IMF SURVEY

Openness, market-friendly institutions, and flexibility are important ingredients for growth

During July 23–27, the IMF Institute offered a course on economic growth as part of its in-house training program. Xavier Sala-i-Martin, Professor of Economics at Columbia University, came to the IMF for the seventh time to discuss growth from a theoretical and empirical perspective. As on previous occasions, there was a large demand for this very popular course. Sala-i-Martin spoke with the Alicia Jiménez of the IMF Institute about the main factors that need to be present in order to stimulate growth.

JIMÉNEZ: If one had to choose the three most important determinants of growth, what would they be?

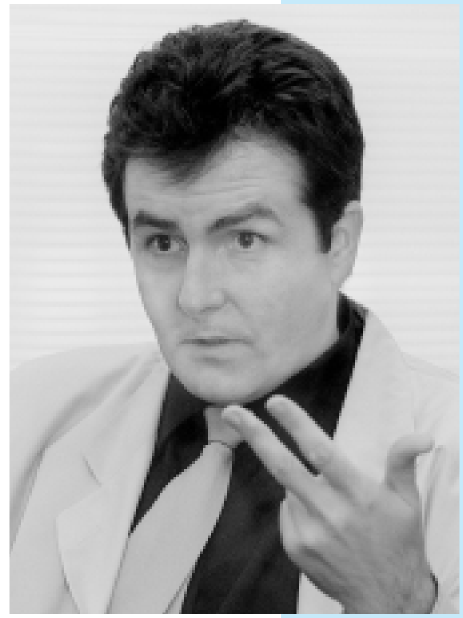
SALA-I-MARTIN: First, factor accumulation—physical and human capital—education, and so on. Second, various institutions that are friendly to markets. Third, openness not only to trade, but also to capital, to technology, to ideas, to foreign direct investment, and to information.

JIMÉNEZ: From a historical perspective, does the empirical evidence show that those three factors were present in most countries that have experienced sustainable growth?

SALA-I-MARTIN: My previous statement comes from empirical observation. But growth experiences are diverse; no single recipe works for every country. Some countries have done well. Other countries in the same circumstances have not done well. But by and large, the three characteristics that I have mentioned—and there are actually more—seem to be present when a country's growth effort is successful, and to not be present when it fails.

JIMÉNEZ: What does the empirical evidence say about the links between health, education, and investment in human capital and growth?

SALA-I-MARTIN: The links between health and growth are pretty clear. Good health is good for growth. Countries with a high life expectancy tend to do a lot better with growth. It's clear that at some level education matters, but the link is not as clear as one would like. In fact, a puzzling finding in the literature is that a lot of education measures—college enrollment, for example—do not seem to correlate well with growth. One possibility is that, in many countries, a college education may not really benefit or enhance human capital. You might go to college and learn a lot of theoretical things that are not useful for production. My favorite explanation is that what you need to learn is not things, but how to *learn* things. In a world in which technologies change very rapidly, the labor force needs to be educated flexibly. You learn how to produce watches today, but in the next year or two, you're going to be producing CDs; and in another five years, you'll be producing something else. So, if you are trained to produce watches, and the economy produces watches, you are fine. But the minute the economy goes on to produce CDs, then you have an inflexible labor force that has not learned to learn, and this can put the brakes on growth. And this is not measured by years of education.



Sala-i-Martin: "In a world in which technologies change very rapidly, the labor force needs to be educated flexibly."

JIMÉNEZ: Can we say that all growth is the same, or are there high-quality growth paths?

SALA-I-MARTIN: There are different kinds of growth, some good, some bad. I think the best growth is the one that is sustainable in that it can keep going for a long time. For example, certain kinds of growth that are driven by heavy demand factors tend to die if there is too much of an increase in aggregate demand without a corresponding increase in aggregate supply. Then you end up with high inflation. So this kind of growth is not sustainable. Sustainable growth drives supply and demand simultaneously.

JIMÉNEZ: In many countries, in particular in Latin America, a question people ask is: Now that we have attained higher macroeconomic stability and fiscal conditions have improved, what is the next step? How do we get rid of slow growth, poverty, and unemployment?

