

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

EBS/86/282

CONFIDENTIAL

December 18, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Enhancing the Use of Indicators as a Tool for Surveillance

Attached for consideration by the Executive Directors is a paper on enhancing the use of indicators as a tool for surveillance, which has now been tentatively scheduled for discussion on Thursday, January 15, 1987.

Mr. Crockett (ext. 8982) or Mr. Boughton (ext. 7477) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

Enhancing the Use of Indicators as a Tool for Surveillance

Prepared by the Research Department

(in consultation with other departments)

Approved by R.R. Rhomberg

December 18, 1986

Contents

	<u>Page</u>
I. Introduction	1
II. Background	2
III. The Analytical Framework	4
1. General considerations	4
2. Assessment of sustainability	7
3. Classification of indicators	8
4. Time period for the analysis	10
5. The role of saving and investment balances	10
IV. The Choice of Indicators	14
1. Specification of a concise list	14
2. Treatment of market-sensitive variables	16
3. Emphasis of nominal or real magnitudes	17
V. Country Coverage	18
VI. Implementation	22
VII. Issues for Discussion	24

I. Introduction

This paper is the second prepared by the staff in response to the April 1986 request by the Interim Committee for the development of a set of economic indicators. ^{1/} The first paper, "Indicators Relating to Policy Actions and Economic Performance" (EBS/86/127, June 11, 1986), outlined a framework for the use of indicators in surveillance, set out a taxonomy for classifying indicators, and proposed a number of procedures for using indicators in the work of the Fund. That paper was discussed by the Executive Board on July 14, 1986 and also served as a background for the discussion of indicators by the Interim Committee on September 28. These two meetings gave rise to a number of suggestions regarding the use of indicators in surveillance. The present paper describes those suggestions and attempts to clarify and to develop a number of relevant issues.

The discussion of indicators that has taken place during the past year has suggested that the issues involved are quite complex. In particular, the choice of which indicators and which analytical approach would be most useful in policy assessment depends crucially on the question being asked. The emphasis attached to particular indicators and relationships will clearly be different, depending on whether the chief concern of policy makers is correcting payments imbalances, controlling inflation, or promoting growth--even though it would be recognized that these objectives are closely linked in the medium term.

Nonetheless, despite the complexity of the underlying issues, the central questions on which Executive Board guidance is needed at the present time are fairly straightforward, and relate to the nature of the staff's analysis of international economic interactions, especially in the World Economic Outlook. In that context, the staff proposes to continue the analysis of policy interactions among industrial countries along the lines of the most recent WEO exercise. This analysis makes use of an analytical framework that stresses the sustainability of projected external balances and their compatibility with other objectives in the field of growth and price stability. The staff proposes to build on its earlier work through further consideration of the choice

^{1/} The request by the Interim Committee arose from the Committee's consideration of the 1985 reports by the Deputies of the Group of Ten and of the Group of Twenty-Four. See "Report of the Deputies of the Group of Ten on the Functioning of the International Monetary System" (EBD/85/154, Sup. 1, June 21, 1985), and Report of the Deputies of the Group of Twenty-Four on the "Functioning and Improvement of the International Monetary System - Transmittal to the Interim Committee" (EBD/85/228, August 30, 1985). The staff's work in this area has drawn on these reports, as well as on the May 1986 Tokyo Economic Declaration by the Heads of State or Government of the Seven Summit Countries.

of indicators, evolution of the analytical approach, and incorporation of more information on developing countries. The essential purpose of the present paper is to seek the views of Executive Directors on how best to proceed on these issues.

An issue that is not discussed in great detail in the present paper is how indicators might be used as the basis of strengthened surveillance in individual countries. This issue involves a number of important operational questions, such as the relationship between the World Economic Outlook analysis and Article IV and supplemental consultations; the nature of the response that would result when economic developments in a member country depart from expected or targeted values; and the degree of automaticity in the procedure. These are important questions, and they will be taken up in the forthcoming staff paper that reviews the implementation of surveillance. Nevertheless, some of the issues involved will be touched on in a preliminary way in the following discussion.

II. Background

The review and analysis of world economic conditions and of the functioning of the international monetary system has always taken place through the consideration of a broad variety of indicators, and there is nothing essentially novel in the idea of applying these indicators in any of the Fund's activities. On one level, the purpose of the development of a more specific set of indicators is to attempt to select from the full range of available information, which will still be examined in its entirety in the course of surveillance-- variables that could play a central role in the process. On a deeper level, it is to be hoped that surveillance may be improved through a more explicit focus on policy interactions among countries and possibly through the development of more explicit criteria against which developments relating to policies or performance can be judged in a medium-term context.

The initial staff paper noted that there are a number of purposes of economic indicators that might be considered and that the way indicators are to be developed depends on which functions are judged to be most important. First, at a fairly general level, indicators may serve as a means by which countries can monitor and review policies and performance retrospectively. Second, they can serve as an aid in defining medium-term policy objectives. Third, indicators may be able to provide a means of signalling the need for discussions of members' policies, and fourth, they could serve more directly as a trigger for policy changes.

The first two of these purposes are closely related to the regular World Economic Outlook exercise, while the latter two would represent a substantial evolution in existing procedures. In particular, the fourth purpose would seem to go beyond what many members regard as practical, and for this reason is not considered in any detail in this paper. The Tokyo Economic Declaration of May 1986 appears to have envisaged the use of indicators primarily as a means of monitoring and reviewing policies. Specifically, the Declaration requested that the countries whose currencies constitute the SDR--and possibly others as well--should, in conjunction with the Managing Director, review their individual economic forecasts, "taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates." However, the specific purpose identified in the April 1986 communique of the Interim Committee (paragraph 6) was related most closely to the third purpose in the above list. The communique asked the Executive Board to seek ways "to improve the scope for discussing external imbalances, exchange rate developments, and policy interactions among members." In this context, it was noted that "indicators might help to identify a need for discussion of countries' policies."

The general purpose of indicators was discussed in detail by the Executive Board in July. As the Managing Director summarized that discussion:

"Indicators can be seen as a means of checking the consistency within a country between performance objectives and the policy measures that are to be used to reach those objectives at a given point in time. They can also be seen as a means of checking the consistency of the national forecasts and objectives of a particular country with the national objectives and forecasts of other countries.

"Indicators can further be seen as providing, in a more ambitious vein, a global model, or, in a less ambitious vein, a limited set of checks in order to provide signals. Indicators could be used to assess the medium-term sustainability of balance of payments developments, including sustainability in the context of an 'optimal' pattern of worldwide growth and stability. That is the most ambitious concept. Indicators can be seen as a tool for intellectual analysis or they can be used to encourage policy action and to trigger more effective international cooperation."

The prospective role of indicators was further clarified at the Interim Committee meeting in September 1986. Paragraph 7 of the communique for that meeting included the following conclusions:

"Committee members welcomed the agreement at the Tokyo summit to use indicators in conducting surveillance as part of efforts to strengthen international economic cooperation. They also supported the greater use, in the latest World Economic Outlook analysis, of indicators of economic policies and performance. They considered that this analysis was helpful in focusing attention on potential incompatibilities in national economic policies and projections, particularly among the larger countries whose policies have substantial international impact. A key focus of indicators should be on points of interaction among national economies, in particular developments affecting the sustainability of balance of payments positions, and on the policies underlying them. It was generally agreed that a better use of indicators would be a helpful tool in strengthening the Fund's surveillance activities. The Committee asked the Executive Board to develop further the application of indicators in the context both of the periodic consultations with individual member countries and of the World Economic Outlook so as to facilitate the multilateral appraisal and coordination of economic policies."

As is clear from the quoted paragraph of the communique, the development of indicators in the Fund is to proceed along two main avenues: through further development of the analytical techniques used in the World Economic Outlook, and through a strengthening of the consultation process with individual countries. These two activities are of course related; nonetheless, the use of indicators in the multilateral appraisal of policy interactions can be regarded as the analytical starting point for the contribution that the Fund can make to assessing policies in individual countries or groups of countries. This paper is therefore largely concerned with how indicators can be used to strengthen the process of multilateral surveillance. In this context, the Interim Committee communique specifies that the principal focus of attention should be the analysis of the sustainability of balance of payments positions and the identification of policies that are consistent with sustainable positions.

Suggestions that have been offered in the course of the various meetings on this subject may be classified broadly as relating to four topics: the analytical framework, the choice of variables to be used as indicators, the coverage of countries, and procedural issues for the implementation of the exercise. That broad outline is followed in the organization of the following sections.

III. The Analytical Framework

1. General considerations

Perhaps the most essential question to be answered more fully before

work can proceed on developing the use of indicators in surveillance is that of what these data are intended to indicate, and for what purposes. Because the Fund's responsibilities for multilateral surveillance involve the full range of macroeconomic variables, indicators--if they are to serve as the basis for general surveillance discussions--should be equally comprehensive. That is, they should indicate the overall economic situation and policy strategy of each member. ^{1/} On the other hand, if the development of a set of indicators is to bring certain key relationships into as sharp a focus as possible, then it may be desirable to concentrate particularly on a smaller subset of data.

In keeping with the perspective emphasized in the Interim Committee communique of April 1986, the staff's work in this area has stressed external variables, particularly from the perspective of their international consistency and sustainability. That is, emphasis has been placed on indicators that help to explain the actual and prospective evolution of international payments balances, the sustainability of those balances, and factors affecting either the balances or their sustainability. This emphasis, it should be noted, is not intended to narrow the focus of Fund surveillance; rather, it represents an effort to provide an appropriate perspective for the use of indicators and to avoid excessive generality in the analysis.

An alternative to the central emphasis on payments would also be consistent with the request by the Interim Committee, would be to stress the determination of exchange rates, either as a substitute for the focus on payments balances or as an important addition to it. In such an approach, the staff could assess the current or the prospective pattern of exchange rates in relation to the pattern of rates that

^{1/} The Executive Board's Decision governing the "principles for the guidance of member's exchange rate policies" (Decision No. 5392-(77/63), April 29, 1977) contains the following paragraph:

"The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment."

might be regarded as "desirable" or sustainable. There is, of course, no doubt about the central importance of exchange rates in the surveillance process. Exchange rates are an important indicator of pressures that might build on payments positions, and they are a highly visible symbol of the interests of the countries involved. There are, however, a number of issues to be addressed if exchange rates are to be assigned a prominent place in a system of indicators.

The first issue relates to the fact that exchange rates are a very sensitive market variable. Quantified assessments of sustainable exchange rate levels--whether by the Fund staff or by the national authorities--would risk provoking strong market reactions. Second, neither the Fund staff nor the economics profession at large has the ability to project exchange rates with great confidence; movements in the exchange rates of the major floating currencies are strongly affected by shifts in expectations and by news of singular events, and only a small portion of observed movements has proved amenable to empirical analysis. For both of these reasons, it has always been seen as problematic to conduct multilateral surveillance discussions on the basis of projections or assessments of the sustainability of a projected evolution of exchange rates. ^{1/} Third, the appropriateness of a given exchange rate can be assessed only by reference to its implications for balance of payments flows. Therefore, even if exchange rates were to be a primary indicator, the role of balance of payments developments would not be diminished.

Another possibility would be to focus on internal rather than external balance. The primary advantage of such an approach would be to give a greater explicit weight to key objectives in the field of growth and price stability. Moreover, the control of inflation and the stability of monetary policy are of great importance for the overall sustainability of the policy stance and for the promotion of stable trade and financial relationships among countries. However, given the international dimension of the Fund's responsibilities, a potential disadvantage of focusing too narrowly on internal balance would be to risk losing sight of the more fundamental determinants of changes in current account balances. In that regard, fiscal policy--and perhaps supply-side policies--would be more important than monetary policy alone. The preferred approach, therefore, would seem to be to continue to focus principally on the major medium-term determinants of current account positions, while ensuring that the domestic implications for growth and inflation are taken adequately into account.

^{1/} It will be recalled that the standard practice of the Fund is to base economic projections on a working assumption about exchange rates. Usually, this assumption has been that nominal exchange rates either would be unchanged or would change so as to leave real exchange rates unchanged.

2. Assessment of sustainability

A key element of the analytical framework that was described in the earlier staff paper on indicators is the assessment of sustainability of economic conditions, especially as regards external positions. Conceptually, policies or economic conditions may be viewed as sustainable if they can be maintained over the medium term (generally taken to mean a period of 3-5 years), are consistent with the long-run growth potential of the economy, and are judged to be appropriate from the standpoint of both the country in question and the international community as a whole. ^{1/} Another way of stating this criterion is that a country's policy stance may be considered to be unsustainable if it is likely to lead to a serious disruption in the economy that would force a reversal of policies, or if it is thought to have exchange rate, interest rate, and trade effects that could severely disrupt economic conditions either at home or abroad.

