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G7 ministers call on world's oil producers to provide adequate supplies

Amid rising concern about the impact that sharply higher oil prices could have on the global economy, the Group of Seven (G7) finance ministers met in New York on May 23. They commended recent announcements by some oil-producing countries that they would boost production and called on “all oil producers to provide adequate supplies to ensure that world oil prices return to levels consistent with lasting global economic prosperity and stability, in particular for the poorest developing countries.”

Although the main purpose of the meeting was to agree on the agenda for the annual economic summit



U.S. Secretary of the Treasury John Snow (left) and U.K. Chancellor of the Exchequer Gordon Brown confer at the G7's New York meeting.

bringing together the leaders of the G7 member countries and Russia in June in Sea Island, Georgia (United States), the ministers made use of the occasion to urge progress on various issues. These included removing the remaining impediments to cross-border remittance flows, which support individuals and finance small businesses in developing countries, and concluding

the Doha round of multilateral trade talks as soon as possible. The ministers also pledged to bring forward proposals that would “top up” debt relief “where appropriate” under the Heavily Indebted Poor

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IMF research conference honors Guillermo Calvo

On April 15–16, 2004, the IMF's Research Department organized a two-day conference in honor of Guillermo Calvo—one of the most influential macroeconomists of the past 25 years. As a senior advisor in the IMF's Research Department from 1988 to 1994, Calvo made important contributions to the internal discussion and formulation of IMF policies, particularly in Latin America and the transition economies of Eastern Europe, and the former Soviet Union.

The conference brought together renowned academics and policymakers who have been associated with Calvo during his illustrious career. Some of Calvo's former colleagues at Columbia University—where he began his academic career in the early 1970s—gave fascinating behind-the-scenes accounts of Calvo's early professional blossoming.

Delivering the opening remarks, Agustín Carstens (IMF Deputy Managing Director) struck a theme that resonated throughout the conference. He said,

“Guillermo's ability to reduce complex problems to their essential elements has taught us that complex models are for lesser minds—for those who cannot grasp the essential elements out of a given reality. In Guillermo's hands, the chaos of reality has always yielded simple and illuminating models.”

Calvo played a particularly crucial role, noted Andres Velasco (Harvard University), in bringing policy issues relevant to Latin America to the forefront of academic discussion. As Velasco put it, “[if] there is one person responsible for bringing modern economics to bear on the problems of the nations south of the Río Bravo, that person is Guillermo Calvo. He brought rigor and discipline to the business. He also made it intellectually respectable.”

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Guillermo Calvo

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G7 commends recent IMF reforms

(Continued from front page) Countries (HIPC) Initiative, and announced their commitment to full implementation of the initiative.

The G7 finance ministers also discussed their strategic review of the World Bank and the IMF, concluding that they were “gratified by the positive response” received so far. Commending recent reforms—including limits on exceptional access, enhanced surveillance, streamlined conditionality, collective action clauses, grants, and measurable results management—the ministers said they intend to continue to engage with the IMF and the World Bank and

their shareholders on how best to broaden reforms based on “principles of accountability and good governance, transparency, clarity of objectives and responsibility, and effective working with markets.”

Describing entrepreneurship as essential for development, ministers asked the World Bank and the regional development banks to scale up their financial and technical assistance programs designed to support small businesses. They also urged the multilateral development banks to work with bilateral donors and developing countries to remove legal and regulatory obstacles to investment. ■

Wide-ranging impact of Calvo’s work highlighted

(Continued from front page)

Monetary and exchange rate policy

Is inflation targeting suitable for developing countries? One of Calvo’s concerns with such a framework is that giving too much discretion to policymakers in a weak institutional environment could lead to poor macroeconomic outcomes. Frederic Mishkin (Columbia University) acknowledged that emerging market countries often have weak fiscal, financial, and monetary institutions; exhibit varying degrees of currency substitution and liability dollarization; and are vulnerable to sudden stops in capital flows and terms of trade shocks. But he argued that inflation targeting could still serve emerging market countries well, provided they put due emphasis on strengthening institutions and on finding ways to deal with large exchange rate fluctuations.

Presenting a paper coauthored with Ariel Burstein and Martin Eichenbaum, Sergio Rebelo (Northwestern University) focused on the effect of large devaluations on real exchange rates in emerging markets. They found that when measured “at the dock,” prices of tradable goods basically rise in the same proportion as the nominal exchange rate. This is critical because, when measured at the retail level, tradable goods prices include distribution costs, which are nontradable and respond very little to large devaluations. Rebelo concluded that the real depreciation of the domestic currency is not due to the failure of the law of one price for tradable goods but rather to the small response of nontradable goods prices.

To fix or to float?

Should an open economy peg its currency to a strong world currency, or let the currency float? The stan-

dard response, based on the Mundell-Fleming model, is that the exchange rate arrangement should depend on the type of shock hitting the economy. If shocks are predominantly real in origin, flexible exchange rates are optimal because they allow a quicker adjustment of relative prices through changes in the nominal exchange rate. If shocks are predominantly monetary, however, then fixed (or predetermined) exchange rates are preferable, because adjustments to the nominal money supply are automatically carried out by the central bank. As Calvo has put it, this is a result that “every well-trained economist carries on the tip of [his/her] tongue.” Two conference papers dealt with challenges to this basic tenet.

Maurice Obstfeld (University of California at Berkeley) took issue with a recent finding by Michael Devereux and Charles Engel that holds that even if an economy is hit by real shocks, fixed exchange rates may be preferable if the nominal prices of both exports and imports are pre-set in the domestic currency. Obstfeld argued that if nontradable goods are added to the model, then flexible rates become optimal again because the nominal interest is freed to serve as a monetary stabilization instrument.

In presenting his paper with Rajesh Singh and Carlos A. Végh, Amartya Lahiri (New York Federal Reserve) had a very different angle on the problem. Arguing that asset market imperfections are likely to be as important as, if not more important than, goods market frictions in developing countries, he described a model of flexible prices, in which some economic agents do not have access to capital markets. In such a world, the standard results are turned on their head: flexible rates become optimal if monetary shocks dominate, while fixed rates are preferable if real shocks



Frederic Mishkin



Sergio Rebelo

dominate. Ultimately, the choice of exchange rate regime should depend not only on the type of shock (real versus monetary) but also on the type of friction (goods market versus asset market).

What do the data say?

In spite of much research on the effects of different exchange rate regimes, the empirical evidence is far from conclusive, to say the least. Two conference papers provided important insights into this topic. In his paper with Igal Magendzo, Sebastian Edwards (University of California at Los Angeles) studied countries that either were fully dollarized (like Panama) or are part of an independent currency union (like the Eastern Caribbean Currency Union). He found that both categories of countries had lower inflation than countries that have a domestic currency. In addition, dollarized countries had lower growth and higher volatility than countries that have their own currency. Currency unions, in contrast, had higher volatility but higher growth.

Assaf Razin (Cornell University and Tel Aviv University), based on joint work with Yona Rubenstein, argued that to disentangle the effects of exchange rate regimes on growth, one had to control for the possible growth effects of the probability of a crisis. After doing so, Razin showed empirical evidence that indicates that the switch from a float to a peg is conducive to higher growth. In the data, however, the overall effect on growth from such a switch may be offset by the larger probability of a crisis under a peg.

