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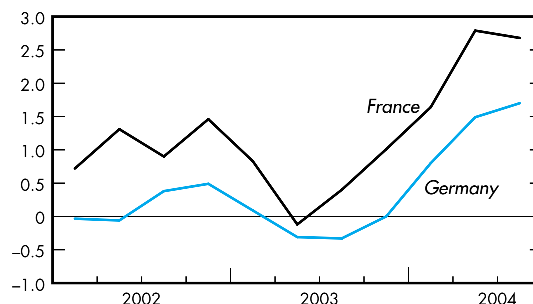
France and Germany need to look beyond the short term for lasting growth

Higher oil prices, a rising euro, and softer global demand are beginning to take their toll on Europe's brittle economic upturn. Will the euro area's two largest economies, Germany and France, be able to sustain their recoveries without losing sight of the pressing goals of fiscal consolidation and comprehensive structural reforms? Alessandro Leipold, mission chief for France and Deputy Director of the IMF's European Department, and Ajai Chopra, mission chief for Germany and Senior Advisor, talk with Conny Lotze of the IMF Survey *about recent developments and how the two countries can meet the challenges ahead.*

French and German recoveries at risk?

(Real GDP, percent change over same quarter of previous year).



Data: IMF, *World Economic Outlook*, and *International Financial Statistics*

IMF SURVEY: Preliminary third-quarter figures for 2004 show that in both countries growth rose by only 0.1 percent from the previous quarter. For the next *World Economic Outlook*, do you expect to revise your growth forecasts from those in your annual Article IV assessments in early November?

LEIPOLD: Third-quarter growth in both countries was obviously a disappointment, and particularly so in France, because its upturn seemed to be better established. In France, the quarter witnessed not only a deceleration in private consumption, but also—and that's more

(Please turn to the next page)

Growth recovers in Pakistan in difficult circumstances

In the space of a few years, a new economic policymaking team has orchestrated a remarkable turnaround in Pakistan. In fact, based on the country's external position, the government opted not to draw the final installment of its IMF financing under the Poverty Reduction and Growth Facility, and the arrangement expired on December 5. But can solid short-term prospects be converted into consistent high growth and a real reduction in high poverty rates? Milan Zavadjil, Assistant Director in the IMF's Middle East and Central Asia Department, discusses with Sheila Meehan of the IMF Survey *what the country will need to do to begin to compete with Asia's strong performers.*

Booming textile exports have played a key role in boosting growth in Pakistan.

IMF SURVEY: In 1998/99, Pakistan had virtually exhausted its foreign reserves and found itself unable to service its debts. Now the country seems confident about tackling the future without IMF financing. What has turned the country around?

ZAVADJIL: After years of economic woes, a lot has gone right for Pakistan over

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France and Germany need to boost confidence

(Continued from front page) worrying—a sharp fall in business investment, and investment plans going forward appear weak. So, yes, we will likely revise our growth projections for France and Germany for 2004 and 2005 down further, though growth in France is set to remain comparatively stronger.

CHOPRA: In Germany, after three years of stagnation we are seeing a modest cyclical recovery. But this recovery is driven largely by exports, while domestic demand has been dormant, and the unbalanced nature of the recovery raises questions about its sustainability. Now, after four quarters of gradually accelerating growth, the third-quarter data show some weakening primarily because of lower exports, underscoring the fragility of the German recovery and the high dependence on exports. But there is a silver lining in the latest data because it appears that the impulse from exports is beginning to boost investment and, to a lesser extent, also employment. So, as Alessandro says, the forecasts for both years are likely to be revised down, but it's too early to say by how much.

IMF SURVEY: What do you see as the main reasons for the slowdown?

LEIPOLD: It seems to be largely due to higher oil prices. French consumers have historically reacted quite strongly to higher inflation expectations. The stronger euro has likely had a lesser impact.

CHOPRA: In Germany, I would say the reason is somewhat softer global growth, which to some extent is linked to oil prices, and the corresponding slower growth of German exports. The stronger euro may have a limited effect on German exports, but for now we still see Germany's external competitiveness as quite sound.

IMF SURVEY: How can France and Germany mitigate the situation and strengthen their recoveries?

LEIPOLD: Short-term countercyclical policies will not save the day in either country. In both, the priority has to be strengthening very anemic rates of long-term potential growth. Decisive measures in this direction are really the most effective way to boost confidence, and thus growth, in the short term as well. The public in both countries is by now all too aware that the fiscal situation cannot allow either sustained tax cuts or stimulatory measures. Some such steps were tried in France, and their effects petered out quite quickly.

CHOPRA: It is the same story in Germany. What Germany needs is a steady hand at the wheel. It's clear that German consumers and investors are jittery, so confidence is an issue, and steady, consistent, forward-looking policies that address the long-term issues are more important than short-term quick fixes.

LEIPOLD: Of course, at the euro-area level, monetary policy can best address cyclical concerns, and the monetary stance thus needs to remain accommodating until there is a sustained recovery of domestic demand or adverse signals from wage bargaining—neither of which are yet apparent.

IMF SURVEY: Do you expect second-round effects—rising wages and prices—from high oil prices?

CHOPRA: The first-round effects in both Germany and France are likely to be more muted than in the past, because higher oil prices have been mitigated by greater energy efficiency in both countries and, to a certain extent, by the appreciation of the euro. On second-round effects, we anticipate that the impact on wages will also be muted. I think there is a keen awareness on both sides—employers and employees—that this is not the time to raise labor costs. Furthermore, the European Central Bank's inflation-fighting credentials are now well established—borne out by low inflation expectations for the euro zone.

IMF SURVEY: Both countries have repeatedly breached the European Union's Stability and Growth Pact, which sets a limit of 3 percent of GDP on the budget deficit. Both governments recently proposed 2005 budgets with deficits just below 3 percent. How realistic are their proposals?

LEIPOLD: On the positive side, France enacted pension reform in 2003 and health care reform in 2004, and product market reforms are also advancing. But the 2005 budget is a disappointment, mainly because of its heavy reliance on a large one-off measure, the pension fund transfer from the electricity and gas utilities. This operation does not represent durable adjustment, being countered by the assumption of equivalent future liabilities.

At the same time, the golden opportunity to reduce a very large civil service is not being seized: 60,000 civil servants retire in 2005, and the budget replaces seven out of eight of them. There was clearly scope for a more ambitious effort and thus stronger structural adjustment, irrespective of whether the 3 percent will be achieved or not.

CHOPRA: For Germany, we're projecting a general government deficit of 3.9 percent of GDP for 2004,

Short-term countercyclical policies will not save the day in either country. In both, the priority has to be strengthening very anemic rates of long-term potential growth.
—Alessandro Leipold

which makes it the third year that it has been above the 3 percent Maastricht limit. The government's goal is indeed to reduce the deficit to below 3 percent in 2005, which we think is going to be very challenging. Some good measures were taken in the 2004 budget, which will continue to yield savings in future budgets, but this will not be sufficient to observe the Maastricht limit in 2005. In our latest report we recommended that Germany take additional high-quality, durable measures before the budget is passed, with a focus on reducing subsidies and tax expenditure. Unfortunately, there was no political consensus in favor of adopting these measures, so the government is relying on one-off measures to reduce the deficit further and meet the 3 percent threshold. In our view, these one-off measures are questionable and will make future consolidation more difficult.

IMF Survey: The debate about changes to the Stability and Growth Pact is in full swing in Europe. What do you think about the various proposals, including those put forward by France and Germany that would exempt certain expenditures?

