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Third IMF Annual Research Conference

Can capital flows be made more user friendly?

Guillermo Calvo (right) delivers the Mundell-Fleming lecture. At left is IMF Research Department Director Kenneth Rogoff.

IMF economists and researchers from outside the institution gathered at the IMF's Third Annual Research Conference on November 7–8. The conference had an overarching theme of capital flows and global governance but also dealt with an eclectic array of other issues that economists at the IMF and elsewhere are exploring.

Nowadays, as IMF Managing Director Horst Köhler noted in opening the conference, the line between interesting research and important day-to-day operational work is blurring, as it should be. As former U.S. President John F. Kennedy once said, "Too often we enjoy the comfort of opinion without the discomfort of thought." Köhler suggested that the IMF needs the "discomfort of thought" to arrive at fresh and balanced views that are useful for policy discussion.

In that spirit, a number of papers focused on the IMF's stepped-up efforts to figure out an orderly way for countries in financial distress to restructure their debts. Two approaches are being studied simultaneously: a statutory approach—a possible new international legal regime in which debt restructuring is mandated—and a purely market-based approach in which *(Please turn to the following page)*

Panelists favor IMF involvement in building better institutions but differ on exact role

The failures of domestic institutions took center stage during the Asian financial crisis. Many critics faulted the IMF for not detecting these weaknesses; others felt that the IMF should not meddle too much in domestic affairs. Should international financial institutions, particularly the IMF, involve themselves in domestic institutions? In a November 8 IMF Economic Forum, part of the IMF's Annual Research Conference, Guillermo Ortiz, Governor of the Bank of Mexico; Nancy Birdsall, President of the Center for Global Development; Jeffrey Frankel, Professor of Economics at Harvard University; and Jeffrey Sachs, Professor of Economics at Columbia University, tackled this question.

The IMF cares about the quality and scope of domestic institutions, which are critical for countries' economic development, growth, and, *(Please turn to page 372)*

Nancy Birdsall (center, with Guillermo Ortiz (left) and Jeffrey Sachs (right)): In Latin America, so many households are close to the poverty line that it is a mistake to distinguish between the poor and the rest of the population.

In this issue

Patrick Bolton

Jeffrey Frankel

Dealing with sovereign debt restructuring

(Continued from front page) debt contracts are encouraged to include renegotiation-friendly clauses.

Insights from corporate bankruptcies

A presentation by Princeton University Professor Patrick Bolton looked at what sovereign debt restructuring efforts could learn from corporate bankruptcy practices. After comparing bankruptcy regimes across a number of countries, he concluded that the U.S. regime is perhaps the most relevant for the international system. Interestingly, despite its acceptance today, the U.S. regime was very controversial in the nineteenth century. At least seven attempts were made to introduce some sort of bankruptcy code between 1789 and 1898, each attempt prompted by a major economic crisis. Laws were passed in 1800, 1841, and 1898, but the first three were repealed within a few years of their enactment. Perhaps there is a lesson here for the quest for an international bankruptcy procedure, Bolton suggested. With patience, a system with merit may eventually earn acceptance, even respect.

Bolton also presented some arguments in favor of a statutory approach. A market-based approach, he said, might lead to debt that is excessively difficult to restructure for several reasons, some of which have been developed in the corporate finance literature. For example, creditors may insist on high restructuring costs mainly as a way of guaranteeing that their loans take priority over those of other lenders. Another problem is that the administrations that build up debt are typically no longer around when the time comes to repay, and thus, they may not fully internalize the future costs of financial distress.

But there is a limit to the similarities between corporate and sovereign debt restructuring, Bolton cautioned. In particular, creditors' ability to collect collateral is more limited in the international context. Thus, debtors have a natural edge in international negotiation. To encourage acceptance by creditors, Bolton noted, U.S. history offers examples of "exemptions" or state provisions for opting out. These helped reduce resistance to a federal system. Bolton also believes that "jurisdiction shopping," whereby debtors choose a court in which to file for bankruptcy, is a useful feature of the U.S. system that may be worth replicating in the international setting.

In discussing Bolton's paper, Harvard University Professor Jeffrey Frankel concurred that the U.S. bankruptcy regime is a relevant benchmark for the international context. "The United States often tries to persuade multilateral forums to extend the approach that it follows at the domestic level to the international level, out of a conviction that its way represents either free market virtue, or lazy ignorance of competing standards, or a conscious desire to give its firms a leg up," Frankel noted. But this time, he said, using the U.S. bankruptcy code as a model for an international statutory approach for sovereign debt restructuring has real merit. Ironically, Frankel pointed out, the U.S. government was slow to come around to this idea, and the U.S. investment community remains opposed, at least for the moment.

Columbia University Professor Jeffrey Sachs, an early proponent of an international bankruptcy court, suggested that Chapter 11 of the U.S. bankruptcy code is not the only chapter relevant to this discussion. In his view, Chapter 9 and maybe Chapters 7 and 13 are also relevant. These offer a "fresh start" to debtors, particularly municipal governments, so that they don't have to be forever burdened with a large debt. The current international system, Sachs argued, does not offer enough of a fresh start to sovereign governments that have accumulated a mountain of debt. This debt, he added, undermines the well-being of people, particularly the poor. He suggested that a new international system should give more explicit recognition to the concept of a fresh start.

Weighing collective action clauses

Adding collective action clauses to bond contracts has been billed as an important component of a market-based approach to the sovereign debt restructuring problem. A collective action clause stipulates that a qualifying majority of creditors can decide on the terms for restructuring payment with the debtor and makes this decision legally binding on the rest of the bondholders. The objective, which is similar to the statutory approach that Bolton discussed, is to minimize the risk that a minority of creditors could unnecessarily prolong the negotiation process to the detriment of the collective interests of the creditors, as well as of the interests of the debtors.

Because collective action clauses do not necessarily grant an automatic stay on debt repayment and do not necessarily allow new borrowing by the debtor to have seniority over existing debt, such clauses are much less ambitious than the statutory approach to sovereign debt restructuring. Nonetheless, some researchers and debtor countries have expressed concern that both collective action clauses and the statutory approach might increase the cost of borrowing. Their reasoning is that anything that could make it easier for debtors to renegotiate their debts could potentially make creditors more reluctant to lend. But an argument could also be made that a collective action clause (or a statutory framework) that helps creditors and debtors reach an efficient outcome faster might *enhance* investors' willingness to lend.

Of course, the argument could be sustained forever in the abstract or it could be grounded in data, as IMF economist Torbjorn Becker sought to do in his paper. He compared the yields of bonds with a collective action clause—issued under London law—with the yields on bonds without such a clause. (Interestingly, the research paper on which Becker based his presentation could be considered a collective action: two of the coauthors hail from the other side of the globe—Australian central bank economist Anthony Richards and Thai central bank economist Yunyong Thaicharoen.)

After dissecting the data in a number of ways, the authors found no evidence that the use of a collective action clause has increased debtors' borrowing costs. In theory, debtors with a relatively high risk of default might be the most likely group to face higher borrowing costs because creditors would be most concerned about this group of debtors. Indeed, this finding is reported in earlier research. Becker, Richards, and Thaicharoen, however, did not find support for this notion in the data. They found, paradoxically, that borrowing costs for high-risk debtors actually declined with the inclusion of a collective action cause.

