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United States is set for recovery, but fiscal problems loom



Residential investment in the United States has helped sustain domestic demand.

The IMF recently concluded its annual “health checkup” (Article IV consultation with the U.S. authorities) of the U.S. economy amid continuing questions about the strength of the economic recovery. While recent data have been reassuring, IMF staff cautioned that lingering effects from the collapse of the equity price bubble could still dampen activity, so that a durable economic upswing was not a foregone conclusion. In view of the large unfunded liabilities in the public pension and health systems and the recent deterioration in the federal fiscal position, the staff also raised concerns about fiscal sustainability and pointed to the risk that fiscal deficits could crowd out private investment and exacerbate the growing U.S. current account deficit. These issues are discussed in the IMF Staff Report and Selected Issues papers now available on the IMF’s website (www.imf.org/external/country/usa/index.htm).

The U.S. economy has only recently begun to show stronger signs of a broad-based expansion, following an uneven and sluggish recovery from a short recession in 2001. *(Please turn to the following page)*

Interview with James Hamilton

World oil prices and U.S. recessions: tracking a slippery relationship

Most Ph.D. theses fall without making a sound in the academic forest. Not Jim Hamilton’s. His 1982 thesis created a stir with its contention that increases in world oil prices had played a role in nearly every modern recession in the United States, including those of the 1950s. Hamilton, now a well-known econometrician at the University of California, San Diego, has devoted part of his research efforts over the past 20 years to tracking the ever-changing relationship between oil prices and the economy. He spoke to Prakash Loungani about his findings.

LOUNGANI: What was the reaction when you presented your thesis?

HAMILTON: My thesis advisors at Berkeley were a little bit skeptical but supportive. Many economists found it hard to believe that there was such a dramatic relationship that no one had noticed before. [Stanford economist] Robert Hall, who discussed my paper at a



James Hamilton: “My evidence showed that six of the seven U.S. recessions since 1947 were preceded by a sharp increase in the price of petroleum.”

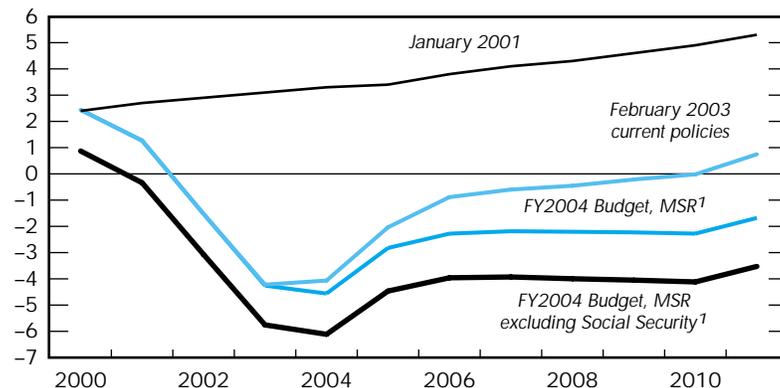
major conference at the time, remarked: “My first reaction to Hamilton’s paper was that he had made up the data!” *(Please turn to page 237)*

United States is set for recovery

(Continued from front page) But it has been able to weather a series of shocks that included one of the largest stock market declines in the postwar period, the September 11 attacks, major corporate failures and scandals, and the war in Iraq. The unemployment rate rose relatively modestly over that period, and large corporate bankruptcies were absorbed without a systemic impact on financial intermediaries.

Fiscal surpluses have given way to large deficits

In percent of GDP, fiscal years



¹IMF staff estimates, based on the fiscal year 2004 Mid-Session Review, Budget of the U.S. Government (July 2003).

To some extent, the United States's resilient performance in recent years is attributable to supportive monetary and fiscal policies. The U.S. Federal Reserve's target for the federal funds rate was reduced by 475 basis points during 2001 and has been reduced a further 75 basis points since November 2002. On the fiscal front, substantial tax cuts were legislated in June 2001 and May 2003; March 2002 legislation increased investment incentives and extended unemployment benefits; and defense and security-related spending was increased significantly in 2002 and 2003. These measures contributed to a massive shift in the federal government's unified budget balance, from a surplus of 2½ percent of GDP in fiscal year 2000 (October–September) to a deficit likely to exceed 4 percent of GDP in fiscal year 2003. With the economic slowdown also weighing heavily on revenues at the state and local levels, the combined deficit of the general government could reach 6 percent of GDP in 2003.

Sources of renewed strength

These measures have been particularly effective in supporting household demand. Consumer spending and residential investment, spurred by low interest rates, the boom in house prices, and strong growth in disposable incomes, have sustained domestic demand.

At the same time, households were able to boost their saving rate—which had fallen to around 2 percent before the recession—to around 3½ percent in early 2003. With long-term interest rates rebounding from recent lows, the refinancing wave has abated somewhat; however, higher house prices are expected to continue to fuel consumer spending in the near term.

By contrast, business fixed investment, which plummeted from historical highs relative to GDP during 2000–2001, has not rebounded as strongly as in past recoveries. Nevertheless, business equipment and software purchases have shown signs of strengthening since mid-2002, except for a brief pause in the first quarter of 2003. Investment in nonresidential structures may also have bottomed out because of high industrial vacancy rates through early 2003.

Helped by continuing robust productivity growth, financial market confidence has improved in recent months. Aggressive labor shedding in 2002 contributed to a 2 percent decline in unit labor costs and a 5¼ percent surge in productivity—the fastest annual rate in over 50 years. As a result, in the second quarter of 2003, profits began to recover, with many companies exceeding profit forecasts. The increased risk aversion triggered by accounting scandals and the buildup to the Iraq war also appears to have eased considerably. These factors have contributed to both an upswing in equity markets and a narrowing of corporate bond spreads.

Meanwhile, however, weak demand abroad and the earlier strength of the U.S. dollar have been a drag on the economy. Export volumes began to recover modestly in 2002 but fell again toward the end of the year and during the first half of 2003. Import volumes, in contrast, have rebounded strongly, reflecting purchases of consumer goods and industrial supplies. These factors, as well as higher world oil prices, helped push the U.S. current account deficit to a record 5¼ percent of GDP in the first quarter of 2003. With less favorable interest rate differentials and weaker global sentiment toward U.S. equities, private capital inflows fell. Although this decline was offset by slower investment abroad by U.S. residents and increased purchases of U.S. dollar assets by foreign central banks, the dollar depreciated in nominal effective terms by around 15 percent between February 2002 and June 2003.

The IMF projects that the expansion of activity will gather momentum in the latter half of 2003, with annual GDP growth rising from just under 2½ percent in 2003 to around 3¾ percent in 2004. Even so, it remains to be seen whether the adjustments associated with the collapse of the equity price bubble have fully

run their course, and downside risks remain a concern given the continued weakness of industrial activity and employment conditions. With economic slack remaining significant, headline CPI inflation is projected to fall to around 1¼ percent in 2004 before rebounding somewhat with the expected closing of the output gap.

Mind the fiscal gap

Despite what appears to be a relatively favorable medium-term growth outlook, recent tax cuts have heightened concerns about the country's fiscal deficit path. To be sure, fiscal policies have contributed to the recovery so far, but the tax package has weakened the United States's fiscal position, making the country even less prepared to cope with the retirement of the baby-boom generation later this decade (see chart, page 234). Sustained fiscal deficits would eventually crowd out investment and erode U.S. productivity growth. They would also tend to boost the already large U.S. current account deficit, further draining global saving and increasing the risk of disorderly exchange market conditions.