Leipold: Some improvements are possible, but what must be preserved is a credible fiscal framework with clear rules. The problems with the Pact have more to do with its implementation and the failure of the large countries to live up to its precepts than with the Pact itself. Modifications that would exclude certain expenditures would further complicate implementation and place the Pact on a slippery slope.

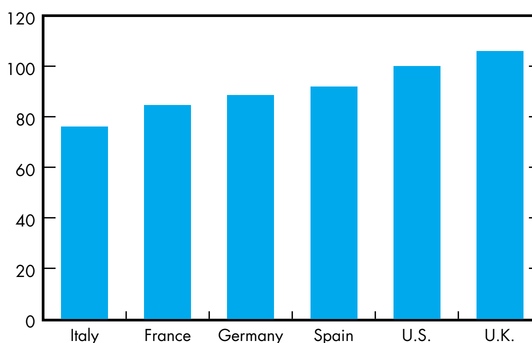
Chopra: Accounting should be made more transparent rather than less so. Some of the specific proposals coming out of Germany and France would make the Pact less transparent, because they do not correspond to the standard definitions of fiscal accounting, and once you start playing with definitions, you will get on that slippery slope that Alessandro mentioned. There will be a tendency to keep on adjusting the definitions to meet the rules. The focus should be on complying with the Pact rather than weakening it, especially as its long-term features provide a needed anchor to deal with the fiscal costs of aging populations.

IMF Survey: The IMF's 2004 assessments urge both countries to accelerate fiscal consolidation. With a slowdown in economic activity, is this still feasible?

Chopra: The growth rates we are projecting for 2005 for both countries—even after the revisions we'll make—are very close to our estimates of potential growth. Therefore, even though there is uncertainty about the strength of the recovery, now is the time to adjust. And certainly consolidation—although difficult—would still be easier now than it would be in the next slowdown or the next recession. Above all, considering their long-term challenges, Germany and France need to put their large fiscal deficits on a firm downward path. Fiscal stabilizers should be allowed free play around this path to provide a cushion if growth falls short of projections, but also to maintain underlying fiscal adjustment during an upswing, contrary to past experience in both countries.

French and German labor utilization rates remain low

Average annual hours worked per employed person (average 2000–02) (U.S.=100)



Data: Organization for Economic Cooperation and Development

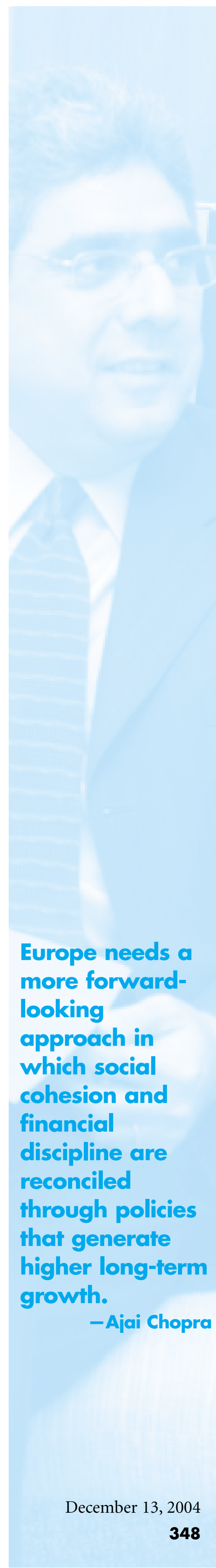
IMF Survey: Even with comprehensive reforms, will France and Germany's entitlement systems be sustainable in the long term?

Leipold: Certainly, the entitlement systems have to be reformed, and there has been some progress. But changes to entitlements need to be accompanied also by other reforms—notably in the labor market. These reforms need to address what we've said time and again is Europe's fundamental problem—insufficient labor utilization. Raising labor utilization is key to ensuring the sustainability of Europe's welfare programs.

Chopra: There is a very telling statistic on labor utilization in Germany and France. If we look at the average annual hours actually worked per employed person, and put the index at 100 for the United States, the corresponding index for Germany would be 89 and for France it would be 85 (see chart, this page).

IMF Survey: What do France and Germany need to do to boost labor utilization?

Chopra: These problems were not created overnight, and they will not be resolved overnight. We have said very clearly that the German government's Agenda 2010 is a forceful start to labor market reforms in



Europe needs a more forward-looking approach in which social cohesion and financial discipline are reconciled through policies that generate higher long-term growth.
—Ajai Chopra

Germany, but it needs to be complemented with further reforms. There are various steps in the Agenda aimed at reducing unemployment and increasing employment, and these are very helpful.

But in the long term, there is greater scope to boost employment by raising participation rates—especially for elderly workers, women, and the young—than by reducing unemployment. That's where the future focus needs to be. Germany is facing a decline in its working-age population, and if corrective steps aren't taken, this will be quite a drag on potential growth and the social security system.

Leipold: In France, labor costs and employment have been adversely affected by a high and rising minimum wage, the mandatory reduction of the workweek to 35 hours, and high marginal tax and benefit replacement rates. The authorities have addressed these disincentives to labor demand and supply through the budget, mainly by reducing social security contributions, but at a very high cost. The link between the labor market and the budget now needs to be broken, and labor market institutions changed—beginning with a relaxation of the workweek restrictions and of rigid employment protection.

IMF Survey: Will health care and pension reforms meet the demographic challenge of large aging populations? Will these countries need to raise the retirement age?

Leipold: In France, the pension reform has done much to lower the fiscal costs of aging, bringing them well below the euro-area average. The reform left the statutory retirement age untouched, and there are advantages in that. What it did was to introduce a link between the contribution period required for a full pension and life expectancy. People now live longer, their pension benefits last longer, and they thus need to contribute longer. Basically, provided the financial implications are fair, the decision when to retire should be left to the individual: earlier with a lower pension or later with a higher one.

Chopra: In Germany, the good news is that there is an extensive debate under way on health care and pensions. And with the Agenda 2010, important progress has been made. But these reforms are not going to be enough. On the specific issue of the retirement age, a proposal to gradually increase the statutory retirement age was not adopted. The current focus in Germany is to raise the effective retirement age by eliminating incentives for early retirement rather than raising the statutory retirement age. But the aging problem is so large and so complex that it will require a complementary mix of policies. It will require not only reforms of entitlement programs but also steps to bolster potential growth to make these programs more affordable, and it will require fiscal consolidation.

IMF Survey: Is there anything in their welfare systems worth retaining?

Chopra: There is indeed much in the European model that should be retained. The basic tenet of this model is social peace and cohesion combined with financial discipline, and there is no reason to think that these goals are incompatible. But at the same time it has to be acknowledged that Europe's growth performance has not been good enough in the past couple of decades. Per capita income in the euro area has remained stuck at about 75 percent of U.S. levels since the 1970s and even dipped a little in the 1990s. However, there is no conclusive evidence that Europe's welfare system as a whole is at the root of this poor economic performance and, hence, should be discarded.

But that said, it is clear that over time, rigidities have emerged, and they need to be addressed. Europe needs a more forward-looking approach in which social cohesion and financial discipline are reconciled through policies that generate higher long-term growth. We believe this is possible. Indeed, some of the smaller European countries have achieved a measure of success. There is no uniform approach to market-based economies. This is speculative, but it is quite possible that somewhat diverse approaches to market-based economies could help render the world economy more stable.

