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Interview with Anoop Singh

Latin America must tackle social ills and increase growth while keeping economies stable

Anoop Singh, a national of India, took charge of the IMF's Western Hemisphere Department in September 2002. Before that, he was Director for Special Operations—a unit formed in 2002 to bring together the IMF's expertise in resolving financial crises. In both positions, he has drawn on his over 25 years of experience at the IMF—as Deputy Director of the departments covering the Asia-Pacific region in the mid- to late 1990s, including during the Asian financial crisis and its aftermath. In the early 1980s, he served as Special Advisor to the Governor of the Reserve Bank of India. Laura Wallace spoke with Singh about the challenges the department faces, especially in the IMF's efforts to end the financial crises in Latin America and rebuild growth.

Singh: "The safe level of debt for many emerging market countries is almost certainly much lower than earlier perceptions."

IMF Survey: What are the main lessons the IMF should draw from Argentina's collapse in 2001–02 and earlier IMF financial support for the country's policies?

Singh: There are many lessons—for policies and for our own surveillance role—and we are still assessing them. But some are already clear. Argentina's exchange rate arrangement, which was a very hard currency peg (a currency board), worked well in the early years to anchor inflation *(Please turn to the following page)*

New IMF loan

Argentina promises financial discipline and greater legal certainty

Argentina's new program includes higher spending for social safety nets to protect the most vulnerable segments of the population.

After a year of negotiations, the IMF approved a $6.6 billion debt rollover for Argentina on January 24, giving the country breathing room to maintain stability ahead of presidential elections scheduled for April. The agreement also clears the way for the multilateral development banks to resume their support of social programs, following Argentina's recent clearance of arrears to them.

The pact includes an eight-month loan of about $2.9 billion, enough to cover all of Argentina's payment obligations to the IMF through August 2003. A first disbursement of $1 billion was made on January 28. The IMF also agreed to extend for one year another $3.7 billion of payments to the IMF expected through August. IMF Managing Director Horst Köhler said the "transitional program is viewed as a step to *(Please turn to page 21)*

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Singh on Latin America

(Continued from front page, top) reduction. However, during the 1990s, key parts of the macroeconomic policy framework, as well as structural policies, became increasingly inconsistent with sustaining the currency board—in particular, the rising level of federal and provincial debt. One clear lesson for other countries is that high public debt increases vulnerability, especially if there is a high degree of dollarization. The safe level of debt for many emerging market countries is almost certainly much lower than earlier perceptions.

IMF Survey: Where do we go from here, and how do you assess the January debt rollover agreement?

Singh: All the parties involved have been trying for at least a year to develop a strong policy framework that will allow Argentina to recover from the crisis and rebuild a basis for growth. This has taken much longer than anybody expected—partly because the crisis is very deep and partly because it is difficult, in the middle of such a deep crisis, to get the consensus needed across the community to carry forward a strong recovery program. The government has formulated a transitional program as a step toward a more comprehensive program that could be developed soon after a new government assumes office in late May. The hope is that this program will help maintain macroeconomic stability during the political transition, thereby helping bridge the period until a more comprehensive program can be developed by the successor government.

IMF Survey: There's a lot of criticism in the press that the motivations for this were a bit suspect. Was the IMF simply responding to pressure from its major shareholders or trying to avoid IMF arrears?

Singh: As I said, we have all searched for a comprehensive program that would give strong assurances not only about immediate macroeconomic policies and their implementation but also about economic restructuring—of the banking system, fiscal relations with the provinces, tax reforms, and debt, to name a few. All this could not be achieved at this time, but we hope that the transitional program will be a bridge to that comprehensive program. I don't think it is very productive to speculate about motives. All parties have shared the same objective for Argentina—a full and durable recovery—and the IMF is committed to making the transitional program work.

IMF Survey: Why does Latin America seem to have benefited so little from the policy improvements that the IMF has been hailing since the 1980s?

Singh: Much was achieved in the 1990s, especially in reducing inflation, and I think we should resist looking at the region as a whole, even though there are many common elements. Several countries were able to strengthen their policy frameworks and maintain growth, whereas others proved more susceptible to recurrent crises. Those in the former group emphasized fiscal strength and institutional reform, while other countries remained crisis prone because of inconsistencies in the policy framework. High or growing dollarization—of banking systems and debt—was another key factor. In many countries, the benefits of reform and growth were not broadly shared, labor reform remained a problem, and the targeting of social spending did not improve sufficiently—this meant that income inequalities remained high or that previous gains began to be quickly reversed as growth faltered later in the 1990s.

One lesson that the IMF has learned is that, in our own policy advice, we need to pay even more attention to sustainability. We must also coordinate better with the World Bank and the Inter-American Development Bank so that, together, we look across macroeconomic, structural, and institutional policies. Political coherence and consensus are, of course, also essential, and often these have tended to overshadow the economic factors.

One lesson that the IMF has learned is that, in our own policy advice, we need to pay even more attention to sustainability.
—Anoop Singh

IMF Survey: Is the worst finally over in Latin America?

Singh: There are some positive events and trends in a number of countries. But the international environment remains difficult for the region, and many countries must still adequately address significant weaknesses and vulnerabilities.

On the positive side, take Brazil, which has completed a complex political transition in an exemplary fashion that must clearly rank as a model for others. Markets have welcomed this, and risk indicators have improved. We have established an early dialogue with the new economic team—which is preserving economic policy continuity even as it prepares to address social and income inequities—and the IMF's Managing Director and I had our second meeting with President Lula da Silva a few days ago. I would like to believe that the IMF has played a supportive role in Brazil's transition. A few months before the elections, the IMF approved a new loan through 2003 in support of a program whose core elements were endorsed by the major presidential candidates. Since the new government has taken office, it has begun to follow through with announcements and policies that are consistent with the program. And, as markets have realized in the last few weeks that economic continuity is being assured and that the new president

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aims to do this with a much stronger emphasis on social equity—an emphasis with which we completely agree—many market indicators have improved considerably. Brazil is not the only example, of course.

IMF SURVEY: Is Brazil's transition model one that Argentina might want to emulate?
SINGH: Each case is, of course, different. Argentina now has a program for its period of political transition, with the expectation that the successor government will quickly develop its own program. Nevertheless, there are important aspects of Brazil's transition that should be highlighted—especially, how the presidential candidates came together to emphasize the broad consensus in the community for core economic goals. Another example is that of Korea in late 1997, when the incoming government endorsed the key policies in the economic program that was being put together in record time.

IMF SURVEY: What are the other promising signs in Latin America?
SINGH: Certainly, Colombia. The government has been successfully steering strong economic policies through congress—recently securing support for some difficult fiscal measures, tax reforms, pension reforms, and labor market reforms. This was a major landmark. In the past month, Colombia has regained market access, showing that markets differentiate and respond to good policies. Granted, Colombia faces very difficult problems—economic ones as well as the problems from the civil conflict. But we see a government prepared to make difficult economic decisions, which is why the IMF Board agreed in mid-January to a new loan. Let me also mention Peru, which has managed to maintain relatively high growth in a difficult external environment while carrying forward essential economic reforms. We are also encouraged by the early steps taken by Ecuador's new government.