The dollar's weakness during 2002–2003 has added to uncertainty and may pose challenges for short-term macroeconomic policy management in partner countries. While the dollar's recent depreciation has been conducive to gradually bringing down the large current account deficit, a further abrupt weakening of investor sentiment and turbulent exchange market conditions could have adverse consequences both domestically and abroad. A firm commitment to reducing the U.S. fiscal deficit over the medium term and strong growth in partner countries would help ensure that the eventual adjustment of the U.S. current account deficit is orderly and rests on a strengthening of national saving rather than on weaker U.S. investment and growth.

Against this background, the staff saw the main challenge for the U.S. authorities as establishing a credible approach to coping with longer-term fiscal pressures while managing short-term risks to the recovery. In the staff's view, monetary policy should be the first line of defense against any renewed signs of weakness. The U.S. Federal Reserve Board has responded appropriately to the economic slowdown, but it may need to ease monetary policy further if the recovery fails to gain momentum. With inflation near postwar lows and interest rates close to zero, the appropriate response is aggressive action to preempt any possible deflationary risks and support a healthy recovery.

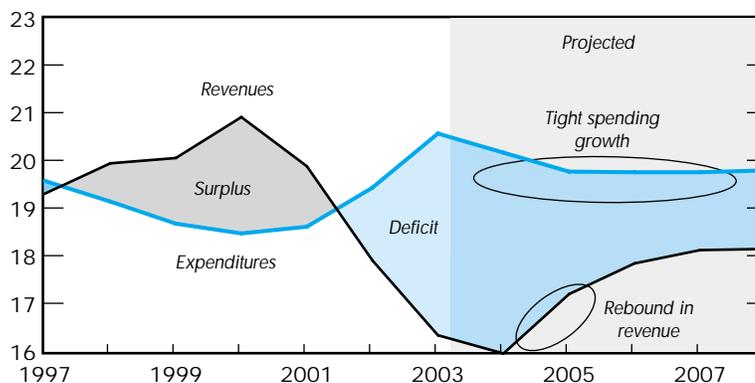
Medium-term fiscal consolidation needed...

The staff's recommendations on ensuring fiscal sustainability were guided by two principal objectives.

The first is to return the federal budget, excluding Social Security, to balance over the medium term—a target endorsed by the administration. Although the administration projects a narrowing of the deficit-to-GDP ratio in the coming years, these projections are based on assumptions—including a sharp increase in tax receipts and strict limits on discretionary outlays, other than defense and homeland security—that may prove optimistic, especially given that supporting policies to ensure strict limits on discretionary spending have yet to be defined (see chart below). Achieving budget balance over the next 5–10 years implies a government debt ratio in 2013 that is more than 10 percent of GDP lower than today, which would provide greater room to implement the needed reform of entitlement programs in advance of the demographic shock (see chart, page 236).

Fiscal deficits remain significant, even on optimistic revenue and spending assumptions

In percent of GDP, fiscal years



Source: Fiscal year 2004 Mid-Session Review, Budget of the U.S. Government (July 2003)

The second objective is to strengthen the long-term financial position of the Social Security and Medicare systems. The retirement of the baby-boom generation will place increasing pressure on these entitlement programs in coming decades, potentially causing U.S. debt and deficits to rise rapidly. The programs' unfunded actuarial liability is estimated at around 180 percent of GDP if measured over a 75-year horizon, according to Congressional Budget Office estimates, and even higher if measured over longer periods.

...and can be achieved

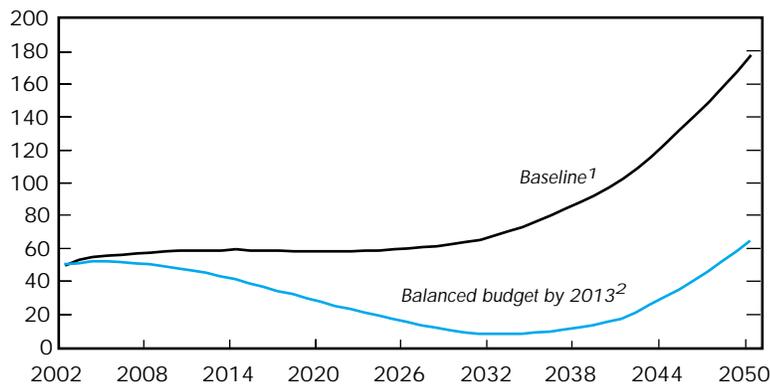
To meet the fiscal costs of population aging, the United States will need to increase its revenues—preferably through the elimination of corporate and personal income tax preferences—and curb spending. In this context, the staff pointed out that the recent tax package had added to the uncertainty about future tax rates, in part because tax cuts have been phased in and

subjected to sunsets. Moreover, as illustrated in a Congressional Budget Office study, the tax cuts are unlikely to boost output in a sustained manner unless their adverse budgetary impact is offset over the medium term.

On the expenditure side, the staff's recommendations were informed partly by an assessment of fiscal standards and codes released jointly with the annual Article IV consultation documents. While the U.S. federal budget was found to be highly transparent and representative of best practice in many areas, the sharp increase in discretionary spending in recent years has raised questions about the adequacy of fiscal discipline. In this context, the staff argued that the recently

Achieving budget balance would ease reform of entitlement programs

Debt held by the public, Social Security, and Medicare (in percent of GDP)



Sources: IMF staff estimates; 2003 OASDI Trustees Report; and 2003 SMI/HI
¹Based on the fiscal year 2004 Mid-Session Review, Budget of the U.S. Government.
²Staff estimates assuming a balanced budget, excluding Social Security, by 2013.

expired Budget Enforcement Act, which contributed to the successful fiscal consolidation during the 1990s, should be restored and strengthened further. Medium-term budgetary commitments are not a practical fiscal policy instrument in the United States, where the budget is an annual process. However, the caps on discretionary outlays and pay-as-you-go requirements introduced by the Budget Enforcement Act proved valuable during the consolidation phase of the 1990s.

In the case of the Social Security system, relatively modest changes—including amendments to indexation formulas, increases in the retirement age, or hikes in contribution rates—would be sufficient to close projected shortfalls, although the longer decisions are delayed, the larger and more painful the required adjustments will be. The financial position of the Medicare system is considerably worse, given the rapid growth of health care costs and the modest share of benefits that are covered by individual contributions. The staff therefore suggested that any measures to

enrich benefits, including prescription drug coverage, should be accompanied by credible measures to address the system's longer-term financial problems.

U.S. trade and aid initiatives

The staff urged the United States to continue to lead the way in promoting trade liberalization, building on the authorities' proposal to move the Doha Round forward. To reinvigorate the momentum toward a successful completion of the Round, the staff encouraged the authorities to find common ground with partner countries in a range of difficult areas, such as the public health exemption on trade-related aspects of intellectual property rights (TRIPs), and to take early action to comply with recent WTO rulings. While ongoing negotiations of bilateral and regional free trade agreements could bring substantial benefits to partner countries, the staff emphasized that such initiatives should complement, rather than replace, broader multilateral liberalization efforts and that the initiatives were designed to limit trade diversion and administrative complexities.

The staff also recommended that U.S. trade and domestic policies be more closely aligned with a broader commitment to development. While welcoming the United States's recent efforts to give countries in Africa and the Andean region greater access to U.S. markets and to boost overseas development assistance—including in the context of the Millennium Challenge Account—the staff pointed out that U.S. development assistance as a share of GNP remained among the lowest across industrial countries. While calling for larger increases in foreign assistance, the staff also saw scope for improving the complementarities between development and trade policies, for example, by reducing subsidies to U.S. agricultural producers and by making greater efforts to eliminate remaining nontariff barriers to imports from developing countries. ■

Martin Mühleisen
 IMF, Western Hemisphere Department

Corrections:

In the last issue of the *IMF Survey* (August 4), in the table on page 222, footnote 5 should read: *Calculated as overall balance minus grants and foreign-financed development expenditures; increase reflects increase in program support.*

In the IMF arrangements table (page 228), the undrawn amount for Argentina under its Stand-By Arrangement is SDR 975.10 million.