Leipold: Yes, and in this vein, the recent report by [former IMF Managing Director] Michel Camdessus on the obstacles to long-term growth in France—an excellent road map on what needs to be done—has a chapter entitled "Others have done it." It cites examples of other European countries that—while retaining the basics of the welfare state—have done much better in terms of growth through fiscal consolidation and other reforms. It shows that this can be done without sacrificing the fundamental tenets of the European model. ■

Copies of IMF Country Report No. 04/343 on France and Country Report No. 04/341 on Germany are available for $15.00 each from IMF Publications Services. See page 350 for ordering information. The reports and the Executive Board assessments are also available on the IMF's website (*www.imf.org*).

Germany has scope to make its federal system more competitive

With Germany experiencing high unemployment and large fiscal deficits, there has been widespread concern about its future prospects. And, increasingly, questions are being asked about the capacity of political institutions to deliver needed change. IMF economists Benedikt Braumann and Jörg Decressin assess the economic effects of Germany's federal political institutions and explain how they can be strengthened to foster reform and fiscal adjustment.

Germany is a federation of regions (Länder) with a central government (Bund). Its parliament is composed of two chambers. The lower chamber (Bundestag) is elected every four years and nominates the chancellor, the head of the central government. The upper chamber (Bundesrat) represents the regions. Its membership changes frequently according to regional elections that follow independent timetables.

The constitution establishes a division of labor between regions and center in providing public services. The two levels spend roughly equal amounts of money, but there is no clear separation of revenue sources to fund this spending. Two-thirds of all taxes are shared between central and regional governments via a complex redistribution scheme that attempts to equalize Länder revenues on a per capita basis. As a result, while regional per capita GDP varies by 50 percent (reflecting remaining disparities between East and West), per capita revenue varies by only 6 percent.

This strong effort to iron out regional disparities has as its basis the constitution's call to establish "the same living standards" across Germany. Germany's federalism is, in effect, highly cooperative, with virtually identical tax laws across the Länder. By contrast, more competitive federations—for example, the United States, Canada, and Switzerland—give their lower levels of government considerable leeway in managing their revenues.

The Länder veto power

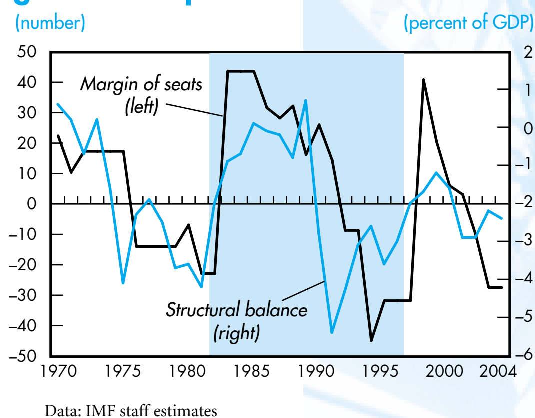
Under the German constitution, the upper chamber of parliament can veto all laws that affect the Länder financially or administratively, and thus the vast majority of laws concerning economic policy. This is mainly because of the mutual dependence on revenues. This makes the partisan composition of the upper chamber important for policymaking. If the opposition has a majority in the upper chamber, legislation can become difficult and drawn-out.

A typical German administration gradually loses power over its life span. While its majority in the lower chamber (Bundestag) is usually stable, its majority in the upper chamber tends to degenerate over time and become a minority. German central governments have changed only twice during the past 35 years: going from left-leaning to right-leaning in 1982, and from right-leaning to left-leaning in 1998. In each instance, adverse Länder election results deprived the three governments of a majority in the upper chamber during the second half of their life span.

Government power and fiscal cycles

As the government loses power, fiscal policy weakens (see chart). The structural deficit is highly correlated with government power and widens during the second half of an administration's life. As the government loses its majority in the upper house, a phase of difficult compromises begins, and fiscal discipline weakens. Typically, expenditure control slips, and taxes cannot be raised because of strong political opposition.

Germany's fiscal deficit widens when government power weakens

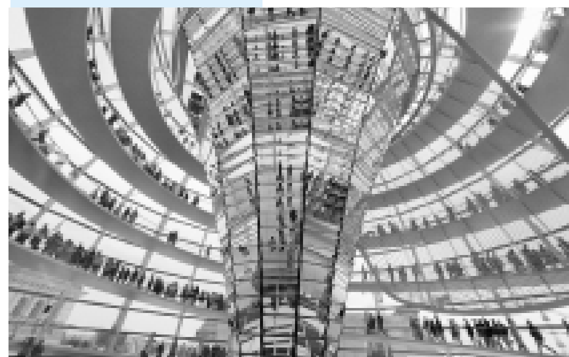


Data: IMF staff estimates

It may seem surprising that this mismatch between economic and political responsibilities has not created more serious fiscal imbalances, but two time-tested budgetary institutions have helped preserve some discipline. First, its constitution limits borrowing at all levels of government to the amount of capital spending (the "golden rule"). As a result, the government deficit has exceeded 5 percent of GDP in only one year (1975) since World War II. Furthermore, outside experts play an important role in the budget process. The government relies on them to elaborate the macroeconomic framework and tax revenue projections, which helps stem fiscal illusion. This has enabled Germany to achieve a high degree of fiscal transparency and sound standards for budgeting, accounting, and reporting. Large deficits are easily detected by the public and punished by a loss of electoral support.

Nevertheless, Germany would benefit from more room for the Länder to follow independent budgetary policies and reduce political pressure on fiscal policy.

This would help regain fiscal stability and promote structural reform. On the fiscal side, even the "golden rule" has not prevented Germany from breaking the European Union's Stability and Growth Pact (SGP) for three years in a row. By design, the "golden rule" is less stringent than the SGP, setting no explicit ceiling for the deficit and allowing asset sales to be counted as revenues. One way forward would be to align the recently introduced Internal Stability Pact more closely with the SGP's rules and make it legally binding. Frameworks that coordinate budgeting at central and regional levels have been adopted by Austria, Belgium, Italy, and Spain. In addition, creating an independent budgetary watchdog that reports directly to parliament could encourage a rational debate on economic policies and help build popular support for reforms.



The interior of Germany's lower house of parliament—the Bundestag—in Berlin.

More competition and experimenting?

If Germany controlled its overall deficit via its Internal Stability Pact, it could allow the Länder more taxation autonomy to align their revenue and expenditure responsibilities. Injecting a measured degree of competition and room for experimenting in economic policy among the Länder could improve economic efficiency. It would reward fiscal prudence and forge a closer link between taxes and public goods. The interpretation of what "same living standards" should mean is currently being debated, with many now stressing the benefits of competition relative to cooperation in fostering a catch-up by the poorer regions.

Finally, realigning the Länder responsibilities for expenditures and revenues could reduce the number of laws that need approval by both houses of parliament. A smoother legislative process would promote both fiscal adjustment and structural reform. The results of an econometric test suggested that even strong German governments perceived a trade-off between fiscal consolidation and structural reform. The political costs of pursuing both goals at the same time are apparently too high. When in doubt about success, governments opted for fiscal consolidation, which is less ideologically charged. The result has been a slow and erratic process of structural reform in Germany, subject to setbacks and reversals. In 1997, for example, the right-leaning government then in power cut pensions, health care, and unemployment benefits. The left-leaning successor government repealed these measures in 1999, only to reintroduce them under different headings in 2003–04. Were this to continue, the public may well become even more disoriented about the general objectives of structural policy. ■

Copies of IMF Country Report No. 04/340, "Germany: Selected Issues," are available for $15.00 from IMF Publication Services. See below for ordering details. The full text of the report is also available on the IMF's website (*www.imf.org*).

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Beating poverty is a key challenge for Pakistan

(Continued from front page) the past five or six years. Pakistan has strengthened its external position; generally managed to keep its inflation under control; and, most encouragingly, enjoyed strong economic growth.

