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Address in Buenos Aires

Argentina needs to continue fiscal and structural reforms, Fischer advises

Following are edited remarks by Stanley Fischer, the IMF's First Deputy Managing Director, at the Argentine Bankers Association Meeting in Buenos Aires on June 25. The full text of his speaking notes is available on the IMF's website at www.imf.org.

Stanley Fischer

The safest thing I could do today would be to deliver a lecture, as I did when I was last in Argentina, on international policy coordination. Or I could adopt the Alan Greenspan approach: after one of his more complicated speeches, he told the audience: "If you have understood what I said, then I must have made a mistake." But much as I probably should do that, I will talk about the Argentine economy, and I will try to be clear. I will start by reviewing the impressive developments in the Argentine economy over the past decade. Then I will turn to the current policy challenges, discussing in turn structural and fiscal policies.

Past record

These are difficult times for Argentina. Argentina is not helped by the difficult external environment: the global slowdown is hitting export demand, the strength of the dollar has complicated the process of adjustment, and the average emerging market interest rate spread has risen, albeit by less than the amount by which Argentina's spread has risen.

But we should not lose sight of Argentina's major achievements during the past decade: democracy has been consolidated; macro- *(Please turn to the following page)*

Interview with Teresa Ter-Minassian

Fiscal Affairs Department introduces policy development and research initiatives

Teresa Ter-Minassian, an Italian national, has been the Director of the IMF's Fiscal Affairs Department since January 2001. She joined the IMF's staff in 1971 as an Economist in the Fiscal Affairs Department, returning to serve as Deputy Director in 1988. Before taking on her present position, she held various senior positions in the IMF's former European Department and, most recently, in the Western Hemisphere Department, where she served as Deputy Director from 1997. Ter-Minassian spoke recently with the IMF Survey *about the work of the department and the new directions it is pursuing in line with the evolving mandate of the IMF.*

IMF Survey: What are the principal functions and responsibilities of the Fiscal Affairs Department, and what changes have you observed in the department's work and focus over the years?

Teresa Ter-Minassian

Ter-Minassian: The Fiscal Affairs Department is one of the most complex in the IMF. It contributes to IMF surveillance; design, negotiation, and review of programs; technical assistance; and policy development and research. All of the IMF's major outputs are, so to speak, part of our work program.

Of course, the specific mix of these activities has varied over time. There have *(Continued on page 215)*

Argentina needs structural, fiscal reforms

(Continued from front page) economic and financial stability was established; most notably, inflation declined dramatically and price stability has been established, but not at the expense of growth; the public sector has been slimmed down, by divesting inefficient public enterprises and reforming the federal civil service; significant progress has been made in deregulation; trade and capital accounts have been liberalized, opening up the economy both within and outside Mercosur; and the financial sector has been greatly strengthened, thanks both to much improved regulation and supervision and to increased foreign involvement. But more needs to be done to make the banking system more efficient, reduce intermediation spreads, and facilitate the recovery of collateral for nonperforming loans.

These achievements were helped by the low burdens of foreign and domestic debt at the beginning of the period. But Argentina's growth performance has been based too much on large fiscal deficits, especially as the decade progressed. The deficit of the federal government averaged 1 percent of GDP in the first half of the 1990s and 3 percent in the second half. The problem was partly a result of terms of trade shocks and a deteriorating external environment in the late 1990s. But it was also a result of a lack of fiscal adjustment and inadequate progress in structural reforms, especially of the labor market.

The economy confronts three mutually reinforcing weaknesses in economic activity, the fiscal position, and investor and consumer confidence.

—Stanley Fischer

Current challenges

This background of impressive achievement sets the scene for the current challenges confronting economic policy in Argentina. The current situation is a result of the dependence of growth on excessive fiscal deficits; inadequate progress in structural reforms, especially of the labor market; and external shocks. The economy confronts three mutually reinforcing weaknesses in economic activity, the fiscal position, and investor and consumer confidence.

Getting out of this situation is not easy, but Argentina has gotten out of difficult situations in the past, including the "tequila crisis" in 1995, when the government, with Domingo Cavallo as finance minister, moved decisively to stabilize the economy in April, including by tightening fiscal policy just a few months before an election.

The Argentine authorities have taken a two-track approach to dealing with the present crisis: enacting structural reforms to promote growth and strengthening the fiscal position of both the federal and provincial governments. The IMF supports this approach, and it demonstrated its support in very concrete terms in December last year by increasing the size of its financial arrangement with Argentina to provide a total package worth approximately $13.5 billion—over 500 percent of Argentina's quota in the IMF.

Structural policies. In April, the Argentine government put in place a number of structural policies designed to improve growth by changing the structure of extra-Mercosur tariffs, lowering the value-added tax on domestically produced capital goods, and introducing "competitiveness plans"—incentives and regulatory changes to boost growth in particular sectors.

On June 15, the government announced fresh measures, including an import tariff and export subsidy to mimic the eventual move to a euro-dollar basket for the exchange rate. The incentives implied by these measures should contribute to boosting growth, but they also take policy in a more interventionist direction that, if pushed much further, could reduce efficiency and confidence in the longer term.

It is important to press ahead with the market-friendly pro-growth reforms outlined in Argentina's economic program supported by the IMF, especially promoting competition in domestic markets (for example, ports and telecoms), implementing the labor market reform approved by congress a year ago, and implementing the proposed deregulation of the union-run health system. The authorities have announced structural reforms in the fiscal area, including plans to streamline the tax system, strengthen tax enforcement, and introduce needed reforms in the social security system. The authorities have also pledged to deepen Argentina's integration into the world economy by pressing for further trade liberalization, which has the potential to help boost the country's growth performance.

These announcements are welcome. Beyond announcements, the implementation of these measures is needed if confidence is to be bolstered in a lasting way.

Fiscal policy. The question that has to be asked at this time of recession is whether Argentina really needs fiscal adjustment. The obvious concern is that such an adjustment would only impede the recovery of the economy. After all, neither the public debt (at around 50 percent of GDP) nor the fiscal deficit (at around 2.5 percent of GDP) is particularly high by international standards—indeed, both would satisfy the Maastricht criteria, as would Argentina's inflation performance.

The problem is that with the current level of spreads on Argentine bonds, the debt dynamics are on an escalating path. In addition, Argentina's gross financing requirements are large although, to be sure, the recent successful debt exchange significantly and importantly reduced the gross financing needs for the next few years. High interest rates, in turn, stifle prospects for sustained recovery, worsening the debt dynamics. So, it seems obvious that the fiscal deficit should be cut.

Nonetheless, we have to ask whether a fiscal contraction would only contribute to a vicious circle of low growth, leading to a worse budget situation, lead-

ing to more fiscal contraction, leading to yet lower growth, and so on. But experience in several countries (including Ireland, Denmark, Italy, and Brazil) suggests that fiscal tightening can be expansionary and can lead to a virtuous circle. How? The answer is simple—by producing a sustained reduction in the risk premium and domestic interest rates. And no one doubts the need for lower interest rates.

There is now widespread acceptance of these realities in Argentina, as is evident from the passage and general understanding of the Fiscal Responsibility Law. The current crisis was triggered by bad fiscal news in the first quarter, which threatened to see the deficit come in at more than $10 billion instead of the $6.5 billion laid down in the program and in the Fiscal Responsibility Law.