World oil price changes = U.S. recessions

(Continued from front page)

LOUNGANI: How has your thesis held up over the past 20 years?

HAMILTON: Quite well. My evidence showed that six of the seven U.S. recessions since 1947 were preceded by a sharp increase in the price of petroleum; the only one that wasn't was the 1960 recession. While I was working on the thesis, U.S. oil prices shot up because of the Iran-Iraq war in the early 1980s and the U.S. deregulation of the oil industry. This was followed by a recession. A decade later, the spike in oil prices triggered by Iraq's invasion of Kuwait was followed by the recession of 1990–91. A decade after that, oil prices played a role in the recession of 2001. So the score is now up to 9 out of 10.

LOUNGANI: Can you tell us more about the role of oil in the 2001 recession?

HAMILTON: Oil prices did go up quite substantially during 1999. However, all of that was just undoing the big collapse of oil prices in 1997. So only starting in 2000 were there significant new highs in oil prices. The historical relation would have predicted that a slow-down would start in the latter part of 2000, and that's exactly what happened. The U.S. economy slowed and then entered into a recession in March 2001.

LOUNGANI: Is oil responsible for the tepid recovery from the 2001 recession?

HAMILTON: It has probably been a factor. Oil prices spiked in the winter of 2002 and early 2003 as a result of concerns about how the conflict in Iraq would play out. These concerns were reflected in volatility in oil markets and in financial markets that could not have been helpful for the economy. But this spike in oil prices and, indeed, even the 2000 spike were different from those associated with earlier events, such as the first Gulf War. In those cases, you had uncertainty but also a very clear disruption to oil supplies. You could easily see it in the data on oil production. In the recent period, there was the potential for a supply disruption, but the fall in oil production was nowhere near the dramatic fall in production in Iraq and Kuwait in 1990.

LOUNGANI: So an actual disruption in oil supplies has a more profound impact on the economy than mere uncertainty about how events will unfold?

HAMILTON: No, I wouldn't put it quite that way. Both channels can operate, and, in fact, I don't know of any scientific evidence that would allow us to distinguish cleanly between the two. Oil is a very

Middle East conflicts disrupt world oil supply, causing prices to spike

| Date | Event | Percent drop in world petroleum production |
|-----------|--------------------|--|
| Nov. 1956 | Suez Crisis | 10.1 |
| Nov. 1973 | Arab-Israeli War | 7.8 |
| Nov. 1978 | Iranian Revolution | 8.9 |
| Oct. 1980 | Iran-Iraq War | 7.2 |
| Aug. 1990 | Persian Gulf War | 8.8 |

Data: James D. Hamilton, 2003, "What Is an Oil Shock?" *Journal of Econometrics*, Vol. 113 (April), pp. 363–98.

important part of the calculations for buying lots of stuff—like what kind of car to buy or what type of machinery will be cost-efficient. People read about events in the Middle East and realize that these events have implications for oil prices. And because they understand the importance of oil in virtually every activity in the economy, they become concerned. It may be that these psychological effects are what's important in disrupting patterns of consumption and investment spending.

LOUNGANI: And once you have a demand shock like this, the standard business cycle mechanisms take over?

HAMILTON: That's right. The old inventory-accelerator model of the business cycle kicks in. You have an unanticipated drop in demand, and it shows up as a piling up of unintended inventories. Production does not actually fall at the moment of the shock to demand, so real GDP is buffered temporarily. Later, when inventories are liquidated, you have the effect not only of a drop in demand but also of a drop from the excess inventories being worked off. That's an old story, but it explains why there is a long lag between the time of the oil shock and the impact on real GDP.

Then, in addition, you have an effect because capital and labor cannot move instantaneously from the sectors most affected by the oil shock to other sectors. For instance, sales of large cars respond very quickly to oil shocks, and people are laid off in related industries. But because they cannot be re-absorbed immediately in other sectors, the impact on the auto industry is felt in other sectors. This is another standard mechanism for the propagation of the business cycle.

LOUNGANI: Can U.S. government policies be effective in buffering the economy from the impact of oil shocks?

HAMILTON: The Strategic Petroleum Reserve is something that could have been used more aggressively both in this recent period and most certainly in 1990. In both episodes, releasing oil from the reserve would have dampened excessive market speculation. And the government would have made a profit on these deals, which is not a bad side effect. I'm not entirely sure what we're saving the reserve for. The next time there's a major outbreak in the Middle East, we ought to start pumping it right away.

The other policy that helps is to avoid getting into a high-inflation environment. That way, the U.S. Federal Reserve Board's hands are not tied in terms of its ability to deal with the recession when it comes. Back in 1973, the Fed could not have been that expansionary given how high inflation already was. But, in both 1990 and 2001, inflation was low, and the Fed was able to be very aggressive about cutting interest rates to stimulate the economy.

LOUNGANI: What about policies to reduce dependence on oil imports or conservation policies?

HAMILTON: There's a world market for oil, so it's not really relevant how much oil comes from particular countries. When the price goes up for one country, it goes up for everybody. The same phenomenon was apparent in 1956 when we were not importing that much oil. In any event, to think that the United States could move to a situation where it imports no oil is totally unrealistic at this point. It has to do with our mix of industries. We need a lot of oil, and lots of U.S. industries are sensitive to fluctuations in oil prices. And it just so happens that a large share of oil supplies are in a region of the world that's very unstable, and we keep seeing these events that disrupt the flow of something that's vital for all kinds of economic activities. That's why oil has been such a big factor in U.S. business cycles over the years. ■

IMF Working Paper

Bank risk-taking and competition revisited

According to prevailing finance and economic theory, when competition in banking markets increases, banks are likely to take on more risk. This can ultimately lead to bank failures, runs, and panics. In a new IMF Working Paper, John H. Boyd (Kappel Chair in Business and Government, Finance Department, University of Minnesota) and Gianni De Nicoló (Senior Economist, IMF Monetary and Financial Systems Department) argue that this notion has prompted regulators and central bankers to encourage bank mergers in response to instability. Taking a closer look at this subject, Boyd and De Nicoló find that banks may actually take on more risk when competition decreases.

With increased banking crises around the globe over the past few decades, policymakers have pursued strategies that are supposed to reduce risk. These include bank consolidation—even though there may be attendant costs, such as monopoly profits. Indeed, domestic and international official agencies have pursued aggressive merger policies in almost all crises, even in banking markets that were already highly concentrated. Yet, combining two or more large bankrupt banks neither increases equity capital nor reduces the loan losses of the survivor banks in any immediate way. But, it may reduce competition and allow survivor banks to earn greater profits in the future.

Dealing with moral hazard

In explaining banks' risk-taking behavior, modern banking models point to the important role of deposit insurance. By providing cover against loss, deposit insurance results in moral hazard—that is, it creates an incentive for banks to intentionally risk failure, possibly without limit.

The moral hazard problem can be solved if all bank shareholders hold enough of a stake in the firm to ensure that their incentives are aligned with those of the deposit insurer. Policymakers can achieve this by forcing bank shareholders to hold a large stake against their will or by giving them a large stake that they will hold voluntarily. The forcing policy refers to mandatory capital requirements in which the regulator imposes constraints on the use of financial leverage. However, there is a continuing debate over whether such policies are efficient or even effective. It may, for example, be necessary to set capital requirements at such a high level to protect the deposit insurer that the value of the bank (the present discounted value of its equity claim) is driven to a very low level, causing it to take on excessive risk because it doesn't have much to lose. The other option is to give equityholders a sufficiently large stake in their bank by allowing the bank to earn monopoly rents so that its franchise becomes valuable and going broke is costly.

