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*"Broader picture"*

# Köhler seeks to place current reform initiatives into new "vision about the future" of the IMF

At his first Washington press conference since taking office as IMF Managing Director, Horst Köhler said on May 25 that the IMF's work program in the coming weeks would be organized in "a double-track process." The first track would be that the Executive Board would continue to work on the agenda set by the International Monetary and Financial Committee at its April meeting (*IMF Survey*, April 24, page 119), specifically a review of IMF facilities, standards and codes, transparency, and the Heavily Indebted Poor Countries Initiative. The second track, he said, would seek to place these initiatives in a broader picture, which he called "a vision about the future" of the IMF. A special working group has been organized to concentrate on this, he disclosed. (For an edited transcript of Köhler's press conference, see page 178.)

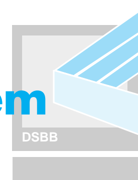
*IMF Managing Director Horst Köhler.*

Köhler further elaborated this vision in an address to the International Monetary Conference in Paris on May 30. He raised the issue of where globalization is heading, the initiatives that are being undertaken by the international community, and the desirability for the IMF "to pay the utmost attention to crisis prevention, especially through sound macroeconomic policy, the promotion of transparency, and the implementation of practical standards and codes." He called for a "well-informed and wide-ranging" dialogue between the IMF and the private sector that would become "a permanent feature of the IMF's work." (For an edited text of Köhler's speech, please see page 180.)

At his press conference, Köhler also reported on his visit to Latin America. *(Please turn to the following page)*

*Metadata posted*

# IMF's General Data Dissemination System enters operational phase




The IMF's General Data Dissemination System (GDDS), launched in December 1997, has entered its operational phase. The entry, announced in a May 22 news brief, was signaled by a posting on the IMF's Data Standards Bulletin Board (DSBB) of information on the statistical systems (or "metadata")—including plans for improvements—of nine participating countries, spanning all the major geographical areas. The GDDS site also provides general information on the GDDS, including its principal features and conditions for participation by member countries.

The posting of the metadata on the IMF's website follows up on the pilot phase, which provided country authorities with information on the GDDS and assisted them with the preparatory work necessary for participation. The IMF will maintain the GDDS site as a service to the membership and will periodically add and update metadata for participants.

## Metadata provide benefits

The metadata posted on the GDDS site are expected to be helpful for several groups, including official statistical agencies in other countries, data users, and providers of technical assistance. Statisticians in other countries may find information on dissemination practices and approaches *(Continued on page 182)*

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# Köhler discloses new vision about the future

(Continued from front page) He said that he had been impressed by the dedication of the political leaders, other senior officials, and businesspeople he met to continuing the democratic process and to organizing their economies on a market-oriented basis, as well as by their readiness to continue with the reform agenda. He had made it clear to them, he said, that the market economy needs to be based on society's consent about the social dimension of development. Also important, he said, was that these countries did not ask for particular favors from the IMF. They agreed that to make growth stronger and steadier, there would have to be a strong reform process and structural change, not only in developing countries but also in industrial countries.

Köhler announced that, beginning May 31, he would visit Asia for meetings with leaders and financial sector representatives from Thailand, China, Korea, Indonesia, and India, to be followed by meetings with representatives of private capital markets in New York. He also said that, beginning July 10, he would visit Africa for discussions with the leaders of several countries, probably including South Africa and Nigeria. Before the September Annual Meetings in Prague, he planned to have a dialogue with civil society and nongovernmental organizations as part of the IMF's ongoing discussions with these groups. ■

*Press conference*

# Köhler discusses activities of first weeks in office, outlines "double track" for forthcoming agenda

*Following are edited excerpts of a press briefing by IMF Managing Director Horst Köhler on May 25, in Washington, D.C. Thomas Dawson, Director of the External Relations Department, also participated. The full text is available on the IMF's website (www.imf.org).*

KÖHLER: I am more impressed than ever with the quality and commitment of the staff, my management colleagues, and the Executive Board. Yesterday at the Board, we had a full day's discussion about the IMF's work program. We agreed to organize our work on a double track. On one track, we will work on the homework given to us at the spring meetings: review of facilities, standards and codes, transparency, and the HIPC [Heavily Indebted Poor Countries] Initiative. On the other track, I want to put these items into a broader picture—what I call a vision about the future of the IMF. We have organized a special working group that is concentrating on that.

Köhler (left, with Thomas Dawson): "My personal priority in these first weeks is listening and getting input."

My personal priority in these first weeks is listening and getting input. I have my ideas, but it is important to listen very carefully, have talks, and build up a dialogue. I have been meeting individually with every Executive Director of our member states. I came back from a tour of Latin America just last week, where I met with the leaders and economic teams of Argentina, Brazil, Honduras, and Mexico. I also took the opportunity to meet with businesspeople. At a lunch meeting in Honduras, I met with representatives of all parts of society—farmers, women, NGOs [nongovernmental organizations], and so on.

Next week, on a tour of Asia, I will meet with leaders and people from the financial sectors of Thailand, China, Korea, Indonesia, and India. Coming back from this tour, I will meet in New York with representatives of private capital markets. And we will, hopefully, have enough time before the Annual Meetings in Prague to organize a meeting here at the IMF with representatives of civil society to show that we are prepared to have a dialogue with civil society and the NGOs.

What impressed me most in Latin America was how clearly committed and dedicated the leaders, ministers of finance, central bank governors, businesspeople, and even trade unions—which I met with in Argentina—are to democracy and to organizing their economies on a market-oriented basis. The leaders made me aware of the dialogue with civil society and encouraged me to build up this dialogue but also expressed some concern that this dialogue should not undermine the legitimacy of democratically elected and established institutions.

I was also very much impressed with how prepared they are to continue with a clear agenda for reform policies. All of them told me they will stay on track with the economic policies they have been pursuing. This has already paid off for Mexico, which has a very strong growth performance, and clearly seems to be paying off for Brazil, whose recovery is gaining strength. It is also showing some success in Argentina, but its economy is not recovering so strongly. In Honduras, which was badly damaged by Hurricane Mitch, there seems to be a new spirit. That is the most important thing—to get out of the mess. So they stay on track.

I discussed very carefully the situation in Argentina. I had a good talk with the leaders of the trade unions. The main focus was on the social tensions in Argentina. I made clear that the market economy needs to be based also on a consensus about the social dimension of development. There cannot be blindness to poverty and social problems—that was also the understanding of the president and the government. So despite the difficulties and the sacrifices, I hope the ongoing process will stay on track.

What was also important is that these countries didn't ask for particular favors from the IMF; they rely on themselves. But they also complained strongly that developed countries seem to believe that only the emerging countries have to reform. I agreed that to make global growth stronger and steadier, there must also be a strong reform process and structural change in the developed countries. For instance, the weak euro was a point of concern in Argentina particularly, but also in Brazil and Mexico. And the request that markets be opened more rapidly for these countries was a constant demand of these leaders.

In the IMF and other forums, there is an understanding that stronger and steadier world economic growth will require structural change and reform policy in the developed as well as the emerging and transition countries. This issue has to get more attention in the political debate to fight poverty and reduce the frequency and severity of crises.

