Rise of the Undaunted Empiricist

Simon Willson profiles ***Beatrice Weder di Mauro***

FOR the first 41 years of its existence, Germany's Sachverständigenrat, or Council of Economic Experts, was popularly known as the "Five Wise Men." If that sobriquet was a veiled invitation to the country's female economists to attempt entry into a hitherto all-male preserve, the council was into its fifth decade before anybody accepted. Beatrice Weder di Mauro was appointed in June 2004 as the council's first female member. "Friends of mine suggested that now they had better call us the Five Wise Guys," Weder di Mauro says.

The council's gender barrier was not the only hurdle Weder di Mauro cleared by taking her seat on the panel that advises the German government and parliament on economic policy issues. Born in Basel, Switzerland, Weder di Mauro was also the first non-native council member and, then aged 38, one of the youngest council members ever appointed. Not surprisingly, after setting such precedents, she is now one of the best-known economists in the world's third-largest economy.

Today, the Five Wise Guys are at the leading edge of the macroeconomic reforms that could turn the euro area into the world's next economic powerhouse. Because the German economic advisory council has a much higher public profile than that of comparable institutions, such as the U.S. Council of Economic Advisers, Weder di Mauro's council tenure started in a blaze of publicity. But the gloss soon faded as the council researched and recommended a series of radical fiscal and labor market reforms. And whatever celebrity Weder di Mauro may initially have bestowed on a structure as technocratic as Germany's economic advisory council has been absorbed and become part of the panel's own heavyweight persona.

Known for her direct and persistent style of inquiry and research, Weder di Mauro brought to the German council a record as a pathfinder in exploring the role of banks in transmitting financial contagion. She had, in addition, investigated the effects of corruption on developing economies—using the term directly in the days when it was usually referred to by the euphemism of "governance." She also brought to the German council a keen sense of how best to disseminate findings and results. In an assertively independent council that partly relies on the mass media to channel its findings and recommendations, this is a powerful asset.

Something about panels

Weder di Mauro's early research was characterized by a comprehensive approach, irrespective of the scale of the project. Gregory Kisunko, a senior public sector specialist at the World

Bank, worked with Weder di Mauro on a 1996–97 worldwide survey on perceptions of links between political uncertainty, investment, and growth. His recollections depict a driven and single-minded empiricist undaunted by trifling taglines such as "Data not available."

"This was the first and the largest effort to collect raw data on the topic of institutional uncertainty, and she was pushing very hard for extending the country coverage as wide as possible," Kisunko remembers. "The data collection exercise was heroic because it required an organized effort spanning more than 70 countries." Colleagues had been "excited and energized by the novelty and magnitude of her ideas. We all had ideas, but she was always one of those leading the pack."

Unusually, Weder di Mauro's position on the German advisory council is her second tour in such a role in a major European economy. She was appointed in 2002 to Switzerland's Kommission für Konjunkturfragen, the Economic Advisory Board of the Swiss government, and served for two years. What intrigued her enough about national economic advisory panels that she would serve on two, back to back? "It is extremely interesting to do work that is relevant for the policymaking of a country and, at the same time, still keep a foothold in the academic world," Weder di Mauro says. "It's not always easy, though, because what is relevant very often is not interesting for research, and vice versa."

The German advisory council is unique, Weder di Mauro asserts, because it is independent (see Box 1). The government appoints council members, but they have a five-year term deliberately at odds with the four-year election cycle. The council has two main channels of influence, Weder di Mauro believes. One is the public—the council is one of the institutions quoted by the mass media whenever there are new economic developments. The other is its inside route to government. "People often ask whether I feel that our recommendations are being implemented right away," Weder di Mauro observes. "I don't think that's the only way to measure the council's influence. Very often it's more about the longer-term influence that we have in a certain direction."