Fragile theories

Earlier studies that have analyzed these policies show that, as the number of competitor banks declines, the remaining banks earn higher profits in deposit markets and their risk of failure declines. Such studies share two important characteristics. First, they largely ignore the existence of loan markets—permitting the number of competitors in the deposit market to change while holding the number of competitors in the loan market fixed. But, in reality, banks compete in both deposit and loan markets. Boyd and De Nicoló construct a model that incorporates both markets simultaneously. As competition declines, they show, banks earn larger profits in deposit markets but also earn more profits in loan markets by charging higher loan rates. Higher loan rates imply higher bankruptcy rates for borrowers, who adjust their investment policies in favor of even more risk. Risks are further enhanced by moral hazard on the part of borrowers.

Boyd and De Nicoló point out that changes in competition among banks have opposite effects on banks and their loan customers. When competition decreases, deposit rates fall, bank profits increase, and banks intentionally seek less risk. For borrowers, less competition in banking means higher loan rates, lower profits, and more risk seeking. The authors show that the loan market effect dominates, and increasing competition unambiguously lowers the risk of bank failure. They do not claim that this is a general result but suggest that the loan market effect exists and is just as important as the deposit market channel.

Sequencing of reforms

Managing risks in financial market development

Domestic financial markets are a critical pillar of a market-based economy. They mobilize and intermediate savings, allocate risk, absorb external financial shocks, and foster good governance through market-based incentives. They also reduce the risks associated with excessive reliance on foreign capital. But how should countries go about developing their local financial markets? Is there an optimal path and sequencing of reforms? And how should these reforms be coordinated with capital account liberalization? In a new Working Paper, Cem Karacadağ, V. Sundararajan, and Jennifer Elliot (of the IMF's Monetary and Financial Systems Department) propose an integrated approach that mitigates the risks inherent in market development.

When countries liberalize financial transactions and capital flows to deepen domestic capital mar-

A second common feature of earlier studies of bank risk-taking is that they ignore bankruptcy costs. In their model, Boyd and De Nicoló factor in a fixed, out-of-pocket cost that banks incur if they go bankrupt. They show that when the number of banks in a market increases, deposits, assets, and profits per bank decline, and, therefore, the (constant) cost of bankruptcy increases relative to everything else. This acts as a disincentive to risk-taking that increases with the number of competitors. Ultimately, this force must prevail, and, when it does, an increasing number of banks will be associated with lower risk of failure.

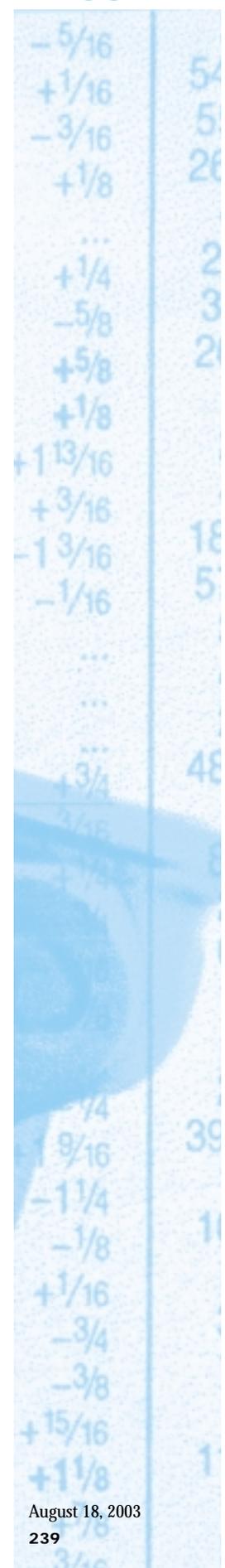
Further research

Boyd and De Nicoló's model of bank interaction and activities is very simple. But future modeling efforts, they suggest, could examine the effects of more complicated forms of market interaction or the implications of the many different kinds of loans (with different potential for moral hazard problems) that banks actually hold. Until that work is done, they conclude, there is no compelling theoretical argument that banking stability decreases (or increases) with the degree of competition in bank markets. As noted above, this conclusion conflicts with existing theory and, arguably, with recent policies of central banks and agencies around the world. ■

Copies of IMF Working Paper No. 03/114, "Bank Risk-Taking and Competition Revisited," by John H. Boyd and Gianni De Nicoló, are available for \$15.00 each from IMF Publication Services. Please see page 245 for ordering details. The full text is also available on the IMF's website (www.imf.org).

kets, they expose their financial systems to risks associated with a wider range of permissible financial transactions, investment instruments, and loanable funds. Therefore, for capital markets to grow without undermining financial stability, the central bank and financial institutions must develop the capacity to manage these risks. A robust legal and institutional infrastructure must also be developed. In their study, the authors present the key elements of institutional reform and some of the best practices in sequencing them.

In examining the role of capital account liberalization in financial market development, they caution that foreign capital can complement—but not substitute for—a domestic investor base, which is critical to developing resilient local capital markets. Before capital from abroad can play a constructive role, they



argue, a critical mass must be reached in terms of the depth of domestic markets, the diversity of local investors, the effective oversight and governance of market institutions, and the length of instrument maturities. Clearly, there are trade-offs between having good domestic institutions in place before under-

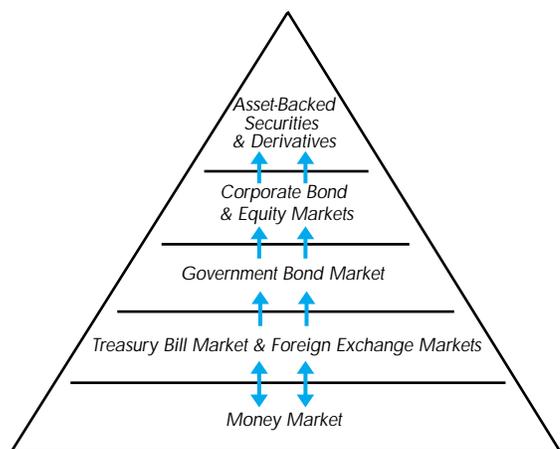
taking capital market liberalization and opening the capital account to import best practices to strengthen domestic institutions. In any case, the optimal pace and sequencing of reforms will vary according to country-specific circumstances and institutional characteristics and must take account of the hierarchy of markets—each market posing a different level of risk.

Risks and risk-mitigation policies

Capital market development requires a careful sequencing of measures to mitigate risks, in parallel with reforms to develop markets. Risks become more complex and grow as markets develop, especially as new instruments and institutions emerge. For example, central banking and money market reforms, including interest rate liberalization, can lead to the release of excess reserves and strong capital inflows, which can stimulate credit expansion, complicate monetary control, and lower banks' asset quality.

Similarly, increased price volatility in equity and real estate markets, particularly in the context of capital account opening, can complicate the conduct of monetary policy as well as the soundness of institutions. In the absence of regulatory and institutional capacities to measure, monitor, and contain them, financial risks can accumulate over time and undermine the policy consensus and commitment to liberalize further. Thus, a critical mass of reforms encompassing both market development and risk mitigation at every stage of the market hierarchy is necessary to avoid buildups in financial system fragility and macroeconomic vulnerability.

