http://www.sge-econ.org Volume 35, No. 4 • April 2003

SGE Bulletin

"A society promoting the application of economic principles to public policy for over 30 years"

Labor and Human Resources Brown Bag

Tuesday, April 29
Noon to 1:30

Panel Analysis of Cohabitation and Child Well-being

Donna Morrison
Georgetown University
Public Policy Institute

National Center for Education Statistics
1990 K Street, NW
8th Floor Conference Center – Room 3
SECURITY INFORMATION: due to security procedures at 1990 K Street, a clearance list must be submitted for this meeting. If you are not an employee of NCES, you should make known your plans to attend no later than 5 PM, April 21 by sending e-mail to Stephen.broughman@ed.gov. Photo identification will be required to enter the elevators.

Metro: Farragut West (Blue and Orange Lines).

For more information contact Steve Broughman (202-502-7315), David Brauer (202-226-2777), or Ken Swinnerton (202-219-7611, ext. 117).

Views presented by speakers and audience participants are their own and may or may not be consistent with those of SGE.

Monthly Luncheon

Wednesday, April 16
Noon to 1:30

The War and the Economy

Eric M. Engen
American Enterprise Institute

Chinatown Garden Restaurant
618 H St., NW, Washington
Metro: Gallery Place (Red, Green, and Yellow Lines).
Restaurant is ½ block east of the Metro station northern (H Street) exit.

Reservations by 12 noon Tuesday April 15 to Warren Hrung (warren.hrung@do.treas.gov) or 202-622-2682.

$15 for SGE and NEC members
$20 for non-members

The speaker will discuss the effects of the current Iraq war on the U.S. economy, and compare it to economic developments around the first Gulf war in 1991. Monetary and fiscal policy around both Gulf wars will also be discussed.

Evening Seminar

Wednesday, April 29

The Need for U.S. Rail Passenger Transportation

See details on page 5

Call for Nominations

SGE is currently taking nominations for the 2003-2004 officers and board members. The nominating committee consists of Bob Shackleton, Harvey Bronstein, and Rakesh Kochhar. If you are interested in serving as an officer or board member, or if you would like to nominate someone, please contact Rakesh Kochhar at 202-872-0990 or send an e-mail to *rkochhar@jpcecon.com.*

March 2003 Monthly Luncheon Review of Remarks by Shang-Jin Wei, "Corruption in Developing Countries"

Page Three!

President's Corner

By Nabeel Alsalam

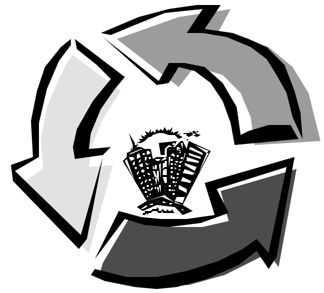
I need your help. There are many economists working in the DC metropolitan area who do not get the word about SGE luncheons, seminars, conferences, calls for papers, and so forth, but who would be interested. Would you be willing to be a point person in your organization? That is, if we email you an announcement once a month or so, would you forward it to a list of your economist colleagues? Or maybe you could print and post an announcement on a bulletin board near the coffee machine? Please email me (nabeel@cbo.gov) or Maricruz Magaowan on the board (Magowan.Maricruz@epa.gov).

The Economics Departments, Institutes, and Research Centers (EDRIC) website (http://edirc.repec.org/usa-dc.html) lists 113 organization in Washington, DC. It is likely that economists work in each of these places. The SGE membership from 2002 worked in roughly 100 organizations. From a quick scan, many organizations do not make both lists. Wouldn't it be great if SGE had a contact in each of these organizations?

ASSA Meetings in San Diego. Remember that May 15 is the deadline to submit session or paper proposals. If you don't have the March Bulletin handy, go to the website: http://www.sge-econ.org.

