
Institutions and economic performance

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Institutions matter for economic performance. But what is meant by “institutions”? In the words of the Nobel laureate Douglass North, “institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.” While the study of markets has dominated economics scholarship over the past fifty years, the importance of institutions on economic outcomes has recently been emphasized by some economists. There is now a sizeable and growing literature on this subject.

Political institutions (such as legislative bodies), for example, play a critical role in the determination of policy. Until recently, however, much scholarship in economics was based on the assumption that policy is determined by a benevolent dictator. Many economists continue to adopt this approach. While in some (limited) instances this can be a reasonable working assumption, in general it is utterly silly. The analyses of policy when political institutions are taken into account are relatively more complex. While simplicity is a good virtue, it should not however be pursued at the cost of flawed analyses and potentially misleading conclusions. As Albert Einstein noted, “make everything as simple as possible, but not simpler.”

The point being made here applies equally to other organizations such as universities and firms. The institutional structure, which delineates who has what decision-making authority, is an important determinant of the performance of an organization. While the qualities of the people who are appointed (or elected) to take those decisions are of equal import, the

constraints imposed on them by the institutions need to be optimally designed.

A concern not mentioned thus far is that institutional *designers* may have their own (private) interests. This suggests the desirability of setting up an appropriate institutional structure within which they are to operate. Recall that they are entrusted to design the institutions within which policy would subsequently be determined, by other people. Sometimes, however, these “other people” could include some of these very institutional designers (such as when members of a parliament are involved in the design of the rules governing their own expenses). How nice it would be if only one could have impartial and wise people (such as the founding fathers that designed the US constitution) as institutional designers. If only life were that simple!

The institution of marriage is another type of (social) institution that impacts on economic performance. While there are a number of economists who study this institution, it is not something that is in the mainstream of the discipline. This is unfortunate as the household is a central organizational unit in society. Economists have overemphasized the centrality of markets at the neglect of institutions like the family for economic performance and well-being. This needs to change.

I close these brief observations on the importance of institutions for economic performance by recommending, as further reading, Douglass North’s classic treatise *Institutions, Institutional Change and Economic Performance*.

The illusion of stability: low inflation in a bubble economy

The Bank of England was granted independence in 1997 with a remit to control consumer price inflation. Research by **Marcus Miller** and colleagues shows that while this narrow focus preserved the semblance of stability for some time, neglect of the growing bubble in the housing market meant that stability was always an illusion.

Economists are deeply divided on how deregulated housing markets work. Some take an “efficient market” view, where house prices satisfy the arbitrage relationships of households making decisions in the light of current and future fundamentals. This is in line with the current mainstream “dynamic stochastic general equilibrium” (DSGE) perspective of how the economy as a whole functions.

Robert Shiller of Yale University, on the other hand, warns that house purchase is an area where “social contagion” plays a large role and buyers can easily lose sight of economic fundamentals.

This perspective finds support from behavioural economics. Using examples from US regional housing markets to show that arbitrage relationships have, in fact, been “broken,” David Laibson of Harvard University argues that the prevalence of “trend-chasing” and the acceptance of “social proof” can

promote prolonged asset price bubbles – and have done so.

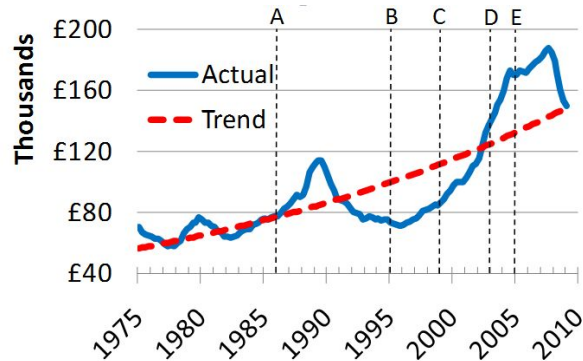
Neglecting house prices is as sensible as ignoring icebergs when steaming across the North Atlantic

What about the UK where house purchase and finance have been progressively deregulated since mortgage rationing ended in the late 1970s? As Figure 1 shows, house prices adjusted for inflation show two pronounced surges above trend since then, with peaks in 1988 and 2007 (when prices stood about a third above the trend line for the last 30 years).Some text.

While Robert Shiller’s index of real home prices in the United States (the Case-Shiller index) increased 85% between 1997 and the peak in 2006, real house prices in the UK more than doubled from 1997 – when

the Bank of England was granted independence with a narrow remit to control consumer price inflation.

Figure 1. Real House Prices in the UK, 1975 to 2009



Key: A. “Big Bang” in the City.

B to C. Most building societies become banks.

D. Andrew Oswald and the IMF warn of house price bubble.

E. Stephen Nickell of the MPC denies existence of bubble.

Source: Nationwide Building Society. Average house prices are deflated by the change in the Retail Price Index, based on 2009 (Q1) = 100. The upward trend is 2.9% per year.