Financial markets are hierarchically ordered and highly interdependent



Source: IMF staff

Hierarchy of markets

One of the most important points made in the paper is that markets are hierarchically ordered (see diagram). At the most basic level are money and foreign exchange markets, above which is the government bond market—first at the short end, then at the long end. Finally, there are the markets for corporate bonds and equity and, at the top, the markets for asset-backed securities and derivatives. This hierarchy reflects the degree and complexity of risks involved in the assets traded in each market. The authors underscore that policies to develop financial markets should be sequenced in a manner that observes these hierarchies and interdependencies and takes into account three additional elements:

- The need to initiate early on measures that have long gestation periods, such as developing a domestic investor base, restructuring weak financial institutions, and building a robust financial infrastructure (including legal, accounting, and insolvency frameworks). Bond and equity market development, in particular, depends on the presence of a domestic investor base.
- The need for the framework for prudential supervision and market conduct to evolve in line with the pace and pattern of market development.
- The need for the overall strategy for capital market development to take into account also the country's size and wealth constraints.

Getting the sequence right

Capital account liberalization and domestic financial reforms need to be integrated. Risks in developing specific types of markets and the hierarchy of markets in terms of the demands they place on risk management and information requirements provide certain benchmarks and principles for sequencing and coordinating domestic financial sector reforms. These principles also apply to liberalizing capital account transactions, where the key challenge is to identify precisely how and when foreign capital can enhance market development.

The authors note, however, that, in practice, countries are likely to be in the midst of various stages of market development and risk mitigation that are out of sync with the hierarchy of markets and the sequencing of reforms outlined in their study. Nevertheless, the proposed approach and principles to market development, risk mitigation, and sequencing can help countries prioritize future financial reforms, regardless of the pattern of past market development.

Role of foreign capital

Foreign capital can play an important role in developing local financial markets. The timing and sequencing of capital account liberalization, however, should be selected to maximize its contribution to domestic market development and minimize its cost in terms of additional risk. Accordingly, foreign capital should

first be used to facilitate real sector and institutional reforms, including banking and corporate sector restructuring through privatization. Thus, capital account liberalization should start with the liberalization of foreign direct investment, which can help import the superior technology and the management expertise needed to implement operational reforms in financial institutions and corporations. Foreign technology and ownership also promote competition and export growth.

Opening up to portfolio inflows widens and diversifies the investor base for local markets and enhances market discipline on issuers and on macroeconomic management more generally. However, volatility in market prices may increase, at least for emerging market economies, in the short run. Well-developed risk-management capacities of local investors and financial institutions can help domestic financial markets benefit from foreign capital without subject-

ing markets to excessive volatility. Similarly, it is desirable to achieve depth in domestic financial markets before exposing them to potentially volatile capital flows. Potential market volatility and high interest rates resulting from a withdrawal of foreign capital are more manageable and short-lived when domestic institutional investors act as counterparties to foreign investors. This once again highlights the importance of developing institutional investors as a critical component in the sequencing of financial market reforms and development. ■

Copies of IMF Working Paper No. 03/116, "Managing Risks in Financial Market Development: The Role of Sequencing," by Cem Karacadağ, V. Sundararajan, and Jennifer Elliot, are available for \$15.00 each from IMF Publication Services. Please see page 245 for ordering details. The full text is also available on the IMF's website (www.imf.org).

Available on the web (www.imf.org)

Press Releases

- 03/125: IMF Completes First Review of Dominica's Stand-By Credit, Approves \$428,000 Disbursement, July 28
- 03/126: IMF Completes Third Review of Argentina's Stand-By Arrangement, Approves \$1.05 Billion Disbursement, July 28
- 03/127: IMF and World Bank Support \$10 Billion in Debt-Service Relief for the Democratic Republic of the Congo, July 28
- 03/128: IMF Completes Sixth and Final Review Under Tanzania's PRGF Arrangement and Approves \$21 Million Disbursement; IMF Also Approves a New Three-Year, \$27 Million PRGF Arrangement, July 28
- 03/129: IMF Supports Indonesia's Decision to Enter into Post-Program Monitoring, July 29
- 03/130: IMF Managing Director Horst Köhler Announces Changes in Organization of IMF Area Departments, July 30
- 03/131: Thailand Completes Early Repayment of 1997 Stand-By Arrangement, July 31
- 03/132: Joint Statement by the Government of Zambia and IMF Staff Mission, July 31
- 03/133: IMF Completes Second Review Under the Extended Arrangement, Approves Request for Waivers and Modification of Performance Criteria and for Extension of Repurchases for Serbia and Montenegro, July 31
- 03/134: IMF Completes First Review of Ecuador's Stand-By Arrangement, Approves \$42 Million Disbursement and Grants Waivers, August 1
- 03/135: IMF Completes Fifth Review of Turkey's Stand-By Arrangement, Approves Request for Extension of Repurchase Expectations, August 1

- 03/136: IMF Completes First Review of Croatia's Stand-By Arrangement, August 1
- 03/137: IMF Welcomes Cameroon's Poverty Reduction Strategy Paper, August 4
- 03/138: IMF Deputy Managing Director Carstens Issues Statement on the Dominican Republic, August 6

Public Information Notices

- 03/89: IMF Concludes 2003 Article IV Consultation with Zimbabwe, July 28
- 03/90: IMF Concludes 2003 Article IV Consultation with the Democratic Republic of Timor-Leste, July 28
- 03/91: IMF Concludes 2003 Article IV Consultation with Uruguay, August 4
- 03/92: IMF Concludes 2003 Article IV Consultation with the Kingdom of the Netherlands, August 8
- 03/93: IMF Concludes 2003 Article IV Consultation with Ireland, August 6
- 03/94: IMF Concludes 2003 Article IV Consultation with the Slovak Republic, August 5
- 03/95: IMF Concludes 2003 Article IV Consultation with Sweden, August 5
- 03/96: IMF Concludes 2003 Article IV Consultation with the United States, August 5
- 03/97: IMF Concludes 2003 Article IV Consultation with Mauritius, August 6
- 03/98: IMF Concludes 2003 Article IV Consultation with Tunisia, August 7

Transcripts

- Press Briefing by Thomas C. Dawson, Director, IMF External Relations Department, July 31
- Conference Call on Turkey with Michael Deppler, Director, IMF European I Department, August 1

World Bank Presidential Fellows Lecture

Former WTO head urges strong leadership to promote globalization

Michael Moore, Director-General of the World Trade Organization (WTO) from 1999 to 2003 and former Prime Minister of New Zealand, visited the World Bank on July 30 to speak about the links between globalization and development. He highlighted the importance of the upcoming September Cancún trade talks, called for strong leadership in promoting globalization, and offered some thoughts on how to move the Doha Development Round of trade negotiations forward.



Michael Moore

Under Moore's tenure at the WTO, the Doha Round was launched in the wake of violent protests in Seattle and elsewhere against the WTO and globalization. It was to Moore's credit, noted Gobind Nankani (vice president of the World Bank's Poverty Reduction and Economic Management network) in his introductory remarks, that in Doha, Moore pushed for a trading system that addressed developing countries' concerns. In the resulting Doha declaration,

WTO member governments committed themselves to duty-free, quota-free market access for products from developing countries and pledged to consider additional measures to improve market access for these exports. Members also agreed to try to ensure that developing countries could negotiate WTO membership faster and more easily.

Globalization: here to stay

Moore said that while globalization is a defining issue in world politics today, it is not new and it will not be stopped. The issue is how globalization is managed to ensure that its benefits are more fairly and evenly shared. "Too often, it is perceived that rich countries and rich people in poor countries get the most benefits," he observed, but "credible research proves that the more open the society and the economy, the better the results for all."