Around Town

A Service Column Listing Professional Activities of Interest to Our Membership



To include your activity, please e-mail the information to ann.dunbar@bea.doc.gov or send it by regular mail to the address on the back of this bulletin.

NEC Luncheons

April 7, Chinatown Gardens
Cynthia Glassman, Commissioner, Securities and Exchange Commission

April 16, Chinatown Gardens
Eric Engen, Resident Fellow, American Enterprise Institute
Global Aging and the Macroeconomy

April 24, Chinatown Gardens
Edward Gramlich, Governor, Federal Reserve Board
Government Loan Guarantee Programs
In the past several years the, the Congress has responded to industrial difficulties by passing four different loan guarantee programs—for oil and gas, steel, airlines and rural utility services. The speaker, a member of all four loan-guarantee boards (and chairman of three of them), examines issues and expected outcomes.

Call NEC's reservation line at 703-739-9404 or e-mail to nec@cbc.org. Reservations are due by 11 a.m. on the Tuesday before the lunch, and your message should include name, phone # and event. Those desiring to hear the talk without lunch may attend at no charge but should also reserve. Lunch price is $15 for SGE and NEC members, including those who join NEC at the door, $20 for others.

March 2003 Monthly Luncheon Review of Remarks by Shang-Jin Wei, "Corruption in Developing Countries"

Reported by Mark DeWeaver

Shang-Jin Wei, Advisor at the IMF and Senior Fellow at the Brookings Institution, began his presentation by noting that the increasing importance now being attached to fighting corruption is linked to the rise of globalization as well as to the end of the Cold War. He then focussed on two questions of particular interest to both academics and policy makers. First, how can we quantify how corrupt particular countries are? And second, is corruption "grease" (beneficial) or "sand" (harmful) from the point of view of economic development? Dr. Wei described several indices of corruption that are useful in cross-country comparisons while arguing that the answer to the second question is "no." It is possible, he said, to find examples of places that have done well in spite of corruption, but hard to think of anywhere that has done well because of it!

Much more attention is now being paid to the problem of corruption than was the case in the past. In fact, until recently, only the US had a law (the Foreign Corrupt Practices Act of 1977) prohibiting companies from bribing foreign officials. So, for example, a German multinational could legally pay bribes and even get a tax deduction for these amounts (if it could present a receipt)! This state of affairs only ended in 1999, when the OECD countries (as well as some non-OECD countries that participated voluntarily) signed a treaty banning bribery.

There are two main reasons for the new focus on corruption. With the end of the cold war, it has become less necessary to tolerate "governance challenged" regimes like those of Marcos and Mobutu. At the same time, increased economic interdependence means that a given level of corruption has become much more costly. It has been estimated that moving from a relatively "clean" government like that of Singapore to one as corrupt as Mexico's would have the same effect on foreign direct investment as an increase in the marginal corporate tax rate of 50% (See Wei's article, "How Taxing is Corruption on International Investors?" in *Review of Economics and Statistics*, 82(1): 1-11). Furthermore, corrupt countries are also more vulnerable to financial crises because they are forced to rely on short-term offshore loans, which flow out much faster then FDI following a shock (See Wei's article "Domestic Crony Capitalism and International Fickle Capital: Is There a Link?" in *International Finance*, 4(Spring): 15-46). Not surprisingly, portfolio investment is also adversely affected by corruption--a study (by Dr. Wei and IMF staff member Gaston Gelos) of six hundred global and emerging market mutual funds found that fund managers tend to overweight less corrupt countries (relative to the Morgan Stanley Capital International indices).