Now, what's behind this? That is much debated both at home and abroad. I feel that strong ownership of government policies, the strengthening of the fiscal accounts, and implementation of structural reforms in many areas have been crucial. A strong economic policymaking team has taken over in Pakistan, and, so far, it is doing well in a country that is not exactly easy to govern.

However, many people think that after 9/11, the United States showered Pakistan with grants, and that it's these grants that are maintaining the country. Even people who you'd think had looked at the country's balance of payments are saying this. Grants, of course, have not hurt, but they are now only a small part of the picture. For this fiscal year, we are projecting $400 million in grants as compared with almost $14 billion in exports and $6 billion in remittances. The World Bank and the Asian Development Bank are big supporters of Pakistan, but not out of proportion to its population. And Pakistan has benefited from its Paris Club rescheduling and enlarged access to the IMF's Poverty Reduction and Growth Facility arrangement.

IMF Survey: What has spurred the recovery in exports?

Zavadjil: Pakistan is still very dependent on textile and clothing exports. With the improved macroeconomic environment, there has been a lot of investment in this area, and these exports have boomed. Of course, it has also been aided by increased European Union and U.S. textile quotas. This bilateral quota system for textile imports is due to expire at the beginning of 2005, but most people believe that Pakistan will, in fact, benefit somewhat from the end of this system. Not as much as China perhaps, but Pakistan should see its textile exports continue to grow.

IMF Survey: IMF staff see higher investment rates as a crucial element in Pakistan's continued good performance. But if foreign investors continue to see Pakistan's security situation as precarious, will the country be able to attract more foreign direct investment?

Zavadjil: Many foreign investors are concerned about security in Pakistan, and these perceptions often drive their decisions. Pakistan's foreign direct investment has increased, but this isn't coming from the blue-chip multinationals. In large part, investment is coming from the Middle East and from Pakistani expatriates. Oil, gas, and banking are doing well, but multinational investment in manufacturing for export is still to come. Perceptions of the security situation remain a big problem and a constraint on the Pakistani economy.

IMF Survey: Can domestic investors, at least in the short term, fill the void?

Zavadjil: They are filling the void. There's little doubt that large-scale manufacturing is growing at annual rates well into the double digits. Domestic private investment seems to be increasing, and it's driving the economy.

IMF Survey: One clear bright spot for Pakistan seems to be the reforms in the financial system.

Zavadjil: Yes, this is one of the strong points of the reforms over the past four years. The IMF conducted a Financial Sector Assessment of Pakistan in the spring of this year and its results reflected the general health of the sector. The banking system is beginning to deliver what everyone wanted it to deliver—lending to the private sector and financial intermediation. Right now, in fact, we are worried that private credit is expanding a little too fast, from the perspective of both aggregate demand management and financial stability. A lot of credit is going into new areas, such as housing and consumer goods, so we'll have to see how the banks handle this.

IMF Survey: In the energy sector, though, you indicate there's more to do.

Zavadjil: Completing the reform of the energy sector is a clear priority. Pakistan has huge energy subsidies. It has taken an important step in unbundling its electricity companies. This provides incentives to reduce losses and allows some of them to be privatized. But there are still big issues with electricity pricing policy, as well as petroleum product pricing policy. The government is reluctant to pass on the increase in international prices to consumers in both areas. It's a highly charged political issue, and these subsidies represent a burden. Luckily, the overall fiscal situation is good. The government has been overperforming, and the budget outcomes in both the past year and the first quarter of this year are sound.

Zavadjil: "If Pakistan continues to respond to new shocks and challenges . . .and sticks to the policies and objectives of the past 4 to 5 years, it should be able to boost income growth very quickly."

IMF Survey: But IMF staff suggest more could be done in terms of raising tax revenues.

Zavadjil: Social spending is low in Pakistan because tax revenues are low. The government has put in place several good reforms, and revenues are edging up. But if you look at the big picture, both where they are now and where they intend to be in the next five years, revenue collection is very low compared to GDP. What's wrong? Well, the tax base is too narrow. There's very little taxation of agriculture, and there is scope for increasing taxation of services. Also, revenues could be collected from existing taxpayers more efficiently.

IMF Survey: What's ahead for Pakistan?

Zavadjil: The challenges in a country like Pakistan are obviously massive. It used to be in a very tough neighborhood, but relations with India are improving, and that's good. Domestically, Pakistan's a politically dynamic but divided country, and one with one-third of its population still mired in poverty. We hope a forthcoming survey will confirm that poverty has been declining. But looking ahead, beating poverty and creating employment opportunities, while maintaining macroeconomic stability, are clearly the main challenges.

IMF Survey: How does Pakistan plan to address its poverty and unemployment?

Zavadjil: There is a Poverty Reduction Strategy Paper, and the government is hopeful that a combination of pro-poor policies and strong growth will drive down poverty rates. Historically, however, growth in Pakistan has not been pro-poor. So the question is still out there whether strong growth can help the poor, who are concentrated in the agricultural sector where potential growth isn't 6–7 percent, but maybe 3–4 percent.

Another priority in beating poverty is making devolution work. Health care and education are the responsibility of local governments, which have to be more effective. That means giving them more control over their civil servants and making sure they have adequate financial resources.

Overall, the government has made a strong commitment to reducing poverty and has pledged to reach 8 percent growth by 2007/08. This is good, but efforts to achieve growth should not come at the cost of financial stability, which has been the basis for Pakistan's achievements in recent years. We are now seeing inflation pick up; the economy is growing very rapidly and there is some overheating. We believe a prompt and forceful tightening is called for to preempt pressures on foreign exchange reserves and consumer prices.

IMF Survey: Is the authorities' goal of an 8 percent growth rate realistic?

Zavadjil: A lot of things have to fall into place for it to be achieved. As always, growth is dependent on continued macroeconomic stability and structural reforms, as well as increased investment in human capital. But growth will also depend on factors outside the control of the economic policy team: on security—domestic and regional—as well as on the external environment. Rising petroleum prices will not help. And weather will remain a key factor. The country went through an extended drought in the early years of this decade. This year, some crops, like wheat, have been affected, but cotton has done very well. Drought would make poverty reduction and growth more difficult.

IMF Survey: Is there room for greater regional cooperation in South Asia?

Zavadjil: Of course. In fact, our report is extremely positive about the potential for regional cooperation. There are a lot of differing opinions on regional trade agreements, but given that India and Pakistan hardly trade at all now, we think the potential is large. Both countries are opening up. Pakistan, in particular, has taken steps to reform its trade system.

IMF Survey: Overall, then, do you see cause for optimism?

Zavadjil: Pakistan has grown quite fast in some periods, but its economic history, especially during the 1990s, has been troubled. Compared with many developing countries, however, Pakistan has exceptional capacity. Its civil servants are able and knowledgeable. They do, however, face terrific pressures to improve the standard of living, and they work in an extremely difficult environment.

The past few years have been encouraging, though. If Pakistan continues to respond to new shocks and challenges—such as higher petroleum prices—and sticks to the policies and objectives of the past four to five years, it should be able to boost income growth very quickly, and, we hope, reduce poverty over the medium term. ■

Additional information on Pakistan—including Press Release No. 04/259 on the completion of the final review under Pakistan's Poverty Reduction and Growth Facility Arrangement with the IMF, as well as reports on the Observance of Standards and Codes and the Financial System Stability Assessment—is available on the IMF's website (*www.imf.org*).

New online external debt database launched

In an effort to improve comparability and analysis of countries' external debt positions, the IMF and the World Bank launched an online database on November 18 that offers access to quarterly external debt statistics for 41 countries.