The authorities announced measures in April worth $3.8 billion, including $2.5 billion from the financial transactions tax and $900 million in spending cuts. The authorities are also expecting a modest further net boost to revenue from the measures announced last week. But there is significant uncertainty about the yield of some of these measures, especially in view of their administrative complexity. We are concerned about the strains this complexity will place on an already weak revenue administration. More needs to be done on the expenditure side. The evidence is very clear that expenditure cuts are more effective than tax increases in sustaining fiscal consolidation and boosting growth. There is, in particular, a need to ensure that the wage bill is under control.

To this end, keeping spending by the provinces under control is essential. The federal government has been more successful than the provinces in improving its fiscal position. Argentina is certainly capable of a stronger fiscal performance. It was done by your neighbor, Brazil; it has been done elsewhere in this hemisphere; and it is being done in Turkey.

Monetary policy. I have not so far talked about monetary policy. That is hardly a surprise, given the convertibility regime, which fundamentally determines what monetary policy shall be. While there is some flexibility within the system to vary liquidity countercyclically, that flexibility is very limited indeed.

Argentina has been very well served by the measures the central bank has taken during the past decade to strengthen the banking system. The banking system's strength has enabled Argentina to withstand major external shocks, and maintaining this strength remains essential for the future of this economy. And to maintain the strength of the system, it is essential to maintain the independence of the central bank.

Conclusion

Argentina today faces a major challenge to sustain and strengthen the achievements of the last decade. But Argentina has met challenges in the past and can do so again. The path to success is to continue fiscal and structural reforms. Policy needs to be set in a way that inspires confidence—in particular by avoiding inconsistent signals. That way lies the virtuous circle of restored growth, greater confidence, and an improving fiscal outlook. It can be done—and for the sake of all Argentinians, it should be done. ■

Keeping spending by the provinces under control is essential.

–Stanley Fischer

Fiscal Affairs work evolves with IMF mandate

(Continued from front page) been periods, for example, in which technical assistance has been emphasized and periods in which it has been deemphasized. Other functions have also developed in relation to the evolving priorities of the IMF.

Actually, the scope of operations of the department has expanded enormously since I joined it in 1971. At that time, there were probably about half the current number of divisions and probably less than half the number of staff. More important, the review of programs supported by IMF financial assistance was just beginning and was a lot less substantive and detailed than it is now. The main emphasis was on technical assistance—which was limited to tax policy, tax administration, and public expenditure management—and research activities. There was some participation in area department missions, but it was not as extensive as it is now.

New areas of activity include public expenditure policy—in particular the focus on social spending and poverty alleviation; that is, how the budget contributes to mitigating the adverse impact of IMF programs on the poorer income groups—and poverty alleviation over the medium term, particularly in the context of the HIPC [Heavily Indebted Poor Countries] Initiative. Other areas that have surfaced include intergovernmental fiscal relations and government financial management.

In addition, our technical assistance work is now more closely linked with the IMF's surveillance activities. Traditionally, it was linked more closely with program design and helping countries implement the structural reforms that were a part of the program. But in the past few years, much more emphasis has been put on crisis prevention, transparency, and adherence to standards and codes; as a result, technical assistance is often provided to address weaknesses identified in these areas.

IMF Survey: What are some of the current issues and initiatives of relevance to Fiscal Affairs?

TER-MINASSIAN: The department has many functions. My basic message has been: we have to prioritize and exploit, to the maximum extent possible, the synergies between the various functions of the department. I'm trying to change or institute procedures to further this basic goal. In consultation with the department's senior staff, we have instituted a system of prioritization of research and policy development work. The department has always been very active in analytical work in the fiscal area. But research has typically been viewed as a residual—you do it when you have the spare time in between assignments or during periods of relative lull in the operational work. And while continuing to encourage this spontaneous and grassroots initiative type of research, we would also like to devote some of the department's resources more systematically to a few flagship projects that are in line with the IMF's priorities and would have a stronger and more lasting impact on the IMF's operations and policy development.

FINANCE & DEVELOPMENT

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The June issue of *Finance & Development* features several articles about international capital flows and their benefits and possible risks to countries. Among the articles in this issue are

Private Capital Flows and Growth
Deepak Mishra, Ashoka Mody, and Antu Panini Murshid

How Beneficial Is Foreign Direct Investment for Developing Countries?
Prakash Loungani and Assaf Razin

FDI and Corporate Tax Revenue: Tax Harmonization or Competition?
Reint Gropp and Kristina Kostial

Exchange Rate Regimes: Is the Bipolar View Correct?
Stanley Fischer

Competition and Business Entry in Russia
Harry G. Broadman

Transition Countries' Choice of Exchange Rate Regime in the Run-Up to EMU Membership
György Szapary

Who Has a New Economy?
Paula De Masi, Marcello Estevao, and Laura Kodres

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Accordingly, we have put together a committee of senior staff members to spearhead a policy development and research program. We also intend to appoint a small group of outside academics to meet with us once or twice a year to review the research program and give us advice and input. The program will be reviewed every six months to keep it current in the evolving academic and general policy context. So far, the committee has sifted through the proposals of all the divisions and other senior staff in the department. We are now compiling a list of priority projects to which we will allocate staff time and responsibility. Among the initiatives being considered is work on indicators of fiscal vulnerability, which fits in very well with the IMF's emphasis on crisis prevention. We are also planning further work on fiscal responsibility and fiscal rules in general. Another project in the pipeline is work on international tax competition and taxation of electronic commerce.

In the public expenditure policy and management area, we are currently heavily involved in work on the Poverty Reduction and Growth Facility (PRGF) and HIPC tracking initiative (in collaboration with the IMF's Policy Development and Review Department and the World Bank), which involves reviewing experience with the PRGF and developing with the HIPC countries some action plans for improving their capacity to track the use of debt relief for poverty reduction purposes. We are also continuing to monitor social expenditure generally.

IMF SURVEY: Technical assistance is a major component of Fiscal Affairs' work. Where has the department concentrated its resources, and will its priorities be changing in the years ahead?

TER-MINASSIAN: We have begun a major internal review of our technical assistance activities, which accounts for approximately 60 percent of our work. I have created three working groups, each focusing on a major topic. One is prioritization: do we do enough to prioritize our resources in technical assistance? Do we need to change our system of screening requests for technical assistance? Should we take a more integrated view of a country's technical assistance needs? Should we be more proactive in generating requests that fit into the general work program of the IMF vis-à-vis the country?

Another working group is analyzing the issue of delivery. We typically deliver technical assistance through two or three channels: missions and the assignment of short-term and longer-term experts. Is the current blend adequate? For example, should we rely less on longer-term experts and more on a series of missions to initiate and sustain a reform effort? Also, how can we best leverage the resources of other technical assistance providers to make sure that an integrated program of assistance is provided to a country in response to its needs?

Finally, another working group is looking at the issue of evaluation, both of ongoing projects and through ex-

post evaluation of the effectiveness of certain types of technical assistance. When these working groups have completed their reports, which will happen very shortly, we'll discuss them within the department, and then we'll come up with some concrete operational changes in our procedures, if appropriate. We may decide that everything is fine, but I suspect that there will be some changes.

IMF Survey: How does Fiscal Affairs interact with other departments, and do you see an increase in the degree of interaction?

Ter-Minassian: Generally speaking, Fiscal Affairs is very supportive of other departments in their operational work, and our cooperation is quite good with both the area departments and the functional departments, particularly the Policy Development and Review Department.