IMF SURVEY: So the worst is over.
SINGH: That's difficult to say. Many countries remain vulnerable because of high debt, dollarization, low growth, and high income inequalities. The external situation also remains difficult, with many downside risks. There is no doubt that countries everywhere need to persevere with economic reforms, extending these to strengthening institutions, but this requires a consensus across the community—which is tough to secure in an environment of low growth and high inequality. Even so, markets can be expected to respond positively to countries that are able to carry out these changes.

IMF SURVEY: To what extent are Latin America's fortunes tied up with those of the United States?
SINGH: The importance of the United States can be demonstrated in at least two ways. First, there is the trade link. Take Mexico, in which the North American Free Trade Agreement has helped increase U.S.-Mexican trade to almost half of Mexico's GDP from around one-fourth before the pact. For other Latin American countries, the trade link is less important, but the United States still accounts for almost a third of their total trade. Second, there is the financial link. A significant proportion of capital flows into Latin America come from the United States. And, given that Latin America has tended to depend heavily on portfolio inflows, U.S. interest rate changes have a major effect on Latin American interest rates. Plus, don't forget the important role that the U.S. economy played in the 1997–98 Asian crisis—it helped accelerate an export-led recovery for the Asian economies and insulate Latin America from some of the worst effects of the crisis.

Singh: "As far as our relationships with countries are concerned, we must reach out to broader sections of the community."

IMF SURVEY: What more can be done to enhance Latin America's trade prospects? Any insights from Asia?
SINGH: Latin America's share of trade in its GDP is generally much lower than in many Asian countries, giving rise to considerable imbalance between its trade openness and its capital market integration. Typically, Latin American countries have been much more open on their capital account than on their trade account, making it difficult for real depreciations to result in export-led recoveries out of financial crises. How can trade openness be increased? Many Latin American countries are still quite protectionist. But the industrial countries, also, need to ensure better market access, along with maintaining robust global growth. We are giving increasing attention to these issues as we look at Latin America's medium-term growth prospects.

IMF SURVEY: With a variety of economic plans being floated, do you have any words of caution for the U.S. administration?
SINGH: As we prepare for the annual consultation with the United States in May, I would just note that we'll be assessing current initiatives against key themes raised in last year's consultation—including preparing for the fiscal and other challenges expected to arise from population aging and aiming to balance the budget (excluding social security) over the cycle.

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Many countries remain vulnerable because of high debt, dollarization, low growth, and high income inequalities.
—Anoop Singh

IMF SURVEY: What lessons did you learn in dealing with the Asian crises that you're trying to use in dealing with Latin America?

SINGH: Although every crisis is different—this is an important lesson in itself—the Asian crisis underscored the links between the financial and corporate sectors and the external situation. We now have a better understanding of how capital account crises develop, the need to maintain financial sector soundness, and the need to act decisively with insolvencies—to have in place efficient mechanisms to deal with nonperforming loans and facilitate corporate restructurings. Alternatives are needed to resolve corporate insolvencies—the court process would take too long—hence the importance of developing out-of-court restructuring procedures with balanced incentives for creditors and debtors. There is also now a better understanding of the need to ensure consistency and coherence between different parts of the policy framework. So, if a country has a fixed exchange rate, it has to adopt economic policies that are consistent with this kind of arrangement.

IMF SURVEY: Is it feasible for Latin America to put more energy into attacking poverty and income inequality while it's trying to sort out its finances?

SINGH: It isn't a question of whether it's feasible. It needs to be done. It isn't possible to have economic sustainability without social sustainability. The challenge is to tackle social inequities while maintaining macroeconomic stability. Many countries have budgetary revenue and expenditure rigidities that, if unlocked, would allow a better targeting of social spending. Let's take Brazil—whose tax ratio exceeds 30 percent of GDP. However, a large proportion of revenue is earmarked for certain uses, leaving little room for discretionary outlays. In other countries, where tax ratios are low, raising social spending does entail raising revenues, but again this can be done to some extent by eliminating exemptions and concessions. It does not always mean higher tax rates, but it does mean building a culture of tax compliance, which is difficult.

IMF SURVEY: Are you hopeful?

SINGH: Yes, I am, but I'm aware that it will require a strong consensus in many countries to overcome vested interests and take all the steps that are needed to build fiscal sustainability and growth. This isn't easy to do, especially in an environment of weak growth.

IMF SURVEY: What are your plans for the Western Hemisphere Department? Should we expect any changes in the way the IMF works with countries in the region?

SINGH: It's only been a few months, but many challenges are clear. We held an early retreat with staff and have set certain principles for good management. Even so, the risk remains of getting excessively preoccupied with some countries that demand immediate attention—and we have been trying to maintain an even balance across the department. We are also looking to build research capacity and learn lessons from the recent experience in Latin America. We have begun work on a paper, which should be done in the first half of this year, that will assess the current situation, draw lessons from the 1990s, and develop proposals for improving our policy advice. We are also planning to hold a conference on Latin America this spring.

As far as our relationships with countries are concerned, we must reach out to broader sections of the community. In my initial visits to Argentina, we made a major effort in this direction—we met with provincial leaders and administrators, trade union leaders, bankers, representatives of the church, and others. I think this effort was extremely helpful in enabling us to more fully understand the depth and complexity of the Argentine crisis. Obviously, we can't make this kind of effort in every country, but we would like to.

IMF SURVEY: You're the first head of Western Hemisphere not to speak Spanish. Is that proving to be a major hurdle?

SINGH: I'm trying to change this but it will not happen overnight, and it's actually proving to be much less of a hurdle than I had feared. English is spoken extremely well across Latin America, and everyone I have met has been very understanding about my obvious lack of Spanish. And when it's necessary, IMF translators provide excellent support. ■

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
January 20	1.89	1.89	2.42
January 27	1.88	1.88	2.41

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

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

Data: IMF Treasurer's Department

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Argentina gains breathing room

(Continued from front page, bottom) a comprehensive medium-term program, which is needed to reestablish investor confidence and capital inflows, achieve fiscal and external viability, and establish sustainable growth in Argentina."

The transitional program focuses on maintaining monetary and fiscal discipline, avoiding policy reversals, and rebuilding legal certainty, the IMF said. The monetary program aims to limit the growth of the monetary base to anchor inflation expectations, while the fiscal program calls for firm control over primary expenditures at the federal and provincial levels. Argentina has promised to raise the primary budget surplus target—an indicator of the government's capacity to pay debt obligations—to 2.5 percent of GDP for 2003, up from 0.7 percent in 2002. The primary surplus for provincial governments should be about 0.4 percent of GDP in 2003 compared with a deficit of 0.5 percent in 2002.