Views that the council's influence is limited have circulated in the economics community for many years, however. Charles Roberts wrote in the *Cambridge Journal of Economics* in 1979 that—and this still applies today—because the council's reports "are published only in German, they are little known and little discussed outside the German-speaking countries." Weder di Mauro says that, while English summaries are published, council reports are mostly in German because they are addressed to the German government and public.

Adversaries, egos, and tantrums

In 2005, the council's close relationship with the press was all too evident as the German media gleefully relayed colorful reports of fragile egos and internal tantrums among the panel's high-octane lineup. Council members even used newspaper articles and interviews to attack each other, prompting suspicions that they were incapable of working as a team. *The Economist* magazine said Germany's marketplace for economists was "coming apart," and recommended that the fixed-term experts be replaced by fresh councils of economic advisers appointed by each incoming government. That way, the advisers would have more of a stake in seeing their recommendations implemented. A potential public relations crisis was eventually defused and the council's image seems to have survived.

"The reputation of the council is extremely high in Germany," Weder di Mauro asserts. "People do ask whether politicians listen to us. Well they can't really avoid us, as we usually make the government uncomfortable. The council usually criticizes the government, which is why there are no other councils like this. Which government would want to establish such a thing?"

Which, indeed? Particularly a government that had, as Germany's did in 2002–06, run its budget deficit at levels higher than the European Union rules allowed. Germany's fiscal slippage had been caused by a creeping economic malaise of slowing growth and rising unemployment that earned the country the unenviable title of "sick man of Europe." Germany's breach of the EU's budget rules in the early 2000s was especially galling for the nation's economic traditionalists, because the EU rules were based on Germany's own penchant for budgetary rectitude—as set out in its landmark Stability and Growth Act of 1967. Key elements of the EU's fiscal rules, set out in the 1992 Maastricht Treaty, were eased in 2005.

Box 1

Informed judgments—by order

Established in 1963, the Sachverständigenrat's mission statement says its mandate is "to periodically assess overall economic developments in the Federal Republic of Germany and to help economic policymakers at all levels as well as the general public to arrive at informed judgments on economic matters."

The council is required, by the law that established it, to produce an annual report that describes "the current economic situation and its foreseeable development. The Council will investigate the possibilities of simultaneously assuring, within the framework of the free market economy, stability of the price level, a high rate of employment and equilibrium in foreign trade and payments, together with steady and adequate economic growth. The investigation will also include the formation and distribution of income and property."

In its latest annual report, published in November 2007 and entitled "The Gains Must Not Be Squandered," the council acknowledges that policymakers contributed to a German economic resurgence in part by launching extensive reforms in the fields of taxation, the labor market, and the social security system.

But the report also states that positive economic trends have in turn opened up wider opportunities for policymakers. "The key need now is not to waste the chance offered by the expanded opportunities for policy action but rather to seize it . . . just as it is gratifying that the policymakers' financial room for maneuver has expanded, so it is frustrating that a whole series of measures that were considered or adopted during the recent past revealed no clear economic policy strategy but instead smacked of tactical electioneering."

"The existing German rules have huge loopholes that are regularly exploited by politicians," Weder di Mauro says. The German council produced a report last year "with suggestions on how to change the entire constitutional framework for limiting the extent of public debt in Germany." She believes a general decline in interest in, and application of, fiscal discipline lay behind Germany's failure to curb deficits that exceeded the Maastricht rules. "But right now there is a chance in Germany for fiscal reform, with a federal commission looking at the rules of fiscal discipline both for the federal government and for the länder [German states]."

Made in Switzerland

The council's report makes stringent proposals that would enforce the original Maastricht rule that national budget deficits be less than 3 percent of GDP, and that any fluctuation align with the business cycle. And, as if to demonstrate the utility of foreign input into council deliberations, a key innovation in the council's proposal incorporates a fiscal feature first deployed in Switzerland.

