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In this issue

Unprecedented joint visit

Köhler, Wolfensohn meet with African leaders to discuss economic challenges facing region

During February 20–25, in an unprecedented joint visit to sub-Saharan countries, IMF Managing Director Horst Köhler and World Bank President James Wolfensohn met African leaders to discuss the pressing economic problems their countries face and endorsed the need for a new approach to achieving the objectives of stronger economic growth and poverty reduction. Köhler and Wolfensohn joined in a meeting in Mali with heads of state from western and central Africa, and subsequently participated in a similar meeting in Tanzania for heads of state from eastern and southern Africa. They also visited Nigeria and Kenya for discussions with the heads of state of those countries.

Speaking at a conference on child poverty, education, and health in London on February 26, Köhler summed up his main conclusions from the meetings with African leaders, saying that "one of the strongest impressions I took away from the joint discussions…was that these leaders increasingly recognize their own responsibility to address homegrown causes of poverty." He identified three main areas of progress in the region:

From left, IMF Managing Director Horst Köhler, with World Bank President James Wolfensohn and President of Mali, Alpha Oumar Konaré.

- "an awareness in Africa that any effort to reduce poverty must start with—and build upon—peace, democracy, and good governance at home."
- "a recognition that the prospects for rapid growth …will depend on the ability of these countries to unlock the creative energies of their people."
- "an increasing awareness among African leaders that stronger regional cooperation and integration is indispensable to increase the competitiveness of their economies."

(For excerpts from Köhler's London remarks, please see page 71.)

Köhler greets children upon his arrival in Mali (right) and (below) is welcomed by Mali's Prime Minister Mande Sidibe.

Bamako meeting

Opening their tour in Bamako, Mali, on February 20, Köhler and Wolfensohn discussed the pressing problems of African debt and poverty with 10 west African leaders at a meeting hosted by Malian President Alpha Oumar Konaré, the current head of the Economic Community of West African States (ECOWAS). Other presidents attending the meeting included Omar Bongo of Gabon, Blaise Compaoré of Burkina Faso, Ahmed Tejan Kabbah of Sierra Leone, John Kufuor of Ghana, Antonio Mascarenhas Monteiro of Cape Verde, Olusegun Obasanjo of Nigeria, Didier Ratsiraka of Madagascar, Mamadou Tanja of Niger, and Abdoulaye Wade of Senegal. After the meeting, Köhler said that

From left, Horst Köhler with President of Niger, Mamadou Tanja; President of Gabon, Omar Bongo; and Alpha Oumar Konaré.

the talks represented "a major step forward to define a new approach to fight poverty in Africa."

The following day, Köhler and Wolfensohn met with Presidents Abdelaziz Bouteflika of Algeria and Thabo Mbeki of South Africa, as well as Presidents Konaré of Mali and Obasanjo of Nigeria to discuss the proposal for a "Millennium Africa Renaissance Program" (MAP). This proposal was developed by Presidents Bouteflika, Mbeki, and Obasanjo and presented in January at the World Economic Forum in Davos, Switzerland. This program, Köhler said later in his London remarks, "is emerging as a distinctly African vision and work program for the future of Africa." It is, he said, "aimed at achieving sustained economic growth of at least 7 percent a year, at doubling Africa's share in world exports in the next five years, and at accelerating the achievement of the international development goals." He noted that the program called for "fast-tracking" actions to combat AIDS and other diseases and to improve information and communications technology.

In Abuja on February 22, Köhler and Wolfensohn met again with President Obasanjo, other senior Nigerian officials, and leaders of the National Assembly. In their joint press conference at the end of this visit, they stressed that they recognized the importance of the Nigerian economy to Africa and wanted to support the country's emerging democracy in coping with severe economic challenges. For its part, the government expressed its strong commitment to working with the international financial institutions.

Discussions in Tanzania

Speaking in Dar es Salaam, Tanzania, following a meeting with 12 eastern and southern African leaders on February 23, Tanzanian President Benjamin Mkapa stressed that the African leaders accepted that the prime responsibility for the continent's development rested with them. They agreed that they must improve their infrastructures to increase their countries' attractiveness to foreign investment and work to remove regional trade barriers. The president asked the IMF and the World Bank to help open markets for African goods. Köhler and Wolfensohn indicated their strong support for this approach and their willingness to serve as advocates for Africa in the international community. Köhler underscored that "the willingness of the advanced countries to open their markets for poor countries will be a crucial test of their commitment to reducing world poverty."

He also emphasized that the IMF is seeking to streamline the conditions associated with its lending programs and tailor them more to the circumstances of individual countries.

Goodall Gondwe, Director of the IMF's African Department, emphasized, "Africa has not benefited much from globalization; and it has to reposition itself in order to maximize the benefits of globalization. Everybody would like to know the African point of view on how it will do that." He said that in the course of the meeting, the African leaders had discussed issues of governance, conflict resolution, and ways of creating a climate that is attractive to foreign investors. While Gondwe noted that a total cancellation of all debts was not an option, he said that Köhler had emphasized that the IMF was undergoing a period of intense review of the conditionality of IMF-supported programs. "The purpose is to reduce the number of conditions, not to eliminate them completely," he said. "We need Africa to do better than it has done. A redoubling of effort is necessary, and we want to see what each one of us can do to accelerate economic growth and reduce poverty in Africa." The World Bank's Vice-President for Africa, Callisto Madavo, observed that both the Bank and the IMF "want to support programs that are really going to accelerate growth rates and reduce poverty."

Besides President Mkapa of Tanzania, the meeting was attended by Presidents Issaias Afewerki of Eritrea, Frederick Chiluba of Zambia, Joaquim Chissano of Mozambique, Paul Kagame of Rwanda, Thabo Mbeki of South Africa, Festus Mogae of Botswana, Daniel arap Moi of Kenya, Robert Mugabe of Zimbabwe, Bakili Muluzi of Malawi, and Yoweri Museveni of Uganda, and Prime Minister Meles Zenawi of Ethiopia.

Following the Dar es Salaam meeting, Köhler and Wolfensohn concluded their African visit by flying to Nairobi for a meeting on February 25 with Kenyan President Daniel arap Moi, who later said that the "very successful" meeting had focused mainly on economic cooperation between the two institutions and his government. ■

Köhler says crucial test for poverty reduction is in opening access to markets for poor countries

Following are edited excerpts from an address, as prepared for delivery, by IMF Managing Director Horst Köhler at the Conference on Child Poverty, Education, and Health, in London, February 26. The full text is available on the IMF's website (www.imf.org).

We are united today by our belief that widespread poverty in the midst of global prosperity is both unsustainable and morally unacceptable. We agree that world poverty is the paramount challenge of the twenty-first century. It is right that United Nations (UN) conferences have established concrete goals for the year 2015 in education, health, environmental sustainability, and poverty reduction. Collectively, their aim is to break the cycle of world poverty in this generation. The IMF is committed to playing an active role in this effort, reflecting its specific mandate and expertise.

Sub-Saharan Africa trip

One of the strongest impressions I took away from the joint discussions that World Bank President Jim Wolfensohn and I had last week with 22 heads of state in sub-Saharan Africa was that that these leaders increasingly recognize their own responsibility to address homegrown causes of poverty.

• First and foremost, there is an awareness in Africa that any effort to reduce poverty must start with—and build upon—peace, democracy, and good governance at home. Lack of respect for the rule of law, armed conflict, mismanagement, and corruption are fundamental obstacles to growth and development.