When I came to Fiscal Affairs, I made some changes, in terms of streamlining and focusing our resources on our comparative advantage—giving specialized fiscal advice, particularly on structural aspects of IMF-supported programs. The streamlining has involved reducing the number of missions we routinely participate in and the countries whose programs we review regularly. This has helped widen the scope for participation on an ad-hoc basis to look at specific fiscal issues in a program or even in a surveillance situation for some industrial countries. This streamlining effort was made in the spirit of trying to be of more assistance to the area departments and to avoid duplicating support provided by other functional departments, and it has been very well received by the area departments. We are also now routinely invited by management to participate in brainstorming sessions on particular countries, particularly crisis countries. I am also trying to integrate technical assistance more fully with program reviews and area department work.

IMF Survey: How does Fiscal Affairs' work fit into the overall mandate of the IMF, and how will possible modifications in that mandate—for example, the new emphasis on crisis prevention and the effort to sharpen the focus of conditionality—affect the department's priorities?

Ter-Minassian: IMF Managing Director Horst Köhler has stressed that fiscal matters are core issues for the IMF. Therefore, structural fiscal conditionality is more in line with a streamlined approach to conditionality than, say, conditionality attached to privatization or the liberalization of markets. I tend to agree that we should limit conditionality to aspects of policy that are crucial to the macroeconomic success of a program, so we have to be parsimonious in our imposition of structural conditionality to ensuring that the authorities really are committed to delivering the structural action. Clearly, the extent of these conditions will need to be decided on a case-by-case basis. In some countries, certain structural or institutional improvements are key to ensuring the sustainability of the improvements in the public finances, and this in turn is key to ensuring the macroeconomic success of the program.

I tend to agree that we don't need a longer list of structural benchmarks, even in the fiscal area. Rather, we need to identify the key ones that call for conditionality. But our policy dialogue with the countries does not stop at conditionality. We can support the authorities through policy advice and technical assistance to build on the more specific agreed-upon aspects of a policy—for instance, the design of a tax reform package or specific advice on structuring a civil service reform, or cutting certain nonproductive expenditures. I don't see that our activities will be reduced by the streamlining of conditionality. In fact, if anything, reducing conditionality will mean we'll have to rely more on technical assistance and the quality of our advice to ensure that the necessary reforms do get carried out.

Ter-Minassian: "We have to prioritize and exploit, to the maximum extent possible, the synergies between the various functions of the department."

IMF Survey: How do you see the work of the department evolving over the years, and what do you think will be the main challenges?

Ter-Minassian: Because Fiscal Affairs is a support department, our main challenge and priority will be to remain fully involved in, and to contribute to the evolving agenda of, the IMF—whether it is surveillance or crisis management or institution building. At the same time, I also want to maintain a high profile for the department outside the IMF, in the sense of being seen as a center of excellence for analysis of public finance issues that are relevant to the work of the IMF. But which issues we will be concentrating on is hard to say beyond the time horizon that we have in mind.

Where will the balance of priorities shift, let's say, three or four years from now? Nobody really knows how the IMF will have evolved by that time. One of the real strengths of this institution is its flexibility and its capacity to adapt to a fast-changing world. We need to keep our staff well trained so that they can face these challenges as they present themselves. I hope that we can do it. I am full of enthusiasm for the future. ■

Joint IMF Institute–German Foundation for International Development forum

Policy dialogue focuses on links between country ownership and IMF conditionality

The IMF is moving to streamline and focus its conditionality while maximizing the scope for countries to make their own decisions on specific policies. A key element of the IMF's current conditionality review is a process of consultation with interested parties outside the organization. As part of this outreach effort, the IMF Institute and the German Foundation for International Development jointly sponsored an international policy dialogue, which was held in Berlin, Germany, on June 11–12. The meeting brought together a distinguished circle of decision makers from around the world (including ministers and former ministers from Armenia, India, Malaysia, Thailand, Yemen, and Zambia); from the IMF, the World Bank, and the European Union, and from nongovernmental organizations (NGOs) in Germany, the United Kingdom, Armenia, Malaysia, Kenya, and Tanzania. Participants reflected on the relationship between IMF conditionality and country ownership of IMF-supported adjustment programs, contributed to the ongoing debate on how IMF conditionality could be streamlined, and suggested alternative forms of conditionality that will be the subject of continuing discussion.

Available on the web (www.imf.org)

Public Information Notices (PINs)

01/58: Bolivia, June 25

Speeches

IMF First Deputy Managing Director Stanley Fischer, the Argentine Bankers Association Meeting, Buenos Aires, June 25 (see page 213)

Transcripts

Press Briefing, Thomas Dawson, IMF External Relations Department Director, June 22

Letters of Intent and Memorandums of Economic and Financial Policies*

Paraguay, June 20

Concluding Remarks for Article IV Consultations*

Finland, June 18

Sweden, June 21

Other

IMF's Financial Resources and Liquidity Position, 1999–May 2001, June 13*

Financing IMF Transactions: Quarterly Report, December 1, 2000–February 28, 2001, June 15*

IMF Financial Activities, June 15

IMF Financial Activities, June 22

Draft Guidelines for Foreign Exchange Reserve Management: A Summary, June 22*

*Date posted

Background

Over the past two decades, the scope and nature of IMF conditionality has expanded considerably, reflecting both a greater emphasis on growth in IMF-supported programs and a recognition that structural impediments had to be dealt with if fiscal and monetary policies were to be more effectively implemented. IMF conditionality grew more expansive and detailed in the 1990s to encourage complex structural reforms in areas such as legal, institutional, and regulatory frameworks.

This broadening of the scope of conditionality, however, tended to strain countries' capacity to implement reforms and to test the bounds of the IMF's expertise. There was also growing concern that excessively detailed IMF conditionality might impede national ownership of the reform effort—something widely viewed as essential for the sustainability and success of the reform process.

Policy dialogue

The joint IMF Institute–German Development Forum seminar brought together a wide range of expertise to promote a policy dialogue on conditionality and to seek fresh perspectives. Several overarching themes arose from the two-day discussions. Broad consensus emerged among participants that some form of conditionality would remain indispensable in governing the relationship between the IMF and member countries seeking its financing assistance. Conditionality both safeguards the use of IMF resources and provides assurances to members regarding the availability of resources.

There was a general perception among participants, however, that IMF conditionality had expanded too much in recent years and that its extension to cover structural areas may indeed have exceeded the limits of the IMF's expertise and overstretched the implementation capacity of countries. Moreover, participants agreed, very broad conditionality can have unintended effects. It can diffuse the focus of the reform effort and galvanize opposition against reform. For several participants, the remedy was for the IMF to refocus on its traditional responsibilities—maintaining macroeconomic and financial stability in its member countries, and resolving and preventing crises. One discussant suggested the IMF should avoid any involvement in development-related policy. Some others, however, emphasized that the need for structural conditionality would persist, given the importance of structural reforms for the success of the overall adjustment process.

Why ownership matters

Broad ownership of the adjustment program is essen-

tial for a successful reform effort, and this could be achieved, participants suggested, by improving the transparency of policy decisions and by consulting the population in a participatory fashion. Ownership at any level requires a committed and responsible government that is able to draw up its own program. Ownership, participants indicated, is more likely to develop within an environment of political stability and where policies are perceived to be appropriate to the country's circumstances. Clearly, ownership is likely to be strengthened by policies that produce positive results. Some participants noted that IMF-supported programs had in some cases failed to generate national support because they were seen as imposed from outside and were thought to have exacerbated the costs of adjustment.

