas are the job of other multilateral institutions. But an expansion of authority at the margin, one step up, strikes me as about right. And the World Bank should probably be operating one row above that, especially along the right margin.

Implicit in the table is the principle that in deciding whether an issue area is an appropriate concern, the IMF should not ask only "how directly relevant is it to the balance of payments?" but also "how confident are we that we know the right answer?" I think we are more confident that spending on education is good for the economy than on whether encouraging bowling leagues and choral groups is. We are more confident that corruption is bad¹⁰ than that American accounting practices are necessarily superior to European practices.

Return to the bottom row of Table 1. What about the point that convincing a finance minister to sign a letter of intent specifying macroeconomic targets—or, for that matter, agreeing to structural reforms along the lines of banking regulation and corporate governance—is unlikely to accomplish much if his heart isn't in it? Macroeconomic and structural policies may be merely the reflection of deeper institutional constraints. In the old days, IMF staff would say that an important function of the Fund was to "take the heat politically" for tough policy decisions that the local finance minister might well understand to be necessary but could not enact domestically. It helped to be able to blame the unpopular policy on the IMF. And they would say it with a bit of pride. Thinking has shifted. Now the mantra is no longer "use the IMF as an excuse for reform," but "the country has to take ownership of reform." This is good as far as it goes. Certainly it is infinitely better to have the local politicians take ownership of a given reform package than not. But it begs the question of how to get them to do it.

My suggestion would be that it may be appropriate to start thinking more systematically about when to cut off perennial borrowers, particularly countries that have consistently failed to meet their agreed targets. The goal should be to move the long-run system toward a higher marginal reward for countries that are taking steps in the right direction, which means withholding support from those who are not. The judgment of which countries are in which category should not be based solely on overall economic performance, nor on how many times they have missed their program conditions, nor even on whether the country has been subjected to adverse developments beyond its control, such as an adverse trend in its terms of trade. I want to suggest that it may also be appropriate, at the stage of judging repeat users, to think about the broad institutional setting. If a country is undemocratic, corrupt, and chronically prone to spend resources on the military rather than health and education, then that may be a reason to conclude that a recurrent budget deficit

¹⁰The subject of corruption was almost taboo at the IMF two decades ago, but this has changed. There is by now a lot of work on the effects of corruption and transparency. See, for example, Gelos and Wei (2002) and Wei (2000).

or overvalued currency indeed has deeper causes. The appropriate strategy for the international community may be to give up on that country for a while.

The IMF and other multilateral institutions cannot determine when the social and political conditions will be right in the country for a new sweeping reform movement. But they can offer would-be reformers grounds for hope that they will be given more help than would bad actors who are their domestic competitors. Of course, the kind of help that is appropriate to give is very different for the IMF than it would be for G-7 governments, aid agencies, or even the World Bank. Nevertheless, I am suggesting that it may be appropriate for the IMF to look at some non-traditional criteria, which could be termed institutional.

These same issues could be addressed in the context of the Poverty Reduction and Growth Facility. I know that part of the intention behind the process that produces Poverty Reduction Strategy Papers is to insure a country-driven agenda of structural reforms. But I don't know much about how this has been working so far in practice.

The historical example of settler mortality rates highlights how long-lasting institutions can be and how infrequently and slowly they change in general. But notwithstanding historical influences, institutions can change, and sometimes quickly. Most institutional change happens at a time of national upheaval, such as the end of a war or the birth of an independent country. We have all been reflecting lately on how successfully Japan and Germany were remade after the end of World War II. The breakup of the colonial empires in the 1950s through 1980s offered another opportunity that some countries (e.g., Singapore, Hong Kong, Botswana, and Mozambique) seized much better than others. In the early 1990s, the ruins of the Soviet Union left an opportunity for building new institutions that, though it appeared frustratingly slow and erratic at the time, ten years later has begun to look better in many transition economies. Finally, today, such new countries as East Timor, Macedonia, and Afghanistan are open to advice on institutional design coming from the IMF and the rest of the international community, more than were the nations that become independent with the original breakup of the big colonial empires forty years ago.

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Remarks by Nancy Birdsall

A New Social Contract for Open Economies
and the Implications for IMF Conditionality

I was inspired by the title of this panel to talk about the concept of a social contract, a crucial and too often neglected national institution. Specifically, I am going to address the need for what might be called an “open economy” social contract—that is, a social contract for developing countries participating in the global economy, and the implications for IMF conditionality.