**QUESTION:** *What kind of structural changes are needed to rescue the euro?*
**KÖHLER:** This has to be defined country by country, but the main direction is quite clear. The big countries in Europe must reform their social security and tax systems and make their labor markets more flexible. There is also a question about the sustainability of the European Union's agricultural policy. These reforms do take time, but if the direction is clear, and commitment is clearly demonstrated, they will also have an impact on the euro in the short term.

**QUESTION:** *How can Argentina simultaneously deal with its social problems and make the adjustments and reductions in debt needed to comply with the IMF?*
**KÖHLER:** First, I was quite impressed that the president of Argentina firmly told me that it is his government's program and not one imposed by the IMF. Ownership of programs and reforms is very, very important. Argentina has to make tough choices. You have to decide to spend on investment or consumption, and emerging countries need to make investment a priority. But when I met with Argentina's trade unions, I had the feeling that this basic principle is understood, or could be explained and in the end will be understood. I am optimistic that these tough choices will pay off for the people. And the most important way for countries like Argentina to deal with debt is to strengthen growth.

**QUESTION:** *Are you planning to talk to anyone in the U.S. Congress?*
**KÖHLER:** Before I answer with regard to the U.S. Congress, let me tell you that I met with members of the Honduran legislature, and we had a very interesting discussion. Honduras is a HIPC [a participant in the Heavily Indebted Poor Countries Initiative] and is in the process of getting to the decision point where it is eligible for debt relief. To do so, it has to take prior actions. And among the items the IMF had suggested is reform of the social security system and approval of a framework law for the energy sector, particularly the electricity sector. Social security reform is well under way, but the law for the energy and electricity sector is a bit stalled, because the legislators told me that the time is too short for them to understand the full impact of this law. I said that certainly the IMF will not press for congressional approval in two weeks' time. It is too important that congress, which is the most important institution in a democracy, have the full understanding of what the law means and what its impact will be. We are flexible in process but firm in substance, so that the issue of, for instance, raising electricity tariffs in the medium term is not forgotten. Based on that, I think that we will get a good conclusion in Honduras.

It is important for me to elaborate first on the congress of a small and poor country before I come to the congress of a big and rich country. But I will take up a dialogue with the U.S. Congress. I am in the process of organizing appointments and am quite confident that it will be a very constructive dialogue.

**QUESTION:** *Will the IMF formally respond to the Meltzer Report [the report of the International Financial Institutions Advisory Commission of the U.S. Congress, March 2000]? And will you meet with Meltzer or others on the commission as part of your listening process?*
**KÖHLER:** I will meet with Professor Meltzer. I have already told him so in response to his letter congratulating me on my appointment as Managing Director. And the then–Acting Managing Director, Stanley Fischer, has already testified before the U.S. Congress on the Meltzer report.
**DAWSON:** Mr. Fischer also appeared with Professor Meltzer as recently as last week. And the actual formality of the commission is that the U.S. Treasury, to whom it was in part directed, is preparing a response.

**QUESTION:** *Some say the only way for Argentina to grow again is to restructure its debt. What is your view?*
**KÖHLER:** Restructuring, rescheduling, or other steps are an issue for Argentina and its creditors. But a major point in dealing with this issue is for Argentina to keep the confidence it has built up in the last years



**"We are flexible in process but firm in substance."**
**—Köhler**

with the private capital markets and the international community. And the IMF is prepared to play a role in this ongoing confidence-building process. Argentina has the potential to prove it is a reliable partner and—even more important—has the potential and the commitment to achieve a very strong growth path.

QUESTION: *Will the working group looking at a vision for the Fund include external experts?*

KÖHLER: We are in mid-process in organizing it. The core of this group will be the heads of some IMF departments. We will also try to get some external advice, but give us a bit more time to organize it more carefully. I am chairing the working group, but it will involve the full management team. In terms of size, it should be big enough to have the full range and expertise needed, but small enough to be practical.

QUESTION: *Do you see the Mexican economy overheating?*

KÖHLER: The Central Bank of Mexico was right to raise its interest rates. Mexico's fundamentals have improved remarkably, and there is potential for steady growth. With some vigilance, which has been demonstrated by the decision of the central bank, it should be possible to hold up strong growth for some period in Mexico.

QUESTION: *When are you going to Africa, and which countries are you going to?*

KÖHLER: I am planning to make a one-week trip to Africa beginning July 10. The countries may include South Africa and Nigeria and several francophone countries—about four or five countries—but the trip is still being planned. ■

*International Monetary Conference*

# In Paris, Köhler calls for continued vigilance and greater focus on crisis prevention

*Following are edited excerpts of an address by IMF Managing Director Horst Köhler at the International Monetary Conference in Paris, on May 30, 2000. The full text is available on the IMF's website (www.imf.org).*

The underlying conditions in the world economy are still broadly quite favorable. The IMF's staff is maintaining its forecast that world output growth will increase from last year's 3 1/4 percent increase to over 4 percent this year, and will continue at about the same pace in 2001. These projections reflect buoyant activity in most advanced economies, which has underpinned the worldwide recovery from the financial crisis that began three years ago. The rebound of the emerging market economies has been particularly noteworthy. Their commitment to structural reforms and sound financial policies has been the basis for this recovery—and the IMF has had a significant part to play in promoting this. But there is no room for complacency. The current situation contains some risks, uncertainties, and challenges, which call for vigilance and policy action.

• First, our current forecast for the world economy assumes that a rebalancing of global growth across the major advanced economies takes place in a gradual manner. But a disorderly correction in U.S. asset prices or any other development that leads to a hard landing of the U.S. economy could have pronounced effects on world demand and the international financial markets.

• Second, external financing flows to emerging markets have shown large fluctuations over the past five years and are likely to remain volatile in the period ahead, particularly since they appear sensitive to U.S. interest rates. With emerging markets vulnerable to such volatility, it is essential that they maintain the momentum of structural reforms and also keep their macroeconomic situation as strong as possible.

• Third, reform is not a one-way street; it is not just a responsibility of the emerging market and developing countries. A revolution in technology and communications is under way, but not all advanced economies are yet realizing its full potential. The advanced economies should accelerate their own efforts to remove the rigidities that may impede the structural transformation that is taking place. A credible reform agenda for the mature economies—in particular, an accelerated opening of their markets—is indispensable for global growth and will reassure markets that the correction currently under way in world equity markets need not become disorderly.

But there is an even broader, longer-term issue: where is globalization heading? Undeniably, it has proven potential for promoting growth, investment flows, and technology transfers in a growing number of countries. But we should also be quite honest in facing up to the reservations that are often expressed.

A vocal constituency questions whether the world economy and globally integrated financial markets can work in the interests of all. We have to acknowledge that there is a problem of global inequality and poverty. And, in the medium to long term, such inequity could easily become a source of political and social instability and, ultimately, of economic instability also. Therefore, poverty reduction should be a vitally important issue for all of us.

## Strengthening financial architecture

The question, then, is how best to tackle this problem. It needs, of course, a comprehensive approach, includ-

ing, not least, education and training, good governance, and a well-functioning social safety net. But key to the solution is strong world economic growth and the opportunity for developing countries to participate in this growth. We know, in this context, that global financial markets are a vital source for global growth and investment. But the experience of the past decade has shown that these markets are also prone to considerable volatility, thus making them a source of turbulence and crisis themselves. Therefore, it is right and important that the international community is now concentrating its discussion on the strengthening of the international financial architecture.