Crises, contagion, and pessimism

Ever since Mexico's December 1994 crisis, Calvo has led the way in analyzing the causes and implications of financial crises. In her paper with Pritha Mitra, Padma Desai (Columbia University) inquired into why some countries recover more readily than others from financial crises. They found that export performance before a crisis appears to be a critical variable in predicting the speed of recovery. Through investor expectations, export performance explains most of the difference in postcrisis interest rate and exchange rate movements between two countries. In contrast, fiscal position and national saving do not seem to matter as much.

Graciela Kaminsky (George Washington University), presenting joint work with Carmen Reinhart, analyzed how financial turbulence in emerging market countries can spread across borders and concluded that it spreads globally only if it affects some major financial centers; otherwise, its effect is, at most, regional. For example, during the Asian crisis, Japanese banks' exposure to Thailand—and their subsequent

curtailment of lending to other Asian countries—played a critical role in spreading the crisis.

Velasco, in joint work with Alejandro Neut, illustrated how changes in asset prices resulting from changes in sentiment rather than fundamentals can be self-validating. Imagine, he said, that stock market prices fall. If investment is subject to collateral constraints, this decline reduces the value of firms and, hence, investment. But lower investment implies smaller returns in the future, which, in turn, reduces stock market prices and thus validates the initial fall. Hence, Velasco argued, bouts of pessimism can be self-fulfilling—a scary thought indeed.

Optimal taxation

Another field in which Guillermo Calvo made important contributions is optimal taxation. In particular, in joint work with Pablo Guidotti, he showed that, under certain conditions, unanticipated increases in government spending are optimally financed with unanticipated inflation. Michael Kumhof (IMF) tackled this issue in the context of how to finance a fiscal crisis optimally. In his model, unanticipated inflation is socially costly because it reduces financial intermediation. Kumhof concluded that a heavy reliance on inflation is optimal only if the fiscal shock is transitory; more permanent shocks are optimally financed mostly through distortionary taxes.

Enrique Mendoza (University of Maryland), in joint work with Linda Tesar, focused on the tax implications of European financial integration, which has led to a situation of harmonized indirect taxes but markedly different factor taxes. In particular, the prediction of a “race to the bottom” in capital taxes did not materialize. Mendoza argued that when countries compete over capital tax rates by adjusting labor taxes to maintain fiscal solvency, there is, in fact, no race to the bottom, and factor tax rates predicted by the model roughly match the observed ones.

Economies in transition

During his tenure at the IMF, Calvo worked extensively on the transition process from planned to market economies. Some of this work—jointly produced with Fabrizio Coricelli (University of Siena)—emphasized the possible role of a credit crunch in explaining the output collapse at the beginning of the transition period. In joint work with Igor Masten, Coricelli revisited this issue in the context of the macroeconomic performance of central European countries preparing to join the European Union (EU). He concluded that the relative underdevelopment of credit markets in these countries is partly responsible for low output growth and high volatility.



Sebastian Edwards



Graciela Kaminsky



Fabrizio Coricelli



Stanley Fischer

EU membership will allow these economies to further build their financial systems.

Stanley Fischer (Citigroup and former IMF First Deputy Managing Director), in a paper he presented jointly with Ratna Sahay (IMF), examined the role of institutions and initial conditions in the transition process. In particular, Fischer rejected the charge that international financial organizations—and main-stream economists—paid inadequate attention to institution building. Institution building was taking place alongside macroeconomic stabilization policies, he said, and the econometric evidence suggests that institution building did, indeed, contribute to growth.

Political economy and end games

Based on joint work with Peter Isard, Allan Drazen (University of Maryland and Tel Aviv University) argued that an often-cited reason that IMF programs go off track is a lack of so-called program ownership, which loosely refers to a country's lack of commitment to a given set of reforms and stabilization policies specified in an IMF program, independent of incentives provided by multilateral organizations. Drazen provided a theoretical framework for the role of public discussion in building and demonstrating ownership, which, in turn, points to various directions in which IMF program design can be strengthened.

Finally, Michael Dooley (University of California at Santa Cruz) presented a model (based on joint work with David Folkerts-Landau and Peter Garber) to explain the current Chinese policy of keeping the

domestic currency undervalued in real terms. In Dooley's view, this policy's objective is to gradually absorb an unproductive labor force of around 200 million. Foreigners may be willing to bear the costs of this "beggar thy neighbor" policy in exchange for some form of access to markets. The end game would have the Chinese real wage converge to the world real wage once the excess labor has been absorbed. At that point, China will presumably be able to compete in world markets at the prevailing world real wage.

In a closing panel discussion chaired by Raghuram Rajan (Director of the IMF's Research Department), Guillermo Perry (World Bank Chief Economist for Latin America) and Ricardo Hausmann (Harvard University) commended Calvo and his coauthors for their efforts to explain the difficulties emerging market countries face in carrying out appropriate fiscal and monetary policies when they are confronted with problems of time inconsistency, sudden reversals in capital flows, and a fear of letting exchange rates float. Calvo himself had the last word, remarking on the strength and influence that participants at this conference had in giving substance and serious underpinnings to critical policy discussions in Latin American and elsewhere, which often translated into actual policy decisions. ■



Guillermo Perry

Papers presented at the conference are available at <http://www.imf.org/external/np/res/seminars/2004/calvo/index.htm>.

Available on the web (www.imf.org)

Press Releases

- 04/96: IMF to Establish Middle East Regional Technical Assistance Center in Lebanon, May 17 (see page 162)
- 04/97: Statement of the IMF Mission in Dominica, May 17
- 04/98: Joint Statement by IMF and Lebanese Ministry of Finance on Regional Conference on Fiscal Reforms in the Arab Countries, May 19
- 04/99: IMF Extends Ecuador's Stand-By Arrangement Repayment Expectation Dates, May 19

Public Information Notices

- 04/55: IMF Concludes 2004 Article IV Consultation with the Union of the Comoros, May 14
- 04/56: IMF Concludes 2004 Article IV Consultation with Barbados, May 14
- 04/57: IMF Concludes 2004 Article IV Consultation with the Republic of Belarus, May 19
- 04/58: IMF Concludes 2003 Article IV Consultation with The Gambia, May 18

Speeches

- Address by Anne O. Krueger, IMF Acting Managing Director, World Trade Organization General Council, Geneva, May 18
- "Willful Ignorance: The Struggle to Convince the Free Trade Skeptics," Anne O. Krueger, IMF Acting Managing Director, Graduate Institute of International Studies, Geneva, May 18
- Opening Remarks by Agustín Carstens, IMF Deputy Managing Director, Conference on Fiscal Reforms in the Arab Countries and the Near East, Beirut, May 18

Transcripts

- "Adopting the Euro in the New Member States: The Next Step in European Integration," IMF Economic Forum, May 4 (see page 162)
- Press Conference by Anne Krueger, IMF Acting Managing Director, May 6
- "Can Central Banks Be Outsourced? Issues in Money & Sovereignty," IMF Book Forum, May 11
- Press Briefing by Rodrigo Rato, IMF Managing Director Designate, May 11

Competitors will have to adjust as China continues to grow

Over the past 20 years, China has emerged from near isolation to become the world's sixth largest economy and fourth largest trader. Its economic importance is likely to increase further as it becomes even more integrated with the world economy. For the April 2004 *World Economic Outlook (WEO)*, IMF staff analyzed how these developments will affect both the world as a whole and individual economies. They found that China's integration with the rest of the world is likely to have a relatively limited and largely beneficial effect, but that individual countries should respond to increased competition by increasing the flexibility of their economies through structural reforms. Nikola Spatafora of the IMF's Research Department provides more details.