But just how much ownership is necessary for successful reform? Participants acknowledged that no program is likely to garner full ownership by all elements of society, but they did agree that a critical mass of support is needed, particularly among elements who are in a position to block reforms. Ownership is also dependent upon a country's capacity to implement the necessary reforms. Some participants argued for greater transparency in IMF-supported adjustment programs. They underscored the value of making a clear and public distinction between policies required

Sugisaki says conditionality effort is work in progress

IMF Deputy Managing Director Shigemitsu Sugisaki delivered the opening remarks at the International Policy Dialogue in Berlin on June 11, outlining the nature of the IMF's ongoing review of conditionality. Below are edited excerpts; the full text of his address is available on the IMF's website (www.imf.org).

The IMF is now moving to streamline and focus its conditionality to make it more effective while providing maximum scope for countries' own policy decision making. A key element of the work is to consult with those outside the IMF on both the existing practice of conditionality and our current reform plans. We expect the policy dialogue here to be a useful and constructive part of this consultation process.

The intended purpose of conditionality, rooted in the IMF's Articles of Agreement: the IMF is "to give confidence" to its member countries by making financing available to them "under adequate safeguards, thus providing them with the opportunity to correct maladjustments . . . without resorting to measures destructive of national or international prosperity." The IMF's financing is thus intended to support countries' own efforts to tackle the problems they face.

IMF lending has typically involved some policy conditions ever since the 1950s, but the nature and scope of these conditions has changed considerably in the past two decades. Originally, the only conditions were those related to the broad thrust of monetary and fiscal policies, but in the 1980s and 1990s, conditions related to structural measures became a common feature of IMF-supported programs. While there were valid reasons for more structural conditionality, including an effort to remove longer-term impediments to growth, this broadening also raised some pressing concerns. At times, both our capacity to give advice and the countries' capacity to implement reforms may have been stretched too thin. More generally, it has become evident that economic policies, however well designed, can take root only if they are owned by the country itself. The need for conditionality must thus be met in a way that also respects the need for ownership: the national authorities must take the lead in the design of policies, and these policies need to be strongly supported within the country.

We are moving toward a more focused approach to conditionality to increase its effectiveness while giving maximum scope for national ownership. Under this approach, policy reforms that are critical for a program to achieve its macroeconomic objectives will be included under conditionality, while conditionality is to be applied more sparingly to structural measures that are relevant but not critical, particularly outside our core areas of responsibility. The IMF's previous program for Mozambique included a structural benchmark related to protection of the domestic cashew nut processing industry. Such protection acts as a tax on raw cashew production, which lowers the incomes of farmers and agricultural workers and hampers the country's exporting capacity. Our present program with Mozambique, however, does not include any conditions related to cashew, as we judged that this was not critical to the program's macroeconomic objectives. Drawing this line involves some difficult judgments; such judgments need to be made on a case-by-case basis, drawing lessons that can be carried forward.

This approach is starting to show results. For instance, in our recent program with Latvia, structural conditionality has been winnowed down to four structural benchmarks focused on requirements for fiscal and financial stability. Peru's recent Stand-By Arrangement contains no structural conditions, even though the government is carrying out structural reforms in a number of areas of its own accord. Streamlining needs to be adapted to the circumstances of individual countries.

At the same time, we are addressing important policy issues, including the appropriate degree of detail with which conditionality is established and the need to clarify the boundaries of what is covered by conditionality. Some steps have already been decided: Letters of Intent are to distinguish more explicitly between the IMF's conditionality and the rest of the authorities' policy programs; the scope of program reviews is to be delineated as clearly as possible; and structural benchmarks are to be used more sparingly. Some issues, such as the scope for results-based conditionality, will need to be considered further. And the need for conditionality to match countries' implementation capacity is partly a matter of realism in designing programs, putting priority on those elements that are most important. It also underscores the importance of helping countries to strengthen their capacity, which is one of the key motivations for the IMF's technical assistance efforts.

Clearly, this is work in progress, and our Executive Board will be returning three times to discuss these issues before the year is out. In a narrow sense, this work is an effort to review the IMF's Conditionality Guidelines, but in a broader sense, the main goal is to change our practice as it affects countries and their citizens. We are aiming to show meaningful results during the remainder of this year and lasting changes in the way the IMF supports the efforts of its member countries.

Shigemitsu Sugisaki

by the IMF, measures desired by the authorities, and policies that represented a compromise between the two parties.

Striking the right balance

Several participants saw a rising tension between expansive conditionality and national ownership of the reform effort. This tension could result, they explained, from a number of factors, including differences in opinion about the underlying causes of economic problems, and hence the appropriate policy response to them; a perception of conditionality as being too detailed and intrusive, leaving little scope for the authorities to choose their own policies; and concern that conditionality did not take sufficient account of the country's social and political realities, as well as its implementation constraints. Striking the right balance between ownership and conditionality would be facilitated, participants suggested, if countries took the lead in setting policy priorities.

Participants encouraged the IMF to support the design and implementation of "homegrown" programs by countries and to be prepared to discuss alternative policies with the authorities. A sound technical analysis of the specific problems facing a country, and a full assessment of the political and technical feasibility of reforms, would allow programs to be innovatively tailored to individual country circumstances, thus enhancing the chances for successful implementation. But some discussants raised a note of caution. Crisis situations might not allow the time needed to build ownership. In such circumstances, they suggested, adjustment programs might be characterized by more conditionality, at least at the outset. Participants also observed that in many cases technical assistance—from the IMF and other donors—could enhance implementation capacity and build up key institutions, thus contributing significantly to the success of the reform effort.

Participants broadly agreed that the effectiveness of IMF conditionality could be enhanced by streamlining it and focusing it on key reforms in the core areas of the IMF's expertise. This would not necessarily exclude structural conditionality, they argued, but it would limit it to policy areas that were deemed essential to the success of the overall program and to the effectiveness of crucial macroeconomic policy reforms. Some participants suggested that greater adherence to international standards and codes could reduce the need for specific program conditions. While endorsing the streamlining objective, however, discussants urged the IMF to work in close collaboration with the World Bank and other donors to ensure that key structural policy reforms are maintained.

Jack Boorman

Boorman sees need to balance conditionality and ownership

Jack Boorman, Director of the IMF's Policy Development and Review Department, addressed the Berlin policy dialogue, examining ownership and IMF conditionality. Below are edited excerpts of his remarks.

Providing financing to countries facing serious external payments imbalances is one of the important purposes of the IMF. But financing must be accompanied by countries' own efforts to tackle the underlying source of their imbalances.

Ownership

Broadly speaking, ownership means that the policies adopted are those the country sees as necessary and the authorities are fully committed to. Without a doubt, reforms with strong and widespread support in a country have the best chance of succeeding. Think of Poland in the early 1990s.

Some see IMF conditionality and ownership as inherently in conflict. I don't. It is in countries' own interest to use the breathing space that IMF financing provides to tackle the underlying problems they face. Otherwise, they would just be taking on more debt without taking the necessary steps to improve their economic situation and ensure they have the means to repay. But there are undoubtedly tensions—for example, differences between the IMF and the authorities on the depth of the problems, the source of the problems, and the solutions. Also, within the country, there will inevitably be differences on these same issues.

These tensions have sometimes manifested themselves in what I have come to call the "two-try approach." Countries initially deny the depth of the economic problem and, partly as a result, exert weak ownership of the reform program. Only after an initial period of insufficiently strong policies and weak commitment is it possible to agree on a policy package with the needed force and broad commitment to carry through the needed reforms.

Whose ownership?

Any program of economic policies creates winners and losers, and this will be reflected in the views within the country on the approach to be taken. As an extreme, Indonesia's IMF-supported program in the fall of 1997 and early 1998 was owned by the ministers and officials who managed economic policy for many years, and it was supported by most of the population. It was clearly not owned by the Suharto family and the political elite, who rightly saw that many measures dismantling monopolies and bringing greater transparency to corporate governance would threaten their grip on the economy. A program that would have been fully supported by the Suharto family would not likely have been worthy of the support of the international community, and a program that did not support broader issues would have been seen as wanting by most in the government. This may be an extreme example, but it reflects the reality that must be confronted in many IMF programs.