The international community has undertaken numerous initiatives, many of which are being implemented by the IMF. Much of the work is still experimental or in its pilot stages, but clear direction and tangible progress are evident in key areas. These include

- promotion of transparency and accountability;
- development of internationally recognized standards and codes;
- strengthening domestic financial systems and to assess financial sector stability in many countries;
- work by the Bretton Woods institutions and others to assess external vulnerability; and
- continuing debate over appropriate exchange rate regimes, which brings attention to bear on the paramount importance of supporting that choice with appropriate macroeconomic policies.

## Two-track IMF work program

This is "work in progress," and the IMF has a strong commitment to carrying it forward through its surveillance and, where needed, through technical assistance. But I want to go a step further and find a credible answer to the question of where the IMF itself has to change. Therefore, we have established a two-track work program for the IMF in the coming months. One track responds to the guidance of the International Monetary and Financial Committee, which, at its meeting last month, set us a very full program—so full and so sophisticated, for example in the area of standards and codes, that I worry a bit about the practicality of implementation in many developing countries.

The second track of our work program will seek to outline a vision for the future role of the IMF. We want the IMF to be as effective as possible in contributing to prosperity in all parts of the world. The IMF has a long history of continuous reform and adaptation, and clearly it has not been standing still in the past few years since the emerging markets crisis. I see no need to turn the IMF upside down or to devise some new, grand design for it. But the crucial question for me is whether the IMF has sufficiently adapted to a world where financial markets have seen such phenomenal growth in size and sophistication. In this context, I see the many recent reports on IMF reform as clearly helpful. The bulk of these reports recommend that the IMF should be more focused in its activities. I share this view. The authority of the IMF derives strongly from its expertise. No institution can have expertise everywhere. The IMF's concentration on macroeconomic stability should lead to a focus in its advice on monetary, fiscal, and exchange rate and financial sector policies. The IMF should have a clear position about the key elements of a global growth strategy, and this should be discussed and agreed upon with the other multilateral institutions. But based on this and with good cooperation among these institutions, there should also be a clear division of labor, not least between the World Bank and the IMF.

No one can rule out the possibility of more financial crises in the future. The difficulty is that we do not know where or when they will occur or how severe they will be. Therefore, clearly, there is a need for an official international lending agency to be able to mount a credible response. The recent establishment of the Supplemental Reserve Facility and the Contingent Credit Lines is certainly a conceptually promising further development of the IMF's facilities. But we have to review the entire range of the IMF's instruments to streamline and sharpen them. And we must also be realistic. We have to ask ourselves whether it is possible or even desirable that the IMF, as official lender, should try to match the extraordinary growth of private capital markets. It seems to me that we have to think about limits to the scale of crisis lending that the IMF can be expected to undertake.

It becomes imperative that the IMF, and the international community, pay the utmost attention to crisis prevention, especially through sound macroeconomic policy, the promotion of transparency, and the implementation of practical standards and codes. If the IMF is effective in this task through its surveillance, then I see a good chance that there may not be a need for the ever-growing rescue packages we saw during the 1990s.

## Private sector—constructive engagement

Undeniably, the private capital markets play the major role in promoting investment and growth around the world. In particular, we should not jeopardize this role in the emerging markets and developing countries. So how can the private sector be engaged to the mutual benefit of all and with less volatility? Three broad considerations should help to find answers to this question:

- First, there should be no presumption about automatic bailouts either of countries or of lenders. The first line of defense against crises is the sound policies implemented by countries and good risk appraisal by investors.
- Second, the framework for the "involvement of the private sector" should shift toward "constructive engagement"—cooperation among borrowing countries, the



**Undeniably, the private capital markets play the major role in promoting investment and growth around the world.**
**—Köhler**

private sector, and the official sector, especially during noncrisis times. This means a focus on crisis prevention and a shift of emphasis away from the coercive or punitive approach that some market participants seem to perceive as the meaning of "private sector involvement."

• Third, in crisis situations, solutions should not be seen as arbitrary. Although it may not be possible to devise a comprehensive set of rules guiding all such cases, there will need to be broad principles that can be applied to avoid the perception of uneven treatment of creditors and countries.

These considerations, especially the search for "constructive engagement," make it essential that the IMF and the private sector engage in a dialogue that is well informed and wide ranging. This should become a permanent feature of the IMF's work. Personally, I intend to meet with private sector groups in these early weeks on the job, which is why I value so highly today's encounter. And we are establishing at the IMF a point of contact, the Capital Markets Consultative Group, to provide a forum for regular dialogue between market participants and the IMF's management and staff. ■

**It [is] essential that the IMF and the private sector engage in a dialogue that is well informed and wide ranging.**
**—Köhler**

# Metadata for nine countries posted on GDDS site

*(Continued from front page)* taken by their peers abroad useful in helping them assess their own systems and initiate remedial action. Data users should be able to use the information in the metadata to assess whether the data are helpful. The information also draws attention to features in the compilation procedures that may affect antecedent analytical strengths or weaknesses. Technical assistance providers will be particularly interested in the plans for improvement, since these plans reflect the countries' own set of priorities. The metadata also indicate in which areas the authorities believe they need technical assistance to carry out improvement projects.

The IMF believes that the dissemination of metadata, in addition to improving data quality and countries' data dissemination practices, can contribute to the transparency and quality of policymaking in member countries. Information included in the metadata on access to and integrity of statistics (and the agencies that produce and disseminate them) is essential in building the confidence of the user community in official statistics. For these reasons, all GDDS participants are encouraged to reach out to the public at home by posting these metadata (perhaps in the national language) on national websites. In this connection, the IMF has worked closely with other international agencies on the development of the GDDS, and guidance provided by the GDDS to statistical agencies on the access and integrity aspects was inspired in part by the *UN Fundamental Principles of Official Statistics*.

## Guide to good practices

The GDDS is an important strategic project for the IMF's Statistics Department, which assists in improving data and statistical practices among IMF member countries. The primary focus of the GDDS is to foster improvements in data quality, but it also serves as a guide to good practices in the dissemination and production of comprehensive, timely, and reliable economic, financial, and sociodemographic data. Thus, it provides member countries with a framework for evaluating current data collection and publication practices and for setting priorities on improvements to their data in accordance with each country's schedule.

The summary tables provided at the beginning of each country presentation on the GDDS site facilitate comparisons of country practices with recommended statistical practices under the GDDS. These summary tables, while bringing together all the authorities' plans to strengthen their statistical systems, also indicate which agency is responsible for implementing the plans.

Member countries of the IMF elect to participate in the GDDS. Participation requires, among other things, the member's commitment to using the GDDS as a framework for statistical development, as well as the preparation of metadata. To date, about 40 countries have expressed a strong interest in participating in the GDDS at an early stage.

The GDDS is distinct from another data dissemination initiative of the IMF, namely, the Special Data Dissemination Standard (SDDS), which is a more demanding standard conceived for countries whose data generally already meet high standards. The GDDS is less prescriptive than the SDDS, which sets specific standards that must be observed by countries that subscribe to it. The GDDS emphasizes progress toward more timely, higher-quality, and higher-frequency data. It includes plans to improve GDDS metadata, but does not set future dates by which participants must complete improvements in existing practices. Participation in the GDDS is open to all IMF members, whereas the SDDS is intended for member countries having or seeking access to international capital markets. ■

Jan Bové
IMF Statistics Department

The GDDS site may be found on the IMF's website at http://dsbb.imf.org/gddsindex.htm. The text of IMF News Brief 00/29 is also available on the IMF's website (www.imf.org).

