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Global Monitoring Report 2004

Sobering verdict on chances of meeting the Millennium Development Goals

James Boughton, Zhang Shengman, Zia Qureshi, Moisés Naím, Gene Sperling, and Ian Goldin, launching the *Global Monitoring Report 2004*.

On current trends, most developing countries will fail to meet most of the Millennium Development Goals (MDGs), according to the *Global Monitoring Report 2004*, which was publicly launched on July 7. It is the first in a series of annual World Bank–IMF reports on the progress being made to achieve the MDGs. Zia Qureshi, lead author and a senior advisor in the World Bank's Global Monitoring Secretariat, and James Boughton, co-author and an assistant director in the IMF's Policy Development and Review Department, reviewed the findings. Commentary was provided by Moisés Naím, editor of *Foreign Policy* and former World Bank Executive Director; Gene Sperling, Senior Fellow at the Council on Foreign Relations ; and Ian Goldin, Vice President of External and UN Affairs at the World Bank.

According to the report, the goal of halving the number of people living on less than a dollar a day by 2015 relative to 1990—the first of the MDGs—will likely be met at the global level, Qureshi said, thanks to strong growth in Asia. Sub-Saharan Africa, however, is "seriously off track." The picture is still more worrisome for other goals, *(Please turn to the following page)*

Interview with Carol Carson

IMF making great strides in data quality

Carol Carson will be leaving the IMF in the fall, after serving as Director of the IMF's Statistics Department since December 1996. Prior to joining the IMF in 1995, she headed the U.S. Department of Commerce's Bureau of Economic Analysis, where she worked for 23 years. Laura Wallace spoke with her about the major effort she helped lead at the IMF to improve the quality of data.

IMF Survey: You've been in the statistical field for over 30 years. What strikes you as the most exciting, significant change?

Carson: Maybe I have a biased view, but I'd have to say the increasing realization of the importance of internationally comparable data. In fact, I'm at the IMF partly because I believe in the value of this type of data. One catalyst of change was the Internet—it's so easy to pick up data on GDP from around the world, but you need to be able to compare one country's data with those of others. Also, there has been an increased recognition, by countries of all sizes, of the importance of the data. For example, I've seen the United States take a lot more interest in international comparability. I've also seen China make it increasingly clear that it wants to move closer to international standards on methodologies. Of course, the regional organizations are also pushing the cause.

Carson: "One catalyst of change was the Internet—it's so easy to pick up data on GDP from around the world, but you need to be able to compare one country's data with those of others."

(Please turn to page 216)

Rich countries need to boost aid, open markets

(Continued from front page) particularly those related to health, including reducing child and maternal mortality rates, combating HIV/AIDS, and improving access to clean water and sanitation. Most, if not all, regions are off track in reducing child mortality rates by two-thirds, for example.

The report's central message, Qureshi pointed out, is that, for the MDGs to be met, all parties—developing countries, developed countries, and international agencies—must scale up their actions significantly and urgently. Developing countries must accelerate reforms to achieve stronger economic growth, with Africa needing to double its growth rate. Developing countries must improve the delivery of health care, education, and other basic human services.

The report does note progress on the policy front, where improvements may be seen in all areas—macroeconomic, structural, social, public sector management—though there is much further to go. Progress has been slowest in improving governance and institutions, but even in this area there have been encouraging developments—notably, the New Partnership for Africa's Development initiative. "Going forward, the core of the reform agenda is institutional," Qureshi emphasized. "For the public sector, it involves improving the quality of governance and reducing corruption, and, for the private sector, it involves protecting market institutions, property rights, and the rule of law," he noted.

For the IMF, the challenge is going to be to find ways to help countries maintain macroeconomic stability while growing strongly enough to meet their development goals.
—James Boughton

Progress on aid inadequate

For the developed countries, the report finds that, to date, actions have fallen well short of the development partnership to which they committed at the meeting of world leaders in Monterrey, Mexico, in March 2002. The report calls for stronger support from the developed countries, particularly in the form of more and better aid and more open access to their markets. While there has been some recent progress in the priority area of aid, it remains inadequate. Even if donor countries honor their post-Monterrey commitments to provide additional aid of about $18.5 billion by 2006, this amount is only about one-third of what is estimated to be needed. International agencies can also do more, by strengthening their support for country-led poverty-reduction strategies in low-income countries and by better helping middle-income countries avoid crises that can set development back.

What separates this report from others, Qureshi explained, is that it functions as an instrument of accountability—presenting a uniquely comprehensive and integrated framework for accountability in global development policies and making use of newly developed indicators to monitor these policies at the level of individual countries. The report is, first of all, a policy document for discussion by the Development Committee, the joint committee of the Boards of Governors of the World Bank and the IMF, and it was the main agenda document at the Committee's spring meeting this year.

The report is also designed to keep the broader international development community informed. This joint report of the World Bank and IMF staffs was produced in close collaboration with a number of other international organizations, including the United Nations, the World Trade Organization, the Development Assistance Committee of the Organization for Economic Cooperation and Development, and regional development banks. "Going forward, we also intend to expand collaboration with civil society in this effort," Qureshi said.

Boughton said that specifically, for the IMF, the challenge is going to be to find ways to help countries maintain macroeconomic stability while growing strongly enough to meet their development goals. He referred to the report as a first step in spelling out how to do this.

The Monterrey Consensus, Boughton continued, provides the framework for the IMF's involvement in the MDG campaign, based on three main dimensions:

- *better policies in developing countries.* Here, the IMF can offer its specific expertise in helping countries devise policies that promote macroeconomic stability and, working with the World Bank, improve investment climates and strengthen the private sector;
- *more and better help from developed countries.* The IMF has a strong comparative advantage in promoting this, through its regular, ongoing dialogue with these countries. It has called for a more open trading system and urged developed countries to provide more and better-focused development aid; and
- *more effective work by international financial institutions.* For the IMF, this means a more clearly defined role in developing countries, better support for the process of developing and implementing countries' Poverty Reduction Strategy Papers (PRSPs), and a clear, rational alignment of the IMF's financial support and policy advice for countries through its Poverty Reduction and Growth Facility, with PRSPs and the MDGs.

Real and personal accountability needed

Naím commended the report for taking very seriously its auditing role—specifically, its candidness in alerting

the international community that "things are not going very well." At the same time, he remarked, this first report is "very silent on what to do about it." It should "say more about why there is such reluctance to do the obvious." After a decade in which there was a global financial crisis every three or four years, he wondered, "why is it we are not assuming that there will be another financial crisis and what would this mean for countries' abilities to achieve these goals?"

Naím added that the report could say more about the implications for the MDGs of a continuation of the trend of failed states—countries where large numbers of poor live, where institutions and aid delivery are ineffective, and where it is not possible to implement even basic, sound policies, let alone more complex policies of reform. In closing, Naím warned that "unless a political constituency in rich countries is developed and, in turn, creates real and personal accountability of people of importance who will pay the consequences if the MDGs fail, it is very unlikely that the MDGs will be achieved."