While globalization is not new, the speed of change has increased markedly, which, Moore conceded, can be destabilizing. But not all change is negative, he said, adding that "we should celebrate how well we have done over the past 50 years." Life expectancy has risen by 20 years, infant mortality has fallen by two-thirds, and hundreds of millions of people have been lifted from extreme poverty, especially in economies that have adopted open economic strategies. Portugal's

living standards have exploded since the country embraced democracy and joined the European Union, Moore said, and while North Korea was richer than South Korea following their civil war, the situation has now reversed.

Moving the Doha Round forward

Moore noted that marginalization, not globalization, threatens development and developing countries. There have to be common international standards and binding enforceable agreements between countries to make globalization work, and that's where the WTO comes in. He viewed the Doha Round as offering "a great opportunity to redress the injustices of the past." Agricultural subsidies in OECD countries are costly for Western consumers and stifle developing country markets. The cost to the average English taxpayer, for example, of the Common Agricultural Policy is £30 a week, Moore said. A successful round with a deal on agriculture "could return five times more to Africa than all overseas development assistance put together, and a deal on cotton could return \$250 million to West Africa alone."

Moore also argued in support of new rules in other areas—trade facilitation, investment, competition, and intellectual property. "Modest rules on investment would provide a transparent base and help stop multinationals from forking investment around from country to country trying to get the best deal on the best subsidy and the most protection," Moore said. The last round of trade negotiations, he noted, "has been distorted by claims of sovereignty and nonsense about compulsory privatization and abolishing public education and public health systems—that debate is false."

And there are other issues on the Doha agenda, such as good governance. Rules on transparency will help expose corrupt practices and give taxpayers a better deal, Moore said. "If we're talking about the quality of institutions, maybe we have to be a little more radical than we have been. I think it is time to redirect a lot of our aid to the building of skills."

Countries and businesses underinvoice to escape tariffs and taxes or overinvoice to smuggle money out of countries with currency controls. Common customs valuation agreements are central to keeping business clean and products moving; trade facilitation, which will be at the heart of the agenda at Cancún, will give great benefits to business and governments. Corporations' reputations also play

an important role in enforcing global standards. “All sorts of leverage can be used with those corporations that want to maintain their good image,” he said. “That’s where guys like us can get those people to raise their standards.”

Certainly, some countries will be hurt by a successful Doha Round, Moore acknowledged, and a system needs to be put in place to assist them. “It is our job to ensure that we can ease that transition.”

Lessons for the future

The most profound lesson Moore learned from his experience at the WTO and in government is that the quality of government institutions is critical for improving a country’s economy, as is a free press. Building a sound customs department, central bank, police department, and education system is as important a use of development aid as building a road or a bridge, he said.

IMF Institute Seminar

Do we really know that the WTO increases trade?

Supporters of the World Trade Organization (WTO) and its predecessor, the General Agreement on Tariffs and Trade (GATT), argue that global trade can be boosted by encouraging countries to lower tariff barriers. But is there compelling evidence that the GATT/WTO has any impact on trade or trade policy? In a new study presented at a recent IMF Institute seminar, Andrew Rose, Professor at the Haas School of Business at the University of California, Berkeley, finds very little.

Until now, Rose says, there has been no rigorous empirical examination of whether the GATT and the WTO, which were set up to ensure that trade flows as smoothly, predictably, and freely as possible, have succeeded in carrying out their mandates. Rose fills this gap and draws provocative conclusions. He finds remarkably little evidence that countries belonging to or joining the GATT/WTO have different trade patterns from outsiders—in other words, GATT/WTO membership has not systematically played a strong role in encouraging trade. Not all multilateral trade arrangements have been ineffectual, though; trade preferences extended to developing countries by developed countries under the Generalized System of Preferences (GSP) have approximately doubled trade.

Rose also finds that few trade policy measures are routinely associated with GATT/WTO membership. Trade liberalizations, when they do occur, lag GATT/WTO entry by many years, and the

“I am a deep believer in the multilateral system,” Moore stressed, and “we who are true believers must do things to make it more effective, more accountable, more transparent for our owners.” As in 1918 and 1945 after the two world wars, there is a need today for progressive leaders with a vision and for ideals of an international order that the rest of the world can buy into. “The idea of global justice has not disappeared,” Moore added; “however, after 50 years, the UN system is middle-aged and overweight and has blood clots and bad circulation.”

Yet “there’s a lot we should be optimistic and enthusiastic about,” Moore said, closing with an anecdote from a visit to Cambodia where he saw dozens of young people line up outside cyber cafes. “The young people out there get it,” Moore said. “What we have to do is get out of their way so they can do it. We are public servants. We are there to serve them by removing the impediments to their hope and their future.” ■

GATT/WTO admits countries whose trade regimes are closed and remain closed for years. The exception to the rule is that WTO members tend to have slightly more economic freedom, as indicated by an index developed by the Heritage Foundation. The index ranks countries according to a range of factors that affect economic freedom and prosperity, such as government intervention in the economy, corruption, trade barriers, rule of law, regulatory burdens, banking restrictions, and black market activities.

No impact on trade

To make his argument as persuasive as possible, Rose uses widely accepted techniques. He starts by estimating the effect of GATT/WTO membership on international trade, using the standard “gravity” model of bilateral trade, based on the idea that the level of trade is inversely proportional to the distance between countries and directly proportional to their joint income (as measured by GDP). Using data spanning 1948–1999 for 178 countries and territories, he finds that the effects of GATT/WTO membership are economically small, often negative, and statistically insignificant.

To account for as many extraneous factors as possible, Rose augments the basic gravity model with other variables that affect trade, including culture (whether a pair of countries share a common language), geography (whether neither, one, or both are landlocked), and history (whether one colonized





Andrew Rose



the other). After taking other factors into account, he compares trade patterns for countries in the GATT/WTO with those outside the system. He searches for this effect across countries (since not all countries are in the system) and time (since membership of the GATT/WTO has grown).

If membership in the GATT/WTO has a large effect on trade, members would be expected to have significantly higher trade than outsiders. A series of “event studies” that looks at bilateral trade around the dates of GATT/WTO entry reveals that countries joining the GATT/WTO neither have significantly different trade from nonmembers nor experience increases in trade, holding other factors constant. As such, the event studies provide little evidence that membership in the GATT/WTO stimulates trade.

Rose underscores that the gravity model does a good job explaining variations in international trade. Countries that are farther apart trade less, while economically larger and richer countries trade more. Countries belonging to the same regional trade association trade more, as do countries sharing a language or land border. Landlocked countries trade less, as do larger countries. A shared colonial history encourages trade. These effects are sensible and explain almost two-thirds of the variation in bilateral trade. But above and beyond these gravity effects, does membership in the GATT/WTO have any substantial effect on trade? Rose’s results indicate that they do not. By way of contrast, the GSP seems to have had a large positive effect on trade.

So why has trade grown faster than income in recent decades, if not because of the GATT/WTO? Possible explanations include higher rates of productivity growth in tradables, falling transport costs, regional trade associations, converging tastes, the shift from primary products to manufacturing and services, growing international liquidity, and changing endowments. But that is a different topic altogether, Rose notes.

Trade policy offers no explanation

Why is GATT/WTO membership not associated with increased trade? Perhaps there is no discernible difference in trade policy between members and nonmembers, suggests Rose. Using over 60 indicators of trade policy—such as the ratio of imports or trade to GDP, tariffs, and nontariff barriers—for 168 countries from 1950 to 1998, he searches for a connection between GATT/WTO membership and trade policy and, indeed, finds little. Outsiders, for example, typically have slightly less nontariff barrier coverage and slightly higher tariffs, but neither of these effects is

significant. An event study confirms this loose relationship. It shows that a typical accession country has an openness ratio of 73.1 percent five years before joining (somewhat higher than the GATT/WTO average of 64.7 percent). But five years after accession, the joiners have openness ratios of only 70.4 percent.

