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In this issue

49
Hong Kong SAR poised for a rebound

49
Adopting the euro

57
AFRITAC East's work plan for 2004

61
Exchange rates: pick your poison

63
In defense of globalization

and...

52
Recent publications

56
IMF arrangements

60
New on the web

62
Selected IMF rates

Interview with Eswar Prasad

Hong Kong SAR looks to rebound

In recent years, Hong Kong SAR's economy has been buffeted by an acute regional crisis, a stubborn global slowdown, and a frightening new virus. But with traditional resilience and a helping hand from the mainland, Hong Kong SAR now seems poised to record strong growth and accelerate the changes needed to align its economy more closely with that of mainland China. Eswar Prasad, editor of a new IMF Occasional Paper on the challenges facing the territory, speaks with Sheila Meehan about the authors' findings and recommendations.

Hong Kong SAR's changing skyline reflects continued optimism.

IMF Survey: Hong Kong SAR has, over the past few years, experienced several short-circuited recoveries. Is it too soon to say that the worst of its economic problems are behind it?

Prasad: The first half of 2003 was difficult for Hong Kong SAR. Just as it was beginning to come out of a recession, the SARS epidemic hit. Tourism and related services sectors were especially badly affected; unemployment peaked at 8.7 percent in July; and deflation, which was seemingly becoming entrenched in the economy, worsened.

But conditions improved rapidly in the second half of 2003. The SARS epidemic came under control, the global macroeconomic environment improved, and growth on the mainland picked up. Certain steps taken by the mainland also helped. The easing of travel restrictions on mainland tourists traveling to Hong Kong SAR and *(Please turn to the following page)*

Prague conference

Adopting the euro—challenges and opportunities for new member states of the European Union

Now that enlargement negotiations have been completed, the 10 countries that will be joining the European Union (EU) on May 1—Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia—are focusing on the challenge of replacing their national currencies with the euro, which they are committed to doing, though not by any specific date. The conference "Euro Adoption in the Accession Countries—Opportunities and Challenges," organized by the Czech National Bank and the IMF and held in Prague on February 2–3, drew together representatives from current and new EU member states, officials from the Euro-pean Commission and the European Central Bank, academics, and IMF staff to explore these issues. Robert Feldman, Louis Kuijs, and Cyrus Sassanpour from the IMF's European Department report on highlights of the conference.

What do countries hope to gain from adopting the euro? According to Jeffrey Frankel (Harvard University), the key benefit of joining a currency union arises from trade creation. The gains are considerable, with two-thirds being realized within three decades. Even in the short period since the inception of the EU's *(Please turn to page 53)*

Hong Kong SAR's financial services likely to grow

Maintaining international competitiveness in the face of rising competition from other aspiring financial centers will remain a challenge.
—Eswar Prasad

(Continued from front page) the signing of the Closer Economic Partnership Arrangement—a framework for fostering economic integration between the two economies—boosted economic prospects and also had an important symbolic value in signaling the rapidly growing linkages between the two economies.

These developments quickly turned around consumer and business sentiment, which had been depressed by SARS. Retail sales picked up rapidly, fueled by tourists from the mainland, and unemployment is now down to about 7 percent. Our latest growth forecast for 2004 is about 5 percent, and we anticipate that deflation, which has now persisted for over five years, could end in late 2004.

IMF Survey: Deflation is notoriously difficult to turn around. What is the basis for your optimism? Do you see property values finally bottoming out?

Prasad: Let me first talk about the work that Papa N'Diaye, one of my coauthors, did on deflation dynamics. It showed that there are channels through which temporary shocks can have persistent or longer-term effects. For instance, through its effects on the balance sheets of individuals and corporations, an initial burst of deflation can end up lasting long after the shocks that initially triggered it have dissipated. But it is very hard to separate out the cyclical (short-term) and structural (longer-term) components of deflation.

Fortunately, a number of recent developments appear to have reversed the downward pressure on prices. These include much stronger domestic demand conditions, supported by rising growth in the mainland; a significant depreciation of the U.S. dollar—to which the Hong Kong SAR dollar is linked; and emerging inflationary pressures on the mainland.

Another aspect supporting the end of deflation is the recovery in property prices. Property prices fell by almost 65 percent between their peak in 1997 and last year. In the past few months, prices in most sectors of the property market have stabilized or even increased gradually. While the evolution of property prices is difficult to predict, indications are that the property market has turned around for good. This has happened because overall macroeconomic prospects have improved and the effects of positive government measures are beginning to take hold.

The government has traditionally had a heavy hand in the property market by subsidizing housing and controlling the supply of land. Over the past two or three years, as Jorge Chan-Lau, another coauthor, documents in the Occasional Paper, the government has made a determined effort to decrease its role, and this has helped improve sentiment in the property market.

IMF Survey: Hong Kong SAR has a long track record as an open, resourceful economy. What do you see as its principal challenges in the medium term?

Prasad: The structure of Hong Kong SAR's economy has changed quite dramatically in recent decades. The share of the manufacturing sector in GDP has declined from about 22 percent in 1980 to less than 5 percent now. This shift has posed significant challenges in terms of the absorption of labor by other sectors.

The composition of trade has also changed. Hong Kong SAR used to be an important intermediary for China's trade with the rest of the world. Now that China has increasingly direct access to world markets, less of this trade goes through Hong Kong SAR. Instead, it is getting a larger share of "offshore" or "transshipment" trade that takes advantage of Hong Kong SAR's superior logistical services. But the value-added component of this sort of trade is much lower.

In this context, Hong Kong SAR's role as a financial services center will become more important over time. Even if China's financial linkages with the rest of the world were to deepen, Hong Kong SAR is likely to continue to play a crucial role as a fund-raising center for Chinese firms. But maintaining international competitiveness in the face of rising competition from other aspiring financial centers will remain a challenge.

The other major policy challenge for Hong Kong SAR is its fiscal deficit. In fiscal year 1997–98, its budget was in surplus, its fiscal policy had a well-established conservative track record, and its fiscal reserves were large. The level of reserves has now declined to less than one year's worth of government expenditures, and the deficit for the fiscal year ending this April is likely to be around 5 percent of GDP.

IMF Survey: What can the government do to strengthen its fiscal position?

Prasad: Our analysis, which has been done by Hong Liang, suggests that, if the deficit were to be maintained at its current level, the fiscal reserves could run out in four to five years. Maintaining a comfortable level of reserves is important for cushioning against future shocks and for ensuring the continued stability of Hong Kong SAR's currency board.

The authorities are very cognizant of this, and the financial secretary has indicated that he intends to balance the budget by 2008/09. Indeed, many substantive measures have already been put in place over the past year, despite the difficult circumstances.

The main effort will have to be on the expenditure side. Hong Kong SAR has traditionally had a small government that nevertheless delivers high-quality public services. But the level of government expenditure as a ratio to GDP, which was about 14 percent in 1997, has now ballooned to almost 20 percent. The financial secretary's clearly stated objective is to reduce the annual nominal operating expenditures from about HK$220 billion at present to HK$200 billion by 2008/09. The challenge—which we think can be met—is to reduce expenditure without diminishing the quality and breadth of public services.

Further efforts will be needed on the revenue side as well. In recent years, Hong Kong SAR has increasingly relied on sales of its investments and properties to meet financing requirements. But asset sales are procyclical and not a reliable source of revenue. While maintaining Hong Kong SAR's low tax environment is a good idea, we have argued strongly that there should be a change in the composition of revenues. The government is considering the introduction of a goods and services tax [GST], which would substantially broaden the tax base and make it more stable. The financial secretary feels that the economy needs to recover strongly and that deflation should end before a GST is introduced. We think it is important, given the long lead time required, to start preparing for its implementation as soon as possible.