• Second, there is a recognition that the prospects for rapid growth—which is indispensable for reducing poverty—will depend on the ability of these countries to unlock the creative energies of their people. In support of this process, African leaders know that there is no alternative to integration into the global economy. This approach requires investment in human capital and infrastructure, as well as the right economic policies and institutions. It requires, especially, an economic climate that encourages private sector investment.

• Third, there is an increasing awareness among African leaders that stronger regional cooperation and integration are indispensable to increase the competitiveness of their economies.

I am encouraged by the indications that there is an emerging collective leadership in Africa. In particular, the concept of a "Millennium Africa Renaissance Program" that is being developed by Presidents Thabo Mbeki, Olusegun Obasanjo, and Abdelaziz Bouteflika is emerging as a distinctly African vision and work program for the future of Africa. It is aimed at achieving sustained economic growth of at least 7 percent a year, at doubling Africa's share in world exports in the next five years, and at accelerating the achievement of the international development goals. Jim Wolfensohn and I have clearly expressed our commitment to support this African vision and work plan. (See also page 70.)

Role of industrial countries

I see the crucial test for the credibility of international support for poverty reduction in the issue of opening markets for poor countries and in the delivery on the promise of higher levels of official development assistance. Increased access to markets is still the best way for poor countries to share in world prosperity. The major industrial countries have a duty to take the lead in jump-starting a new round of multilateral trade negotiations under the World Trade Organization. And to give special assistance to those with the greatest need, rich countries should give the world's poorest countries free access to their markets. To be meaningful, free access should cover the products that matter most to poor countries.

In addition, more than 30 years ago, the UN adopted the Pearson Commission recommendation that the major donors should provide at least 0.7 percent of GNP in official development assistance. While many Organization for Economic Cooperation and Development (OECD) countries have used this target ever since as a point of reference, in practice bilateral aid flows from OECD countries fall short of this target by about $100 billion a year.

The UN will be holding a conference on Financing for Development in the spring of 2002 [see *IMF Survey*, February 19, page 53]. In anticipation of this event, I would gladly join in a campaign to mobilize public sup-

I see the crucial test for the credibility of international support for poverty reduction in the issue of opening markets for poor countries and in the delivery on the promise of higher levels of official development assistance.
—Köhler

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
February 19	4.33	4.33	5.02
February 26	4.29	4.29	4.97

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?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

port for action by all OECD governments and parliaments to reach the 0.7 percent of GNP target within this decade.

Role of the IMF

At last year's Annual Meetings in Prague, the IMF's 182 member countries stressed that now, more than ever, globalization requires cooperation, and it requires institutions that organize this cooperation. I want to reemphasize: the IMF intends to be a part of the workforce to make globalization work for the benefit of all.

To do this more effectively, the IMF is adapting to the lessons of experience and changes in the global environment. We have learned that program countries cannot solve everything at the same time. We are streamlining the IMF's conditionality to help pave the way for greater national ownership and sustained implementation. And the IMF has to refocus. This means that it should concentrate on macroeconomic stability and on the financial sector, which are essential for sustained growth. And it must help countries take advantage of the opportunities of global markets. Recent events make it clearer than ever that the IMF must work harder to find answers to the risks of disruptive volatility in international capital flows.

Within this new focus, the IMF must be part of an integrated concept of the international community for dealing with globalization. This should be a concept that recognizes that the social dimension cannot be separated from the economic dimension. And our concept must also respond to the fact that all humanity shares one world. This means that the poor must be full partners and participants, but also that poverty is an issue for everyone. Operating within that concept, a refocused IMF must be aware of issues outside its core areas of responsibility and work in a complementary fashion with the organizations primarily responsible for those issues.

Debt relief and poverty

Clearly, debt relief is an important part of a comprehensive concept to reduce poverty. The IMF and the World Bank have been spearheading the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, which brought debt relief to 22 poor countries during the past year. I also welcome the decisions by the United Kingdom and other countries to forgive 100 percent of bilateral claims in the context of the HIPC Initiative. But I would caution against viewing debt relief as a panacea. Credit is an indispensable element for economic development. That is why, in the longer run, it will be crucial for poor countries to win the trust of private investors in their ability and willingness to repay what they borrow. And that is why they need to make good use of the breathing space that is being provided now from their debt-service obligations to make decisive progress in their efforts to reduce poverty.

The fight against poverty requires courage, commitment, and prolonged effort. That is why it will succeed.
—Köhler

The fight against poverty requires courage, commitment, and prolonged effort. That is why it will succeed only if it is based on a poverty reduction strategy designed by the country itself, rather than one that is imposed from outside. This is the philosophy behind the poverty reduction strategy paper process, which the IMF and the World Bank helped to initiate just over a year ago. During the first two years of Poverty Reduction and Growth Facility operations, spending on education and health is expected to rise by about 1 percent of GDP. We know that this is still far from satisfactory. But the issue is firmly on the agenda of the international institutions. Still, let me be clear: the needs are enormous and, even in the best of circumstances, resources and implementation capacities will be constrained. Countries will not be able to avoid making hard choices.

Our discussions with African leaders have confirmed for me that lack of capacity, rather than lack of political will, is often the main obstacle to programs for growth and poverty reduction. It is clear that we need to give a higher priority to capacity building. We need more resources for technical assistance, and we need to make existing technical assistance more efficient.

Conclusion

It would be a tragedy if we left this meeting and went back to business as usual. I think it is crucial to establish a cooperative mechanism for monitoring progress and coordinating our activities to meet the international development goals for 2015. This means that we need to allocate responsibility for actions to meet these goals at the country, regional, and global level and agree on ways to monitor performance. We would also need a monitoring process for the delivery of international support in areas such as market access, aid, debt relief, capacity-building, and control of arms trade. Out of these elements could come a framework for accountability in the effort to achieve the international development goals. The appropriate forum for an overall assessment would, of course, be the UN. The IMF would be prepared to participate actively in a concrete, constructive, and transparent monitoring process.

In this and other ways, we need to really focus on the role our organizations can best play in the fight against poverty and keep that thought at the forefront of our activities throughout the year. ■

Photo Credits: Padraic Hughes, for the IMF, pages 69–70; Mike Palazzotto for AFP page 73; Denio Zara, Pedro Márquez, and Michael Spilotro for the IMF, pages 75, 79, 83–84; and Stephanie Pilick for AFP, page 80.

Palermo meeting

Group of Seven financial leaders assess growth prospects in light of slowdown in U.S. economy

Against a background of a slowing U.S. economy and continuing weakness in the Japanese economy, the finance ministers and central bank governors of the Group of Seven industrial countries met in Palermo, Italy, on February 17 to discuss recent developments in the world economy. IMF Managing Director Horst Köhler, European Central Bank President Willem F. Duisenberg, and Eurogroup President Romano Prodi of Italy also participated in the discussions. In addition to the global implications of the slowdown in the United States, financial leaders discussed progress made toward strengthening the international financial architecture, implementing the Heavily Indebted Poor Countries (HIPC) Initiative, and finding ways of proceeding beyond debt relief. The ministers and governors also met with the finance minister and central bank governor of Russia and with representatives of the European Commission to discuss recent economic developments in Russia. Below are edited excerpts of the statement issued at the end of the meeting. (The full text is available on the University of Toronto's G-7 website at www.g7.utoronto.ca/.)

Developments in the world economy

Although global growth this year is likely to be somewhat slower than we expected when we last met, the basic factors that have supported sustained growth in many of the major industrial economies remain in place.

We agreed on the need for both macroeconomic and structural policies in all our countries to support growth. In this context, lower energy prices and stable oil markets are important.