I. A Social Contract for Open Economies

A social contract is the outcome of a collective decision, usually through a political process, in which members of the relevant groups bind themselves to collectively finance and provide certain investments and protections for themselves in their mutual interests. Typically, these investments and protections encompass health, education, employment, and old age security. A social contract mitigates the inherent injustices of unfettered markets where initial endowments of financial, human capital, and other assets are unequal. In that sense, a social contract can address inequality of opportunity. In addition, a social contract reflects and reinforces the capacity of societies to manage different economic interests, across income groups, as well as among ethnic groups, across regions, and so on.

Given that a domestic social contract has to be forged and sustained in the political arena, it needs to reflect the interests not just of the poor but of the large majority of members of a particular collectivity. A social contract is particularly important for emerging market economies, where the large majority of citizens, not just the poor, are vulnerable to the volatility and instability that seem to accompany the benefits of greater openness. As Dani Rodrik pointed out some years ago very well, more open economies spend more on social transfers. The most open economies in developed Western societies tend to have the deepest social contracts.

What does this notion of an open economy social contract have to do with the IMF? Is this IMF business? Doesn't it sound like World Bank business or Inter-American Development Bank business? The social contract implies redistribution, and the IMF is wary of redistribution. It sounds like politics, where the IMF does not belong. And what does it have to do with conditionality?

II. Is an Open-Economy Social Contract the IMF's Business?

Let me suggest three reasons why supporting countries in forging and sustaining a social contract is so tied up with typical IMF business:

1. The first reason is that *good fiscal policy, which is obviously at the heart of the IMF's mandate, is the basic ingredient of a healthy, open economy social contract*. Obviously, good fiscal policy affects job creation, and in most societies, this is the central issue for the great majority of people. It affects job creation insofar

as bad fiscal policy tends to crowd out the private sector by driving up interest rates and imposing on monetary authorities the burden of maintaining stability.

In addition, lack of fiscal discipline and any resulting buildup of public debt affects the ability of governments to be countercyclical and to protect various groups in the population—not just the poor, but the vulnerable middle-income groups, when times are bad. One of the big differences between East Asia and Latin America in their ability to protect their middle-income as well as poor citizens during the crises of the last decade has been that when East Asia went into its crisis, most countries had much less public debt than Latin American countries.

2. My second reason is the same. *Good fiscal policy is the basic ingredient of a healthy social contract.* But I make it a second point because I want to emphasize not just the average levels of taxes and expenditures, but the *composition of the tax burden and the incidence of expenditures.* What is the role of the IMF versus the World Bank in these areas? Sadly, that is not very clear.

Consider Argentina in the late 1990s. In the late 1990s, when Argentina was growing rapidly, I believe there was a sin of omission on the part of the international financial institutions. None of them—not the IMF, the World Bank, or the Inter-American Development Bank—was focusing on, and putting on the table for public discussion, the composition of expenditures and the formal burden of taxes in Argentina. Who was there, making transparent and more visible to a larger public that large expenditures were going to patronage, to political ends? Who was clarifying that the richest 10 percent of households in Argentina weren't paying very much in taxes? (IMF research suggested that the average effective tax burden of those households was about 8 percent in the 1990s.) The IMF wasn't there because the IMF leaves to the World Bank the issues of expenditure allocation and institutional strengthening. But the World Bank wasn't there because the World Bank leaves to the IMF macroeconomic policy. Plus, the World Bank and the Inter-American Development Bank were busy with social programs, overlooking the reality that the social contract is about healthy fiscal policy, not just social programs per se.

Argentina illustrates that it makes little sense to pretend there is a simple distinction between good economic policy and good social policy, or to assess fiscal and monetary policy strictly and solely in terms of its effects on stability and efficiency, ignoring its implications for social cohesion.

3. A third reason is that the financial sector in open economies is IMF business, and *what happens in the financial sector affects the capacity of societies, particularly in open economies and particularly in emerging markets, to manage the social contract.* The structural problem is that financial sectors in emerging markets, because they are emerging markets, tend to be shallower and thus less resilient and less able to help manage what happens if there is either an external shock or some sort of internal policy shock or a natural disaster.