A related issue concerns the assessment of consistency in policy settings. In the course of the discussions held by the Executive Board and the Interim Committee, two types of inconsistencies were mentioned. First, there may be inconsistency among national objectives, as when the desire for more rapid growth clashes with a desire to avoid inflationary pressures or a large external deficit. Second, there may be inconsistency between (coherent) national objectives on the one hand, and acceptable outcomes internationally on the other, as may happen when a country adopts a policy mix that has external effects that run counter to the interests of other countries.

Judgments regarding sustainability or consistency are very difficult to make, partly because of the data limitations already cited, but also because there are a great many factors that affect the sustainability of a given position. For example, safe haven considerations and shifts in saving or investment propensities can have a significant effect on the international flow of capital. Experience suggests, as one Executive Director put it, that it is often easier to agree that a particular position or a value is unsustainable than it is to agree on what constitutes an optimum position. In light of that experience, it is preferable to emphasize the identification of actual and prospective domestic fiscal and monetary policy mixes that generate unsustainable external imbalances. If existing policies are judged likely to lead to unsustainable outcomes, the World Economic Outlook could discuss different ways of dealing with the problem.

^{1/} See the discussion on this point in Jacques Artus and Malcolm D. Knight, "Issues in the Assessment of the Exchange Rates of Industrial Countries," International Monetary Fund, Occasional Paper 29 (July 1984), pp. 1-2.

A difficulty in assessing the implications of such policies is that unsustainability usually results in political reactions and policy reversals that are not easy to project on the basis of economic reasoning. This raises the technical issue of how the staff should develop its projections so as to illuminate the "tensions" inherent in unsustainable policies while avoiding unduly speculative forecasts about the reactions of markets and policymakers. This issue is considered later in the paper.

In spite of these difficulties, the concept of sustainability over the medium term is essential to the practice of surveillance. That is, one must be able not only to say where economies are headed but also to make judgments about whether that direction will eventually have to be changed in order to avoid running into severe tensions or inconsistencies. Under normal conditions, a judgment that policies will have to be reversed within a few years will constitute a prima facie case that the country's interests and those of its trading partners would be better served by moving toward a different policy stance at an early stage.

3. Classification of indicators

Because of the wide range of variables that might be considered as indicators, the staff felt that it would be useful to provide some order to the discussion by classifying data into different groups. Fundamentally, the criterion for such a classification should be its usefulness in specifying the role of each variable in the economy and its relevance to the policy options facing the authorities.

The initial staff paper proposed classifying data into three types: indicators of economic performance, indicators of economic policy, and intermediate variables through which policies affect performance. It was suggested that economic growth, employment, the balance of payments, and price stability would be included under indicators of performance; policy indicators would include variables such as monetary growth, fiscal balances, and exchange market intervention; and intermediate variables would include saving and investment levels, interest rates, and exchange rates.

Subsequently, some Ministers and Directors indicated a preference for emphasizing the distinction between policy instruments and policy targets. Although these two schemes are quite similar, there are two differences. First, an emphasis on targets rather than on performance could limit the range of variables under consideration, especially for countries that prefer to formulate policies in terms of nominal rather than real variables. In such cases, real output growth or unemployment might be appropriate indicators of performance, but not of policy targets.

The second difference concerns the treatment of policies. In the staff's proposed classification, the course of economic policy would be indicated by variables that are closely influenced by policy actions but that may not be under the direct control of the authorities. Monetary growth and the fiscal deficit would fall in this category. Indicators of policy instruments would presumably be somewhat more narrowly focused. Monetary policy instruments, for example, might include variables such as the growth of bank reserves or the monetary base, and the setting of the discount rate. Fiscal policy could be indicated by reference to changes in expenditure or tax plans, adjusted for cyclical or other endogenous influences. By and large, the staff would suggest a pragmatic approach to this issue, choosing as policy indicators variables that are under the effective control of the authorities within a relevant policy-planning horizon. This would suggest using as an indicator of monetary policy the variable or variables that the authorities of the country concerned perceive as most relevant. As an indicator of fiscal policy, it would seem desirable to gauge the short-term stance of policies with reference to a cyclically-adjusted measure of changes in the budgetary position. (Over a longer-term horizon, however, it may be that the actual deficit is a better indicator, especially in view of difficulties on assessing "normal" activity levels.)

A related issue concerns the emphasis that should be given to one group of variables or another. One view expressed by a number of Ministers and Executive Directors was that the role of objective or target variables should be given less prominence in the indicators exercise than would be given to policy and intermediate variables. While countries may have objectives for variables such as the growth rate of real output, the unemployment rate, or the rate of inflation, it is recognized that outcomes for these variables depend importantly on factors outside the scope of demand management policies. In contrast, variables such as monetary growth or fiscal deficits are rather more directly influenced by policy actions.

On the other hand, it was argued that performance variables are very important for the proper conduct of surveillance, for many of the same reasons described above with reference to the need for a broadly based analytical framework. That is, if the exercise does not help to ensure that economic growth is sustained at a reasonable non-inflationary level, it may be difficult to make informed judgments regarding sustainability. It was also argued that priority should be placed on monitoring and evaluating economic performance, even in the short run, because problems with performance require early attention if they are to be corrected before they assume major proportions. Overall, because of the ambiguities of delineating these categories and because of the advantages that have been cited regarding the use of both policy

and performance variables as indicators, it seems best at this stage not to narrow the focus of the exercise to one particular group or the other.

4. Time period for the analysis

The Interim Committee communique of April 1986 suggested "the formulation of a set of objective indicators related to policy actions and economic performance, having regard to a medium-term framework." [Emphasis added.] The importance of the medium-term focus was widely accepted, albeit with differing emphasis being given to the importance of looking at shorter-run (one- to two-year) developments as well. It was noted that policies are always implemented in the short run, even though they may be formulated in a medium-term context. Therefore, it was argued in the course of the discussions that indicators should be projected for both the short and the medium term, but that short-term divergencies should be appraised in a medium-term framework. In any event, the avoidance of even the semblance of a "fine tuning" approach was universally viewed as quite important.

The general problem in this context is to determine an appropriate horizon over which projections may be made with reasonable confidence, taking account of the desirability of covering the period that is relevant for policy formulation. A number of countries do use horizons of four to five years in making general policy plans; current examples include the medium-term financial strategy in the United Kingdom, which specifies plans to 1990, and the deficit-reduction programs in the United States and Japan, which give policy paths through 1991. Nevertheless, the uncertainty of making projections that far ahead may militate against using such a long horizon in a multilateral setting. On the other hand, a two-year horizon may be too short to cover adequately the medium-term effects of demand-management policies or the role of supply-side policies.

The practice that has normally been adopted for the World Economic Outlook has been to present annual numbers for the current and the following year, and then to show either averages for the medium-term period or a value for the final year (in the most recent case, 1991). This procedure has the advantage of consistency with the short- to medium-term breakdown employed elsewhere in the World Economic Exercise, but it may be useful to consider other ways of attacking the problem at hand. An alternative that could be examined would be to provide more detailed information for one or perhaps two years immediately following the short-run period.

5. The role of saving and investment balances

The paper discussed by the Executive Board in July (EBS/86/127)

proposed an analytical framework that would make use of the relationships among current account balances, fiscal positions, and private and domestic saving and investment balances. The August World Economic Outlook (SM/86/196) implemented this framework in the chapter on policy interactions in industrial countries. The framework itself is, of course, both simple and basic, and it has been used for many years in all forms of surveillance work. What was different in the treatment developed in the latest World Economic Outlook was the degree of emphasis placed on these relationships, and the additional detail that was introduced into the analysis.

The saving-investment approach begins with the accounting identity that the sum of sectoral net saving balances in any economy must be zero. That is, net domestic private saving plus net government saving plus net foreign saving will, by definition, equal zero. Another, more convenient, way of expressing this identity is that the current account deficit (which is equivalent to net foreign saving) must equal the sum of the government deficit and the financial deficit of the private sector (investment net of private saving).

By itself, of course, this identity reveals nothing about causal relationships. Its usefulness arises because if projections are made for each component of the equation, the results may be checked for consistency, both within each country and between countries. Such inconsistencies imply that the initial assumptions regarding variables such as interest rates or exchange rates, or the estimated behavioral relationships, will be invalidated. Attention is thereby directed to the emergence of tensions in the projections and possibly to the need for policy adjustments.

A key element in using the saving-investment framework to appraise potential balance of payments pressures is the assessment of factors affecting the financial position of the private sector. As with any macroeconomic data, examination of historical trends may give only a very imprecise indication of future developments. A preferred procedure is to base judgments regarding sustainability on estimated functional relationships. Here, too, the difficulties are not negligible, not least because the statistical development of private saving data is generally inferior to many other macroeconomic series; in most cases, private saving data are themselves derived residually in national accounts. Nonetheless, trends in saving and investment in the major countries have generally proved amenable to empirical estimation, and fluctuations in saving-investment balances may not have been notably more difficult to analyze or project than those of other related data.

Discussion of the saving-investment framework by the Executive Board and the Interim Committee highlighted both its potential

usefulness in illuminating and clarifying surveillance and a number of practical limitations. On the one hand, some observed that the use of the saving-investment framework in the World Economic Outlook had improved the Fund's insight into the nature and determination of major trade imbalances and exchange rate misalignments. Others, however, pointed to inadequacies of data and to the incomplete picture that saving-investment relationships give by themselves. Suggestions for improvement related primarily to the need to develop an integrated analysis that accounts as fully as possible for the many complexities and differences between countries.

A number of Executive Directors observed that a given pattern of net saving-investment balances may be as compatible with a stagnating world economy as with a growing one. For example, a reduction in a country's fiscal deficit could be accompanied by a fall in personal saving or by an increase in private investment. Either shift would limit the strengthening in the country's current account balance that would follow from the fiscal shift, but the implications for sustainability of the situation could be quite different. This observation does not by itself prejudice the usefulness of the saving-investment approach as an analytical tool; however, it underlines the importance of examining saving and investment separately. It also suggests the need for an analysis of the mechanisms by which basic identities are preserved, and the implications of these mechanisms for factors such as growth and inflation.

A related point is that the ultimate function of the analytical framework must be to help policymakers focus on the broad range of underlying policies that can affect external positions and exchange rates. However one defines the framework, it must be capable of permitting an analysis of the effects of policy actions on the variables that are the objectives of policy.

Several Executive Directors pointed to the severity of data problems in this sphere. A number of issues arise. First, the huge global discrepancy in measuring current account balances makes it difficult to assess the consistency of the components of the saving-investment identity. ^{1/} Second, private saving data are derived residually in national accounts and may be subject to large errors. Third, some saving and investment data become available relatively late and may not be practical to use as the sole basis for policy evaluation.

^{1/} Since 1978, this discrepancy has fluctuated between minus \$24 billion and minus \$106 billion.

Other participants in the discussions, however, noted that these problems may not be much more serious than those facing empirical macroeconomic analysis generally.

A few conclusions may be drawn at this stage. First, The advantage of the saving-investment framework is that it promotes analysis of the relationship between domestic and external development and aids in the assessment of sustainability and international consistency. For example, if one were to determine that the recent surpluses in the Japanese and German current account balances and the deficits in the U.S. balance should decline over a period of several years, then a careful analysis of saving-investment balances would play an important role in drawing implications for domestic saving and investment and in formulating recommendations for policy adjustments to bring about the desired internal and external adjustment.

Second, an analytical framework based on saving-investment balances must be sufficiently flexible to permit the analysis of sustainability and consistency to develop along several lines. With reference to an individual country, one should be able to examine whether the projected patterns of domestic saving and investment are in line with historical experience, taking due account of developments that might affect these patterns over time. In addition, one should be able to examine the effects of sustained shifts in saving and investment flows on the international net asset position of the economy. Do prospective payments trends imply a buildup of international claims and liabilities that will create tensions in financial markets?