*Executive Board agenda*

# Work program to focus on key areas of responsibility, future role of IMF

*In a news brief issued on May 31, the IMF released a summary of the work program adopted by its Executive Board that broadly defines the Board's agenda for the period leading up to the IMF Annual Meetings in Prague, September 26–28. This is the third time the IMF has released a summary of its work program (see* IMF Survey*, July 5, 1999, page 218; and November 8, 1999, page 353). The full text of News Brief No. 00/32 is available on the IMF's website (www.imf.org).*

Drawing on the recommendations of the International Monetary and Financial Committee at its meeting in April, the work program contains a wide range of topics in key areas of the IMF's responsibilities.

At the same time, the work program—the first in the term of Horst Köhler, IMF Managing Director and Chairman of the Executive Board—gives particular attention to the reform of the IMF itself. "Our aim in the coming months should be to articulate our vision for the future role of the IMF and to bring a sharp focus and a clear sense of mission to the work of the organization in the context of a well-defined understanding of the division of labor with other agencies and forums," Köhler said in a statement to the Executive Board. "Our work should establish the IMF—specifically the Executive Board—as the driving force in the debate on the reform of the IMF, thereby giving it a greater stature in the debate on strengthening the international monetary and financial system. This will require the IMF, under the overall guidance of the Executive Board, to take stock of the full range of reform proposals and to articulate guiding principles from them."

The work program, Köhler said, should be based on first principles, including making the IMF as effective as possible in realizing the objective of achieving prosperity worldwide; identifying clear priorities in the IMF's activities and keeping the IMF focused on its key competencies; achieving an appropriate balance between conditionality attached to the use of IMF resources and the ownership of policy programs by member countries; broadening the debate on the role of the private sector, so as to promote its potential for acting as the main engine for stimulating productivity and growth in the developing countries; and strengthening the cooperation between the IMF and other international agencies and forums, based on a clear division of labor to enhance efficiency and accountability.

The priorities within the work program follow below.

## Review of IMF facilities and conditionality

Work in this area will build on previous work programs, focusing on such features of nonconcessional IMF facilities as maturities, rates of charge, and eligibility criteria. Items for consideration include a proposed modification of the Contingent Credit Lines, along with possible changes in Stand-By and Extended Arrangements. The Board will also begin a broad review of the application of conditionality based on past experience with IMF-supported programs, particularly in the area of structural reforms but also with regard to fiscal, monetary, and exchange rate policies. This review is expected to be extensive, with papers being considered both before and after the Annual Meetings. Other issues covered by the review will include access policy, early repurchase, and misreporting.

*IMF Executive Board.*

## Financial sector issues

The IMF's efforts to promote the smoother functioning of private financial markets will include developing a dialogue with financial market participants, analyzing market developments, and encouraging members to provide reliable, up-to-date information to the public. The 2000 *International Capital Markets Report* will put into perspective the rationale for deepening the IMF's work on such financial sector issues. The Board will examine issues in the assessment of offshore financial centers and will carry forward its work on the involvement of the private sector in preventing and resolving financial crises. A key question will be the extent to

which IMF support can be relied on to generate an early return of private capital to countries that have undergone crises and the extent to which concerted private sector involvement should be sought. Other papers will address the corporate restructuring process, the development of debt workout principles, and collective action provisions in international sovereign bonds.

### Debt relief and poverty reduction

In presenting the new work program to the Executive Board, Köhler stressed that making the debt-relief initiative for Heavily Indebted Poor Countries (HIPC) a success is among the most important tasks that the IMF is currently undertaking. In the period ahead, the Board will have opportunities to review progress with the HIPC Initiative and to discuss the development of Poverty Reduction Strategy Papers, which encapsulate the strategy underlying PRGF [Poverty Reduction and Growth Facility] programs in individual countries. The Board will also review papers on financing the PRGF-HIPC Trust.

### Surveillance and transparency

The work program will advance recent work on how the IMF discharges its key responsibility of surveillance, taking into account the lessons from both internal and external evaluations. In the recent internal biennial surveillance review, it was agreed that the primary focus of bilateral surveillance should be on the IMF's traditional mandate—monetary stability, balance of payments sustainability, and growth-oriented economic policies. For noncore issues, a macroeconomic relevance test should be applied. Central issues in advance of the Annual Meetings will include the lessons to be drawn from the pilot project for the release of Article IV staff reports and the link between strengthened IMF surveillance and the work under way on financial sector issues, as well as on standards and codes. The review of the release of Article IV reports will include a wider discussion of IMF transparency, taking into account the wide range of IMF information released into the public domain. Additional work in the period after the Annual Meetings will involve a broad review of surveillance initiatives and the IMF's experience with governance.

### Standards and codes

In the next few months, most work in this area will consist of the implementation of policies already in place—in particular, the program of voluntary, experimental reports on standards and codes for individual countries. In the months after the Annual Meetings, experience with this program and with working with other standard-setting bodies will be evaluated. Papers will also be prepared on various aspects of the codes on monetary and financial transparency, fiscal transparency, and data dissemination.

### Other agenda items

Among the other topics that the Executive Board will consider in the coming months are

- the fall 2000 *World Economic Outlook*,
- establishment of an independent evaluation office in the IMF,
- report of the Quota Formula Review Group, and
- Article IV consultations with individual members and requests for IMF financial resources. ■

### Available on the web

**Press Releases**

00/35: IMF Approves Stand-By Credit for Uruguay, May 31

**News Briefs**

00/29: IMF's General Data Dissemination System Enters Operational Phase, May 22 (see page 177)

00/30: IMF Managing Director Horst Köhler to Visit China, India, Indonesia, Korea, and Thailand, May 23

00/31: IMF Launches the "Week Ahead" Country Data Feature on Website, May 23

00/32: Work Program of the IMF's Executive Board, May 31 (see page 183)

00/33: IMF Completes Brazil Fifth Review, May 31

00/34: IMF Approves One-Week Extension of Stand-By Credit to Romania, May 31

**Public Information Notices (PINs)**

00/36: Georgia, May 18

00/37: Debt- and Reserve-Related Indicators of External Vulnerability, May 19

00/38: Belize, May 25

**Press Briefings**

Transcript of a press briefing by IMF Managing Director Horst Köhler, May 25 (see page 178)

**Speeches**

Remarks by IMF First Deputy Managing Director Stanley Fischer at the University for National and World Economy, Sofia, Bulgaria, May 25

Address by IMF Managing Director Horst Köhler at the International Monetary Conference, Paris, France, May 30 (see page 180)

**Other**

IMF Financial Activities—Update, May 19

IMF's Financial Resources and Liquidity Position: 1998–April 2000, May 19

**Notes**

PINs are IMF Executive Board assessments of members' economic prospects and policies issued—with the consent of the member—following Article IV consultations that contain background on the members' economies, and following policy discussions in the Executive Board at the decision of the Board.