Alternative conditionality

Could IMF conditionality take other forms and still be effective? Participants reflected on alternatives to the present policy-based conditionality in IMF-supported programs, discussing two specific variants in some detail. One suggestion was floating tranche conditionality. This would be used particularly for structural reforms, its supporters indicated, and would avoid the disadvantages of predetermined timetables. The floating tranches would link disbursements to the implementation of agreed policy actions, with the authorities responsible for their timing.

A second alternative was an outcomes-based conditionality. This would make the authorities responsible for the results but leave the means—the choice of implementing policies—up to them. This would, its adherents argued, enhance a country's ownership of the reform process. Although both alternatives come with some disadvantages of their own—namely, less assurance about the timing of disbursements, questions about how exogenous shocks would be handled, and concerns about how the choice of appropriate policies would be sustainable over the longer term—there was support for looking at these alternatives in more detail.

Conclusion

The discussions over the two days pointed to general agreement that IMF conditionality is necessary but should be as parsimonious as possible, particularly in structural areas. Possible tensions between conditionality and ownership could be mitigated, participants indicated, by more open communication on the rationale for policy choices. Discussants also favored having the IMF give countries more room to make their own policy choices from a range of options, and having technical assistance provided to improve countries' ability to formulate and implement their own policies and to build a stronger consensus for the reform effort. ■

Elliott Harris
IMF African Department

IMF seeks wide range of views on conditionality

In conjunction with its review of conditionality, the IMF is cosponsoring a series of seminars to solicit a broad cross-section of views.

In addition to the Berlin forum, reported on in this issue, a Tokyo forum, cosponsored by Japan's Ministry of Finance, will take place on July 10 and will focus largely on the Asia-Pacific region.

A London seminar, cohosted by the Commonwealth Secretariat and the World Bank and chiefly devoted to issues relating to low-income countries, is scheduled for July 23–24.

Additional seminars may be organized later this year in Africa and Latin America.

This reality underscores three points. First, it is unrealistic to think that ownership means that everyone in the country supports a program. But it is equally unrealistic to think that a program can succeed if it is supported by only a few politicians or officials. We have to look for a critical mass of support by those groups who will be affected by the policies adopted and especially by those who can block its implementation. We do reach out within countries to try to assure both an understanding and an acceptance of certain key elements of programs. A crucial step in assembling Korea's 1997–98 program, for example, was to win the support of the trade unions for the labor market changes.

Second, since an appropriate degree of ownership is a necessary condition for a program to succeed, we cannot simply take the authorities' program, and the breadth of support it commands, as given. We also need to help the authorities broaden ownership for a viable program. An example is the poverty reduction strategy paper framework for lending to low-income countries.

Third, there is a trade-off between conditionality and a greater willingness to refrain from lending at all. In many cases in which ownership and commitment are questionable, the IMF faces a difficult choice. Should we say no outright, waiting for proof that a viable program is fully supported in the country? Or should we remain engaged while relying more heavily on conditionality to ensure that certain minimum policy actions are taken? We could ensure high ownership by lending only to a select few countries with first-rate policies, but if we did this, we would not be fulfilling the IMF's mandate to make resources available to member countries that face external financing problems subject to adequate safeguards and while ensuring that the support is consistent with the purposes of the IMF. At the same time, there are clearly limits to the extent to which conditionality can compensate for weak ownership, and it is at least a question whether the IMF should be ready to say no more often when ownership is weak.

Striking a balance

There is a need to balance ownership and conditionality to ensure that the IMF is supporting viable economic policies. There is a need to better focus conditionality, to bring greater clarity to the instruments of conditionality, and to give more room for countries to set their own priorities—that is, for ownership.

The process of deciding the appropriate form and coverage of conditionality will require difficult judgments on a case-by-case basis. Every program that comes to the IMF's Executive Board is an opportunity to scrutinize whether the right balance has been struck between streamlining and ensuring that policies are up to the challenges set by the country's problems and the program's objectives. So far, this process appears to have been successful in focusing greater attention on getting this balance right. But conferences like this are also critical for helping us think through and find workable solutions to these difficult questions.

New database

IMF releases comprehensive data on reserves and related information on Internet

The IMF's Executive Board in March 2000 approved the establishment of a database on countries' international reserves and related information to be available on the IMF's website. The database, operational since October 2000, is accessible at http://www.imf.org/external/np/sta/ir/index.htm.

Countries' data on the IMF website are presented in a common format and in a common currency. The objectives are to facilitate comparisons of international reserves and related information among countries, provide market participants and other users easy access to the data, and promote transparency of information of important interest. Users of the IMF database include market analysts, financial institutions, researchers, country authorities, and the press.

Development of the IMF database was possible because many countries over the past year began to disseminate information using the data template on international reserves and foreign currency liquidity.

Countries disseminating data on international reserves and foreign currency liquidity

Argentina*	Hong Kong SAR, China*	Norway*
Australia*	Hungary *	Peru*
Austria*	Iceland*	Philippines*
Belgium*	India	Poland*
Brazil*	Indonesia	Portugal*
Canada*	Ireland*	Singapore*
Chile*	Israel	Slovak Republic*
Colombia*	Italy*	Slovenia*
Croatia*	Japan*	South Africa*
Czech Republic*	Korea	Spain*
Denmark*	Latvia*	Sweden*
El Salvador*	Lithuania*	Switzerland*
Estonia*	Malaysia*	Thailand*
Finland*	Mexico	Tunisia
France*	Netherlands*	Turkey*
Germany*	New Zealand*	United Kingdom*
		United States*

*Template data available on the IMF's external website at http://www.imf.org/external/np/sta/ir/index.htm

The IMF and a working group of the Committee on the Global Financial System of the Group of Ten central banks jointly developed the template. The template is designed to provide a comprehensive presentation of a country's official foreign currency assets and drains on such resources resulting from various foreign currency liabilities and commitments of the authorities. Such information can be used to assess the adequacy of countries' reserves, the authorities' exposure to foreign currency risks, and the official sector's short-term financing needs, among others.

Guidelines and technical support

Specifically, the template reports the amount and composition of official reserve assets, other foreign currency assets held by the monetary authorities and the central government, and the foreign currency obligations of the monetary authorities and the central government coming due in the short term, including those related to their financial derivative positions and guarantees extended for quasi-official and private sector borrowing. The international financial crises of the late 1990s have underscored the importance of the public disclosure of such information by countries on a timely and accurate basis. Such information is critical to assessing the external vulnerability of countries, especially for those under managed or pegged exchange rate regimes.

To assist countries in compiling the template data and to facilitate users' analysis and interpretation of the information, the IMF has issued the *Operational Guidelines for the Data Template on International Reserves and Foreign Currency Liquidity.* The *Operational Guidelines* provide guidance on how the requisite data are to be reported in the template and set forth an underlying conceptual framework. To enhance the analytical usefulness of the data and to minimize the prospect that users may misinterpret information reported in the template, the *Operational Guidelines* also recommend that country-specific exchange rate arrangements (such as the operation of a currency board or the implementation of dollarization), special features of reserves management policy, and accounting practices of certain financial transactions (such as repurchase agreements and securities lending) be disclosed in country notes accompanying the data. The *Operational Guidelines* are accessible on the IMF's website where the data are posted.