A third conclusion is that the analysis of global payments patterns is complicated by the statistical discrepancy in global current account balances. Furthermore, any global inconsistency in measuring current account balances will necessarily be mirrored by a commensurate error in the domestic saving and investment counterparts. The magnitude of this global error--and, more importantly, of its year-to-year changes--calls for caution in the application of the saving-investment framework to the assessment of the sustainability of payments positions. It may be anticipated that the forthcoming report of the Working Group on the Statistical Discrepancy will provide some guidance for incorporating at least limited information about the likely allocation of the discrepancy to individual countries or groups of countries.

Finally, it should be noted that, although the saving-investment framework has been an integral part of the staff's initial approach to the use of indicators in surveillance, this framework is not intended to be all-inclusive or to exclude the introduction of other relevant information. It is particularly useful for studying the effects of large shifts in fiscal policies or of external shocks affecting current account balances, but in the absence of such events it may prove to be less useful in capturing the implications of smaller shifts in saving

or investment patterns. Furthermore, an analysis of net saving balances does not by itself provide an explanation of changes in economic growth rates. Nonetheless, although the complexities of the problems and the limitations of the framework should not be underestimated, the analysis of saving and investment data does provide the means for integrating diverse information into a coherent framework focusing on the sustainability of the balance of payments position.

IV. The Choice of Indicators

In the general conduct of surveillance, it is appropriate and desirable to use all available information about each economy, and the issue of limiting the set of variables to examine does not normally arise. However, if indicators are to serve to focus attention systematically on particular developments or trends that require collective international review, it may be useful to specify a more limited set of variables that--as the earlier staff paper noted--should be timely, quantifiable, relatively easy to interpret, and adequately comparable, both across countries and in relation to objective standards. These principles were broadly accepted during the ensuing discussions, but a number of points were made regarding specific issues.

1. Specification of a concise list

A minimum list of indicators of performance might include, as measures of economic performance, growth (real GNP and domestic demand), inflation (GNP/GDP deflators and consumer prices), and current account balances; as intermediate variables, exchange rates and interest rates (in nominal and real terms); and, as indicators of economic policies, fiscal positions (for central and general governments) and growth rates for relevant monetary aggregates. In order to analyze each of these indicators, information on private saving and investment, structural budgetary policies, supply-side policies, changes in international reserves, employment and unemployment, and other data could be introduced as needed. Clearly, these lists would have to be allowed to evolve over time, as experience was gained, and the problems confronting the world economy changed.

The difficulty with attempting to focus on a limited list of indicators is that different indicators acquire prominence for different purposes. It is possible to focus on the international or the domestic manifestations of unsustainability, and on the symptoms or the underlying causes of potential disorders. Furthermore, regardless of the purpose, it may be necessary to examine more than one variable in order to gain a clear picture of a given dimension of economic policies or performance.

Policy indicators may be especially difficult to cover with a short list that is both comprehensive and internationally comparable. To take only one example, fiscal policy can be represented by the budgetary deficit at the central or the general government level, and can be measured with or without adjustment for cyclical factors. Moreover, with several major countries giving prominence to fiscal reform, analysis of the structure of fiscal revenues and expenditures is important to provide an adequately rounded picture of the economic effects of a particular budgetary stance.

Performance indicators are also subject to possible proliferation. As was noted in the first staff paper, nominal domestic demand may provide important information that is not contained in GNP figures. The rate of growth of domestic demand is important in judging whether a given rate of GNP growth is consistent with the reduction of external disequilibria. Moreover, the composition of domestic demand is important in judging the sustainability of a given rate of output growth. In addition, even if employment data prove difficult to work with as performance indicators, data on potential output or capacity utilization would be indispensable in some circumstances. If it is desirable to have only one measure of income, GNP has the advantages of being widely understood and comprehensive. But there clearly will be occasions when supplementary information will be called for.

The appropriate role for structural (i.e., supply-side) indicators was also considered. It was pointed out that these indicators are critical for certain purposes, and they play an increasingly prominent role in surveillance. However, in the context of the indicators exercise, the criteria of commensurability and importance for the linkages among countries might make it reasonable to exclude such variables. Some felt that it could be useful for countries to provide descriptive material on structural indicators, and others called for additional research. As for employment indicators, if they were used it would be essential for them to be supplemented with indicators of the utilization of capital capacity.

Because of the difficulties in reaching agreement on a relatively short list of indicators, it was argued by some that it would be preferable to have as complete a list as possible. It was noted that, in order to promote stability of exchange rates through convergence of performance toward sustainable, noninflationary growth, analysis is needed of a wide range of indicators, including real output, inflation, budget deficits, and monetary growth. In assessing the balance of payments, the current account balance may need to be supplemented with indicators of quantities, terms of trade, and capital flows. In addition, it would help to have indicators that reflect the impact of trading activities on, inter alia, countries engaged in adjustment programs.

The foregoing considerations argue against being too ambitious about trying to specify a limited set of indicators. On the other hand, if the development of indicators is to play a significant role in furthering the implementation of surveillance, it will be essential to define a limited and clearly relevant list. The objective of this task should not be to eliminate consideration of a subset of available information, but rather to select those variables that might be able to play a special role in the process by providing an early warning system and signalling the need for a deeper analysis.

2. Treatment of market-sensitive variables

A common theme in the discussions of the Board and Interim Committee was that market-sensitive variables, in particular exchange rates and interest rates, should be handled with care so as not to give misleading signals to the markets. In particular, it has never been seen as appropriate for the Fund to make explicit projections of exchange rates, and most Ministers and Directors would consider that the development of a system of indicators should be consistent with that constraint.

The difficulty is to reconcile the avoidance of exchange rate projections with the desirability--cited by a number of speakers--of making the assessment of exchange rate levels a prominent part of the exercise. Present practice for the World Economic Outlook is to assume unchanged real exchange rates throughout the medium-term period. In general, however, it must be recognized that treating both policies and exchange rates as variables that are given exogenously creates potential inconsistencies in projections; the farther into the future the projections are made, the more serious these inconsistencies are liable to become.

One means of reconciling the desire to assume a given set of policies with that of avoiding making explicit projections of exchange rates would be to exclude exchange rates from the analysis of policy interactions among industrial countries. That is, the staff would treat exchange rates as endogenous variables for the purpose of generating projections of economic performance, and it would acknowledge that the projections of policy instruments and current account balances might imply changes in exchange rates, but it would not reveal in its circulated papers what it estimated these implications to be. Alternatively, at least one policy variable could be made endogenous and not constrained. That approach would enable one to develop a consistent medium-term scenario with unchanged real exchange rates.

It may be that neither of the latter two approaches is really practicable, and that the best strategy would be to adhere to existing practices and to deal with any inconsistencies as they arise, in

whatever way seems most appropriate in each particular case. An example of this flexible approach was the assumption made for the World Economic Outlook in early 1985; the staff's analysis at that time, while retaining the conventional working assumption of unchanged exchange rates in the short term, assumed that the U.S. and Canadian dollars would depreciate gradually over the medium term against the currencies of other industrial countries. Following the substantial depreciation that actually occurred during 1985, the World Economic Outlook analysis then returned to the standard assumption of unchanged real exchange rates in the medium term.

3. Emphasis of nominal or real magnitudes

During the Executive Board discussion in July, some Directors argued that variables such as nominal GNP should be emphasized, because demand management policies do not have a predictable impact on real magnitudes. It was argued in particular that multilateral surveillance should follow the practice of the major industrial countries in recent years by giving a central role to the control of nominal magnitudes. Others, however, felt that real GNP should be of primary interest in the exercise of surveillance. ^{1/} In this view, the use of indicators should be consistent with the fact that the promotion of high levels of employment and real income was one of the original objectives of the Fund, as embodied in the Articles of Agreement, in recognition of the possibility that a balanced current account accompanied by weak growth could conceal an unsustainable situation.

A related issue arose with regard to the emphasis that might be given to real or nominal exchange rates. It was observed that concentration on the real exchange rate could tend to abstract from the problem of inflation. However, others pointed out that balance of payments developments depend on international competitiveness, which is better reflected by trends in real exchange rates; such indicators are already used in the Information Notice System.

The essence of the argument in favor of giving primary emphasis in policy formation to nominal rather than real values is that for some variables, there is less agreement about the real than about the nominal effects of financial policies. For example, an increase in the growth rate of the money stock should lead eventually to an increase in nominal GNP; how that increase will be split between real growth or

^{1/} If either nominal or real GNP is used as an indicator along with the GNP deflator, then the other can be readily derived. Nonetheless, there is a substantive issue concerning which of the two should be highlighted.

prices will depend on market structures and the expectations of various economic agents. Because those factors may be volatile and hard to analyze, it is less easy to find a common ground for discussion of these effects. Similar arguments may be advanced regarding effects on real interest rates and real exchange rates.

The advantage of focusing on real values is that it is real exchange rates and interest rates that affect spending decisions and, in a more general sense, it is essential to have a view of how economies are evolving in real terms. A prerequisite for effective surveillance is to know whether an economy is growing near its potential, whether real interest rates are positive or negative, and what the international competitive situation is.

The key issue in this regard is empirical: is it possible to develop enough of a consensus regarding the effects of policies on real variables to permit meaningful discussions about the appropriate actions to take when economies drift off course? This question is really part of a broader issue regarding the compatibility of the implicit models that the different participants in a debate have in mind. If surveillance is to be effective--and, a fortiori, if countries are going to seek to coordinate their policies--it is essential for there to be sufficient common understanding of how economies work. One potential benefit of a more systematic use of indicators will be in distinguishing more effectively international disagreements that result from different policies and assumptions and those that result from the use of different implicit models.

V. Country Coverage

During the discussions of indicators by the Executive Board and the Interim Committee, many speakers noted the importance of maintaining the symmetrical and even-handed nature of surveillance, and argued that this concept should be applied to the use of indicators as well. However, it was also noted that the nature of the proposals that have been made for using indicators in multilateral surveillance requires them to be applied with special reference to the larger countries. Only a relatively few countries, it was argued, have a large enough weight in world or regional trade that their policies have to be assessed with international repercussions explicitly in mind.

There are three important reasons that emerged from these discussions for incorporating material relating to countries other than the large industrial countries. First, it is important to consider the effects of the large countries' policies on the rest of the world, both for the sake of understanding fully the implications of policy changes and to

enable the Fund to examine the feedbacks that might be expected on the major countries themselves. Second, the larger developing countries, as well as some of the smaller industrial countries, play an important role in the international trading system, and their policies should be examined in the same way as those of the large industrial countries. Third, there is a need to ensure not only consistency among the policies implemented by the industrial countries, but also consistency between financial and trade policies adopted by the developed world, on the one hand, and the adjustment policies implemented by the developing countries as a group, on the other. For example, policies that imply a change in the aggregate current account balance of the large industrial countries will give rise to tensions if they are not compatible with the objectives and policies of the rest of the world.

In considering the extension of indicators to developing countries, two additional issues arise. The first concerns whether it would be preferable to emphasize developments pertaining to major analytical or regional groups of countries, or to include information relating to individual countries. The other concerns the choice of indicators that would be appropriate given the particular characteristics of developing countries and the problems that they face.

One reason that the discussion of economic indicators might be confined to the larger industrial countries for purposes of multilateral surveillance is that only for those countries do policy actions have substantial repercussions for the world economy. This distinction reflects the large share of each of these countries in both world trade and capital movements. In this regard, no single developing country approaches in size the five countries whose currencies constitute the SDR (Table 1). Furthermore, the use of indicators for borrowing countries is a subject that is properly considered as part of an integrated approach to program design and performance criteria.^{1/} Consequently, for the purpose of multilateral surveillance, developing countries could be considered as groups. This need not, of course, prevent the inclusion of relevant country-specific detail in considering the situation and prospects of developing countries in the World Economic Outlook. The staff intends to increase the attention given in the WEO to the situation of individual developing countries and would welcome the Board's guidance on how best to do this.

In grouping developing countries, criteria utilized should be relevant to the assessment of the performance of countries, the sustainability of their current account, and the role of domestic and foreign

^{1/} See "Program Design and Performance Criteria" (EBS/86/211, September 8, 1986) and Supplements 1 and 2 (September 11 and November 11, 1986, respectively).