"Our proposal has something that we imported from Switzerland: a component that is more strict than the Maastricht rules," Weder di Mauro explains. "It's a special fiscal error-correction account that you have to balance. If the budget deficit turns out to be larger than expected, it is debited to this error-correction account that has to be balanced separately. An unexpected fiscal surplus would also have to be paid into this account. The Swiss implemented it in 2003." This mechanism installs "memory" in the system. "No fiscal rules that I am aware of have a memory. They always say that if you overestimated revenues in the past and run a higher deficit than expected, you don't have to correct for that problem first—even Maastricht doesn't do that. In a way, these rules are promoting an 'I will start my diet tomorrow' way of life," Weder di Mauro says. "But with an error-correction account, you can't just start again on a clean sheet. You have to repair past damage. Having memory in the system creates incentives to make conservative revenue estimates and to keep tight checks on spending."

How receptive, though, are German fiscal traditionalists to tighter discipline principles imported from another country? And might Swiss-born Weder di Mauro, who speaks seven languages, be seen as some kind of foreign agent among the Five Wise Guys, advocating foreign solutions to a domestic problem? "It has never been a problem that I am Swiss and Italian," she states.

Although Weder di Mauro's professional focus has latterly been solidly European and increasingly financial, her upbringing prepared her well for her earlier interests in the macroeconomics of growth and development. She was raised in Guatemala, where her father worked for a Swiss multinational company. For nine years Weder di Mauro attended the German school in Guatemala City, where daily life made early impressions that would guide her later work. Her exposure to Latin America laid the foundations, for example, for her subsequent interest in the role of institutions in promoting economic growth.

"Awareness of institutions and of institutional differences comes very much from my Guatemala experience and was reinforced by a research project with the Peruvian *Instituto de Libertad y Democracia* of Hernando de Soto [profiled in *F&D*, December 2003]," Weder di Mauro says. "The project investigated obstacles to small enterprise in Latin America and found that in many countries the enforcement of rules is often not credible, and that this limits the scope of entrepreneurship and exchange. This applies in particular to financing, which is why informal finance flourishes."

The role of banks

Returning to Switzerland, Weder di Mauro completed her education at the University of Basel and was also a research and teaching assistant at the university. "In the past I have had basically two pillars of interest and research," she muses. "One is how to make institutions work so that they promote growth. The second concerns financial crisis contagion, and the role of banks in particular. A third area is coming on stream now: when I was appointed to the German council I tried to refocus my research to work on issues that are more related to Germany in order to exploit synergies." Her current research interests include the impact of real exchange rate changes on job flows in an inflexible labor market and the effects of public sector banks on the reallocation of capital.

It was the second area of interest that led Weder di Mauro to take her first salaried job in 1994 at the IMF in Washington. While at the IMF she took a leave of absence to contribute to the World Bank's 1997 *World Development Report*. "The break-

Box 2

Another conduit for contagion

In a groundbreaking 2001 paper in the *Journal of International Economics*, Weder di Mauro and Caroline Van Rijckeghem identified an indirect channel for contagion between countries that were exposed to the same banks. They found evidence that spillovers through bank lending, as opposed to trade linkages and country characteristics, could help explain contagion.

If the banks shared the same risk models, then a crisis in one country could be transmitted to another country through simultaneous cutting of bank credit lines. Weder di Mauro's findings might align her with critics of the new capital adequacy framework for banks, which is currently being phased in by about 100 countries.

The new framework—known as Basel II because it follows the 1988 Basel I framework developed by the Bank for International Settlements in Basel, Switzerland—is being widely adopted by bank regulators. It establishes a global benchmark for the amount of capital that banks need to hold as standby resources to cover potential risks in their financing and operations.

Critics say Basel II is procyclical—that is, it is too lax on banks' capital requirements in good times and too tough during hard times, exacerbating boom-bust cycles in the process. These naysayers believe that Basel II might lead banks to herd into and out of markets and could eventually pose systemic risk (see related articles in *F&D,* June 2008).

through was this survey that we did, observing firms and asking for their views on obstacles to doing business," Weder di Mauro recalls. This survey approach (with Aymo Brunetti and Kisunko) has since been absorbed into the research mainstream, and much more refined techniques have been developed to take account of institutional issues, she says.