We reemphasized our commitment to foster conditions for sustainable growth worldwide. We stressed the importance of continued cooperation among the Group of Seven countries. More specifically:

• In the United States, economic growth has slowed, though economic fundamentals remain strong. Monetary and fiscal policies should aim at supporting sustained growth, while reserving budgetary restraint and price stability and increasing national saving over the medium term.

• In the United Kingdom and Canada, growth remains healthy and unemployment is low, with some signs of a temporary slowing in economic growth. Policies should continue to sustain growth and employment over the medium term, while meeting inflation targets.

• In the euro area, growth prospects remain favorable, thanks to strong domestic demand. Policies should be directed at enhancing growth potential, through continued coordinated reform efforts aimed at increasing product and labor market efficiency. Tax reforms are being implemented while fiscal consolidation is pursued. In view of Europe's aging population, budgets and social security systems need to be further strengthened.

• In Japan, while a modest recovery is expected, prices continue to decline and downside risks remain. In this context, monetary policy should continue to ensure that liquidity is provided on ample terms. Efforts to strengthen the financial sector should be enhanced.

Photo Not Available

At the Palermo meeting are finance ministers (from left) Paul Martin, Canada; Didier Reynders, Belgium; Gordon Brown, United Kingdom; Paul O'Neill, United States; Vincenzo Visco, Italy; Laurent Fabius, France; Kiichi Miyazawa, Japan; and Caio Koch-Weser, State Secretary of German Finance Ministry.

Emerging market economies

After two years of strong recovery, the outlook for emerging market economies has become more mixed. We welcome the substantial progress achieved in emerging Asia to reduce vulnerabilities, including the improvement of the external debt structure in the crisis-affected countries and the adoption of more sustainable exchange rate regimes. To secure future growth, it is important to pursue necessary reforms of the financial and corporate sectors. In Latin America, sound macroeconomic and structural policies are needed to help reduce vulnerabilities. In all emerging market economies, we stress the importance of further intensifying efforts to implement internationally agreed standards and codes. The pace of reforms should not be relaxed.

Russia

We welcome the recent improvements in the macroeconomic and balance of payments situation of the Russian economy. We strongly urge the Russian authorities to step up the process of economic reforms and meet in full their financial obligations in order to restore promptly normal relations with the international financial community. While some elements of the comprehensive tax reform package have been adopted, critical challenges remain, such as enforcing the rule of law, attacking nonpayments and barter, strengthening the banking system, improving corporate governance, and fighting money laundering. On the latter, we urge the Russian authorities to move quickly to remedy the deficiencies identified by the FATF [Financial Action Task Force on Money Laundering] in June 2000. We call upon the Russian authorities, as they address the difficult and complex process of economic transition, to implement a credible program of reform and create the essential market institutions and infrastructure for sound growth. In this context, we encourage the Russian authorities to continue to work with the IMF and the World Bank.

HIPC and development beyond debt relief

We noted with satisfaction that the implementation of the enhanced HIPC Initiative has already enabled 22 countries to reach the decision point. These countries are now receiving significant debt relief. We are committed to helping them implement their poverty reduction strategies and thereby reach their completion points.

This will lead to $34 billion of debt relief under the initiative, reducing the debt of these countries on average by two-thirds. Most eligible countries that have not yet reached the decision point are currently in, or just emerging from, conflict. We call on these countries to reach a peaceful resolution of their problems, and we intend to help them in their reconstruction efforts.

We urge all creditors to participate fully in providing on a timely basis their share of debt reduction under the enhanced HIPC Initiative. The Group of Seven governments have gone beyond the HIPC targets and agreed to commit to provide 100 percent debt reduction on official development assistance and eligible commercial credits for countries qualifying for HIPC debt reduction. We urge other bilateral creditors to take similar action.

We consider that debt reduction is only one element of a broader, more ambitious strategy for poverty reduction, based on three pillars. First, action is needed to launch a new multilateral trade round and to open further markets to exports from the poorest countries. Second, a more favorable environment for attracting private investment needs to be created in the poorest countries. Third, within country-owned poverty reduction strategies, resources need to be channeled, in a more efficient and coordinated way, to the social sector, as we work toward the objectives contained in the 2015 International Development Goals.

Strengthening financial architecture

We noted the progress made to reinforce the international financial system. We look forward to further progress on prioritization of IMF conditionality, implementation of the internationally agreed codes and standards, crisis prevention, private sector involvement, and financial liberalization. We note the need for further discussion on quotas at the IMF Board.

We also discussed the main features of the reform of the multilateral development banks. These institutions have made considerable progress on internal and policy reforms in recent years, but more can be done to focus their action on poverty reduction. Key principles of the reform are using greater selectivity in setting priorities, focusing on the needs of the poorest, fostering effective and transparent internal governance, and improving development impact.

Selectivity in setting priorities and improving development impact require particular attention to appropriate provision of global public goods, good governance, private sector development in lower income countries, and financial sector development, including fighting financial abuse. We look forward to intensifying our dialogue with the multilateral development banks and to reviewing progress at the Spring Meetings.

Abuses of global financial system

Following our report to the Okinawa Summit [in July 2000; see *IMF Survey*, July 31, 2000, page 241] and the recommendations of the heads of state of the Group of Seven, we note the positive evolution of the dialogue with the countries involved. The FATF has recently reported the significant progress made by most of the 15 noncooperative countries and territories listed in June 2000. Seven countries have already enacted most, if not all, of the legislation needed to fight money laundering effectively. We encourage those jurisdictions to demonstrate their willingness and ability to implement these reforms, so that they can be delisted at the earliest possible time. To this end, we remain committed to continuing dialogue with the identified countries and to providing technical assistance where possible. However, we reaffirm our commitment, where dialogue has failed to generate adequate progress, to implement coordinated countermeasures that may be recommended by the FATF at its meeting in June 2001. We urge the international financial institutions, in particular the IMF and the World Bank, to help noncooperative countries and territories implement the relevant international anti-money laundering standards, as appropriate, through technical assistance, program design, and policy dialogue.

We welcome the intent of certain offshore financial centers to improve supervisory, regulatory, cooperation, and information exchange policies and practices and encourage offshore financial centers to disclose assessment findings, including those done by the IMF, as a means of demonstrating compliance with and progress in meeting international standards in these areas. We ask the Financial Stability Forum to monitor the implementation of its recommendations and to consider means of recognizing progress being made by certain offshore financial centers and recommend any future action, if necessary. ■

Mundell calls for a closer monetary union as step toward single world currency

Robert Mundell, the 1999 Nobel prize winner for economics and a former IMF staff member, reiterated his advocacy of a "group of three" monetary union, comprising the United States, the euro area, and Japan, with the stabilizing influence of a common monetary policy .

Mundell's lecture, on the theme of "The International Monetary System: Quo Vadis?" was delivered at the IMF as a memorial in honor of Manuel Guitián, the former Director of the IMF Monetary and Exchange Affairs Department, on the first anniversary of his death. His remarks were preceded by tributes to Guitián by IMF Managing Director Horst Köhler (see box); First Deputy Managing Director Stanley Fischer; Guillermo Ortiz, Governor of the Bank of Mexico; Joaquim Muns, Professor of Economics at the University of Barcelona; and Joaquin Ferran, former Director of the IMF's Office in Europe. The speakers were introduced by Mohsin S. Khan, Director of the IMF Institute, who also coordinated the lecture.

In his remarks, Mundell called for "a new way of looking at the world," based on country size measured in monetary terms: "You've got the dollar area, which is the dominant figure, and then the euro area and the yen area, and then much smaller economies." The United States, he said, had a GDP of about $10 trillion; the euro area about $7 trillion; and Japan about $5 trillion. Further down the list were countries like China and the United Kingdom, with some $1.5 trillion each. "So the big countries represent 60 percent of the world economy," he noted. If you talk about international financial architecture, he stressed, you have to be talking about the group of three and the exchange rate relationships among the group.