Table 1. Twenty-Five Largest Countries, by GNP/GDP
and by Total Trade, 1984-85

(In percent of world total) 1/

<u>GNP/GDP</u> <u>2/</u>		<u>Total Trade</u> <u>3/</u>	
1. United States	34.9	1. United States	16.1
2. Japan	11.7	2. Germany, Fed. Rep. of	8.8
3. Germany, Fed. Rep. of	5.6	3. Japan	8.5
4. France	4.5	4. United Kingdom	5.6
5. United Kingdom	3.9	5. France	5.5
6. Italy	3.2	6. Canada	4.6
7. Canada	3.1	7. Italy	4.4
8. Brazil	3.1	8. Netherlands	3.3
9. China, People's Rep. of	2.2	9. Belgium	2.9
10. India	1.7	10. Hong Kong	1.7
11. Australia	1.5	11. Saudi Arabia	1.7
12. Spain	1.5	12. Sweden	1.6
13. Mexico	1.4	13. China, People's Rep. of	1.6
14. Iran, Islamic Rep. of	1.3	14. Switzerland	1.6
15. Netherlands	1.1	15. Korea	1.6
16. Sweden	0.9	16. Taiwan, Prov. of China	1.5
17. Saudi Arabia	0.8	17. Spain	1.5
18. Switzerland	0.8	18. Singapore	1.4
19. Argentina	0.8	19. Australia	1.4
20. Nigeria	0.7	20. Brazil	1.2
21. Korea	0.7	21. Mexico	1.1
22. Indonesia	0.7	22. Austria	1.1
23. Belgium	0.7	23. Indonesia	1.0
24. South Africa	0.6	24. Norway	1.0
25. Austria	0.6	25. Denmark	0.9

1/ The world total excludes certain nonmember countries for which statistical data are not maintained. The term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice.

2/ Converted to a common currency using average exchange rates for 1984-85.

3/ Exports plus imports.

factors in current account developments. For these purposes, the current analytical grouping of countries in the framework of the World Economic Outlook exercise--by predominant export and by financial criteria--would appear to suffice.

The second major issue concerning the use of indicators for groups of developing countries is the choice of indicators to be monitored. It may be noted that the problems facing developing countries differ from those of industrial countries, and the availability of data will in general be more limited. For instance, of importance in the case of developing countries is the role of external financial constraints in affecting economic performance, especially the growth of real GDP. The existence of such constraints would imply that attempts to monitor the aggregate performance of developing countries could benefit from explicit examination of export growth and changes in net capital inflows to these countries.

The financing of current account deficits of developing countries often takes the form of debt-creating flows that are either to the government or government-guaranteed. The sustainability of current account positions in such cases becomes closely associated with the sustainability of the public sector borrowing that is occurring. In this context, the size and rate of increase of external public debt and debt service in relation to exports and GDP become economic variables to be carefully monitored.

The economic performance of developing countries and the sustainability of their current account positions are influenced by economic developments in, and outlook for, industrial countries. There may therefore be some benefit in the use of indicators that help clarify the extent to which aggregate current account developments in the developing countries are traceable to changes in economic variables of industrial countries. In the evaluation of the compatibility of economic policies of industrial countries, and hence of their policy options, the usefulness of economic indicators would be enhanced *pari passu* with their ability to capture effectively the implications of such policy options for the performance and the sustainability of the current account positions of developing countries. Indeed, indicators that focus attention on such points of interaction between developing and industrial countries would help in appraising the policy options facing the major industrial countries.

Apart from the indicators discussed above for industrial countries, there are a number of other variables that appear to be important in assessing the sustainability of current account positions of groups of developing countries. Taking into account the role that they have played in the past, and in the context of the discussion in this section, additional variables that would be suggested either as indicators or as a means of analyzing the basic indicators could include the real

value of official development assistance and the net inflow of commercial bank credit. As a first approximation, movements in those variables provide some indication of the external financing constraints that developing countries face, even though the magnitudes of the flows are affected by the domestic economic policies of the developing countries themselves. Also useful for inclusion would be the terms of trade, the stock of external debt (in relation to exports), and the magnitude of debt service (also in percent of exports). Finally, the growth in the volume of exports and imports would appear to be useful as indicators in light of the role that these variables play in the growth process of the developing countries.

VI. Implementation

The role of the Fund in the implementation of a system of indicators also came under discussion by the Executive Board and the Interim Committee. It was acknowledged that, although the Fund had a broad representation of countries in the world economy, it would not be the most effective setting for the actual implementation of decisions regarding the coordination of policies among the larger countries. Nonetheless, even in cases where economic developments and policy issues are reviewed within a fairly small group of member countries, great importance was attached to involvement by the Fund (for example, through the participation by the Managing Director in ministerial meetings).

An approach to multilateral surveillance that many saw as potentially useful would be for the Fund staff to collect and analyze national forecasts, and for the Fund to establish procedures for discussing the consistency of objectives and policies and for reconciling discrepancies among the forecasts. A variant on this approach would be for national authorities to provide projections concerning policy and performance indicators; the Fund's role would be to try to make them comparable and globally consistent. Other variables could be projected by the staff, perhaps with the assistance of Executive Directors and national authorities.

Others stressed the problems that might arise under such a scheme. To base a surveillance exercise on national forecasts could lead to problems of widely different methodology and coverage. In addition, while national forecasts are indicative of expected trends, they should not be viewed as rigid policy targets that could be negotiated or agreed through multilateral discussions.

Another difficult issue concerning implementation concerns the treatment of unsustainable or inconsistent situations in the projections presented in the World Economic Outlook. The difficulty is that if the indicated policies are judged to be unsustainable, it may not be easy to describe adequately the most likely scenario that follows from them.

For example, excessive reliance over time on foreign savings for financing a fiscal deficit--even for the largest reserve-currency countries--could lead eventually to a forced reversal of fiscal policy, to a shift to greater monetary accommodation, or to a sudden change in financial market conditions if an event occurred to cause a loss of investor confidence. The particular way in which unsustainability eventually manifests itself is hard to predict and depends on non-economic factors. Moreover, forecasting quantitatively a disruption in economic relationships may be viewed as unnecessarily alarmist, when most observers would accept that a policy change could pre-empt such an outcome.

In the past, the staff has usually dealt with unsustainability in an indirect way, through reference to "tensions" or difficulties that might arise through the continuation of current policies. Underlying this practice is a notion of ex ante "consistency" of payments balances at existing real exchange rates. However, at times of particular difficulty in projecting the medium-term consequences of unsustainable policies, it is all the more important to be as explicit about these consequences as possible, in order to clarify the reasons for concern.

It may be useful to consider several alternatives for presenting the tensions inherent in a set of projections. One possibility would be to base the projections on actual policies, and follow the data wherever they lead. The advantage of this approach would be to emphasize very clearly the dangers of continuing on a present course. Nonetheless, this option raises potentially serious problems. As already noted, if the policies are unsustainable, it is generally impossible to determine the form that the rupture will take or even when it is likely to come. It also becomes especially difficult in such cases to defend the use of unchanged real exchange rates as a working assumption.

A second possibility would be to base the projections on assumed alternative policies, modified so as to make the outcome "sustainable." This option, however, would seem to be inconsistent with the need for the Fund to discuss the implications of existing policies and to offer warnings if policies are thought likely to lead to undesirable outcomes, especially with respect to external balances.

A third option is to present projections in which the outcome avoids unsustainable paths--perhaps by simply assuming that domestic and external imbalances will be financed at the assumed interest and exchange rates--and then to discuss the various difficulties that might prevent this outcome from materializing. This option, which is the general approach that has been taken by the staff, may be the only feasible one, in view of the problems with the others. Nonetheless, it too raises dilemmas. In practice, this approach amounts to saying, "Here are the projections, but here are some reasons why they might not be the most likely outcome." A surface reading of such a document could give the impression that the forecast is basically optimistic, with some possible concerns being raised. The deeper message would be that

in order for the forecast to turn out all right, policies will have to be changed, or a shift in exchange rates will have to be accepted.

A fourth option would be to present a central scenario based on unchanged policies, with alternatives based on "preferred" policies. If the pursuit of unchanged policies were thought to lead to unpredictable outcomes, then a truncated set of projections could be set out. For example, for the period during which U.S. fiscal policy was thought to be on a path leading to an unsustainable medium-term outcome, a path could have been given for U.S. deficits and debt through the medium term, but with only short-term projections for output, inflation, current account balances, and so forth. A second scenario would have given the outlook under the assumption of stricter budgetary control. For purposes of depicting medium-term scenarios for developing countries, the international economic environment could have been described by reference to that second scenario.

A final question that generated a great deal of interest was whether and in what manner indicators should be used to trigger discussions or adjustments in policies. Some would prefer to see a strong role in order to give more content to the process. Others cautioned against the risk of introducing inappropriate rigidities into the surveillance process. The issue of whether and how supplementary discussions with individual member countries should be triggered is one that is properly dealt with in the context of the Board's regular review of the implementation of surveillance. As such, detailed consideration of this issue is left to the forthcoming Board paper on this subject. One possible procedure that might be of assistance would be to circulate a list of current economic indicators in major countries (which the staff already prepares for internal purposes) for the information of Executive Directors.

VII. Issues for Discussion

This paper has raised a number of questions regarding the use of indicators in the conduct of surveillance and in the coordination of economic policies. To some extent, these open questions call for further research on particular issues, and the staff is undertaking or plans to undertake a number of research projects that relate to policy coordination. The guidance of Directors concerning priorities for these projects, as well as suggestions for additional topics, would be welcome.

First, a Staff Study for the World Economic Outlook is being prepared that will discuss critically the available theoretical and empirical literature on policy coordination and the relevance of that literature to the Fund. Second, a study is under way that will develop an analytical framework that emphasizes the international spillovers resulting from policy actions, and the way in which specific indicators

can provide information about past or prospective developments. Third, a model has been developed and estimated for the purpose of studying the likely current account implications of different medium-term fiscal policy stances in the three largest industrial countries. Fourth, the saving-investment framework is being investigated in greater depth, with an eye toward making further progress in analyzing the sustainable current account positions of industrial countries.

As a fifth project, the indicators of real effective exchange rates that were developed in conjunction with the Information Notice System are being refined for both industrial and developing countries, as are estimates of potential output in industrial countries. Sixth, a review is being made of the forecasting track record of the World Economic Outlook; a similar review could be undertaken of past episodes in which complex policy interactions were at play, in order to determine whether and how the analysis of those circumstances might have been improved through the use of indicators or of the analytical framework discussed above. Seventh, with regard to developing countries, studies are being developed that will examine the prospects for import-saving growth and export diversification; these studies will discuss the implications of various indicators for policy adjustments and for medium-term growth prospects.

The resolution of broader issues, of course, cannot rely simply on research; the guidance of Directors is also sought in determining the best ways to deal with a number of the issues raised throughout this paper. Perhaps the most difficult issue concerns the assessment of sustainability of external positions. The staff has proposed strengthening its existing procedures for analyzing saving and investment balances. The major empirical question--which can probably be resolved fully only through experience--is whether enough is known about the fundamental determinants of private domestic saving and investment to warrant drawing conclusions about the sustainability of the movements that are implied by projections of current account and fiscal balances.

A second question about the analytical framework is whether there exists enough of a consensus about the effects of policy actions on economic performance to enable a substantive dialogue to occur. Obviously, disagreements will always exist, and there is no firm line between healthy dissent and the absence of a common ground. A related issue is whether agreement can be reached concerning a range of acceptable values, or at least the desired direction of change, for key variables such as current account balances, exchange rates, fiscal deficits, inflation, or output growth. Again, it would appear that experience will provide the only means of answering these questions.

On a more technical level, the best way to approach the medium term remains open. The question is whether it is feasible to extend forecasts beyond the normal two-year period over which the World Economic Outlook exercise is conducted, and whether the linkages between medium-term (three- to five-year) scenarios and shorter-term forecasts can be made sufficiently clear.

The staff also would seek advice on the best ways to develop a list of indicators that is both concise and reasonably complete. The paper has suggested that, while it will always be desirable and necessary to bring in as much information as possible in the course of surveillance discussions, the indicators themselves should be limited to the variables that contribute most clearly to an understanding of international linkages and that provide reliable information about impending unsustainable situations. It may, however, prove difficult to establish a consensus regarding a short list of variables that would apply to all of the countries concerned.

A related question concerns the role of sensitive variables. The key problem centers on exchange rates. These data must play a central role, and some would prefer that they be made the basis of a set of reference zones that would help to signal the need for policy adjustments. Regardless of how far one would wish to go in that direction, the sensitivity of projections and of assessments of appropriate levels cannot be ignored.

In spite of these complexities, there do not appear to be major obstacles that would limit the usefulness of indicators as a means of improving the dialogue among countries and of furthering a mutual understanding of policy interactions. But it is apparent that much remains to be done before this type of exercise could provide the basis for a more systematized approach to the coordination of economic policies.