SALA-I-MARTIN: Well-functioning macroeconomics is important, but it's not the only thing. You need well-functioning microeconomics too. And that means well-functioning labor markets that are flexible, not only from a legal point of view, but more in terms of the flexibility of the mind. You should not go into the job market at age 16, get a job in a bank and think that you are going to retire from the bank. In a changing and technology-driven world, you have to be ready to move not only across regions and maybe countries, but also across sectors. People are not born bankers or

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producers of radios; they are born people, and they should be ready to work in many different places throughout their lives.

Another component you need is well-functioning institutions. The main failure in many countries does not come from macroeconomic policy or from markets not working well, but from the lack of institutions that are important for growth—for example, property rights. If, in a certain country, there's a strong probability that somebody is going to steal an investment or there's going to be a war, or there's a lot of crime and an ineffective police force, nobody is going to invest in this country even if it has implemented good policies.

Finally, you need to be connected to the world. Closed economies don't work well. I'm not talking just about trade; an open economy means free movement of goods, capital, ideas or technologies, information, and people.

Having said this, I would say that the optimal institutions and policies are different for different countries. If you try to implement Norwegian institutions in Zimbabwe, or east Asian institutions in Lesotho, you're going to fail. Each country—or maybe each region—has its optimal way of working.

Jiménez: So, if a region or a country is trying to find its optimal path for growth, how would the process work—through consultation among people, from the bottom up?

Sala-i-Martin: Exactly. That is better than having intelligent people in Washington listen to the experts, because the experts tend to look at what has succeeded. Look at Singapore, Hong Kong SAR, or Taiwan Province of China; they have grown a lot, they are big success stories. So let's introduce these same things in Zambia. Well, that's not going to work because Zambia's people, history, institutions, weather, and geography are different. Zambia is not going to be able to do exactly what Singapore did. People around the region in Singapore can copy each other because they are similar culturally, historically, geographically. If you look at development worldwide, the success stories and the disaster stories tend to come in regions. I think this means that you should learn from your neighbors, not from people who are far away. I am not saying that the people inside the continent or the region know exactly what they should be doing. But at least, we should be listening to them. Those of us from the rich countries don't know these things. We can offer advice and our expertise, but the main policies have to come from them.

Jiménez: On the relationship between the political system and growth: Many people say that for sustainable long-term growth, the best political system is a democratic one. What is your view?

Sala-i-Martin: I would first question the premise that democracy is a prerequisite for growth, because some of the biggest success stories have not been in countries that are very democratic. I think that, to succeed, you need to involve the very poor people in the economy. One way to make sure that people are not left behind is to institute a good democratic system that makes people feel that they belong in the process. But a lot of dictators are able to do that, too. For example, at least until 1997, Indonesia during the Suharto years did quite well, and the poor did especially well; the cronies did very well, too, of course, much better than everybody else. But the government eradicated poverty in numbers that we had not seen before. The same is happening in China. Millions of people are leaving poverty. Neither country has a democratic system. The key is not to leave the masses behind; then you can succeed.

Jiménez: What can the IMF do to help in this process of growth? Aside from promoting macroeconomic stability, what role do we have in growth and poverty reduction?

Sala-i-Martin: These are two different questions. Does the IMF have a role in poverty reduction? And should the IMF do it? I am not sure the answer is yes. For a number of reasons, everybody should do their job and only their job. If you try to do somebody else's job, you don't do as well. The IMF's main goal is not to eradicate poverty or to educate little girls in poor countries. There are other institutions that should be dealing with these issues. Since the IMF is not the expert on these issues, when it fails, say, in trying to eradicate poverty, then everybody says the IMF is useless. But it's not useless; it's simply not the IMF's job. The IMF may be doing a perfect job with the work it should be doing, but if it fails at something it shouldn't be doing anyway, then the reputation of the whole institution suffers. That's one part of the answer.