*Joint task force report*

# Small states face special challenges as they seek integration with global economy

Small states have a number of characteristics and vulnerabilities that present them with special challenges over and above the normal challenges of development, as they adjust their economies and exploit the opportunities of closer integration into a rapidly changing global economy. This is the main finding of *The Report of the Commonwealth Secretariat/World Bank Joint Task Force on Small States*, which was issued shortly before the spring 2000 World Bank-IMF meetings in Washington. The product of 18 months of consultation, analysis, and research, the report is addressed both to small states and to the international development community. It sets out a contextual framework and a continuing agenda for action and analysis by the small states and by the international and other organizations that provide external support and influence their development.

## Features of small states

The report uses a population cutoff of 1.5 million for small states as a useful starting point only and does not recommend the creation of a special category of small states. It argues that countries should be regarded as lying along a size continuum, with a number of larger states sharing some or all of the same characteristics.

Among the world's 45 sovereign developing states with populations of less than 1.5 million, 41 are members of the World Bank and the IMF, more than 30 are eligible for Bank Group borrowing, and 29 are members of the Commonwealth. The incomes and stages of development of these states vary widely, from very poor African countries such as Guinea-Bissau (with per capita GNP of $160) to wealthy countries such as Brunei, Cyprus, Malta, and Qatar (with per capita GNP of more than $9,000).

Small states are found in every geographic region, but most countries fall into three main groups: 12 are in the Caribbean, 14 in East Asia and the Pacific, and 12 in Africa. While each small state is unique, and there are also differences between regions, most small states share a number of common characteristics. These include remoteness and isolation, openness, susceptibility to natural disasters and environmental change, limited diversification, limited capacity, income volatility, and limited or difficult access to external capital. In particular, the report found both that most small states are more vulnerable and experience greater income volatility than larger states, and that the sources of this vulnerability are often a result of the external environment.

In these common characteristics of small states, the report finds clear indications of the challenges they face in improving their development prospects. It emphasizes up front that sound domestic policies will be essential to successful development. As with all other countries, policies that bring macroeconomic stability need to be supplemented by good and appropriate structural and social policies that provide the basis for growth, successful transformation of their economies, and poverty reduction. Arguably, such policies are even more important in small states than in larger ones; first, in countries that are vulnerable to external shocks, it is even more important to avoid internally generated instability; and second, in small states, policy mistakes—for example, in using nonrenewable resources or in environmental protection—can have longer-lasting and more pervasive effects than they would in larger states. In effect, one aspect of vulnerability is susceptibility to domestic policy mistakes.

## Crucial policy areas

The report details how small states can tackle the challenges they face with a combination of appropriate policies and external support and assistance and identifies a specific list of actions for the future. In particular, the report examines four areas of special relevance to successful development in small states: tackling volatility, vulnerability, and natural disasters; adapting to the changing global trade regime; strengthening production capacity; and meeting key challenges and new opportunities arising from globalization. For each of these areas, the report draws up a work program of actions, analysis, and new initiatives for the states and for the international community.

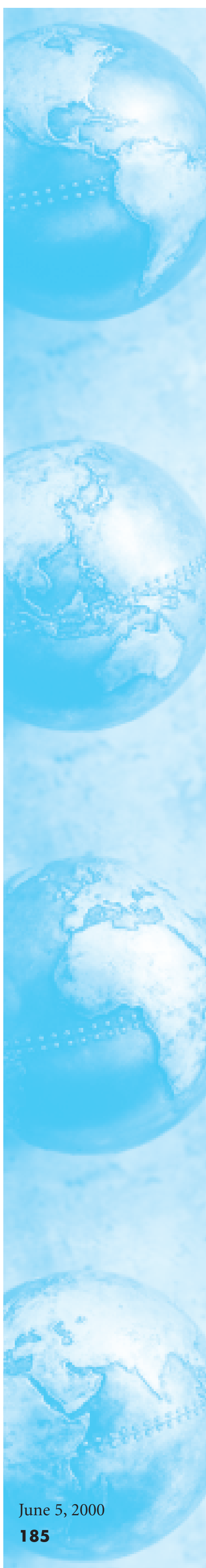
Among the steps that the international community should consider in addressing the special development problems of small states are

• new approaches to regional cooperation, as a way of tackling limited capacity in small states;

• maintaining a high level of external support and official assistance in cases where the correct policies are in place, to compensate for the perceived riskiness and the difficulty in attracting investment flows;

• improvements, where achievable, in the external environment;

• new mechanisms to address the mitigation of natural disasters (an area in which the World Bank has been active);



• assistance in strengthening capacity in both the private and public sectors;

• helping small states exploit the new opportunities arising from globalization; and

• action, whenever possible, to reduce or remove barriers to the exports of small states and to achieve greater flexibility in the transition to the changing global trade regime.

One area of particular interest singled out in the report is the provision of offshore financial services, which has become an important economic activity for many small states, but is also under much scrutiny by the major industrial countries. The report recognizes the clear need for improvements in financial operating practices and regulatory standards and the need to take action to prevent financial and tax crime and to address concerns about harmful aspects of tax competition. The report sympathizes with the concerns of small states about their lack of representation in the Organization for Economic Cooperation and Development (OECD) and the Financial Stability Forum and lack of adequate consultation on matters of interest and relevance. At a London conference in February 2000, the OECD indicated its willingness to constructively engage small states on tax competition issues and to respond to their call for a multilateral discussion. It is important, the report stresses, that all these issues be considered in international forums where small states have a voice, so that their interests can be taken into account.

Another area of interest relates to trade liberalization, which the report views as an integral part of a sound overall economic development strategy. However, in view of the potential fiscal consequences of liberalization, the report urges the IMF to continue to take a pragmatic approach to the advice it gives to small states that risk losing a major source of fiscal revenue as tariffs fall. The report recognizes that for some small open economies, low flat-rate tariffs may be one component of an efficient tax system.

## Work programs

Eleven international agencies, including the World Bank, the Commonwealth Secretariat, and the IMF, submitted specific work programs or frameworks to the task force in the course of the preparation of the report.

The World Bank framework centers on helping small states develop and implement effective strategies to reduce poverty, developing programs to support private sector development, exploring new approaches to Bank support for risk pooling and disaster insurance, and emphasizing a flexible approach to graduation policy. The World Bank framework also takes into account the special circumstances of small states to ensure that none is graduated prematurely.

The framework of the European Union includes, among other things, financing an African, Caribbean, and Pacific countries office in Geneva to assist member countries in their dealings with the World Trade Organization, and supporting transition of the most banana-dependent economies by improving competitiveness of the banana sector, creating new activities to replace traditional banana production, financing new infrastructure, and retraining labor.

## IMF activities with small states

The IMF's framework focuses on the provision of support to member countries (large as well as small) through policy advice and financial and technical assistance. It emphasizes that advice and assistance are tailored to each country's specific circumstances and needs, including special factors related to size.

On surveillance—the main channel for the IMF's policy advice—the report notes that for slightly more than half of its small member states, the IMF maintains a close dialogue through annual consultations. Other small member states, including most of those in the Asia and Pacific region, are on a 24-month cycle for such consultations (18-month in one case). For these countries, the IMF maintains continuity in its surveillance activities through interim staff visits. Small states have also availed themselves of staff-monitored programs with the IMF, which can play an important role as a catalyst for aid and private capital flows. These various bilateral discussions are supplemented by discussions with the regional authorities of those small member states that participate in a monetary union (namely, the Eastern Caribbean Currency Union, the West African Economic and Monetary Union, and the Central African Economic and Monetary Community).