IMF Survey: Hong Kong SAR has traditionally had an exceptionally efficient and liquid financial sector and a particularly strong banking system. How has the financial sector weathered these rocky economic times, and what do you see as its future role?

Prasad: As two other coauthors, William Lee and Ida Liu, note, Hong Kong SAR's financial system is fundamentally very strong and resilient. It is a testament to its robustness that Hong Kong SAR has withstood sharp price declines in the property market—where a lot of the lending takes place—without any major turmoil in the banking sector. In fact, the IMF completed a Financial Systems Stability Assessment of Hong Kong SAR in 2003, and the stress testing indicated that the banking system could withstand a variety of shocks without major distress.

This is a tribute to two factors: Hong Kong SAR banks compete internationally, and this requires them to maintain very high standards of internal prudential supervision. And the supervisory regime has been very effective in maintaining the soundness of the financial sector. The assessment did indicate that some steps could be taken to improve corporate governance; increase the transparency of the institutional policy framework; and better coordinate cross-industry supervision. The authorities have responded very favorably to these suggestions and taken a number of steps to further strengthen the financial system to deal with future challenges.

Hong Kong SAR will increasingly face competition from other financial centers, but its intrinsic advantages—which include easy access to the mainland, a strong legal framework, a world-class regulatory and supervisory apparatus, and a leading-edge financial infrastructure—are likely to keep it the dominant player in the region for quite some time to come.

Prasad: "While maintaining Hong Kong SAR's low tax environment is a good idea, we have argued strongly that there should be a change in the composition of revenues."

IMF Survey: What sort of investments in human capital will Hong Kong SAR need to make?

Prasad: We specifically looked at trends in wage inequality, and Dora Iakova's research finds that it has risen sharply over the past two decades. Skilled workers have been able to command an increasingly large premium over unskilled workers, so the "returns on human capital" have increased over time. Employment opportunities are also likely to be better for skilled workers as Hong Kong SAR increasingly specializes in high-end services, which require a higher level of education and more specific skills.

Getting the education system ready to meet these challenges will be a key component of Hong Kong SAR's structural transformation. In particular, our work suggests that there might be some scope for increasing the efficiency of expenditure at the university level. The authorities are also putting in place training and retraining programs to address skill mismatches in the job market.

IMF Survey: Has the time come for Hong Kong SAR to float its dollar?

Prasad: Hong Kong SAR introduced its currency board in turbulent times in 1983. The Hong Kong SAR dollar's link to the U.S. dollar has since provided stability helpful to Hong Kong SAR's role as an international financial center. The dollar link is underpinned by Hong Kong SAR's strong external position, characterized by zero net external debt and sizable foreign exchange reserves, and flexible markets. The Hong Kong SAR authorities are well aware that the long-term sustainability of the link will depend crucially on prudent fiscal policies, maintenance of a sound financial system, and flexible markets—which are also crucial for robust and sustainable long-term growth. And this is what they are focused on.

IMF Survey: What can Hong Kong SAR do to prepare for the challenges of integrating with an increasingly dynamic mainland economy?

Prasad: As the analysis by Tao Wang and Hong Liang indicates, integration with the mainland has been proceeding quite well in a number of dimensions and is likely to offer significant benefits over the medium term. But serious challenges remain. Structural change will have to continue in an efficient manner that allows the economy to quickly shift its resources—especially its human resources—into those sectors that will allow it to best align itself with the mainland's growth.

The big challenge for the financial sector will be adapting to the opening of the mainland. This does provide a lot of opportunities—Hong Kong SAR banks are very familiar with the mainland and will be allowed to enter the mainland financial markets earlier than banks based elsewhere. But China itself is opening up more, and Hong Kong SAR's role in raising finance for Chinese companies could become less important over time. Still, Hong Kong SAR banks will have an edge, given their familiarity with the Chinese economic structure.

A related challenge will be supervisory coordination between Hong Kong SAR and the mainland, which will become more important as financial integration continues. The authorities are cognizant of the need to harmonize standards and are taking steps to improve prudential supervision of banks that have operations in both economies. A recent initiative by the mainland has already given Hong Kong SAR banks a head start in doing renminbi business.

Hong Kong SAR's traditional strengths—its flexible markets and strong legal and institutional structures—if they are complemented by sound macroeconomic and structural policies, will prepare it well for meeting the challenges of integration with the mainland.

Hong Kong SAR's traditional strengths—its flexible markets and strong legal and institutional structures—if they are complemented by sound macroeconomic and structural policies, will prepare it well for meeting the challenges of integration with the mainland.
—Eswar Prasad

IMF Survey: Isn't Hong Kong SAR's experience somewhat emblematic of the kinds of challenges and transformations that will be occurring elsewhere in the region and the world? What larger lessons can be drawn?

Prasad: China's trade expansion and rapid integration with the world economy are indeed going to pose major challenges for countries in the region. China is proving to be an engine of regional growth and is also sucking in a lot of imports for domestic consumption, which suggests good opportunities for those countries whose trade patterns are complementary with China's. But even in these economies, a fair amount of flexibility will be needed, especially in their labor markets, to reallocate labor to the sectors likely to benefit from trade with China.

For countries that are more direct competitors with China in international markets, the adjustment process could be much harder. But the general lesson from Hong Kong SAR's experience is that the best way for these economies to prepare themselves for change is to improve the flexibility of their domestic product and labor markets, and here the quality and cohesiveness of their structural and macroeconomic policies can play a key role. Hong Kong SAR's experience indicates that a strong market orientation and a sound institutional framework can make the adjustment process a lot smoother. ■

Copies of IMF Occasional Paper No. 226, *Hong Kong SAR: Meeting the Challenges of Integration with the Mainland*, are available for $25.00 ($22.00, academic rate). Please see below for ordering details.

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Lowering fiscal deficits crucial for new EU members

(Continued from front page) Economic and Monetary Union (EMU), studies have estimated that trade volume within the euro zone has increased by 15 percent—beyond what can be explained by growth and other factors. The already significant trade links between the new member states and the euro area are expected to strengthen in coming years even without adopting the euro. Frankel also said that patience may be rewarded on the timing of euro adoption. By waiting—perhaps for as long as five years—countries may achieve higher cyclical convergence, thereby reducing their risk of experiencing asymmetrical shocks.

Christian Thimann from the European Central Bank discussed the link between real convergence and monetary integration which, in his view, has so far been insufficiently highlighted in the debate. He argued that real convergence matters for monetary integration through its impact on economic dynamics. While trade and financial market integration between accession countries and the EU is already well advanced, there is still room for further convergence in business cycles. Advances in real convergence can be expected to increase similarity in economic dynamics between the new member states and the euro area, and thereby reduce possible problems of macroeconomic stabilization for prospective euro area entrants.

Costs of giving up monetary independence

Paul De Grauwe (Katholieke Universiteit, Leuven) suggested that exchange rate stability would support low inflation—particularly in the early stages of convergence. The positive relationship between exchange rate stability and economic growth is even more robust than for exchange rate stability and inflation. Moreover, a period of exchange rate stability within ERM2—the transitional exchange rate mechanism that countries have to join at least two years before they adopt the euro—with a clear end-point for adopting the euro could anchor expectations and be a source of macroeconomic stability. Against this background, Central European countries need not wait until they meet all the common currency area criteria before joining ERM2, De Grauwe said.