The IMF said the Argentine authorities intended to work closely with the congress to secure approval of the revenue measures needed to meet the fiscal targets. The program provides for a doubling of outlays on a social safety net—from 0.6 percent of GDP in 2001 to 1.2 percent of GDP in 2003. To prepare the ground for the successor government expected in May, the authorities will formulate the needed fiscal structural reforms to broaden the tax base, improve tax administration, and reform intergovernmental relations.

The transitional program assumes real GDP growth of about 2–3 percent for 2003, compared with an estimated decline of 11 percent in 2002; inflation being held within 35 percent; a current account surplus of about $6.5 billion; and broadly unchanged gross international reserves. ■

Recent publications

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02/211: *An Evaluation of Monetary Regime Options for Latin America,* Andrew Berg, Eduardo Borensztein, and Paolo Mauro

02/212: *A Political-Economic Model of the Choice of Exchange Rate Regime*, Yan Sun

02/213: *The Persistence of Corruption and Slow Economic Growth*, Paolo Mauro

02/214: *WTO Financial Services Commitments: Determinants and Impact on Financial Stability*, Nico Valckx

02/215: *Implications of Migration on Income and Welfare of Nationals*, Kenichi Ueda

02/216: *Population Aging and Long-Term Fiscal Sustainability in Austria*, Leif Lybecker Eskesen

02/217: *International Liquidity and the Role of the SDR in the International Monetary System*, Peter B. Clark and Jacques J. Polak

02/218: *Financial Contagion and Investor "Learning": An Empirical Investigation*, Ritu Basu

02/219: *Welfare Effects of Transparency in Foreign Exchange Markets: The Role of Hedging Opportunities*, Burkhard Drees and Bernhard Eckwert

02/220: *Monetary Policy Credibility and the Unemployment-Inflation Trade-Off: Some Evidence from 17 Industrial Countries*, Douglas M. Laxton and Papa N'Diaye

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03/04: Bosnia and Herzegovina: First Review Under the Stand-By Arrangement and Request for Waiver of Performance Criteria

03/05: Republic of Tajikistan: Selected Issues and Statistical Appendix

03/06: Madagascar: 2002 Article IV Consultation, Second Review Under the PRGF, and Requests for Extension of Arrangement, Waiver of Performance Criteria, and Additional Interim Assistance Under the Enhanced HIPC Initiative

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The Pension Puzzle: Prerequisites and Policy Choices in Pension Design, Nicholas Barr (No. 29)

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IMF Institute Seminar by Leiderman

Inflation targeting in emerging markets: Easier said than done

Leiderman: "The success of inflation targeting—as with any monetary regime—requires that 'all members of the orchestra play together.'"

Nearly 20 countries around the globe have officially adopted inflation targeting, a framework for monetary policy based on a specific target (or target range) for inflation. On December 19, 2002, Leonardo Leiderman of Tel Aviv University presented a seminar at the IMF Institute on the challenges faced by emerging market economies with inflation targeting. He concluded that, despite these challenges, inflation targeting had, overall, produced satisfactory results for these countries.

Inflation targeting is no longer confined largely to industrial countries but has been embraced by many emerging market and developing countries (see table, this page). But for emerging market economies, Leiderman said, implementation is more of a challenge than for industrial countries for a couple of reasons. First, emerging market economies appear more susceptible to shocks that can make attainment of the target a challenge. For instance, exchange rates in these countries are generally more volatile than in industrial countries, and an unexpected and sharp depreciation of the domestic currency can make it difficult for the central bank to meet previously announced targets.

Indeed, in a number of emerging market economies, inflation rates last year were outside the announced target range. How countries respond to this divergence between plan and outcomes, Leiderman said, may be critical in determining the eventual success of inflation targeting as a monetary regime.

Second, the success of inflation targeting—as with any monetary regime—requires that "all members of the orchestra play together." This means that the country's treasury and central bank have to agree on the inflation target and the policy settings that will achieve it. Pressure from the treasury to make the central bank finance a large part of the budget (through the printing of money) can undermine the success of any monetary regime. The experiences of emerging market economies suggest that the adoption of inflation targeting does not automatically insulate the central bank from such pressures. Wage-setting institutions also have to be supportive of the central bank's inflation targets.

A testing time

Leiderman noted that inflation forecasts for a number of emerging market countries—among them Brazil, Colombia, Israel, and Mexico—were currently outside the announced target ranges. For instance, the Brazilian central bank had originally targeted inflation for 2003 of 4 percent, plus or minus 2.5 percent. But private sector expectations for inflation in 2003 are currently about 11 percent, reflecting the run-up in inflation as a result of the sharp depreciation of the peso last year and an increase in fuel prices.

How will the central banks of these countries deal with this situation? On the one hand, they must take

More emerging market economies are adopting inflation targeting
(classification by exchange rate regime)

Independently floating	Pegged exchange rates within horizontal bands	Exchange rates within crawling bands	Managed floating with no preannounced path for exchange rate
Australia	Hungary	Israel	Thailand
Brazil			
Canada			
Chile			
Colombia			
Czech Republic			
Iceland			
Korea			
Mexico			
New Zealand			
Norway			
Poland			
South Africa			
Sweden			
United Kingdom			

Source: IMF, *International Finance Statistics,* January 2003. Classification is as of end-2001.

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Israel missed yearly targets, but average performance was close to target range for the period

Years	Inflation target	Inflation outcome
1992–2002	7.0	7.1
1992–1996	10.2	10.8
1997–1998	6.3	7.8
1999–2002	3.3	2.3

Source: Leonardo Leiderman, "Inflation Targeting in an Emerging Market Context," IMF Institute Seminar, December 19, 2002. Figure on inflation outcome for 2002 is an estimate based on data for the first 11 months of that year.

these deviations seriously if they are to maintain the credibility of the regime. On the other hand, Leiderman said, they most likely also want to avoid being thought of as "inflation nutters"—policymakers who are oblivious to the short-term effects on output and employment of rigid adherence to inflation targets. Leiderman noted that this tension between wanting a "hard target" to gain or maintain credibility versus wanting a "soft target" to allow flexible responses to unforeseen developments in the economy had been present since the inception of inflation targeting. In the early days, hard targets were preferred, but sentiment appears to be veering toward the soft target approach.

Try a little tenderness

Leiderman reckoned that, among the emerging market economies, "more and more countries will move to the Australian model" of soft inflation targeting, under which the central bank seeks to adhere to an inflation target "on average over the course of the cycle" or "as a medium-term objective."