Focusing many of his remarks on the MDG for universal primary education, Sperling commented that, although he found the section on education too brief, it was right in describing both the progress and limitations of the Fast Track Initiative, which is designed to address the data, policy, capacity, and resource gaps that constrain progress in achieving "Education for All." Sperling agreed with Naím that, in the past, aid has had a very low profile in developed countries. The absence of a sizable and vocal constituency for aid policies, he argued, has hindered an appreciation of why development assistance is in donor countries' own interest and of what they need to do to help poor countries.

While agreeing with Naím that "we are finding it most difficult to move from this broad analysis of the goal posts … to how to get there," Goldin nevertheless cautioned against forgetting how much has been achieved so far. He specifically cited the overall decline in the proportion of people worldwide living on less than one dollar a day, which has dropped from 40 percent to around 21 percent over the past two decades (although the rate of absolute poverty in sub-Saharan Africa—where poverty is deepest—actually climbed from 42 to 47 percent over the same period). "The key question in my mind," Goldin said, "is not why the developing countries have not done more but why the rich countries have not done more." ■

Jacqueline Irving
IMF External Relations Department

Printed copies of the *Global Monitoring Report 2004* are available for $26.00 from the World Bank. For more information, please see *http://publications.worldbank.org/ecommerce/*.

Unless a political constituency in rich countries is developed and, in turn, creates real and personal accountability of people of importance who will pay the consequences if the MDGs fail, it is very unlikely that the MDGs will be achieved.

—Moisés Naím

Available on the web (www.imf.org)

Press Releases

04/141: Statement by IMF Managing Director Rodrigo de Rato on the Occasion of His Visit to Honduras, July 9

04/142: IMF Completes in Principle Second Review Under Ghana's PRGF Arrangement and Reviews Noncomplying Disbursement, July 9

04/143: Statement by IMF Staff Mission to the Philippines, July 12

04/144: IMF and World Bank Support $3.5 Billion in Debt Service Relief for the Republic of Ghana, July 13

04/145: IMF Completes Fourth Review Under the Democratic Republic of the Congo's PRGF Arrangement and Grants Additional Interim Assistance Under the Enhanced HIPC Initiative, July 13

04/146: IMF Completes Fourth Review Under PRGF Arrangement with Albania and Approves $6 Million Disbursement, July 14

04/147: Statement by IMF Deputy Managing Director Agustín Carstens at the Conclusion of His Visit to Costa Rica, July 14

04/148: Statement by IMF Staff Mission to Indonesia, July 16

04/149: Madagascar Formally Begins Participation in the IMF's General Data Dissemination System, July 16

04/150: The Central African Republic Formally Begins Participation in the IMF's General Data Dissemination System, July 16

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04/70: IMF Concludes 2003 Article IV Consultation with Zambia and Discusses Ex Post Assessment of Performance Under IMF-Supported Programs, July 16

Speeches

Opening Remarks by Agustín Carstens, IMF Deputy Managing Director, Third Regional Conference on Central America, San Pedro Sula, Honduras, July 8

Remarks by Rodrigo de Rato, IMF Managing Director, Third Regional Conference on Central America, San Pedro Sula, Honduras, July 9

"Twenty Years Without a Crisis in Costa Rica: The IMF's View," Agustín Carstens, IMF Deputy Managing Director, Seminar on Volatility and Vulnerability, Academy of Central America, Costa Rica, July 12

Transcripts

Press Briefing by Rodrigo de Rato, IMF Managing Director, July 2

Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, July 15

HIPC=Heavily Indebted Poor Country
PRGF=Poverty Reduction and Growth Facility

Better data help lower borrowing costs

(Continued from front page) ***IMF Survey:*** How close are we to achieving internationally comparable data?

Carson: That depends on whether you want perfection or whether you're prepared to accept that it's simply getting better. And it depends on which data set you're looking at. In balance of payments, for example, we can track how many countries are reporting data according to the standard presentation of the *Balance of Payments Manual*, fifth edition. But in other areas, progress is not as clear.

IMF Survey: Over the past decade, there's been a tremendous push in high international circles to improve data quality. How confident are you of the progress that's been made?

Carson: Looking back over the decade, I'm very confident that tremendous progress has been made. There is better coverage, greater timeliness, and a huge leap in the publication of advance calendars that show planned release dates. A decade ago, very few countries published them, let alone worried about whether they would meet their promised release dates. Now, our monitoring of Special Data Dissemination Standard (SDDS) subscribers shows that around 90 percent are on time. In terms of coverage, we have an international reserves template and a data set on external debt. Plus a number of countries regularly disseminate quarterly GDP estimates. If you want to quantify the improvement, just look at the number of SDDS improvement plans that were laid out and then implemented. These number well into the hundreds.

The question is why, for something like GDP and national accounts more broadly, there can't be a standard whereby a country puts the data on its website with tags so that international organizations can go there to pick up what they need.
—Carol Carson

IMF Survey: Has it paid off in terms of the countries getting better prices when they float bonds?

Carson: Definitely. A recent IMF study by John Cady [see *IMF Survey*, June 14, page 172] found that countries that participate in the SDDS have enjoyed lower borrowing costs in the primary capital markets. In the case of seven emerging market countries, it was a reduction of around 75 basis points—or about 20 percent—which could add up to savings of millions of dollars in interest. This confirmed trends that some other agencies had reported for the secondary markets.

In addition, countries are able to generate better numbers. At the UN Statistical Commission in March, one speaker—representing the chief statisticians of a wide range of countries—made the point that the SDDS, the General Data Dissemination Standard (GDDS), and the Data Quality Assessment Framework (DQAF) have contributed greatly to the improvement of data around the world (see box). Chief statisticians wouldn't say that if they didn't feel that the attention given to data has helped them make the case for better data.

IMF Survey: One recent initiative has been to strengthen the sociodemographic data section of the GDDS to help countries develop indicators to trace progress in meeting the Millennium Development Goals on poverty, health, and education. At the same time, many international bodies can't even agree on how to measure poverty. What needs to happen to resolve these differences? How hopeful are you of coming up with the needed indicators?

Carson: For economic data, there has long been an agreement that money—typically market prices—is the measuring rod. But for sociodemographic data, we don't have such a firm measuring rod. That said, I believe it's very important for the GDDS to have sociodemographic data. And although there has been a good deal of controversy over which indicators to include, over time there has been progress toward an agreed list. As we go forward, we want policymakers to be aware that, although there's a quality issue with the indicators, we don't want to undercut their use. If indicators are used, they will receive priority when they need to be fixed. If they aren't used, no one will want to spend money on them. It's a balancing act.