The Central European countries are likely to be buffeted by significant shifts in their capital accounts, Leslie Lipschitz (Director, IMF Institute) said in his presentation. The volatility of capital flows would be related to changes in market perceptions of risk and, based on historical experience, would likely be so great at times that it would overwhelm stabilization policy. The analysis suggested that an independent monetary policy would not be able to buffer these shocks. On the other hand, an inappropriate exchange rate regime could exacerbate the volatility. Lipschitz saw the greatest danger in a "soft peg" regime that could invite challenges from markets in difficult times. "Hard pegs" or "free floats"—the choice depending on various structural characteristics—were less dangerous. In any event, strong fiscal positions, rigorous prudential and financial regulation, and transparent policies would militate against large and sudden shifts in risk premiums and capital account volatility.

Eduard Hochreiter (Austrian National Bank) and George Tavlas (Bank of Greece) shared the experiences of their two countries. In both cases, establishing policy credibility and political consensus was essential. However, the choice of exchange rate regime differed in the run-up to euro adoption: whereas Austria achieved nominal convergence before entering ERM2 with a hard currency peg that was able to withstand the test of capital mobility, Greece was a latecomer and had to meet the Maastricht criteria within a fairly short time. Greece used a strategy of setting the central parity below the market rate to help preserve some monetary independence. Following ERM2 entry, Greece benefited from the increased credibility of its exchange rate arrangement, in the context of a supportive fiscal policy and a credible exit date.

Challenges of adopting the euro

What are the main challenges facing the new member states? Ensuring fiscal discipline and flexible labor markets, as well as anticipating the effects of euro adoption on countries' financial sectors were some of the issues highlighted during the conference.

Lowering fiscal deficits below the Maastricht ceiling of 3 percent of GDP will be key for new member states, Professor Jürgen von Hagen (University of Bonn and Indiana University) said. While the Maastricht government debt limit of 60 percent of GDP is not a serious problem for most of the new member states, some countries could breach it within a decade if they do not undertake fiscal consolidation. Extrabudgetary spending, open-ended and indexed spending programs, mandatory spending outside the budget framework, and contingent liabilities should be avoided, he said. New member states should also adopt best practices, such as binding fiscal targets and a strong supervisory role for the ministry of finance, and use revenue windfalls to retire public debt.

While the need for labor market reforms is no greater in new member states than in current ones,

The already significant trade links between the new member states and the euro area are expected to strengthen in coming years even without adopting the euro.
—Jeffrey Frankel

> The period leading up to euro adoption could expose countries to potentially large risks emanating from volatile capital flows, credit booms, asset bubbles, foreign exchange borrowing by residents, and "testing" by financial markets.
> —Susan Schadler

reforms are needed and are best started early, according to Tito Boeri (Bocconi University, Milan). The key labor market challenges will be to absorb asymmetric shocks, resist wage pressures, accommodate stronger competitive pressures in product markets, create a favorable environment for foreign direct investment, and adjust to a reorientation of trade. Because many of the new member states already have flexible wage-setting mechanisms, it could be risky for them to introduce formal social pacts to restrain wage growth, as this might result in more centralized wage bargaining that would limit the ability of these states to respond to shocks.

Boeri identified three key labor market reforms:

- increasing labor market mobility by making employment protection laws less stringent while giving greater weight to unemployment benefits;
- raising employment rates by implementing stricter activation policies for workers who receive unemployment benefits; and
- bringing the underground economy to the surface by discouraging employers and employees from colluding to avoid paying social security contributions.

Francesco Giavazzi (Bocconi University) focused on developments in the financial industry of the euro area since the euro's launch and the lessons these may hold for new member states. Five years after the adoption of the euro, the degree of home bias has been reduced; the financial industry is more consolidated (though still largely limited to home markets); country- specific factors are less important in determining risks and returns; a liquid corporate bond market has developed; and a few world-class asset managers have emerged in the euro area, Giavazzi said. But some business activity has been lost, most notably investment banking to U.S. institutions, and attempts to establish new financing opportunities for small enterprises through stock exchanges have largely failed (possibly due to unfortunate timing). Moreover, only limited cross-border mergers have taken place between euro area banks, and many of those banks that have crossed borders expanded by acquiring local banks (mostly in the Central European countries).

Defining the right strategy

What strategies can help maximize the benefits of joining a currency union while ensuring that key challenges are met? In their analysis of this question, IMF staff looked specifically at the issues facing the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia.

Susan Schadler (Deputy Director, European Department, IMF) agreed with Frankel that introducing the euro as the national currency offers the potential for a significant catching-up of income through increased trade. She also pointed to the benefits of lower borrowing costs and implementation of a rigorous macroeconomic framework that would follow entry into ERM2. But Schadler warned that the period leading up to euro adoption could expose countries to potentially large risks emanating from volatile capital flows, credit booms, asset bubbles, foreign exchange borrowing by residents, and "testing" by financial markets. Strategies for adopting the euro

What are Balassa-Samuelson effects?

The rate at which real incomes in less advanced economies catch up to the income levels of more advanced economies depends on labor productivity gains stemming from increases in both capital labor ratios and total factor productivity. Generally, these gains are faster in the tradables sector, which is dominated by manufacturing, than for nontradables. As wages in the tradables sector rise with productivity, they also bid up wages in the nontradables sector. Then, to maintain profit margins, the prices of nontradables must increase relative to those of tradables. This process is called Balassa-Samuelson effects.

There is strong evidence of Balassa-Samuelson effects in the new member states, with three main implications.

- First, these effects tend to raise domestic inflation relative to what it would be without them. Empirical evidence for Central European countries suggests that productivity growth differentials have been increasing the relative price of nontradables by up to 4 percent a year in recent years.
- Second, they tend to cause appreciations in real, CPI-based terms of new member states' currencies relative to the advanced economies in the euro area. On average, sectoral productivity differentials have been adding 1–2 percent a year to the CPI-based real exchange rates of the new member states relative to Germany.
- Third, depending on the extent of nominal appreciations, Balassa-Samuelson effects also result in inflation differentials between countries. Empirical studies suggest that Balassa-Samuelson effects contribute between 0.2 and 1.8 percentage points to the excess of Central European countries' inflation over German inflation. Because Balassa-Samuelson estimates would differ between periods of nominal exchange rate flexibility and fixed exchange rates, these results cannot, however, be extrapolated to determine likely inflation differentials once countries limit exchange rate movements in ERM2 or EMU.

Many studies conclude that Balassa-Samuelson effects on the real exchange rate—and on inflation when nominal exchange rate flexibility is curtailed in ERM2 or EMU—will probably be on the order of 1–2 percent a year.

should therefore be aimed at mitigating these and other vulnerabilities, she said, and should take into account each country's specific circumstances.

Schadler identified three critical tasks facing the five countries on the road to adopting the euro:

- pursuing fiscal consolidation that aims at prudent debt management and seeks to offset the prospect of a private sector demand boom while creating room for automatic stabilizers to operate after adoption of the euro;
- lowering inflation to a rate no higher than the euro area average plus the Balassa-Samuelson effects (see box, page 54) arising from productivity gains in the tradable goods sector; and
- implementing structural reforms that ensure flexible product and labor markets, a strong legal and institutional framework, and a lean public sector.