This would not be a bad thing, he said. The experiences of countries that had been on inflation targeting regimes for a number of years suggested that the public cared about the central bank's average performance over the period rather than its performance in any one year. For instance, he noted that Israel's central bank had missed its inflation target in 9 of 11 years. But, because the deviations were small, the average performance of inflation over the whole period was pretty close to the average of the target ranges, and the inflation targeting regime had enjoyed credibility and public support (see table above).

(Since Leiderman's seminar, the Brazilian central bank has announced that it will now target an inflation rate of 8.5 percent for 2003 and 5.5 percent for 2004. The new target for 2003 is more than double its original target but still below private sector forecasts for the year. In a letter to the finance ministry, the central bank noted that "monetary policy will be able to make inflation converge with the ceiling of the (original) goals in two years.")

It's mostly fiscal

While generally supporting a move by emerging market economies to an Australian model of inflation targeting, Leiderman also sounded a note of caution. There is a "danger that countries may move to the Australian model . . . without adopting Australia's fiscal rectitude." In emerging market economies, he said, "if the fiscal situation is going wrong, most other things will follow." He noted that many observers considered the success of inflation targeting in New Zealand—which pioneered the move to inflation targeting—to be due in large part to the country's putting its fiscal house in order at the same time. Emerging markets that move to softer inflation targeting regimes should guard against getting soft, at the same time, about achieving their fiscal targets.

In some cases, Leiderman said, the pressures on the inflation targeting regime come not from fiscal but from wage-setting institutions. Many emerging market economies turned to inflation targeting after a history of chronically high inflation; even though low inflation has generally been achieved under inflation targeting, in some countries—Leiderman suggested Mexico as an example—wage-setting institutions have not yet fully adjusted to this change. Demands for wage increases made as though the old high-inflation regime were still in place will end up imparting inertia to the inflation process and make achieving inflation targets more difficult.

The bottom line, Leiderman said, is that emerging market economies may encounter many obstacles on the path to an inflation targeting regime, but these are surmountable. Inflation targeting has worked very well for most of those that have adopted it, at a time when they needed monetary policy autonomy and flexibility to deal with severe shocks. ■

In emerging markets, if the fiscal situation is going wrong, most other things will follow.
—Leonardo Leiderman

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Annual AEA meeting

Economists link economic well-being to sound institutions

Coverage of the January 3–5 American Economic Association meeting continues in this issue of the IMF Survey. *Asimina Caminis, Jeremy Clift, Markus Haacker, and Sheila Meehan report on diverse subjects, ranging from the importance of institutions in economic outcomes and the role of information technology in spurring growth in the United States to the growing links between the world's economies and the prerequisites for poverty reduction.*

Over the past decade, crises in emerging market countries and stalled development in sub-Saharan Africa have prompted economists to reconsider the role of institutions in shaping economic outcomes. Several AEA sessions this year explored this subject in both contemporary and historical contexts.

From left: Stanley Fischer, Andrei Schleifer, and Lawrence Summers.

Institutions now. . . In the panel "New Comparative Economics," Andrei Shleifer (Harvard University, presenting the findings of an upcoming paper coauthored with J. Botero, S. Djankov, R. La Porta, and F. Lopez-de-Silanes) suggested it was a good time to look at comparative systems. In designing institutions, he said, we should be trying to evaluate the roles of law and order, the rule of law, and government. His goal is to map where countries are on a curve of "private orderings" (how neighbors resolve disputes among themselves, civil and common law traditions, and government regulation) and how technology and social organization can shift that curve. Shleifer argued that institutions that functioned well in their original environment could founder when "exported" to poorer, more disordered states. The more organic and flexible common law traditions of Britain, he said, traveled better than the more formal and rigid traditions of French civil law.

Discussants in this session (MIT's Olivier Blanchard) and in a later session (MIT's Daron Acemoglu) noted the complexity of the links between theory, practice, and impact. Both cited the intricacies that attended the origins, forms, and applications of civil and common law.

In their paper, Stanley Fischer (Citigroup and previously IMF First Deputy Managing Director) and Ratna Sahay (IMF) marshaled statistical evidence to counter the oft-made argument that the international financial institutions neglected institutional and rule of law concerns in their single-minded quest to rebuild the economies of the former Soviet Union. The data show, Fischer and Sahay said, that output began to collapse when the old system started to fail (not when transition began), that structural reforms had a strong and positive impact on growth, and that initial conditions—whether proximity to Western Europe or the length of time under communism—mattered. The international financial institutions, they said, provided enormous technical assistance, and structural concerns weighed heavily, for example, in the conditions attached to IMF lending.

This measured argument was amplified by an impassioned defense of the IMF's handling of the Russian crisis from Lawrence Summers (Harvard University, previously U.S. Secretary of the Treasury). He argued that it was "ludicrous to say there was no attention to institutions" or that maintaining existing institutions was a viable option. A fast-failing operation could not be kept running, he insisted, and those who favored a gradualist approach had to come up with a successful example of one.

Why does this debate still exert such a hold over the public's imagination? It is partly because Sovietologists still have a vested interest in the topic, Summers suggested, but also because the laws of economics do not garner the respect that, say, the laws of physics do. He acknowledged, also, real concerns about the dramatic declines in life expectancies and the debate over whether the Chinese approach to transition from a state economy to a market economy held out the possibility of a "different way." Summers

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argued that it did not—that the Chinese strategy was unavailable to the more industrial and highly inefficient Russian economy. Two hundred years from now, he predicted, history will look back at the former Soviet Union and marvel at how unlike the fall of other empires its transformation was—happening almost without bloodshed and with a relatively rapid recovery.

. . . and then. One of the AEA's most intriguing sessions on institutions centered on four papers that never made it to the twentieth century. In fact, before the panel on long-run growth and institutions was over, the discussion had shifted from trade to marriage and gone back in time to 1000 AD.

A question that has long puzzled economists is why Europe's fortunes rose rather than those of, say, Asia. Daron Acemoglu (MIT), in a paper coauthored with Simon Johnson (MIT), argued that Europe's rise reflected the growing vigor of Atlantic port cities and the institutional changes effected by the increasingly powerful merchant class. In England, France, and the Netherlands, where existing institutions limited the monarchies' claims on the proceeds of trade, the changes were particularly striking.

Trade was also the focus of a study by Oded Galor (Brown University) and Andrew Mountford (University of London), who examined why one-third of the world's population is Indian and Chinese. In the eighteenth and early nineteenth centuries, in a critical interaction between trade and demographic transitions, trade emphasized the importance of skilled labor, encouraged technological innovation, and fueled investments in human capital and smaller families. In agrarian economies like those of India and China, they said, much of this effect was delayed or inverted, with substantial implications for per capita income.

The human capital component, two other papers said, may tell an even more basic story. Eric Gould (Hebrew University) and his coauthors argued that monogamous marriages were a conspicuous feature of developed societies and reflected the growing value placed on human—rather than physical—capital and the need for "quality" mates and offspring, which, in turn, greatly enhanced the bargaining power of women.