Over the past two decades, China's role in the global economy has increased sharply. Its GDP has grown at an average annual rate of over 9 percent, and its share of world trade has risen from less than 1 percent to 5 percent (see Chart 1). China's economic weight in, and integration with, the world economy are likely to increase further as structural reforms are implemented in key areas (see box, page 154). The *WEO* team researched the likely effect of these developments on different countries, sectors, and socioeconomic groups. It focused on three key questions:

- How does China compare with other countries that have also experienced rapid growth and integration?
- How will developments in China affect the rest of the world in the years to come?
- How should individual countries respond to increased competition from China?

China in a historical perspective

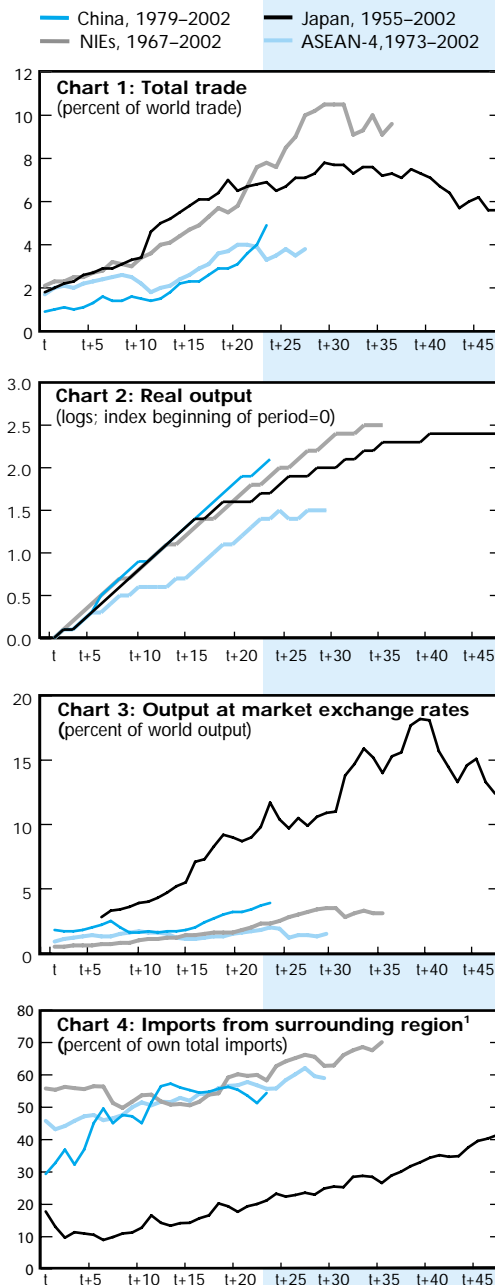
China's growth experience does not differ fundamentally from the postwar experience of Japan, the newly industrialized economies (NIEs)—a group that includes Hong Kong SAR, Singapore, and Taiwan Province of China—and the ASEAN-4, which comprises Indonesia, Malaysia, the Philippines, and Thailand. China's rate of output growth is not unprecedented (see Chart 2), and while its share of world GDP has been rising, it is still significantly below Japan's, and not much above that of the NIEs or the ASEAN-4 at corresponding phases of their development (see Chart 3). China's exports and imports and inflows of foreign direct investment reveal a similar pattern (see Chart 4).

That said, the past is not necessarily a reliable guide to the future. There are good reasons to think that

China will continue to grow rapidly and that it will eventually play a much larger role in the global economy than any of the countries mentioned above. First, China has consistently had a high saving rate (see Chart 5). Even if it were to decline somewhat due to demographic change, China would still be able to maintain high levels of investment over the medium term (see Chart 6). Second, human capital (as measured, for instance, by literacy rates) remains relatively low and can also be expected to improve further (see Chart 7). Third, economic growth has been driven to a large extent by the reallocation of labor from agriculture to the more productive urban industrial sector, and this process still has far to go (see Chart 8). China's GDP per capita—at about \$1,060—is still only a fraction of the levels in Japan, the NIEs, and even most of the ASEAN-4. As convergence continues, China's GDP per capita is likely to catch up with many of these countries.

China and the world

How will China's continued growth affect the rest of the world? The effects are likely to be mostly positive, taking place through a number of channels. For instance, rising Chinese imports are currently yielding huge benefits to commodity producers, while lower Chinese export prices are benefiting consumers all over the world. More generally, China's growth will have dynamic effects on investment and productivity elsewhere that, while difficult to quantify, could be substantial.



¹The surrounding region is defined as China, Japan, the NIEs, and ASEAN-4.

Note: *t* denotes the year when integration starts: 1955 for Japan, 1967 for NIEs, 1973 for ASEAN-4, and 1979 for China.

Data: IMF, *Direction of Trade Statistics*; and IMF staff calculations

Yet there is significant concern in many countries about the potential weakening of their manufacturing bases in the face of increasing Chinese competition. To examine these concerns, the *WEO* research team

used a global trade model to assess the effect of continued Chinese growth until 2020—including the effect of absorbing the country’s surplus agricultural labor (currently estimated at about 150 million) into the global workforce.

The *WEO* team found that, not surprisingly, China itself stands to gain the most from its rapid growth and continued integration. And while individual sectors could suffer significant losses, the losses will typically be offset by gains in other sectors. In particular, advanced economies will benefit from cheaper labor-intensive imports as well as greater demand for skill-intensive goods and services. Other developing countries will see increased opportunities for exporting both primary commodities and manufactures (including for reprocessing and re-export) to China. And while increased Chinese competition will require workers to become more mobile, the mobility required to respond to other world-wide developments (such as continued trade liberalization) between 2002 and 2020 will be far greater.

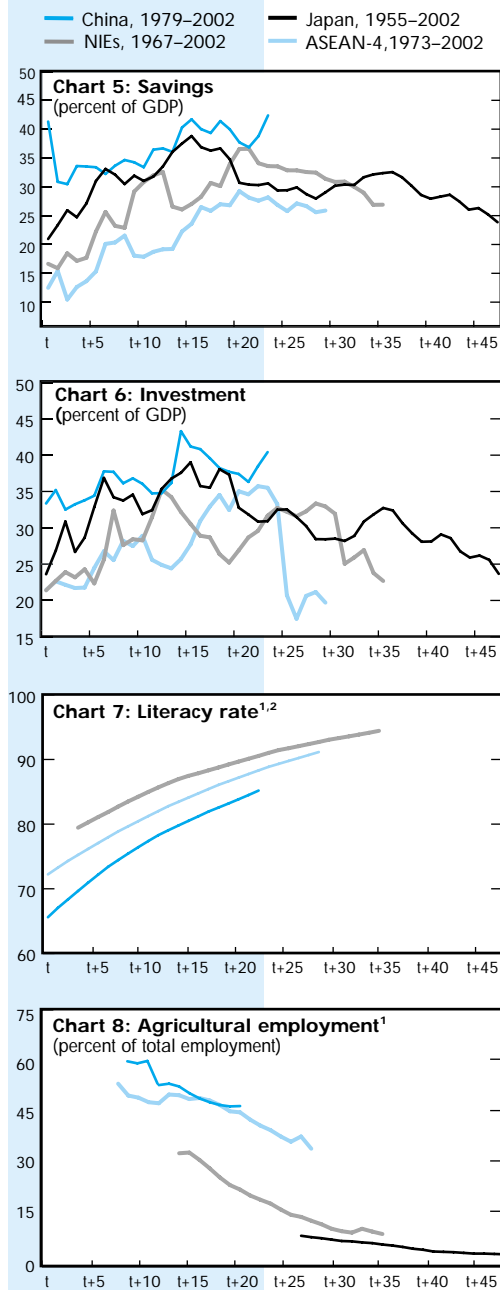
How should other countries respond?