The five countries also face the difficult task of choosing the "right" parity for entry into ERM2, Schadler said. And they must select a monetary policy framework that is not only consistent with various policy objectives (such as disinflation and exchange rate stability) but also able to withstand "testing" by financial markets once in ERM2. And, finally, countries must decide on a well-defined exit horizon from ERM2. Clear communication with markets would be essential in all circumstances, she concluded.

European Union perspectives

Representatives of the European institutions (Tommaso Padoa-Schioppa, a member of the European Central Bank's Executive Board, and Klaus Regling and Johan Baras from the European Commission) agreed that no single path toward euro adoption can be prescribed. Strategies would have to be developed on a country-specific basis and should take into account the experiences of current euro area members, with the principle of equal treatment applying during the entire period leading to monetary integration. No additional criteria for adopting the euro would be introduced, they said. At the same time, there would be no relaxation of the existing criteria established by the Maastricht Treaty (see *IMF Survey*, February 16).

The EU officials also said that the current controversy within the EU regarding the Stability and Growth Pact should be resolved, and European Union rules followed. In this respect, Regling added, there is no controversy over the medium-term objective of budget balance, given today's high debt levels, and the deficit ceiling of 3 percent of GDP should be seen as a ceiling and not as a norm.

The existence of Balassa-Samuelson effects has led to some criticism of the inflation criterion. However, given the generally limited size of these effects, the criterion should be able to accommodate them, Baras said. Alternative benchmarks (such as the average inflation rate in the euro area) from which to measure the allowable excess of 1½ percentage points would imply moving away from the Maastricht Treaty and conflict with the principle of equal treatment. Moreover, alternative benchmarks would risk accommodating other, less benign causes of inflation, including domestic demand pressure, which can, in practice, be difficult to distinguish from Balassa-Samuelson effects.

From left to right, Pavlína Bolfová (Director of Communications, Czech National Bank), Zdeněc Tůma (Governor, Czech National Bank), and Michael Deppler (Director, European Department, IMF) at a press briefing after the conference.

While there are no preconditions for joining ERM2, any significant policy adjustments that may still be outstanding (such as major fiscal consolidation or adjustments in administered prices) should be undertaken prior to entry, the EU officials said. Once countries join ERM2, markets could test the authorities' commitment to exchange rate stability. Thus, a credible fiscal policy must be in place, and the exchange rate policy within ERM2 would have to be consistent with the overall macroeconomic policy framework. At the same time, ERM2 should be seen as a convergence tool intended to steer policies toward macroeconomic stability. But while ERM2 is a flexible mechanism (which avoids setting up a "one-way" bet for the markets), a free float within the +/–15 percent margins would not be consistent with the exchange rate stability criterion, according to the EU officials.

The central parity and the width of the exchange rate band—which initially will be set at +/–15 percent unless the country has reached a high degree of convergence with the euro area, as is the case for Denmark—will be determined by all parties to the agreement. But beyond the minimum two-year stay in ERM2, the appropriate time frame for adopting the euro would have to be assessed in terms of "what is most helpful" for achieving real economic convergence, the EU officials said. Concerns about a prolonged stay in ERM2 would have to be weighed against the significant benefits of participating in the mechanism, which—together with a clear exit—has the potential to act as a catalyst for good policies, as it did for most of the present euro area members during their stay in the ERM (the exchange rate mechanism that preceded ERM2).

Edmond Alphandéry (Chairman of CNP Assurances and a former French Minister of Finance) stressed that countries must make key policy adjustments before they join ERM2. He also said that they should not remain in the mechanism too long beyond the minimum two year stay. Finally, Michael Deppler (Director, European Department, IMF) observed that adopting the euro is not an end in itself, but an instrument of income convergence. As countries move closer to euro adoption, most risks they encounter will stem from inconsistent and inappropriate policies—hence the need to focus on an appropriately ambitious macroeconomic framework. Leszek Balcerowicz (National Bank of Poland) echoed these sentiments, counseling policymakers in new member states to focus less on timing and more on fiscal adjustment. ■

A volume containing the various conference papers and the comments of discussants will be published by the IMF.

Stand-By, EFF, and PRGF arrangements as of January 31

Member	Date of arrangement	Expiration date	Amount approved	Undrawn balance
			(million SDRs)	
Stand-By				
Argentina	September 20, 2003	September 19, 2006	8,981.00	6,910.00
Bolivia	April 2, 2003	April 1, 2004	85.75	21.43
Bosnia & Herzegovina	August 2, 2002	February 29, 2004	67.60	12.00
Brazil	September 6, 2002	March 31, 2004	27,375.12	10,175.48
Bulgaria	February 27, 2002	February 26, 2004	240.00	52.00
Colombia	January 15, 2003	January 14, 2005	1,548.00	1,548.00
Croatia, Republic of	February 3, 2003	April 2, 2004	105.88	105.88
Dominican Republic	August 29, 2003	August 28, 2005	437.80	350.24
Ecuador	March 21, 2003	April 20, 2004	151.00	90.60
Guatemala	June 18, 2003	March 15, 2004	84.00	84.00
Jordan	July 3, 2002	July 2, 2004	85.28	74.62
FYR Macedonia	April 30, 2003	June 15, 2004	20.00	8.00
Paraguay	December 15, 2003	March 31, 2005	50.00	50.00
Peru	February 1, 2002	February 29, 2004	255.00	255.00
Turkey	February 4, 2002	December 31, 2004	12,821.20	1,701.00
Uruguay	April 1, 2002	March 31, 2005	2,128.30	652.40
Total			**54,435.93**	**22,090.65**
EFF				
Sri Lanka	April 18, 2003	April 17, 2006	144.40	123.73
Serbia and Montenegro	May 14, 2002	May 13, 2005	650.00	350.00
Total			**794.40**	**473.73**
PRGF				
Albania	June 21, 2002	June 20, 2005	28.00	16.00
Armenia	May 23, 2001	May 22, 2004	69.00	19.00
Azerbaijan	July 6, 2001	March 31, 2005	80.45	38.61
Bangladesh	June 20, 2003	June 19, 2006	347.00	248.00
Benin	July 17, 2000	March 31, 2004	27.00	1.35
Burkina Faso	June 11, 2003	June 10, 2006	24.08	20.64
Burundi	January 23, 2004	January 22, 2007	69.30	69.30
Cameroon	December 21, 2000	December 20, 2004	111.42	31.83
Cape Verde	April 10, 2002	April 9, 2005	8.64	3.72
Côte d'Ivoire	March 29, 2002	March 28, 2005	292.68	234.14
Congo, Democratic Republic of	June 12, 2002	June 11, 2005	580.00	106.63
Dominica	December 29, 2003	December 28, 2006	7.69	5.33
Ethiopia	March 22, 2001	July 31, 2004	100.28	20.86
The Gambia	July 18, 2002	July 17, 2005	20.22	17.33
Ghana	May 9, 2003	May 8, 2006	184.50	131.80
Guinea	May 2, 2001	May 1, 2004	64.26	38.56
Guyana	September 20, 2002	March 19, 2006	54.55	43.03
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	June 30, 2004	24.50	7.00
Madagascar	March 1, 2001	November 30, 2004	79.43	34.04
Malawi	December 21, 2000	December 20, 2004	45.11	32.23
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	69.64
Niger	December 22, 2000	June 30, 2004	59.20	8.44
Pakistan	December 6, 2001	December 5, 2004	1,033.70	344.56
Rwanda	August 12, 2002	August 11, 2005	4.00	2.86
Senegal	April 28, 2003	April 27, 2006	24.27	20.80
Sierra Leone	September 26, 2001	September 25, 2004	130.84	42.00
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	16.80
Uganda	September 13, 2002	September 12, 2005	13.50	8.00
Vietnam	April 13, 2001	April 12, 2004	290.00	165.80
Total			**4,589.66**	**2,315.39**

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

Extended Fund Facility (EFF) arrangements are designed to rectify balance of payments problems that stem from structural problems.