Now, I wanted to raise the financial sector to reemphasize that the social contract is not just about poverty and the poor. The middle-income working class households are particularly vulnerable to shocks that arise because of this problem of a relatively shallow financial sector. It is the middle-income households and working class households who are, in the end, the political bedrock of a social contract that works.

During the Asian crisis, it was actually not the poorest households who suffered the largest absolute or relative losses, but what I would call the “urban strivers” (the emerging, potential, incipient middle class in urban areas). In many emerging market economies, there are so many households so close to the poverty line that we have made a mistake, I think, in distinguishing between the poor and the rest. What we should be distinguishing between, especially in the case of Latin America, is the 10 percent of households that are at the top of the distribution, where household heads have post-secondary education, and all the rest. Median household income in a country like Brazil is only one-third of average household income. In Peru, households in the middle of the income distribution have surprisingly poor health indicators. It may surprise you to know that the infant mortality rate for the middle quintile of households in Peru is higher than the average infant mortality rate in Ghana.¹ Median income in Brazil is so close to the poverty line (at \$2 a day) that it is not surprising that when there are negative or positive shocks (a positive shock for Brazil with the “Real” program), you see big shifts in poverty head count up and down.

Behrman, Birdsall, and Szekely (2001) conclude that overall, the set of reforms during the 1990s in Latin America did not increase wage gaps between the skilled and unskilled workers, nor did they hurt the poor. However, among reforms (including trade liberalization, labor, tax reforms, and privatization) capital market opening and financial sector liberalization were most conducive to increasing wage gaps. That finding is consistent with the evidence presented in this conference by Kose, Prasad, and Terrones (2002) about how increasing financial openness is associated with rising relative volatility of consumption for a significant group of emerging economies.

Surely, the political popularity of Lula in Brazil represents the demand by the great majority of middle-income households in Brazil that are above but precariously close to the poverty line, for a new kind of social contract. Of course, that social contract would recognize that fiscal and financial discipline are critical to capturing the benefits of more open economies. But it would also recognize that those disciplines have to be managed in ways that are more explicitly “fair” and just. In its work on the financial sector, it seems to me the IMF must take into account and work with countries on managing the implications of financial liberalization (and of work-outs) for the social contract.

III. Conditionality: Implications for the IMF

Ownership by governments (and implicitly by societies) of reform programs is necessary for sustained success. Conditionality is certainly not a substitute for ownership, but in its defense I would say it can be a useful complement to ownership. The issue for the IMF is to focus not only on limiting the number and the domain of the conditions it negotiates, but to ensure that conditionality avoids undermining and indeed more often visibly strengthens societies’ efforts to forge, sustain, and ultimately “own” their own social contract. That implies a mandate

¹For more on the characteristics of middle-income groups in Latin America, see Birdsall (2002).

for the IMF to assess not only the implications of its advice for the poor and changes in poverty, but also for the stability and sense of security of the great majority of developing countries' citizens, in short the implications of its advice and lending for modern open economy social contracts that reflect societies' sense of justice as well as hopes for growth.

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Remarks by Jeffrey Sachs

A key part of the message I want to deliver is that we need to avoid trivializing the complicated issue of institutions. Indeed, I am going to stress why it is so easy to get the issue of institutions wrong. Institutional reform is an area that is tougher than it looks, and the international community is not always on the right track in its particular focus and recommendations. Too often, it fails to account for, or even recognize, the deeper forces that lead to institutional failure.

I want to start with a general methodological observation. For a long time, certainly since Walras, economists have aimed to create economics in the image of classical physics; that was a great mission of general equilibrium analysis, and it obviously has produced very powerful results. However, I think we are finding more and more that economic analysis has to be even more like the science of ecology than physics. Like ecosystems, or living organisms, economies are complex, interdependent, and nonlinear systems. Such systems require a very special kind of analysis, and it is one in which I view the institutions debate as being embedded.

Maybe we can think of the institutions in a society like the organelles of a cell: the ribosomes, the mitochondria, and the other specialized units that perform specialized functions in an interconnected manner to keep the cell alive. One of the features of a complex interconnected system like a living cell is that when any one of those organelles is misfiring, the whole cell can die. Even if component A is failing, the root cause may be component B. A medical analogy applies, since human

bodies too are complex systems. When the body is misfiring, the doctor has to make a *differential diagnosis*. It is not good enough to say that the heart stopped beating, and therefore, the person has a cardiac problem. Maybe the heart stopped beating because it stopped being profused with oxygen, as a result of suffocation. The cardiac problem is secondary to a respiratory problem, which must be solved first.