Michael Mussa, former Economic Counsellor and Director of the IMF's Research Department and now a Senior Fellow at the Institute for International Economics, agreed that the collective action clause has not raised the borrowing cost. And this is quite consistent with what he knows about market participants. Investors simply do not consider collective action clauses an important feature in pricing bonds and often confess to blissful ignorance of the subject. Mussa reminded his audience of Rudiger Dornbusch's quip that all empirical work should pass the "pigs do not fly" test. Any empirical finding that collective action clauses have a significant impact on bond prices is, he said, a pig that flies.

Why "sudden stops" in flows?

Another hot topic was the volatility of capital flows. Around the time of the Latin America debt crisis in the 1980s, the Turkish crisis of 1993–94, and the Asian crisis of 1997–98, for example, capital flows to the affected countries dried up or reversed sharply just before, or during the early phase of, the crisis. Guillermo Calvo, Chief Economist at the Inter-American Development Bank and professor at the University of Maryland, dubbed this phenomenon "sudden stops." In the conference's annual Mundell-Fleming lecture, he pondered the causes of sudden stops and how developing country governments could mitigate their negative impact. Calvo offered a new theory. Like wind and rain in a storm, a sudden stop of capital flows, a halt in growth, and a balance of payments crisis often occur simultaneously. He argued that fiscal policy holds the key to why these three phenomena can occur together, particularly in emerging market economies. Because government expenditure must be financed partly by output taxes that tend, in turn, to discourage production, multiple outcomes are possible. In the favorable scenario, output is high and there is less need to collect taxes, which helps maintain high output growth. In the unfavorable scenario, a low rate of output growth leads to a high rate of tax that must yield a given amount of revenue. But the high tax rate discourages economic growth and could lead to a growth crisis. At the onset of the crisis, capital inflows stop suddenly.

Calvo's theory is simple and elegant and gives rise to many interesting insights. According to his model, currency crises, as a direct consequence of sudden stops, may be a sideshow of the dysfunctional domestic policies and financial vulnerabilities that can trigger and amplify these crises. Thus, rather than deal with currency crises on the surface, governmental authorities, the IMF, and other international institutions should concentrate on improving fiscal policies and financial institutions. Policymakers should also be prepared with appropriate emergency drills. There is a message the IMF and other international institutions can take from Calvo: they should try to coordinate a high-growth, low-tax scenario for developing economies facing the threat of a sudden stop in capital flows. The coordinating efforts should include possible burden sharing by the lending community (under the label of a "private sector bail-in").

Consumption volatility

Sudden stops in international capital flows can cause dramatic ups and downs in developing countries' income and consumption. But capital flows, by allowing these countries to borrow in bad times and repay in good times, can also help stabilize consumption. In the final analysis, then, does international financial integration reduce or raise consumption volatility? Three IMF economists—Ayhan Kose, Eswar Prasad, and Marco Terrone—centered their presentation on this question.

They found that output volatility declined in the 1990s relative to the three previous decades but that consumption volatility relative to income volatility

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF; Rodrigo Arangua for AFP, page 377; Yuri Cortez for AFP, page 378; and U. S. National Archives, pages 382–84.


Torbjorn Becker


Michael Mussa


Guillermo Calvo


Eswar Prasad


Ratna Sahay

actually increased, on average, in the most financially integrated developing countries.

When they looked at what financial integration brought to developing countries, they found a "threshold effect." Up to a certain point, more financial integration appears to be associated with more consumption volatility. But beyond this threshold, consumption volatility starts to decline as integration increases. This effect suggests an interesting way to view the consequence of financial globalization. In his discussion of the paper, MIT economist Roberto Rigobon termed the results interesting but maintained that more research would be needed to check their robustness before firm policy conclusions could be drawn.

Another research paper, by IMF economists Paul Cashin, Luis Céspedes, and Ratna Sahay, investigated the real exchange rate movements of countries that are highly dependent on a small number of commodities, such as cocoa, cotton, or copper. They found that changes in commodity prices for 22 out of 58 such countries largely explained the movements in the real exchange rate. Their study highlights the importance of stabilizing commodity prices for these economies.

No one at the conference said that volatility of capital flows or debt crises would disappear any time soon, but many papers suggested directions that developing countries and the IMF could take to better manage these phenomena. If the conference demonstrated the "discomfort of thought," then the discomfort was lively as well as informative. And the search for a deeper understanding of capital flows and global governance goes on—to be continued at next year's Annual Research Conference. ■

Shang-Jin Wei, Haizhou Huang, and Olivier Jeanne
IMF Research Department

Also at the conference . . .

"IS-LM-BP in the Pampas," Andrés Velasco (Harvard University), Luis Céspedes (IMF), and Roberto Chang (Rutgers University)

"Banking, External Flows, and Crises," Raghu Rajan and Douglas Diamond (University of Chicago)

"Bubbles and Capital Flows," Jaume Ventura (CREI-UPF and MIT)

"Securities Transaction Taxes and Financial Markets," Karl Habermeier and Andrei Kirilenko (IMF)

"Global Financial Integration," Philip Lane (Trinity College, Dublin) and Gian Maria Milesi-Ferretti (IMF)

All of the conference papers are available on the IMF's website (www.imf.org/external/pubs/ft/staffp/2002/00-00/arc.htm)

Backbone of a market economy

The key is for the IMF and other international organizations to find the right degree of involvement, so that they help mobilize domestic support for reform but do not meddle in domestic affairs.
—Guillermo Ortiz

(Continued from front page) especially, stability, according to IMF Deputy Managing Director Eduardo Aninat, who served as the forum's moderator. But exactly what role should the IMF play in promoting sound institutions? Some critics believe that when the IMF gives advice or attaches conditions to loans—known as conditionality—it should stick to monetary, fiscal, and exchange rate issues and financial sector policies and avoid issues related to governance, accountability, quality of institutions, and standards and codes.

Institutions are backbone of society

Guillermo Ortiz noted that domestic institutions establish the "rules of the game" for a society—that is, they set the laws and practices sanctioned by custom and tradition that lend stability to the relationships between individuals and groups. Good institutions, he said, provide a framework for private agents to carry out their transactions efficiently. "They are the backbone of a market economy," he said.

So why don't governments devote more resources to improving them? One reason is a lack of knowledge and resources in the organizations that could help manage change. A second reason is that special interest groups, actively pursuing their own interests, do not allow change. A third reason is inertia.

Can international organizations help change domestic institutions? The answer, according to Ortiz, is yes. They can be very helpful in overcoming the first problem—knowledge base; somewhat helpful in overcoming the second problem—special interest groups; and of absolutely no help on the third problem—inertia.

The key, Ortiz suggested, is for the IMF and other international organizations to find the right degree of involvement, so that they help mobilize domestic support for reform but do not meddle in domestic affairs. That means they must ensure that countries stand behind their reforms (this is known as ownership). The IMF also needs to remember that it is as important to create institutions as to preserve them.

"Social contract"

Nancy Birdsall agreed on the importance of country ownership, but for her it was critical to ensure that it occurred in the context of a "social contract," especially when it came to emerging market economies, which are subject to a lot of volatility and instability in part because they are open market economies. Birdsall defined such a contract as the outcome of a collective decision, usually through a political process, whereby a society and its citizens arrange to mitigate some of the cruelties of the unfettered market.