A primer on the IMF's statistical initiatives

Special Data Dissemination Standard (SDDS): Established in March 1996 to guide members that have, or that might seek, access to international capital markets in the provision of their economic and financial data to the public. It currently has 57 subscribers, consisting mainly of industrial and emerging market economies.

General Data Dissemination System (GDDS): Established in December 1997 to guide countries in the provision to the public of comprehensive, timely, accessible, and reliable economic, financial, and sociodemographic data (population, education, health, and poverty). It currently has 60 subscribers, all developing countries. Another 20 are expected to join in the coming year.

Data Quality Assessment Framework (DQAF): Established in July 2001 as a framework for assessing data quality by national producers of official statistics, international organizations, and other data users, including those in the private sector.

IMF Survey: Is the problem in measuring or collecting data?

Carson: There still isn't agreement on a methodology for many of the sociodemographic data indicators and that makes it harder to provide guidance and technical assistance.

IMF Survey: What about a basic measurement like poverty?

Carson: I don't see an early resolution to the debates, but I think the attention that indicators like poverty are getting will help get us where we need to go. There are some movements afoot—like at the UN Statistical Commission—to try to develop an internationally agreed approach. One can hope that it takes hold.

IMF Survey: It's assumed that part of the problem is the inability of some countries to collect data. What is the IMF doing in its technical assistance and outreach efforts, especially for Africa?

Carson: We devote about 40 percent of our technical assistance resources to African countries. We have GDDS projects for Anglophone, Francophone, and Lusophone African countries. There are now 36 African countries that are GDDS participants. We work with them to describe their statistical production and dissemination practices, leading to a statement of their plans for improvement. Then we target our technical assistance to help them with these plans. This, combined with the assistance that these countries are receiving from the IMF's two regional technical assistance centers in Africa, results in a substantial effort. On top of that, PARIS21—an advocacy group composed of policymakers, analysts, and statisticians from all countries of the world—prepares videos, flyers, and conferences to drive home the importance of good statistics for sound policymaking and tracking progress on the Millennium Development Goals (see box on technical assistance, page 218).

IMF Survey: Under your stewardship of the Statistics Department, the IMF has become a recognized leader in organizing and promoting work within the international statistical context. The work on external debt statistics is a good example. What is the secret to your success?

Carson: We've definitely benefited from the greater realization by individual countries that statistics aren't just for the country itself. Each country is part of a bigger scene, and each country needs to care about its neighbors' statistics. We have also benefited greatly from working with other international organizations. For example, with external debt, we managed to develop a compilation guide on methodology in just four years, working with six other international organizations. As a result of that cooperation, the methodology has far more clout than if we had just developed it alone.

Carol Carson presents Horst Köhler (the IMF's former managing director) with the *International Financial Statistics Yearbook* for 2003.

IMF Survey: Do you feel that your primary responsibility has been to these other world statistical agencies or to the IMF's operational work?

Carson: My primary obligation has been to the IMF—its operational and surveillance work. However, I also believe that I get more for the IMF if I engage with the other international organizations. Take a country's willingness to report. If you want external debt statistics, you can approach a country by saying: The IMF wants these data, and if you want a program, you need to provide them. Or you can approach the issue by first developing the needed guidance with other international organizations. The message for a country then becomes: We can help you understand why you need the data and why we want them, and we can help you put them together.

IMF Survey: The DQAF is increasingly viewed as the international standard for assessing good practice in national statistical systems. Some of your staff consider that this may prove to be your most enduring contribution as Director of the Statistics Department. Would you agree?

Carson: If it stands the test of time, I would be pleased that I had a hand in it. It has proved robust so far, and the way we went about it suggests that there may be buy-in. We started it in 1997 and kept pushing. It's now been embedded in the Reports on Standards and Codes, and some countries even use it for their own self-assessment.

IMF Survey: Is there anything you regret not having had the chance to do—items that your successor, Robert Edwards, will need to take up?

Carson: I could give you a long list! Let me focus on two issues that I think should be among his top priorities. First, the SDMX, which stands for Statistical

China joined the GDDS in 2002. Here, Carol Carson and Horst Köhler welcome China's then central bank governor, Dai Xianglong.

Data and Metadata Exchange. It was formed by a group of international organizations that wanted greater standardization in the exchange of data, particularly from countries to international organizations, and then among international organizations.

Currently, European countries will report to us, to Eurostat, to the European Central Bank, to the Organization for Economic Cooperation and Development, and even sometimes to the United Nations. The question is why, for something like GDP and national accounts more broadly, there can't be a standard whereby a country puts the data on its website with tags so that international organizations can go there to pick up what they need. Moreover, countries often send slightly different data sets to each agency to meet the agency's specifications.

We got serious about the SDMX about three years ago, and I've chaired the group of international organizations that is sponsoring it. It's somewhat hard to let this go because I think it has great potential. My successor is going to need to see that the IMF stays a part of that operation.

Second, over the past decade, the IMF and other organizations have put a lot of effort into updating methodologies. We now need to focus more on implementing them. Which brings us back to international comparability. If you have a methodology and you're helping countries implement it, you will get more comparable data. For example, we're working on standardized report forms for monetary statistics.

IMF Survey: Is this part of an effort to standardize country data within the IMF?

Carson: Yes. For example, in monetary statistics, we have an ongoing series of projects to develop what is known as an integrated monetary database. We help countries set up a reporting system that they can use for their own purposes, that the IMF's regional departments can use, and that we can use for *International Financial Statistics*.

IMF Survey: How about regional data?

Carson: We haven't put a lot of effort into regional data. We've been happy to work with regional organizations, like AFRISTAT, Eurostat, and the European Central Bank, which need standardized methodologies for their own purposes. However, if the IMF gets more involved in regional surveillance, then our own need in this area will increase.

IMF Survey: Any future plans?

Carson: I think I'll just let the next stage unfold slowly, but I expect it to include some combination of words, flowers, and photography! ■

Helping countries improve data quality

The IMF's Statistics Department gears its technical assistance to bringing about lasting improvements in member countries' national statistical systems and support the IMF's surveillance activities and the use of IMF resources.

Technical assistance is offered in national accounts, balance of payments, monetary and financial, government finance, and price statistics, as well as in statistical organization. The assistance is typically provided in the context of internationally accepted data standards frameworks, and in recent years it has had a growing regional focus. Regional projects use the General Data Dissemination System (GDDS) framework to help countries improve their ability to produce and disseminate macroeconomic and sociodemographic statistics. These projects are carried out in coordination with other technical assistance providers, including the World Bank.

The Statistics Department is prioritizing its technical assistance projects to reflect the IMF's main program areas, including crisis prevention, poverty reduction, and postconflict country assistance. In carrying out its work, the department complements short-term visits by staff teams with the long-term placement of statistical advisors.

In 2003/2004, the Statistics Department sent 294 mission teams to 112 countries—a sharp rise from the 150 missions to 85 countries only two years earlier. In addition to its own program, the Statistics Department also supports technical assistance delivered through the IMF's regional technical assistance centers in Asia (PFTAC), the Caribbean (CARTAC), and Africa (East AFRITAC and West AFRITAC).