Office Memorandum

EW
STB
IO
F

TO: Mr. Crockett

December 11, 1986

FROM: Douglas A. Scott

1986 DEC 12 AM 11:22

SUBJECT: Enhancing the Use of Indicators as a Tool for Surveillance

As a brief comment on style, the draft paper takes such a balanced view on so many topics that it seems more oriented towards an initial opinion survey rather than an attempt to advance the discussion along a particular path. If the style is to be preserved, then an early statement of major conclusions would be beneficial. This may be less necessary if the style is altered so as to give more firm indications of staff views on important issues.

In the section on country coverage, we have reservations regarding the usefulness of extending indicators to major developing countries, particularly if this were to lead in the direction of including information relating to individual countries (second sentence of last paragraph on page 38). This reservation is particularly important if ex post performance were to show a divergence from indicators which would cause the staff to feel compelled to enter into a discussion of individual country policies. In many such cases one could anticipate concurrent bilateral negotiations on programs to be supported by the use of Fund resources. Bringing discussion of key policy issues into papers on multilateral surveillance would be detrimental to the conduct of negotiations. However, the reservations regarding coverage of important developing countries is less strong if the interest is limited to showing the impact on a group or groups of such countries arising from the stance of policies in major industrial countries.

- cc: Mr. Finch
- Mr. Gianviti
- Mr. Ouattara
- Mr. Rhomberg
- Mr. Shaalan
- Mr. Tanzi
- Mr. Van Houtven
- Mr. Whittome
- ✓ Mr. Wiesner



Office Memorandum

TO: Mr. Crockett

DATE: December 11, 1986

FROM: S. T. Beza *STB*

SUBJECT: Enhancing the Use of Indicators as a Tool for Surveillance

We are very much aware of the difficulty of writing on the subject of how the use of indicators might be intensified in surveillance.

While the paper quite appropriately dwells extensively on the many problems faced in making effective use of indicators, there is a basic question that is not addressed directly, namely, the specific contribution to be expected from the so-called indicators exercise. In our view this key issue needs to be dealt with early in the paper; clearly, we should avoid any suggestion that the use of indicators will change markedly our analytical capabilities.

In this respect, while the paper does not ignore the fact that indicators are already used extensively in surveillance, both in the WEO and Article IV consultation reports, the obvious question of what the new exercise can be expected to contribute that is different from present practices is not really answered. Various kinds of indicators are already used in a systematic way and thus it does not appear that the innovation being considered is the more systematic use of indicators. Perhaps what the paper has in mind is the use of a given set of indicators in a specific or predetermined way, but it is easy to see that a proposal to that effect would not be accepted by the Board or by the members. To be sure, the paper stresses that indicators should be used in a judgemental fashion, but some isolated references (for instance, the comparison to the Information Notice System) may suggest that they might be used in a rather mechanical way. I do not think you wish to leave this impression, and perhaps the references to the Information Notices should be dropped.

We think it is right that the paper warns readers not to expect dramatic changes to come from the indicator exercise. In particular, it is stated in the conclusion that "much remains to be done before this type of exercise could provide the basis for a more systematized approach to the coordination of economic policies". However, immediately following that statement there is a fairly long list of research projects that are to be carried out, and the reader may be led to think that completion of these studies will open the way for the operational use of indicators in a substantially new form. This is not likely to be the case, and thus that impression should be clearly dispelled, perhaps by referring to the studies in a different place or in another context.

Finally, we agree with the suggestions made by Mr. Finch to simplify the paper and to avoid entering into the field covered by the general reviews of surveillance.

Additional comments in the margins of a copy of the paper will be forwarded to you.

Attachment

cc: Mr. Finch
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Rhomberg
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Whittome



Office Memorandum

EW
STB
IO
F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT

TO: Mr. Crockett

December 11, 1986

FROM: Douglas A. Scott

Das

1986 DEC 12 AM 11: 22

SUBJECT: Enhancing the Use of Indicators as a
Tool for Surveillance

As a brief comment on style, the draft paper takes such a balanced view on so many topics that it seems more oriented towards an initial opinion survey rather than an attempt to advance the discussion along a particular path. If the style is to be preserved, then an early statement of major conclusions would be beneficial. This may be less necessary if the style is altered so as to give more firm indications of staff views on important issues.

In the section on country coverage, we have reservations regarding the usefulness of extending indicators to major developing countries, particularly if this were to lead in the direction of including information relating to individual countries (second sentence of last paragraph on page 38). This reservation is particularly important if ex post performance were to show a divergence from indicators which would cause the staff to feel compelled to enter into a discussion of individual country policies. In many such cases one could anticipate concurrent bilateral negotiations on programs to be supported by the use of Fund resources. Bringing discussion of key policy issues into papers on multilateral surveillance would be detrimental to the conduct of negotiations. However, the reservations regarding coverage of important developing countries is less strong if the interest is limited to showing the impact on a group or groups of such countries arising from the stance of policies in major industrial countries.

- cc: Mr. Finch
- Mr. Gianviti
- Mr. Ouattara
- Mr. Rhomberg
- Mr. Shaalan
- Mr. Tanzi
- Mr. Van Houtven
- Mr. Whittome
- ✓ Mr. Wiesner

Finally, we agree with the suggestions made by Mr. Finch to simplify the paper and to avoid entering into the field covered by the general reviews of surveillance.

Additional comments in the margins of a copy of the paper will be forwarded to you.

Attachment

cc: Mr. Finch
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Rhomberg
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Whittome



Office Memorandum

TO: Mr. Beza
Mr. Ferrán

FROM: Y. Horiguchi and S. Dunaway

SUBJECT: Paper on Indicators

DATE: December 10, 1986

Notwithstanding our admiration for skillfull drafting, we have a few, rather fundamental, problems with the paper. One of the problems is the total absence of a comparison between multilateral surveillance based on "indicators" and such surveillance as currently practiced. The paper talks about the "improvement" that would result from the application of "indicators" but the discussions of this improvement lacks specificity altogether. We guess the underlying cause of the problem is the fact that the paper does not analyze shortcomings of the present approach. Without clear understanding of shortcomings of the present approach, it is not easy for the readers to see clearly the benefits and drawbacks of the new approach.

Another problem is related to the one just discussed, and perhaps more basic. We still have difficulties in understanding what is meant by the "indicator exercise". We guess the lack of clarity in this regard stems from the fact that the paper does not describe the present approach. Without a point of reference, it is not easy to visualize what the new approach is all about. We might note in this connection that we (the Fund staff) do make use of a variety of indicators under the present approach. Furthermore, we do it in a systematic way, and we do focus on medium-term considerations. Thus, the differentiation of the new approach from the present one is not at all straight forward, and needs to be elucidated. The only difference we see is that the new approach would perhaps be more mechanical while the present approach is more judgemental in the use of indicators. ^{1/} If the authors of the paper think we are completely off the mark, that perhaps would mean that efforts need to be made to clarify the issue.

^{1/} For justification of our impression, we would refer you to the discussion on p. 28 about the choice of actual fiscal deficit as the main indicator in the fiscal area. We wonder what the point is of designating a variable as the main indicator when one knows full well about its limitation. One has to be mindful of a well known trade-off between theoretical validity and empirical difficulties in determining the usefulness of a variable as an indicator, and reasonable analysts would make sure to look at a comprehensive set of variables, with clear understanding of the limitation of each, to draw conclusions.

Finally, while the savings/investment balance is a useful tool for assessing fiscal policy, one drawback we see in it is that it may not be helpful in analyzing monetary policy. As a somewhat related matter, we may note that the paper seems to put greater focus on fiscal policy than monetary policy as an area in which the "indicator exercise" could make a contribution, for example, by clarifying international repercussions. In this regard, it might be useful to recall that, in a basic world model with floating exchange rates, it is monetary reflation that is characterized as a "beggar thy neighbor" policy while fiscal reflation is characterized as a policy that will raise GNP abroad as well as at home (at least in the short run).

mm6mac11--12/10/86

TO: Mr. Crockett

DATE: December 10, 1986

FROM:

SUBJECT: Enhancing the Use of Indicators as a Tool for Surveillance

In reading the draft paper, it becomes ^{rather} ~~very~~ obvious that the most important issue^s to be addressed should be, as stated on page 7, what the proposed set of indicators is expected to indicate and for what purpose. The paper makes abundantly clear that there is a great deal of disagreement and confusion among the people who have requested the development of the indicators. Certainly the task facing the staff is rather tough; however, unless these important issues are addressed and solved, the task would be even harder. The conclusions of the paper correctly point out the difficulties of the project, yet we believe that even more emphasis should be stressed on the need to clearly defining the purpose of the exercise and that, in any event, the success of the exercise will depend on the will of the member countries to consider seriously its findings.

The conclusions are, however, also a source of concern, as they list and promise the preparation of at least seven projects. Given the fact that the staff is already overburdened, the Board should be informed that the carrying out of these projects may either require additional manpower or the elimination of other tasks. Finally, it is hoped that the staff in the interested departments would be given sufficient time to comment on the numerous papers that would be prepared in connection with this project.



Office Memorandum

Mr. Wisner Ecw
STB
IO
F

1986 DEC 12 AM 9:11

TO: Mr. Crockett December 10, 1986

FROM: Vito Tanzi *Vito Tanzi*

SUBJECT: Comments on "Enhancing the Use of Indicators as a Tool for Surveillance"

Thank you for letting us see this paper. The paper has been written in a clear and comprehensive manner; however, we find that the principal notion, that of "developing the use of indicators", remains ambiguous. Does "developing" indicators mean engaging in research analyzing the interdependence of national economies, focusing on them intently in the WEO, giving a more global picture in Article IV consultations, and providing technical support in the compilation and interpretation of the set of indicators used in policy discussions of the G-7? If so, we agree that the Fund has a very natural role in calling attention to the "externalities" of national policies and in doing research on these issues.

However, if "developing" indicators means selecting a short list of economic variables that will serve as indicators of the need for consultations, we have some questions. The first definition is consistent with the statement of the objective of the paper on p. 6, the communiqué of the Interim Committee quoted on p. 4, and the research program described in the conclusion. We wonder, then, why much of the discussion addresses the problems raised by the second definition. As pointed out on p. 32, the only reason to adopt a "concise" list of indicators is as "an early warning system". But why should the Fund rely on such crude indicators when the countries are already carefully monitored by desk economists? Why should the Fund's credibility be jeopardized by concentrating on, e.g., the crude measure of the fiscal deficit cited on p. 28, when we have specialists who could keep management or the Board much more fully and accurately informed about the fiscal situation? Furthermore, it is unclear to us what is gained by an a priori discussion of the optimal length of the list of indicators, or why items on this list should be "simple". For example, we fail to see the logic of the statement that "there is thus a significant trade-off between seeking a good indicator of fiscal policy--which would require making adjustments to fiscal balances--and the desire to stick to a straightforward view of the actual fiscal position of government" (p. 21-22).

One point that is worth bringing out is that, contrary to the statement on p. 8, indicators by themselves "explain" nothing. Theory and parameter estimates attempt to explain events. Movements in time series are useful indicators only if we are able to interpret those movements. It is an understatement to say that ". . .if countries are going to seek to coordinate their policies, it would be helpful for there to exist a common understanding of how economies work" (p. 37).

The goals stated on p. 6 are good ones. We are on much shakier ground theoretically with an "early warning system". With the countries in question we are not dealing with short-run adjustment programs but rather with complex intertemporal international problems. Any attempt to simplify this problem merely for the sake of simplification seems unwise.

Other comments

1. A paper of this length should contain a table of contents.
2. The section on classification of indicators is of dubious value. There also seems to be an assumption that "data" and "variables" are interchangeable concepts.
3. We are confused as to the meaning of the statement on p. 29 that estimates of fiscal impulse do not "gauge" the ". . . relationship between policies and the level of economic activity". It seems to be a veiled criticism, yet, should one expect an indicator to spell out a functional relationship? Only a model could do this. Models suggest relevant adjustments to variables and thus it is hard to see how a meaningful discussion of the proper indicators can take place other than against the backdrop of a theoretical framework.

cc: Mr. Finch
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Whittome
Mr. Wiesner. ✓



Office Memorandum

Mr. Wiesner

EW

S/K

TO

F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1986 DEC 11 PM 12: 17 December 10, 1986

TO: Mr. Crockett

FROM: C. David Finch *CD*

SUBJECT: Draft Paper on Indicators as Tool of Surveillance

Several issues remain to be settled as regards the use of objective indicators and most of these are discussed in the draft. However, I wonder if the very detailed discussion of the pros and cons of the many proposals for individual or ranges of indicators (much of which was already in the first paper on indicators) is likely to result in a Board discussion providing the clear guidance sought by the staff. A first general comment, therefore, is that I believe the paper could be more effective if it was focused more sharply on those operational issues on which guidance is sought (e.g., list of indicators, list of countries, time horizon, scenario presentation) in developing the use of indicators in the WEO. As regards, in particular, the list of indicators the paper could also be more effective if it was focused on a specific staff proposal rather than the detailed review of earlier proposals and comments.