Expanding on his theme in a wide-ranging review, Mundell said that such a monetary union would in time serve as a prelude to the establishment of a single international currency. Five prerequisites for monetary union, in his view, are a common index of inflation, a common target for inflation, an exchange rate "fixed forever," a common monetary policy, and the redistribution of seigniorage so that no one gains from the change.

Robert Mundell (left) with Mohsin Khan.

"So you could do all that, and I think it would be a better economic system for these three currency areas and for the world, he said. "What a blessing it would be if Asia didn't have to worry about these agonizing fluctuations in the dollar-yen rate and for the other countries in Africa and eastern Europe that now have to worry about the euro-dollar rate changes."

Mundell harkened back to the creation of a common currency in the United States in 1792 and to the

Köhler pays tribute to Manuel Guitián

IMF Managing Director Horst Köhler, in remarks delivered before Robert Mundell's memorial lecture, paid tribute to Manuel Guitián as "a Spaniard by birth, but a true internationalist by choice." His contributions, Köhler said, "did much to strengthen the institution of which we are a part, and he was here during an important and formative phase of its evolution."

Köhler highlighted five areas in which Guitián's work continued to influence policy discussions in the IMF:

- He saw the IMF primarily as a vehicle for international monetary cooperation, recognizing that, over time, globalization would make this work even more important.
- He viewed conditionality as an essential component of IMF lending—both to protect the revolving nature of IMF financing and to contain the risk of moral hazard.
- He wrote eloquently about the trade-off between rules and discretion in the conduct of monetary policy. Underlying his analysis was the proposition that, in the end, the difference is one of degree, since all economic policy frameworks must include both some rules and some elements of discretion.
- He insisted that bank soundness and supervision were, as he put it, "the neglected dimension of monetary policy." The need for the IMF to focus on the soundness of the banking system in member countries is now recognized as one of its core responsibilities.
- Finally, he was an unwavering proponent of capital account liberalization. He believed that the IMF's Articles of Agreement were badly out of date and argued they should be revised to catch up with the realities of a world of current account liberalization, enormous growth of capital flows, and exchange rate flexibility.

In concluding, the Managing Director noted that, in his nearly thirty-year career, Guitián served with distinction in three IMF departments: Exchange and Trade Relations (now Policy Development and Review), European, and, finally, Monetary and Exchange Affairs. He retired in late 1998. "The IMF is built upon the work and dedication of people like Manuel Guitián," Köhler said.

Manuel Guitián

Bretton Woods conference of 1944, when both the U.K. and the U.S. delegations presented plans for world currencies known, respectively, as Bankor and Unitas. At the present time, he said, a world currency could be an IMF currency. The SDR basket, which in 1974 was valued in terms of a basket of 16 currencies had now, he observed, shrunk to four currencies—the dollar, the euro, the yen, and the pound sterling—and the last could disappear if the United Kingdom were to join the euro area.

Such an IMF currency would need a new name, he said, "because who wants a world currency called special drawing rights." The currency would be perfectly convertible into the currencies of the group of three, and the IMF Board of Governors could then designate the group of three area as the agent for managing the world currency. The establishment of a world currency along the lines of the original 1944 proposals would insulate it from the criticism that the IMF was being transformed into a central bank, he said, or that the world currency would be "run by a bunch of international bureaucrats."

A world with a single currency, he said, "would be a tremendous inducement to trade and to a great opening up of trade. It would make for transparency. There'd be no currency crises in the world, by definition. There'd also be no hedge funds to make $20–30 trillion on derivatives now floating around the world—hedge funds trying to overcome the inefficiency that's created by this absurd currency system." ■

Executive Board review

FSAP provides a framework for identifying financial sector vulnerabilities in countries

Financial crises, particularly banking crises, have been common in recent years. While crises have occurred with somewhat greater frequency in developing and emerging market economies, industrial countries have not been spared either. Such crises impose significant costs on the economy. In the great majority of cases, for instance, banking crises are followed by recessions, with the cumulative loss in output sometimes running as high as 10 percent of GDP.

The high incidence of these crises has prompted a global effort to promote greater financial stability. One initiative that has come out of this effort is the Financial Sector Assessment Program (FSAP), jointly introduced by the IMF and the World Bank. Launched on a pilot basis in May 1999, the program involved a dozen countries, including industrial countries such as Canada and Ireland, emerging market countries such as South Africa, and developing economies such as Cameroon and El Salvador.

The IMF's Executive Board reviewed the pilot program in mid-December, and the World Bank's Board did so in early January 2001. The program received a strong endorsement, with the IMF Board stating that "the FSAP process provides a sound framework for identifying financial sector vulnerabilities, strengthening the analysis of macroeconomic and financial stability issues, identifying development needs, and helping national authorities develop appropriate policy responses."

Components of FSAP

The FSAP is, in effect, a comprehensive health checkup for a country's financial sector. What tests are performed? One assesses how well the country's financial institutions handle adversity. FSAP "stress tests" show whether individual institutions, and the financial sector as a whole, are likely to remain solvent in the face of shocks such as sharp changes in the country's exchange rate or world interest rates.

The FSAP also provides a reading on "macroprudential indicators" that have in the past signaled crises. For example, high levels (in excess of a country's foreign exchange reserves) of short-term borrowing in foreign currencies have been associated with many past crises. High readings may suggest the need for remedial measures.

In addition, the FSAP assesses the extent to which countries are observing internationally accepted standards and codes, such as the Basel Core Principles for Effective Banking Supervision. This assessment allows governments to compare their regulatory, supervisory, and other practices against best practices elsewhere in the world. It also helps them evaluate how well risks and vulnerabilities in the financial system are being managed and highlights gaps that may need to be addressed to ensure that all citizens have access to a reasonable range of financial services.

The tests conducted under the FSAP are not ends in themselves. The diagnostic results are integrated into the work of the Bank and the IMF. Based on the FSAP reports, the staffs of the two institutions prepare separate reports for their Executive Boards. The report to the IMF's Board, called a Financial Sector Stability Assessment (FSSA), discusses the likely consequences of alternate macroeconomic policies, exogenous shocks, and financial sector reforms on the financial sector's health.

Collaborative program

While financial sector assessment has always been an important part of IMF and World Bank activities, the

FSAP envisages a greater collaborative effort, based on joint Bank-IMF missions. The program also supplements Bank and IMF staff expertise with outside experts. The knowledge and judgment of these outside experts also adds a valuable element of international "peer review," particularly with regard to the assessment of financial sector observance of standards and codes. To date, more than 50 institutions—central banks, supervisory agencies, and others—have agreed to furnish experts for this program.

Next steps

As is the case with health checkups, follow-up on FSAP missions will be critical if countries are to derive the full benefit of this program. The IMF's Board noted that "an underlying objective of the FSAP is to encourage national authorities to redress identified vulnerabilities and development needs." The IMF and the World Bank are taking steps to ensure that technical assistance is available to countries that seek to remedy deficiencies identified by the FSAP.

The program has also been expanded to cover about 24 countries a year. The IMF and the World Bank intend to use a variety of criteria to establish priorities in selecting countries for the program: a country's systemic importance, its external sector weakness or financial vulnerability, the nature of its exchange rate and monetary regime, and geographic balance among countries. Participation in the program remains voluntary.