Macroeconomists often fail to make this kind of differential diagnosis. When an economy is collapsing, we try to isolate the problem in the places we know best, whether that is the budget or the tax policy or the exchange rate. We have endless debates about manipulating macroeconomic variables, when the deeper problems in the system—the organelles that are misfiring—may be rooted in completely different institutions, whose failure is being transmitted throughout the entire system, and therefore manifesting itself as a macroeconomic problem as well. In that case, the macroeconomic failures are symptoms, not the primary causes of social and economic collapse.

There is another point about living systems that is particularly important for the world's poorest countries. Complex living systems are open energy systems, as Schroedinger told us 50 years ago. They require energy inputs to achieve a high level of organization and to combat entropy. In prosaic terms, societies need to be fed. When these systems don't have enough energy input, enough to cover the needs of basal metabolism, the cell collapses. The same thing is true with some of the poorest societies in the world. They cannot survive physically right now at the low level of productivity of their internal economic systems, and there is not enough "energy" (in the form of foreign aid, foreign exchange earnings, external loans, or other transfers) coming from the outside.

The result is literally mass death in a lot of impoverished places in the world, which we talk about prosaically as macroeconomic crises. For instance, Southern Africa is a region of mass death right now, as a result of AIDS, drought, poor governance in some of the countries (but not others), and resulting social disorganization. It is not merely a macroeconomic crisis. We have to understand that if we are going to get this right.

I. What Is the Range of Interesting Institutions to Deal With?

Because of the complexity of social organization, we cannot limit our institutional view to just a few chosen institutions, such as commercial law, or the budget, tax, and monetary institutions. Critical social institutions also include the systems for delivering safe drinking water, energy, sanitation and waste disposal, education, health services, and the production and diffusion of scientific knowledge. When any one of these institutions breaks down, it puts the rest of the society at risk. The economy loses productivity, and the "energy" inputs needed to maintain a high degree of social organization are lost. A fiscal or banking crisis may result, leading to a generalized collapse of economic activity.

Now, why do I go on about this perhaps trivial point? Because, as I've already emphasized, we are sometimes really barking up the wrong tree when we are trying to understand what is going on in a country. We go straight to the tax policy or the exchange rate, and we think we are doing something, when the problems are

really much deeper, perhaps in the failure of the health sector, or the power sector, or the education sector.

Let me turn again to the poorest countries. The IMF has been in the business of large-scale involvement with the poorest countries for almost 20 years, since the first structural adjustment lending in the 1980s. The record of performance in a large number of those countries is dismal. I'm not saying that things would have been worse or better without the IMF, only that with the IMF the situation has been far from satisfactory. In large parts of sub-Saharan Africa, the past two decades have been marked by a continuation of economic crisis, falling living standards, environmental degradation, and of course the spread of pandemic diseases, led by AIDS. I would argue that this dismal record reflects the fact that the IMF, and the international community more broadly, did not have a realistic diagnosis of what was happening in those countries, and therefore, the focus of reform efforts did not get to the core of the problems.

For the countries that I am dealing with in sub-Saharan Africa, the problem is one of insufficient energy input. These societies, I will stress again, are literally dying. Food productivity is too low to provide the necessary metabolic inputs at the household level. Infectious diseases are rampant. Energy is mobilized unsustainably by chopping down the forest. Macroeconomic balance in these circumstances, brought about by tight budgets and hard monetary constraints, will stabilize prices but will not stop millions of people from dying of disease. Macroeconomic stabilization in the face of mass suffering is not sufficient. These countries desperately need an infusion of help, of real help, of a much larger amount than is in play right now.

The Managing Director makes this point all the time these days, but it is not operationalized in the IMF programs and what the Board reviews when it considers the plight of these countries, and how we talk about these countries in the Article IV consultations. In none of these documents is there a realistic assessment of what would be needed institutionally to make these societies function. This is a severe shortcoming, since we continue to get societal crises that are absolutely out of control.

There are other countries, the Andean countries for example, where again, the basic problems are not macroeconomic. Some of the basic problems today reflect the profound economic costs of being 12,000 feet above sea level, particularly in landlocked regions. Those geographical problems are really serious—the Andean countries have among the highest transport costs in the world, and this makes it very difficult for them to attract export-oriented industries other than in a few high-value primary commodities: oil, gas, gold, copper, and, of course, cocaine.

