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Exit Interview

Rajan Reviews Experiences at Fund, Discusses Next Moves

Raghuram G. Rajan, Economic Counsellor and Director of the Research Department at the IMF since September 2003, will be returning to the University of Chicago's Graduate School of Business in January as the Eric J. Gleacher Distinguished Service Professor of Finance. As Rajan neared the end of his term, he discussed his experiences at the IMF and his plans for the future with the Editor of the IMF Research Bulletin.

Raghuram G. Rajan

Research in General

Before joining the Fund in September 2003, what was your general perception of the research done in the Research Department? What did you see as its strengths and weaknesses?
Before joining the Fund, I had been at the Research Department a few times to give talks, including at the Annual Research Conference (ARC). I had some sense that there were a group of people doing good work here, but I wasn't intimately aware of all the research being done. I was, however, familiar with the work of Research Department people who published in my own area of research—banking and corporate finance—such as Enrica Detragiache and Shang-Jin Wei. So, I came to the department in learning mode.

Your main specialization was in corporate finance, while the focus of IMF is on macroeconomics. Which were the challenges and the opportunities of seeing problems from "a different angle"? Did not being a macroeconomist faze you? What were the objectives you set out for yourself and the department?
First, it seemed to me that not only the academic profession but also multilateral institutions were becoming increasingly focused on the political economy of reforms. So trying to understand how reforms were devised and carried out was important, especially given the great interest in notions like

country ownership. Under what kind of circumstances did reforms become more feasible, and could we understand the political underpinnings of the problems even better? Closely tied to these issues was the role of institutions in the process of reforms. Achieving institutional change had become central to our mandate. Regarding countries' policies, we know that not only growth but also well-functioning institutions are important in achieving stability.

Second, we needed to spend more time on low-income countries, including countries such as India and China, which are becoming a much bigger part of the world economy.

Third, we needed to do more on the financial sector in terms of research and operational work in the Fund. So these were the areas that I wanted to put more emphasis on. I also had a very strong sense that, because I had expertise in banking and corporate finance, but not in macroeconomics, I should be very careful not to disrupt the continuity of research in the Fund, which provided the organization with valuable support in carrying out its mission. Instead, I should attempt to enhance it. Among the issues concerning ongoing research here, two were quite central. One was modeling, on which we've made considerable progress. Regarding this, I would like to acknowledge the contributions of my predecessor, Ken Rogoff, who did an incredibly farsighted job in setting up this process, and of Douglas Laxton, Gian Maria Milesi-Ferretti, and Tamim Bayoumi, who took it forward. I also think the work we have done on exchange rates is very important. I think we understood, to some extent, the macroeconomic underpinnings of exchange rates, but understanding their financial underpinnings was a greater challenge, and putting more effort into such research is an important way to improve our understanding of exchange rate determination.

I also came here with a very strong view that the Research Department should not try to be an academic department, because by doing so it would get none of the benefits of being in a multilateral institution but all of the costs. We really could not replicate what was going on in academia without being in Cambridge or San Francisco. Instead, we should draw on our rich store of contacts and experience to produce research that would be far more interesting to academia. In other words, we should make the best of being at the center of policy formulation. Our research therefore should become more closely tied to the work of the Fund's area departments (those covering the various regions of the world). We have sought to support surveillance, stabilization, and reform efforts by focusing more on applied work, without, however, insisting that every piece of work meet this test. I continue to believe it is very important for our economists to be seen not as working in an ivory tower but instead as doing work that is closely connected to issues at the Fund.

Clearly, I also came here with a sense of my own inadequacies. I had taken courses in macroeconomics in graduate school but had not done any research in macro. Obviously, if you haven't done research and haven't touched this stuff for 12 or 13 years, you will have forgotten a lot. One confession I have to make is that during the couple of months before I joined the Fund, I diligently read Ken Rogoff and Maurice Obstfeld's massive international macroeconomic textbook and a bunch of other macro textbooks. I also have to say that economics has an underlying commonality: optimization with constraints is basically what we do in all branches of the discipline, and the single biggest common concept in economics is that of general equilibrium, which is how we distinguish our answers to problems from those of laymen. The other thing I thought was very important was to play to my strengths—the set of tools, techniques, and knowledge I came with—but not try to speak knowledgeably about things that I didn't fully understand yet. I think that one of things you learn early in life is that since you cannot know everything, it is very important to admit it when you don't know and be willing to learn.

What would you consider your main achievements during your tenure? What work you are proudest of?