Publication of findings

In recent years, both the IMF and the World Bank have taken giant steps toward making the findings of their missions a matter of public knowledge. In the case of FSAP findings, however, some caution has to be exercised. Some information needed to carry out the diagnostic aspects of an FSAP mission's work, especially that related to individual financial institutions, is highly sensitive. Consequently, FSAP reports will continue to be prepared as confidential documents for national authorities. (An exception is that the detailed assessments of observance of standards and codes included in FSAP reports can be published.) However, FSSA reports can be published if the member country consents, under conditions broadly similar to those that currently govern the publication of the Article IV consultations—the IMF's annual reviews of policies with member countries.

Contribution to reducing crises

Although its experience with FSAP so far has been positive, the IMF's Board emphasized that the program "is still relatively new and is built on analytical techniques, tools, and methodologies that are evolving as all the parties involved in the process learn from their experience."

But the IMF and the World Bank are aware that even a more mature FSAP cannot inoculate countries against all future financial crises. These tests can signal the buildup of vulnerabilities, but they are not foolproof. And, to some extent, risk taking—and occasional crises—are an integral part of a dynamic, market economy. But by identifying weaknesses in a country's financial sector and suggesting remedial policies, the IMF and the World Bank believe the FSAP should, over time, contribute to reducing the incidence of crises. ■

Prakash Loungani
IMF External Relations Department

On February 5, the IMF posted on its website Public Information Notice (PIN) No. 01/11, *IMF Reviews Experience with the Financial Sector Assessment Program and Reaches Conclusions on Issues Going Forward*, which summarizes the IMF Executive Board's review of the FSAP pilot program. The full text of the PIN is available on the IMF's website (www.imf.org).

IMF supports Turkish lira flotation

In a news brief dated February 21, IMF Managing Director Horst Köhler said that the IMF supports the decision of the Turkish authorities to float the lira.

"Looking forward," Köhler said, "we welcome the Turkish government's goals of continuing to reduce inflation and ensuring sustainable growth. Continued fiscal adjustment and a strict monetary policy should help stabilize the exchange rate and ensure—possibly after an initial increase—that the inflation rate continues to decline and that the other substantial gains under the IMF-supported economic program are preserved.

"Although the goals of the Turkish government's economic program are unaltered, the change in the exchange rate regime requires a revision of the macroeconomic framework for the economic program supported by the IMF. The authorities have announced that the structural components of the program will be implemented as planned.

"We expect that discussions between IMF staff and the authorities of the necessary changes in the program will begin this week, with a view to allowing the next disbursement to Turkey under the current IMF agreement within the coming weeks. These discussions will explore the possibilities of making resources available under the program to cover some of the increased fiscal costs of bank restructuring," Köhler said.

"The continued involvement of private creditors is critical to the success of Turkey's adjustment program. The IMF expects that commercial banks will continue to maintain their exposure to Turkish commercial banks, in line with the voluntary agreement reached in December 2000."

The full text of News Brief No. 01/21 is available on the IMF's website (www.imf.org).

Aninat address

Capital markets in Latin America face challenges, but benefits are worth the effort

The overall cautiously optimistic outlook for emerging markets provides a valuable opportunity to tackle many of the persisting obstacles to capital market development in Latin America and the Caribbean.
—Aninat

Following are edited excerpts of an address delivered by IMF Deputy Managing Director Eduardo Aninat at the Inter-American Development Bank Conference on Capital Market Development in Washington, DC, on February 5. The full text is available on the IMF's website (www.imf.org).

Over the past decade, Latin America has made great strides in the area of capital market development. Even so, the region still has a long way to go. The potential benefits of further mobilizing capital markets are big; but so, too, are the challenges.

Outlook for emerging markets

We are cautiously optimistic about the near-term outlook for emerging markets for a number of reasons. First, the 1990s financial crises brought home the importance of strong macroeconomic policies and sound financial systems.

Second, we are "cautiously realistic" about the external environment. At this point, world growth now seems likely to be positive, but lower, at about 3½ percent this year, down from its 12-year high in 2000 of 4¾ percent—a steeper drop than had been expected only some months ago. Even in this context, Latin American could well maintain output growth at a respectable 4 percent this year, with inflation declining further to 5–6 percent on average for the region.

Third, we are cautiously optimistic about emerging markets because most global funds now increasingly follow some global benchmark index that has fixed allocations to emerging markets.

On the downside, however, we must acknowledge that the external environment continues to pose three risks. First, the outcome of several external factors, such as U.S. economic growth, interest rates, oil prices, mature market equity prices, and major exchange rates, will heavily influence flows and spreads, as mentioned earlier. Second, emerging markets, being small relative to global capital markets, are affected significantly in the event of a reweighting of benchmark indices. Third, the investor base in emerging markets at times has been quite unstable.

Microeconomic obstacles

The overall cautiously optimistic outlook for emerging markets provides a valuable opportunity to tackle many of the persisting obstacles to capital market development in Latin America and the Caribbean.

In domestic bond markets, Latin America is relatively advanced, owing to the traditionally high financing needs of the public sector, the early introduction of private pension funds, and the associated growth of institutional investors, as well as recent efforts to improve the financial infrastructure of bond markets. There is still a long way to go in developing corporate bond markets, but the progress in government bond markets and the growth of institutional investors now provide a better foundation.

For stock markets, the obstacles are somewhat more challenging, but we see some progress here. Some of Latin America's stock markets have achieved a reasonable market capitalization, although turnover, liquidity, and new offerings are still relatively low. Moreover, domestic market participants are concerned with the decline in liquidity in regional stock markets, as former benchmark stocks are delisted and new offerings are done offshore. It is encouraging to see, however, that several countries are tackling these obstacles and revamping legal infrastructures.

The issue of market size is intimately linked to the integration and deepening of capital markets. One widely recognized benefit of integration—especially for small countries—is access to a greater (and, hopefully, better diversified) pool of capital. In this respect, it is encouraging to see recent initiatives by several stock exchanges in the region to establish alliances with each other, as well as with exchanges outside of the region.

Systemic obstacles

Latin America also faces major obstacles at the systemic level, which is where the IMF has a bigger role to play. The past boom-bust cycles prevented the building of a broad investor base, which is critical for the development of Latin America's capital markets. Indeed, one of the region's biggest challenges is to come to grips with this volatility. In recent years, it has become abundantly clear that the stability of the world economy

Correction: In the February 19 issue of the *IMF Survey*, the table accompanying the article about the IMF Board of Governors' approval of a quota increase for China (page 55) was incorrect. The corrected table follows.

Ten members with largest IMF quotas

Country	Million SDRs	Percent of total
1. United States	37,149.3	17.49
2. Japan	13,312.8	6.27
3. Germany	13,008.2	6.12
4. France	10,738.5	5.06
4. United Kingdom	10,738.5	5.06
6. Italy	7,055.5	3.32
7. Saudi Arabia	6,985.5	3.29
8. Canada	6,369.2	3.00
8. China	6,369.2	3.00
10. Russia	5,945.4	2.80

depends increasingly on the stability of its financial system. That is why Latin America needs to make further progress on implementing sound macroeconomic and financial policies. The IMF will reinforce these efforts by strengthening its work on capital markets and issues in banking system stability.

In terms of crisis prevention, we have begun a permanent dialogue forum with borrowers and creditors, with the recently created Capital Markets Consultative Group, launched by IMF Managing Director Horst Köhler. We are also convening regional meetings with financial sector participants with active senior management presence. The theme of these forums is "constructive engagement"—that is, a continuing dialogue with the private sector in good times as well as bad, in order to learn from our experiences.