Measuring the degree of corruption in particular countries is important both for academic studies of economic growth and for the administration of World Bank and IMF loans, Millenium Challenge Accounts, and other programs which seek to tie assistance to good governance. Several indices are now available for this purpose. For example, the Political Risk Services Group (www.prsgroup.com) provides (for a fee) corruption ratings for a number of countries in its International Country Risk Guide. These are based on the expert opinion of its staff. The Global Competitiveness Report, a joint effort of Harvard University and the World Economic Forum (www.weforum.org), rates countries on the basis of surveys of six to seven thousand business executives around the world. Each is asked to think through a sequence of seven transactions involving things like getting an import license or arranging for foreign exchange remittances and to estimate how much these would typically cost in illicit payments. And Transparency International's (www.transparency.org) Corruption Perceptions Index provides a useful (and free) average of the findings of a number of other sources.

All of these indices are somewhat subjective, but this does not detract from their usefulness. It is after all the perceptions of investors that matter for FDI and portfolio investment. Further support for the subjective approach comes from a study of German exporters done during the early 1990's (when it was not illegal to bribe foreign officials), which achieved a more objective measure by asking respondents to report the amounts of the bribes they actually paid. The results were highly correlated with those of perceptions-based surveys.

There are two schools of thought on whether cor-

(Continued on page 5)

Book Review

Famous First Bubbles:
The Fundamentals of Early Manias
by Peter M. Garber
(Cambridge, MA; MIT Press, 2000).
Reviewed by Mark A. DeWeaver, Ph.D.

Rational Exuberance?

Famous First Bubbles provides brief histories of three early asset price bubbles--the Dutch "tulipmania" of the seventeenth century and the Mississippi and South Sea bubbles of the eighteenth. These episodes are important both because of their historical significance and because they are often cited as evidence that financial markets are not always efficient. The author, well-known financial economist Peter Garber, reaches the surprising conclusion that all three can actually be explained in "fundamental" terms. In the case of the tulipmania, his argument is persuasive--high prices for new tulip varieties are not surprising, as these prices should discount not only the value of a single flower, but also the net present value of all future bulbs of that type. However, in the other two cases, he appears to have done little more than replace one *ad hoc* notion, "speculative mania," with another, "changing views of the fundamentals."

The tulipmania occurred during the period from 1634 to 1637 and was apparently the consequence of an early seventeenth-century French tulip vogue, which followed the introduction of the tulip to Europe from Turkey during the mid-sixteenth century. The best known version of the story can be found in Mackay's *Popular Delusions and the Madness of Crowds* (1852), which describes how prices started rising following the entrance of non-professional speculators into the market in 1634, and the start of futures trading (in Dutch taverns) in 1636. At the peak of the speculation, the price for a single bulb of one variety reached 5,500 guilders ($33,000 at today's gold prices) and Mackay also reports some bizarre barter transactions. One of his anecdotes relates how a single bulb was exchanged for a long list of items including four oxen, eight pigs, twelve sheep, 1,000 pounds of cheese, and one silver chalice. Then, at the beginning of 1637, prices collapsed and the settlement of futures contracts was suspended.

While the tulipmania has long been accepted as a matter of historical record, Garber shows that there are actually a number of problems with this story. First, much of the evidence has been misinterpreted. For example, Mackay's claim that, following the crisis, prices fell to less than ten percent of their peak levels appears to have come from a proposal that was never implemented, calling for futures contracts to be settled at ten percent of their contracted values. His account of bizarre barter transactions rests on a similar misinterpretation of the evidence--apparently these trades never really took place. Furthermore, Garber finds that "the discounted value of bulb sales can easily justify extremely high prices for the unique bulb of a new variety." Similar flower price patterns in subsequent centuries lead him to conclude that even at 5,500 guilders a bulb, tulips were not "obviously overvalued." Finally, it turns out that while the speculation primarily involved futures, these were not recognized by the courts. Garber concludes that much of the trading may have been little more than a "winter drinking game, " in which people "without equity" made "million dollar bets" on unenforceable contracts.