Why should the IMF be involved in promoting such a contract? Birdsall suggested two reasons. First, good fiscal policy, which is certainly IMF business, is the basic ingredient of a healthy social contract in an open economy. It promotes job creation and enables governments to both implement countercyclical policies and protect the most vulnerable groups—not just the poor but also, when times are bad, vulnerable middle-income groups. It also refers to the composition of the tax burden and expenditure benefits, which Birdsall argued had received inadequate attention from the international financial institutions.

Second, financial sector policies, which are also IMF business, affect the capacity of societies, particularly in open and emerging market economies, to manage the social contract. Financial sectors in emerging markets tend to be shallower and less able to help manage shocks, to which middle-income working-class households (the "political bedrock of a social contract that works") are particularly vulnerable.

During the Asian crisis, it wasn't the poorest households that suffered the largest losses, Birdsall said, but the "urban strivers"—the potential emerging middle class in urban areas. And in Latin America, so many households are close to the poverty line that it is a mistake to distinguish between the poor and the rest of the population. Indeed, she suggested that it was misleading to think that Brazil recently elected Luiz Inácio Lula da Silva as president for "populist reasons." Brazil did so, she said, because middle-income working-class households were looking for a new kind of social contract.

What does this have to do with conditionality? Birdsall stressed that conditionality is not a substitute for ownership but rather a complement. As the IMF streamlines its conditions, she said, it should focus on limiting both their number and their breadth, crafting conditions that reflect more clearly the need for open economies to build social contracts that they own.

Where to expand?

Drawing on the recent growth literature, Jeffrey Frankel referred to the evidence found by some economists that institutions are the key determinants of economic growth, more important than geography and economic openness. But he suggested that the IMF's involvement with institutions—in which he included property rights and the rule of law—was also important in terms of its narrower responsibility for helping countries solve balance of payments problems. The IMF should support structural reform in countries, and, in fact, the organization is increasingly doing so.

Frankel presented a table (see below) to illustrate his point. The major issues that countries deal with are ranked vertically according to their relevance to balance of payments problems and horizontally according to how sure economists are that they have the right answer. The IMF has traditionally focused on macroeconomic issues (bottom row of table). But it (and the World Bank) has slowly expanded into institutional issues (middle two rows) that are "fairly" and "somewhat" relevant to balance of payments problems. Some critics, he said, feel that by moving up from the bottom row, the IMF has engaged in "mission creep." But Frankel believes the institution's involvement is appropriate, especially on those issues where economists are most confident of their answers. The World Bank, he said, should probably be moving more toward the upper rows of the table.

Doing more

The IMF is increasingly getting involved in institutional issues (shaded area).

How relevant is the issue to balance of payments problems?	How sure are economists that they have the right answer?			
	Not very	Somewhat	Fairly	Very
Not very	religion	capital punishment; drug policy	democratic elections; labor rights	human rights; environment
Somewhat	social capital	intellectual property rights rules; executive compensation	legal systems; competition policy; land tenure	poverty; education; military spending
Fairly	closing banks; disposing of nonperforming loans; best accounting rules; bankruptcy procedures	corporate governance; financial systems (capital adequacy; or relationship banking versus securities markets)	property rights; trade policy	corruption; fiscal transparency
Very	restoring confidence in a crisis	exchange rate regime; capital control; private sector involvement	budget deficits	monetary policy

It is easy to get institutional reform wrong.
—Jeffrey Sachs

Of course, country ownership of reform is highly desirable, he added, but may not always occur.

Ways that the IMF can help with institution building, according to Frankel, are by providing technical assistance and training; by assessing observance of standards and codes of best practices, including evaluations of countries' financial systems (through Financial Sector Assessment Programs); by including structural conditionality in IMF-supported programs; and by looking for deeper institutional causes in countries that repeatedly miss their targets and end up as prolonged users of IMF financing. "If a lack of democracy and a lack of stability are giving rise to repeated failures," he said, "then it may be appropriate to take that into account when deciding whether to cut a country off."

Dangerous misdiagnoses

Jeffrey Sachs cautioned that it was easy to get institutional reform wrong. "It is tougher than it looks, and we are not always on the right track," he said, stressing that it is the interconnectedness of the functions that is critical.

If one naively looks at a favorite institution, Sachs said, and sees that it is not flourishing, one may easily believe that the problem lies in the institution, even though it may be due to a failure of the interconnections. He said economists tend to focus on what they know best, engaging in endless debates about manipulating macroeconomic variables, when the roots of the problem may be much deeper—and thus need a different instrument for correction. Indeed, Sachs believes this misdiagnosis is partly to blame for the continued misery in what he referred to as the "dying societies" of sub-Saharan Africa, which is not a failure of macroeconomics.

If the IMF is going to maintain its involvement with Africa, he said, it should "take responsibility for understanding what it is doing," which doesn't mean taking responsibility for everything. But something it *does* mean is that the IMF should calculate a country's "financing gap" in a way that shows the amount needed to achieve the international community's development goals—and present this to donors. Countries should not just be told, "Here is what the donors are going to do, and you live within your means." ■

The full text of the November 8 Economic Forum, "Promoting Better National Institutions," is available on the IMF's website (www.imf.org/external/pubs/ft/staffp/2002/00-00/arc.htm).

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02/248: France: Report on the Observance of Standards and Codes

02/249: France: Selected Issues

02/250: Republic of Lithuania: Report on the Observance of Standards and Codes

02/251: France: 2002 Article IV Consultation

Other

Moral Hazard: Does IMF Financing Encourage Imprudence by Borrowers and Lenders? (Economic Issues, No. 28; free)

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More countries are providing data needed for effective IMF oversight

There is work still to be done, but an increasing number of countries are providing the IMF with data of the quality it needs to provide effective oversight of members' economic policies. According to the recently released staff report, Data Provision to the IMF for Surveillance Purposes, *and a summary of the Executive Board discussion of it, poor data remain a problem in one-third of the IMF's member countries. But the number has been declining and there has been progress on many fronts, notably with data on international reserves.*

Good data are a valuable commodity. Policymakers need them to make informed decisions; markets rely on them to fulfill their allocative role efficiently and to reward good, and penalize bad, policies; and the IMF requires them to provide effective oversight (surveillance) of members' economic policies. Crises have, in turn, underscored how severely data inadequacies can affect a country's economic well-being. The Executive Board noted that timely and adequate economic and financial data, especially on international reserves, external debt, and capital flows, are essential for assessing countries' external vulnerabilities and are key to the IMF's ability to strengthen its surveillance. But data enhancements can be costly in terms of resources, and the Board recommended balancing minimum data requirements and country capacity to fulfill these needs.

Progress on the reserves front

Rapidly diminishing international reserves have figured prominently in most external crises, but data have often been unavailable to alert other countries, markets, or sometimes even domestic policymakers of impending problems. Because data inadequacies have often hidden the need for remedial action until it is too late, improving international reserves data has been a focal point of IMF data reviews. Over the past two years, there has been noteworthy progress. Currently, nearly half of the countries covered in the report provide international reserves data to the IMF with lags of one week or less—up from the 38 percent recorded in the previous survey.