Frankly, I think that the main achievements during my tenure will be judged by others in the future. I can tell you, however, that there are a number of things I feel we have done on aspects of political economy. We certainly have started some work on improving our understanding of the political economy of reforms in developed countries. Some of this work done for the *WEO (World Economic Outlook)* was, I think, quite influential. The OECD (Organization for Economic Cooperation and Development) replicated that work, confirming many of the results. That was a good start, and I think we are now in the process of extending this work to developing countries and finding out how reforms take place and under what circumstances. It think this research is very promising—it takes advantage of the capabilities of the Fund and can be very beneficial to its work.

We have done a fair amount of work on institutional change, both as part of the WEO and separately. Over time, my view of institutions has evolved, and I now think that they are very endogenous. Trying to understand how institutions have developed and changed, and what triggers you can pull to encourage changes, is therefore very important, and I am very happy about the work the Research Department has done on these issues. We have also, I think, done extraordinarily good work on China, to which Shang-Jin Wei, Eswar Prasad, and Marcos Chamon made important contributions. Also, through writing and publishing a bunch of op-ed pieces, in coordination with APD (the Asian and Pacific Department), we have helped to change the tenor of the message the news media are sending their readers, including policymakers, about China's policies. The Fund's message has obviously had an impact, and I think the intellectual contributions that have made this possible should not be underestimated. I also think that we have done a fair amount of research on India, to which Arvind Subramanian has made a significant contribution, and, here again, both policymakers and the broader public have been influenced by it. And certainly, the work on low-income countries that is emerging from the Macroeconomic Studies Division has been quite valuable, including the work on the effectiveness of aid. Over time, policymakers and their advisors are likely to take these findings into account in their work practices and decision making.

"Many important issues are vigorously debated in battles fought inside the Fund, but outsiders are unaware of this."

The third issue on which we made notable progress was finance. Take, for example, the recent *WEO* chapter on how financial systems affect economic cycles. I think that was a significant contribution because it linked issues in microfinance to macro issues and thereby attempted to improve our understanding of the microfoundations of economic cycles. This chapter could have important effects. We have also worked, for example, on understanding financial sectors in low-income countries, including the role of foreign banks, on which some good contributions have been made by Enrica Detragiache and Thierry Tressel. And in the work on country insurance done by the Strategic Issues Division, and on financial globalization done by the Financial Studies Division, we are doing cutting-edge research.

I am also quite happy that we have not only continued our research but also expanded it, and its findings are being more extensively shared with, and applied in, the rest of the Fund. Take our modeling work. Increasingly, the models we've developed are being discussed with and used by IMF country teams in Article IV (regular consultation) missions. I think this has been an important improvement, because earlier, without these models in their toolkits, some country teams had a sense that they were dealing with counterparts in member countries who were more informed about some of the latest developments and techniques than they were. I'm therefore happy that we're back on the frontier on these issues.

The CGER (Consultative Group on Exchange Rate Issues, an interdepartmental group of IMF economists) has made significant strides, especially in a timely extension of our exchange rate analysis to emerging markets, thanks to Gian Maria Milesi-Ferretti, Jaewoo Lee, and Luca Ricci. Our macro-modeling work and various *WEO* essays have helped us shed substantial light on the global payments imbalances. The most widely accepted diagnosis of the problem has largely been crafted at the Fund, while the most widely accepted steps toward resolution were also proposed by the Fund—the so-called Fund or G-7 mantra. Indeed, that proposal recognizes that there are deep fundamental forces at work in creating these imbalances, and it is not just a matter of an exchange rate movement here or a saving rate change there, but rather a whole bunch of things that need to be done by many countries to bring about the expenditure switching and expenditure reduction needed to attenuate the global imbalances. Of course, since then, we've also played a large role in starting the multilateral consultation which is attempting to make progress on policy actions to reduce possible risks associated with the imbalances. So, I would say, we have been centrally involved in formulation of the Fund's policy on this issue. Also in the financial sector, we have been very much involved in trying to reform the Fund's approach to Article IV consultations in order to incorporate more analysis of member countries' financial sectors. Finally, our researchers have joined country teams in preparing the analysis for their discussions with national authorities—the mark of our researchers' success is the immense demand we have experienced for them.

Are there areas of research you wished the Research Department had investigated? Was there a topic which was "too political" to investigate?

No, I can't think of any areas that I wish the Research Department had investigated, nor of any area that was too politically sensitive to investigate. I think people in the department investigated what they wanted, and I did what I wanted. Of course, some areas are too peripheral to be of much relevance. It's OK to do a paper on these once in a while, because it is interesting, but it cannot be an economist's main contribution—I think that is well understood.