Nils-Petter Lagerlof (Concordia University), in a paper coauthored with Lena Edlund (Columbia University), broached a related topic, asking what love had to do with growth. According to their research, quite a bit. The rise of Europe, they said, dates back to 1000 AD, when both population and GDP per capita income started increasing. One ingredient in Europe's takeoff, they said, was the move away from arranged marriages. Love marriages spurred the transfer of wealth between generations and encouraged investment in offspring; arranged marriages, Lagerlof said, tended to move wealth within the parental generation and to be associated with a stagnation of capital.

Will U.S. economic growth pick up?

In a session devoted to globalization, the new economy, and growth in the United States, Martin Feldstein (Harvard University and the National Bureau of Economic Research), Joseph Stiglitz (Columbia University), Dale Jorgenson and Lawrence Summers (both of Harvard University), Martin Baily (Institute for International Economics and McKinsey), and Robert Gordon (Northwestern University) debated the contribution of information technology (IT) to the phenomenal growth of the U.S. economy in the 1990s.

Baily argued that IT investment contributed to productivity growth only if accompanied by business process innovations that, in turn, were induced by the competitive pressure facing companies. Feldstein addressed the differences in IT adoption between the United States and Europe and highlighted the role that incentives for business managers played in innovation. Stock options and an emphasis on shareholder value encourage innovations in the United States, he argued. European firms, however, have neither the incentive structure nor a corporate environment that supports change, which could involve significant layoffs.

Gordon and Jorgenson, who analyzed the sources of recent productivity growth, said the United States was unlikely to see a return of the high rates of labor productivity growth the country experienced in the 1990s. Conventional growth-accounting exercises, according to Gordon, underestimate the productivity effects of IT investments because they fail to account for the lags in the adoption of existing production processes. However, inflation was held down in the late 1990s because of a favorable macroeconomic environment, including an appreciation of the dollar, low energy prices, and a temporary hiatus in medical care price increases. Much of the IT boom was fueled by onetime sources of demand, including the invention of the World Wide Web. Jorgenson emphasized that much of the increase in labor productivity reflected longer working hours, a trend that he said

Daron Acemoglu

Oded Galor

Eric Gould

Dale Jorgenson

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could not continue. "Spread the word!" he concluded. "Economic growth is going to revert to [that of] the 1973–95 period despite the new economy."

Turning to developing countries, Stiglitz emphasized that those that gained access to the new economy should be able to close the knowledge gap with the advanced countries. Globalization as managed by the IMF has enhanced the prospects of some developing countries, he said, but there is clear evidence that it has exposed some others to more risk,

Taylor urged the international community to make labor productivity growth one of the Millennium Development Goals.

Taylor cites successes of international monetary policy

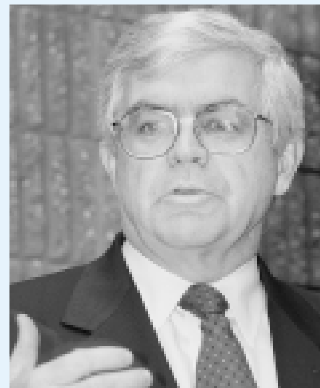
In the Distinguished Lecture on Economics in Government, John Taylor, U.S. Undersecretary of the Treasury for International Affairs, argued that the interrelated goals of productivity growth and economic stability were critical to reducing poverty.

Comparing average per capita income in the United States—$90 a day—with that in the world's poorest countries—where 1.3 billion people live on less than $1 a day—Taylor attributed the huge gap to differences in labor productivity and urged the international community to make productivity growth one of the Millennium Development Goals. He dismissed concerns that productivity growth might make the rich richer without benefiting the poor, citing empirical studies that showed that higher productivity growth increased the per capita income of the lowest-income quintile of the population by about the same amount as the other quintiles.

According to economic theory, Taylor said, capital should be flowing to where the returns are the highest—that is, the poor countries—and these should be growing faster than the advanced countries. This is not happening because of impediments in poor countries to the inflow or use of capital and technology—namely, poor governance (weak rule of law and corruption), poor education, and restrictions on economic transactions (such as lack of openness to trade, state monopolies, and excessive regulation).

He discussed new efforts by the Bush administration to remove these impediments in the developing world. One such initiative is the Millennium Challenge Account, to be established in 2004, which would raise total U.S. foreign aid to $16 billion by 2006. This aid will go to countries meeting certain criteria, such as "ruling justly," "investing in people," and "encouraging economic freedom." At the same time, the United States will increase its contribution to the World Bank's International Development Association by $100 million a year over three years, with the incremental increases in the second and third years contingent on results. Nearly 100 percent of this aid will be in the form of grants, not loans, for projects in education, health, nutrition, clean water, and sanitation. Again, it will be confined to countries with good policies.

In contrast with the disappointing performance of developing country economies, Taylor said that, over the past 15 years, "much good has happened" in the area of international monetary policy. Forty-seven countries have adopted the feasible and desirable "trinity" of flexible exchange rates, low inflation rates, and monetary policy "rule" that establishes specific instruments for targeting specific goals (such as low inflation). Fifty other countries are highly dollarized or have joined currency unions or adopted currency boards, while 75 have fixed or heavily managed exchange rates. Only seven have multiple exchange rate systems. Central banks are taking much stronger measures to combat inflationary pressures, a strategic change that Taylor said had led not only to lower inflation but also to greater financial stability and greater stability in the real economy.


John Taylor

Turning his attention to emerging markets, he listed three problems now confronting them: a "substantial increase in the severity and frequency of crises" in the 1990s, a dramatic decline in capital flows to these countries, and high real interest rates. Taylor proposed a four-pronged strategy to address these problems. First, the emerging markets must get their policies right, while the IMF should concentrate its efforts and conditions in the areas of its core competencies: monetary, fiscal, and exchange rate policy. The seven major industrial countries and the Group of 20 (19 industrial and emerging market countries, the European Union, the IMF, and the World Bank) need to develop better models and indicators of financial vulnerability and emphasize economic, rather than political, considerations in determining which countries receive assistance.

Second, markets and donors need to better differentiate between countries to reduce the possibility of contagion. There has already been an improvement in this area, he said, offering as evidence the contrast between reactions to Russia's default in 1998, which drove up interest rates for countries in other regions, and those to Argentina's default in 2001, when spreads for other countries remained steady or even decreased. Third, he stressed the importance of clarifying limits on access to emergency loans from the international financial institutions and the official sector and called for a formal justification of exceptional access. Reliance on large assistance packages should gradually decrease, in the interest of debt sustainability, he said, and, to reduce uncertainty in the wake of a crisis, countries should rely less on large, unpredictable bilateral loans and more on IMF assistance. Fourth, he called for reform of sovereign debt workouts to make them more orderly and predictable.