The IMF's Executive Directors lauded this progress as well as the use of benchmarks to promote and monitor the provision to the IMF of timely data for international reserves and for external debt. These benchmarks, which are the same as the prescriptions for the Special Data Dissemination Standard (SDDS), have provided a coherent and uniform framework for assessing these data and were seen as a "particularly encouraging step." The Board nevertheless viewed benchmarks as points of reference rather than as absolute standards and saw technical assistance in support of the provision of international reserves and external debt data as a priority.

Frequent and timely disclosure of international reserves data to the public is emerging as a best practice for subscribing countries, and countries with access to private capital markets are increasingly moving to weekly reporting with a week's lag to demonstrate "good housekeeping" and build market confidence in their data. For example, Peru started releasing weekly data on the composition of official reserve assets and reserve-related liabilities in mid-2001 while releasing daily data on gross reserves with a one-day lag. Thailand now posts, on a weekly basis, data on official foreign reserves of the central bank, including the net forward position, on its website.

At the time of the Board discussion, Directors did not consider it necessary to change the frequency and timeliness of reserves data dissemination under the SDDS. They cited technical and resource constraints for most subscribers and the prospect that a more demanding requirement might deter prospective subscribers. They urged more countries to subscribe to the SDDS and participate in the General Data Dissemination System. Over the past six months, the SDDS has, in fact, added 1 new subscriber for a total of 51. More subscribers to the SDDS are expected in the coming months.

Vulnerability assessments

Doing a good job of assessing country vulnerabilities is one of the best ways the IMF can help prevent crises,

Data issues have figured prominently in IMF oversight

Staff reports[1]
(number of reports; percent of totals in parentheses)

	Assessed overall adequacy of data	Adequate for surveillance	Inadequate for surveillance	Discussed implications of data deficiencies[2]
All countries[3]	**107**	**70 (65)**	**37 (35)**	**30 (81)**
Industrial	16	14 (88)	2 (12)	2 (100)
Transition	18	14 (78)	4 (22)	4 (100)
Emerging	12	8 (67)	4 (33)	4 (100)
Developing	61	34 (56)	27 (44)	20 (74)
Memo item: market-access economies[4]	45	32 (71)	13 (29)	13 (100)

[1] IMF staff reports on annual consultations with member countries, December 2000–November 2001, that assessed the overall adequacy of data for IMF surveillance.
[2] Of those reports whose data were assessed as inadequate for surveillance.
[3] Countries classified according to *World Economic Outlook* categories.
[4] All nonindustrial countries with access to international financial markets that have received external sovereign ratings from Moody's and Standard & Poor's as of 2001.

Data: IMF staff estimates

About one-third of the IMF's member countries still provide data judged inadequate for effective surveillance.

and the Board welcomed recent improvements in the IMF's discussion of vulnerabilities with its member countries. Given that the quality of these discussions is closely linked to the quality of data countries can compile, the Board called on staff to more clearly identify data deficiencies and the technical assistance needed to address them.

Since countries with access to international capital markets can be subject to rapid reversals of capital flows, sound data and transparent statistical practices are particularly vital for identifying these developments. The Board indicated that IMF vulnerability assessments should include frequent and comprehensive data on international reserves; detailed data on international investment positions, capital flows, and the maturity profile and repayment schedules of external and public sector debt; and financial soundness indicators, including corporate sector data. The objective should be compilation of these data in line with country circumstances and characteristics and internationally accepted statistical methodologies.

Priorities for improving the data were also debated. A number of the Directors felt the IMF should strengthen its analysis of public sector debt (especially its composition) before addressing issues related to private sector balance sheet exposures. Many viewed the compilation of comprehensive data for vulnerability assessments as particularly important for countries that borrow substantially on international capital markets in foreign currencies. But a number also suggested that international investment positions should be covered for a broader range of countries, including industrial countries that borrow internationally in domestic currency or whose private enterprises have significant international exposure. Most also sought a further strengthening of creditor data on cross-border exposures to complement debtor country data with creditor data.

Staff reviews typically give special attention to countries whose data are considered insufficient to meet the IMF's surveillance needs, and their reports recommend measures to address shortfalls. About one-third of the IMF's member countries still provide data judged inadequate for effective surveillance. But there is progress: now 65 percent of members—up from 60 percent in 2000—provide adequate data. The Board also noted other key advances, especially the recently completed *Government Finance Statistics Manual 2001*, which should help bolster the quality of critically important fiscal data. They also welcomed the new *External Debt Statistics: Guide for Compilers and Users*.

The Board encouraged national authorities to articulate their policies on data revisions. This would enhance the transparency of the data provided, document statistical practices, and help the IMF assess when the reporting of revised data could, in fact, constitute misreporting. To address the resource implications for member countries that are trying to strengthen their data, the Board urged staff to prioritize by carefully evaluating data gaps, capacity constraints, and technical assistance needs. ■

The staff report, *Data Provision to the IMF for Surveillance Purposes*, and Public Information Notice 02/133, IMF Executive Board Reviews Data Provision for Surveillance, are available on the IMF's website (www.imf.org).

IMF extends Argentina's repayment of SRF by one year

On November 20, the IMF's Executive Board approved a request from Argentina to extend by one year the repayment of SDR 105.9 million (about $141 million) under the Supplemental Reserve Facility (SRF).

On January 12, 2001 (see Press Release No. 01/3 on the IMF's website), the IMF approved financing for Argentina under the SRF as part of a Stand-By Arrangement to ease a short-term financing constraint. Normally, an SRF is expected to be repaid in two installments—one year and one and a half years after it is disbursed. For Argentina, the second installment would have come due on November 22, 2002. But the borrowing country may request an extension of up to one year if repayment would cause undue hardship and if it is working to strengthen its balance of payments. At the end of the extension, the country is obligated to repay the loan.

In commenting on the Executive Board decision, Acting Chair and Deputy Managing Director Shigemitsu Sugisaki said that, in light of Argentina's difficult economic and social circumstances, Executive Directors agreed to the Argentine authorities' request for an extension. "The shifting of the SRF disbursement to an obligations basis would signal again the IMF's commitment to help Argentina," he said.

However, Directors were concerned that it had not been possible so far to reach agreement on an economic program that the IMF could support. Although progress has been made in some areas toward formulating such a program, they noted that a number of important issues remained to be resolved. Directors expressed the hope that understandings on the open issues could soon be reached.

For the full text of IMF Press Release No. 02/51, see the IMF's website (www.imf.org).

Poverty and inequality in Central America

Although poverty in Central America declined slightly and growth picked up in the 1990s, inequality increased. In a recent study, IMF Economists Ana Corbacho and Hamid Davoodi outlined the problems faced by seven countries—Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua, and Panama—and the reforms they need to undertake.

During the 1980s, the Dominican Republic was the only one of the seven countries in the study to register a positive average annual growth rate of output—a meager 0.9 percent. In the 1990s, however, all of the countries enjoyed positive rates of growth, ranging from 0.1 percent in Nicaragua to 3 percent in El Salvador.

Of the five countries for which poverty head count indexes and data on income distribution are available, poverty declined in three—Costa Rica, Honduras, and Panama—and increased in two—El Salvador and Nicaragua. In Honduras, poverty declined, even though inequality increased. Inequality also increased in El Salvador and Nicaragua, while Costa Rica and Panama saw no change.