Research Department

Do you think there is enough freedom for Research Department staff to express their views?

I think the answer has to be a qualified yes. And I say qualified because we must understand our part in an organization which is seen as having views on issues. Any member of the organization who spouts something to the outside world is seen as expressing the organization's views. No matter how many times we include the standard disclaimer in our Working Papers stating that the views expressed are just those of the individual authors and not those of the Fund, journalists invariably attribute them to Fund. Given this, we cannot say just anything that comes to mind, and I have to say that none of us do.

But we also have to work on easing this constraint, so that we can test ideas. What the Managing Director says is what the Fund thinks, but what a research economist here says and thinks is not necessarily what the Fund thinks. He or she is expressing an idea to peers. The idea needs to get out there to be discussed, tested, and—where relevant—improved. So, how can controversial ideas which are useful and relevant to the Fund be circulated and tested in the public arena without being seen as Fund policy? In this context, it is very important for the Research Department to be seen as a department carrying out actual research, which does not necessarily follow the official Fund line.

Now, at the same time, one has to realize that what our department does cannot be seen as completely unrelated to what the Fund does. Likewise, when, for example, the Economic Counsellor says something on an issue, this cannot be treated as completely irrelevant to the Fund's view. So we need to keep trying to find a better balance here. Many important issues are vigorously debated in battles fought inside the Fund, but outsiders are unaware of this. They see only what emerges and thus assume that no intellectual ferment is taking place here. It is very important for outsiders to understand what the issues are in some of these battles and to find ways for them to provide comments and criticism, but they'll need to be aware that the issues under discussion do not constitute Fund policy.

What is the secret of balancing the need for IMF research to be relevant against researchers' need to explore topics of particular interest to them?

The Fund's research effort is a two-way street. On the one hand, the Fund has some needs. On the other hand, if you force people to do research in areas that don't stimulate them, you are not going to get very good research and it will be difficult to attract good people. In order to attract them and keep them, you need to ensure that they have leeway to do things they are interested in. So, it is a delicate balance. I am happy to say that, for the most part, we've taxed people relatively lightly, in that we've required them to do very few things that were far from what they wanted to do. One of the benefits you have as a department is that you can bring people together to work on a common issue and then get them to transmit the findings of this work to colleagues, thereby getting more of an impact. I've therefore suggested, every once in a while, that economists come together within divisions or across divisions to do work which can have high impact. Otherwise, a fair amount of time is open for people to do their own work.

Now, I don't think that "directed research" is bad; in fact, it sometimes tells people "here is an important problem that the Fund is interested in." One example of this was when we had a question about how we could address the issue of country insurance, which may be provided by reserves, lending facilities, diversification of activities, and so on. The relevant division went away and thought about it and produced a whole bunch of papers. Some of these came together in a board paper (prepared for the IMF's Executive Board), but they were also instrumental in generating some of the ideas expressed in ongoing discussions and debates about various possible forms of Fund facilities. Of course, we've gone much further on some of these issues, but since they are, to some extent, in the realm of PDR (the Policy Development and Review Department), we have been collaborating with them on specific items.

I have given you some highlights of directed research, but I don't want to minimize the amount of individual, self-motivated work that is going on in Research. At the same time, some people draw, I think, a little too much of a distinction between work that is Fund oriented and work that is self oriented. I think most of the people who come here eventually develop interests that are Fund oriented, and, for the most part, people have had the time and resources to do what they want.

You also introduced fundamental changes in the organization of the department, decentralizing expenditure by making some resource allocations to economists and providing research grants. Do you think this was a positive experience? Why or why not?

I think credit is due to Alessandro Prati of our front office for making it possible to decentralize budgets throughout the department, so that people could actually spend money the way they wanted. It is hard to measure what effect this has had, but when someone can decide for themself whether to bring in a visiting scholar, spend more money on RAs (research assistants), or go to a conference, you give them more freedom to carry out their research. Many people wanted to get more RAs, and their ability to do so has allowed them to do research that they could not have done otherwise. Regarding decentralizing budgets and creating a common pool for funding projects, I think these organizational changes will be useful in allowing individual-oriented research to flourish, and ten years from now, say, we will see whether it has been as successful as we had hoped. At least, we expanded the possibilities, and I'm really happy that people have taken advantage of the opportunities created. The flip side of providing this increased support for individual research was that I cut out the practice of inviting big, important people to come to the Fund for three months, do their own research work here, and then go away. I thought that expenditures for this were unnecessary and a big waste of Fund money. After doing this, I got a tremendous amount of pressure from outside people who wanted to spend the usual paid vacation at the Fund, but I thought there were far better uses for our money.