"A very simple question"

From institutions and governance, Weder di Mauro's studies in Washington led to a more prickly and sensitive topic: corruption. In a paper with Harvard's Alberto Alesina, Weder di Mauro asked with characteristic directness, "Do Corrupt Governments Receive Less Foreign Aid?"

"We asked a very simple question," she recalls. "'Is there any evidence that in the past the distribution of aid had taken into account differences in corruption across countries?' And the answer at the time was: 'no.' It has since become generally accepted that corruption is an obstacle to growth and therefore that development systems should pay much more attention to it."

Alesina says this project typifies Weder di Mauro's approach to research. "One of her strengths is her creativity in looking at issues that are important and relevant and not esoteric, but at the same time with a point of view that is quite novel. This was one question left on the table and ready to be addressed in the discussion at the time on whether foreign aid achieved its targets or was wasted." Alesina thinks Weder di Mauro's skills are a good fit for the German council of experts: "She tackles problems head on."

While studying governance, Weder di Mauro also spent two years as a research fellow at the United Nations University in Tokyo. Her 1997–98 sojourn in Japan coincided with the Asian financial crisis and opened up a new area of interest: the role of banks in financial crisis contagion. It helped that her earlier findings on governance and aid flows had made her a natural skeptic of conventional wisdom.

It seems that whenever a major financial crisis occurs, the earliest and most repeated questions are "How could this happen?" and "How is it possible that (insert your target here) did not see it coming?" Weder di Mauro remembers precisely these questions swirling around Tokyo in 1998, and hears eerie echoes today in the context of the subprime mortgage problems in the United States.

In Tokyo, 10 years ago, "people were pointing to trade and also to third-market effects—not only direct trade—to explain part of the contagion. At the time, to me it just didn't sound right. So we started looking for ways in which finance could be part of the contagion process. At that time banks were the major financiers of many of the Asian crisis countries, and there was anecdotal evidence that maybe it was the banks, in reacting to losses in one country by cutting back credit in another, that were conduits for the contagion."

Weder di Mauro says the new Basel II capital adequacy standards for banks will need to be monitored carefully (see Box 2). "If Basel II incorporates risk management systems that respond to prices and ratings and which change in cycles, then in theory it could increase procyclicality. But the real question in my view is empirical: Are capital regulations binding or is economic capital of banks the binding constraint? And if regulatory capital is actually binding, what is the size of the effect on lending?"

After working in Japan, Weder di Mauro in 2001 secured her current position as professor of international macroeconomics at the University of Mainz in Germany. She was part of a 2007 exercise simulating the impact of Basel II on the lending of German banks to emerging markets, finding that the effect should be minimal since banks already seemed to allocate lending according to economic capital.

Two-way teaching

Weder di Mauro was first appointed to the German Council of Economic Experts to finish the term of Axel Weber, who had left to head the Bundesbank. Undaunted by the workload or the attendant publicity, she was reappointed to the council in her own right to a full five-year term last year. The glare of the media spotlight has never bothered her, partly because she knows how journalists work. While at the University of Basel, she and a few faculty colleagues offered courses to train journalists in basic economics. And the teaching ran both ways: the hacks learned about inflation, disinflation, deflation, and stagflation while Weder di Mauro and her fellow bean-counters learned about headlines, deadlines, bylines, and blue lines—and how to explain complex economic insights to a wider audience.

Does designing an economics course for journalists mean she sees a particular weakness in the fourth estate concerning the dismal science? "I wouldn't limit that to journalists," she says. "Everybody could use some basic instruction in economics—and that's part of the role of a body such as the council. If people aren't listening, it's our fault, not theirs." ■

Simon Willson is a Senior Editor on the staff of Finance & Development.

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