Link to SDDS

As part of efforts to strengthen the Special Data Dissemination Standard (SDDS), the IMF's Executive Board in March 1999 made the data template a prescribed category of the SDDS, with a transition period to run through March 31, 2000. Following the end of the transition period, countries subscribing to the SDDS were to begin disseminating the template data on a monthly basis, with up to a one-month lag. Thus, the first set of the template data for end-April

2000 was disseminated by most SDDS-subscribing countries at the end of May 2000. Countries that wish to have their international reserves and related information redisseminated on the IMF's website provide their data to the IMF soon after they disseminate the data in their national media. Non-SDDS countries are also encouraged to compile the template data and report the information to the IMF for redissemination.

The common format in which the data are posted on the IMF website is shown in the *Operational Guidelines*; the common currency in which the data are presented is the U.S. dollar. In addition to current data, the IMF database presents historical (time series) information on countries' data and by selected data categories (for example, official reserve assets and other foreign currency assets of the monetary authorities and the central government). To make it easier for users to view, print, and download the information for analysis, the data available on the IMF's website are presented in several ways. For example, countries' current data are accessible in html (hypertext markup language) format, and historical (time series) data are shown in both pdf (portable document format) and csv (comma separated values, spreadsheet compatible) files.

As of June 2001, 49 economies have been disseminating the template data on their national websites on at least a monthly basis with a lag of no more than one month (see table, page 222). Among these, 43 provide the template data to the IMF for redissemination on the IMF's website. ■

Anne Y. Kester
IMF Statistics Department

Interview with Alberto Alesina

Growing interest in currency unions may reflect real benefits for some countries

A growing number of countries are choosing to give up their monetary independence to join currency unions, establish a currency board, or dollarize. Recent work by Robert Barro and Alberto Alesina of Harvard University has examined what is behind this trend, notably the decision to join a currency union. Both were recently at the IMF Institute to offer in-house seminars. Prakash Loungani talks with Alesina about why fewer currencies may be a healthy development. The accompanying box summarizes Barro's seminar on how countries can calculate the costs and benefits of joining a currency union.

Alesina: *"Printing your own money doesn't require much effort or competence. Better to be proud of your Olympic team."*

LOUNGANI: A currency is a source of national pride. Like the national flag. Or a national airline.

ALESINA: Yes, but it is misplaced pride. Printing your own money doesn't require much effort or competence. Better to be proud of your Olympic team, where there is genuine effort involved from your compatriots. And countries often use the language of other countries, often even the language of their former colonizers. If there's no loss of pride in that, why should there be any in using the currency of other countries?

LOUNGANI: So the trend toward countries giving up their currencies doesn't worry you?

ALESINA: We can't be sure it is a trend as yet, but it would not worry me—just the opposite—if it were a trend. What we do have is a handful of cases such as the franc zone in Africa; the use of the U.S. dollar in Panama and, now, Ecuador; and the European Union countries that will soon start using the euro. And you have prominent cases like Argentina and Hong Kong SAR, where the local currency is tied to the U.S. dollar through a currency board even though they continue to use their own currency. But, yes, the fact that we now have fewer currencies than countries is not in itself a cause of concern.

LOUNGANI: What's behind this development?

ALESINA: Many countries have misused monetary independence. They have not been able to pursue stable monetary policies—I mean policies that would deliver a low and stable inflation rate. And over the years we have learned to value low and stable inflation over a very active fine-tuning of the economy. We don't believe anymore that fine-tuning gives such great benefits in terms of lower unemployment that it would be worth the costs of a very erratic inflation policy.

LOUNGANI: Does increased trade and integration—globalization, if you will—also contribute to the shedding of currencies?

ALESINA: You have to be careful there—increased trade can be both a cause and an effect of currency unions. On

Research on currency unions

Alberto Alesina and Robert J. Barro, "Currency Unions," forthcoming, *Quarterly Journal of Economics*. (Also available as NBER Working Paper No. 7927, September 2000.)

Andrew K. Rose, "One Money, One Market: Estimating the Effect of Common Currency on Trade." *Economic Policy: A European Forum*, April 2000 (30), 7–33.

the one hand, countries that already trade extensively are more likely to join a currency union. On the other hand, Andy Rose's paper [see box, page 223] claims that sharing a common currency leads to an increase in the volume of trade by a factor of 2 or 3. That's a big number.

LOUNGANI: How does Rose deal with the causality issue you raise—that countries that already trade are more likely to enter a currency union?

ALESINA: It's always a very difficult issue to deal with. Rose controls for nearly everything people have mentioned as a factor influencing the volume of trade between two countries—their relative sizes and incomes, the distance between them, and whether they share a border or a language or have a regional trade agreement. He finds that sharing a currency is associated with an increased volume of trade even after accounting for the effects of all these other factors. However, while I believe in the correlation between currency unions and trade flows, I would argue that causality is much more difficult to establish. Rose's results, however, have stimulated a useful research effort on this point.

LOUNGANI: Is the effect of currency unions on the volume of trade uniform across countries?

ALESINA: I don't think we really know. Actually, one concern that people have about Rose's findings is whether the results hold only for countries that are quite small. Rose can't do much about that, because many of the countries involved in currency unions have been small countries. So we are left unsure about whether large countries will also experience an increased volume of trade after union. How the euro works out will tell us something about the costs and benefits to large countries from currency unions.

LOUNGANI: Are fixed exchange rates also associated with increases in the volume of trade?

Barro on costs and benefits of currency unions

The number of independent economies in the world has increased from about 75 at the end of World War II to nearly 200 today. Do they all need separate currencies and independent monetary policies? Economists suggest the answer is no and are busy matchmaking to see what currency unions may be desirable among the 200 economies. In an IMF Institute seminar on April 6, Robert Barro—drawing on his work with Alberto Alesina—discussed the benefits and costs to a country of joining a currency union.

Barro: "The evidence, though still somewhat controversial, indicates that currency unions can confer much greater benefits in terms of an increased volume of trade than fixed exchange rates can."

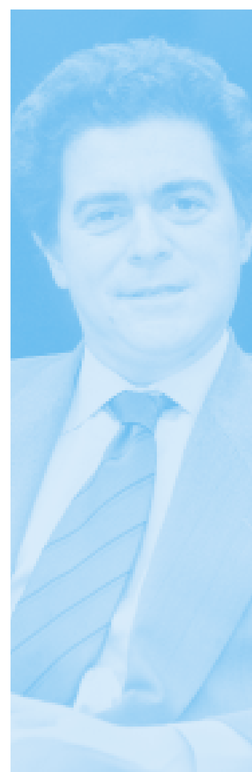
The benefit of joining a union, he suggested, is that a country's exporters gain less risky access to a larger market. Why is this the case? First, exporting is risky business. It involves getting paid in a foreign currency and then having to convert the receipts into one's own currency. Adverse changes in the exchange rate can entail a real cost. A currency union, Barro noted, takes some of the fear out of this business by reducing what economists call "transactions costs"—that is, by allowing both parties to carry out trade in the same currency. And, second, since industries often need to be a certain minimum size to produce efficiently, currency unions also provide a larger market for members and can thus encourage the development of such industries.

According to Barro, the evidence, though still somewhat controversial, indicates that currency unions can confer much greater benefits in terms of an increased volume of trade than fixed exchange rates can. The reason may be, he said, that fixed exchange rate systems are often not credible; exporters cannot be sure that countries' promises to exchange one form of currency for another at a fixed rate will always be honored. Joining a currency union seems to offer a far more credible commitment that a country will not revert to using its own currency.