One important initiative of the IMF and the World Bank to reduce country vulnerability to external shocks is through "health checks" of a country's financial sector. We want to know how well the financial system would handle adversity. We also want to get a reading on indicators that have signaled crises in the past and on the precise quality of the supervisory and regulatory system. Of course, risk taking is an integral part of a dynamic market economy. But this new program—known as the Financial Sector Assessment Program—should help reduce the incidence of crises by identifying weaknesses in a country's financial sector and by making timely suggestions of remedial policies in the policy dialogue. Where needed, the IMF and the World Bank stand ready to support the national authorities with follow-up technical assistance to help overcome the identified weaknesses.

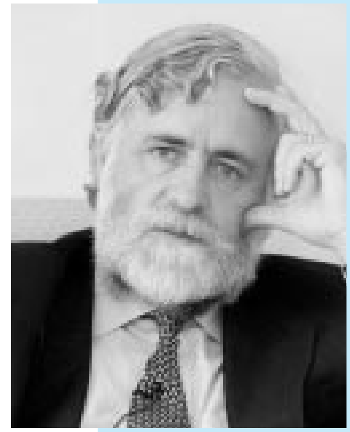
The IMF, in cooperation with the World Bank, is also in the process of developing guidelines for public debt management.

Of course, if Latin America hopes to attract a broader group of investors, it also has to step up its level of transparency—getting better and more timely information out to the markets and the public generally at all levels. Transparency enhances the accountability of policymakers and the credibility of policies and also facilitates the orderly and efficient functioning of financial markets and creates greater competition. One way the IMF is trying to help is through the crafting of international standards and codes of good practice.

As for crisis resolution—for crises will still occur—the IMF is making progress on a framework for private sector involvement. Our strategy has been to use the catalytic approach. This is based on the expectation that with the sustained implementation of corrective macroeconomic and structural policies and the provision of official financing, countries stand a good chance of regaining access to international capital markets relatively quickly.

But how about when countries face more difficult situations? In these cases, we need to explore a wider range of financing options, including encouraging the private sector to stay involved.

Finally, we are hopeful that some Latin American countries will choose to take advantage of a new loan facility set up in 1999 by the IMF, the Contingent Credit Line Facility. Unlike other IMF facilities aimed at countries already in trouble, this new facility is aimed at keeping countries out of trouble. It offers countries with strong policies an additional, preventive defense line against potential episodes of financial contagion and of excessive volatility. ■



Aninat: "The past boom-bust cycles prevented the building of a broad investor base, which is critical for the development of Latin America's capital markets."

IMF establishes International Capital Markets Department

In a news brief dated March 1, the IMF announced the creation of an International Capital Markets Department.

The IMF will establish an International Capital Markets Department to enhance its surveillance, crisis prevention, and crisis management activities, Managing Director Horst Köhler announced.

The new department will consolidate activities and operations that are currently spread among three departments, and it is envisioned that the new unit will have some enhanced responsibilities, including systematic liaison with the institutions that supply the bulk of private capital worldwide. The department will also play a central role in the IMF's conceptual work related to the international financial system and to capital market access by member countries, Köhler noted.

"I see this department," Köhler said, "as a vital part of the ongoing efforts to strengthen the international financial architecture, and in particular to strengthen the IMF's role in crisis prevention.

"With this move, the IMF is sending a clear signal that it is serious about its commitment to being a center of excellence for work on financial markets issues. It will:

• deepen the IMF's understanding of capital market operations, and of the forces driving the supply of capital;

• strengthen the IMF's capacity for addressing systemic issues related to capital market developments;

• enable the IMF to conduct more effective surveillance at both the national and international levels;

• enhance the IMF's capabilities in providing early warning of potential stress in the financial markets; and

• strengthen the IMF's ability to help member countries gain access to international capital markets, and to deal with and benefit from interactions with the international capital markets."

Köhler said he hopes to appoint a department director with the appropriate professional background and experience as soon as possible.

The full text of News Brief No. 01/24 is available on the IMF's website (www.imf.org).

IMF surveillance of euro area reflects increasing interest in multilateral approach

The IMF recently posted on its website (www.imf.org) the concluding statement of an IMF mission to European Union (EU) institutions to discuss the economic policies of the euro area. Alessandro Zanello, Chief of the IMF's EU Policies Division, explains how the IMF conducts surveillance of the euro area and discusses the issues raised in the IMF's concluding statement.

In stage 3 of the European Economic and Monetary Union (EMU), member countries replaced their national exchange and monetary policies with common policies determined by EU institutions, including the European Central Bank (ECB). This institutional change had immediate procedural and operational implications for IMF surveillance.

The key issue is that only countries are members of the IMF, and EU institutions have no obligations under the IMF's Articles of Agreement to discuss their policies with it. However, euro-area countries must make sure that the IMF is able to carry out its mandate under the Articles, and an Article IV consultation with a member cannot be completed without the IMF having an opportunity to assess core policies—such as monetary and exchange rate policies—that fall within its jurisdiction.

Therefore, in late 1998, just before the start of stage 3 of EMU, the IMF Executive Board decided that discussions with representatives of the relevant EU institutions—the ECB, but also the Council of Ministers, which has prerogatives in the area of the exchange rate—needed to take place as part of the Article IV consultations with individual euro-area countries.

Photo Not Available

The headquarters of the European Central Bank in Frankfurt, Germany.

In practice, the current frequency of Article IV consultations with individual euro-area countries—generally a 12-month cycle—has been maintained. Staff missions visit these countries and report to the Executive Board on national economic developments and the policies that are shaped and implemented at the national level (notably, fiscal and structural policies).

In addition, twice a year IMF staff hold discussions with the EU institutions responsible for common policies (monetary and exchange rate policies). Although these discussions are held separately from the discussions with individual euro-area countries, they are considered an integral part of the Article IV process for each member. Board discussions of individual euro-area countries are clustered, to the extent possible, around the time of the discussions with the relevant EU institutions. While the key policy discussions are essentially at the ECB in Frankfurt, IMF staff also visit the European Commission in Brussels to provide a context on EU- and euro area–wide developments.

Staff reports on these discussions are issued to the IMF Executive Board. One of these reports provides the basis for a Board meeting on the monetary and exchange rate policies of the euro-area countries in the context of the Article IV consultation with these countries. This discussion typically takes place every fall. A follow-up report on the second set of discussions is normally issued each spring for the information of the Board; it provides the context for bilateral consultations with the euro-area countries whose reviews do not coincide broadly with the annual Board discussion of the euro area. It is expected that this second report will not give rise to a Board meeting, but any Executive Director can call for a formal discussion of the matters covered in the paper.

At the end of each mission, the staff team prepares a concluding statement that is left (and discussed) with the president of the ECB and the Eurogroup—the informal group of finance ministers in the euro-area countries. This short paper contains preliminary remarks and highlights themes that are usually more fully explored in the subsequent staff reports.

The recently released concluding statement argues that, while the internal dynamics of the euro area remain robust, a weaker external environment heightens downside risks to the outlook. Domestic demand growth is projected to hover around 3 percent on the back of tax cuts, steady employment creation, and high corporate profitability. Against the background of a sharper-than-expected slowdown in the United States, a faltering recovery in Japan, and some turnaround in the euro exchange rate, the external sector will, however, contribute less this year to GDP growth than in 1999–2000. Overall, growth in the euro area is likely to decline from the 3.4 percent annual rate in 2000 to about 2¾ percent in 2001.

In this context of slower global growth and reversing oil prices, the staff argues, the risks to medium-term price stability are receding, and headroom may be emerging for cutting interest rates, especially if the global slowdown proves deeper than currently anticipated or if the euro appreciates sharply. However, a wait-and-see attitude in monetary policymaking seems appropriate for now, given that currently some indicators of inflationary pressure are still in excess of ECB targets.