Per Jacobsson Foundation Lecture

New directions needed for financial stability?

Over the past 15 years, central banks have made enormous progress on the monetary policy front. But on the financial stability side, much remains to be done, according to Professor Charles Goodhart of the London School of Economics and formerly of the Bank of England. Presenting a Per Jacobsson Foundation Lecture in Zurich, Switzerland, on June 27, to an audience mainly of governors and other central bank officials attending the Annual Meeting of the Bank for International Settlements (BIS), he argued that central banks will need to take some new directions if they are to make comparable progress on financial stability.

Central banks have two main responsibilities—monetary stability (meaning reasonable price stability) and financial stability. On the monetary side, Goodhart said, there has, in the past 15 years, been "enormous progress in operational success, practical procedures, and theoretical understanding." But comparable progress on the financial stability side has proved more elusive. Indeed, even among experts, financial stability does not appear to be well defined, save as an absence of financial instability.

Goodhart began by noting that a number of central banks—those of China, Germany, Japan, and the United Kingdom, for example—are charged with maintaining systemic financial stability without having supervisory oversight of individual financial institutions. This separation of supervision from central bank responsibilities—together with the enhanced involvement of finance ministries and the greater role of the IMF and the World Bank—is making the procedures for reforming the international financial architecture "more messy and complicated." Yet these changes are also, he said, making procedures "somewhat more 'democratic'" than they were between 1974 and the late 1990s, when the private and informal Basel Committee of central bankers established "soft law" for the system.

What can be done to strengthen the financial stability side of central banking? Goodhart suggested that valuable benefits could be reaped from fresh approaches in four areas—research, linkages with fiscal policy, regulatory requirements, and accounting.

Modeling systemic stability

With regard to research, Goodhart pointed to a need for economic models of systemic financial stability and fragility, comparable to the macroeconomic models that underlie central bank analysis of, and decisions about, monetary policy. "We need to construct models of systemic stability, not just of individual bank probability of default…. A major problem is that almost all the quantitative techniques for risk measurement that have been devised apply to the individual (banking) institution, not to the banking system as a whole…. Almost by definition, such exercises relating to individual banks cannot cope with interactions, or contagious effects, between banks."

A model suitable for analyzing and quantifying systemic financial stability must, Goodhart said, include incomplete financial markets (otherwise, the need for financial intermediaries does not arise); heterogeneous banks (otherwise, contagion cannot be considered); and, most important and most difficult, default, which must be endogenous—that is, explained by the model. "Most macro models effectively assume that there is never any default, with a transversality condition which implies that all debts are repaid by the final horizon. Such an assumption is totally out of place in any model of systemic risk," he said.

Goodhart went on to refer to research on models of default that he has been conducting with colleagues, drawing on the work of Martin Shubik of Yale University. "The ultimate aim of this exercise," he noted, "is to try to lead the way toward a quantitative measure and model of *systemic*, aggregate financial stability that can complement the continuing risk measurements of individual institutions. If this can be done, it could start to provide an intellectual backstop to the more descriptive commentaries in financial stability reviews, and possibly allow for a more coherent unification of the various roles of a central bank in its financial stability remit."

Reconsidering fiscal policy linkages

Goodhart argued that linkages with fiscal policy are "just as important and problematical" on the financial stability side as they are on the monetary policy side of central banking. Because banking crises often entail significant fiscal costs, their handling necessarily involves the relevant fiscal and political authorities. (He noted that losses from lender-of-last-resort operations that give rise to fiscal costs are more likely, the greater is the incentive for troubled commercial

Fresh approaches are needed in research, linkages with fiscal policy, regulatory requirements, and accounting.

banks to use every other possible avenue of raising funds before approaching the authorities. This led him to wonder whether there might be an analogy here at the international level with national governments and the IMF.)

Goodhart saw no particular administrative problem with the fiscal policy link in the national context, although the need for crises to be handled, in effect, by a committee drawn from the central bank, supervisory authority, and finance ministry may add to coordination and operational difficulties. "The problems arise when the crisis has international dimensions," he explained, since, in a globalized financial system, losses that occur in a bank in one country could effectively be passed through to the depositors or the fiscal authorities in another. "There is no mechanism in place to devise a generally acceptable sharing of burdens from international [banking] crises," he observed.

Goodhart: The increasing complexity of the financial system calls for a "holistic approach to financial regulation."

These problems are most acute in three groups of countries:

- those (such as the transition countries of eastern Europe) whose banks are mostly foreign owned and are therefore subject to supervisory decisions made by the banks' home countries;
- the United Kingdom, which has so many foreign banks and, as a major international financial center, is likely to feel the reverberations of any cross-border crisis; and
- countries whose domestic banking systems are already largely interpenetrated, such as in the Scandinavian and the Benelux countries. "Since all three involve European countries, this is primarily a problem for the EU [European Union] to handle," Goodhart said, "even aside from the concerns expressed by many about the differing domains of macro monetary and financial stability policies within the eurozone." (In the euro area, monetary policy comes under the aegis of the European Central Bank, while financial stability policies remain under national control.)

Given the aim of establishing a common European financial system, it might seem a logical step to shift both the fiscal competence to deal with banking crises and the banking supervisory function to the federal EU level. Moving only the fiscal function would cause too much moral hazard, Goodhart said, while moving only the supervisory function would be unacceptable to national treasuries, which usually want control over what they are paying for.

But Goodhart doubted that it will prove possible in the foreseeable future to move the fiscal function for crisis resolution to the EU level. And absent such a shift, "calls for transfers of supervisory functions to a central, European body are, in my view, nugatory and little more than whistling in the wind. That, alas, brings us back to the question of how to share out the burden of rescues when the relevant public authorities are national but the financial system is international." In these circumstances, he argued, the European Central Bank should be encouraged to adopt the role of arbiter in handling financial crises that have international overlaps in the euro area and there is disagreement and deadlock among the national bodies.

A holistic approach to regulation

The increasing complexity of the financial system also calls for a "holistic approach to financial regulation" that extends beyond risk-related capital requirements, Goodhart emphasized. He likened devising good financial regulation to the labors of Sisyphus: the difficulties are not just that financial innovation and interactions between the supervised and the supervisors will continuously require regulations to be updated, "though this, too, will happen, and Basel II will be succeeded in due course by Basel III." There are also so many aspects of risk that no one set of negotiations can, or will, fully take on board all of them.

Basel II—the new capital adequacy framework issued by the BIS—focuses on the application of capital to credit risk and other operational risks, Goodhart noted, but numerous other facets of risk management need attention—notably liquidity, the pricing of risk via interest rate margins, and devising a structure of incentives to "encourage bankers (and, for that matter, also supervisors) to abide by the various standards and requirements that may have been promulgated."