The creation of the Quarterly External Debt Database was prompted by strong demand, particularly from capital markets, for better access to timely and comparable debt data. It is designed to help policymakers and analysts assess vulnerabilities and make informed borrowing and investment decisions.

Up to now, cross-country comparison was cumbersome as it involved looking up individual data in various currencies for those countries that subscribe to the IMF's Special Data Dissemination Standard (SDDS), which provides economic and financial data from member countries that have or may seek access to international capital markets.

Earlier this year, the IMF and the World Bank set out to design templates, aligned with the model presentations of debt tables in the *External Debt Statistics: Guide for Compilers and Users,* that could use the SDDS-supplied data and compile the information in a way that offers timely, high-quality data. Participation in the database is voluntary and of the 57 SDDS subscribers, 52 countries have agreed to provide external debt data to the new online database, and the data of 41 of them can already be accessed. The remaining 11 countries are working on implementing and reporting the appropriate templates. Eventually, the goal is to extend participation to all countries whose external debt data can be disseminated according to the SDDS requirements.

"The database is a good demonstration of countries' willingness to compile and disseminate macroeconomic data based on internationally accepted methodologies and standards," Robert Edwards, the Director of the IMF's Statistics Department, said in a statement. "I welcome the increase in transparency of countries' external debt positions that this database promotes."

The database is organized into three sets of tables, which allow cross-country comparisons and other types of data analysis. The core table covers countries' external debt position by sector, maturity, and instrument, as well as debt liabilities to affiliated enterprises and direct investors. Users can also query and extract data by country, groups of countries, external debt components, and reference period. ■

The online database can be accessed through the World Bank website at *http://worldbank.org/data/working/QEDS/sdds_main.html*. The *External Debt Statistics: Guide for Compilers and Users* is available on the IMF's website at *http://www.imf.org/ external/pubs/ ft/eds/Eng/Guide/index.htm*.

Available on the web (www.imf.org)

Press Releases

04/241: World Bank and IMF Launch Quarterly Online External Debt Database, November 18 (see above)

04/242: IMF Mission Statement at the Conclusion of the 2004 Article IV Consultation and Post-Program Monitoring Discussions with the Philippines, November 17

04/243: Statement by the Director of the IMF African Department, Abdoulaye Bio-Tchané at the Conclusion of His Visit to Zimbabwe, November 17

04/244: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of a Visit to Russia, November 18

04/245: IMF Executive Board Completes First Review Under Peru's Stand-By Arrangement, November 19

04/246: IMF Executive Board Extends Dominica's Repayment Expectations, November 22

04/247: IMF Managing Director Rodrigo de Rato's Statement at the Conclusion of a Visit to Poland, November 23

04/248: Statement by IMF Staff Mission to Honduras, November 23

04/249: Statement by an IMF Article IV Staff Mission to Panama, November 24

04/250: Discussions on New IMF Stand-By Arrangement for Turkey to Resume on November 30, November 24

04/251: Statement by IMF Staff on the Dominican Republic, November 24

04/252: Statement by IMF Staff Mission to Malawi, November 29

04/253: The Republic of Tajikistan Formally Begins Participation in the IMF's General Data Dissemination System, November 29

04/254: IMF Executive Board Completes Sixth Review Under Uruguay's Stand-By Arrangement, November 29

04/255: IMF Managing Director Rodrigo de Rato Underscores Urgency of Collaborative and Global Fight Against HIV/AIDS and its Effects, December 1

04/256: IMF Executive Board Reviews the Republic of Moldova's Poverty Reduction Strategy Paper and Joint IMF-World Bank Staff Advisory Note, December 1

An assessment of Chile's foreign reserve holdings

Several emerging market economies hold a strikingly high level of foreign reserves. Among them is Chile, whose reserves equaled about 22 percent of GDP at the end of 2003—about the same ratio as those of Asian emerging market economies and significantly higher than the Latin American average of 15 percent of GDP. Economists still have not developed a formula to determine a country's optimal level of reserves, but in a recent study, Marco Espinosa-Vega (Senior Economist, IMF Monetary and Financial Systems Department) and Mercedes Vera-Martin (Economist, IMF International Capital Markets Department) assess the appropriateness of Chile's reserves and find that they are above the levels that common benchmarks suggest would be adequate, and the optimal levels implied by an econometric model.

One reason a country accumulates foreign reserves is to help smooth out the impact on the economy of temporary shocks to its balance of payments. While such shocks could also be managed through domestic adjustment, this could induce large, undesirable output swings. Countries also hold foreign reserves to help avoid destabilizing exchange rate movements. Even countries with freely floating exchange rate regimes, such as Chile, at times intervene in the foreign exchange market to correct perceived excessive exchange rate volatility.

Measures of adequacy

How much is enough? It's an important question because there are opportunity costs of holding reserves. Espinosa-Vega and Vera-Martin estimate Chile's annual average cost of holding reserves at 0.3 to 0.5 percent of GDP for 2002–04. To determine a country's reserve adequacy, economists look at various measures related to its various likely foreign payments obligations—imports, short-term debt, and potential capital outflows. Espinosa-Vega and Vera-Martin compare Chile's outcome on these measures to commonly used benchmarks.

Reserves-to-imports. Traditionally, economists have tended to track the reserves-to-imports ratio as an indicator of reserve adequacy on the grounds that foreign exchange payments usually arise mainly from the import bill. A frequently used guideline is that reserves should be equivalent to at least three to four months of imports. Chile, with the equivalent of about nine months of imports, is well above that ratio. Its ratio is about the same as in Asian emerging market countries and more than twice as high as in Australia and New Zealand—countries that, like Chile, have flexible exchange rates and where commodities play an important role.

Reserves-to-short-term external debt. The 1994 Mexican crisis and the 1997–98 Asian crises highlighted the problems associated with sudden stops in capital financing. Unable to continue to tap capital markets to finance their current account deficits, countries were faced with sharp current account adjustments and costly output contractions. By some accounts, Espinosa-Vega and Vera-Martin point out, these crises originated partly in excessive reliance on external short-term debt, and more emphasis has since been placed on measuring reserves as a ratio to a country's short-term external debt. Some suggest that the ratio of reserves to short-term debt (debt with maturities shorter than or equal to one year) should equal at least 1:1 so that the country's reserves are sufficient to pay off its debts falling due in the year ahead. Chile's ratio of reserves to short-term debt has consistently exceeded this benchmark (see chart, page 355).

Reserves-to-broad money. Espinosa-Vega and Vera-Martin point out that the possibility of a bank-run-induced crisis calls for a complementary indicator of the appropriate reserve level. A confidence crisis can translate into runs on bank deposits with a corresponding drop in the level of reserves and sharp exchange rate depreciation. To capture the vulnerability associated with a sudden reversal of confidence and capital flight, the ratio of reserves to broad money has been commonly used. Chile's gross reserves cover about 57 percent of broad money, a ratio higher than in Asian emerging market economies and close to the Latin American average.

Composite benchmark. Finally, compared with an adequacy benchmark range that takes into account short-term debt and risks of capital flight, Chile's reserves have been well above the estimated mid-point of the adequacy range since 1999 and a higher than the mid-point since 2002.

Toward a definition of optimum reserves

While the above-mentioned rules of thumb provide useful guidelines, they lack theoretical underpinning and contain several shortcomings, say Espinosa-Vega and Vera-Martin. The rules indicate an adequate level of reserves but do not provide any guidance on the optimal level of reserves. They usually consider only one source of vulnerability and ignore countries' idiosyncratic features that

could serve to dampen or exacerbate the need for adjustment in the event of a shock. And they fail to distinguish among policies or institutions across countries, or consider the cost of holding reserves explicitly.