IMF surveillance of the euro area exemplifies its increasing interest in regional and multilateral surveillance. This interest is also reflected in the procedures for monitoring the other monetary unions among IMF members, notably the West Africa Economic and Monetary Union (WAEMU), the Central African Economic and Monetary Communities (CAEMC) (which jointly comprise the CFA or Communauté financière africaine), and the Eastern Caribbean Central Bank (ECCB). The IMF's Executive Board holds yearly discussions on monetary and trade policies of the CFA, while developments in the ECCB are reported to the Board but are not for now the subject of a formal Board meeting. ■

Recent publications

Books

India at the Crossroads—Sustaining Growth and Reducing Poverty, edited by Tim Callen, Patricia Reynolds, and Christopher Towe ($27.00)

Kosovo: Macroeconomic Issues and Fiscal Sustainability, Robert Corker, Dawn Rehm, and Kristina Kostial ($18.00)

Occasional Papers ($20.00)

No. 204: *Monetary Union in West Africa (ECOWAS)*, Paul Masson and Catherine Pattillo

Working Papers ($10.00)

01/01: *Monetary Independence in Emerging Markets—Does the Exchange Rate Regime Make a Difference?* Eduardo Borensztein, Jeromin Zettelmeyer, and Thomas Philippon

01/02: *Crises and Liquidity—Evidence and Interpretation*, Enrica Detragiache and Antonio Spilimbergo

01/03: *China's Provincial Growth Dynamics*, Jahangir Aziz and Christoph Duenwald

01/04: *Are African Current Account Deficits Different? Stylized Facts, Transitory Shocks, and Decomposition Analysis*, César Calderón, Alberto Chong, and Luisa Zanforlin

01/05: *Recursive Utility, Endogenous Growth, and the Welfare Cost of Volatility*, Anne Epaulard and Aude Pommeret

01/06: *Growth Slowdown in Bureaucratic Economic Systems: An Issue Revisited*, Zuzana Brixiová and Aleš Bulíř

01/07: *Inflation Targeting with NAIRU Uncertainty and Endogenous Policy Credibility*, Peter Isard, Douglas Laxton, and Ann-Charlotte Eliasson

01/08: *Budgetary Transparency for Public Expenditure Control*, Franco Reviglio

01/09: *Time-to-Build and Convex Adjustment Costs*, Petya Koeva

01/10: *Modeling Politics with Economic Tools: A Critical Survey of the Literature*, Jan-Peter Olters

01/11: *The Role of Medium-Term Fiscal Frameworks for Transition Countries—The Case of Bulgaria*, Balazs Horvath and Istvan Szekely

01/12: *Different Strokes? Common and Uncommon Responses to Financial Crises*, James M. Boughton

01/13: *Counterfeit Goods and Income Inequality*, Stefania Scandizzo

IMF Staff Country Reports ($15.00)

01/27: Burkina Faso: Second Review Under the Poverty Reduction and Growth Facility

01/28: Ukraine: Statistical Appendix

01/29: Albania: First Review Under the Third Annual Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criteria

01/32: Malawi: Selected Issues and Statistical Appendix

01/33: Norway: 2000 Article IV Consultation

01/34: Norway: Selected Issues

01/35: Cambodia: Second Review Under the Poverty Reduction and Growth Facility

01/36: Tunisia: 2000 Article IV Consultation

01/37: Tunisia: Statistical Appendix

01/38: Malawi: 2000 Article IV Consultation and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility

01/39: Panama: 2000 Article IV Consultation

01/40: Republic of Lithuania: Statistical Appendix and Tax Summary

01/41: Panama: Recent Economic Developments

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Interview with Malcolm Knight

Canada's inflation-targeting regime provides transparency and effective nominal anchor

On February 16, Malcolm Knight, Senior Deputy Governor of the Bank of Canada, delivered an IMF Institute seminar on monetary policy and inflation targeting in Canada. Knight, who had a long and distinguished career at the IMF before joining the Bank of Canada, spoke with Martin Kaufman, Economist in the IMF's Western Hemisphere Department, about Canada's experience with inflation targeting and about the circumstances in which inflation targeting might be appropriate for other countries.

The inflation-targeting framework bolsters credibility because it is very transparent.
—Knight

KAUFMAN: What prompted Canada to adopt inflation targeting? And what major challenges did the country face in implementing it?

KNIGHT: In the 1970s and 80s, Canada experienced high and variable inflation. At times when inflation rose, the Canadian dollar tended to depreciate, and that fed back into a higher inflation rate. Partly because of this vicious circle, Canada's macroeconomic performance during the 70s and 80s was weaker than it could have been. As a result of this experience, Canadians came to realize that our country needed a clear nominal anchor for monetary policy if its floating exchange rate was to do an effective job in helping the economy to adjust to external shocks. And the best nominal anchor that the Bank of Canada could find was a direct target for low and stable inflation.

Canada adopted its inflation-targeting regime in 1991, during a time when the inflation rate was more than 4 percent a year. The authorities wanted to bring the annual inflation rate down to a range of 1 to 3 percent, but without severe adverse effects on output and employment. To do this, the Bank of Canada embarked on a gradual path of disinflation. In the wake of the 1990–91 recession, inflation came down more quickly than expected, and over the past nine years it has stayed at close to 2 percent on average.

In terms of better economic performance, Canada really didn't see the benefits of low inflation until the move to reduce fiscal deficits at the federal and provincial levels began in earnest in 1995. This strengthening of fiscal policies has led, more recently, to a declining trend in the ratio of public debt to GDP. With this move, interest rates under the inflation-targeting policy also came down. All in all, I'd say that since 1996 the combination of our solid record in maintaining low inflation and enhancing fiscal policies has been a major contributor to the improved economic growth and declining unemployment rates Canada has seen.

KAUFMAN: How does Canada determine its inflation target, and how does it make inflation targeting operational?

KNIGHT: The inflation target is jointly agreed between the government and the Bank of Canada. There have been three such agreements since 1991. The current one remains in place until the end of this year, 2001. The target range has been 1–3 percent a year since 1995, and this range has been broadly viewed as appropriate for maintaining low and stable inflation, increasing the credibility of monetary policy, and—over the past five years—underpinning steady growth in output and employment.

We target the middle of the 1 to 3 percent range over time. For operational purposes, the Bank of Canada uses "core inflation," a measure that generally conforms to the total consumer price index (CPI) over time but excludes the more volatile energy and food commodities and the effects of changes in indirect taxes. At present, total CPI inflation is about 3 percent, reflecting the effect of energy prices that have been rising sharply since early 1999, but core inflation is about 2 percent.

Ultimately, of course, households and businesspeople are concerned about the overall rate of inflation. So if the divergence between core inflation and total CPI inflation were to persist, we would want to make sure that the overall inflation rate remained in the 1–3 percent range.

KAUFMAN: How does the inflation-targeting framework foster credibility and help anchor long-term inflation expectations?

KNIGHT: The inflation-targeting framework bolsters credibility because it is very transparent. Maintaining low and stable inflation, within a 1–3 percent target range, is a very clear goal that the average person can understand. It resonates with people because they know we are trying to watch changes in the cost of living and keep it low. The transparency of this target also helps our two-way communication with the financial markets and the general public. It makes it clearer that whenever we act, we are doing so to keep the future trend of inflation within the target range. Then, we can interpret market and media reactions to our policy actions to determine whether they think we are doing the right thing.

The credibility of the inflation-targeting policy can be measured by whether expectations of future inflation are broadly consistent with the level we are targeting. For several years now, the available indicators have consistently suggested that the financial markets and the general public expect an inflation rate of about 2 percent a year, which is right in the middle of our target range.