Drug trafficking to serve the U.S. demand is a phenomenally important part of the real life of Bolivia, Peru, Colombia, increasingly Ecuador, and other countries in the region. The level of corruption that it causes, the distortions of the macroeconomic environment, the inability to run other, normal functions is profound. Militarization of that crisis, backed by the United States, solves little. But we don't talk about the real things—and as a result we have a whole region that remains in profound crisis.

For a lot of emerging markets, we also talk about superficial matters, not the deeper issues. When we talk about Argentina, for example, we talk endlessly about the exchange rates, provincial budget deficits, and corruption. I think that in the final

analysis, these problems do not get at the core of what is wrong in Argentina. Argentina, it strikes me, is a society that has lacked yet another set of missing institutions—the institutions of science, technology, and higher education. When Argentina reached a relatively high level of income, around \$10,000 per person, future economic growth depended on making the transition away from primary commodities (and foreign loans) to a knowledge-based economy. That would have required a set of public and private institutions to promote science, technology, and higher education. Alas, it was not to be. Argentina’s budget deficits were a symptom of its chronic lack of competitiveness. And the fixed exchange rate regime of the 1990s was inconsistent with an otherwise technologically stagnant economy.

Yet when Argentina was told about the Washington Consensus, it was not told that the consensus includes major investments in science and technology. It was told only to privatize, not to invest public funds in raising the technological sophistication of the economy. Nobody mentioned, it seems, that the “free market” U.S. invests more than \$100 billion per year of federal budgetary funds in science and technology programs.

II. What Should (or Should Not) the IMF Do in This Context?

Given that key underlying problems in Africa are problems of disease, geography, soil infertility, energy insufficiency, and the like, I used to think that the best decision for the IMF would be to get out of African lending altogether. These problems are obviously not at the core of IMF expertise. Yet the IMF decided to “stay in” Africa, to try to help. With that decision, however, comes a much greater responsibility. The IMF simply must do a better job of differential diagnosis, that is, a much better job of understanding that the roots of extreme poverty lie in terrible problems of disease, climate, geographical isolation, and other related factors.

I am not saying that the IMF should quickly form a malaria research group on 19th Street. I am saying, instead, that the IMF has a much greater responsibility to mobilize expert knowledge—from the World Health Organization, UNICEF, the World Bank, elsewhere—in order to be responsible and accurate in its differential diagnosis. And what difference would that make in practical programming terms? Here’s the nub of the issue.

When the IMF says that the financing gap for country “X” is so-and-so, that judgment has got to be against a standard. The standard has been, roughly speaking, the following: “Here is what the donors are going to provide you in loans, grants, and debt relief. Now you have to live within your means. And since inflationary financing is not effective for long-term growth, you have to tighten the budget and monetary policy sufficiently to achieve price stability.”

What I am saying is that the international system can no longer stop at that point, because the results can be disastrous. We have to put the financing gap calculation in a different perspective, by asking what the country needs in external help in order to achieve the internationally accepted development goals, for example, of controlling disease, reducing hunger, cutting child mortality rates, and so forth. And if that’s not possible within a macroeconomic framework as currently funded by external donors, then it is the IMF’s responsibility, actually, to go back

to the donors and say that there is a true financing gap. The financing gap is not the gap to fill some notional balance of payments target that leaves millions of people dying each year. The financing gap is the donor financing that is needed to achieve the development goals that the international system has adopted, specifically the Millennium Development Goals. Identifying that kind of *development financing gap* requires a deeper knowledge of what the underlying problems are in impoverished societies wracked by crisis. It requires enough knowledge of AIDS, malaria, TB, drought, soil infertility, and the like, to get to the core of the society's basic needs, with donor help when necessary.

In the end, the role of the IMF in the poorest countries, and it could be a critical and magnificent role indeed, is to assess the macroeconomic framework that can produce economic development, not merely a framework to produce price stability. And for that, the Executive Board and staff of the IMF will need to become closer partners with the specialized U.N. agencies that can help to assess the needs in health, environment, energy, water and sanitation, and other critical underpinnings of long-term and sustainable economic development. By addressing the deeper forces that shape economic development, the IMF will be far more successful in promoting long-term economic development, and will find itself spending less time having to battle the macroeconomic symptoms that reflect more fundamental development challenges.