The average Gini coefficient (a commonly used measure of income inequality, with 0 representing perfect equality and 100 perfect inequality) for the seven countries increased to 54.4 at the end of the decade, from 53.4 in the early 1990s. Inequality was greatest in Honduras and Nicaragua, the two poorest countries.

Noting the high correlation between poverty and inequality, Corbacho and Davoodi discussed the complex relationship between poverty, inequality, and growth and argued that growth could have less impact on poverty in countries with large income disparities. Nonetheless, sustained growth is a prerequisite for poverty reduction, and Central America's growth performance in the 1990s was not strong enough or steady enough to make a dent in the region's high poverty rates. One reason, the authors suggested, was that, even though the countries cut spending in the 1990s and narrowed their deficits, the composition, efficiency, and equity of spending hardly changed.

Social spending

Investment in *education* is an important contributor to longer-term economic growth, and education is crucial to helping people get out of poverty. However, the progress the region has made in educating its people over the past four decades masks a continuing polarization. Although the average number of years of schooling doubled from 2.5 in the 1960s to 5 in 2000, and the proportion of the population with no formal schooling decreased from nearly 50 percent in the 1960s to about 27 percent in 2000, the proportion of the population that has completed a primary education has remained constant. At the same time, the percentage with a higher education has increased eightfold.

Educational attainment in Central America is still low, and illiteracy rates are still high, for several reasons. First, as a share of GDP, government spending on education has increased only modestly. Second, spending on public education is less efficient in Central America than in other developing regions. Third, the distribution of education spending has not been equitable. Studies show that in two of the five countries for which data are available, the rich capture more of the benefits than the poor. Teachers' salaries are high, by regional standards, but higher wages do not necessarily guarantee teacher quality, a key input in student learning.

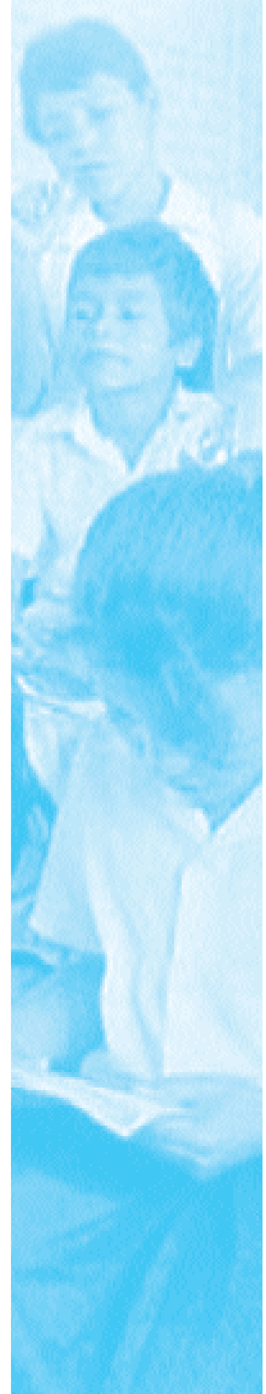
The level of training for teachers varies throughout the region. Teachers in Costa Rica, El Salvador, and Panama all receive a tertiary education, while those in Guatemala, Honduras, and Nicaragua are trained in "normal" schools, which are similar to secondary schools. Nearly one-third of Nicaragua's teachers are uncertified. Student-teacher ratios are high, except in Costa Rica and Panama, while the number of hours of schooling is low.

The picture is somewhat rosier for *health care*, another important factor in economic productivity as well as poverty reduction and human welfare. Central America invests relatively heavily in health care—in 1998, total expenditures on health averaged 6.5 percent of GDP, of which 3.6 percent came from public funds (only the Dominican Republic and Guatemala allocated less than 3.2 percent of GDP to public health). As a result, life expectancy increased from 54 years in the 1960s to nearly 70 years in the 1990s. Infant and child mortality rates have dropped, while immunization rates have soared. According to the study, health spending is well targeted in three of the four countries for which data are available.

Corbacho and Davoodi reported that, despite these impressive results, there were striking disparities between countries and between the poor and the nonpoor within countries. While Costa Rica and Panama have good health indicators (Costa Rica's are comparable to those in industrial countries), health care development is lagging in Guatemala, Honduras, and Nicaragua.

Other problems, the authors said, stemmed from the fragmentation and rigidity of health systems in all

The progress Central America has made in educating its people over the past four decades masks a continuing polarization.



Infant and child mortality rates have dropped, while immunization rates have soared.

of the countries but Costa Rica. Resource allocation tends to be inefficient, so that some health care needs go unaddressed while others receive a disproportionate share of resources. Curative health care tends to be emphasized over preventive health care. Public facilities are generally of poor quality, and there is no accountability for performance or effective management. Moreover, the relationship between public health spending and health indicators is weak, indicating a need for greater efficiency in resource allocation.

The study also found that most of the countries do not have adequate *social safety nets* to protect the poor during economic downturns or natural disasters. Most safety nets fall into one of three categories: food and cash transfers, targeted human development programs, and employment and infrastructure programs. Although Costa Rica, El Salvador, Honduras, Nicaragua, and Panama have at least one program in each category, social safety nets in the Dominican Republic focus exclusively on food and cash transfers, and Guatemala has a school lunch program and several infrastructure programs but no targeted human development programs. Corbacho and Davoodi asserted that better targeting of social safety net programs, preventing abuse of them by the nonpoor, and periodic evaluation were crucial for fighting poverty and inequality.

Governance

Finally, the authors said, the countries should concentrate on improving governance and reducing corruption, which are critical for increasing the effectiveness of propoor public spending as well as of safety nets. To this end, governments must reduce the power of monopolies, make procurement procedures transparent, and increase the financial accountability of public spending. In addition, budget formulation and execution should be strengthened, with a larger share of resources allocated to providing the poor with a primary education and basic health care and reducing their out-of-pocket expenses.

Based on the World Bank's six indicators of good governance—voice and accountability, political stability and lack of violence, government effectiveness, rule of law, regulatory quality, and control of corruption—Costa Rica is the most advanced of the seven countries in this area, with a score close to the average for the OECD countries. All seven made great strides between 1997 and 2001 with respect to political stability and control of corruption.

Adherence to international standards and codes—such as the IMF's Code of Fiscal Transparency—is another way to reduce public sector corruption and improve governance. Honduras and Nicaragua have drafted, in collaboration with the IMF, a Report on the Observance of Standards and Codes for public administration, and other countries in the region have begun to work on similar reports. ■

Copies of IMF Working Paper 02/187, *Expenditure Issues and Governance in Central America*, by Ana Corbacho and Hamid Davoodi, are available for $10.00 each from IMF Publication Services. See page 374 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Available on the web (www.imf.org)

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Transcripts

IMF Economic Forum (panel discussion at the IMF's Third Annual Research Conference), "Promoting Better National Institutions: The Role of the IMF," November 8

Press Briefing, Thomas C. Dawson, Director, IMF External Relations Department, November 19

Interview with Leo Van Houtven

Former IMF Secretary and Counsellor examines strengths and weaknesses in IMF governance

Leo Van Houtven met recently with the IMF Survey *to elaborate on remarks he delivered at an IMF Economic Forum on governance in the IMF, held on September 17 (see box). Responding to questions about the IMF's record, he offered his views about what the IMF has done well and where it needs to improve. He emphasized the IMF's demonstrated ability to adapt to fundamental changes in the international monetary system and in the world economy in a way that benefits all members of the international community. He also praised the IMF's record of decision making by consensus, which ensures that policies are set collaboratively.*

IMF Survey: In terms of IMF governance, where has the record been satisfactory, and where are improvements called for?