AFRITAC East's agenda for 2004 stresses improving fiscal and customs administration

On January 26, the East Africa Regional Technical Assistance Center (AFRITAC East) held its fourth semiannual steering committee meeting in Kigali, Rwanda, to review progress and agree on the center's work plans for the year ahead. Priority aims for 2004 include raising the effectiveness of individual projects through close monitoring and follow-up, and building on the good relations with other technical assistance providers in the region to enhance coordination. Later this year, an independent evaluation of AFRITAC East and its counterpart center in West Africa will help to determine whether this regional approach to delivering technical assistance will be extended to other parts of sub-Saharan Africa.

From the outset, AFRITAC East has emphasized country involvement in the development of its work programs, and the six countries served by the center have a strong voice in the semiannual steering committee meetings. As John Crotty, who served as the center's first coordinator, explained, "the governance structure of AFRITAC East was designed to ensure that countries themselves effectively drive the process."

Commenting on his impressions of the meeting in Kigali, Bassirou Sarr, the incoming coordinator for AFRITAC East, said that he "was impressed by the frankness and the quality of the discussions." The networking and sharing of successful experiences among peers during these meetings can also provide a powerful impetus for reforms. As one example, Sarr pointed out that Tanzania's success in carrying out tax reform has spurred other countries in the region to look at a more centralized tax administration model that can increase revenue collection.

Sarr: "Judging from the discussion at the recent steering committee meeting, there was unanimous praise and full support for the work of the center so far—from both donors and participants."

Building on 2003 priorities

Since most capacity-building efforts, by their very nature, have multiyear time horizons, AFRITAC East's work plan for the coming year largely continues and builds on activities begun in 2003. When it met in January, the steering committee reviewed the work plan to ensure that the proposed capacity-building activities continued to be fully consistent with the priorities stated in countries' Poverty Reduction Strategy Papers (PRSPs). These activities can be grouped into five broad categories:

• ***Public expenditure management.*** The center undertook 17 activities in public expenditure management in 2003, including two major regional workshops encouraging the sharing of information and experiences in fiscal decentralization and treasury reform issues. In Eritrea, for example, AFRITAC East focused on modernizing budgetary and accounting

What is AFRITAC?

As part of the Africa Capacity Building Initiative—which aims to increase the volume, range, and coordination of assistance from various multilateral and bilateral providers—the IMF opened two African Technical Assistance Centers (or AFRITACs) in 2002–03. AFRITAC East, based in Dar es Salaam, Tanzania, serves Eritrea, Ethiopia, Kenya, Rwanda, Tanzania, and Uganda. AFRITAC West, its counterpart based in Bamako, Mali, serves Benin, Burkina Faso, Côte d'Ivoire, Guinea, Guinea-Bissau, Mali, Mauritania, Niger, Senegal, and Togo. Focusing on the IMF's core areas of expertise, the AFRITAC initiative aims to strengthen the capacity of African countries to design and implement their poverty-reducing strategies and to improve the coordination of technical assistance relevant to the Poverty Reduction Strategy Paper (PRSP) process.

The IMF has made use of this regional approach to delivering technical assistance to its member countries since 1993, when it opened the Pacific Financial Technical Assistance Center (PFTAC) in Fiji. All of these regional centers are guided by steering committees with representatives of participating countries and supporting donor agencies, as well as observers from regional institutions involved in capacity building. Each country appoints a representative and an alternate to the committee, and both members often attend its semiannual meetings, which are chaired by a country representative (currently the Governor of the Bank of Tanzania) and hosted by the participating countries on a rotating basis. Center coordinators have responsibility for day-to-day management.

At each of the centers, a small number of resident advisors deliver technical assistance and training throughout the subregion, typically supplemented by short-term specialists. The benefits of this regional center approach include flexibility to respond rapidly as the need arises; ability to field frequent and consistent follow-up visits, which keep up the momentum of reforms and solidify relationships; and continued access to high-quality technical expertise that might otherwise be difficult to obtain for resource-constrained countries. In addition, the format and role of the regional centers enable them to help shape and advance regional policy initiatives and strengthen cooperation and coordination.

classifications and implementing a cash management system as part of a broader treasury reform action plan. In other countries, such as Rwanda, assistance involved an overall review of public expenditure management systems.

• ***Bank supervision.*** All six of the countries served by AFRITAC East benefited last year from bank supervision assistance. Kenya, Rwanda, and Uganda received significant help in improving supervision of nonbank financial institutions. The center's 16 activities in this area in 2003, which included support for two regional workshops sponsored by the African Capacity Building Foundation, mostly centered on helping countries improve the legal and operating environment by providing advice on countries' plans for legislative reform and measures for addressing problem banks and strengthening their supervision.

Rwandan Minister of Finance, Donald Kaberuka, delivers the opening address at the steering committee meeting in January. Seated next to him (left to right) are Daudi Ballali, Bank of Tanzania Governor and steering committee chairman, and John Crotty, outgoing AFRITAC East Coordinator.

• ***Central banking operations.*** AFRITAC East's work so far has focused on helping countries with their foreign reserves management, monetary operations, government securities market development, and payment systems. A regional workshop on foreign reserves management was an important priority under the work plan last year and was followed by detailed operational reviews of foreign reserves management functions in Ethiopia, Kenya, and Rwanda. Improving the environment for implementing monetary policy also featured prominently, with most countries undertaking activities relating to the development of the government securities markets and payment systems reform.

• ***Revenue administration.*** AFRITAC East has provided revenue administration assistance—which has concentrated on modernizing organizations, their systems, and procedures—for all of the countries served except Uganda. This, too, has been a key area for coordinating assistance from development partners. AFRITAC East has endeavored to build good relations with development partners, Crotty said, citing the center's strong cooperation with six donors on revenue administration reforms in Tanzania as an example of a particularly effective partnership.

In response to requests by Ethiopia, Rwanda, and Tanzania, detailed evaluations of revenue administration operations have been carried out, with significant support from the IMF's Fiscal Affairs Department. These evaluations have helped the national authorities identify reform priorities and develop comprehensive reform plans.

• ***Statistics.*** A key focus of assistance on statistical issues has been on developing short-term indicators of production and prices, with Rwanda, Tanzania, and Uganda having benefited thus far. Developing a comprehensive strategy for strengthening the legal and institutional infrastructure for statistical systems and developing a methodology for compiling regional national accounts have been important activities in other countries. Close coordination with other sources of technical assistance has also been particularly critical in AFRITAC's delivery of assistance on statistical issues. For example, the United Kingdom's Department for International Development (DFID) is a major provider of technical assistance in this area. AFRITAC East's statistical advisor has worked closely with DFID counterparts over the past year to ensure that the center's activities complement that agency's projects.

Attention to fiscal, customs administration

While technical assistance priorities are set to remain broadly unchanged for 2004, AFRITAC East intends to devote more attention to helping countries improve their tax and customs administration. This is being driven partly by efforts to accelerate the creation of a customs union among the three members of the East African Community—Kenya, Tanzania, and Uganda. For Ethiopia, Rwanda, Tanzania, and Uganda, assistance in carrying out fiscal decentralization—more effective revenue sharing between central and local governments, greater devolution of spending, and improvements in tracking poverty-related spending in fiscal reporting systems—will also be in higher demand this year. This is in line with priorities identified in these countries' poverty reduction strategies—namely, Sarr said, "to further enhance the delivery of public services at local government levels through more empowerment of local authorities."