On financial assistance, the IMF framework notes that, like all member countries, small states that face balance of payments difficulties are eligible for all of the IMF's financial facilities and loans and that all programs take into account country-specific circumstances, including size. Thus, small states that are vulnerable to natural disasters or have a higher degree of export concentration have opportunities to avail themselves of emergency assistance for natural disasters and the Compensatory Financing Facility. Small states that have low per capita income are eligible for the IMF's concessional loan facility, the Poverty Reduction and Growth Facility (PRGF). Eligibility for the use of PRGF resources has tended to follow

**Photo Credits:** Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF.

closely the World Bank's decisions on eligibility for loans under the International Development Association. Of the 19 small states eligible for PRGF (or its predecessor, Enhanced Structural Adjustment Facility) financing, 8 have used these concessional resources to date (some more than once) and 2 are currently in a PRGF arrangement with the IMF.

Finally, the IMF framework emphasizes the wide array of technical assistance programs provided through the Fiscal Affairs, Monetary and Exchange Affairs, Statistics, and Legal departments, and the training courses and seminars offered by the IMF Institute to member government officials both in Washington and outside. The provision of technical assistance to the small states of the South Pacific (by the IMF and the United Nations Development Program (UNDP)) has benefited from the establishment of a regional center in Fiji in 1993, whose activities are coordinated by the IMF and financially supported by the Asian Development Bank, Australia, and New Zealand.

The IMF is currently working with the UNDP and other multilateral and bilateral donor agencies to establish a similar center in the Caribbean. The proposed Caribbean Technical Assistance Center would involve the posting of a core team of three or four experts in the region—working in collaboration with an IMF coordinator—to provide technical assistance in specified fields (statistics, bank supervision and regulation, and fiscal management) on a peripatetic basis. The center in the Pacific has demonstrated the many benefits of this approach to providing technical assistance. The assignment of experts for two or three years allows sufficient time to initiate a project in a country and assist in the execution and follow-up in subsequent visits. The approach contributes significantly to the building of local expertise and facilitates arrangements for in-country training courses, workshops, and special consultancy arrangements.

The technical assistance project is part of a wider "Caribbean initiative," which includes expanding surveillance, deepening research on regional issues, and establishing closer collaboration between the IMF and the regional institutions [see *IMF Survey,* March 6, page 65]. In this regard, the IMF and the Caribbean Development Bank were joint sponsors of a high-level seminar held in Barbados in February 2000, which centered on the Caribbean's adaptation to globalization. ■

Frits van Beek
IMF Western Hemisphere Department

*The Report of the Commonwealth Secretariat/World Bank Joint Task Force on Small States* is available on the World Bank's website at http://www.worldbank.org/html/extdr/smallstates/

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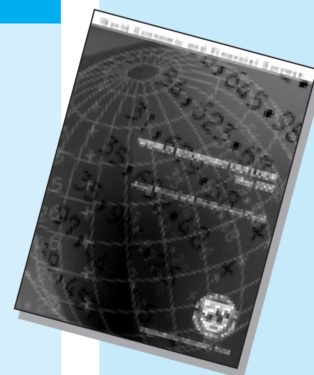

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*High capital flows environment*

# Transition economies preparing for EU accession face challenges in choosing exchange rate regime

*Over the next few years, five of the most advanced transition economies in central and eastern Europe—the Czech Republic, Estonia, Hungary, Poland, and Slovenia—will be readying themselves for entry into the European Union (EU). This article, which condenses an IMF Policy Discussion Paper by Robert Corker, Craig Beaumont, Rachel van Elkan, and Dora Iakova, reviews the issues at stake in choosing an appropriate exchange rate regime for the run-up to EU accession. In a period likely to be characterized by large and volatile capital inflows, the authors conclude the most serious risks arise from too much or too little exchange rate variability.*

In the lead-up to EU membership, an appropriate exchange rate regime can help the Czech Republic, Estonia, Hungary, Poland, and Slovenia balance sometimes competing agendas. With per capita incomes between 16 percent (Estonia) and 43 percent (Slovenia) of EU levels, these countries can expect a sustained period of high growth and real exchange rate appreciation. They must complete the process of transition to market economies, meet accession requirements, and cope with large and potentially volatile capital inflows. The economic transition process in these countries is far advanced but not yet complete. The unfinished transition process increases their vulnerability to adverse domestic and external shocks and constrains fiscal flexibility. At the same time, to meet EU eligibility criteria, they must liberalize their capital accounts, create efficient market-oriented financial sectors, and ensure that their central banks are fully independent.

On current expectations, EU accession is roughly three to five years away for these five countries. The timetable is thus near enough to be a factor in shaping their exchange rate regimes but far enough away to give them latitude in adjusting their regimes to meet transition and macroeconomic policy needs. In the lead-up to accession, candidate countries can choose whichever exchange rate system suits them. Once they become EU members, however, they are obliged to avoid excessive exchange rate fluctuations and competitive devaluations and to embark upon a phased process toward adoption of the euro. The first step will be participation in the new exchange rate mechanism (ERM2). Participants must agree to an entry exchange rate of their currency against the euro and maintain the exchange rate within a band of ±15 percent for at least two years prior to adopting the euro. In principle, ERM2 is compatible with a range of exchange rate regimes, including a narrow-band system or a currency board arrangement. However, the EU would have to agree to departures from the standard ERM2 arrangement.

With competitive labor costs, well-educated labor forces, proximity to western Europe, and the expectation of EU accession, the Czech Republic, Estonia, Hungary, Poland, and Slovenia offer attractive platforms for investment. The sizable capital inflows these countries already enjoy are likely to swell as structural reforms progress and as confidence grows in the countries' stability and continued free access to the common market. New members will also receive annual net transfers from the European Union amounting in some cases to up to 5 percent of the recipient's GDP for several decades.

But capital inflows are likely to be highly sensitive to actual or perceived policy slippages and to news regarding the timing of EU entry and the size of future transfers from the EU budget. In the run-up phase, a country may also experience an increase in temporary capital flows, as interest rates are bid down toward euro zone levels and markets speculate about entry central parities. Moreover, the foreign exchange market fortunes of these countries are likely to become more closely intertwined, suggesting a collective as well as an individual interest in each country's getting its fundamentals in shape to minimize the opportunities for contagious speculative attacks.

## Policy options

Against the background of high and variable capital flows, monetary and exchange rate policy decisions in these five countries will be attuned over the next few years to achieving or sustaining inflation at close to EU levels. This goal will be pursued at a time when the countries' reliance on capital controls will have to diminish, real currency values will likely appreciate, real interest rates may fall, and upward pressure on current account deficits could be substantial. Neither a fixed nor a flexible exchange rate regime is a panacea for policymakers' problems. And neither regime is a substitute for appropriate supporting fiscal and structural policies.

Under a fixed exchange rate system, capital inflows will, in the absence of sterilization, put downward pressure on interest rates and upward pressure on the money supply, thereby potentially conflicting with inflation goals. Moreover, a peg may discourage hedging, thereby encouraging unbalanced portfolios that would greatly add to the economic costs of an exit from a fixed exchange rate regime. A degree of exchange rate flexibility would raise the exchange risk premium (driving a wedge between the interest rate differential), helping to dampen interest-sensitive capital flows.