What do you see as the optimal relationships among the Research Department, Management, and the Executive Board? How about the optimal relationships between the Research Department and other Fund departments?

In terms of relationships with Management and the Executive Board, I think the Research Department has responsibilities to maintain state-of-the-art knowledge of issues relevant to the Fund and to update the Board and Managing Director on these issues. But we also, I think, have a role in providing an independent view. We have the luxury of focusing on economics while area departments are somewhat tied down by the political issues. Now, Research has to be careful about this, since if, on the one hand, we focus only on economics and not at all on the political issues, we will become irrelevant. If, on the other hand, we focus too much on the political issues, we will become more like an area department. How do we pick a point in between where we challenge the area departments in situations where they are moving too far away from economics owing to political constraints but also recognize that there are limits to what can be done, given those constraints? That is really the challenge that we face. And the need to meet it is a reason why it is very important for the Economic Counsellor to be from outside the Fund, because he or she should be the person who is trying to bring an independent view to policy discussions in the Fund and focus more on what is good for the member country in the medium term. You cannot always be uncompromising, because then you will become irrelevant. In contrast, you can't just take on board what all of the other departments are saying without demur, because, again, you will become irrelevant. It is hard to pick a spot in between, but it is important to do so. Indeed, one of the best compliments the department has received was from the Managing Director, who jokingly cautioned, the other day, against giving us a task because we tended to be politically incorrect.

"We have the luxury [in the Research Department] of focusing on economics while area departments are somewhat tied down by the political issues."

I think the Research Department has to engage with other Fund departments, and I hope we've tried to build good relationships with them. A good relationship doesn't always mean a relationship without frictions. We have had to defend the independence of the Research Department in quite a few instances, but these disagreements have been settled between departments. I think everybody involved understood where we were coming from; they have respected us, and we have respected where they were coming from; and we have reached reasonable compromises. I have no doubt that if I were an area department director, I would do pretty much what they do.

In a changing world with fewer financial crises, is there a new role for the Research Department?

Of course, in a world with fewer financial crises, fewer short-term issues need to be addressed but there is more opportunity to prepare for the medium term. The Research Department has played an important role in crafting the Fund's medium-term strategy (MTS), and participating in strengthening Fund surveillance and refining the MTS in the light of experience are very important priorities at this time of relative calm in international financial markets. I am not sure that we are completely rid of crises, however; and we therefore need to make changes now to improve the Fund's ability to react quickly and effectively to crises if and when they occur.

You put a lot of emphasis on new databases (e.g., on corporate governance, structural reforms, and the structure of public debt). Do you think it this was the right strategy? Why or why not?

We work with data, and our access to data is one of the advantages of working at the Fund. Working with countries to encourage them to supply important data, and creating databases and trying to learn more by using them in our work are important parts of our strategy for maintaining a strong Research Department.

Broader IMF Issues

During your tenure, the Fund launched the initiative on multilateral surveillance. What are the challenges of multilateral surveillance from the research point of view?

The main challenge in multilateral surveillance now is how to influence large countries which have systemic effects on the world economy. What leverage do you have over them when you believe their policies are going in the wrong direction and will have adverse effects on other countries? During the period that I have been here, and certainly for the last couple of decades, the large developed countries have, for the most part, charted independent courses without being much affected by what the Fund has advised them to do. Now that some large emerging market countries are building up large foreign exchange reserves, they have also become more independent and less subject to Fund leverage. I think the big challenge of multilateral surveillance is getting these large players to see that there is a need for them to engage in dialogue to discuss not necessarily their short-term policies but primarily the spillover effects their policies are having on each other and the consequent need for reforms. What I'm talking about is not policy coordination, but instead the need for countries to accept, in their enlightened self-interest, certain limitations on their policies. I don't think we are there yet. I think that the Research Department can help by making the economic case for this, and certainly we have done so regarding the issue of how to narrow global imbalances. Our job is to try to persuade countries that what is in the interest of the global economy is also in the interest of their domestic economies. Establishing the connections between what is good for the domestic economy and what is good for the global economy and, based on these, figuring out how we can get better cooperation among large countries is going to be one of the central challenges facing the Fund.

Your position involved considerable managerial and administrative responsibilities. Looking back on your time here, what observations do you have about this side of the job? Do you have any suggestions for how your successor might most effectively cope with these responsibilities?