Over the previous 40 years, the attention of regulators had swung from concerns about liquidity, with requirements for various cash and liquidity ratios, to a focused concentration on capital requirements. In Goodhart's view "this pendulum has swung far too far . . . . It is arguable," he observed, "that the case for externally imposed liquid asset ratios is actually much stronger than the case for externally imposed risk-related capital adequacy ratios." Banks' maintenance of liquid assets protects the system as a whole from damaging fluctuations in asset prices. In fact, much of the benefit of any bank's holding more liquid assets accrues to other banks, while the negative effect on profitability is almost entirely internalized; thus, there will be an incentive for banks to hold less than the socially optimal amount of liquid assets. Moreover, banks' holdings of liquid assets protect not

only other commercial banks but also the monetary authorities and help them to maintain systemic stability.

Goodhart also argued for more attention to interest margins, suggesting that one approach to countering procyclicality in the financial system would be to have regulatory requirements, including for capital and liquidity, vary inversely with margins. Thus, "when risk margins fell during booms, relative to the historical norm, aggregate required ratios would rise, and vice versa."

With regard to incentives and sanctions, Goodhart observed that there is "an apparently irresistible temptation among regulators to focus solely on what banks should desirably do, and issue regulations and suggested standards and codes of conduct" (including those promoted by the IMF) that exemplify such good behavior. But more difficult and more important, he said, is to work out what sanctions to apply—sanctions to "give bite and backup" to standards, codes, and other regulatory requirements.

The Per Jacobsson Lecture in Zurich drew governors and other central bank officials, as well as officials from the Bank for International Settlements.

Accounting choices

Finally, Goodhart turned to an accounting issue. Should banking data always be presented on a current market value basis, or is it sometimes desirable to present data on a historic cost basis or apply some other device to smooth the data? Europeans tend to argue that, because markets can be volatile, using current market value data will exacerbate financial instability. For example, in a financial panic, when asset values shrink dramatically, the capital ratios of banks—if based on current market valuations—will contract sharply, too. Bank lending will consequently decline at a time when continuing, indeed additional, loans are desirable from a macro viewpoint.

Until recently, Goodhart said, he had defended the use of smoothing devices to adjust banking data, but "market innovations and the trend of thought" had now led him to believe that "their day is done." These devices, he argued, are usually nontransparent and subject to manipulation; reduce the availability of information, including early warnings of impending problems in financial institutions; and are likely to lead to a misallocation of investable funds. Moreover, with the advent of securitization and credit default derivatives, market valuations of loans are now more readily available.

So if accounts, ratings, and valuations are all to be based on current market values, how will volatility in the system be restrained? Goodhart lent his support to a proposal—made by several economists at the BIS—to adjust regulatory ratios to the rate of change of a key systemic factor—for example, GDP growth or house price inflation.

With these recommended new directions, Goodhart hoped, the progress that central banks have made since the late 1980s in their understanding and conduct of monetary policy will be replicated in the next 15 years in their other main area of responsibility. ■

Graham Hacche
IMF External Relations Department

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
July 12	1.83	1.83	2.82
July 19	1.87	1.87	2.88

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?2004).*

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

Data: IMF Finance Department

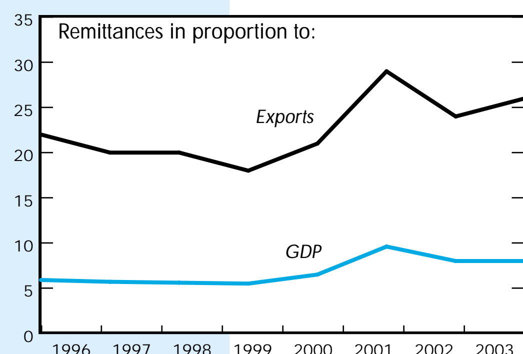
The full text of the lecture is available at *http://www.perjacobsson.org/lectures/062704.pdf.*

No evidence of slowdown in Moroccan workers' remittances

Workers' remittances are playing an increasingly vital role in developing countries. The volume of these flows can, for example, significantly affect the liquidity of banking systems, influence monetary and exchange rate policies, and bolster external positions. To better understand their impact on developing country economies, the IMF is taking a closer look at remittances. One such study, by Jacques Bougha-Hagbe of the IMF's Middle East and Central Asia Department, examined the determinants and long-term prospects of remittances to Morocco.

Morocco receives sizable remittances. With $3 billion to $4 billion in annual receipts. Its remittances are now equivalent to about 9 percent of GDP—up from an annual average of 5 percent between the mid-1990s and 2000—and about 25 percent of exports (see chart). Transfers from Moroccans living abroad—mainly in France, Italy, and Spain—play an important role in Morocco's balance of payments. They almost offset the trade deficit and have helped boost its balance of payments surpluses. Accumulated surpluses have allowed Morocco to build up external reserves, which now cover the country's external public debt.

Moroccan workers' remittances are up from the mid-1990s
(percent)



Data: IMF

What could determine remittances?

To help analyze the motivation for workers' remittances, Bougha-Hagbe develops a theoretical model that considers several possible explanatory factors. One of these, highlighted in the economic literature, is altruism or solidarity—that is, a union of interests or sympathies among members of a group. Other motivating factors include attachment to homeland, which could be viewed as a willingness to have a nonfinancial asset, such as real estate, in a given country; prosperity of the workers, indicated, for example, by economic growth in countries where remittances originate; and portfolio diversification or other investment goals.

Additional factors may also influence the level of remittances. The exchange rate, for example, could do so through substitution and wealth effects. The idea behind the substitution effect is that because goods in the home country become less expensive in foreign currency terms when the home country's currency depreciates, workers abroad will tend to substitute some goods in the home country for the relatively more expensive ones in the foreign country of residence. The effect on the amount of foreign currency remitted, however, will depend on the sensitivity of demand to such a change in relative prices. Remittances may even be reduced by the substitution effect of a depreciation because workers wishing to buy the same volume of goods will be able to do so with less foreign exchange.

A decline in value of the home country's currency can also make its citizens living abroad and possessing foreign assets wealthier. This may encourage them to transfer more money to buy even more goods and assets in the home country, including residential real estate. This is the wealth effect. However, Bougha-Hagbe does not emphasize the potential role of exchange rates in his analysis because, as he notes, "even if the actual effect of exchange rate movements were known, interpreting their long-term effect on the sustainability of the external position would not be certain."

A qualitative influence on transfers may be national policies toward workers living abroad. In Morocco, the authorities recognize the value of keeping Moroccans who live abroad in close contact with their home country. To this end, they have created a ministry that, among other things, helps streamline the administrative procedures that Moroccans overseas must deal with in transactions with their country of origin. While Bougha-Hagbe's model does not take such qualitative items explicitly into account, he suggests ways in which they might be incorporated.

What does the evidence suggest?