That’s not to say that countries will not be affected by China’s continued growth.

First, countries such as Bangladesh that compete closely with China in labor-intensive manufactures may suffer losses unless they display considerable flexibility. Second, adjusting to the competition from China could reduce the wages of unskilled workers,

thereby further exacerbating income disparities in developing countries. Third, the analysis assumes that adjustment to China’s new place in the world economy will take place gradually and will not be accompanied by similar developments elsewhere, notably in India. If either of these conditions were to be proved false, the impact on other countries would be correspondingly larger.

All this suggests that while China’s emergence should not be feared, countries will need to increase the flexibility of their economies through structural reforms. As resources move to more productive areas, problems may arise, particularly for low-skilled workers. Countries can minimize such problems by speeding up their own reforms and integration with the global economy. In particular, developing countries will need to ease impediments that hinder the absorption and mobility of low-skilled workers, as well as increase investment in training them and upgrading their skills. Their efforts could be helped significantly by accelerated multilateral trade liberalization, such as reductions in trade barriers currently being negotiated under the Doha round. ■



¹Values end in 2000, and data for agricultural employment for the NIEs consists only of Korea.
²There are no data for Japan.
 Note: *t* denotes the year when integration starts: 1955 for Japan, 1967 for NIEs, 1973 for ASEAN-4, and 1979 for China.
 Data: World Bank, *World Development Indicators*; and IMF staff calculations

Restructuring China’s banks

Restructuring the mainly state-owned banking sector will be of critical importance to China’s continued economic growth, IMF Deputy Managing Director Takatoshi Kato told the Beijing International Finance Forum on May 19.

China has already improved bank supervision and disposed of many nonperforming loans, and the December 2003 announcement that the Bank of China and China Construction Bank would be recapitalized represents another important step. But much more remains to be done, Kato noted. Given the magnitude of the needed reforms, it will be some time before the financial system is fully strengthened. Until then, maintaining China’s steady and gradual approach to capital account liberalization is appropriate, he said, adding that the Asian financial crisis in 1997–98 had demonstrated that a premature liberalization of capital controls can expose financial systems to substantial risk.

The existence of capital controls should not be a reason to delay movement toward greater exchange rate flexibility. A more flexible exchange rate would help shield the money supply from international influences, moderate the effect of economic shocks, and help the economy adjust to structural change, Kato said. “Increased exchange rate flexibility can be pursued while capital controls are maintained and the banking system gradually strengthened before the capital account is opened.”

The full text of Kato’s speech is available at www.imf.org.

Financial Markets and Development Conference

Should state-owned financial institutions be privatized or reformed?

What does the future hold for state-owned financial institutions? Some urge privatization; others suggest that the wiser, more realistic course is improving their management and supervision. Neither side won the day at the 6th Annual Financial Markets and Development Conference in Washington, D.C., April 26–27, but both sides used the event—jointly sponsored by the IMF, the World Bank, and the Brookings Institution—to wrestle with the substantial challenges associated with state-owned financial institutions, review recent research and country experiences, and weigh future options.

In many countries, the state has a major presence in the financial sector. This is particularly so in banking, where, despite several privatization initiatives over the past decade, public sector banks still account for an estimated 40 percent of total banking sector assets. State intervention also extends, albeit to a lesser degree, to insurance schemes and investment funds. And, though it is often more prominent in the developing world, state intervention can also play an important role in the developed world, taking various forms of intervention from explicit (banking in Germany) to implicit (government-sponsored enterprises in the United States).

Why does the state intervene?

Supporters cite a number of rationales for state intervention—notably, information failures, economic disequilibrium, failure of competition, incomplete markets, and the need to redistribute resources according to a social agenda. Detractors insist there are wide-ranging downsides, including distortions in credit allocation, thwarted competitive forces, limited supervisory effectiveness, and clouded budgetary processes. All of which, they argue, lead to frequent recapitalization and increased scope for patronage and corruption.

What seems clear, despite a growing emphasis on private ownership of financial institutions in recent years—especially in Europe and Latin America—is that the state is likely to remain a dominant player in the financial sector for some time to come.

If this is the case, the conference suggested, there is value both in examining the role these institutions play (and how their supervision and governance can be strengthened) and in evaluating experiences with privatization. Not surprisingly, banks remained at center stage, and practices in developing countries

received the bulk of attention. One clear view that emerged was that whether bank or nonbank, an institution that represented a contingent liability to the state required effective governance and supervision, though the form of this supervision would need to be shaped by the specific context.

Bolstering supervision and governance

What do we know about supervisory practices? David Marston (IMF) reported on a survey of practices in 22 countries that covered, among a wide range of operations, commercial and development banks, insurance companies, and investment funds. The varied landscape raised questions, however, as to the appropriate regulatory paradigm for these institutions, given that they encompass banks and non-banks, finance and refinance institutions, and for-profit and nonprofit institutions.

In his examination of the performance of state-owned banks, James Hanson (World Bank) suggested that even the best-intentioned governments face a problem of multiple objectives, and measures such as recapitalization and modernization often do not work because providing the right incentives—not just addressing costs—is the central issue. But, if the idea is to run a public sector bank like a private bank, why not simply privatize and reap the gains that privatization has to offer? Hanson added, however, that privatization seems to work best when it involves a sale to a strategic foreign investor.

Where privatization is not an immediate option, management and supervision of these institutions should be improved. Richard Hemming (IMF) noted, for example, that where directed credit and subsidized lending cannot be avoided, banks should be subject to best practice treatment consisting of disclosure, a transparent process of parliamentary approval, and provisioning for costs in the government budget.

Clearly, inadequate fiscal transparency and supervision hold significant dangers. As Nicholas Lardy (Institute for International Economics) estimated in an analysis of the economic implications of the continuing dominant role of the government in China's allocation of capital, as much as 90 percent of the country's currently reported nonperforming loans should be considered contingent liabilities of the government. China may also face a new wave of nonperforming loans in the next few

years following rapid credit growth since 2002; this could have an adverse effect on long-term fiscal sustainability, he said.

Greg Wilson (McKinsey & Company) underscored the importance of establishing sound corporate governance to protect taxpayers' interests. If these banks cannot be privatized, he argued, their objectives need to be spelled out in transparent priorities and specific targets; political insulation needs to be ensured; and accountability should be achieved through the kind of full disclosure to which listed companies are subject. This may require, he acknowledged, new standards and skills for risk management, governance, productivity, and performance.