On the cost side of the ledger is the loss of an independent monetary policy. A country whose exchange rate is tied to that of an "anchor" country as part of a currency union cannot then use the exchange rate to buffer the consequences of external shocks. How important is this cost? Barro demonstrated in his seminar that this cost depends on two calculations. The first is the extent to which a country's economic activity moves in tandem with that of the anchor country. If a country's slowdowns and booms are not synchronized with those of the anchor country, it is more likely to need to use the exchange rate to offset these fluctuations. In this situation, the loss of monetary independence will be onerous. The second calculation involves the extent to which there are fluctuations in the relative prices between the two countries (that is, fluctuations in what economists call the real exchange rate). A country that gives up monetary independence to enjoy the benefits of the lower inflation of the anchor country can do so only if there is no change in relative prices.

On the basis of these calculations, then, which anchor currencies are best matched with which countries? Barro, citing some examples from his ongoing empirical work with Alesina, looked at which countries were the most likely to profit from using the dollar, the euro, or the yen as a potential anchor. For many countries in Central America and for Mexico, he said, the U.S. dollar emerges as the best anchor currency. But for many South American countries, including Argentina, anchoring their currencies to a basket comprising both the dollar and the euro may be a better bet than the dollar alone. This is because these countries trade heavily with Europe, and their economic fluctuations are as tied to those of the euro area as to the United States. Many countries in Africa and Eastern Europe are also potential clients of the euro. In contrast, the yen does not seem appealing as an anchor currency, except perhaps for Indonesia. ■

Prakash Loungani
IMF External Relations Department



Alesina: No, that's the interesting thing. The effect of fixed exchange rates on trade is all over the place. The big effect seems to come from currency unions. It suggests, perhaps, that most fixed exchange rate regimes are not fully credible.

Loungani: How should countries decide whether to join a currency union or to have monetary independence?

Alesina: Do a cost-benefit analysis. The benefit is easier access to a larger market—what economists call the benefits of economies of scale. The cost is the loss of an independent monetary policy. How useful an independent monetary policy is depends on a lot of factors—for instance on how correlated a country's business cycles are with those of the proposed anchor country. The cost-benefit calculation may suggest that it is not optimal to join a currency union. For large countries like China and India—which, by definition, already have access to a large market and whose business cycles may not be that correlated with those of other countries—that could well be the answer.

Loungani: Is this cost-benefit analysis the focus of your work with Robert Barro?

Alesina: Yes, we have made quite a bit of progress with the theory and are starting to do the empirical applications [see box on Robert Barro, page 224].

Loungani: What are some of the predictions from the empirical applications?

Alesina: We're just starting out, as I said, so I don't want to push this too hard. But one interesting finding is that the optimal arrangement for Argentina could indeed be a currency tied to both the euro and the dollar. So whatever one might think of the timing of [Argentine Minister of the Economy Domingo] Cavallo's attempts, a change in the basket does make sense from the perspective of a better longer-term arrangement.

Loungani: One thing that puzzles me is that you see regions within countries increasingly asserting their identity but at the same time willing to give up monetary independence.

Alesina: Well, I think we have to get used to the idea that monetary policy is a public good that can be provided at a supranational level. We know that different public goods are provided at different levels of government. We have tended to assume that monetary policy should be provided at the national level, but perhaps it doesn't need to be. You can do the same kind of cost-benefit analysis we were just talking about for regions and see whether giving up monetary independence makes sense. Currency unions could make regions more independent in other ways. Look at Catalonia. Having its monetary policy provided by the European Union has made it easier for it to be more independent of Spain.

Loungani: How far can this process of shedding currencies go? Nobel laureate economist Robert Mundell said the optimum number of currencies for the world is like the optimum number of gods—an odd number less than three.

Alesina: I'm not as fervent as Mundell. I wouldn't be comfortable going all the way to just one currency provider. What if this provider messes up? It would be better to have some competition among currency providers, but certainly we can do with a lot fewer currencies than we have at present. ■

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Exchange rate regimes

Canadian experience offers some lessons on economic integration, choice of exchange regime

A current issue generating considerable interest is whether, with growing economic integration among countries, a fixed exchange rate, or even a common currency, becomes more desirable than a more flexible regime. A recent study of the Canadian experience since the inception of the 1989 United States–Canada Free Trade Agreement seeks to shed some light on this question. The authors of the study—Vivek Arora of the IMF's Western Hemisphere Department and Olivier Jeanne of the Research Department—spoke to the IMF Survey *about their findings.*

Arora: "The general conclusion we came to was that Canada has derived significant benefits from exchange rate flexibility."

IMF SURVEY: What recent economic developments or concerns prompted you to undertake this study?

ARORA: This was a project for the Article IV consultation with Canada and grew out of discussions with our colleagues on the Canada team, to whom we are very grateful for their comments and suggestions.

A key feature of the world economy in recent years has been growing economic integration among groups of countries. At the same time, a question is often asked about the choice of exchange rate regime—is it better to fix or float or do something in between, or even to adopt a common currency? Increasingly, the issues are being raised together: as countries become more closely integrated, will the costs of a floating exchange rate increasingly outweigh the benefits? For example, should all free trade areas eventually adopt common currencies, as the trend has been in much of Europe?

We were struck by the closeness of Canadian-U.S. economic integration, even as the exchange rate remained flexible, and by the significant asymmetry in the nature of shocks that these countries faced—in the sense that the timing and size of shocks were significantly different in the two countries, partly because of the relatively more important role of commodities in the Canadian economy. It seemed worthwhile to look at the issue systematically and put together some of the evidence. The general conclusion we came to was that Canada has derived significant benefits from exchange rate flexibility, which has not impeded Canadian-U.S. economic integration to any great extent and which has helped buffer the Canadian economy against asymmetric shocks.

IMF SURVEY: Economic integration has increased substantially since the United States–Canada Free Trade Agreement was introduced. What are the features of this integration in terms of Canada's trade and exchange regime; its degree of integration with the United States, including factor market integration; and other aspects?

ARORA: Canadian-U.S. integration has always been remarkably close as a result of history and geography, but it's true that it has increased substantially during the decade since the inception of the Free Trade Agreement. Trade integration is very close, with four-fifths of Canada's foreign merchandise trade being conducted with the United States. Merchandise exports to the United States account for nearly one-third of Canadian GDP. These shares are much larger than between countries in other parts of the world, including among European countries. Factor market integration is also close, especially in terms of capital flows. In other dimensions, such as the legal and regulatory frameworks, Canada-U.S. integration is less deep than European integration, reflecting political decisions in Europe. Our main point here is that exchange rate flexibility hasn't prevented Canada-U.S. integration from becoming very, very close.

IMF SURVEY: Your paper notes that during the past 20 years, the Canadian dollar has fluctuated by less against the U.S. dollar than several other floating currencies have. How do you account for this relative stability? Is there any possibility that the conditions that appear to foster this stability may change?

JEANNE: The main reason for the stability of the United States–Canada exchange rate is the close synchronization between the business cycles of the two countries. One of the first things we did when we started working on this paper was to construct a chart with the variables entering one side or the other of the Taylor rule [a way of characterizing how central banks adjust short-term interest rates in response to deviations of inflation from target or of output from potential]. We were struck by the correlation between the two countries. It is much more striking than the correlation between, say, the United Kingdom and the euro zone. The exchange rate has not moved a lot because Canadian and U.S. interest rates have moved in parallel most of the time.

Will this change? Most probably not. Of course, the U.S. and Canadian business cycles could become less closely synchronized, or their monetary or fiscal courses could diverge for other reasons. But these are not very likely developments.