In both countries, the “doctrine of denial,” espoused by Alan Greenspan (Federal Reserve chairman, 1987–2006), prevailed: since bubbles are difficult to detect and control, the central bank should restrict itself to coping with the after-effects of bubbles that burst.

Studies confirm that changes in real house prices in the UK have a momentum that can lead to prolonged departures from the trend or “equilibrium” prices. For example, a report by the International Monetary Fund (IMF) in 2003 provides evidence of excess valuation after deregulation in the 1980s, and of growing “disequilibrium” after 2000.

The IMF gave a clear public warning of asset price disequilibrium four years before UK real house prices peaked, as indicated in Figure 1. So too did our University of Warwick colleague Andrew Oswald, who, in early 2003, forecast a coming fall of 30%.

Two years later, however, Stephen Nickell, then the

longest-serving member of the Bank of England’s Monetary Policy Committee (MPC), took a very different view – effectively endorsing the efficient markets perspective.

New policy instruments require closer coordination between the Bank, the Treasury and the Financial Services Authority

What if a housing bubble affects aggregate demand via a “wealth effect,” boosting consumer spending excessively as rising house prices make people feel better off? Our research shows that a narrow focus on consumer price inflation – while neglecting a growing bubble in housing – may preserve the semblance of stability for some time.

But with the bubble-distorting policy on the way up and wreaking havoc on the banking system when it bursts, this is an illusion. A policy of neglecting house prices in these circumstances is about as sensible as ignoring icebergs when steaming across the North Atlantic!

What should be done? As Charles Bean, Deputy Governor of the Bank of England, has recently acknowledged, new instruments of policy, such as dynamic capital requirements and loan-to-value limits, are needed as a complement to interest rate setting for a bubble-prone economy. Effective use of these new instruments will surely require closer policy coordination between the Bank, the Treasury and the Financial Services Authority.

Publication details

This article summarises “The illusion of stability: low inflation in a bubble economy,” by Marcus Miller, Ishita Mohanty, and Lei Zhang, published in 2009 in *The Manchester School* 77, Supplement 1, pp 126–149.

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Climate change: a global deal or local solutions?

This December, the Copenhagen summit will aim to reach a global deal on reducing greenhouse gas emissions to mitigate climate change. Research by **Sayantana Ghosal** and colleagues explains the problems with a multilateral agreement, and proposes an alternative policy framework that builds on unilateral commitments, innovation and technology transfer and from which global solutions could emerge.

There is overwhelming evidence of both global warming and the contribution of human activities to climate change. To mitigate the possibility of potentially catastrophic climate change, the rise in global temperatures needs to be stabilised at 2°C initially and 3°C thereafter (relative to pre-industrial levels). This, in turn, requires a substantial cut in greenhouse gas emissions: estimates vary from between 50% and 80% relative to 1990 levels.

Given the global nature of emissions, the seemingly obvious solution is a multilateral agreement. And that is the ambition of the United Nations climate change conference due to meet in Copenhagen in December to finalise a successor to the Kyoto Protocol.

The problem is that such an agreement is highly vulnerable to one nation or a group of nations deciding not to participate or not to comply. This is ultimately because of the “negative externality” associated with greenhouse gas emissions: emitters do not pay the full

costs of the damage they cause to other nations or future generations.

Cutting emissions incurs costs in the short run while yielding uncertain benefits in the future. By delaying participation or by not complying with agreements, nations can capture the benefits from continuing with “high-carbon” economic activities while passing a significant portion of the costs to other nations and future generations.

Unilateral commitments to cut emissions can stimulate innovations that lower the cost of switching to low-carbon activities

Our research suggests that the fact that there are weak property rights over global emissions (and the threat of retaliatory punishment is limited) is likely to blunt the effectiveness of a broad-based multilateral agreement on climate change. Instead, we propose a

policy framework that builds on unilateral commitments to deliver cuts in emissions, which stimulate appropriate innovation and technology transfer.

Although a multilateral agreement to cut emissions has been hard to achieve, there have been many local, regional and national unilateral initiatives to mitigate climate change. Such unilateral initiatives are more likely to emerge at sub-national levels, which requires effective local powers as in federal political systems. The question is how should policy be designed to respond to such local or national initiatives to ensure they can have a global impact.

Subsidising the transfer of innovations that lower emissions can help local solutions become global solutions

We argue that an initially limited, unilateral commitment to cut emissions by a small group of nations (or individuals, firms, cities or regions within a nation) will stimulate innovation in technologies that can lower the cost of switching to “low-carbon” economic activities. Such innovation – together with a system for subsidising technology transfer – will alter the participation constraints of economic actors over time and result in a cumulative process of emissions reductions.