Similarly, tariffs rise (although the effect is not statistically significant) five years after accession from 12.5 percent to 13.1 percent of imports. Using the example of Mexico, Rose points out that the country joined the GATT in 1986, at which time its tariffs averaged 6.4 percent of imports. But five years after accession, the Mexican tariff rate was 7.1 percent. In fact, Mexican tariffs did not really fall until NAFTA (North American Free Trade Agreement) took effect in the mid-1990s. Nor is Mexico special; for instance, in Colombia and Venezuela, average tariffs were higher even five years after they acceded to the GATT in 1981 and 1990, respectively. And India, a founding member of the GATT, still has some of the highest tariffs in the world.

The exception to Rose’s conclusion about the impact of GATT/WTO membership on trade policy is that, according to an index compiled by the Heritage Foundation, members of the system usually enjoy slightly more economic freedom, as measured by foreign investment codes, taxes, tariffs, banking regulations, monetary policy, black markets, and more.

The lack of regime changes—that is, a switch from a closed to a liberalized trading system—provides further evidence that membership has no more than a subtle or weak impact on trade policy. Using data compiled in 1994 (pre-WTO), Rose finds that GATT repeatedly admitted countries that were closed and remained closed for an average of eight to nine years following entry.

No surprise

The absence of any strong impact of GATT/WTO membership on trade or trade policy is not particularly surprising, Rose says. After all, the GATT/WTO has not typically forced countries to lower trade barriers, especially developing countries that have received special and differential treatment. In fact, the GATT built in a large number of provisions to allow countries to pursue their own policies. For instance, Article XVIII of the GATT’s Articles of Agreement allowed protection by developing countries; Articles XIX through XXI include opt-outs for a variety of reasons, including public morals, health, and security. There was also a procedure to waive obligations in Article XXV. That is, there was plenty of room for countries to be members of the GATT

without adhering to the spirit of the agreement. In addition, members of the WTO seem to extend most-favored-nation (MFN) status unilaterally to countries outside the system, even though they are under no formal WTO obligation to do so. For example, the United States extended MFN status to Russia and Saudi Arabia.

A burning question remains: what is the function of the GATT/WTO? It might be the case, Rose suggests, that its very existence acts as an interna-

tional public good by encouraging more liberal trade among countries, regardless of membership status. However, he concludes, it is impossible to test this hypothesis. ■

“Do WTO Members Have More Liberal Trade Policy?” is available via the Internet: <http://faculty.haas.berkeley.edu/arose/WTO.pdf>, and “Do We Really Know That the WTO Increases Trade?” is also available via the Internet: <http://faculty.haas.berkeley.edu/arose/GATT.pdf>.

Recent publications

IMF Working Papers (\$15.00)

- 03/135: “Central Bank Foreign Exchange Market Intervention and Option Contract Specification: The Case of Colombia,” Ousmene-Jacques Mandeng
- 03/136: “Enterprise Restructuring and Transition: Evidence from the Former Yugoslav Republic of Macedonia,” Juan Zalduendo
- 03/137: “Exchange Rate Regime Considerations for Jordan and Lebanon,” Rina Bhattacharya
- 03/138: “Insurance and Issues in Financial Soundness,” Udaibir S. Das, Nigel Davies, and Richard Podpiera
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- 03/144: “A Political Agency Theory of Central Bank Independence,” Gauti B. Eggertsson and Eric Le Borgne
- 03/145: “Assessing Fiscal Sustainability: A Cross-Country Comparison,” Enzo Croce and V.H. Juan-Ramon

IMF Country Reports (\$15.00)

(When the country name appears alone, the report is its Article IV consultation.)

- 03/214: Argentina: First Review Under the Stand-By Arrangement and Exchange System

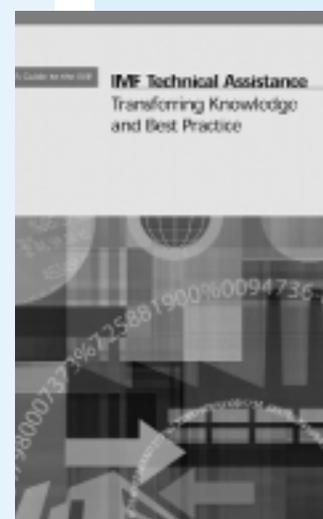
- 03/215: Argentina: Second Review Under the Stand-By Arrangement and Request for Waivers of Non-observance and Applicability of Performance Criteria
- 03/216: Kyrgyz Republic: Third Review Under the PRGF and Request for Waiver of Performance Criteria
- 03/217: Cape Verde: Joint Staff Assessment of the Poverty Reduction Strategy Paper Preparation Status Report
- 03/218: Albania: Second Review Under the Three-Year Arrangement Under the PRGF
- 03/219: Albania: Joint Staff Assessment of the Poverty Reduction Strategy Paper Annual Progress Report
- 03/220: The Bahamas
- 03/221: The Bahamas: Statistical Appendix
- 03/222: Republic of Tajikistan: First Review Under the Three-Year Arrangement Under the PRGF and Request for Modification and Waivers of Performance Criteria
- 03/223: Rwanda: Report on the Observance of Standards and Codes
- 03/224: Zimbabwe
- 03/225: Zimbabwe: Selected Issues and Statistical Appendix
- 03/226: Argentina
- 03/227: Democratic Republic of Timor Leste
- 03/228: Democratic Republic of Timor Leste: Selected Issues and Statistical Appendix
- 03/229: Cape Verde: Second Review Under the PRGF Arrangement
- 03/230: Sweden

Other

IMF Technical Assistance: Transferring Knowledge and Best Practice (pamphlet)

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Appreciation, anyone?

What a weak dollar may mean for the United States, Europe, and Asia

What does a widening U.S. current account deficit mean for global exchange rates? Is there an increased risk of a rapid adjustment of exchange rates—one that could create difficulties for Asia and Europe and potentially lead to renewed stress in financial markets? Some sharp currency fluctuations in recent months turned a July 22 seminar at the American Enterprise Institute (AEI) into a timely and topical event. What emerged was consensus on the need for structural reforms in Europe and Japan and on the difficult political issues that would need to be resolved before Asian economies would tolerate a greater appreciation of their currencies. However, there was much divergence on whether the U.S. current account deficit should be giving policymakers, and many others, sleepless nights.



Kenneth Rogoff



Ted Truman



Mickey Levy

Cause for alarm?

Kenneth Rogoff welcomed the fall in the dollar during 2002–2003 as a broadly healthy development but warned that the adjustment so far has not been enough to put the current account deficit on a path toward sustainability. On the basis of present trends, he saw the United States on course to increase its net external liabilities to around 40 percent of GDP within the next few years. Rogoff expressed concern over what he termed unprecedented levels of external debt for such a large industrial country. Only a number of emerging market economies and some smaller industrial countries have reached comparable debt ratios.

Although a reversal was not necessarily imminent, Rogoff and Ted Truman argued that this exter-

nal imbalance could not be sustained. In Truman's view, an eventual further dollar depreciation of some 30 percent in effective terms is needed to return the U.S. current account deficit to a sustainable range. But, as Rogoff noted, short-term movements in the exchange rate are essentially impossible to forecast, and a depreciation scenario could easily take three to five years to fully play out.

Even a rapid depreciation need not necessarily be catastrophic. During the late 1980s, for example, when the trade-weighted dollar fell by more than 40 percent over a relatively short period, the problems proved manageable. But this time, Rogoff warned, with the United States reaching record net external debt levels, the global economy could be drifting into uncharted waters, and the risks, especially to financial markets, should not be underestimated. In his view, it was of particular concern that the U.S. current account deficit increasingly reflected low saving (in part because of the dramatic shift of the U.S. budget into deficit) rather than high investment, as it did through most of the 1990s.