I have one very simple answer to handling the position's managerial and administrative duties, and it is to find good people. If you find good people to help you, basically they take care of pretty much everything. But in addition to finding good people, you have to give them room. You cannot micromanage what they do. And so, every once in a while, you have to accept that certain decisions they make may not be exactly what you want but rather what they think is best. That certainly doesn't mean losing control, but it means having an overall sort of framework within which people have leeway. If you find good people who understand what you are trying to do and work within the framework you've prescribed, they pretty much do what is best to further the overall objective. I find it an exciting challenge to persuade people, so that what I think is useful also becomes what they think is useful. And if they have different views, you should be willing to engage in dialogue by which you may change each other's views. I have to say that the people I have been working with in Research have been incredible. Certainly the front office have been superb and the divisions chiefs have all been very good, so it has been a pleasure.

To my successor, I would say that as long as he or she keeps the members of the current team or replaces them with people who are equally strong, I don't think there will be a serious problem. I think is very important to respect their opinions, because these are very strong individuals with very sensible opinions. As I discussed earlier, I arrived here without a macro reputation and was, I think, one of the youngest directors, so I needed to prove to my new colleagues that I was not a fake on either the intellectual front or the managerial front (because I had come from academia). I think it is therefore very important to convince people within your department that you are not inflexible—that you can listen; that you can respect them; and that if they start backing you, you will have no problem. So I would advise my successor to get your department behind you, because once you have their support, you are unstoppable; but if you are fighting daily battles within the department, then you cannot perform outside the department, let alone outside the Fund.

Your position involved a lot of public speaking and meeting with member country officials and many other Fund "constituents" as you represented the Fund in many forums. Did you enjoy this aspect of the job, and what did you learn from it?

The position of Economic Counsellor gives you a tremendous platform, but you need to be very careful about using that platform. It is important to solve internal issues internally, and when you talk on the outside, you should talk about issues that matter to outsiders.

Occasionally, you can affect internal debates by making statements outside, but you have to be very judicious about doing that so that you are not perceived as a "loose cannon," generating more opposition by what you say than movement.

Going Back to Academia

At the Fund, you probably came across many interesting ideas but had little time to write research papers. In view of this, what will be the topics of the first papers you plan to write once you are back in academia?

One thing I am really interested in exploring is the process of institutional change, so I will do some work on that. An interesting aspect of this is the power of vested interests and how it affects a country's ability to grow and develop. I am also very interested in understanding more about the global liquidity glut and the important role that openness plays in countries' and global economic development. I worry about some of the forces that are discouraging openness and how little we are doing to address some of the relevant issues.

"I worry about some of the forces that are discouraging openness and how little we are doing to address ... the relevant issues."

Which of the ideas expressed in your book,* Saving Capitalism from the Capitalists, *were most useful in guiding your work at the Fund? If you were to update your book in light of your experience at the Fund, which chapters would you change, add, or delete? Do you have any plans to write another book exploring some of the issues you explored while working at the Fund?

I don't remember it chapter by chapter. The book is, to a certain extent, about the role of finance in this process of creating more competition. But clearly so many other factors play a role in creating competition; and during my time at the Fund, we explored a whole range of them. I want to give myself some time to reflect. I must say that the Fund is a fascinating place, but I have no intention of writing a tell-all book about the Fund or anything of that sort. I think that when you work inside an organization for some time, you tacitly agree that unless you learn of corruption or malpractice, you will keep silent, after you depart, about what is going on inside it—it would be a breach of trust to do otherwise. But there are so many other interesting issues I have come across. One of the areas that I am very interested in is understanding more about the growth of the Indian economy and writing something about it. So, if I do write a book, it would be about those issues and perhaps about development more broadly speaking, which I think is very interesting.

Did you find many co-authors here with whom you will continue to work from Chicago?

Yes, I have made a number of friends here, and certainly some of them have been coauthors. One's role as chief economist severely limits one's ability to work on research, so I hope that, in the future, I will be able to explore issues with some people at the Fund who I haven't yet had a chance to do research with.

Would it be fair to say that it is maybe even better to be an ex-chief economist of the Fund than being the chief economist?

I don't know if it is better to be an ex-chief economist or the current one. I think this has been a tremendous experience not only in terms of my own personal development, through gaining both knowledge and managerial sense, but also in terms of meeting people and just getting to see the broad range of their capabilities. I think the Fund staff is made up of very intelligent and dedicated professionals. I've seen them at work and seen the way they think, and the experience has been quite an eye-opener. So, until I return to the outside world and see how it feels, I can't say that it's better. What I can say is that if anything beats this job, then it is pretty damn good.