Stephen Pacala and Robert Socolow of Princeton University have outlined fifteen policies, which they call “wedges” because of the impact their implementation would have on the growth of emissions. Implementing seven of these wedges would cut that growth by enough to place the world on a path to stabilising the climate by around 2050.

If a high-emissions nation (or locality) implements some wedges within its borders, others can learn from the experience and use the innovations, whether they are policy innovations or technological innovations.

For example, a city might introduce a set of measures (such as congestion charging or improved public transport) to encourage greater use of public transport. If some of these measures are successful, other cities elsewhere in the world can learn from its experience

and implement similar measures.

At a national level, reducing the cost of generating electricity by wind or solar power potentially benefits many nations and not just the one within whose borders the innovation takes place. In other words, in any unilateral initiative of this kind, there are significant “positive translocational externalities.”

Nations on their own may never achieve a complete switch to low emissions, but a well-designed learning process that builds and strengthens “positive spillovers” across nations may eventually deliver a global switch. A global funding mechanism to subsidise technology transfer, together with the adoption of open technology standards, may well be the essential ingredient here to encourage participation by nations that are otherwise reluctant to make the switch.

How should policy empower economic actors to act unilaterally to cut emissions? How might unilateral initiatives interact with existing multilateral agreements? And how should the sequencing, coverage and design of these local, national and regional climate change agreements be structured to minimise the delay in the global transition to a low-carbon economy? Our research continues to address these challenging questions.

Publication details

This article draws on “Technology, Unilateral Commitments and Cumulative Emissions Reduction,” by Shurojit Chatterji and Sayantan Ghosal, *CESifo Economic Studies* 55:2, pp. 286-305, June 2009, available at http://www.cesifo-group.de/link/vsio8_GE_Ghosal.pdf, and “Unilateral Measures and Emissions Mitigation,” work in progress by Shurojit Chatterji, Sayantan Ghosal, Sean Walsh and John Whalley.

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Barriers to trade within the European Union

Tariffs on trade within the European Union were abolished decades ago. But research by **Natalie Chen** and **Dennis Novy** finds that significant trade barriers remain, notably “technical barriers to trade,” such as health and safety requirements as well as packaging and labelling requirements.

European economic integration was launched in the 1960s with the creation of customs unions, abolishing internal tariffs and trade quotas. The process was revived within the European Union (EU) by the Single European Act of 1986, which aimed to complete a Single European Market by the end of 1992.

More recently, the introduction of the single European currency – the euro – was intended to accelerate the process of trade integration by eliminating exchange rate uncertainty and increasing transparency and competition across markets.

The single market was motivated by the observation that in the 1980s, trade within Europe was still impeded by significant barriers to trade. In particular, there remained many non-tariff barriers, including so-called “technical barriers to trade.”

These barriers result from regulations that affect the sale of goods in some markets by requiring specific

product characteristics or production processes, for example, a certain package size for food products.

With intra-EU tariff barriers having been completely eliminated by 1968, technical barriers have become increasingly visible. They are also a key concern in today's global trade negotiations, with the World Trade Organisation (WTO) seeking to ensure that (from the WTO Agreement on Technical Barriers to Trade):

... technical regulations and standards, including packaging, marking and labelling requirements [...] do not create unnecessary obstacles to international trade.

The costs of technical barriers to trade eclipse the costs associated with being outside the euro area

So how much progress has the EU made in removing internal barriers to trade? Our research measures trade integration within the EU by examining 166 manufacturing industries in 11 member states over the period 1999-2003. We find that significant trade barriers remain and, apart from the inevitable transport costs, the most substantial costs are technical barriers.

Indeed, the costs of these barriers eclipse the costs associated with being outside the euro area. They also eclipse the costs of not abolishing physical border controls – between continental Europe and the UK – by opting out of the Schengen Agreement.

In quantitative terms, we find that the costs associated with geography and transport explain 25% of the variation in trade integration. The most important factor is the weight to value of traded goods (17%), followed by the distance between the origin and destination of shipments (5%).

Policy action could lead to further gains from the reduction of trade barriers within Europe

Policy factors explain 7% of the variation in trade integration, which is far from negligible. Technical barriers to trade are the most important factor (5%), while public procurement, Schengen and the euro only

play very minor roles.

The policy implications of these results are clear. While the barriers related to geography and transport costs arise from the very nature of spatial separation between markets, policy barriers such as technical barriers to trade are in principle removable. This suggests that there is room left for policy action and that further gains are possible through the reduction of trade barriers in Europe.

Publication details

This article summarises “International Trade Integration: A Disaggregated Approach,” by Natalie Chen and Dennis Novy, Centre for Economic Policy Research Discussion Paper No. 7103 and Centre for Economic Performance Discussion Paper No. 908, available at

http://cep.lse.ac.uk/_new/publications/abstract.asp?index=3276. A more detailed account of the research is available on Vox at

<http://www.voxeu.eu/index.php?q=node/2831>.

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