Looking at data for 1993–2003, Bougha-Hagbe finds that, over the long run, two factors—altruism and attachment to homeland—seem to provide the major motivation for remittances to Morocco. The data suggest that (everything else held constant) as Morocco's real GDP (a proxy for real income in the home country) decreases, remittances increase. At the same time, remittances also increase as wages in the countries

where migrants live (used as a proxy for migrants' income) increase. Both findings suggest a willingness to help and to share—that is, an altruistic motive.

The evidence also suggests that as remittances increase, so does construction activity in Morocco. This result is in line with the fact that there is a great deal of housing construction in Morocco by Moroccans living abroad, a sign of attachment to their homeland. For reasons yet unknown, remittances surged in 2001; various events in the post–September 11 environment could support an explanation based on increased attachment to the home country.

Portfolio diversification, in contrast, does not seem to be a significant motive. This finding suggests that there are relatively low risks of a sudden end to, or reversal of, transfers from Moroccans living abroad.

Will remittances remain stable?

The influence of altruism or solidarity as a determinant of workers' remittances could contribute to their long-run stability, Bougha-Hagbe notes, "mainly because it seems reasonable to expect such motives to remain stable." However, he adds, "the stability of this motive should be seen in the context of changing migration patterns." If family members also move overseas, for instance, the importance of altruistic motives might be reduced. Nonetheless, in the case of Morocco, he explains, "this effect would be counterbalanced by waves of new emigrants who are attracted by the increasing labor demand in industrial countries. Moreover, altruistic motives may, in fact, partly reflect self-interested reasons for transfers from Moroccans who want their residential investments to be looked after while they are away."

Attachment to homeland could also contribute to stable remittances, since such motives would likely remain constant. However, improved settlement opportunities for Moroccans in their countries of residence may reduce their attachment to their home country. But these improvements in settlement opportunities, Bougha-Hagbe observes, "could be expected to occur at a slow pace and, thus, in the foreseeable future, to have only a limited offsetting impact on Moroccans' attachment to their homeland."

Other considerations

Remittances as portfolio investment flows, which would likely be sensitive to their rate of return and therefore subject to sudden reversals, could be expected to add to a country's vulnerability. A small part of remittances are direct investment flows by Moroccans willing to create small and medium-sized enterprises in their home country. This could also be interpreted as a sign of their attachment to their home country and, thus, is not likely to add to the country's vulnerability.

Still, such transactions, given their investment nature, could be sensitive to rates of return. If this were true, remittances in the form of portfolio investment flows should be positively correlated with interest rates in Morocco and negatively correlated with interest rates abroad. "This possibility does not seem to be confirmed by the evidence," Bouhga-Hagbe says, adding that stock market returns could also be tried in future research."

No evidence of sharp slowdown soon

What is the prognosis, then, for remittances to Morocco? Bougha-Hagbe sees "no evidence of significant risks of a sharp slowdown or reversal of workers' remittances in the foreseeable future." Remittances are, thus, likely to continue to be an important source of foreign exchange inflows to Morocco.

The evidence of Moroccans' attachment to their home country, he adds, also supports the view that Morocco should maintain its economic and political reform efforts, which could further help diversify the investment allocation of remittance inflows, limit the negative impact that remittances could have on labor force participation, and therefore help create sustained and broad-based economic growth.

With workers' remittances largely flowing into construction activity and only a small portion going to the creation of small and medium-sized enterprises, it is clear, Bougha-Hagbe says, that Morocco is not yet taking full advantage of the skills of the younger generations, who are not only highly qualified but also more likely to be entrepreneurs.

To increase investment inflows and the entrepreneurial skills of its citizens living abroad, Morocco could, for example, set up a special entity specifically devoted to assisting emigrants who want to create small and medium-sized enterprises and who may even wish to manage them from abroad. Such an entity would not only provide needed information and administrative documents, but could also help establish the legal environment that would be required for such investors. In a broader context, faster implementation of the country's structural reform agenda is also essential, concludes Bougha-Hagbe. ■

There is no evidence of significant risks of a sharp slowdown or reversal of workers' remittances in the foreseeable future.
—Jacques Bougha-Hagbe

Photo credits: Simon Willson for the IMF, page 213; Eugene Salazar and Michael Spilotro for the IMF, pages 213, 216–218, 224, and 227–228; World Bank, page 214; and Klaus Brodhage/BIS, pages 219–221.

IAMB briefing

Iraqi audit cites weak controls

Ongoing audits of Iraq's oil revenues and the operations of the Development Fund for Iraq (DFI) have concluded that all known oil proceeds seem to have been properly and transparently accounted for. However, insufficient internal controls over oil extraction led the auditor, KPMG, to qualify its report on May-December 2003 operations. KPMG said it was not possible to ensure that all oil export sales were captured or that all DFI disbursements were made for the purposes intended.

IAMB members (from left) Khalifa Ali Dau (Arab Fund for Economic and Social Development, Bert Keuppens (IMF), Jean-Pierre Halbwachs (UN and chair of the IAMB), and Fayezul Choudhury (World Bank) briefed the press on July 15.

The International Advisory and Monitoring Board (IAMB) for Iraq— the audit oversight watchdog set up following the adoption of a UN Security Council Resolution—approved the appointment of KPMG to conduct the audit. The IAMB is responsible for ensuring that the DFI benefits the Iraqi people and that export sales of oil and gas conform to market best practices.

In a July 15 press briefing, IAMB members—Fayezul Choudhury (World Bank, Vice President and Controller), Jean-Pierre Halbwachs (UN, Assistant Secretary General and chair of the IAMB), Bert Keuppens (IMF, Finance Department Senior Advisor), Khalifa Ali Dau (Arab Fund for Economic and Social Development, Senior Financial Advisor), and a representative from the new interim government of Iraq—let the audit results speak for themselves but provided context and outlined what remains on the IAMB's agenda.

KPMG findings

Reflecting continuing concerns that the board had been raising with the Coalition Provisional Authority (CPA) in Iraq, the IAMB directed KPMG to pay special attention to the treatment of bartered transactions in the DFI financial statement, to sole-source contracting procedures, and to control over oil transactions, according to Jean-Pierre Halbwachs.

In its findings, KPMG concluded that all known oil proceeds, reported frozen assets, and transfers from the Oil for Food Program seem to have been properly and transparently accounted for in the DFI. KPMG qualified its audit report, however, citing weak controls on a number of fronts, particularly

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- oil extraction, notably the absence of metering;
- the CPA, where the audit identified a lack of clearly defined duties and high turnover of personnel, inadequate accounting systems, nonadherence to controls over spending allocations in some instances, and uneven application of agreed-upon contracting procedures; and
- Iraq's spending ministries, where the audit highlighted inadequate controls, including the absence of reconciliation procedures for transfers between ministries and for bank accounts, inadequate accounting records, deviations from procedures designed to ensure competitive bidding, and insufficient payroll records.