Formal supervision could help mitigate both fiscal and reputational risk. Jonathan Fiechter (IMF) proposed 10 core guidelines that stressed, among other aspects, a clear mandate, authority and independence, adequate resources, and minimum capital requirements. These guidelines have universal applicability, argued Patrick Lawler, Chief Economist of the Office of Federal Housing Enterprise Oversight, which supervises the two giant U.S. government-sponsored enterprises—the Federal National Mortgage Association (“Fannie Mae”) and the Federal Home Loan Mortgage Corporation (“Freddie Mac”). These government-sponsored enterprises, he said, face issues similar to those that state-owned institutions face, in that perceived implicit state guarantees render market discipline ineffective. These enterprises also lack the advantage of being able to gain from adopting industry best practice (they *are* the industry) and see their risks aggravated by a lack of diversification and an absence of checks on their growth.

Senior country officials complemented analyses with firsthand experiences of their own. Shuangning Tang (China's Banking Regulatory Commission) outlined the 10 guidelines his country is using to improve corporate governance in the state-owned banks. They stress clear governance structures, strategic investors, clear priorities, sound decision making, appropriate human resources management, prudent accounting, secure information technology systems, and gradual restructuring.

A case study of Indonesia's experience by P.S. Srinivas (World Bank) indicated that the postcrisis restructuring process there actually increased the role of state-owned banks, which now account for 46 percent of all bank assets. And while full privatization is the long-term goal, the authorities are placing greater emphasis for the medium term on improved governance, greater shareholder and board oversight, and more effective supervision. Arminio Fraga (former governor of Brazil's central bank) seconded the

importance of effective and independent supervision but expressed skepticism about the role of state-owned banks in middle-income countries.

Privatization experiences and techniques

Is there a foolproof recipe for privatization? Perhaps not, but country experiences suggested that some methods had greater success than others. Ishrat Husain (Governor, State Bank of Pakistan) shared his country's experiences in lowering the state share of the banking system assets from 92 percent in 1990 to around 19 percent in 2004. He urged that elaborate and comprehensive restructuring be undertaken in preparing a bank for privatization. Louis A. Kasekende (former governor, Central Bank of Uganda) also suggested that if the size of the bank is substantial, then politics should be taken into consideration. He differed with Husain, however, on the need to prepare a bank for sale. He urged that banks be sold “as is” whenever possible.

A World Bank study reinforced many of the lessons from country experiences with privatization, finding that continued ownership by the state, even when it is a minority shareholder, harms performance and that, in weak institutional environments, public share offerings produce worse results or lower prices than direct sales to strategic investors. Further, prohibiting foreign participation in privatization reduces the gains from both these processes. The study also suggests that privatization improves performance even in weak regulatory environments, though the gains are reduced.

Speakers from the private sector also offered their experiences with various ownership and partnership arrangements. David Binns and Ron Gilbert (consultants) argued, on the basis of five case studies, that a carefully designed employee stock ownership plan can facilitate capital formation. These strategies can fail, however, in the absence of appropriate regulatory guidelines and management checks and balances, or in the face of economic reversals.

In the view of Herman Mulder (ABN AMRO Bank NV), bank ownership was not an issue as long as a bank was run by independent professionals, had good risk management systems in place, and priced its risk accordingly. Besides, he observed, private sector banks can suffer from the same maladies as state-owned banks, including preferential lending and corruption. Could twinning help? Under this arrangement, a foreign bank agrees to transfer knowledge to a local bank for a fee, mainly through assignment of its own personnel for a specified period. William Nichol (Deutsche Bank AG) recounted his bank's experience with twinning in Asia, noting that twinning is also



Jonathan Fiechter



Patrick Lawler



Ishrat Husain

being motivated by regulatory changes, such as Basel II, and foreign competition, which are driving local banks to seek quick means to improve their risk management systems. But Nichol found very few providers of such services and low economic incentives. Many potential foreign providers preferred to buy stakes in local banks.

As for initial public offerings (IPOs), Fred Huibers (ING Barings) mentioned that 44 percent of emerging

economy bank privatizations occur this way. The advantage of the IPO route is that such issues, which are normally large, stimulate stock market capitalization and trading, lower the cost to equity, and attract further investments. The wider share ownership also serves as insurance against later renationalization. ■

Aditya Narain

IMF Monetary and Financial Systems Department

Recent publications

IMF Working Papers (\$15.00)

- 04/66: "Prudential Responses to De Facto Dollarization," Alain Ize and Andrew Powell
- 04/67: "New Estimates of Government Net Capital Stocks for 22 OECD Countries 1960–2001," Christophe Kamps
- 04/68: "A Bayesian Approach to Model Uncertainty," Charalambos Tsangaridis
- 04/69: "Estimation of Economic Growth in France Using Business Survey Data," Alain Kabundi
- 04/70: "Credit Rationing in Emerging Economies' Access to Global Capital Markets," Edda Zoli
- 04/71: "Emerging Strains in GCC Labor Markets," Ugo Fasano and Rishi Goyal
- 04/72: "Are Uniform Tariffs Optimal?" Mary Amiti
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PRSP=Poverty Reduction Strategy Paper

PRGF=Poverty Reduction and Growth Facility

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Northern Pacific islands look for new growth strategies in a globalizing world

The past decade was a disappointing one for Pacific island countries. As globalization intensified, the region's population growth outpaced economic growth and the private sector created few jobs. Clearly, "business as usual" offered no prescription for the future. In early April, senior government officials and private sector representatives from Kiribati, the Republic of the Marshall Islands, the Federated States of Micronesia, the Republic of

Palau, and Tuvalu joined researchers and officials of multilateral and bilateral donors for a high-level seminar—"Seizing Opportunities for Growth in a Globalizing World"—in Palau. The seminar—co-hosted by the IMF, the Asian Development Bank, the World Bank, and the Japan International Cooperation Agency—explored the challenges facing these island economies as they seek their own path to sustainable growth and development.

Weak growth, rapidly rising populations, growing fiscal pressures, and increasing demands for investments in infrastructure, education, and health care services continue to pose major challenges for many Pacific island economies. Add to this a limited ability to capture the opportunities from new technologies and globalization, and significant constraints in

the areas of policy and institutions—especially weaknesses of economic and social institutions—and the picture for the region is a gloomy one.

One of the major challenges for the northern Pacific islands, government officials and donor representatives agreed, will be to achieve sustainable growth with diminishing resources from external assistance. In fact, as participants acknowledged, the easier availability of external assistance had translated into a lack of reforms in domestic taxation

systems and high, but not necessarily efficient, public expenditure. The northern Pacific island countries have some of the highest wage bills in the region, and human development indicators tend to indicate low levels of efficiency despite very high per capita public spending on health and education.

Acknowledging these issues, Luc Leruth (Pacific Financial Technical Assistance Center) drew parallels between dependency on external assistance and on oil. Wealth of this type, he noted, often encourages complacency and provides disincentives to sound management. In his view, the region needs to take steps to strengthen its institutions, improve governance, and increase the efficiency with which resources are used. While recognizing the constraints on what can be achieved in the short run, he suggested a policy agenda that highlighted the right fiscal priorities and developed realistic sequencing.