Van Houtven: IMF governance refers to how the institution pursues its purposes for the benefit of its members and how it demonstrates leadership by adjusting its mandate in light of changes in the global economy and in members' circumstances. Since its creation, the IMF has been scrutinized by academia, the media, and others. For years, IMF governance appeared beyond reproach, with criticism focusing largely on such policy issues as conditionality.

That changed sharply in the 1990s, when civil society questioned the relevance of the IMF's mandate and the adequacy of its governance structure to serve the needs of the global community in the twenty-first century. Critics saw the IMF as a lopsided instrument in the hands of the rich countries, and some member countries' authorities became more hesitant to express their support for the IMF. But the quality of the IMF's own governance will enhance the effectiveness of its involvement in issues that affect the welfare of citizens in its member countries.

The IMF's rapid reaction to the Asian crisis—its development of a program focusing the financial architecture on crisis prevention and resolution—was an important show of good governance. Similarly, the IMF showed leadership in its search for monetary reform following the breakdown of the par value system in the early 1970s, its creation of the Interim Committee to strengthen political oversight of the IMF, and its adaptation to the growing weight and needs of the developing countries.

But IMF governance has been less satisfactory in the distribution of its quotas, used to meet the IMF's capital requirements, and voting power, which has become distorted over time. To the detriment of Asia and developing countries in other regions, the current system is geared to defending the status quo. The quota formula, which attaches sizable weight to foreign trade and official reserves, plays to the advantage of Western European countries, which needed large quotas when they were still candidates for the use of IMF resources.

Van Houtven: "A small number of industrial countries hold 60 percent of the voting power, while the vast majority of member countries—and of the global population—have only 40 percent."

Quotas attempt to reflect member countries' economic and financial importance. The industrial countries are the predominant creditor countries and should remain the majority shareholders. But a small number of industrial countries hold 60 percent of the voting power, while the vast majority of member countries—and of the global population—have only 40 percent. That is increasingly seen as evidence of the lopsidedness in the governance of the monetary system.

At the IMF's recent Annual Meetings, the Managing Director called for further work to improve the structure of the IMF's governance and achieve a distribution of quotas that would better reflect members' relative economic positions.

IMF Survey: Is the IMF's surveillance (or oversight) effective, and what deficiencies do you see in current practice?

Van Houtven: The 25 years of experience with the Interim Committee in a period of considerable turbulence was fruitful. The committee immersed itself in the major issues on the IMF's agenda, leaving the IMF's day-to-day management to the Executive Board. But it failed to strengthen multilateral surveillance over the policies of major industrial countries. It also failed to provide leadership in the 1980s and 1990s on the implications of global financial markets for national economic policies and for the evolution of the international monetary system. This lapse in leadership became part of the prologue to the Mexican and Asian crises.

Transparency is one of the best things to happen to the IMF in the 1990s.
—Leo Van Houtven

In 1999, the Interim Committee was transformed into the International Monetary and Financial Committee (IMFC), but this has not, thus far, opened a new chapter of political leadership and IMF governance. Leadership could perhaps be strengthened if the IMFC were made into a decision-making council. It's not necessarily the right solution, however, because of the concern that the industrial countries may be tempted to impose their voting power superiority rather than take the time to work toward consensus decisions. We are still looking for ways to make political oversight of the IMF more effective.

IMF Survey: Should the institution be so dominated by the Group of Seven?

Van Houtven: The existence of groups of members, regional caucuses, and constituencies within a global institution is natural and useful. Groups promote their agendas and have an opportunity to influence decision making. In all this, the Group of Seven plays a unique role. Its original intent was to improve the performance of the world economy and to strengthen multilateral surveillance over the participating countries. Gradually, however, the group's surveillance ambitions faded, but it was determined to keep to itself the consideration of multilateral surveillance, which affects the health of the world economy as a whole.

When new systemic issues and financial crises took center stage in the 1990s, the role of the Group of Seven increased. In recent years, IMF members and observers have voiced concern that these countries—holding nearly one-half the total voting power in the IMF—are setting the institutional financial agenda. Their leadership in the management of the system is natural. However, their dominance could endanger the IMF's cooperative character unless they exert their influence within the global framework of the IMF rather than appear to impose it from above. Also, the group's insistence that IMF members strengthen their policies and that the institution have a reduced financing role appears to be out of balance with its weak surveillance over its own members, with the lackluster economic activity in major industrial countries, and with the urgent need for structural reform in a number of them.

IMF Survey: Is it appropriate for the IMF to continue to make its decisions on a consensus basis?

Van Houtven: Consensus decision making, a feature of IMF governance since the institution's creation, ensures that all members are involved in the process. IMF policies are developed through deliberate and thorough consideration by the Executive Board, the management, and the staff of all aspects of an issue. And the diversity of interests among the IMF's membership makes consensus decision making even more important.

Policymaking by consensus continues to be broadly supported and provides particular protection for the developing countries, which are keenly aware that it is in their interests to have strong Executive Directors who will participate actively in decision making. In the Board environment, the influence of an individual Director can, and frequently does, reach well beyond his or her voting power. Complex issues often involve financial matters requiring a special majority of 70 percent, providing the developing countries with potential veto power, which they have used effectively over the years.

For consensus decision making to work well, Executive Directors must have seniority in their capitals and the authority to engage in give-and-take. Moreover, the system needs protection against forces that can put it at risk. The Group of Seven increasingly tends to act as a self-appointed steering group of the IMF, raising questions about whether its Executive Directors have the necessary room to maneuver to shape decisions in a framework based on consensus. The creation of the Group of Deputies within the IMFC raises similar concerns.

IMF Survey: Is transparency working?

Van Houtven: Transparency is one of the best things to happen to the IMF in the 1990s. The institutional discourse has been much broadened: parliaments in member countries take a more direct interest in IMF affairs, civil society has opportunities to contribute to the development of policy initiatives, and the publications program and coverage of the IMF's daily activities on the website allow outsiders to follow what is happening in the institution.

The creation of the Independent Evaluation Office in 2001 also enhanced IMF transparency and

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
November 18	1.99	1.99	2.55
November 25	1.97	1.97	2.52

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2002).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

accountability. Although no backsliding in transparency should be tolerated, care should be exercised to ensure that transparency does not interfere with members' confidentiality requirements and the IMF's operational needs.

IMF Survey: How can the IMF be made more accountable, particularly to the people its decisions most affect?