Follow-up

Over the next few months, the IAMB will continue to monitor ongoing audits and, in particular, consider whether further investigations will be needed of the CPA's controversial sole-source contracts. A special audit has already been requested to list all sole-source contracts that have used DFI resources, together with a summary of the findings of audits already conducted by U.S. agencies. The IAMB then has the power to request additional work, if it deems this necessary.

The IAMB also expressed its hope that the interim government of Iraq will make oil metering a priority. The larger issue, the World Bank's Choudhury noted, is to develop comprehensive control of the country's oil assets, covering everything from the extraction of crude to the production of refined product to exports and internal consumption. This mechanism would raise awareness of losses (which might be natural) and, at the very least, he said, allow authorities to "identify where things might be unaccounted for."

In addition, as the KPMG audits underscored, weak controls in Iraq's spending ministries remain a concern. "If there are no strong controls in place," the IMF's Keuppens pointed out, "there is no assurance that the monies, as appropriated, are spent on the intended Iraqi people." While there is no evidence of misappropriation, he said, there are strong indications that controls in the spending ministries are very weak, leaving the door wide open for misuse. The Arab Fund for Economic and Social Development's Dau added that KPMG's work is incomplete, with a number of ministries still to be visited.

The IAMB urged that steps be taken to ensure the adequacy of financial controls in spending ministries (starting with the integrity of the payroll process, because it is a large part of the budget). Other key priorities include effective follow-up on KPMG's recommendations to the State Oil Marketing Organization and implementation of a strong budgetary and financial management framework. ■

The KPMG audits and the full transcript of the IAMB press briefing, as well as earlier press releases and related materials, are available on the board's website (*www.iamb.info*).

04/105: "Financial Crisis, Economic Recovery, and Banking Development in Russia, Ukraine, and Other FSU Countries," Haizhou Huang, Dalia Marin, and Chenggang Xu
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04/127: New Zealand: Selected Issues
04/128. New Zealand
04/129: Ukraine: Request for Stand-By Arrangement

FATF=Financial Action Task Force
HIPC=Heavily Indebted Poor Countries
PRSP=Poverty Reduction Strategy Paper
ROSC=Report on the Observance of Standards and Codes

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Stand-By, EFF, and PRGF Arrangements as of June 30

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	4,810.00
Bolivia	April 2, 2003	December 31, 2004	128.64	53.60
Brazil	September 6, 2002	March 31, 2005	27,375.12	10,175.48
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Dominican Republic	August 29, 2003	August 28, 2005	437.80	306.46
Gabon	May 28, 2004	June 30, 2005	69.44	55.55
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
Macedonia FYR	April 30, 2003	August 15, 2004	20.00	8.00
Paraguay	December 15, 2003	March 31, 2005	50.00	50.00
Peru	June 9, 2004	August 16, 2004	287.28	287.28
Turkey	February 4, 2002	February 3, 2005	12,821.20	1,360.80
Ukraine	March 29, 2004	March 28, 2005	411.60	411.60
Uruguay	April 1, 2002	March 31, 2005	2,128.30	559.20
Total			**54,343.66**	**19,700.59**
EFF				
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	250.00
Total			**794.40**	**373.73**
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	12.00
Armenia	May 23, 2001	December 31, 2004	69.00	9.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	38.61
Bangladesh	June 20, 2003	June 19, 2006	347.00	248.00
Burkina Faso	June 11, 2003	June 10, 2006	24.08	17.20
Burundi	January 23, 2004	January 22, 2007	69.30	42.90
Cameroon	December 21, 2000	December 20, 2004	111.42	31.83
Cape Verde	April 10, 2002	April 9, 2005	8.64	3.72
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	79.93
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Dominica	December 29, 2003	December 28, 2006	7.69	5.02
Ethiopia	March 22, 2001	July 31, 2004	100.28	10.43
Gambia, The	July 18, 2002	July 17, 2005	20.22	17.33
Georgia	June 4, 2004	June 3, 2007	98.00	84.00
Ghana	May 9, 2003	May 8, 2006	184.50	131.80
Guyana	September 20, 2002	March 19, 2006	54.55	43.03
Honduras	February 27, 2004	February 26, 2007	71.20	61.03
Kenya	November 21, 2003	November 20, 2006	175.00	150.00
Kyrgyz Republic	December 6, 2001	December 5, 2004	73.40	19.12
Lao People's Democratic Republic	April 25, 2001	April 24, 2005	31.70	13.58
Lesotho	March 9, 2001	October 31, 2004	24.50	3.50
Madagascar	March 1, 2001	March 1, 2005	91.65	22.70
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
Mali	June 23, 2004	June 22, 2007	9.33	8.00
Mauritania	July 18, 2003	July 17, 2006	6.44	5.52
Mongolia	September 28, 2001	July 31, 2005	28.49	16.28
Nepal	November 19, 2003	November 18, 2006	49.91	42.78
Nicaragua	December 13, 2002	December 12, 2005	97.50	55.71
Pakistan	December 6, 2001	December 5, 2004	1,033.70	344.56
Rwanda	August 12, 2002	August 11, 2005	4.00	1.71
Senegal	April 28, 2003	April 27, 2006	24.27	17.33
Sierra Leone	September 26, 2001	March 25, 2005	130.84	28.00
Sri Lanka	April 18, 2003	April 17, 2006	269.00	230.61
Tajikistan	December 11, 2002	December 10, 2005	65.00	39.20
Tanzania	August 16, 2003	August 15, 2006	19.60	14.00
Uganda	September 13, 2002	September 12, 2005	13.50	8.00
Zambia	June 16, 2004	June 15, 2007	220.10	137.56
Total			**4,560.04**	**2,260.36**

EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Finance Department

Members drawing on the IMF "purchase" other members' currencies, or SDRs, with an equivalent amount of their own currency.

Interview with Mark Watson

Predicting the present: prospects for the U.S. economy

Princeton University's Mark Watson is one of the foremost students of the U.S. economy. Along with Harvard University's James Stock, he has pioneered the use of modern statistical techniques to analyze and forecast economic activity and inflation. During a recent visit to the IMF Institute, Watson spoke with Prakash Loungani about the near-term prospects for the U.S. economy, lessons from two decades of studying U.S. business cycles, and the "great moderation" in the volatility of incomes.

LOUNGANI: Is the U.S. economy out of the woods now?

WATSON: I think so. There's a very nice indicator of the U.S. economy that the Federal Reserve Bank of Chicago produces every month. It's called the National Activity Index, and it's an average of about 85 different measures of economic activity. That indicator is looking very positive and does suggest that we're out of the woods. The past four or five months have looked good, including the employment picture.

LOUNGANI: Could another shock—say, a sustained increase in oil prices—push the U.S. economy into another recession?