Or maybe not?

By contrast, Mickey Levy and Vincent Truglia attached a low probability to any large exchange rate adjustment. Their presentations emphasized the lackluster domestic demand of U.S. trading partners as the main factor behind the large trade deficit. At the same time, the relative weakness of the European and Japanese economies implies that the United States remains by far the most attractive destination for foreign capital, offering higher risk-adjusted returns than the rest of the world. Levy likened the current phase of technological progress to the expansion of the U.S. rail network in the nineteenth century, which was also financed to a large extent by foreign investment.

Levy and Truglia put the onus on U.S. trade partners to raise growth and attract international investment capital. In their view, the difficulties in these economies have little to do with exchange rates and a good deal to do with their failure to tackle long-standing structural weaknesses. When pressed, Levy acknowledged that Europe had recently made some progress, which is reflected in the moderate strengthening of the euro and some private capital outflows from the United States. However, this

The AEI seminar featured presentations by Yusuke Horiguchi (Institute of International Finance), Mickey Levy (Bank of America), Adam Posen (Institute for International Economics), Kenneth Rogoff (IMF), Michael Rosenberg (Deutsche Bank), Vincent Truglia (Moody's), and Ted Truman (Institute for International Economics), as well as closing remarks by Allan Meltzer (AEI).

served only to show that the exchange rate reacted quickly once the market sensed a change in underlying fundamentals, which in his view illustrated that the euro area and Japan needed to boost growth rather than focus on particular exchange rate levels.

If the euro strengthens

Other discussants also called for an acceleration of structural reforms in Europe, if only to cope with the consequences of an exchange rate appreciation. With Asian countries generally reluctant to tolerate a strengthening of their currencies, Truman and Michael Rosenberg expected the euro to absorb a considerable share of any future exchange rate adjustment. The euro area accounts for about 25 percent of U.S. trade (excluding oil). However, with even larger financial links, Truman suggested that a dollar depreciation vis-à-vis the euro would account for around 40–50 percent of any future decline in the U.S. Federal Reserve's nominal exchange rate index. Both he and Rosenberg suggested that the euro could appreciate to \$1.50—a level consistent with past exchange rate cycles.

Truman estimated that a strengthening of the euro to such a level could cut GDP growth in the euro zone by up to 1–2 percentage points over two years. He was pessimistic about the scope for policy measures to respond to such a major shock. Besides further monetary easing, which could help reduce

interest rate differentials, he thought intervention was likely to prove only marginally effective. Truman maintained that European policymakers had so far been “largely in denial” about the potential impact of the exchange rate on the European Union's trade position, which left them with few options for softening the blow.

Meanwhile, in Asia...

As for Asian countries, some participants questioned the wisdom of their accumulating large foreign exchange reserves, notwithstanding recent successes in preventing currency appreciation.

Asian central banks have acquired large amounts of U.S. treasury securities over the past year, amounting to more than \$100 billion since early 2002. The bulk of these assets is held by Japan, whose recovery remains largely dependent on export growth, and China, which has acquired dollars to maintain the renminbi's peg to the dollar. Smaller Asian economies have also maintained their close currency relationships with the dollar, and Rogoff pointed out that there was no obvious limit to the quantity of reserves a country could accumulate. However, most participants agreed that the rising cost of reserve holdings, as



Vincent Truglia



Michael Rosenberg

IMF regional departments are reorganized

The number of the IMF's area (regional) departments will be consolidated, IMF Managing Director Horst Köhler announced on July 30. The changes, to be implemented by November 1, follow an internal review to determine the best way to structure and manage these departments. “The changes in the structure of area departments will ensure that the IMF continues to provide the best possible service to our membership,” Köhler said.

Changes in the work of the European II Department (EU2), in particular, were one impetus for the consolidation. This department was created in 1992 to assist the Baltic countries, Russia, and the other countries of the former Soviet Union with economic transition and integration with the global economy. Given the progress these countries have made and the prospects of a number of them for accession to the European Union, EU2 will be dissolved, reducing the number of area departments from six to five.

Seven countries in EU2 will move to the European I Department, which will be renamed the European Department (EUR). The other eight EU2 countries will move to the Middle Eastern Department (MED), which will be renamed the Middle East and Central Asia Department (MCD).

Michael Deppler, who currently heads EU1, will be director of EUR. Initially, George Abed, who heads MED, will be director of MCD. On September 1, Mohsin Khan, currently Director of the IMF Institute, will move to MED as Associate Director and will assume the title of Director of MCD upon Abed's retirement in December. John Odling-Smee, who has led EU2 since its inception, has announced his intention to retire in early 2004.

The country composition of the IMF's other three area departments—the African Department, the Asia and Pacific Department, and the Western Hemisphere Department—will not change.

The full text of Press Release No. 03/130 is available on the IMF's website (www.imf.org).



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Yusuke Horiguchi

Allan Meltzer

Adam Posen

well as increasing political pressure from the United States and Europe, would eventually force most of these countries to rethink their policies.

Against this view, Yusuke Horiguchi argued that criticism of Asian exchange rate policies was misplaced—at least as far as Europe was concerned. In his view, the adjustment burden on Europe is independent of whether Asian currencies appreciate or not. Rogoff said that there had been few cases where governments decided to unilaterally initiate a substantial appreciation of their currency; he cited Italy in 1926 (40 percent) and Japan in 1971 (17 percent) as rare exceptions. On the basis of historical experience, he argued that current account adjustments eventually involved both an adjustment in the exchange rate and a narrowing of relative growth rate differentials.

Michael Rosenberg supported this view. He expected the Japanese yen to be the first currency to appreciate during a “second wave” of dollar weakness, and others, including China’s, to follow in later stages. Allan Meltzer and Adam Posen pointed out that this step would require difficult political decisions by Japan, partly because it conflicts with Japanese attempts to establish greater exchange rate coordination with Southeast Asian economies. Posen suggested, however, that the scope for yen appreciation was limited by the continued need for monetary easing and the weakness of the domestic economy.

Most participants also agreed that any decision about the Chinese currency peg had to be viewed largely in domestic policy terms, notwithstanding calls by U.S. and Japanese manufacturers to allow the renminbi to appreciate. For Truglia and Meltzer, the renminbi exchange rate reflected China’s long-

standing desire to acquire sufficient reserves to withstand economic shocks, such as those that hit Mexico and the Asian crisis countries in the 1990s. While this objective has largely been achieved, the country is now reluctant to face a possible appreciation, given deflationary pressures both in its domestic economy and in Hong Kong SAR.

Of course, Posen said, a change in Chinese exchange rate policy need not necessarily lead to an appreciation, particularly if it is accompanied by a relaxation of capital controls that allows some pent-up savings to exit in search of higher returns. He and Truglia pointed out that China’s overall foreign trade was broadly balanced, that Chinese exporters were not competing directly with high-end U.S. manufacturing companies, and that China already had a saving rate of close to 50 percent. Any exchange rate move would hardly be large enough to offset extremely low labor costs, so it is unlikely that Chinese trade flows would be significantly affected. Echoing this view, Rogoff expressed support for the current level of the renminbi but called for a more flexible exchange rate regime. ■

Martin Mühleisen
IMF, Western Hemisphere Department

Selected IMF rates

| Week beginning | SDR interest rate | Rate of remuneration | Rate of charge |
|----------------|-------------------|----------------------|----------------|
| August 4 | 1.52 | 1.52 | 2.01 |
| August 11 | 1.53 | 1.53 | 2.02 |

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?2003).

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

Data: IMF Finance Department

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