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discouraging debt financing and, indirectly, IT investment. Responding to Stiglitz, Summers noted that some developing countries would be held back by geography and corruption, among other things, which could not be blamed on the IMF. As for the United States, he stressed the increasing share of the IT sector in the overall economy and noted that product market competition, trade openness, a lack of barriers to entry, and an absence of restrictions created pressure that spurred innovation, which was good for productivity.

G-7 economies in tune?

In another session, panelists examined whether, given the increasing links between the world's economies, the advanced economies were now synchronized or if policymakers could rely on strength in one market to compensate for weakness in another. Economists stepped up research on this issue when, after a decade of economic expansion, growth began to slow simultaneously in early 2000 in the seven major industrial countries (Group of Seven)—Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. But research presented at the AEA conference, while supporting the synchronization theory, was not conclusive.

Brian Doyle and Jon Faust (U.S. Federal Reserve Board) said that a rise in the co-movement of GDP among industrial countries would have important implications for the making of national economic policies. Governments, for example, would need to take closer account of forecasts for conditions abroad in formulating forecasts for their domestic economies.

But, while they found that there was a correlation among Group of Seven growth rates during the current slowdown, it was not bigger than in previous economic cycles. "Overall, despite many changes in the international economy, the evidence does not reveal the arrival of a permanently higher correlation of growth rates among the Group of Seven," they said.

Research by economists at the European Central Bank (ECB) indicated that, while the economies of the Group of Seven were driven "to a substantial extent by common dynamics," the impact of the North American economies on the economies of Europe was far bigger than that of Europe on North America. With globalization, this asymmetry appeared to be increasing.

Rasmus Ruffer (ECB) said it was clear that oil prices had an important influence on trends in Group of Seven economies, particularly in downturns. But the asymmetrical influence of North America and Europe on each other merited further study.

Taking a different tack, Tamim Bayoumi (IMF) examined the impact of wealth—as measured by equity holdings and housing—on consumption. With interest rates increasingly running in parallel across the Group of Seven, trends in asset prices could be more important for the health of Group of Seven economies. "It seems clear," Bayoumi said, "that developments in asset prices are likely to become increasingly important for policymakers because of both their direct impact on demand and—given their synchronization across countries—their role in the transmission mechanism of business cycle movements." ■

Joseph Stiglitz

Tamim Bayoumi

Available on the web (www.imf.org)

News Briefs

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02/133: IMF Completes Second Review Under Madagascar's PRGF Arrangement and Approves $15 Million Disbursement, December 23

Speeches

Opening remarks for the IMF Sovereign Debt Restructuring Mechanism (SDRM) Conference, Horst Köhler, IMF Managing Director, Washington, D.C., January 22

"Emerging Market Debt: What Is the Problem?" Kenneth Rogoff, Economic Counsellor and Director, IMF Research Department, SDRM Conference, International Monetary Fund, Washington, D.C., January 22

Press Releases

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Indonesia Consultative Group Meeting, Daniel Citrin, Senior Advisor, IMF Asia and Pacific Department, January 21

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Interview with Clark and Polak

SDRs could meet growing demand for reserves at no cost while reducing systemic risk

In 1969, the IMF created the Special Drawing Right (SDR) as an international reserve asset to supplement members' existing reserve assets (official holdings of gold, foreign exchange, and reserve positions in the IMF). In a new Working Paper, International Liquidity and the Role of the SDR in the International Monetary System, *Peter B. Clark, Senior Advisor in the IMF's Research Department, and Jacques J. Polak, Director of that department from 1958 to 1979, describe how changes in the international monetary system have undermined the role originally envisaged for the SDR. They argue that although the concept of a global stock of international liquidity—fundamental to the creation of the SDR—is no longer relevant, there are still good reasons to satisfy part of the growing demand for international reserves with SDR allocations.*

Clark: "The main argument for SDR allocations is that SDRs can be created essentially without cost—other than a very small administrative cost."

IMF Survey: How did the concept of a global stock of international liquidity become irrelevant?

POLAK: Over the past century, people interested in international financial policy—those working in universities, ministries of finance, and central banks—have focused a great deal of attention on one question: Will the stock of international liquidity enable countries to accumulate a level of reserves that can support continued growth in the world economy? Several conferences have dealt with this subject, including two that were held immediately after World War I in Brussels and Genoa, the 1933 World Economic Conference held in London, and the 1944 Bretton Woods Conference.

But it was not until 1969 that an apparent resolution of the question was found with the introduction of the SDR—a new form of international liquidity that would allow the international community to create the amount of reserves that the world needed. At that time, reserve assets were mainly in the form of U.S. dollars, whose supplies were constrained by the Bretton Woods system of fixed exchange rates, and in gold. Increases in the supply of dollars to foreign holders threatened U.S. official gold holdings—a problem known as the Triffin dilemma.

Not much more than a decade later, the problem evaporated. It wasn't that the SDR solved it. Instead, the problem itself went away when the United States gave up its commitment of gold convertibility of the dollar in 1971. All of a sudden, there proved to be an almost limitless stock of dollars and other major currencies, which countries in need of reserves could either earn or borrow, thus taking away the very basis of the SDR.

IMF Survey: What influences the demand for reserves?

CLARK: A country's demand for reserves is related to the size of changes in its balance of payments, typically in the current account. In fact, there is a fairly close relationship between a country's level of reserves and its imports of goods and services. Over time, fluctuations in the capital account have also assumed increasing importance. During recent crises—in Asia, Russia, and Latin America—massive fluctuations in capital flows boosted the need for reserves to help ward off a crisis and moderate the impact of capital outflows on exchange rates. Research at the IMF and elsewhere suggests that the ratio of reserves to short-term debt may be a key indicator of reserve adequacy in countries with substantial, but uncertain, access to capital markets. Greater capital market integration tends to increase the demand for reserves.

There are also situations in which countries' demand for reserves may decline. For example, to the extent that countries move from relatively fixed to flexible exchange rate arrangements—that is, they respond to external imbalances by allowing the price, rather than the quantity, of foreign exchange to adjust—the need for reserves to intervene in the foreign exchange market would be expected to diminish. Many observers thought this would occur with the demise of the Bretton Woods par value system, but reserves have continued to grow significantly over the past 20 years. Even if a country only lightly manages its exchange rate, with a relatively closed capital account it would still want to hold reserves—and probably increase them over time—to help smooth output fluctuations arising, for example, from large movements in its terms of trade. Moreover, research indicates that the shift to floating rates has not been as dramatic as popularly believed. Ken Rogoff and Carmen Reinhart have found that

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there is little evidence of countries—other than the major industrial countries—moving significantly toward floating exchange rates. So, the shift to floating is perhaps more apparent than real, and it hasn't had any clear impact on the world's long-term growth in reserves.

IMF SURVEY: What options are open to countries in acquiring reserve assets?