WATSON: I think we have enough momentum to ride out even some very large shocks. Of course, in forecasting the economy, "never say never." Certainly one can imagine shocks that can be devastating to confidence. Moreover, as you know, our econometric models explain, at best, 25 percent—or 35 percent if we really push them—of the variance of near-term economic activity. So there is a lot that drives the economy that we just don't know about.

LOUNGANI: Is inflation kicking up?

WATSON: There's a lot of inertia in inflation. The fact that it has been low for a while helps keep it down. And the Fed [U.S. Federal Reserve Board] is much more credible now than it was, say, 20 years ago. That keeps long-term inflation expectations pegged or nailed down at a low level. Now this doesn't mean there cannot be short-run blips—up and down—in inflation. It also doesn't mean inflation can't get away from us again, but the likelihood of that is pretty low. We should, of course, expect some upward pressure on inflation from the pickup in real activity, but it can be contained by the Fed's actions.

LOUNGANI: What has the profession learned over the past two decades about forecasting economic activity, particularly recessions?

WATSON: We're much more successful at predicting where the economy is now than where it is going. Saying that we've gotten better at predicting the present sounds odd to people outside the forecasting profession. They say, "You should know where you are now; why do you have to predict it?"

But it isn't always easy to describe in real time what the state of the economy is; there are almost always conflicting signals. So even being able to provide a more accurate description of the present state of the economy is an improvement over where things stood 20 years ago. We've been less successful at saying where things will be in six months, and predicting a recession remains a difficult, if not impossible, task. Certainly the models that Jim Stock and I developed failed to predict the past two recessions. To use what I'm told is the new terminology, we are better at "nowcasting" than at "forecasting."

Another thing we've learned is that to forecast the economy, it is better to use 70, or even 700, variables rather than 7. There's more information in the economy than can be captured in a small number of variables. It's better to average the information in a large number of variables than to select a few up front. And then, because the structural features of the economy may be changing, the statistical model that you use should have some ability to adapt. In the jargon, the model should have time-varying coefficients instead of coefficients that are fixed for all time.

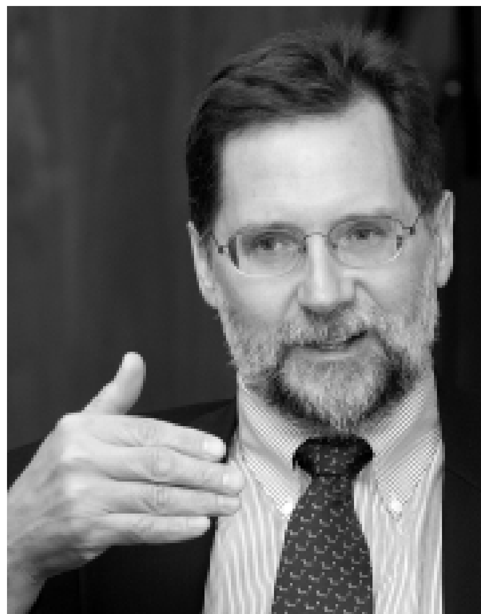
LOUNGANI: Having gone through another business cycle, what do we know now about what causes recessions—a few large shocks or many small ones?

WATSON: My view is that recessions occur as a result of a sequence of small shocks from many sources that eventually accumulate. We get a run of bad luck, a bunch of negative shocks—there's a big run-up in oil prices, the Fed tightens monetary policy around the same time there are other kinds of demand shocks. We just get, if you will, unlucky. The economy turns down. We know that even a simple linear statistical model, with some dynamics built in, generates cycles when perturbed by small shocks. This is what [Eugen] Slutsky told us ages ago. But it still seems to be a fair description of what causes cycles in the U.S. economy.

We are better at "nowcasting" than at "forecasting."
—Mark Watson

LOUNGANI: You don't agree then with James Hamilton, who argues that nearly every modern U.S. recession is due to an oil price increase associated with a supply disruption?

WATSON: Oil is part of the story and one of the negatives in several of the past U.S. recessions. But in a couple of those episodes there were also monetary tightening and other kinds of demand shocks. All these things conspired against the U.S. economy; any one of them by itself wasn't big enough to push the economy over into a recession.



Watson: "It's good news that the fluctuations in our individual incomes are less synchronized and less tied to the business cycle."

LOUNGANI: Have recessions become less frequent now, and is this behind what's being called the "great moderation" in incomes?

WATSON: In the 1970s and early 1980s, expansions were not too long and recessions quite frequent. But then the rest of the 1980s went by without a recession, and when one did come, in 1991, it was a pretty minor one. Then you had another decade of growth followed by our recent mild recession of 2001. This is certainly part of the story behind the great moderation in the volatility of U.S. aggregate incomes. But even if we look at times outside of the roller-coaster periods of recessions and recoveries, quarterly swings in real GDP—in our incomes, that is—are more moderate now than in the past.

LOUNGANI: Many people will be surprised to be told that their incomes have gotten smoother.

WATSON: As they well should be. What we're talking about here is a moderation in *aggregate* incomes, not necessarily in *individual* incomes. Those remain, as I understand it, as volatile as ever. This can happen for good and bad reasons. For example, if your health suffers, your income will quite likely become more volatile. But there are plenty of good reasons why our individual incomes are volatile. In a dynamic economy, people are changing jobs, always looking for new ways to do things, and so on.

LOUNGANI: So why should an individual care about what has happened to the aggregates?

WATSON: It's good news that the fluctuations in our individual incomes are less synchronized and less tied to the business cycle. If my income takes a hit the same time as yours, I'm going to be less able and less inclined to help you out. But if fluctuations in our incomes are on different cycles, we can each help the other out through bad phases. That's why the moderation in aggregate incomes is good for the individual. In the jargon, we can—as a group—insure better against the idiosyncratic risks to our incomes.

LOUNGANI: Why have we had this great moderation?

WATSON: We don't know yet. We have several candidates, but none takes us all the way in providing an explanation. One theory is that the Fed is doing a better job of conducting countercyclical policy, of leaning against the wind when economic times start getting turbulent. But that story turns out to be more useful in explaining what has brought inflation down over time than in explaining the great moderation. Another possibility is that the shocks have gotten less severe. But the shocks that we can identify, such as oil shocks, are just as variable as before.

LOUNGANI: Hasn't the switch from manufacturing to services helped stabilize incomes?

WATSON: That's not the whole story either, because even the volatility of aggregate manufacturing activity is lower now than it used to be. We're left, then, with good luck as the possible explanation. But that's an unsatisfactory explanation intellectually, and so the work will go on.

A student of mine, Austin Saypol, studied changes in financial institutions, such as in the way mortgages are issued and the way houses are financed. He found that those changes could explain a large part of the reduction in the volatility in residential construction, which is a sector that accounts for a fair chunk of the volatility in real GDP. You can extend that idea and look at changes in the way autos are financed, in the way washing machines are financed, and so on. Perhaps the great moderation will turn out to be due to the evolution in our financial institutions—that, at least, is my conjecture for the moment. ■

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