Remarks by Guillermo Ortiz

I. Institutions: Their Importance and Barriers to Their Change

According to Douglas North, institutions are, basically, the rules of the game of society, and they are the set of laws and practices sanctioned by custom and organizations that give a stable structure to the relationship between individuals and groups.

I would venture that most policymakers have a sense of which institutions work and which institutions don't work in their own countries. Then we have to ask ourselves why is it that there is not a change either of agents, society, governments, and so on toward improving institutions. I think there are three basic reasons for that.

One of them is the weakness of the organizations that could manage change. Another reason is the existence of special interest groups. They are many times heavily entrenched in the institutions themselves and they are actively pursuing their own interests and do not allow for change.

The third reason is probably inertia. As you know very well, institutions develop from historical and cultural patterns. Some people would say—I hope I offend no one—that the institutions that colonial Spain left in Latin America are to some extent responsible for some of the difficult times that we have had over the past two centuries.

II. How Can International Institutions and Organizations Help Change Domestic Institutions?

International institutions can be very helpful to overcome the first problem—knowledge base; they can be somewhat helpful in overcoming the second problem—the existence of special interest groups; and they have absolutely no relevance to the third problem.

With respect to the first problem, it is obvious that the IMF, in particular, and the World Bank are like hubs of economic knowledge and experience. Every time an IMF or World Bank mission goes to a country to tackle a problem, there is experience acquired that can be processed and hopefully applied to other countries.

Membership in international organizations can really help strengthen institutions. For instance, the North American Free Trade Agreement (NAFTA) has been a tremendous force to create institutions in Mexico. The fact that you have a horizon for tariffs to be reduced, the fact that you have investment rules, the fact that you have clear mechanisms for solving controversies—all this has helped to create institutions. For example, the new foreign investment law was enacted in 1993 when the NAFTA was being negotiated, so that itself is important.

It is frequently argued that both central banks and finance ministries are effective only if their reputations are high. So there is a reputational component that is very important and that can be strengthened by positive action on the part of the Fund. In many cases, Fund programs actually strengthen the hands of domestic authorities, particularly, again, central banks and ministries of finance, and they help them to be somewhat isolated from political pressures.

Another important impact, for example, is the role of international watchdogs. For example, the OECD recently published a report on education in member countries. Mexico got pretty bad marks and that spurred a national debate, easing the creation of an Institute for the Evaluation of Education, formed with the broad participation of the teachers' union and so on.

Another point that I would like to underline is the issue of transparency. The work on standards and codes, financial sector assessment programs, and so on has been extremely useful in many countries, including Mexico.

Finally, of course, the Fund and international organizations can finance the domestic building of institutions.

III. Can International Organizations, on Occasion, Do More Harm Than Good?

There is a fine line between providing a useful spur to help mobilize domestic support for reform and meddling in domestic affairs on the other hand. The difference between constructive incentives and meddling is a thin one. This discussion is not new and it relates to the whole question of ownership. Therefore, I think it is very important, both in terms of the substance and of the form, how the Fund and international organizations interact with domestic authorities.

One of the main risks that international organizations run into is the flip side of the expertise that they accumulate in their, let's say, connection with all the

countries. They have expertise in a vast number of countries, but they really lack in-depth expertise in a single country. And since institutions often interlock, it is very difficult to see how pushing, for example, in one direction will affect other economic and social interactions.

IV. Final Thoughts

Two additional points deserve to be mentioned. The first is related to the Sovereign Debt Restructuring Mechanism (SDRM). I think that it is very laudable, of course, that the Fund has launched the discussion on the SDRM to try to smooth the relations between different agents, creditors and debtors, in a country. However, I think that the form and timing of these efforts in the framework of pretty strong opposition on the part of issuers and the international financial community is something odd, and one has to reflect on it.

The final point is that it is as important to create institutions as it is to preserve them, so one of the important roles of the Fund when it assists a country is to avoid a breakdown of the institutions. The tragedy of Argentina, I think, more than anything is the total breakdown of existing institutions. In countries where the Fund has been effective—Mexico, Brazil, and so on—it has helped to preserve and strengthen institutions. In the case of Mexico, as part of our 1995 program we took this issue of transparency very seriously at the central bank, and this was an important element in enhancing, let's say, the working and the credibility of our institutions.