Fostering private sector development

The area's private sector has not yet been able to take the lead in boosting economic growth—one reason why growth in the Pacific is falling behind other developing regions. High wage rates, high communications and transportation costs, difficulties in gaining long-term access to land for investment and commercial use, and small domestic markets remain major impediments to private sector development in an area where there are few industries other than agriculture, fisheries, and tourism. A smaller and more efficient public sector is necessary for private sector development, but several participants suggested that greater use of public-private partnerships could also play a vital role.

One innovative approach was offered by Hiroshi Tsukamoto (Japan External Trade Organization), who touted Japan's "one-village, one-product" initiative, which sought to encourage local people to be more creative and take leadership in commercial activities. The program, which encourages local participation in identifying and developing niche products, elicited a strong response from many participants, who suggested the possibility of a "one-island, one-product" initiative for the Pacific.

As Manjula Luthria (World Bank) explained, however, economic growth will require job creation. And the path to more jobs, she said, lies in promoting education and boosting private sector

Elbuchel Sadang,
Minister of Finance,
Palau.



Maatia Toafa,
Deputy Prime
Minister, Tuvalu.

growth. Allowing labor access to more developed markets in the region could both increase job opportunities and stimulate overseas remittances, which could, in turn, stimulate private sector development in the very small island states.

Financing for the private sector

Some cautioned, however, that private enterprises are looking for handouts, when they—and financial institutions—should be investing in globally competitive enterprises. For many participants, the principal question was how to strengthen financing for the private sector. While there are no easy practical solutions, all agreed that resolving the land tenure issue—a common constraint in many Pacific islands—was a priority. Allowing the use of land as collateral for loans would help to reorient commercial bank lending toward the private commercial sector. In addition, Hiroto Arakawa (Japan Bank for International Cooperation) highlighted several other financing options, notably two-step loans (onlending to final borrowers through development finance institutions within the recipient country) and micro-finance. The major challenge for these small island economies, however, remains how to develop projects of a scale large enough to be eligible for such financing.

Rapid population growth and urbanization, and increasing dependency on imported goods, have also created a problem more typical of highly developed economies—that is, what to do with a rising volume of solid wastes. Coupled with limited land space, inefficient waste management is threatening environmental sustainability. Shiro Amno (Japan International Cooperation Agency) argued that the key to effective waste management will lie in government-provided resources, appropriate technology, capacity building, and action by the community.

Way forward

Although the Pacific island countries may differ from other developing countries—in terms of their small land masses, geographical isolation, and limited natural resources and institutional capacity—a “one size fits all” development strategy is inappropriate for the region. However, participants agreed that it was equally wrong to argue that “no size fits me.” Each country should be able to formulate a strategy for sustainable growth and development that takes account of its unique circumstances.

The discussions clearly yielded a sense that greater participation by governments, businesses,

and other stakeholders in designing and implementing development projects was indispensable. And donors could play a greater role in fostering closer public-private partnerships and could lend valuable assistance in helping Pacific island economies convince constituents of the need for structural reforms.

The seminar also featured a genuine debate on the priorities for donor assistance. Donors voiced concern that past projects had performed less than satisfactorily, mainly because of a lack of commitment from recipient countries. To address these concerns, the Asian Development Bank’s proposed strategy for the region, Stephen J. Pollard noted, will stress participatory approaches and technical assistance designed to improve capacity. Japan’s bilateral assistance, its officials explained, will continue to focus on environmental protection, waste management, and capacity building. And the United States indicated that its economic assistance will give greater emphasis to improved accountability and more detailed monitoring of investments in health care, education, public infrastructure, private sector development, capacity building, and environmental protection. For their part, Pacific island participants placed great value on greater project financing to improve physical infrastructure.

There are no easy solutions, Reverend Francis X. Hezel (Micronesian Seminar) noted in his conclusion. But the seminar’s proceedings did convey broad agreement that development processes in the Pacific will require more community ownership and better collaboration among donors in fostering capacity building. Clearly, too, greater integration with the globalizing world would be a driving force for economic growth in the Pacific region. ■

Nabuti Mwemwenikarawa, Minister of Finance and Economic Development, Kiribati.



Rev. Francis X. Hezel, Director, Micronesian Seminar.

Yu Ching Wong

IMF Regional Office for Asia and the Pacific

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ECOSOC meeting seeks renewed momentum on Monterrey Consensus and achieving MDGs

On April 26, the United Nations (UN) Economic and Social Council (ECOSOC) met for the seventh annual high-level dialogue with the Bretton Woods institutions and the World Trade Organization (WTO). The meeting, which took place at UN headquarters in New York City, took up issues related to maintaining the political momentum for implementing the Monterrey Consensus and achieving the UN Millennium Development Goals (MDGs).



IMF Deputy Managing Director Agustin Carstens briefs participants on the outcome of the April 24 meeting of the International Monetary and Finance Committee.



ECOSOC President Marjatta Rasi (left) addresses the meeting. With her is United Nations head Kofi Annan.

On their way home from the spring meetings of the IMF and the World Bank, ministers of finance and development stopped in New York City for a day-long session with UN delegates, senior officials, and executive board directors from international organizations (including the UN, the IMF, the World Bank, the WTO, and the UN Conference on Trade and Development) and with

representatives from civil society organizations and the private sector. With the aim of bolstering “coherence, coordination, and cooperation” among international agencies and other development partners, the delegates used small, interactive roundtables to address three topics: the effect of private investment and trade-related issues on financing for development, the role of multilateral institutions in reaching the MDGs, and debt sustainability and debt relief.

Investment, trade, and aid

In their discussions of private investment and trade-related issues, delegates emphasized the benefits that better market access for developing countries can confer on efforts to reach the MDGs. Participants broadly welcomed the IMF's recent establishment of the Trade Integration Mechanism (see *IMF Survey*, May 17, page 135) and generally expressed support for the

IMF's review of the fiscal treatment of infrastructure and public-private partnerships. They agreed that higher saving and investment, more efficient use of resources, and greater private sector development are needed in developing countries if they are to reach the MDGs by the target date of 2015. Delegates also reiterated their call to developed countries to meet their official development assistance target of 0.7 percent of

gross national income and asked all development partners to increase aid effectiveness.

Debt sustainability and debt relief

In their discussion of debt sustainability, delegates made it clear that sustainable debt was not an end in itself but an essential element in realizing the growth needed to reduce poverty and achieve the MDGs. Indeed, many speakers suggested that debt sustainability assessments should specifically take into account how countries can achieve the MDGs.

Concern was also expressed about the debt sustainability challenges facing middle-income countries, with several delegates suggesting that debt sustainability assessments ought to take account of the financing needs of the private as well as the public sector.

There was also substantial support for the IMF's efforts to strengthen crisis prevention measures as a means of bolstering debt sustainability. It was useful, in the view of many participants, to have a comprehensive crisis prevention strategy that included consistent macroeconomic, financial, and monetary policies, as well as adequate sources of domestic financing. Strong domestic institutional frameworks were also needed to avoid the potentially costly impact of corruption on debt sustainability.

There was strong support for debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, as well as for IMF-World Bank efforts to develop a debt sustainability framework for low-income countries. Many delegates made a case for allowing all eligible countries to benefit from the HIPC Initiative and urged that the initiative be extended beyond its scheduled expiration date of end-2004. Participants also urged creditors to deliver on their debt-relief commitments.