But capital inflow problems do not vanish under flexible exchange rate systems. Persistent capital inflows put upward pressure on the exchange rate, potentially weakening competitiveness more rapidly than under a fixed regime and widening external current account deficits. Concerns about external sustainability could increase the vulnerability to wide swings in capital inflows. And considerable exchange rate volatility could damage trade and investment and be inconsistent with low and stable inflation.

Also, what would anchor monetary policy under a flexible exchange rate? In principle, inflation targets can deliver less inflation volatility than a monetary policy centered on a monetary or exchange rate target. In practice, this may not be so because any discretionary policy is open to political pressures, and the technical requirements to forecast inflation and understand policy transmission lags are considerable. And there are added complications for countries that have to dismantle remaining capital controls. Liberalization reduces the scope for using interest rates to achieve domestic monetary policy objectives, and freer capital flows make it easier for investors to take large positions against a currency.

In general, countries would thus do well to avoid too much and too little exchange rate variability. The exception would be where a country has a credible currency board arrangement. In this case, abandoning the currency board would involve discarding considerable institutional and policy investment for uncertain gains of exchange rate flexibility.

## Country options

Throughout the course of their transition to market economies, the Czech Republic, Estonia, Hungary, Poland, and Slovenia have differed considerably in the composition of their monetary and exchange rate policies. Different approaches can be rationalized partly by the different economic structures and policy preferences of the five countries. For example, greater exchange rate flexibility in the Czech Republic, Poland, and Slovenia is consistent with these countries' somewhat greater economic restructuring needs and the relative rigidities in their labor markets. By contrast, the more fixed regimes in Estonia and Hungary are consistent with more flexible labor markets and the relatively advanced state of industrial restructuring. Nonetheless, all five countries have, since transition began, been successful in reducing inflation to 10 percent or less—testimony to the importance of consistent policies rather than the choice of an exchange rate system per se. For the period ahead, the following appear to be key issues for the five countries:

**Exchange rate and monetary policy regimes**

| Country | Exchange regime | Official intervention | Capital controls | Monetary goal |
|---|---|---|---|---|
| Czech Republic | Relatively free float | Occasional intervention to smooth large swings | Largely liberalized | Announced inflation target: 3½–5½ percent, end-2000 |
| Estonia | Currency board arrangement | | Fully liberalized | Maintain exchange rate fixed to the euro |
| Hungary | Crawling peg to the euro with a narrow band of ± 2.25 percent | Intervention at the edges of the band | Long-term controls liberalized; controls on short-term capital remain | Low inflation (2–3 percent above euro zone) and sustainable external position |
| Poland | Relatively free float | Occasional intervention to smooth large swings | Long-term controls liberalized; some short-term controls remain | Announced inflation targets: 5.4–6.8 percent, end-2000; below 4 percent, 2003 |
| Slovenia | Managed float | Closely managed on a gradually depreciating path | Long-term controls liberalized; short-term controls remain | Announced targets for annual M3 growth. Day-to-day intervention with intention to reduce interest rate differential with EU and limit excessive volatility in the exchange rate |

Data: IMF, *Exchange Rate Regimes in Selected Advanced Transition Economies*

The *Czech Republic*, which moved to a more flexible exchange rate arrangement in 1997, now uses an inflation-targeting framework to achieve price stability. In view of the expected size and volatility of capital inflows, the uncertain impact of completing transition reforms, potential shocks from domestic sources (including fallout from banking sector difficulties), and likely real exchange rate appreciation, a return to a relatively fixed exchange rate regime appears risky. In addition, the burden on government expenditures from EU-required reforms and the large, unreformed, state-owned enterprise sector suggests that neither fiscal nor wage policy may be sufficiently flexible to support a rigid exchange regime.

*Estonia*'s currency board arrangement has weathered domestic and external crises. In addition, its banking system has been consolidated, labor markets are quite flexible, and a very low level of public sector debt provides room for fiscal policy flexibility. All in all, the currency board is highly credible and, if it continues to be supported by consistent policies, seems an appropriate arrangement to maintain all the way to adoption of the euro. Indeed, exit from the currency board arrangement could adversely affect stability and policy certainty; instead, early adoption of the euro may be warranted, given the currency board's long-established record.

*Hungary*'s crawling peg to the euro and its narrow band regime, together with fairly firm control over short-term capital flows, have so far provided a credible anchor for reducing inflation. The authorities are, however, contemplating widening the bands once they have reduced inflation to 4–5 percent by further slowing the rate of crawl. In due course, a move to a wider band appears appropriate, particularly to help insulate the economy from the monetary effects of large capital inflows. While some increase in the risk premium resulting from more exchange rate volatility would raise debt-service costs, it would help to discourage interest-sensitive flows and could provide more scope to meet inflation objectives. A wider band would also facilitate the phasing out of remaining capital controls.

*Poland* has made judicious use of a crawling peg and, following successive band widenings, the zloty was floated in April, consistent with the authorities' reliance on an inflation-targeting framework. As in the Czech Republic and Hungary, flexibility should prove a key element in responding to strong capital inflows. Nonetheless, there are constraints on the authorities' use of exchange rate flexibility. Further increases in Poland's current account deficit (7½ percent of GDP in 1999) could engender an adverse shift in market sentiment. The key challenge is to support the flexible exchange rate regime with an appropriately ambitious fiscal stance. This would help strengthen performance on inflation and the current account balance and relieve the constraint on inflation targeting.

*Slovenia* pursues a pragmatic approach to monetary targeting, supported by intervention to limit short-term exchange rate variability. However, a recent relaxation of capital controls and the authorities' intention to fully liberalize capital flows by 2002 are likely to make it harder for the Bank of Slovenia to balance its objectives of lowering inflation and exerting some control over exchange rate movements. With more volatile capital flows and the expectation that non-debt-creating inflows will increase in the run-up to accession, the authorities will likely have to accept greater exchange rate flexibility. While the balance between money and exchange rate variability will need to be kept under review, commitment to a relatively flexible exchange rate regime and the absence of formal exchange rate bands offer few hostages to speculators.

While differences among these countries are likely to diminish as they adopt more EU-like institutional structures, bolster already strong economic ties with the European Union, and address remaining transition issues, in the near term there is no necessity to adopt a common strategy for monetary and exchange rate policy. In an environment of high and variable capital inflows, narrow bands or overly managed exchange rates (with the exception of credible currency boards) are unlikely to provide sufficient flexibility to reconcile domestic and external policy objectives, and they may offer tempting targets for speculators. On the other hand, benign neglect of the exchange rate also carries risks. Some formal or informal commitment to avoid excessively large exchange rate swings seems desirable to support credible inflation-reduction policies and avoid uncompetitive exchange rates.

Finally, countries wishing to enter ERM2 at an early stage should not leave the required removal of capital controls to the last minute. This would exacerbate exchange rate volatility and compound the difficulties of managing monetary policy at a time when the focus will be on macroeconomic convergence. ■

Copies of IMF Policy Discussion Paper 00/3, *Exchange Rate Regimes in Selected Advanced Transition Economies—Coping with Transition, Capital Flows, and EU Accession*, by Robert Corker, Craig Beaumont, Rachel van Elkan, and Dora Iakova, are available for $10.00 each from IMF Publication Services. See page 187 for ordering details.