Van Houtven: Good governance and accountability will enhance the IMF's legitimacy and its mandate for the benefit of its members. Public opinion increasingly accepts the importance of price stability and fiscal discipline to foster sustainable growth and free resources for social priorities. The transformation of IMF program design and conditionality to program ownership by members and the publication of the related documents have involved public opinion more closely. Although the IMF is accountable to member governments, it needs to explain itself better to members, civil society, and electorates. Much progress has been made through IMF transparency and an active media policy. ■

Although the IMF is accountable to member governments, it needs to explain itself better to members, civil society, and electorates.
—Leo Van Houtven

Modest and radical proposals to reform IMF governance

At the IMF Economic Forum on September 17, the other panel members who weighed in on IMF governance were Ian Clark, formerly an Executive Director of the IMF and currently president of the Council of Ontario Universities in Canada; Vikash Yadav, lecturer at the University of Pennsylvania; and Martha Finnemore, associate professor of political science at George Washington University in Washington. Moderator James Boughton, Assistant Director in the IMF's Policy Development and Review Department, guaranteed the discussion would "generate some fireworks."

Until very recently, Boughton observed, the IMF would not have felt comfortable discussing its governance in a public forum. "It is a welcome and positive sign that we are now able to have an open discussion," he said. He then raised two fundamental issues that had to be addressed in any discussion of reforming the IMF.

First, how can such an institution be governed in a way that is politically legitimate without sacrificing its efficiency and effectiveness in doing what it was set up to do? Second, how can poor countries and developing countries, as well as the borrowing countries that are most affected by IMF decisions, be assured of adequate representation without sacrificing the interests of the creditor countries that provide the IMF with the financial resources it needs to operate?

According to Vikash Yadav, the financial crises of the 1990s called into question the IMF's ability to carry out its mandate. He pointed to several recent IMF initiatives designed to strengthen the international financial system but noted that their efficiency depended on members' compliance. Further democratizing the IMF, he argued, would make the organization's initiatives more effective because decisions produced through the democratic process have greater legitimacy and credibility. Yadav said that the distribution of power within the organization had to "adapt to reflect the growing weight of developing and emerging market countries." And this makes reform of the quota system essential. Members' contributions should be based on their stake in the global economy and their ability to pay; access to IMF resources should be based on gross financing need; and basic votes should have more weight in determining voting power, he concluded.

Ian Clark, however, suggested that modest reform was the answer to governing the IMF. He reminded listeners that the IMF is a membership-based institution and that "we must avoid attributing to it the characteristics of a government." Thus, Clark said, while principles of democracy and inclusiveness are fundamental to governance in a modern nation-state, they are not central to governance in a membership-based institution. The IMF, he said, currently meets the essential legal and constitutional requirements of good governance. Some reforms designed to force more openness and transparency could actually weaken the IMF and undermine its governance.

There are two classes of problems, he noted—those that are best addressed by universal participation and those that should be resolved by a limited number of countries. Small groups will thus always have an incentive, Clark said, to create forums outside multilateral institutions to deal with issues where they can achieve most of the benefits that could be secured by a wider consensus, which would be much harder to obtain. Finally, he said that IMF procedures should respect the fact that, to be effective, some of the consensus-building process must be conducted in confidential forums.

Martha Finnemore echoed Clark's conservative approach, centering her comments on some very modest organizational reforms—in culture, training, and recruitment patterns—that might increase the influence of developing countries in the IMF. For example, she said, Executive Board workloads are asymmetric. Single-member constituencies have one state to represent, no IMF programs to monitor, and an extensive flow of expertise on the home front. African Executive Directors, in contrast, each represent more than 20 countries, the majority of them with IMF programs. She suggested allocating area department staff differently and splitting each African Executive Board constituency in two.

Another way to increase the influence of developing countries, Finnemore said, was for the IMF to continue its ongoing mission of fostering expertise in these countries to prepare them to actually take ownership of their economic strategies. Such training would also fight brain drain by giving people a reason to stay where they are instead of coming to work in Washington.

IMF Institute seminar

Back to the future: lessons from the Great Depression

The Great Depression of the interwar period is widely regarded as the most important economic event of the twentieth century and the worst economic downturn of modern times. Its toll in human terms was incalculable and particularly poignant, according to Professor Christina Romer of the University of California at Berkeley, because the extensive damage it caused was largely avoidable. The lessons of this prolonged worldwide crisis underscore the dangers of policy failures in times of great economic uncertainty.

It is difficult to overestimate the scale and the impact of the Great Depression. In the United States, where the depression began and where it hit the hardest, real GDP plummeted 27 percent from its peak in 1929 to its trough in 1933. Unemployment rates reached double digits in nearly every industrial country, climbing to roughly 25 percent in the United States. Developing countries suffered as well, mostly because exports of their primary products declined. Globally, prices of goods fell substantially. Deflation reached more than 10 percent a year in the United States.

Speaking at an IMF Institute seminar on October 3, Romer, a distinguished scholar of the Great Depression, drew on her own research, historical narrative, and the works of other noted economists to piece together the causes and effects of the depression. The story, she noted, was one of repeated shocks to aggregate demand. The shocks, particularly in the United States, were largely monetary—precipitous, repeated drops in the money supply—and had a number of causes. Also, in the United States, banking panics and policy failures played a key role. In a number of other countries, international financial strain and the gold standard were important.

The toll of the Great Depression in human terms was incalculable and particularly poignant because the extensive damage it caused was largely avoidable.
—Christine Romer

What triggered the U.S. depression?

Although the Great Depression ultimately became a global phenomenon, its epicenter was the United States. Why? Romer emphasized that the depression was not a structural adjustment to correct the excesses of the 1920s. The Roaring Twenties were not the sustained boom they are often made out to be. The decade was characterized by moderate growth, punctuated by three short recessions, and remarkably steady prices. Nothing about the 1920s made the Great Depression inevitable.

The Great Depression in the Unites States came in phases: first, as a mild recession, then as a downward spiral as different shocks hit the economy. These shocks were primarily domestic because the United States had become, after World War I, a nearly closed economy: by the end of the 1920s, imports and exports made up only 5 percent of GDP.

Uncertainty. The first shock was the one now famously connected with the Great Depression—the stock market crash of 1929. For years, the crash was viewed as a side issue. But Romer said her research suggested a more central role for the crash in explaining the initial downturn of the U.S. economy. By the summer of 1929, the economy was sliding into recession as a result of monetary tightening. What had been a gradual decline, however, became a dramatic one when, in October, the stock market plunged 40 percent, most of it within a five-day period. Industrial production plummeted soon after, and, by late 1929, consumer spending had declined sharply.

In seeking explanations for the decline in consumer spending, economists typically look at losses in wealth caused by changes in asset prices. But in 1929 (unlike in the 1990s), not many people were in the stock market, and stock market wealth was a small fraction of total wealth. Likewise, negative expectations cannot explain consumer behavior, because neither press reports nor financial forecasts at that phase pointed to a dire economic outlook. What the crash did do—with its dramatic movements in asset prices—was to cause great uncertainty about future economic developments. It was this uncertainty, Romer argued, that drove down consumer spending and, with it, output.

If consumers become more unsure of future income, they postpone spending, particularly on durable goods. But in this situation, they are likely to maintain or even increase spending on nondurable goods. Romer found this thesis borne out by data on different types of consumer spending in 1929–30. In the six months following the crash, automobile registrations and department store sales declined sharply, but sales in "five-and-ten" (cent) stores fell only slightly, and grocery store sales actually rose. Output of durable goods plummeted, while semidurable goods went down less, and perishable goods remained relatively constant.