For additional biographical information on Raghuram Rajan, please visit http://www.imf.org/external/np/bio/eng/rr.htm *and* http://faculty.chicagogsb.edu/raghuram.rajan.

Country Study

Canada

Vladimir Klyuev

Over the last decade, Canada has enjoyed robust GDP growth, declining unemployment, low and stable inflation, and a string of fiscal and current account surpluses. These outcomes owe much to sound macroeconomic policies as well as a favorable external environment. IMF staff analysis has focused on these policies and the economy's salient features, including its close trade integration with the United States, large commodity sector, and substantial decentralization and regional diversity.

Canada is an open economy whose trade is dominated by the United States. Kose (2004) finds that Canadian-U.S. free trade agreements have substantially increased trade and financial flows while increasing business-cycle synchronicity. Justiniano (2005), using factor analysis, finds that the U.S. cycle explains about half the variation in Canada's real GDP and industrial production. Ivaschenko and Swiston (2005), using a small monetary model, find spillovers from U.S. activity are significant but can be mitigated by a speedy monetary policy response, while U.S. monetary policy has relatively modest effects on Canada.

Canada's lack of productivity catch-up with the United States since 1995 is analyzed in Cardarelli and Kose (2004), who find that it is explained by Canada's industrial structure rather than increased trade integration with the United States. Although productivity differentials across sectors have been similar, the United States has been much more successful in shifting resources toward high-productivity industries.

Canada's impressive GDP growth over the last decade despite somewhat lackluster productivity performance is explained by a substantial rise in labor force participation, particularly among women. Tsounta (2006) finds that reforms in the Canadian tax and benefit system in the mid-1990s account for at least a third of the observed increase in female participation during 1995–2001.

Since the early 1980s, Canada, like the United States, has experienced a secular decline in the household saving rate. Faulkner-MacDonagh (2004), who estimates a long-run relationship between the saving rate and household net worth, inflation, interest rates, and government spending, finds this has reflected improvement in the fiscal balance, success in fighting inflation, and increases in households' net worth. Klyuev and Mills (2006), using an error-correction framework on saving behavior in four "Anglo-Saxon" economies, find that, in contrast to the experience in the United States, the decline in the Canadian household saving rate in recent years has not coincided with a rise in home-equity withdrawal.

Canada's large commodity sector makes the country susceptible to terms of trade shocks that spill over into its "commodity currency," which has appreciated strongly in the last four years as oil and other commodity prices have soared. Lee and Mühleisen (2004) and Bayoumi and Mühleisen (2006) argue that this appreciation has largely been in line with the fundamentals. The latter paper, in particular, argues that the relationship between the Canadian dollar and energy prices has tightened over time, reflecting the growing importance of net energy exports.

Another of Canada's challenges is that it has a regionally specialized economy, with manufacturing concentrated in the central provinces and raw materials production elsewhere. Klyuev and Luzio (2006) find that despite some convergence over the last decade, Canadian regions are still significantly more diverse than their U.S. counterparts in terms of industrial structure and their responses to macroeconomic shocks.

By making asymmetric shocks more likely, regional diversity underscores the need for flexible markets. Bayoumi, Sutton, and Swiston (2006) find that Canada's labor markets are flexible by international standards, with migration playing a significant role in this adjustment. Flexibility is particularly notable from the province of Ontario westward, while adjustment is more sluggish in Quebec and the Atlantic provinces. This may reflect the finding by Kaufman, Swagel, and Dunaway (2003) that the Employment Insurance system discourages migration and impedes convergence in per capita output. Moving beyond the labor market, Bayoumi and Cardarelli (2005) find that the Canadian economy is characterized by a relatively high degree of flexibility, as demonstrated by substantial changes in the industrial structure over time, high rates of firm entry and exit and of job creation and destruction, and speedy adjustment to macroeconomic disturbances.

Canada was among the pioneers of inflation targeting (IT). Bayoumi and Klyuev (2006) examine the contribution of the IT regime to reducing Canada's macroeconomic volatility. They find that the greater stability in the IT period can be attributed primarily to high credibility of the new regime, which made inflation expectations more forward looking, rather than to changes in the monetary reaction function or tamer shocks. Roldós (2006) finds marked changes in the monetary transmission mechanism in Canada around 1990 and shows that the shift from indirect (bank-based) to direct (market-based) financing has contributed to this change by increasing the responsiveness of aggregate demand to the real interest rate. Luzio (2004) examines the information content of real return bonds and finds them useful for gauging market expectations of real yields and inflation.