CLARK: One way is for a country to improve its current account. But that requires it to reduce domestic demand—give up the use of resources for consumption or investment. Obviously, this involves a real resource cost, which is measured by the country's rate of return on investment and is typically manifested in a market-determined interest rate in that country. The rate is fairly low for some emerging market economies and industrial countries, but for many other countries it is quite high. A country can also obtain reserves by issuing foreign-currency-denominated bonds in international capital markets or by borrowing from banks at market interest rates. It could then hold these reserves in the form of deposits or short-term assets in the major reserve currency countries to earn interest.

IMF SURVEY: How about the terms?

CLARK: These can vary widely. Most advanced countries can borrow at interest rates that are only slightly higher than the return on reserve assets. They can satisfactorily finance increases in reserve holdings by borrowing in international capital markets and therefore really have no need for an SDR allocation to supplement reserves. However, for other countries—largely emerging market economies—the difference between the interest rate on their sovereign bonds and the return on reserve assets is typically much higher. They must also deal with dramatic changes in the availability of funds and the terms on which they can borrow, as we have seen in times of crises. For these countries, borrowed reserves are a useful supplement to owned reserves acquired through current account surpluses, but they are often unreliable and their cost can vary significantly, particularly when countries need them most.

IMF SURVEY: Despite changes in the international monetary system, you still make a case for SDR allocations to improve the system's operation and to meet most countries' need for reserves. Why?

CLARK: First, most countries wish to add to their reserves over time. Second, adding to reserves is costly through both current account adjustments and borrowing. The main argument for SDR allocations is that SDRs can be created essentially without cost—

Jacques J. Polak (left) and Peter B. Clark: "Since the recent balance of payments crises, the IMF has urged members to build up their stock of owned reserves."

other than a very small administrative cost. This argument is analogous to substituting fiat currency for commodity currency—that is, the substitution of currencies for gold clearly saves society the resource cost of digging gold out of the ground and storing it. Third, SDRs can reduce systemic risk. Rather than depend on borrowed reserves, countries would have access to more owned reserves, which would reduce their vulnerability to changing conditions in international capital markets. They also wouldn't have to pay interest to borrow reserves, making them a better credit risk.

IMF SURVEY: Why can't the IMF simply provide more credit, rather than distribute new reserve assets?

CLARK: Conditional credit is, of course, very important for the IMF. But there is no reason the IMF's activities should be restricted to conditional financing—that is, under IMF programs. The IMF itself has always recommended that members not depend exclusively on conditional reserves. Indeed, an adequate stock of owned reserves is, in almost all cases, a condition in IMF programs. Since the recent balance of payments crises, the IMF has urged members to build up their stock of owned reserves and has issued a number of papers on reserve management emphasizing the role of reserves in reducing a country's vulnerability to crises.

IMF SURVEY: If the IMF's membership were to back a resumption of regular SDR allocations, what would be their optimal timing, frequency, and size?

POLAK: Much of the criticism surrounding the idea of SDR allocations is based on the misconception that countries would suddenly receive a large amount of money that they would be very tempted to spend instead of hold as reserves. That was never the idea of the SDR mechanism. On the contrary, given that countries wanted to consistently build up their

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Industrial countries have easy access to capital markets, so they don't need the SDR system. That wasn't so at the time the SDR was created in the 1960s.
—Jacques J. Polak

reserves in line with the increase in their international transactions, the idea was that allocations would be made annually to take care of this slowly growing need. Allocations shouldn't be a onetime event. They should take place regularly, annually or even quarterly, in modest amounts.

CLARK: The question of the optimal size of an SDR allocation is a difficult one, even for a single country. The answer would require consideration of a range of variables, including the cost of acquiring reserves, the cost of adjustment in the absence of reserves to finance payments imbalances, and a country's risk preferences. To make estimates for all members would be a daunting task. The past approach to SDR allocations involved estimating growth in demand for reserves and then judging what fraction of that growth should be satisfied by SDRs. It is important not to make the allocation so small as to be inconsequential or so large as to cause concerns about inflation.

POLAK: A fundamental element of the design of the SDR system was that the size of the allocation to a country would be based not on its need for reserves at a certain time but on an objective measure that would reflect the country's relative need for reserves over the long term. After much discussion, it was decided that, in the absence of a better alternative, IMF quotas would serve as that measure.

Polak: "Much of the criticism surrounding the idea of SDR allocations is based on the misconception that countries would suddenly receive a large amount of money that they would be very tempted to spend instead of hold as reserves."

IMF SURVEY: Since the last allocation of SDRs in 1981, there has been considerable resistance to additional allocations. Why?

POLAK: This resistance, which dates back to shortly after the first allocation in 1970–72, comes from industrial countries. Some of them considered the last allocation to be a political arrangement and not a logical extension of the SDR system because, by then, many of the changes in the international financial system that we talked about earlier had already become evident. Industrial countries have easy access to capital markets, so they don't need the SDR system. That wasn't so at the time the SDR was created in the 1960s.

In addition, some may find awkward the idea of a single institution—the IMF—providing both conditional and unconditional credit in the form of SDRs. Industrial countries, in particular, have difficulty with this concept. But their objection to SDR allocations—helping debtor countries maintain an adequate level of reserves at no cost to the creditor countries—is curiously inconsistent, because these same countries are bearing the considerable cost of providing very low interest loans to finance other capital needs of the developing countries through IDA [World Bank's International Development Association] loans and the IMF's concessional loan facility.

IMF SURVEY: Do you have any reason to be optimistic that this resistance can be overcome any time soon?

POLAK: I'm not at all optimistic that it can be overcome in the near future. In the mid-1990s, industrial countries favored a special SDR allocation to help channel resources to Russia and other countries that had been members of the former Soviet Union. And in 1997, at the [World Bank-IMF] Annual Meetings in Hong Kong, the IMF's Board of Governors finally endorsed this allocation, but it hasn't become a reality because the United States has not passed the necessary legislation.

While SDR allocations are no longer favored by most industrial countries, they have recently received attention in nonofficial circles. For example, the Zedillo Report—prepared for the UN International Conference on Financing for Development held in Monterrey, Mexico, in March 2002—advocates a resumption of SDR allocations, and George Soros has put forward a proposal to use SDRs to finance expanded foreign aid. Although these proposals were not endorsed in the Monterrey Consensus, at least they were given consideration. ■

Copies of IMF Working Paper No. 02/217, *International Liquidity and the Role of the SDR in the International Monetary System*, by Peter B. Clark and Jacques J. Polak, are available for $15.00 each from IMF Publication Services. For ordering information, see page 21.

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The euro

European Central Bank plans reforms to cope with EU enlargement

With the prospect of its membership increasing substantially over the next few years, the Governing Council of the European Central Bank (ECB) has proposed a system of rotating voting rights to ensure efficient and timely decision making. Before the Council's December 19, 2002, proposal, the IMF's Helge Berger analyzed the ECB's different options.