The countries making the most use of the resources of AFRITAC East so far have been Eritrea, Rwanda, and Tanzania, with work in revenue mobilization and statistical issues expected to increase this year, particularly for Rwanda and Tanzania. For Eritrea, work in monetary operations and financial sector supervision is expected to pick up. Given its limited resources, the center will continue to pay particular attention to prioritization and sequencing to

ensure that resources are channeled to the most effective activities.

In Kenya, the volume of work is expected to increase significantly this year, partly to catch up on some delayed assistance and also to capitalize on the momentum for reform created by the country's policy program newly approved by the IMF for support under the Poverty Reduction and Growth Facility (PRGF). AFRITAC East has worked closely with senior officials there since the new government took office to determine how best to provide more support for capacity building. "Two areas, in particular, where I expect that we will be providing additional assistance in Kenya," Crotty said, "are public expenditure management and revenue administration reforms." Last year, the center participated in a multidonor assessment and action plan intended to develop an overall public expenditure management reform program for Kenya. Toward the end of the year, the center began providing assistance to improve budgetary and accounting classifications. AFRITAC East has also undertaken significant preparatory work with the Kenyan authorities toward modernizing revenue administration.

Aims for 2004

"One of my first priorities in 2004," Sarr explained, "will be to work closely with all providers of technical assistance in the subregion—both bilateral and multilateral—in carrying out the work plan, to ensure effective coordination and cooperation." Increased coordination will be essential to avoid duplication and ensure that the assistance delivered remains coherent, complementary, and cost-effective. While noting that an effective mechanism to coordinate the various providers will always be a challenge, he indicated his intention to build on the good working relations with the subregion's donors and technical assistance sources established by his predecessor, Crotty, and by center staff.

Sarr anticipates that these efforts will be aided by the African Development Bank's plans to increase its physical presence in the subregion, thereby further improving the information flow between AFRITAC East and this important regional institution. Moreover, the structure of the steering committee lends itself to effective use as a forum for exchanging information between country representatives and donors about the likely sources of technical assistance and the nature of supported activities in the region. A planned website for AFRITAC will help to further speed the dissemination of information on the center's activities to a much wider audience, he added.

A second priority for 2004 that emerged clearly from the January steering committee discussions will be to raise the effectiveness of individual projects. Indeed, one specific aim of the IMF's capacity-

Delivering technical assistance

Although AFRITAC East's work plan for 2004 continues to emphasize sectorwide and strategic projects over hands-on support, it will be important to retain the capacity and the flexibility needed to respond to pressing needs for more ad hoc assistance. "One advantage of this regional initiative," Sarr emphasized, "is precisely the ability of technical assistance advisors to provide quick and continuous hands-on support to counterparts and help them resolve specific technical issues before they become a serious problem." This is typically done by e-mail or telephone or through a short visit.

AFRITAC's five resident advisors were on the road for a large part of 2003 because, given available human and financial resources, this proved the most effective way to support capacity-building activities. In the first year of operations, about two-thirds of the advisors' time was spent in country, working directly with counterparts.

Short-term, peripatetic experts hired by the center complement the skills of resident advisors. Most short-term experts are employed in specialized areas requiring immediate attention. "As 2003 progressed," Crotty noted, "we drew heavily on our short-term resource allocation to help us complete our busy schedule of work. We expect to fully utilize all of the short-term resources available this year." For 2004, short-term experts will chiefly provide assistance with budget and treasury reforms and anticipated fiscal decentralization activities.

In 2003, the center's advisors also devoted quite a lot of time to an active program of regional workshops, closely linked with the main areas of capacity building in which the advisors were engaged. A number of seminars and regional workshops are planned for this year and will be carried out in collaboration with regional institutions, such as the African Capacity Building Fund and the Macroeconomic and Financial Management Institute of Eastern and Southern Africa, and in consultation with the IMF Institute. Short-term consultants based in the region and recruited internationally assist in conducting the seminars and workshops, which are held at facilities provided by participating countries and regional organizations. The topics—which for 2004 are likely to focus on monetary operations, financial sector supervision, and public expenditure management—are generally selected based on country requests and reflect training needs and the desire to strengthen cooperation among relevant country officials.

building initiative is to accomplish this objective through close monitoring, follow-up, and more transparent reporting of outcomes. The steering committee is the main vehicle for this, Sarr said, because its semiannual meetings review the center's strategic issues and operational activities and assess results in each country against the work plan's agreed benchmarks. "It is through this peer review mechanism that stakeholders can determine whether the assistance provided has resulted in actual reforms and the degree of commitment of recipient countries in making full use of the technical assistance provided," Sarr said. A number of quantitative and qualitative benchmarks are used in carrying out this assessment: for example, the completion of specific legislative steps needed to implement a particular reform effectively. The indicators used to monitor performance are expected to be refined further over the course of the year. Moreover, according to Crotty, the presence of the center's advisors in the subregion has greatly facilitated follow-up and monitoring of projects and activities in a cost-effective way.

Later this year, a team of outside experts will carry out an in-depth and independent evaluation of the center to assess its effectiveness and the sustainability of its capacity-building approach. "Judging from the discussion at the recent steering committee meeting, there was unanimous praise and full support for the work of the center so far—from both donors and participants," Sarr reported. Based on the recommendation of this evaluation team, IMF staff and the Executive Board will determine whether to set up more centers to serve other parts of sub-Saharan Africa. "While it is still too early to draw definite lessons," Sarr said, "I am fully convinced that the peer review mechanism through which donors, technical assistance providers, and country officials collectively assess and monitor assistance and discuss any needed corrective measures can substantially improve technical assistance effectiveness." ■

Available on the web (www.imf.org)

Press Releases

04/22: IMF Begins Publishing Executive Board's Weekly Calendar, February 9

04/23: IMF Completes First Review of the Dominican Republic's Stand-By Arrangement, Approves $66 Million Disbursement, and Grants Waivers, February 11

04/24: Former Yugoslav Republic of Macedonia Formally Begins Participation in the IMF's General Data Dissemination System, February 12

04/25: Angola Formally Begins Participation in the IMF's General Data Dissemination System, February 12

04/26: IMF Completes First Review Under Senegal's PRGF Arrangement and Approves $5.2 Million Disbursement, February 13

04/27: Statement of the IMF Mission to Dominica, February 18

04/28: Uruguay Subscribes to the IMF's Special Data Dissemination Standard, February 18

04/29: IMF Approves in Principle Three-Year $107.6 Million Poverty Reduction and Growth Facility Arrangement for Honduras and Grants Additional Interim Assistance Under the Enhanced HIPC Initiative, February 18

04/30: IMF Managing Director Horst Köhler to Visit Japan and Korea, February 19

04/31: Second Stage of IMF Discussions for the Seventh Review of Turkey's Stand-By Arrangement to Start on February 27, February 20

04/32: IMF Completes Fourth Review of Uruguay's Stand-By Arrangement and Grants Waivers, February 20

04/33: IMF Completes Fourth Review Under Sierra Leone's PRGF Arrangement and Approves $21 Million Disbursement, February 23

04/34: IMF Completes Fourth Review of Peru's Stand-By Arrangement and Grants Waiver, February 23

04/35: IMF Managing Director Horst Köhler's Statement at the Conclusion of His Visit to Japan, February 25