Recent empirical literature based on the buffer stock model—which says that central banks should choose a level of reserves to balance the macroeconomic adjustment costs incurred in the absence of reserves with the opportunity cost of holding reserves—has tried to compensate for some of the shortcomings of the rules of thumb reviewed above, by considering simultaneously some potentially key explanatory variables. These include economic size, current and capital account vulnerabilities, exchange rate flexibility, and the carrying cost of reserves. (For a similar analysis applied to reserves in Asia, see *World Economic Outlook*, September 2003, pp. 78–92.)

The relationship between these variables and reserves is postulated as follows:

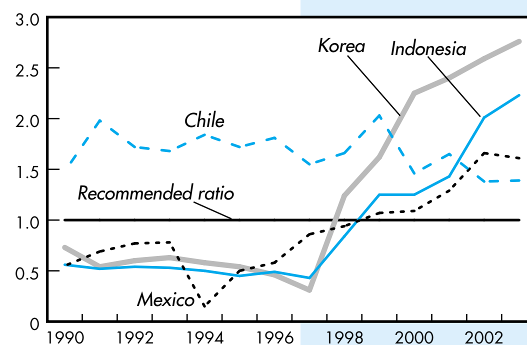
- ***Economic size.*** International transactions increase with the size of an economy, and reserves are thus expected to increase with real GDP per capita and population.
- ***Balance of payments vulnerability*.** The more open an economy's capital account, the more vulnerable it tends to be to sudden stops of capital flows and, therefore, the higher the desired level of reserves. Similarly, the higher the ratio of imports to GDP, the more vulnerable the current account.
- ***Exchange rate flexibility.*** The greater the flexibility in the exchange rate regime, the lower the need to support the currency and the more likely the exchange rate will serve as a shock absorber, thus reducing the need to accumulate reserves.
- ***Carrying cost of reserves.*** Higher costs of holding reserves should induce lower holdings of reserves.

Espinosa-Vega and Vera-Martin estimated what this empirical model would suggest the optimal reserve holdings for Chile should be. Their results—which they say should be interpreted with caution—suggest that the optimal reserve level for Chile is below actual reserve holdings. A possible explanation for this finding, Espinosa-Vega and Vera-Martin conjecture, may be that the model fails to include other equally important considerations in the estimation, such as precautionary motives for reserve holdings. In this regard, Chile belongs to a region that has repeatedly experienced financial and economic crises, and although Chile has not recently been prone to contagion, its geographical location may be viewed as justifying higher reserve holdings.

Alternative mechanisms

Espinosa-Vega and Vera-Martin note that while reserve accumulation remains a country's main buffer against external shocks, other mechanisms—such as contingent credit lines and bilateral swap arrangements—could also provide additional liquidity at time of stress. Among the alternative financial instruments available to Chile—and other countries, of course—are private contingent credit lines (PCCLs). PCCLs, voluntary market mechanisms supplied by a pool of private banks, provide access to liquidity in times of stress. Such facilities are complementary to a country's official reserves and may reduce the overall carrying costs due to lower financial costs. The limited ability of banks to hedge their country exposures may, however, be an important obstacle to a broader use of PCCLs. Banks may be reluctant to provide contingent financing because it would increase their exposure to a country after economic conditions have deteriorated and access to new financing has been lost.

Chile's reserves: a comparison with other countries
(share of reserves to short-term debt)



Data: Bank for International Settlements

Countries can also arrange bilateral swap arrangements to provide liquidity in times of need, but the effectiveness of these mechanisms has not yet been tested. Under swap arrangements, member central banks are allowed to swap their currencies for major currencies for short periods and for amounts predefined at the time of the contract. A country with liquidity needs can borrow foreign currency from another country and use the funds to buy its own currency. The swift availability of liquidity is designed to help limit currency speculation and counter investors' herding behavior. However, it is too soon to draw conclusions about the effectiveness of swap arrangements, as they are relatively new to emerging market economies and it is unclear how they would operate in the presence of common regional external shocks. In the meantime, the IMF is studying a number of complementary and alternative mechanisms to PCCLs and swap arrangements that could better help countries fend off external shocks. ■

Copies of IMF Country Report No. 04/292 and "Chile: Selected Issues" are available for $15.00 each from IMF Publications Services. See page 350 for ordering information. The full text of the report is also available on the IMF's website (*www.imf.org*).

IMF Book Forum

The Macroeconomics of HIV/AIDS

To commemorate World AIDS Day, December 1, the IMF hosted a Book Forum entitled *The Macroeconomics of HIV/AIDS* (see box), opened by IMF Managing Director Rodrigo de Rato. The new book, which explores the economic and fiscal consequences of HIV/AIDS, drew commentary from Rachel Gesami, Markus Haacker, and Simon Johnson of the IMF, and Shantayanan Devarajan of the World Bank.

Rachel Gesami

Markus Haacker

According to the UN, close to 40 million adults between the ages of 15 and 49 worldwide live with HIV/AIDS, and an estimated 3.1 million people will die from AIDS in 2004. While most of the worst-affected countries are in sub-Saharan Africa, India is estimated to have the world's largest population living with HIV/AIDS, and in China the number of infected people could reach 10 million by 2010. The enormous size of the Asian population, said Rachel Gesami (Advisor to the Executive Director for one of the IMF's two sub-Saharan constituencies), means that the region could account for a substantial share of new infections in coming years and, given a further increase in prevalence rates, most HIV-positive people in the world may very soon be living in these countries.

Markus Haacker (Economist, IMF African Department, and editor of the book) described how HIV/AIDS has become an important issue for economic analysis and policy advice in countries facing severe epidemics. While the most direct effects of the epidemic are deteriorating health and increased mortality, these effects, in turn, have significant economic and fiscal consequences—for example, on economic growth and government finances. At the same time, the impact is very uneven across individuals and households. An economic assessment therefore also needs to take into account effects on poverty rates and income distribution.

Putting the epidemic into a historical context, Simon Johnson (Assistant Director, IMF Research Department) noted that the spread of infectious diseases has dominated most of human history—at least since the beginning of urbanization. Disease and human societies have essentially coevolved. The good news is that while the past 100 years have been marked by wide-scale outbreaks of influenza, typhus, and malaria, global pandemics have been largely absent, notwithstanding the onset of HIV/AIDS. "You have to go back to cholera in the 19th century for something that was huge, initially misunderstood, and had a really devastating effect on everybody's expectations about their life and whether it was worth making investments in human capital," Johnson said.

"The past 50 years," said Johnson, "have been a wonderful aberration" in the sense that infectious diseases have come under control or even been eliminated thanks to scientific advances, such as the development of miracle drugs and learning how best to administer them. These breakthroughs, he said, have been central to the advancement of human welfare.

Some progress has also been made in fighting HIV/AIDS. As IMF Managing Director Rodrigo de Rato noted, "The World Health Organization's work, supported by steep discounts in the prices of antiretroviral drugs, has provided a road map to an expansion of access to treatment for large numbers of people living with HIV/AIDS in low- and middle-income countries."

How HIV/AIDS affects the macroeconomy

How about the economic ramifications of this epidemic? Shantayanan Devarajan (Chief Economist, South Asian Region, World Bank) saw AIDS as a profound threat to economic development because it cuts off the process of human capital transmission, which is the engine of long-term economic growth. Unlike diseases such as malaria, he explained, AIDS kills primarily young adults and therefore also affects their children. Children of parents afflicted with HIV/AIDS are less likely to go to school or to receive vital nurturing and life skills. Less educated children are then less able to provide for their own children's education—a vicious cycle that will have deeply negative consequences for long-term economic growth.