A related comment, to some extent of a presentational nature, is that the discussion and proposals could often be simplified by adhering more strictly to the distinction drawn between, on the one hand, the indicators themselves and, on the other hand, the need for analysis in setting and interpreting values for the indicators. For example, is it really necessary to extend the list of indicators for developing countries? Should not instead exports, debt, etc., simply be used in the assessment of the central indicators? Similarly, would it be necessary to consider a (possibly wide) range of monetary indicators?

A final general comment is that, operationally, an early discussion by the Board is needed for guidance in preparing the WEO and I would suggest that the scope of the paper be kept within the confines of this issue only. As the paper recognizes, indicators are not a separate end product or separate Fund activity but a tool which may help strengthen Fund surveillance. In this connection, the paper should indicate explicitly that issues of a follow-up nature (e.g., supplemental discussions or consultations) will be kept for the regular review of surveillance on which I expect we will be cooperating fully. I believe that several issues will have to be examined in somewhat more detail in the context of such a general review of surveillance and therefore need not be taken up in the current paper. In particular, the inter-relationship of WEO/Article IV/supplemental consultations "indicator-based" strengthened surveillance; whether all subsequent departures from established indicator values should result in follow-up surveillance action; and the form of such action given the often reaffirmed view of the Board that supplemental surveillance should not be automatic. If you have difficulty in agreeing to this approach, I would suggest that we have a further discussion.

The following specific comments may also be useful.

Page 3, middle. The reference to what the communique asked the Board to do could be misleading since the call to seek the improvements indicated was specifically to the WEO rather than generally. Also, since "consultation" has a special meaning in the Fund, discussion and consultation should probably not be used interchangeably, reading the call for "discussion of countries' policies" as a call for consultation.

Page 4, bottom. Increased specificity and quantification (including the variables labeled indicators) would help strengthen Article IV consultations. It is doubtful, however, that indicators alone will do it, except to the extent that their use in consultations will maintain the continuity of analysis and assessment in a multi-lateral framework against the background of the (and in anticipation of the next) WEO.

Page 6, top. Giving a more prominent place to global considerations in individual consultations has been an ongoing process initiated well before the current focus on indicators. Also, it is not clear how much more was done in this respect during the last year.

Page 7. Given the emphasis in the papers for last year's review of surveillance on the desirability of including explicitly within the formal scope of surveillance the broad range of policies having external effects, the somewhat formalistic presentation of the Fund's responsibility for surveillance over all policies is awkward. The quoted portion of the decision in the footnote, in particular and as Mr. Polak reminded other Directors last year, was not meant to say that all policies were subject to surveillance but to reassure (LDCs in particular) that each member's circumstance would be taken fully into account in assessing its exchange rate policy.

Page 12, middle. The saving-investment framework is not yet included explicitly in reports for all major countries.

A more general comment on the saving-investment framework is that the absence of any suggestion that the balance be further disaggregated into its saving and investment components is surprising. Would not data on the individual components help to some extent in assessing the implications for sustainability (including growth, p. 16). As a minimum, some of the difficulties with interpretation of the balance noted in this section would be alleviated.

Page 15, top. A fuller discussion of movements in stocks of assets/liabilities in relation to stock equilibrium could be useful as changes in actual stocks will involve further changes in flows only to the extent that actual stocks must be brought back to equilibrium.

Page 16, bottom. Perhaps a brief reference to longer term sustainability (integrating saving investment, growth and consumption) 1/ could be useful.

Page 17, middle. It is not clear why large countries should be better able to sustain deficits in relative terms (i.e., relative to their own GDP).

Page 18, middle. It is not clear why emphasis should be on fiscal and monetary policies only, rather than all policies including structural policies discussed in some detail subsequently.

Page 19, middle. The distinction between sustainable and desirable is not clear or very useful as policies involving low growth would not be sustainable in the longer term while a policy moving one toward a sustainable position, even if the policy is to be changed after adjustment is completed, could itself be said to be sustainable.

Page 20. It is not clear that the difference between the staff's proposed classification and the alternative target/instrument classification is as important as is suggested. Why could not growth and inflation be ultimate (if not proximate) targets with nominal "targeting"? Also, is it necessary to interpret the policy "instruments" so narrowly: could not, for example, money be the instrument even if the levers are more precise?

Page 21, bottom. Are other indicators needed or simply analysis in interpreting the indicator?

Page 23, top. The first paragraph is troublesome. First, why should "international agreement" be needed on any target with indicators a tool for analysis and discussion? Also, the ideal trigger described in the third sentence seems hardly realistic.

Page 26, 5th line. The following could be clearer "and the issue of limiting the set of variables."

Page 39. In addition to the general comment above on the relationship of the indicators/surveillance discussions, the following should also be noted:

8th line.- We would prefer that "using" be replaced by "greater specificity and quantification, including of" and that the reference be to all rather than only developing countries;

1/ Along the lines of the Salop/Spitaeller 1980 paper.

Last sentence, 1st para. The applications described are not agreed and need a substantially fuller discussion.

Page 47, bottom. What "existing procedures under the Information Notice System" are being referred to?

Page 50, top. The word "norm" is perhaps better avoided.

cc: Mr. Whittome
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Rhomberg
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Wiesner ✓



Office Memorandum

Mr Wiesner

EW
S-1B
ID
F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1986 DEC 11 PM 12:17

TO: Mr. Crockett

December 10, 1986

FROM: Paul Chabrier *PC*

SUBJECT: Enhancing the Use of Indicators as a
Tool for Surveillance

The paper provides a thoughtful and well-formulated analysis of the issues arising out of the recent discussions on the subject in the Board and Interim Committee and will serve as a good basis for further discussion.

The reader is struck with the very formidable problems that arise in developing this exercise. The paper rightly brings them out very clearly. For that reason, one has the uneasy feeling that the conclusion in the second complete paragraph on p.51 (viz.: "there do not appear to be major obstacles that would limit the usefulness of indicators as a means of improving the dialogue among countries and of furthering a mutual understanding of policy interactions") might be a little optimistic at this stage.

In the same vein, some of the fundamental issues that have yet to be addressed and are identified in the body of the text could usefully be brought forward into the conclusions and guidance sought. In particular, the "most essential question", noted on p.7, regarding "what these data are intended to indicate and for what purposes" is surely a matter for further Board discussion. Equally, the analytical impediments to the development of a system of indicators which are referred to frequently in the text (e.g., p.9 and from time to time pp. 35-38) do not seem to be given sufficient weight in the conclusions (at the top of p.50).

Though a number of trade-offs are considered (especially that between conciseness and comprehensiveness), perhaps somewhat more could be made of the possible scope for individualizing indicators. Clearly the preference is for "the development of a specific set of indicators" (p.26); however, the notion of flexibility is referred to (on p.18), though in a specific context. Could this not be developed a little further, recalling the difficulty of standardizing criteria for cross-country comparisons even in much less ambitious endeavours?

As to country coverage, the discussion seems to move too quickly from the major industrial countries to the developing countries: some mention of the other industrial countries would seem desirable, and some of the proposed indicators regarding external

indebtedness would seem to be called for in that regard. Also in this context, would it not be possible (p.40) to single out those developing countries that are experiencing problems.

cc: Mr. Finch
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Tanzi
Mr. Whittome
✓ Mr. Wiesner



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1986 DEC 11 PM 12:17

EW
118
ID
F

TO: Mr. A. D. Crockett

December 10, 1986

FROM: François Gianviti F.G.

SUBJECT: Enhancing the Use of Indicators as a Tool for Surveillance
- Comments on Draft Paper

General Comments:

1. The central difficulty we find with the draft paper is well put as a question on page 7, but it is not answered satisfactorily. The question is what the indicators are intended to indicate, and, until this question is answered, the discussion necessarily lacks focus and cannot contribute much to the discharge of the Fund's responsibilities under Article IV.

2. The Fund has not yet adopted principles or procedures to give effect to its responsibility under Article IV, Section 3(a) to "oversee the international monetary system in order to ensure its effective operation." Until this is done, the discussion of indicators that might be helpful for promoting economic policy coordination is likely to remain a discussion of technical solutions in search of a purpose.

3. In present circumstances, that is, until the Fund takes the step forward to which the previous paragraph refers, the analytical framework can be of two kinds: a general study, such as the World Economic Outlook, or the exercise of Fund surveillance over the exchange rate policies of members, as referred to in Article IV, Section 3(b). The latter framework is what the draft paper refers to as "bilateral surveillance," but the term "bilateral" is misleading: it is country-specific surveillance by the Fund, which is a multilateral institution.

4. Insofar as the draft paper discusses Fund surveillance under Article IV, Section 3(b), it is striking that no reference is made to the Fund's experience with program design and performance criteria (see, e.g., EBS/86/211, September 8, 1986, and Supplements). This point is even more striking when consideration is given to extending the use of indicators, as discussed in the draft paper (pages 39-40), to members for which stand-by or extended arrangements are in effect. We are concerned about the risk of using differing compartmentalized economic models and appraisals affecting the Fund's advice to members, with the possibility of inconsistent advice based on different indicators. We are also concerned about casting doubt on the approach used in Fund arrangements.

5. There is a further point implicit in the question raised in the preceding paragraph. It is whether the approach used in Fund arrangements is not a better basis for policy coordination than the general indicator approach that is discussed in the draft paper. The obstacles of inconsistent national data, policies and preferences, as discussed in the draft paper, have not prevented the use of performance criteria in Fund arrangements. The comparison between these two levels of Fund experience provokes the more fundamental question whether coordination may not be more successfully structured on the basis of understandings on policies and their monitoring between the Fund and individual members than from a search for general agreement among members concerning these matters. Perhaps this question, which was raised in a previous paper (SM/86/3, pp. 20-23), may be given further consideration.

Specific Comments:

1. Page 4, last paragraph: The development of indicators to support efforts by countries participating in economic summit meetings is not mentioned in the communique referred to.
2. Page 18, second paragraph, third line from the end: "Incomes" does not seem correct.
3. Page 43, second paragraph, line 2: "acknowledged" by whom?
4. Page 46, second paragraph, line 4: Substitute "role" for "obligations."

cc: Mr. Finch
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Whittome
Mr. Wiesner
Mr. Rhomberg



Office Memorandum

WESTERN HEMISPHERE DEPT.
1986 DEC 10 AM 10:46

elt Wiesner
EW
STB
IO
F ✓

To: Mr. Crockett

December 9, 1986

From: L.A. Whittome / *LAW*

Subject: Enhancing the Use of Indicators as a Tool for Surveillance

I have an impression that international interest in this question is presently waning though it may revive later. If this presumption is correct it is important that the paper should have a focus if it is to be debated seriously, but I found myself unclear as to the direction in which your draft was attempting to push its readers. Perhaps you are just fulfilling a request for yet another paper and feel a need to keep the pot on the simmer but if this were to be our limited (though respectable aim) then I question whether the present draft does not risk alienating some readers by emphasizing the mass of problems which surround the issue.

I realize that at this stage the paper is de facto largely written but if the draft is intended to carry the discussion forward then there seem to be some changes, partly cosmetic, which could be reasonably readily accommodated. I would suggest:

1. Bringing the conclusions to the front, greatly condensing the introduction and so plunging more directly into the considerations that need to be borne in mind before seeking to answer the questions raised in the conclusion.

2. Seeking to choose between the relative importance of issues rather than seeming to treat all as of equal importance. If for instance the basic aims are those enshrined in Article I and if indicators could be one instrument for enhancing the achievement of these aims then certain matters such as real versus nominal and the country coverage issues become relatively minor matters that can be left for later decisions.

3. You need surely some assessment as to whether the extra work that could be involved in this exercise is practicable. You could seek to make it more manageable by bringing it firmly into the Article IV/WEO mold and keeping it there.