04/36: IMF Completes Final Review Under Stand-By Arrangement for Bosnia and Herzegovina and Approves $18 Million Disbursement, February 25

Public Information Notice

04/7: IMF Concludes 2003 Article IV Consultation with Burundi, February 10

04/8: IMF Concludes 2003 Article IV Consultation with the Republic of the Marshall Islands, February 13

04/9: IMF Concludes 2002 Article IV Consultation with Comoros, February 13

04/10: IMF Approves Decisions Strengthening the Effectiveness of the Legal Framework for the Provision of Information to the IMF, February 23

04/11: IMF Concludes 2003 Article IV Consultation with Korea, February 25

Speeches

"Lessons from the Asian Crisis," Anne O. Krueger, IMF First Deputy Managing Director, SEACEN Meeting, Sri Lanka, February 12

Remarks by Agustín Carstens, IMF Deputy Managing Director, Fifth Annual Conference of the Parliamentary Network on the World Bank, Paris, February 15

Transcripts

"Do Developing Countries Have a Say at the IMF?" IMF Economic Forum, February 5

Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, February 12

Choosing an exchange rate regime to deal with capital account shocks: pick your poison

What is the optimal exchange rate regime—rigidly fixed, freely fluctuating, or a managed float? Historically, most emerging market economies have opted to peg their exchange rates, but such regimes are more susceptible to the speculative attacks associated with substantial capital outflows. Some have suggested that emerging market economies should permit more exchange rate flexibility, but greater flexibility can have other, negative consequences for economic performance. In a recent IMF Working Paper, Shigeru Iwata (Professor, Department of Economics, University of Kansas) and Evan Tanner (Senior Economist, IMF Institute) assess the trade-offs.

When confronted by adverse capital account shocks, central banks must choose how such shocks are transmitted to the domestic economy: they must, in effect, "pick their poison." As one option, central banks can defend the exchange rate by raising interest rates, but doing so is likely to adversely affect economic activity and financial sector balance sheets. Alternatively, central banks can let the currency depreciate, but this can spur inflation and it will increase the domestic currency value of the country's foreign currency liabilities. If a central bank wanted to limit both interest rate and exchange rate changes, it could instead let international reserve flows absorb the shock. That is, the central bank would sell foreign exchange reserves to maintain the currency's value—but this policy may be risky and will, after a period, become unsustainable.

Using a sample of three emerging market economies that have faced external shocks over the past decade—Brazil, Mexico, and Turkey—Iwata and Tanner analyze how the shocks were channeled into international reserve movements, interest rate movements, and exchange rate depreciation. They then assess the impact of such shocks on the domestic economy. For each country, Iwata and Tanner analyze selected subperiods that correspond to distinct, well-known policy regimes. For Mexico, they contrast the low-inflation, managed exchange rate period before the Tequila crisis (January 1988 to October 1994) with the postcrisis period of more flexible exchange rates (January 1995 to December 2000). Similarly, in Turkey, they look at two periods separated by an exchange rate crisis—namely, January 1987 to December 1993 and May 1994 to January 2001. For Brazil, data are available only for the exchange rate band period (August 1994 to December 1998).

Characterizing regimes

Characterizing a country's exchange rate regime can be difficult. Indeed, a country's stated exchange rate policy, as presented in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions,* can differ substantially from the policy it actually pursues. The same report now also shows how IMF staff classifies countries' actual exchange rate policies. Exactly how to classify an exchange rate regime—that is, its degree of flexibility—is a difficult question. In the approach adopted by Iwata and Tanner, they first isolate econometrically shocks to the capital account, where a positive (negative) shock is associated with a capital inflow (outflow). They then estimate parameters that correspond to the fractions of a given shock that are channeled into reserve movements, interest rate changes, and currency depreciation. Their estimated parameters can be combined to form a single indicator of exchange rate flexibility: the exchange rate is considered to be freely floating if the entirety of an external capital account shock is channeled to exchange rate movements. Moreover, the estimated parameters also reveal what combination of reserve and interest rate movements a central bank uses when it defends the exchange rate.

Their estimates suggest that prior to Mexico's 1994 exchange rate crisis, the entirety of a given external shock was absorbed by sales or purchases of international reserves. But after the crisis, Mexico's policy changed. During 1995–2000, the fraction of an external shock that was absorbed by reserve movements fell to about 80 percent; to compensate, interest rates and exchange rate depreciation each absorbed about 10 percent. Thus, while exchange rate flexibility increased, the authorities nonetheless continued to actively manage the exchange rate.

During Brazil's managed float period (1994–99), the authorities permitted about 80 percent of an external shock to be absorbed by reserve movements; of the remainder, about 18 percent was absorbed by interest rate hikes, so that the exchange rate absorbed only about 2 percent, on average, of a given shock.

In Turkey, as in Mexico, there is a striking contrast in central bank policy before and after 1994. In the earlier period, the authorities channeled over 90 percent of a shock into reserve movements, but only about 54 percent afterward. During the later period, the Turkish authorities relied to a greater degree on interest rates to defend the domestic currency. The

degree of overall exchange rate flexibility stayed about the same: exchange depreciation reflected about 6 percent of a given shock in both periods.

Assessing the domestic impact

What effects, if any, did the capital account shocks have on these three economies given their various exchange rate regimes? Looking at two key variables—industrial output growth and inflation—Iwata and Tanner find strong evidence for Mexico and Turkey that the effects of an external shock depended on the exchange rate regime chosen by the authorities. While in Mexico external shocks had no statistically significant effect on output growth prior to the 1994 crisis, significant effects were evident (with a three-month lag) after the crisis. This finding supports the idea that the exchange rate regime affects the transmission of capital account shocks to the domestic economy. The central bank did not permit interest rates to respond to capital account shocks in the precrisis period, but did so in the postcrisis period. Thus, stabilizing the exchange rate through interest rate movements (as happened in the postcrisis period) might have made output growth more volatile than it would have been otherwise.

The effects of external shocks on Mexican inflation also differed substantially between the exchange rate regimes. Prior to the 1994 crisis, when exchange rates were tightly pegged by reserve movements, positive (negative) external shocks to the capital account had positive (negative) effects on inflation. Iwata and Tanner say that this is a logical outcome because a positive shock to the capital account will cause the real exchange rate to appreciate. If the nominal exchange rate is pegged—as it was before the crisis—this appreciation takes place through domestic (nontradable) inflation. However, in the postcrisis period, when exchange rates were more flexible, the real appreciation associated with an increase in capital inflows instead took place through a nominal appreciation. This reduced inflation through the tradable goods component.

In Turkey, differences were also evident from one regime to another. During the earlier period, capital account shocks were primarily channeled by the central bank to reserve flows and, with a lag, to the exchange rate. Here, such shocks, when positive, significantly raised output growth, with a lag of four months. However, in the later period, shocks were absorbed to a much greater extent by interest rates, thereby affecting output about two months sooner and by a somewhat greater magnitude. The behavior of inflation also mirrors the exchange rate regime. In the earlier period, a positive capital account shock would significantly increase inflation, with a one-month lag. By contrast, in the later period, external shocks had no significant impact on inflation. This finding reflects the more active interest rate policy during the later period.

Iwata and Tanner also address a counterfactual question: how would inflation and output have behaved in these countries if the central bank had chosen a different exchange rate regime? Their simulation has important implications for inflation: if the exchange rate regime were to become more flexible—that is, if external shocks were to be absorbed to a greater degree by exchange rate movements rather than interest rate movements—the inflation rate would become even more sensitive to capital account shocks because of the exchange rate pass-through mechanism. By contrast, if such shocks are transmitted to interest rates, with less exchange rate flexibility, such pass-through would be less, making inflation less sensitive to capital account shocks.