What can be done to mitigate or moderate the adverse macroeconomic impact? An effectively managed AIDS intervention program, like Botswana's, said Gesami, could significantly moderate the adverse economic effects on the labor force, capital accumulation, and economic growth. As Devarajan underscored, intervention in the form of treatment will also allow parents more time to transmit some of their life skills to their children. However, even for a relatively rich country like Botswana, the cost of implementing such a comprehensive intervention plan would be astronomical and probably not feasible without donor support. Alternative, cheaper intervention programs may be the answer. Gesami urged further research in this area, including closer attention to the experiences of Uganda and Thailand.

Johnson emphasized that "either we collectively and individually deal with HIV/AIDS—and this

means adapting what we've done before—or the disease will have first-order consequences for human development."

Persuasion is also an important element in the battle against HIV/AIDS. Among policymakers, even in countries with high prevalence rates of HIV/AIDS, there is still a tendency, Devarajan said, to think that "it's the health minister's problem." The problem is of such a magnitude that it cannot be resolved by reallocating resources within a budget. Haacker suggested that while increased resources have become available to fight the epidemic, the implications for governments are more far-reaching. Increased mortality erodes governments' human resources, increasing personnel costs and expenditures indirectly related to HIV/AIDS, which add to the fiscal burden.

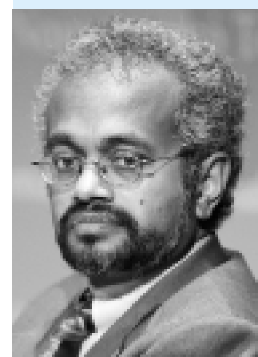
Where the IMF fits in

Turning to the role of international institutions, Johnson called on the IMF to think through carefully the consequences of the catastrophe and to figure out how much can be spent on it without destabilizing economies. In response to a question, Haacker explained that the IMF does not provide direct funding for HIV/AIDS prevention and treatment. However, through its concessional lending under the Poverty Reduction and Growth Facility and debt relief under the Heavily Indebted Poor Countries Initiative, the IMF supports poverty-reducing policies that include measures to fight HIV/AIDS and mitigate its effects.

The IMF's role in the fight against HIV/AIDS has also changed over time, explained de Rato. Initially, IMF staff focused on the adverse social, economic, and fiscal effects of the epidemic, but the emphasis has since been shifted. As national responses to HIV/AIDS in member countries take shape and greater external financing for HIV/AIDS programs creates new challenges for member countries, the IMF is increasingly called upon to assist member countries in managing fiscal or macroeconomic aspects of the response to HIV/AIDS. De Rato underscored the IMF's commitment to work with member governments and donor agencies to ensure that adequate and predictable financing for HIV/AIDS programs is available and that these funds are used in effective and macroeconomically sound ways. ■

The full transcript of the Book Forum is available on the IMF's website at *http://www.imf.org/external/np/exr/BForums/2004/120104.htm.*

Simon Johnson


Shantayanan Devarajan

New book addresses economic and fiscal consequences of HIV/AIDS

The Macroeconomics of HIV/AIDS, the first book published by the IMF on a public health issue, addresses HIV/AIDS as a key economic development issue, and provides a comprehensive resource on the epidemic's multiple economic consequences, as well as the implications for government finance, public services, and key areas of public policy.

The book begins with a chapter by Brynn Epstein (U.S. Bureau of the Census) on the global HIV/AIDS epidemic and its demographic impact. Five chapters focus on the epidemic's economic consequences, starting with a discussion of the impact of HIV/AIDS on the social fabric and the economy by Markus Haacker (IMF). Clive Bell and Hans Gersbach (University of Heidelberg) and Shantayanan Devarajan (World Bank) link the impact on the household level to the accumulation of human capital and highlight the potential long-run consequences for economic growth. Nancy Birdsall and Amar Hamoudi (Center for Global Development) look at the role of human capital in economic growth more generally and providing some empirical evidence linking life expectancy to the demand for education. As the impact of HIV/AIDS is uneven across households, Robert Greener (UNAIDS) concludes that HIV/AIDS can have a substantial effect on poverty or inequality even if the change in GDP per capita is small, especially if poor households are disproportionally affected by the epidemic. Nicholas Crafts (London School of Economics) and Markus Haacker (IMF) argue that most of the welfare effects of HIV/AIDS arise directly from increased mortality, and that they are several times larger than the impacts on income or output.

The final four chapters of the book discuss some of the policy implications of HIV/AIDS. Markus Haacker (IMF) discusses the epidemic's impact on public services and government finance. In an examination of the financial effects of HIV/AIDS on national social protection schemes, Pierre Plamondon, Michael Cichon, and Pascal Annycke (International Labor Organization) project that the cost of health care, sickness, and unemployment benefit schemes may rise. Iyabo Masha (IMF) describes and assesses Botswana's National Strategic Framework on HIV/AIDS, illustrating the potential of a comprehensive national strategy to reverse the macroeconomic damage associated with the epidemic. Finally, Mead Over (World Bank) discusses the impact of HIV/AIDS on the health sector and the challenges facing countries that set out to substantially expand access to HIV/AIDS treatment.

The full text of *The Macroeconomics of HIV/AIDS* is available at *http://www.imf.org/external/pubs/ft/AIDS/eng/index.htm*. Copies of the book are available for $28.00 each from IMF Publication Services. See page 350 for ordering information.

Preferential trading arrangements: Stepping-stones or stumbling blocks?

Economists traditionally view preferential trading arrangements as "second best" to multilateral free trade. Over the past decade, however, these arrangements have proliferated. Are these new agreements likely to promote or thwart increased global integration? Robert Lawrence, professor of international trade and investment at Harvard University, discussed his views with Jacqueline Irving of the IMF Survey.

Lawrence: "We have seen small countries participate effectively in regional trade negotiations with the United States and simultaneously pursue their multilateral interests."

IMF Survey: You wrote in 1997 that it was uncertain whether preferential trading arrangements would make the achievement of full multilateral liberalization more or less likely. Have the intervening years made the relationship between preferential agreements and multilateral liberalization clearer?

Lawrence: We are likely to see progress on multilateral liberalization, although there are some difficulties to resolve. In general, the rise of preferential trading arrangements has not impeded progress toward multilateral liberalization and has not made it less likely that we are going to get an agreement coming out of the Doha Round. With more countries participating in preferential trading arrangements over the past several years, however, this has become an increasingly important question and the answer remains open.

IMF Survey: You emphasize the merits of regional initiatives that have emerged since the 1990s, arguing that many of these are not exclusive arrangements in which insiders increase restrictions on trade with outsiders. Yet Jagdish Bhagwati, writing in 2000, cited evidence that NAFTA [the North American Free Trade Agreement] caused substantial trade diversion when the United States accommodated imports from Mexico by reducing imports from the more efficient nonmember suppliers through anti-dumping measures.

Lawrence: While there has been some trade diversion in the textiles and apparel sector, the more important, general issue is that U.S. imports from all sources have grown rapidly since NAFTA went into effect in 1994. Whatever other effects there may be, they are not overwhelming the dominant impact, which is a liberalization of the U.S. marketplace. Moreover, the United States has since been negotiating more trade agreements, making this, in a sense, a more inclusive outcome that will likely lead to less trade diversion, particularly in the Western Hemisphere. I remain somewhat more optimistic than Jagdish, but I do agree that there is some danger that the proliferation of rules brought about by preferential trading arrangements could make the overall world trading system much more complicated.