At a landmark summit meeting held in Copenhagen in December, the 15 members of the European Union (EU) agreed to admit 10 new members, paving the way for their accession in May 2004. The 10 are Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. Three other states have candidate status: Turkey, which has been told that it must wait at least two more years before starting talks on joining, and Bulgaria and Romania, which appear on course for accession in 2007.

The expansion will pose special challenges for decision making within the EU's institutions. While joining the euro area is a second step after being admitted to the EU, most observers foresee the possibility of membership in the euro area increasing from the current 12 (EU members Denmark, Sweden, and the United Kingdom have not yet joined the euro area but may do so) to 24 by the end of the decade.

Such rapid growth in membership could have severe consequences for the efficiency of monetary policymaking in the euro area, according to Berger, whose analysis was published in an IMF Working Paper, *The ECB and Euro-Area Enlargement*. Without revision of the current ECB statute, the doubling of the number of euro-area member states would increase the size of the ECB Council from 18 to 30 (see box), making it by far the largest monetary policy–making body among industrial countries. Discussion and voting procedures would likely become more time consuming and complicated. The central bank tradition of consensus-based policymaking—said to play an important role in today's ECB decision-making process, too—could further amplify the large number problem and increase decision-making costs.

How the ECB is run now

The ECB is run by a Governing Council and a six-person Executive Board. The current president is Willem F. Duisenberg. The Council is the supreme decision-making body and comprises the heads of the central banks of the 12 member countries of the euro area and the 6 members of the Executive Board. The Council formulates monetary policy and sets interest rates for the euro area. It usually meets once a fortnight.

Emerging mismatch

An increase in euro-area member states would also be likely to increase the overall wedge between the economic and political weights of member countries within the ECB, according to Berger. Currently, all member states have equal voting power within the Council, and policy decisions are based on a simple majority-voting rule. Since almost all the accession countries are small in economic terms relative to current euro-area members, enlargement within the existing institutional setup would significantly increase the mismatch between the smaller member countries' voting share in the ECB Council and relative economic size. Such "overrepresentation," while not necessarily a problem, could, nevertheless, introduce an unwelcome bias into the ECB's decision making, Berger suggests.

The EU expansion will pose special challenges for decision making within its institutions.

To address these problems, the ECB's Governing Council in December proposed a system of rotating voting rights. The proposal would restrict the size of the Council by limiting to 15 the number of national central bank governors who can vote. Once there were more than 15 member countries in the euro area, a rotating voting system would apply. The five largest economies would form one group and share 4 votes that would be rotated among them. The remaining countries would share 11 votes, also on a rotating basis, and (once there were more than 21 euro-area members) would be organized into two groups. According to the ECB proposal, within each of the resulting three country groups, countries would exercise their voting right with different frequencies depending on an indicator of their relative economic size that has yet to be fully specified. The EU's Council will have to take into account the opinions of the European Commission and the European Parliament on its proposals. Each participating country would also have to ratify it.

Other possibilities

A rotating voting system was not the only possible reform, Berger says. He also looked at the following alternatives in his paper:

• *Centralization:* Decision making could be centralized, for instance, in the hands of the six members of

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the current ECB Board. The role of the ECB Council would be reduced to that of a forum to debate decisions, curbing the participation of national central banks.

• *Weighted voting:* Another possibility would be to introduce weighted voting—for instance, by GDP or population share—for non-Board members of the ECB Council.

• *Group representation*: Alternatively, voting rights could be allocated jointly to groups of national central bank governors, with group representatives voting in the ECB Council.

Of these suggestions, Berger says, both the *centralization* and the *rotation* schemes offer a somewhat more complete solution to the problems euro-area enlargement poses for the setting of monetary policy in the euro area. Both *weighted voting* and *group representation* could ensure that ECB Council members carry a political weight roughly in proportion to economic size—that is, the Council would be broadly representative of the entire euro area. But the large number of policymakers involved under these reform scenarios (directly or indirectly) could be reason for concern, Berger notes. Approaches that aim to centralize decision-making power or reallocate it through an asymmetric rotation scheme (where the rotation frequencies vary by country) can address not only the possible wedge between the economic and political weights of council members but also the issue of decision costs.

Full centralization might not be optimal

While full centralization—which has been proposed by some—has many advantages, Berger says, a number of informational and political economy considerations suggest that giving the Board sole power over monetary policy decisions might not be optimal. For instance, the presence of national central bank governors in the ECB Council is often viewed as helping with the production and processing of information originating on the regional level. There is also the pragmatic (or legalistic) consideration that full centralization would fail to safeguard the established voting rights of current member countries' central banks—a safeguard that was an integral part of the Maastricht Treaty that created the euro area. Moreover, as Berger explains in his paper, a role for national central banks in ECB decision making, while potentially problematic on other grounds, could contribute to the independence of the euro-area central bank. These arguments suggest that reforms should ensure that the Board continues to play an important, but perhaps not dominant, role in the ECB Council as the euro area grows. The reform proposal put forward by the ECB's Governing Council, which implies only a limited reduction in the relative voting share of the Board compared with the status quo, seems to follow this line of thought.

(L-R) French President Jacques Chirac, French Foreign Minister Dominique de Villepin, and Polish Prime Minister Leszek Miller at the EU summit in Copenhagen, Denmark, December 13, 2002. Poland is one of the ten countries that will accede to the EU next year.

Organizing the presence of national central bank governors in the ECB Council along the lines of a rotation scheme could help limit the overall number of voting Council members without sacrificing regional representation. Rotation would mean that, at any given time, a portion of euro-area countries as represented by national central banks could vote at ECB Council meetings, while all bank governors could be present. Under the ECB's reform proposal, about 75 percent of the area's GDP would be represented, on average, by voting governors. Even though this percentage could drop to about 60 percent in some circumstances (because of the rotation of countries within the three groups—a possible disadvantage of the plan), the proposal would still secure strong regional representation.

In addition, if rotation frequencies were selected asymmetrically to reflect the relative economic size of the respective countries—a feature of the ECB's reform proposal—rotation could ensure the congruence of the political and economic weights of euro-area member countries.

Berger's analysis suggests that, while some aspects of the ECB's reform proposal deserve further attention and clarification, the proposed rotation scheme strikes a reasonable balance between ensuring the efficiency of the Council's decision making as euro-area membership increases and securing the participation of the new members in the setting of monetary policy. This balance should help in the political arena and increase the prospects of ECB reform before euro-area enlargement actually takes place. ■

This article is drawn from IMF Working Paper 02/175, *The ECB and Euro-Area Enlargement*, by Helge Berger. Copies of the paper are available for $15.00 each from IMF Publication Services. See page 21 for ordering information. The full text of the ECB's press release on the proposed rotating voting system is available on the ECB's website at http://www.ecb.int/press/02/pr021220en.pdf.

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