But suppose we say the IMF should be attempting to promote growth. As I've already said, there is no single recipe for growth. And even if there were, it would be impossibly complicated. So it would be foolish for a single institution to try to promote growth everywhere in the world. How would you do it? Conditionality? We'll give you money if you do these 75 things. But we don't know whether these 75 things are good for every country. So you're going to make mistakes. If you try to introduce European institutions in Latin America, it's going to be a disaster. So I think the IMF can help the process by doing what it should be doing: promoting macroeconomic stability. I know it's only one of the four legs involved in the growth process. Other people should be responsible for the other three legs.

Jiménez: The IMF and the World Bank have been looking at poverty and growth. In your view, should it be up to each country or region to decide what is the optimum way to grow and then call in the IMF for help?

Sala-i-Martin: The IMF should help but should listen more. Maybe the way to do it is to set up objectives common to both of you and that they like, rather than the means to achieve objectives. Suppose you try to quit smoking. It's obvious to everybody who has tried to quit smoking that unless you want to you're not going to. Suppose somebody says, unless you quit smoking, I'm not going to give you any food. You're going to pretend you've quit, and then you're going to run to the bathroom for a smoke every time you can. Many times when the IMF tries to impose too many conditions—even if they are good for the country or the country agrees that this is exactly what it should be doing—countries say the IMF or the World Bank told us to do it, so now we don't want to. The idea must be theirs. They say, how do we start growing? They think they've come up with answers, so you tell them, "Here is the money to do what you want but within certain rules; we'll help you do what you think is right." I think this would be more successful than reading off 75 points from a recipe. And the people in the country have to be committed, because all of these things—all of these 75 points—will mean big sacrifices and lots of problems implementing these policies. Unless you are really committed, you are not going to make it, because the first time it hurts, you're going to stop.

Jiménez: What are poverty traps and why do countries fall into them?

Sala-i-Martin: Some countries appear to be stuck at a certain level of income and poverty and are unable to get out. In that sense, it's a trap. But I am not sure that people fall into traps. Remember, before 1750 and the industrial revolution, all the countries in the world were poor. Effectively, everybody was in the trap and slowly countries began leaving it—first England, then the United States and Europe, and then Japan and east Asia, and, most recently, India and China.

I think we should be optimistic about moving out of the poverty trap for two reasons. First, we've seen a lot of countries leaving and almost none going back. You read of many success stories; people call them miracles. But I don't agree because the word "miracle" implies that we don't know what happened. We can analyze developments in China and the east Asian economies, for example, and it is very clear what has happened.

If you apply this principle generally, you will reach the conclusion that in 300 years, everybody is going to be rich, out of the trap. Every 40 years, we have 15 countries leaving and 1 coming back. Maybe we don't want to wait 300 years, but at the end of the day, that's what's going to happen.

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In the last 20 years, we have seen that inequality in the world is falling rapidly. This isn't immediately apparent if you look at variations among countries. People say: Oh, the poor are becoming poorer and the rich are becoming richer. But this leaves out something very important that is happening in the middle of the distribution: The two largest countries in the world—China and India, one-third of the world's population—are growing tremendously and eradicating poverty at rates not seen in previous history. So if you think of population rather than countries, then inequality is falling.

Jiménez: Do you think that promoting growth and preserving the environment are incompatible? Can one grow and at the same time protect the environment for the benefit of future generations?

Sala-i-Martin: I don't think they are incompatible. As we get richer, we are more concerned about the environment. Poor people don't worry about whales; they have other worries that are much more important. In this sense, growing might be a solution. Once everybody is rich, everybody's going to be worried about the environment. There's going to be a moment when we can say, okay, we can reserve 5 percent of GDP to protect the environment. But you have to be rich before you can save.

Second, I think growth is going to help the environment because the solution will be technological. We burn carbon dioxide, which is presumably causing this global warming, because we don't have anything better to burn. If we had a way to transmit the sun's energy for free and use it to move our cars and our industry without emissions of carbon dioxide, we would use it. Eventually, we will develop the technology, but we need to be sufficiently rich to devote enough resources to research and development. New technologies are not going to come from poor countries. So stopping growth will not help solve the problem and, in fact, could make it worse. ■