Turning to financial stability and efficiency, a key policy issue is whether to allow further mergers in a banking system dominated by six large banking groups (LBGs). Ivaschenko (2005) finds that the Canadian banking system is relatively competitive and efficient despite this concentration. De Nicoló, Tieman, and Corker (2005), who calculate market-based soundness indicators for the six LBGs, find that the low correlation of risk profiles across LBGs enhances the resilience of Canada's financial system. De Masi and Ivaschenko (2003) focus on financial and regulatory spillovers from the United States to Canada, documenting the negative impact of U.S. corporate scandals on equity valuation in Canada and the responses of Canada's corporate governance system to these scandals and the subsequent tightening of the regulatory framework in the United States.

Canada has had an enviable fiscal record in recent years, moving from chronic deficits and rising public debt to nine consecutive federal budget surpluses. Cardarelli (2003) finds the country's long-term fiscal prospects to be relatively favorable even in the face of demographic pressures, although Mühleisen (2004) points out scope for simplification and better targeting of public pension benefits, and the health care system cost pressures remain a challenge (De Masi and Towe, 2003). Using the Fund's Global Fiscal Model, Bayoumi and Botman (2005) demonstrate significant macroeconomic benefits of debt reduction, while Botman (2006) uses the model to compare the efficiency gains from different tax cuts and concludes that the efficiency gains from cutting the goods and services tax (Canada's value-added tax (VAT)) are relatively low.

Turning to the fiscal framework, Mühleisen and others (2005) emphasize that macroeconomic uncertainty implies that a considerable cushion is required to ensure that Canada's asymmetric "balanced budget or better" objective can be met. They find a tendency for the authorities to build that cushion partly by using conservative macroeconomic and fiscal assumptions, and suggest that the transparency of the budget process could be improved.

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Conference Summary

Vienna Conference on Trade Policy Research

Clinton R. Shiells

The European Research Workshop in International Trade (ERWIT), which was jointly organized and sponsored by the Joint Vienna Institute (JVI) and the Center for Economic Policy Research (CEPR), was held June 15–18 at the JVI. It is an annual trade policy research conference that brings together experienced and younger scholars to discuss work in progress, and has developed as a principal institution promoting collaboration between international trade policy researchers in Europe.

The conference explored a variety of themes related to the effects of trade on productivity and economic growth, with many of the 19 papers focusing on trade policy issues relevant to European economic integration, including with the transition economies. In particular, it included sessions on World Trade Organization/General Agreement on Tariffs and Trade (WTO/GATT) issues, European Union (EU) integration, the global organization of production, trade and financial sector development, labor markets and trade, immigration, trade and competition, and regional trading arrangements (RTAs). Given the wide range of topics, this brief article can describe only a selection of the papers. (The detailed program is available on the JVI's website at *http://www.jvi.org/index.php?id=6246*.)

The session on WTO/GATT issues considered the structure of international trade agreements from an institutional perspective and the benefits of joining the WTO. Henrik Horn (Institute for International Economic Studies (IIES), Stockholm University), in a paper coauthored with Giovanni Maggi (Princeton University and the National Bureau of Economic Research (NBER)) and Robert W. Staiger (University of Wisconsin and NBER), developed a framework in which incompleteness of contracts arises endogenously to investigate many features of existing GATT agreements, including the asymmetry in the coverage of trade versus domestic policy instruments. Man-Keung Tang (IMF), in joint work with Shang-Jin Wei (IMF and CEPR), found that WTO/GATT accession yielded strong growth and investment effects but only for those countries that were subject to rigorous accession procedures, including, notably, many of the transition economies. Policy commitments associated with accessions were helpful, especially for countries with poor governance.

A number of papers considered the effects of European economic integration. Beata S. Javorcik (World Bank and CEPR), in joint work with Jens Arnold (World Bank and Bocconi University) and Aaditya Mattoo (World Bank), showed that the liberalization of the Czech services sector in the 1990s was associated with substantial productivity *(continued on page 12)*

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Vienna Conference
(concluded)

gains in manufacturing industries. Importantly, they found that allowing foreign entry into service industries may be the key channel through which services liberalization contributes to improved performance of downstream manufacturing sectors. Gianmarco I.P. Ottaviano (University of Bologna, Fondazione Eni Enrico Mattei (FEEM) and CEPR), in joint work with Massimo Del Gatto (University of Cagliari and Centro Richerche Economiche Nord Sud (CRENoS)) and Giordano Mion (Center for Operations Research and Econometrics (CORE), Université Catholique de Louvain, and Fonds National de la Recherche Scientifique (FNRS)), used a calibrated trade model with heterogeneous firms and monopolistic competition to show that trade integration within the EU generated substantial productivity gains through firm selection in response to import competition.