Multilateral institutions and the MDGs

Many delegates in the roundtables saw Poverty Reduction Strategy Papers (PRSPs) as central to country-owned efforts to reduce poverty, but they also acknowledged that more needed to be done to clarify the relationship between PRSPs and the achievement of the MDGs. A number of participants also favored exploring alternative sources of financing to help achieve the MDGs, including an international financing facility and global taxation mechanisms. ■

Patrick Cirillo and Jones Morco
IMF Secretary's Department, and
Axel Palmason, IMF Office, United Nations

AFRITAC East seminar

Local experts identified and trained to meet growing demand for improved statistics

As part of a training program that was the first of its kind for the IMF, the Statistics Department conducted a five-day seminar in Dar es Salaam, Tanzania, during March 29–April 2 for prospective technical assistance experts. The seminar, which was organized in collaboration with the East Africa Regional Technical Assistance Center (AFRITAC East), was designed to identify and train individuals who would then help meet the region's growing demand for assistance in developing better national accounts and price statistics.

AFRITAC East retains a resident statistical advisor for this purpose, but demand has far exceeded what a single expert can provide. The IMF's Statistics Department helped out by making its panel of experts available to the center, but demand has continued to outstrip available resources. To ensure AFRITAC East's ability to respond expeditiously to its members' requests, the Statistics Department sought new ways to increase the supply of qualified consultants.

The Statistics Department, which has had extensive experience in delivering high-quality technical assistance and in training experts, proposed a seminar that would provide training in data assessment tools and project management and, at the same time, identify and train local candidates who could then train others. Participation in the seminar was restricted to individuals from the region, in keeping with the center's commitment to use the services of experts from the region and, where possible, to build expertise in the center's member countries.

In all, 15 participants from 11 countries were selected to attend the seminar, with preference given to individuals who had demonstrated strong technical skills in national accounts or price statistics during previous IMF courses or in work with IMF staff. Participants with a good command of French as well as proficiency in English were also sought because they could then also be available to provide technical assistance in the French-speaking AFRITAC West countries.

The principal focus of the seminar was on developing and monitoring technical assistance projects in real sector statistics. Using a combination of lectures and workshops, Adriaan Bloem and Thomas Alexander (of the Statistics Department's Real Sector Division) introduced participants to the Data Quality Assessment Framework—a tool that provides a qualitative assessment of official statistics for five key data



sets, including national accounts and consumer price statistics, and is designed to highlight major weaknesses. The seminar also provided participants with an introduction to the department's Project Management System, which is used to monitor and evaluate technical assistance delivery.

During the workshops, each participant interviewed a colleague about his or her country's national accounts or price statistics database and drafted an assessment using the framework. Participants then noted institutional and data quality weaknesses and developed recommendations for improvement. Based on their assessments and recommendations, participants developed a mock project using the management system and practiced linking assessments with the fulfillment of project objectives.

The training is intended to help standardize the reports that experts file and to improve their clarity—two areas that have become critical as the Statistics Department takes on increasing responsibility for reviewing experts' mission reports and providing technical advice. The Statistics Department and AFRITAC East will now set about the task of short-listing experts for technical assistance assignments.

At a closing ceremony, Bassirou Sarr, the new coordinator of AFRITAC East, expressed his appreciation of the seminar, and reiterated the urgent need for expertise in delivering technical assistance to the region. With demand for technical assistance continuing to grow worldwide, the IMF's Statistics Department plans to repeat this exercise in other regional technical assistance centers. ■

Seminar participants and two IMF instructors gather outside AFRITAC East's facilities in Dar-es-Salaam. The week-long seminar focused on developing and monitoring technical assistance projects in real sector statistics.



Workshop participants received hands-on training in data assessment and project management.

IMF creates Beirut-based technical assistance center

On May 17, the IMF announced that it will establish its Middle East Regional Technical Assistance Center (METAC) in Beirut, Lebanon, to promote capacity building and training in countries in the region. Modeled broadly on the IMF's other regional technical assistance centers in Africa, Asia, and the Caribbean, METAC is a collaborative effort between the IMF and bilateral and multilateral donors. The government of Lebanon will provide the center's offices and support and service staff, as well as help underwrite the center's activities, which will be guided by a Steering Committee with representatives from participating countries and donors.

METAC, expected to start operations in late autumn 2004, will provide technical assistance and training services to Afghanistan, Egypt, Iraq, Jordan, Lebanon, Libya, Sudan, Syria, West Bank and Gaza, and Yemen. The center's main objective will be to help strengthen macroeconomic and financial management capacity in these countries. In providing targeted capacity building, METAC will focus on helping the postconflict countries in the region foster macroeconomic stability and develop basic institutions, such as ministries of finance and central banks, and other public institutions, such as banking supervisory agencies, national statistical agencies, and other regulatory agencies.

Technical assistance provided by METAC will fall largely in the IMF's main areas of expertise, including macroeconomic policy, tax policy and revenue administration, public expenditure management, financial sector issues, and macroeconomic statistics. This assistance will be provided by a team of IMF experts assigned to METAC and supplemented by short-term specialists contracted to provide targeted advice and training. The assistance will mainly take the form of in-country workshops, training assignments to institutions associated with IMF member countries, and regional training courses.

IMF-supported centers

The IMF has used a regional approach to provide technical assistance to member countries since 1993. Originally conceived to assist small island economies, first in the Pacific and later in the Caribbean, the approach is now being adopted in Africa.

The Pacific Financial Technical Assistance Center (PFTAC), located in Suva, Fiji, was jointly established in 1993 by the United Nations Development Program and the IMF. The Caribbean Regional Technical Assistance Center (CARTAC) was established in Barbados by the CARICOM Council of Ministers of Finance and Planning in 1999. The East African Technical Assistance Center (AFRITAC East) was opened in October 2002 in Dar es Salaam, Tanzania. AFRITAC West was opened in May 2003 in Bamako, Mali.

IMF Economic Forum

Adopting the euro: how to pick the right strategy

The 10 countries that joined the European Union (EU) on May 1 are committed also to joining the euro area—as the 12 countries already using the euro are collectively known. How soon this will happen depends on the strategies for adopting the euro that each of the new member states will pursue. In an IMF Economic Forum held May 4, Lajos Bokros (Director of Financial Advisory Services at the World Bank and former Finance Minister of Hungary), Peter Kenen (Professor of Economics and International Finance at Princeton University), Hari Vittal (Alternate IMF Executive Director for the constituency that includes Greece), and Onno de Beaufort Wijnholds (Permanent Representative of the

European Central Bank (ECB) in the United States) discussed the implications for the new member states of adopting the euro. The debate was moderated by Susan Schadler, Deputy Director of the IMF's European Department.

Unlike the United Kingdom and Denmark, which have an opt-out option, the new member

states all have an obligation to adopt the euro, although it is up to each country to decide on the timing. Countries must first fulfill the four criteria set out in the Maastricht Treaty—one of which is a minimum two-year stay in ERM2, the exchange rate mechanism that links the currencies of prospective euro area members to the euro. Some countries have indicated they intend to join ERM2 as quickly as possible. Still, January 1, 2007, in Wijnholds' view, is probably the earliest realistic date for any new member to adopt the euro.