4. Incidentally although this might lead to some more serious redrafting we would question the heavy emphasis you place on the savings/investment balance in order to judge "unsustainability". We

suspect that this identity may be less useful today than it used to be in judging the sustainability of balance of payments positions if only because of the massive capital flows that can occur and seemingly can be sustained.

I attach a list of some more detailed points.

Attachment

cc: Mr. Finch
Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Rhomberg
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Wiesner

Annex

1. On a number of occasions it is stated that the principal focus of indicators should be the sustainability of balance of payments positions. Only once, on page 12, is it noted that this sustainability is compatible, at least over the medium-term horizon, with an indeterminate level of world-GNP and world trade growth. More specifically, if the medium-term is defined as three-five years, then the focus on balance of payments equilibrium would appear to bias the assessment of policies toward demand-management recommendations. This aspect would seem to warrant a more comprehensive discussion and could lead to a clearer focus of the issues involved and to some ranking of indicators.

2. Reference is made to "sensitive market variables" (e.g.; on p. 8 and p. 34) and is essentially limited to the exchange rate. This does not seem to be justified. Experience suggests that any findings or statement on crucial economic variables may lead to equally sharp gyrations of the exchange rate as an assessment of the exchange rate itself. Thus, the exclusion of the exchange rate from the list of indicators may imply an unnecessary restraint.

3. The short shrift that monetary policy and the growth of monetary aggregates get in the paper (relative to fiscal policy, see, e.g., p. 26) seems inappropriate, given the fact that adjustments in financial asset positions are a principal determinant of exchange rates and ultimately of competitiveness and the current account.

4. The problem of accuracy of medium-term projections (p. 24 sqq.) may be exaggerated and appears to apply only if a complete coverage is being sought. At least at the outset of a more comprehensive global surveillance exercise, an assessment of the general direction of developments and of likely effects of policies may be sufficient to assess consistency and compatibility within the system. This would be especially so, if there existed a clear ranking of indicators and if the number of principal indicators were strictly limited.

5. Monetary targeting is quoted as an example of "problems with a limited set of indicators" (p. 32). For two reasons this reference does not appear to be very useful for the selection of surveillance indicators. First, the literature on monetary indicators and intermediate targets quite explicitly points to the problems with multiple indicators, notably the problem of conflicting information and the uncertainty about policy reactions that may follow from such information. Second, unlike for monetary indicators, there will always be the need for some ranking of possible indicators in connection with surveillance indicators. Once this selection has been made, all other variables must have a subordinate characteristic. If not, the system will be overdetermined. While it may therefore be useful to collect information on a number of indicators, the majority of them will have to be analyzed

only for the purpose of consistency checks and as intermediate variables, the importance of which will depend on the economic problem that has been identified as the principal one at a given point in time.



Office Memorandum

Mr. Wiesner / Mr. Beza

EW
STB
EHC
ID
F

To: The Managing Director
The Deputy Managing Director

September 26, 1986

From: Wm. C. Hood *W.C.H.*

Subject: Policy Coordination Among Industrial Countries

Mr. Tanzi draws attention to the possibility that coordination of economic policies could be destabilizing if economic forecasts are wrong, and countries react in a synchronized fashion to the wrong forecast (his memo of 9/19/86). This is sometimes considered to be the "lesson" from the ill-starred locomotive episode of the Bonn Summit.

In fact, however, coordination need not and should not be seen as a search for a common and synchronized set of policies among the major countries. Rather, it is an attempt to find mutually supportive means of addressing points of tension in current trends.

In present circumstances, the goal of policy coordination has been to slow down domestic demand growth in the United States while strengthening it in Europe and Japan. Another point of coordination over the past eighteen months has been the goal of bringing about a realignment of exchange rates among the major currencies. These objectives are based on the forecast that divergences in current account balances would remain large, and the judgment that this situation was not sustainable. I do not believe that a continuation of the policy course that prevailed up to early 1984 would have produced a better prospect for the world economy.

- cc: Mr. Finch
- Mr. Narvekar
- Mr. Tanzi
- Mr. Whittome
- ✓ Mr. Wiesner/Mr. Beza
- Mr. Crockett
- Mr. Brown

1986 SEP 29 AM 10:31
INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

B. INFLATION RATES AND LABOR MARKET INDICATORS
(IN PERCENT)

DATE :SEPTEMBER 18, 1986

	AVERAGES OR YEAR-ON-YEAR CHANGES			END OF YEAR (Q4) OR THROUGH THE YEAR CHANGES		
	1985	1986	1987	1985 Q4	1986 Q4	1987 Q4
<u>GNP/GDP DEFLATOR</u>						
UNITED STATES	3.4	2.8	3.4	3.3	2.8	3.5
JAPAN	1.7	1.8	1.2	1.7	1.6	1.5
GERMANY, FED. REP. OF	2.2	2.8	1.6	2.4	2.3	2.2
FRANCE	5.8	4.5	3.4	6.5	3.4	3.1
UNITED KINGDOM	6.1	3.8	3.7	7.4	3.5	3.9
FIVE COUNTRIES	3.3	2.8	2.8	3.5	2.6	3.0
<u>CONSUMER PRICES</u>						
UNITED STATES	3.5	2.0	3.5	3.5	1.6	4.0
JAPAN	2.1	0.5	0.5	1.9	-0.3	1.3
GERMANY, FED. REP. OF	2.2	-0.2	1.5	1.8	-0.5	2.5
FRANCE	5.8	2.7	2.7	4.8	2.6	2.0
UNITED KINGDOM	6.1	3.4	3.8	5.5	3.3	4.0
FIVE COUNTRIES	3.5	1.6	2.6	3.3	1.2	3.1
<u>UNIT LABOR COSTS IN MANUFACTURING</u>						
UNITED STATES	0.6	1.1	1.4	0.5	1.2	2.0
JAPAN	0.5	4.3	1.6	2.5	4.1	2.3
GERMANY, FED. REP. OF	0	3.0	1.5	1.9	1.4	3.2
FRANCE	2.2	1.0	0.3	0.5	1.3	1.0
UNITED KINGDOM	6.0	6.1	4.5	6.1	4.5	4.5
FIVE COUNTRIES	1.1	2.2	1.6	1.4	2.0	2.3
<u>UNEMPLOYMENT RATE 1/</u>						
UNITED STATES	7.2	6.9	6.5	7.0	6.7	6.5
JAPAN	2.6	2.8	3.0	2.8	3.0	3.0
GERMANY, FED. REP. OF	8.2	7.9	7.5	8.1	7.6	7.4
FRANCE	10.4	10.7	10.7	10.5	10.7	10.8
UNITED KINGDOM	11.3	11.6	11.5	11.3	11.6	11.4
FIVE COUNTRIES	6.8	6.8	6.6	6.8	6.7	6.5
<u>GROWTH OF EMPLOYMENT 2/</u>						
UNITED STATES	2.0	2.4	2.5	1.9	2.6	2.3
JAPAN	0.7	0.6	0.6	0.1	0.7	0.9
GERMANY, FED. REP. OF	0.8	1.3	1.0	0.9	1.5	0.8
FRANCE	-0.3	0.2	0.5	-0.3	0.3	0.5
UNITED KINGDOM	1.3	0.4	0.4	1.2	0.2	0.5
FIVE COUNTRIES	1.3	1.4	1.5	1.1	1.6	1.5

1/ DATA ARE BASED ON NATIONAL DEFINITIONS AND ARE NOT DIRECTLY COMPARABLE ACROSS COUNTRIES. FOR THE UNITED STATES DATA ARE FOR CIVILIAN LABOR FORCE; FOR FRANCE DATA ARE FOR RESIDENT LABOR FORCE; FOR THE UNITED KINGDOM UNEMPLOYMENT DATA EXCLUDE SCHOOL LEAVERS; FOR JAPAN, THE FEDERAL REPUBLIC OF GERMANY AND THE UNITED KINGDOM DATA ARE BASED ON TOTAL LABOR FORCE.

2/ FOR THE UNITED STATES DATA ARE FOR CIVILIAN EMPLOYMENT; FOR JAPAN DATA INCLUDE SELF-EMPLOYED; FOR THE FEDERAL REPUBLIC OF GERMANY AND THE UNITED KINGDOM DATA ARE FOR DEPENDENT EMPLOYMENT; FOR FRANCE DATA ARE FOR NON-FARM EMPLOYMENT.

	AVERAGES OR YEAR-ON-YEAR CHANGES			END OF YEAR (Q4) OR THROUGH THE YEAR CHANGES		
	1985	1986	1987	1985 Q4	1986 Q4	1987 Q4
<u>CENTRAL GOVERNMENT BALANCE (IN PERCENT OF GNP/GDP) 1/</u>						
UNITED STATES	-5.0	-4.8	-3.1			
JAPAN	-4.4	-4.4	-4.6			
GERMANY, FED. REP. OF	-1.1	-0.8	-0.8			
FRANCE	-3.3	-2.9	-2.6			
UNITED KINGDOM	-2.4	-2.5	-2.4			
FIVE COUNTRIES	-4.2	-4.0	-3.1			
<u>GENERAL GOVERNMENT BALANCE (IN PERCENT OF GNP/GDP) 2/</u>						
UNITED STATES	-3.4	-3.6	-2.0			
JAPAN	-1.6	-1.7	-2.0			
GERMANY, FED. REP. OF	-1.1	-0.8	-0.8			
FRANCE	-2.6	-2.5	-2.5			
UNITED KINGDOM	-3.1	-2.9	-2.9			
FIVE COUNTRIES	-2.7	-2.8	-2.0			
<u>MONETARY GROWTH RATES: TARGET OR FORECASTED AGGREGATE (IN PERCENT)</u>						
UNITED STATES (M2)	9.1	8.0	9.0	8.7	9.0	8.3
JAPAN (M2+CD)	8.4	8.4	7.5	8.7	8.0	7.0
GERMANY, FED. REP. OF (CBM)	4.5	5.6	4.9	4.2	6.0	5.5
FRANCE (M3)	7.3	5.3	5.0	5.5	5.0	5.0
UNITED KINGDOM (M0)	4.6	3.3	3.0	2.4	3.0	3.0

1/ DATA FOR JAPAN INCLUDE THE SURPLUS OF THE SOCIAL SECURITY ACCOUNTS AND NET LENDING BY THE FISCAL INVESTMENT AND LOAN PROGRAM (FILP) TO NONFINANCIAL PUBLIC ENTITIES. DATA FOR FRANCE ARE ON AN ADMINISTRATIVE BASIS AND DO NOT INCLUDE SOCIAL SECURITY TRANSACTIONS. DATA FOR OTHER COUNTRIES ARE ON A NATIONAL INCOME ACCOUNTS BASIS. (SEE GENERAL NOTE TO TABLE A.)

2/ NATIONAL INCOME ACCOUNTS BASIS. (SEE GENERAL NOTE TO TABLE A.)

D. INTEREST RATES
(IN PERCENT)

	1985	1986	1987
<u>SHORT-TERM — NOMINAL 1/</u>			
UNITED STATES	7.5	6.0	6.1
JAPAN	6.7	5.0	4.5
GERMANY, FED. REP. OF	5.4	4.6	4.8
FRANCE	10.1	7.4	7.0
UNITED KINGDOM	10.8	9.2	8.5
<u>SHORT-TERM — REAL 2/</u>			
UNITED STATES	4.1	3.4	2.6
JAPAN	5.0	4.2	3.5
GERMANY, FED. REP. OF	3.3	3.1	2.9
FRANCE	4.0	4.0	3.9
UNITED KINGDOM	4.7	5.4	4.6
<u>LONG-TERM — NOMINAL 3/</u>			
UNITED STATES	10.6	7.6	7.7
JAPAN	6.3	5.0	5.0
GERMANY, FED. REP. OF	6.9	5.8	5.7
FRANCE	10.9	8.1	7.8
UNITED KINGDOM	10.6	9.0	8.5
<u>LONG-TERM — REAL 2/</u>			
UNITED STATES	7.1	4.9	4.2
JAPAN	4.6	4.2	4.0
GERMANY, FED. REP. OF	4.8	4.3	3.8
FRANCE	4.8	4.7	4.7
UNITED KINGDOM	4.5	5.2	4.6

1/ INTEREST RATE ON THE FOLLOWING INSTRUMENTS: UNITED STATES, THREE-MONTH TREASURY BILLS; JAPAN, TWO-MONTH PRIVATE BILLS; FEDERAL REPUBLIC OF GERMANY, FRANCE AND UNITED KINGDOM, THREE-MONTH INTERBANK DEPOSIT RATE.
 2/ NOMINAL INTEREST RATE LESS THE AVERAGE OF THE CHANGE IN THE GNP/GDP DEFLATOR AND THE DOMESTIC DEMAND DEFLATOR.
 3/ AVERAGE YIELD TO MATURITY ON THE FOLLOWING BONDS: UNITED STATES, 10-YEAR GOVERNMENT BONDS; JAPAN, GOVERNMENT 7-YEAR BONDS; FEDERAL REPUBLIC OF GERMANY, PUBLIC BONDS WITH THREE OR MORE YEARS TO MATURITY; FRANCE, LONG-TERM CENTRAL GOVERNMENT BONDS; UNITED KINGDOM, 20-YEAR GOVERNMENT BONDS.