In a session on the global organization of production, Dalia Marin (University of Munich) and Thierry Verdier (Paris School of Economics) presented a theory of why—among other things—firms in larger countries have flatter, more decentralized corporate hierarchies than firms in smaller countries, a feature which is supported by the authors' analysis of firm-level data for Austrian and German corporations. Based upon a unique new dataset constructed using detailed information on U.S. international export transactions in the 1990s, Andrew B. Bernard (Amos Tuck School of Business, Dartmouth College and NBER), in joint work with J. Bradford Jensen (Institute for International Economics) and Peter K. Schott (Yale School of Management and NBER), examined how prices set by multinational firms vary across arm's-length and related-party customers, with arm's-length prices substantially higher than related-party prices for U.S.-based multinational exporters, especially for goods sent to countries with lower taxes and higher tariffs.

Andrei A. Levchenko (IMF), in joint work with Quy-Toan Do (World Bank), presented empirical findings suggesting that financial market development may be spurred in a country that has a comparative advantage in financially intensive sectors, a result which complements those of existing studies showing that an efficient financial sector may be a source of comparative advantage.

A number of papers considered the interactions among labor markets, immigration, and trade. Notably, Alejandro Cuñat (University of Essex, Center for Economic Performance (CEP), and CEPR), in joint work with Marc Melitz (Harvard University, CEPR, and NBER), constructed a model in which international differences in the flexibility with which labor market regulation enables firms to adjust to idiosyncratic shocks are a source of comparative advantage if the within-industry dispersion of shocks is different across industries. Other things being equal, countries with more flexible labor markets specialize in industries with high volatility—a finding that is consistent with empirical evidence for a large sample of countries.

Several papers considered the interactions between product market competition and trade. For instance, Natalie Chen (University of Warwick, European Center for Advanced Research in Economics and Statistics (ECARES), and CEPR), in joint work with Jean Imbs (Hautes Etudes Commerciales (HEC), Université de Lausanne; Swiss Finance Institute; and CEPR) and Andrew Scott (London Business School and CEPR), showed that trade openness exerted a procompetitive effect, with prices and markups falling and productivity rising, using disaggregated data for EU manufacturing sectors during the 1990s. Consistent with their theoretical model, however, these effects diminished over time as less competitive economies became attractive havens from which to export.

Two papers considered the economics of regional trading arrangements. Giorgia Albertin (IMF) showed that a maximum size of an RTA exists, beyond which member governments would prevent any further enlargement to avoid a loss of political support for the RTA. Klaus Desmet (Universidad Carlos III and CEPR), in joint work with George Deltas (University of Illinois at Urbana-Champaign) and Giovanni Facchini (University of Illinois at Urbana-Champaign and Centro Studi Luca d'Agliano), showed how a hub-and-spoke arrangement—under which a hub country has free trade agreements with multiple spoke countries—tends to increase welfare in the hub country but decrease it in the spoke countries.

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The International Monetary Fund will hold a conference on "New Perspectives on Financial Globalization" at its headquarters in Washington on April 26–27, 2007.

The conference, sponsored by the IMF Research Department and Cornell University, aims at providing a forum to present recent theoretical and empirical research on the macroeconomic implications of financial globalization. In particular, the conference will address the following topics: measures of financial globalization; financial globalization and economic development; financial globalization and business cycles; and challenges of financial globalization for economic policy. (See *http://www.imf.org/external/np/seminars/eng/2007/finglo/042607.htm* for details.)

Interested authors should submit either a draft of their paper or a detailed abstract by December 1, 2006 to *globconf@imf.org*. Papers presented in this conference will be considered for publication in a symposium issue of the *Journal of Development Economics*. The papers will go through the standard refereeing process of this journal, and hence there is no precommitment to publish them. Travel and accommodation expenses of paper presenters and discussants will be covered.

The conference organizers are Ayhan Kose, Enrique Mendoza, Eswar Prasad, and Marco Terrones. If you have any question about the conference, please feel free to contact any of the organizers by e-mail at *globconf@imf.org*.

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Jaume Ventura; Center de Recerca en Economia Internacional (CREI) and Universitat Pompeu Fabra, Barcelona; 9/18/06–9/29/06