IMF SURVEY: The terms of trade can be a significant source of shocks in the Canadian economy, given the large share of commodities in its exports. When the economy has been hit by asymmetric shocks, what role has the flexible exchange rate played? Would a fixed rate have been more effective? Why?

JEANNE: These are central questions. In theory, the main benefit of a separate currency is monetary independence—the freedom to adjust monetary policy to domestic economic conditions, which is valuable insofar as these conditions differ from those in the rest of the world. But if Canada's business cycle is so correlated with that in the United States, what is the benefit of monetary independence for Canada?

The Canadian authorities' answer to this question is that the exchange rate helps to buffer asymmetric terms of trade shocks between the two countries. Fluctuations in commodity prices affect U.S. and Canadian terms of trade differently, because Canada is a net exporter of commodities of which the United States is a net importer. This is a significant source of shocks, because commodities still represent a relatively large share of Canada's exports and GDP.

Does the evidence suggest that the Canadian exchange rate plays its role of buffer against terms of trade shocks? Well, broadly speaking, yes. Overall, the exchange rate has responded to terms of trade shocks in a stabilizing way, and these shocks explain a good deal of the variations in the exchange rate. This is not to say that the exchange rate is never subject to market sentiments that seem unrelated to the fundamentals and could be an autonomous source of volatility, but in the case of Canada, these nonfundamental influences do not seem overwhelming.

Let's take an example. In 1998, Canada suffered a substantial drop in commodity prices as a result of the crisis in Asia and other emerging economies. The Canadian economy weathered the shock in part through a significant depreciation of the currency that mitigated the impact of the shock for Canadian exporters of commodities and encouraged net exports of manufactured goods. Under a fixed exchange rate, Canadian exporters would have faced a much larger decline in the nominal demand for their products, while the Canadian monetary authorities might have had to increase interest rates to defend the fixed peg, possibly generating a recession.

The Canadian and U.S. business cycles are very correlated, yes, but this is to some extent the result of exchange rate flexibility—not a reason to abandon flexibility.

IMF SURVEY: How has exchange rate flexibility contributed to adjustment in long-term trends in Canadian competitiveness?

ARORA: Over time, real depreciation of the Canadian dollar has helped offset the impact of the gap in productivity vis-à-vis the United States. The real depreciation has come about through both lower inflation and a depreciation of the nominal exchange rate. If the exchange rate had been fixed, then, given rigidities in nominal prices, a likely result would have been a chronically overvalued exchange rate—and all the problems that go with it. Alternatively, if prices were flexible and real depreciation were achieved, it is quite possible that it could have been achieved only through deflation (an actual decline in prices), which also has adverse effects.

IMF SURVEY: What effect has exchange rate flexibility had on Canada's productivity performance?

ARORA: This is closely related to your previous question about the adjustment to trends in competitiveness. Some people argue that exchange rate flexibility has, in fact, contributed to the productivity gap. This is the so-called lazy dollar hypothesis, which argues that exchange rate depreciation reduces the incentives for firms to innovate and change in order to stay competitive. However, we know of no strong empirical support for this claim. The alternative argument—the one that we make and for which there is some empirical support—is simply that without exchange rate flexibility, the effects of the productivity gap would have been much more painful.

IMF SURVEY: You suggest that flexibility is not necessarily the best policy for all free trade areas. What features set the Canadian situation apart from other free trade areas?

ARORA: While exchange rate flexibility has worked well in Canada, we are reluctant to generalize this conclusion to all free trade areas, because each case has features that set it apart from others and is perhaps best viewed on its own terms. Canada retained a flexible exchange rate even before the collapse of the Bretton Woods system, suggesting that different exchange rate regimes may work well for different countries. While the Canadian experience is illustrative of the benefits of exchange rate flexibility, the benefits depend in part on several features that other countries may or may not share.

A few features that are relevant are the symmetry of supply shocks, monetary policy credibility, and balance sheet risks. Supply shocks, such as those arising from commodity prices, affect Canada and the United States quite differently, so that an independent monetary policy is particularly useful. Among other countries, supply shocks may be less asymmetric. In some countries, especially those where monetary policy credibility is not well established, there is often a "convergence gain" from pegging the exchange rate to the currency of a more credible anchor country, and interest rates fall toward those prevailing in the anchor country. In Canada, with the credibility of monetary policy well established, this is less valid, and in recent years long-term interest spreads have been close to, and even sometimes below, U.S. levels. Also, in some countries, there may be more "balance sheet risk," meaning that a larger proportion of domestic liabilities relative to assets may be denominated in foreign currency, so that large exchange rate fluctuations can be especially disruptive.

Jeanne: "The Canadian and U.S. business cycles are very correlated, yes, but this is to some extent the result of exchange rate flexibility—not a reason to abandon flexibility."

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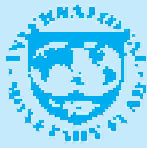

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Finally, in areas such as Europe, where integration covers more than the traditional economic dimensions, it's possible that the costs of exchange rate uncertainty are larger.

Jeanne: Another factor is relative size. The Canadian economy is small compared with the U.S. economy, which is relatively insensitive to the level of the Canadian exchange rate. This reduces the risk of self-defeating "beggar-thy-neighbor" devaluations. This is another difference between North America and the European Union, where countries are more equal in size, and the cost of uncoordinated exchange rate policies may be larger.

IMF Survey: What effect might a change in conditions over time—for example, a deepening of economic integration—have on the trade-offs between fixed and floating exchange rates in Canada?

Jeanne: This depends on how the structure of Canadian production and trade evolves over time. On the one hand, the importance of primary commodities in Canadian GDP and trade might decrease, reducing the asymmetry in the terms of trade shocks. But the deepening of trade integration could also lead to more specialization in Canadian industry, making it more vulnerable to shocks in a few industries.

Now, the choice is not necessarily between fixing and floating. Another possibility is the adoption of a common currency. A common currency could have a much larger impact on trade flows than simply fixing the exchange rate. It eliminates currency conversion costs and is a more definitive commitment to monetary integration than a fixed exchange rate regime.

The different nature of a common currency compared with a fixed exchange rate has been emphasized in some recent influential empirical work by Andrew Rose of the University of California at Berkeley (see also page 223). He suggests that, other things being equal, two countries that share the same currency trade three times as much with each other as they would with different currencies, with possibly dramatic effects on growth. Many doubt that Rose's results—which are largely driven by the behavior of trade flows in a group of developing or very small countries—are applicable to Canada. This said, the Canadian perception of the trade-offs could change if the European experience with a common currency seemed to vindicate Rose's predictions.

IMF Survey: How does Canada's integration with the United States compare with Mexican-U.S. integration?

Arora: Both countries have a long history of close integration with the United States going back to the earliest years of U.S. history. The United States accounts for a substantial share (four-fifths) of both countries' foreign merchandise trade, equivalent to half of Mexico's GDP and 60 percent of Canada's. An interesting development in the past few years is the closer trade and financial linkages between Canada and Mexico, contributing to closer economic integration across North America as a whole. ■

Vivek Arora (left) and Olivier Jeanne, authors of a study on Canadian-U.S. economic integration.

Copies of IMF Policy Discussion Paper 01/1, *Economic Integration and the Exchange Rate Regime: Some Lessons from Canada*, by Vivek Arora and Olivier Jeanne, are available from the IMF's Publications Services for $10.00 each. See page 225 for ordering information.

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Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
June 18	3.49	3.49	4.10
June 25	3.46	3.46	4.07

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).

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Data: IMF Treasurer's Department