Iwata and Tanner's results suggest that capital account shocks can have substantial effects on inflation and growth. The nature and magnitude of the effects depend on the exchange rate regime. When capital account shocks are channeled into the exchange rate, they are passed through to inflation. If such shocks are channeled into the interest rate, exchange rate pass-through effects are substantially reduced. The interest rate movements may also be transmitted to output: an increase in interest rates, for example, is likely to reduce output growth. Inescapably, Iwata and Tanner argue, authorities must pick their poison: in the event of an adverse shock, they must choose between higher inflation and lower growth. ■

Copies of IMF Working Paper No. 03/92, "Pick Your Poison: The Exchange Rate Regime and Capital Account Volatility in Emerging Markets," by Shigeru Iwata and Evan Tanner, are available for $15.00 each from IMF Publication Services. Please see page 52 for ordering details. The full text is also available on the IMF's website (*www.imf.org*).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 16	1.60	1.60	2.11
February 23	1.61	1.61	2.13

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

Economic Forum

In defense of globalization

One of the main points of contention surrounding globalization is whether the flow of technology, skills, culture, ideas, news, information, entertainment, and people across borders consigns many parts of the world to grinding poverty. On February 18, Jagdish Bhagwati (Professor, Columbia University), in discussing his new book, *In Defense of Globalization*, took on the skeptics, arguing that, when properly managed, globalization is the most powerful force for social good in the world today. The venue was an IMF Economic Forum moderated by Raghuram Rajan (Economic Counsellor and Director of the IMF's Research Department) and with commentary by Daniel Yergin (Chair, Cambridge Energy Research Associates and author of *The Commanding Heights: The Battle for the World Economy*).

"The principles of free trade are ones that almost every economist subscribes to," Rajan said, "but paradoxically, they are very hard to convey to the lay public." In introducing Bhagwati, Rajan added that " it is difficult to convince people of the merits of free trade, which is why every generation needs its champion—an economist who stands up for the principles and talks to the lay public in a lucid language about its merits."

His new book, Bhagwati explained, explores the concerns of antiglobalization critics—those who, as he noted, want to "drive a stake through globalization, who reject multinationals on principle." He added that "when people say that globalization needs a human face, they must mean it lacks one," and that "globalization is handicapping them, rather than advancing them." Bhagwati argued that, on balance, globalization does have a human face. This, he said, is evidenced by studies that have shown that trade—a major element of globalization—increases prosperity. More than any other country, globalization has benefited the United States, where increased trade helped create nearly 35 million new jobs over the past two decades.

Justified worries?

Given these accomplishments, then, why is the outsourcing of some white-collar jobs to India or the Philippines "a major issue in this country and not in Britain, for example, or not in European countries"? Why does the United States "always get into a funk"? Part of the answer lies in the misperception about the number of jobs transferred through outsourcing. In reality, Bhagwati said, the number outsourced is minor compared with the number of jobs in the system. In a highly competitive system, if export industries do not reduce their cost levels to the absolute minimum, they will not be able to compete with those firms that are outsourcing or buying the cheapest imports. "Okay, we are taking 10 jobs away by buying services from abroad," he said, "but we are saving 90 jobs in the firm because the firm survives."

Left to right: Raghuram Rajan, Jagdish Bhagwati, and Daniel Yergin discuss the merits of globalization at the IMF Economic Forum.

Rajan wondered whether public opinion has shifted in the United States, because previously nontraded goods and services are increasingly becoming traded. In the past, he said, individuals working in nontraded industries supported free trade. Now, when doctors and accountants see that their jobs are at risk—however small the job losses—are they shifting to the other side of the debate? Bhagwati said that the answer is not entirely clear because many of these same individuals are also exporting medical, accounting, and legal services.

In Bhagwati's view, U.S. concerns about trade liberalization have cultural roots. The system in the United States "is based on competition much more than any other system." In this environment, he said, the desire to be number one is very important. When the Detroit auto industry faced intense competition from the Japanese, it "exploited that cultural reality in this country very well." The same was true more recently, under the North American Free Trade Agreement (NAFTA), when the United States "was petrified that it would be cleaned out by competition" from Mexico's labor-intensive exports.

Bhagwati also related these fears to the lack of institutional support for the losers in the United States, both at the state and familial level. The fear

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of being underemployed or unemployed is much greater in the United States than in countries with advanced welfare systems. A traditional safety net—family institutions—is of little help, too. There is no extended family support, and not too much is expected of one another during times of stress. In view of all this, he argued, the United States may "need overcompensation rather than undercompensation from the state" compared with other countries. "Institutional support, even if it's inefficient, has to be there."

Demonstrators protest at a November 2003 meeting of the Free Trade Area of the Americas in Miami, Florida.

Finding appropriate policy responses

While many antiglobalizers concede that globalization "increases the size of the pie," they also claim that it has injurious social implications, such as environmental degradation and child labor. "Many of these evils are inherited over the centuries, and there are deep-seated causes in history," Bhagwati explained, but the relevant question for us today, from a policy point of view is how to accelerate the fulfillment of the social agenda.

His concern was that in the United States, particularly, and among labor unions—including the International Confederation of Free Trade Unions—trade sanctions are often advocated as a means to advance the social agenda, the argument being that some countries' lax labor standards or use of child labor amounts to unfair competition. "NAFTA," he said, "was the starting point of the corruption of the trade issue with all these extraneous issues."

Bhagwati questioned whether imposing trade sanctions to redress nontrade concerns is the best policy option. Because it is very difficult for poor countries to "throw stones at big ones," such an asymmetrical response becomes resented and counterproductive. Moral suasion and boycotts, he argued, can be much more effective in advancing social agendas. At the same time, Bhagwati called upon international organizations to provide poor countries with adjustment assistance to help them cope with the downsides of trade liberalization. "The advanced countries have been doing it ever since Kennedy's time," he said, adding that "every trade act has had trade adjustment assistance drawn out." Bhagwati also felt that the transition to a more open trading regime should be managed with caution and that the speed on developing or improving policies to meet social agendas should be accelerated.

Passing the test

Globalization excites such fiery passions, said Daniel Yergin, because "it is shorthand for change, much of it disconcerting and even controversial. It is central to issues like global poverty, the environment, but also genetically modified foods, Hollywood movies, shifts in jobs, big companies, the role of the IMF, competition, and restructuring." There is a sense, he added, that in a more globalized world, competition and the pressures that come with it are more intense.

The search for facts, figures, and the truth is useful, but there is also, Yergin cautioned, a need to challenge the myths about globalization before they become part of the lingua franca. The fundamental question that prompted his own book, *The Commanding Heights*, was why the world has moved from an era in which government sought to seize and control the commanding heights—the strategic sectors of the economy—to an era in which ideas of trade, competition, deregulation, and privatization have captured a large part of the commanding heights of world economic thinking, and he welcomed Bhagwati's great clarity in defending globalization. One of the great tests of globalization is what it can do to reduce poverty, he said, citing Asia's success over the past 30 to 40 years in achieving higher growth rates and raising per capita incomes as one of the best examples of the benefits of expanded trade. ■

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The webcast of the discussion can be accessed at the IMF's website *(www.imf.org)*. *In Defense of Globalization* by Jagdish Bhagwati was published by Oxford University Press.