IMF Survey: You take a benign view of regional trade arrangements involving developing countries, seeing these initiatives as generally facilitating their members' participation in the world economy rather than their withdrawal from it. Bhagwati, in contrast, has referred to preferential trading arrangements involving developing countries that are "not free from high trade barriers" as "particularly dangerous."

Lawrence: I differ with others in my views on the empirical role of trade diversion. For instance, I simulated a free trade agreement between India and the United States and found that, on balance, the agreement would be welfare enhancing for India, even though India still has quite high trade barriers with the rest of the world. Empirical evidence also shows that countries, once they sign an agreement with the United States, are not stopping there. They are signing with many other trading partners as well, thereby mitigating the trade diversion effects. For instance, Mexico has signed almost 30 free trade agreements. The virtue of a free trade agreement is that countries can mitigate the trade diversion as long as others are willing to sign similar agreements.

IMF Survey: For regional agreements that involve a small, poor country and a larger economy, you argue that the gains—particularly from economies of scale—are likely to be greater for the small country. But how do you respond to those who argue that negotiating regional or bilateral arrangements can be time-consuming and difficult for small, poor countries that already find it difficult to cope with the demands of negotiating multilateral trade negotiations?

Lawrence: We have seen small countries participate effectively in regional trade negotiations with the United States and simultaneously pursue their multilateral interests. For example, the Andean countries—Colombia, Ecuador, Peru, Bolivia, and Chile—as well

as Central American countries have been intensively involved in negotiations with the United States, and these countries played leading roles within the Group of 20 during the WTO [World Trade Organization] meeting in 2003 in Cancún, Mexico. It can be taxing for these small countries, but the more relevant question is: do the benefits from a regional agreement outweigh the costs of the added commitments of intellectual capital? My simulations suggest that they do.

The Doha Round probably will not be able to achieve more than an average 25 percent reduction in developing countries' tariffs. And this might not be binding on many of these countries because their tariffs are actually lower than their bound rates. To understand this probable outcome, one must look at the investments they are required to make and their potential reward. By contrast, for many countries that have the European Union or the United States as their largest trading partner, the value of additional total trade associated with liberalization as part of a regional agreement may well be greater.

IMF Survey: A number of regional and subregional integration initiatives have taken on new momentum on political agendas in sub-Saharan Africa in the past several years. What are their relative merits or disadvantages as a means of seeking deeper regional integration?

Lawrence: There is a great danger—not only in Africa but in many regions undertaking these sorts of initiatives—that the political impetus will not be supported by a willingness to undertake the hard economic actions required to reap the benefits. At the end of the day, the agreements will reach their potential only if they are supported by actions on the ground. In fact, without those actions, the result is likely to be disenchantment and a loss of credibility.

The most successful regional integration agreement in Africa has been the long-lived South African Customs Union, which has had the institutional structure required to support regional integration. In Latin America, Mercosur has had problems, but it has led to increased trade as internal barriers have fallen.

There is a tendency to underestimate the potential for intraregional trade among poor countries. The potential increase may not be large, but it certainly could be greater than at present. It is often the best hope for manufacturers in these countries, who know how to sell in the local marketplace and for whom it is not a great step to move into neighboring markets. One indication of the potential for more trade is the fact that many of these countries maintain barriers against each other—clearly, because domestic firms feel threatened.

IMF Survey: The United States has been negotiating a series of free trade agreements with developing countries. How well would you say these agreements fit the "new regionalism" criterion of "equal rules for developed and developing countries"?

Lawrence: By and large, there is remarkable symmetry. A few sectors in each country have been excluded under the negotiations, although the United States also has not been immune from such exclusions. But once implementation has taken place, there will be no tariff barriers and there will be similar obligations when it comes to standards, regulatory measures, competition policy, and intellectual property rights. These are very good examples of what I characterize as the "new regionalism," indicating a shift away from the idea of special and differential treatment. There is a remarkable difference in many of these countries' negotiating positions at the WTO, where they call strongly for special and differential treatment.

However, I think countries that enter into bilateral or regional negotiations with the United States are taking a risk. The United States has, in a sense, a template to negotiate fairly deep agreements with many countries, and it therefore cannot afford to create exceptions for one or a few that may incite other negotiating partners to line up and ask for similar treatment. If these agreements will help countries transform their domestic institutions in a positive way and are conducive to economic development, then they could be considered good agreements. But countries should not be entering into such agreements that require them to undertake policies that they believe may impede development. ■

But countries should not be entering into . . . agreements that require them to undertake policies that they believe may impede development.
—Robert Lawrence

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
November 29	2.21	2.21	3.40
December 6	2.22	2.22	3.42

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

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Helping Grenada rebound

Grenada suffered a direct hit from Hurricane Ivan on September 7. A Category 3 hurricane with winds of nearly 200 km/hour, Ivan claimed several lives and left a trail of devastation estimated at twice the country's annual income. Approximately 90 percent of the island's houses were damaged or destroyed, and 30 percent of the population was rendered homeless. A wave of international support, including emergency assistance from the IMF, is helping the country recover.

An IMF staff team, visiting Grenada three weeks after the hurricane hit, was shocked by the devastation they saw. "The roofs of most houses had been blown away, complete sections in several others had collapsed, and some homes had been completely flattened," said Rishi Goyal, a member of the team. "Sidewalks and hillsides were littered with twisted galvanized roofing and personal belongings. Most trees had been uprooted, and those that were left standing had been stripped bare by the hurricane. Electricity poles too had been uprooted, while cables dangled dangerously in several places," he added. Most schools, which prior to the hurricane had been designated as storm shelters, were badly damaged.

A hillside in St. George's, Grenada. Approximately 90 percent of the island's homes were damaged or destroyed by Hurricane Ivan.

Grenada is a small island economy in the Caribbean, dependent on tourism and agriculture. Both sectors were hit hard. Many hotels will miss the high season this year and will have to undertake intensive rebuilding to open in time for the next season. Also worrisome is the impact of the storm on the production of nutmeg, which had been a lucrative industry and the basis for Grenada's claim as the "Isle of Spice." Most of the island's nutmeg trees were destroyed and will require a lengthy period of replanting.

To assist Grenada, the international community rallied to provide both short-term relief and longer-term reconstruction assistance. Owing to the relief efforts, the basic infrastructure of the country is now well on its way to being restored. A massive cleanup of the debris has taken place, schools have been reopened, and electricity is being restored.

Support from the international community has also enabled the government to meet its obligations for this year, such as wages to public sector employees. The government was able to do so thanks, in part, to two successful donor conferences organized with the involvement of the World Bank and the IMF. The first donor conference was held in Washington, D.C., on October 4. Ratna Sahay, Assistant Director of the IMF's Western Hemisphere Department, had just returned from Grenada. She detailed the country's extensive devastation and appealed for budgetary support to fill the government's estimated financing gaps of almost 10 percent of GDP in 2004 and 2005.

By the time of the second conference, held in Grenada on November 19, pledged support from donors had completely filled the financing gap for this year and narrowed the gap for next year to under 2 percent of GDP. Nevertheless, financing gaps remain large in the medium term, and disbursement of donor pledges remains key. The IMF's Executive Board has approved $4.4 million for Grenada under the IMF's emergency assistance policy for natural disasters. The money approved is available immediately to help meet the country's needs.

While the situation in Grenada is much better than had been feared in the immediate aftermath of Hurricane Ivan, the country remains extremely vulnerable to adverse economic developments. A major reason for this vulnerability is the country's high public debt-to-GDP ratio. Already high before the hurricane struck, this ratio now stands at 120 percent. How to reduce it to safer levels is one of the main economic policy challenges facing the country. ■

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