## Selected IMF rates

| Week beginning | SDR interest rate | Rate of remuneration | Rate of charge |
|---|---|---|---|
| May 22 | 4.39 | 4.39 | 5.09 |
| May 29 | 4.35 | 4.35 | 5.04 |

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 (as of May 1, 1999, the U.S. dollar was weighted 41.3 percent; euro (Germany), 19 percent; euro (France), 10.3 percent; Japanese yen, 17 percent; and U.K. pound, 12.4 percent). The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion (115.9 percent) 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/external/np/tre/sdr/sdr.htm).

Data: IMF Treasurer's Department

# Countries need to assess domestic objectives in deciding extent of global economic integration

Based on a simple but powerful promise—that international economic integration will improve economic performance—globalization has tremendous appeal to policymakers and world leaders as a development strategy, according to Dani Rodrik of Harvard University. Speaking at a seminar organized by the IMF Institute in Washington on May 15, Rodrik explained that as countries reduce tariff and nontariff barriers to trade and open up to international capital flows, the expectation is that growth increases. This, in turn, will reduce poverty and improve the quality of life for most of the population of developing countries.

*Rodrik: The issue is not "more trade versus less trade," but whether globalization is a viable development strategy in and of itself.*

But, he asked, does this glowing description paint a true and complete picture? Is opening up to capital markets alone sufficient as a development strategy? Is, as some world leaders and policymakers have declared, "integration into the world economy the best way for countries to grow"? Or does globalization—with all its admittedly potential benefits—need to be seen as only part of the picture? These questions need to be asked, Rodrik said, because strategy and priorities matter when administrative capacity, human resources, and political capital are limited, as is inevitably the case in small developing countries.

## Does trade promote growth in small economies?

The answer, Rodrik said, is "it depends." Proponents of globalization claim that countries with lower policy-induced barriers to international trade grow faster. But, Rodrik asserted, the empirical evidence does not back this claim of a direct link between trade policies and growth. In fact, he said, even in theory, the effects of lowering trade barriers are ambiguous. Notably, while models of endogenous growth indicate that lower trade restrictions boost output growth in the world economy as a whole, a subset of countries may experience diminished growth. In particular, trade liberalization may push resources into sectors in which a country has a comparative advantage but which are technologically less dynamic than the sectors benefiting from protection.

The widespread belief that openness is linked to growth appears to derive from much of the recent empirical literature, Rodrik said. But, in his opinion, there are problems with the methodology used in these studies. Their results are questionable because they do not control for other relevant country characteristics; in particular, he said, the results "conflate trade policy with other policies and variables, such as level of macroeconomic stability, quality of institutions, and geographic location."

Despite this tendency in academic and policy discussions to greatly overstate the systematic evidence in favor of trade openness, Rodrik stressed that he was not suggesting the opposite—that trade protection is good for economic growth. Indeed, there is no credible evidence, he said, that suggests that trade restrictions are systematically associated with higher growth rates. What he emphasized, though, is that caution and humility are called for in interpreting cross-national evidence on the relationship between trade policy and economic growth. Countries that do a poor job handling volatility in the international environment are not necessarily insufficiently open but, rather, have had trouble managing their openness. Some countries that have remained relatively closed have weathered serious crises and have prospered.

Many observers point to the experience of developing economies—especially the East Asian economies—during the 1970s and early in the 1980s as an example of open economies outperforming closed ones. But, Rodrik observed, the 1970s were turbulent years—rocked by major crises—and are thus not a good control period. For example, in the years before the oil shock of 1973, East Asia was doing well, but so also were other newly industrializing countries in Latin America, the Middle East, and North Africa. After the oil shock, Latin America and the Middle East suffered serious reversals, while Asia remained afloat, and some countries, like India, weathered the storm relatively well. Why did some countries sink and some stay afloat? It is misleading, Rodrik said, to focus solely on the trade strategies of these countries. Countries that did not succumb were able to adjust their macroeco-

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nomic policies in the aftermath of the oil crisis, even though some, like India, had highly restrictive trade policies. Others, especially in Latin America and the Middle East, went on a "borrowing rampage" that culminated in a disastrous debt crisis. In addition, Rodrik noted, the countries that fell apart had deep social and economic cleavages and weak institutions for conflict management, such as the rule of law, governance, and democracy.

*Rodrik addresses staff members in a seminar sponsored by the IMF Institute.*

Korea's experience provides another example, Rodrik said. Korean trade and industrial policy in the 1980s was characterized by marked subsidization, administrative guidance, and implicit guarantees for investors in favored sectors. Yet the economy performed well. Now we have decided that free trade and most capital flows are good, so we are building a new set of rules, Rodrik said. But it is disingenuous to use the experience of the "Asian tigers" as an example, because before the latest crisis, they, like Korea, had been following models that did not adhere to the rules we are trying to develop today.

## Capital flows

Proponents of international integration of capital markets claim that free flows of capital augment domestic saving and encourage higher domestic investment rates. But, Rodrik noted, domestic saving will rise, as happened in East Asia, if domestic investment possibilities already exist or are created, without the catalytic benefit of external flows. Moreover, the statistical evidence shows that although growth spurts promote higher rates of saving, saving booms do not necessarily increase growth.

Adherents of capital market integration also claim it permits portfolio diversification; facilitates the undertaking of higher return, higher risk activities; allows consumption smoothing; exerts discipline on fiscal and monetary policies; and generates positive technological externalities in the case of foreign direct investment. However, Rodrik noted, in the presence of asymmetric or incomplete information, inadequate enforcement of property rights, incomplete contracting, and weak regulatory structures, such integration can result in credit rationing, capital flows that move in the "wrong" direction (that is, from poor countries to rich countries), boom-and-bust cycles, and periodic financial crises with severe real consequences.

## International economic arrangements

Adherents of international economic integration counter arguments about the potentially damaging effects of open capital markets by pointing to the benefits provided by international economic arrangements, Rodrik said. By adopting internationally accepted codes and standards and regulatory and legal frameworks, countries enhance their credibility and instill confidence in potential investors; these standards and regulatory frameworks also help shield their own economies from attacks, reversals, and setbacks. However, these arrangements may not be particularly development friendly, Rodrik argued, for several reasons. The budgetary and administrative costs, for example, of implementing World Trade Organization agreements or other international financial codes and standards may be prohibitive. Standardization of law may not be the most effective way of building legal institutions in developing countries. Also, priorities may differ from country to country, depending on the development strategy: for example, trade and finance versus public health, human resources, and labor mobility. And finally, the general adoption of international standards and regulations raises questions about domestic ownership and popular voice in rule making.

Thus, despite what passes for the prevailing conventional wisdom, integration into the world economy may not, by itself, be the best or only way for countries to grow, Rodrik concluded. Strategic use of international trade and capital flows is certainly *part* of a development strategy but does not substitute for it. The issue, Rodrik stressed, is not "more trade versus less trade," or "more openness versus less openness." It is, rather, whether globalization is a viable development strategy in and of itself. What policymakers should focus on, he said, is the degree to which policies and institutional reform should be targeted on trade and capital flows, as opposed to domestic investment, technological capabilities, and institutions that serve purposes far beyond that of facilitating globalization. Policymakers may certainly want to incorporate some features of external models into their development strategies—especially those that will enhance a country's attractiveness to foreign investors. But the choice of priorities and institutions should be homegrown; tailored to domestic needs, aims, and objectives; and based on a consensus drawn from all segments of the domestic population. ■