ERM2: a waiting or workout room?

There are two views on how to approach ERM2, Wijnholds said. It is seen either as a waiting room, where the attitude is "Let's get it over as quickly as possible because . . . you might be subject to capital flows that could be quite disruptive" or a workout room, where "you build up muscle to be strong when you enter the euro zone as a full-fledged member." The view of the ECB is that countries should undertake necessary major adjustments of their economies before they join ERM2, he said.



Wijnholds: The view of the ECB is that countries should undertake major adjustments of their economies before they join ERM2.

One question often asked about ERM2 is how much exchange rates will be allowed to diverge from the central parity, Wijnholds said. It has now been clarified that the standard fluctuation band of ± 15 percent will apply. An important caveat remains, however: When it comes to deciding on adoption of the euro, countries need to participate in ERM2 for a period of at least two years prior to the convergence assessment without severe tensions, in particular, without devaluing against the euro.

Fiscal deficits matter for growth

The World Bank's Bokros focused his remarks on what the new member states must do "to put their house in order" before joining ERM2. Currently, patterns of economic growth in the Baltic countries (Estonia, Latvia, and Lithuania) and the Visegrad countries (Poland, the Czech Republic, Hungary, and Slovakia) differ greatly, he said. The Baltics experienced a recession in 1999 following the financial crisis in Russia. But since 2000 all three countries have enjoyed rapid growth. In contrast, Poland and Hungary grew rapidly until 2000, but have since slowed markedly. The same pattern applies to Slovenia. In the Czech Republic and Slovakia, important structural reforms undertaken in 1998 have resulted in higher unemployment and slow growth.

The size of the public sector reveals even greater differences between the Baltic and Visegrad countries, he said. In the Baltics, the public sector now accounts for less than 40 percent of GDP. In the Visegrad countries, it has expanded continuously and now accounts for considerably more than 40 percent.

What this adds up to, Bokros said, is "high growth, a small public sector, low deficits, and prudent fiscal policies" in the Baltics, and "markedly slower growth, a big public sector, high deficits, and much less prudence in managing fiscal affairs" in the Visegrad countries. Accordingly, he said, it is no surprise that Estonia, Lithuania, and Slovenia have indicated that they will join ERM2 very soon. The Visegrad countries are likely to follow only after they have undertaken comprehensive reforms to reduce the size of the public sector, as well as their fiscal deficits and public debt.

Greece's experience

Greece's experience is of interest because it is the only current member of the euro area that was not a founding member, Vittas said. There are also similarities between Greece's economic structure and stage of development and that of the new member states.

Research shows that the economic benefits derived from integration are potentially very large—perhaps as large as 20 percent of GDP, Vittas said. But there are also significant costs, the most important of which is the loss of monetary autonomy. What is less clear is how quickly economic benefits accrue. In Greece, standards of living actually declined relative to the EU average during the first 15 years of EU membership. However, the situation improved from the late-1990s, when Greece decided to give up its monetary independence.

Greece's experience shows that the potential benefits of monetary integration may be large, but they are not automatic and can easily be wasted in the absence of good policies, Vittas said. Monetary integration may help countries by providing strong incentives to pursue disciplined macroeconomic policies. "For Greece," he added, "the loss of monetary autonomy was more a blessing than a curse."

The typical advice given to new member states with respect to ERM2 has three elements, according to Vittas. First, do not rush—it is important to achieve nominal convergence before entering the mechanism. Second, avoid a prolonged stay in ERM2, as this could be risky. Third, have a clear target date for adopting the euro.

Greece's experience supports the first and, perhaps to a lesser extent, the third element of this advice, but not the second, Vittas said. Greece stayed in ERM for more than two years, and significant tensions emerged only in the early part of that



Bokros: It is no surprise that Estonia, Lithuania, and Slovenia have indicated that they will join ERM2 very soon.



Vittas: Greece's experience shows that the potential benefits of monetary integration . . . are not automatic and can easily be wasted in the absence of good policies.

Selected IMF rates

| Week beginning | SDR interest rate | Rate of remuneration | Rate of charge |
|----------------|-------------------|----------------------|----------------|
| May 17 | 1.66 | 1.66 | 2.56 |
| May 24 | 1.69 | 1.69 | 2.60 |

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).

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period. Setting a clear target for adopting the euro certainly helped. It provided an anchor to stabilize market expectations, and it also helped marshal support for the policies required to meet the convergence criteria. "Greece was very fortunate . . . in that it had a very clear target date to choose. It had

missed the opportunity to be among the founding members of the euro area, and it was determined not to miss the second most significant event in the history of EMU, which was the introduction of euro notes and coins."

ERM2 a stiff and asymmetric test

During the cold war, it was said that the North Atlantic Treaty Organization (NATO) was meant to keep the Russians out, the Americans in, and the Germans down. Cynics have suggested that the Maastricht Treaty's convergence criteria were meant to lure the Germans in and keep the Italians out, Princeton's Kenen said in his presentation. However, "it would be more accurate to say that these criteria were devised to require that the national governments do the hard work of achieving domestic price stability and fiscal sustainability before EMU began, thereby assuring that the ECB . . . could start its work in a benign environment and escape the onus of imposing the hardships required to create that environment."

The convergence criteria are, noted Kenen, colored by Europe's recent monetary history. For instance, the decision in 1993 to suspend the ERM's old, narrow margins of $\pm 2\frac{1}{4}$ percent reflected recognition of a basic truth: "Free capital mobility, fixed exchange rates, and independent monetary policies constitute what Robert Mundell [a Nobel Prize winner in economics] described as an unholy trinity." ERM members themselves learned that when they dismantled their capital controls but then tried to keep their currencies within the old, narrow margins. This led them to choose for ERM2 the wide margins of ± 15 percent they had adopted temporarily for ERM. Yet the new member states will face



Kenen: Under ERM2, the obligation to stabilize exchange rates will reside primarily with the government of the country concerned.



Schadler: The EMU is a rules-based system, and everybody agrees that opening up the box of rules would be a mistake.

"an asymmetric and stiff test" when they join ERM2, Kenen said. The European Commission has said that their eligibility for EMU will depend on their ability to respect the old, narrow margins, so they will be unable to let their currencies depreciate by the full 15 percent allowed by ERM2.

ERM2 differs from ERM in another fundamental aspect, Kenen said. Under ERM, the obligation to stabilize exchange rates was borne jointly by the strong and weak currency countries. Under ERM2, this obligation will reside primarily with the government of the country concerned—there is no legal obligation for the ECB to intervene. This, Kenen said, could cause problems for the new member states. During a country's stay in ERM2, market participants will be tracking its progress in meeting the other criteria. If they do not see satisfactory progress, they will bet against it by selling its currency.

The EMU is a rules-based system, and everybody agrees that opening up the box of rules would be a mistake, Susan Schadler noted. But, she asked, "Is it good to have a strict interpretation of the rules that provides a clear marker for countries, or is flexibility in interpreting those rules a good thing?" The range of considerations specific to the new member states raised during the forum suggests the latter, even though it could lead to some ambiguity "that could easily be construed as being unfair or politically motivated." In this context, strong communications will be critical to a smooth entry of new member states to the euro area, Schadler said. ■

Camilla Andersen
IMF External Relations Department

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