KAUFMAN: Can the design of institutional arrangements ease the costs associated with credibility building?

KNIGHT: The basic law governing the operations of the Bank of Canada—the Bank of Canada Act—sees it as an independent institution. The law also sees the governor—or in his or her absence, the senior deputy governor—as responsible for the conduct of monetary policy. That is why the act insists that the governor and the senior deputy governor be people of proven financial experience. They are appointed, on good behavior, for a term of seven years, which gives them a degree of independence. In practice, for some years monetary policy has been formulated by the Governing Council of the Bank, which currently consists of the governor, the senior deputy governor and five deputy governors. In reaching its decisions, the Governing Council takes account of the advice and recommendations of its senior economics staff, gathered together in a group called the Monetary Policy Review Committee.

It's also important that the inflation-targeting procedures give the Bank of Canada a degree of independence. The target range is agreed upon by the government and the bank, but the bank is responsible for taking the monetary policy actions needed to achieve that objective. That, I think, gives the bank an important degree of independence in the public's mind. If people believe the bank will always take policy actions to achieve its announced goal of maintaining low and stable inflation, that confidence tends to reduce the costs of building credibility, because people are really focusing on a clear monetary policy objective.

KAUFMAN: What benefits has Canada gotten from adopting an explicit inflation-targeting regime?

KNIGHT: Although Canada is an advanced industrial country, a relatively large proportion of its production and exports consist of primary commodities. This means that changes in commodity prices affect our terms of trade differently from those of most other advanced industrial countries. When commodity prices fall relative to the prices of manufactured goods, our flexible exchange rate helps to absorb some of the adjustment more efficiently than would be the case if all the pressure fell on nominal wages and other factor incomes.

But the exchange rate only works well in helping the economy adjust if there is a clear nominal anchor for domestic prices. When people are confident that, regardless of whether the Canadian dollar appreciates or depreciates, the Bank of Canada is committed to maintaining the inflation rate at the same low and stable rate, then businesspeople know that an appreciation of the Canadian dollar means they are going to have to find efficiencies in other areas of their cost structure if they want to maintain profit margins. Similarly, when the Canadian dollar depreciates, businesspeople know that if they try to pass on the increased Canadian dollar price of imported goods into their prices, the demand for their products may weaken.

High inflation creates a lot of uncertainty in the economy, and people have to use real resources to adjust to that. Low and stable inflation should reduce those costs and allow the economy to perform better. But does it? If you look at Canada in the early 1990s, growth of output and employment was not particularly strong. But this was a period when the Canadian economy was restructuring very deeply in response to worldwide technologi-

Knight: "If you float, you absolutely must have a clear nominal anchor."

Available on the web (www.imf.org)

Press Releases

01/5: IMF Approves Third Annual PRGF Loan for Senegal, February 16

01/6: Republic of Yemen: Third PRGF and EFF Credits, February 28

01/7: Madagascar: $103 Million PRGF Loan, March 1

News Briefs

01/20: IMF Publishes Staff Ethics, Financial Disclosure, Dispute Resolution Information on Website, February 15

01/21: IMF's Köhler Supports Turkey's Lira Flotation, February 21 (see page 77)

01/22: IMF Approves Letter of Intent for Colombia's Second Year Under EFF, February 26

01/23: IMF Completes Uruguay First Review, February 26

Public Information Notices

01/13: Tunisia, February 13

01/14: Panama, February 16

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Speeches

IMF Managing Director Horst Köhler, "Breaking the Cycle of World Poverty," Conference on Child Poverty, Education, and Health, London, February 26 (see page 71)

Transcripts

Press Briefing, Thomas Dawson, IMF External Relations Department Director, February 15

Report on the Observance of Standards and Codes*

Greece (update), February 22

Other

Progress Report on the Heavily Indebted Poor Countries Initiative and Poverty Reduction Strategy Papers Program and Work Priorities for 2001, February 15

IMF Financial Activities, February 16

The IMF–World Bank Financial Sector Assessment Program, Paul Hilbers, February 23 (see also page 76)

* Date posted.

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cal changes and intensifying competition, the U.S.-Canada Free Trade Agreement, and, later, the North American Free Trade Agreement. At the same time, it was also adjusting to lower inflation under the inflation-targeting regime. And the early 1990s were a time when we still had a lot of problems with the stance of fiscal policies.

If you look at the years since 1996—a period when there has been a real strengthening of fiscal positions at both the federal and provincial levels, and inflation expectations have become anchored around the middle of our inflation-target range—you see consistently strong growth of output and a steady decline in our unemployment rate to its lowest level in a quarter of a century. You also see a significant strengthening of business investment in machinery and equipment. We hope that these are signs that under low and stable inflation the economy does perform better in real terms. We have seen improvements in productivity growth over the past year or so, and we hope that they will now be sustained over the longer term.

KAUFMAN: What lessons can other countries, especially developing countries, draw from Canada's experience?

KNIGHT: Canada's experience suggests that inflation targeting can be a very good element of a monetary regime for a country that chooses to float its exchange rate. For a developing country likely to be subject to economic developments that differ from those that affect its trading partners, it's important to have a floating exchange rate. And a floating exchange rate will work better in helping the country adjust to shocks if there is a clear nominal anchor for domestic prices. For these reasons, at the Bank of Canada we are convinced that consistently achieving low and stable inflation improves overall economic performance in the longer term.

Another point I would make is that targeting low and stable inflation, particularly in a developing country, really imposes a lot of discipline on fiscal policy. In many developing countries, there is quite a direct relationship between excessive fiscal deficits, monetary expansion, and inflation. Targeting low and stable inflation in a developing country is a way to give a transparent commitment to the public that the authorities will maintain good performance, not only in monetary policy but also in fiscal policy.

KAUFMAN: What role do initial conditions play in the choice of an appropriate monetary policy?

KNIGHT: Initial conditions pose a tricky question. If a country has a large outstanding debt stock denominated in foreign currency, variations in the exchange rate are going to have an impact on the debt-servicing profile relative to the country's export receipts. But this is a transitional problem. You can still move into a

Malcolm Knight (left) with Martin Kaufman.

framework of inflation targeting. It's just a question of knowing the maturity of your foreign currency debt and debt service, and structuring the move to the new framework so that it doesn't create problems.

For example, it would be more difficult for a country like Argentina, with its past history of high inflation and currency depreciation, to shift easily to a flexible exchange rate and inflation targeting. But we can take a different example: Brazil. One factor that seems to make a flexible exchange rate a good choice for Brazil is that it is a large economy with lots of nontraded goods, and this structure ensures that there is less pass-through from exchange rate changes to the domestic inflation rate. I believe that Brazil's experience over the past two years has shown that the institutional arrangement of a flexible exchange rate and inflation targeting has worked well, particularly since it has been reinforced by a marked improvement in the commitment to fiscal stability. Mexico is also doing well under inflation targeting. But since the Mexican economy has a much larger traded goods sector, the authorities have to be more conscious of the pass-through effects.

KAUFMAN: What difference does it make if a country has a very open economy?

KNIGHT: If a country has a totally open economy and no nontraded goods, then it may want to peg its exchange rate and accept the world inflation rate. A hard exchange rate peg or membership in a currency union is a good way to stabilize the domestic price of consumer goods. In a small, open, oil-exporting country, for example, movements in the exchange rate would have little effect on the profitability of petroleum exports. Such exchange rate pegging arrangements also help to maximize the microeconomic gains from international exchange. But when an economy has nontraded goods and services—and certainly labor is a nontraded service—then it may well be better to allow the currency to float. But I guess that, to repeat my main message, if you float, you absolutely must have a clear nominal anchor. ■