The relevant lesson for today's economies, Romer suggested, is that dramatic movements in asset prices can cause high levels of uncertainty, with subsequent deleterious effects on consumer spending. Japan's experience over the past decade may be the most recent example. Uncertainty created by the bursting of the investment bubble in 1990 may be one of the factors behind the decline in Japanese spending and hence the long and painful Japanese recession of the 1990s.

Monetary shocks and the Federal Reserve. After the crash and until 1930, Romer explained, the actions of the U.S. Federal Reserve (the Fed) were basically correct, with nominal interest rates declining between 1929 and 1930. But between the fall of 1930 and the end of 1931, three successive monetary shocks hit. These created a massive monetary contraction that choked investment, hastened business failures, and accelerated deflation.

Drawing from narrative histories by Milton Friedman and Anna Schwartz, Ben Bernanke, Barry Eichengreen, and others, Romer explained that these monetary shocks were largely independent of the real economy—that is, they were caused by factors other than the fall in output. Federal Reserve mistakes were crucial.

Over the course of the late nineteenth and early twentieth centuries, banking panics were quite commonplace in the United States. Indeed, the Fed was formed principally to prevent them. But after World War I, two aspects of the U.S. banking sector were setting the stage for severe problems. First, the system was dominated by "unit," or individual, banks. Most states did not allow branch banking—they did not permit successful banks to open branch offices. This meant, in the late 1920s, that there were many small rural banks with little scope for geographical diversification. Second, the country's agricultural sector, which had boomed during World War I, now saw farm incomes contract sharply. This left many farmers on the margin, unable to repay bank loans. With bad loans and deflated food and land prices, the banking sector was ripe for crisis.

When the first banking panic hit in the fall of 1930, the Fed's instinct, honed by the prevailing wisdom of the time (and by past experience under the gold standard), was to do nothing and let the money supply plummet. Why the inaction? Romer suggested two possible explanations. First, the Fed was still a relatively young institution and uncertain about its role in handling monetary shocks. Second, its influential head, Benjamin Strong, had died in 1928, creating a power vacuum. Control over monetary policy shifted to the "liquidationists," who strongly opposed both fiscal and monetary expansion on the grounds that such policies would hinder readjustment and hurt investor confidence.

A second panic hit in the spring of 1931 and a third in the fall of 1931. Because the Fed did nothing to stem these panics either, by the spring of 1932 the U.S. money supply had declined almost 30 percent. This huge monetary contraction had devastating effects through increases in the real interest rate and more pessimistic expectations.

Romer: "At the depth of the depression, with the economy reeling from a credit crunch, deflation, and falling output, raising interest rates was tantamount to pumping water into a sinking ship."

The panics also took a huge toll on the U.S. banking sector. By 1933, nearly half of the banks in existence in 1929 were no longer operating. Bernanke's research argued that the scale of this loss destroyed knowledge crucial to the process of credit intermediation. Many banks no longer had long-term relations with their clients or knew which of their small borrowers were creditworthy. In this climate, the cost of credit intermediation rose significantly, aggravated by continuing deflation, which reduced the value of collateral. One sign of the rising cost of credit intermediation was the greatly widened spread between safe yields on government securities and risky interest rates on business loans in the early 1930s. Small borrowers also faced important credit rationing. Bernanke found that these credit channel effects compounded the direct monetary effects of the panics and further depressed real output.

In September 1931, in the midst of this scenario, Great Britain was forced off the gold standard. In response, the Fed raised interest rates substantially to avert fears that the United States might also be forced to go off the gold standard. At the depth of the depression, with the economy reeling from a credit crunch, deflation, and falling output, such a policy choice was tantamount to pumping water into a sinking ship. With the rise in nominal rates, real interest rates also rose. This, Romer emphasized, was not the characteristic response of money to falling output. It was a deliberate policy action that produced a large monetary contraction—and another shock to aggregate demand.

Were the Fed's actions required by U.S. adherence to the gold standard? Romer discussed her current research with Chang-Tai Hsieh. They found that the United States had significant scope for monetary expansion even during the worst years of the depression. In the spring of 1932, the one period when the Fed did expand the money supply substantially, there is

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no evidence that monetary expansion triggered large gold flows or expectations of devaluation. This suggests that the monetary contraction that was central to the Great Depression in the United States was the result of policy mistakes, not institutional constraints.

The international scene

What caused the depression to become worldwide? One factor was what Barry Eichengreen refers to as the "golden fetters"—the constraints imposed by the gold standard. The other was a sharp decline in international lending. In both cases, events in the United States played a large part.

The U.S. recession had an immediate and direct effect on primary commodity–producing countries, particularly in Latin America, which were among the first to show economic decline. Although the United States was a small buyer of manufactured goods in international markets, it was a significant buyer of primary commodities. The decline in U.S. production had a direct impact on the exports of primary goods producers. It prompted a drop in prices for primary goods and resulted in a steep decline in the purchasing power of exports in those countries, making the depression especially painful for them. In response, primary commodity–producing countries (and others facing a foreign exchange crisis) had to either increase their interest rates substantially to defend the gold standard or relinquish the standard altogether. One by one, they chose the latter, starting with Argentina in 1930.

Even when the direct effect of the U.S. downturn was small (as in the nonprimary commodity–producing economies), countries were affected by the U.S. decline through induced policy changes. The tightening of U.S. monetary policy resulted in falling output and prices in the United States. The high real interest rates and low prices attracted significant gold inflows into the United States. While many countries were close to the statutory minimum in their gold reserves, the United States and France (which had a deliberately undervalued currency) accumulated gold, draining reserves from other countries. By 1927, roughly half of the world's gold was in the United States and France. Countries losing gold were forced to deflate by running very tight monetary policies. The result was a massive global monetary contraction that set in motion the worldwide economic downturn.

Lessons from the recovery

The recovery from the Great Depression, Romer argued, holds many lessons for today's policymakers. In the United States, devaluation and monetary expansion were the key sources of the recovery. Real interest rates

Unemployed workers line up for a free bowl of soup.

plummeted in 1933, and the first types of spending to recover were those typically thought to be sensitive to interest rates, such as automobiles and investment goods. The New Deal's fiscal policy elements, she said, had only a small direct effect on spending and output. That monetary expansion worked effectively in the 1930s—a time when deflation was rampant and nominal interest rates were near zero—may suggest a note of hope for modern economies facing prolonged recession and deflation. Monetary expansion, when coupled with concrete changes in the policy regime, appears to be able to generate expected inflation and lower real interest rates even in severely depressed economies.

The experience of the 1930s showed that the gold standard both spread the downturn more widely and prolonged it. In fact, countries that relinquished the gold standard early (Argentina, for example) experienced less deflation and recovered earlier than countries that remained on the gold standard until the bitter end (United States, 1933; France, 1935). Once free of the gold constraint, countries were able to devalue, which allowed them to generate more exports and run more expansionary monetary policies. This lesson has resonance for today's economies as well, Romer said. A system of rigidly fixed exchange rates can be destructive, particularly in the presence of large external shocks.

But simply choosing a more flexible exchange rate regime may not resolve or prevent a crisis. Good policies are critical, too. In the United States in the late 1920s and early 1930s, policymakers did not understand how the economy worked and essentially relied on the wrong model. The choices they made, Romer argued, created a huge and avoidable monetary contraction. It was truly, she concluded, a colossal policy mistake whose effects were felt around the world. ■

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