The Mississippi (1719 - 1720) and South Sea (1720) bubbles involved schemes by private companies to refinance the national debts of France and England, respectively. In both cases, these companies used new issues of their own shares to purchase government debt, which was, in theory, supposed to provide a steady source of income to finance other projects. Both companies' share prices rose approximately ten times before crashing in the middle of 1720. In the first case, the crash was precipitated by the cessation of the issue of government guaranteed notes to support the market (a practice not unlike the Bank of Japan's "price keeping operations"!). The South Sea bubble appears to have collapsed as a result of both "contagion" from the collapse of the Mississippi bubble and of the passage of the Bubble Act of 1720, which set off a general liquidity crisis by banning unauthorized companies.

Garber believes that neither case is evidence of investor irrationality because both companies might well have been successful in the long run given the strong government support they enjoyed. In the French case, he believes it would also not have been unreasonable to suppose that the increase in the money supply (used to finance share purchases) might have had beneficial macroeconomic effects, thus creating an even more promising environment for the company's projects. Garber argues that only after this "experiment had been run could investors have known" that it would not succeed. Similarly, in the case of the South Sea bubble, he finds that what happened was not a speculative mania, but rather speculators "pushing prices along by their changing view of the fundamentals."

The lesson that Garber would like us to draw from these two episodes is that the claim that they (and similar subsequent crises) were simply the result of investor irrationality is an *ad hoc* explanation. The problem with his analysis, however, is that it is equally *ad hoc*. There is no basis for claiming that Mississippi bubble investors could not have figured out on *a priori* grounds how things would turn out, nor is asserting that investors' views of the fundamentals changed any better than simply saying that they were "irrationally exuberant." The problem with both "irrational exuberance" and "fundamental" explanations is that neither tells us where investors' expectations come from in the first place or why they change. Both treat the investor's mind as a black box--an unlikely starting point for a useful theory of his behavior during an asset price bubble.

Mark DeWeaver is a partner at Ithaca Advisors, LLC, an emerging markets fund-management company (on the web at www.ithacaadvisors.com). The opinions expressed are his own.

Monthly Luncheon Review

(Continued from page 3)

ruption is necessarily bad for economic development. Samuel Huntington at Harvard University has argued that corruption can be beneficial because it allows firms to get around inefficient regulations (barriers to import, entry, etc.) and thus promotes competition in the domestic market. As Huntington argued, "the only thing worse than dishonest and rigid bureaucracy is honest and rigid bureaucracy." Dr. Wei believes that this argument is incorrect because it takes the inefficient regulations as given. In fact, it is more likely that the only reason such inefficiencies are introduced in the first place is to create opportunities for officials to accept bribes. He also finds that the empirical evidence offers "overwhelming" support for the idea of corruption as "sand" rather than as "lubricant." (See, for example, Paulo Mauro's article "Corruption and Growth" in the August, 1995 *Quarterly Journal of Economics*).

So is the new focus on corruption having any practical effect? Dr. Wei cited two cases in which IMF loans were cut off in response to unacceptably severe governance problems. Loans to Kenya were suspended some years ago. Similarly, during the 1999 Russia crisis, support was withdrawn partly because it was found that some of that country's forex reserves had been hidden in accounts in the Cayman Islands. While much still remains to be done, he feels that cases like these show that the international community is finally beginning to move in the right direction on this important issue.

Evening Seminar

The Need for U.S. Rail Passenger Transportation

Wednesday, April 30, 2003 6:00 p.m.

Conference room 483, Congressional Budget Office, 2nd & D Streets, SW, 4th Floor, Washington, DC 20515 (Metro: Federal Center Station)

Panel Participants

Dr. Francis Mulvey, Staff Director, Railroad Subcommittee, House Transportation and Infrastructure Committee, U.S. House of Representatives

Dr. Jack Wells, Chief Economist, Bureau of Transportation Statistics, U.S. Dept. of Transportation

Edgar Courtemanch, Director, Business Operations, Amtrak

Light refreshments served. The seminar is free, but please E-mail Melvyn Sacks at Msacks1031@aol.com for reservations.

SGE

Society of Government Economists
10371 Painted Cup
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