E. SAVINGS AND INVESTMENT RATIOS
(IN PERCENT OF GNP/GDP)

	1985	1986	1987
<u>SAVING 1/</u>			
UNITED STATES	17.2	17.8	17.7
JAPAN	27.3	27.8	27.9
GERMANY, FED. REP. OF	19.7	20.6	20.2
FRANCE	17.3	18.7	19.3
UNITED KINGDOM	21.6	20.5	20.0
FIVE COUNTRIES	19.7	20.2	20.4
<u>INVESTMENT 2/</u>			
UNITED STATES	16.5	16.1	17.1
JAPAN	28.2	28.1	28.9
GERMANY, FED. REP. OF	20.3	20.2	21.1
FRANCE	15.9	15.7	16.2
UNITED KINGDOM	16.1	16.5	17.0
FIVE COUNTRIES	19.0	18.8	19.9

1/ PRIVATE SECTOR.

2/ DATA FOR JAPAN AND FEDERAL REPUBLIC OF GERMANY PERTAIN TO WHOLE ECONOMY. DATA FOR OTHER COUNTRIES PERTAIN TO PRIVATE SECTOR.

F. BALANCE OF PAYMENTS AND RESERVE CHANGES

DATE :SEPTEMBER 18, 1986

	AVERAGES OR YEAR-ON-YEAR CHANGES		
	1985	1986	1987
<u>CURRENT ACCOUNT (IN BILLIONS OF U.S. DOLLARS, EXCEPT IF OTHERWISE NOTED)</u>			
UNITED STATES	-117.7	-123.0	-123.0
JAPAN	49.2	82.7	74.1
GERMANY, FED. REP. OF	13.3	30.8	25.5
FRANCE	-0.1	5.5	6.5
UNITED KINGDOM	4.9	2.3	-1.3
FIVE COUNTRIES	-50.4	-1.8	-18.2
<u>CURRENT ACCOUNT AS PERCENTAGE OF GNP/GDP</u>			
UNITED STATES	-2.9	-2.9	-2.7
JAPAN	3.7	4.1	3.3
GERMANY, FED. REP. OF	2.1	3.4	2.5
FRANCE	0	0.8	0.8
UNITED KINGDOM	1.1	0.4	-0.2
FIVE COUNTRIES	-0.7	0	-0.2
<u>MERCHANDISE EXPORTS (FOB)</u>			
UNITED STATES	214.4	227.2	268.6
JAPAN	174.0	201.9	203.0
GERMANY, FED. REP. OF	175.0	234.0	259.8
FRANCE	100.9	124.1	138.1
UNITED KINGDOM	101.2	108.5	117.7
FIVE COUNTRIES	765.5	895.8	987.2
<u>MERCHANDISE IMPORTS (FOB)</u>			
UNITED STATES	338.9	368.0	405.2
JAPAN	118.0	116.2	124.9
GERMANY, FED. REP. OF	145.7	179.4	201.4
FRANCE	104.2	122.5	135.3
UNITED KINGDOM	103.9	116.4	128.3
FIVE COUNTRIES	810.7	902.5	995.0
<u>TRADE BALANCE (FOB/FOB)</u>			
UNITED STATES	-124.4	-140.9	-136.7
JAPAN	56.0	88.7	78.1
GERMANY, FED. REP. OF	29.2	54.7	58.4
FRANCE	-3.3	1.7	2.9
UNITED KINGDOM	-2.7	-7.9	-10.5
FIVE COUNTRIES	-45.2	-3.7	-7.8

	AVERAGES OR YEAR-ON-YEAR CHANGES		
	1985	1986	1987
<u>VOLUME OF MERCHANDISE EXPORTS (CHANGE, IN PERCENT)</u>			
UNITED STATES	0.8	5.5	11.5
JAPAN	4.4	-3.0	-8.2
GERMANY, FED. REP. OF	6.4	2.4	3.1
FRANCE	1.7	1.5	2.5
UNITED KINGDOM	6.8	2.2	2.0
FIVE COUNTRIES	3.8	2.0	2.6
<u>VOLUME OF MERCHANDISE IMPORTS (CHANGE, IN PERCENT)</u>			
UNITED STATES	4.5	10.2	3.9
JAPAN	0.4	7.4	7.9
GERMANY, FED. REP. OF	4.5	8.5	4.8
FRANCE	4.9	6.0	5.7
UNITED KINGDOM	5.5	2.7	5.5
FIVE COUNTRIES	4.0	8.0	5.1
<u>CAPITAL ACCOUNT, EXCL. RES. CHGS. (IN BILLIONS OF U.S. DOLLARS) 1/</u>			
UNITED STATES	102.7		
JAPAN	-64.5		
GERMANY, FED. REP. OF	-16.1		
FRANCE	2.4		
UNITED KINGDOM	7.1		
FIVE COUNTRIES	31.7		
<u>CHANGE IN LEVEL OF GROSS RESERVES (IN BILLIONS OF U.S. DOLLARS)</u>			
UNITED STATES	3.9		
JAPAN	0.2		
GERMANY, FED. REP. OF	0.7		
FRANCE	6.4		
UNITED KINGDOM	-0.2		
FIVE COUNTRIES	11.0		

1/ DATA COVERAGE: THE UNITED STATES, PRIVATE CAPITAL, EXCLUDING ERRORS AND OMISSIONS; JAPAN, LONG-TERM CAPITAL; FEDERAL REPUBLIC OF GERMANY, EXCLUDING ERRORS AND OMISSIONS.

G. EXCHANGE RATES

DATE : SEPTEMBER 18, 1986

	1985	1986	1987	1985 Q4	1986 Q4	1987 Q4
<u>NATIONAL CURRENCY PER U.S. DOLLARS — NOMINAL</u>						
UNITED STATES	1.00	1.00	1.00	1.00	1.00	1.00
JAPAN	236.74	165.85	152.43	206.93	154.01	151.14
GERMANY, FED. REP. OF	2.92	2.17	2.01	2.58	2.03	2.00
FRANCE	8.99	6.94	6.66	7.88	6.68	6.65
UNITED KINGDOM	0.77	0.67	0.68	0.70	0.67	0.68
<u>U.S. DOLLARS PER NATIONAL CURRENCY — REAL</u>						
UNITED STATES	100.0	100.0	100.0	100.0	100.0	100.0
JAPAN	100.0	141.4	151.3	114.7	152.3	152.3
GERMANY, FED. REP. OF	100.0	134.5	142.9	113.7	143.9	143.9
FRANCE	100.0	130.3	135.7	114.8	136.9	136.9
UNITED KINGDOM	100.0	115.4	116.1	112.6	117.3	117.3
<u>EFFECTIVE (MERM WEIGHTS) — NOMINAL</u>						
UNITED STATES	100.0	81.5	78.2	91.5	78.3	78.3
JAPAN	100.0	128.1	136.9	109.0	135.2	138.1
GERMANY, FED. REP. OF	100.0	110.5	114.9	103.9	113.5	115.8
FRANCE	100.0	105.6	105.7	104.5	105.3	105.8
UNITED KINGDOM	100.0	94.1	89.7	102.1	90.9	89.0
<u>EFFECTIVE (MERM WEIGHTS) — REAL</u>						
UNITED STATES	100.0	80.9	77.8	91.2	77.8	77.8
JAPAN	100.0	126.1	132.3	108.3	132.3	132.3
GERMANY, FED. REP. OF	100.0	109.2	111.6	103.3	111.6	111.6
FRANCE	100.0	106.2	106.1	104.8	106.1	106.1
UNITED KINGDOM	100.0	94.2	91.2	102.4	91.2	91.2

NOTE: EXCHANGE RATES ARE ASSUMED TO REMAIN UNCHANGED IN REAL TERMS (AS MEASURED BY GNP/GDP DEFLATORS) FROM THE LEVEL PREVAILING IN THE TWO WEEKS ENDING SEPTEMBER 5, 1986.



Office Memorandum

EW
STB
F

To: Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Whittome
✓ Mr. Wiesner/Mr. Beza

September 16, 1986

From: E. Whitely EW.

Subject: Managing Director's Note to Interim Committee on Indicators

Mr. Crockett has asked me to circulate the attached section of the Managing Director's note to the Interim Committee under Item 5a of the proposed agenda. The note has been prepared in collaboration with ETR, and Mr. Crockett, who is away, has dictated additional changes to me over the telephone. He would be grateful to receive comments by close of business Thursday, September 18.

Attachment

cc: Mr. Hood (o/r)
Mr. Van Houtven
Mr. Crockett

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1986 SEP 16 PM 6:04

September 16, 1986

Issues in the Reform of the International Monetary System

(Note Submitted by Managing Director)

I. Indicators of Economic Policies and Performance

1. Background

The communique issued following the April 1986 meeting of the Interim Committee contained the following statement:

"... To improve the multilateral setting for surveillance, the Committee asked the Executive Board to consider ways in which its regular reviews of the world economic situation could be further adapted to improve the scope for discussing external imbalances, exchange rate developments, and policy interactions among members. An approach worth exploring further was the formulation of a set of objective indicators related to policy actions and economic performance, having regard to a medium-term framework. Such indicators might help to identify a need for discussion of countries' policies. The Committee noted that increased emphasis would be given in the World Economic Outlook to policy interactions among industrial countries in order to strengthen the basis for assessing the international repercussions of the policies and objectives of the major industrial countries, and also to help promote the further development of recent initiatives to enhance policy coordination among these countries."

In accordance with the Committee's request, the Executive Board held a first discussion on the use of indicators in implementing Fund surveillance on July 14, 1986, on the basis of a staff paper on the subject. The World Economic Outlook papers produced subsequently

and considered by the Board on September 10-12, were prepared in the light of this discussion.

2. Views expressed by Directors

Although the two discussions that have taken place in the Board have been of a preliminary character, certain broad lines of agreement can be discerned. First, it is accepted that the process of developing an appropriate role for indicators should be a gradual one: a search for too much precision at an early stage would be a mistake. Second, indicators must be complemented with judgment: the exercise should not be allowed to become mechanistic. Third, the ultimate objective of indicators is to help guide governments' policies into consistent and mutually beneficial directions: thus the analysis should not be seen as an end in itself. And fourth, no surveillance will be effective unless it is grounded in an increased political will to frame domestic policies in the light of international considerations.

It is also agreed that the central focus of surveillance should be on how developments in the policies and economic performance of individual major countries affect the opportunities and constraints faced by other countries. The principal point of direct interaction between national economies is trade and capital flows. Thus it is these flows, and the factors that determine them, that should receive attention in the development of indicators and the discussion of international economic interdependence. Of course, domestic variables such as demand growth, inflation, and the stance of monetary and fiscal policies, have a major effect on the international transmission of economic influences. It is thus of key importance to examine these indicators also, to assess

their sustainability over time and their international compatibility across countries.

Concerning the specific variables to be used in analysis, it is accepted that attention needs to be given to real and nominal GDP growth, and also to the structure of demand underlying that growth (in particular, the relationship between domestic and external demand components). Inflation is also viewed as an important indicator, although it is recognized that there are different ways of defining inflation that may sometimes provide differing impressions of the extent of underlying price pressures. Other domestic variables that it was considered useful to monitor, included developments in unemployment and the trend of domestic saving and investment ratios.

With respect to the balance of payments, there was no dissent from the view that the current account balance should be a primary focus of attention. It is clear, however, that information on current account balances can usefully be complemented by judgments based on, inter alia, data on capital flows and trade balances. Moreover, developments in exchange rates are clearly an important indicator; exchange rate volatility or misalignment can reveal inconsistencies or divergences in economic policies and performance among countries.

Directors also agreed on the importance of monitoring satisfactorily policy variables. In this regard, developments in fiscal deficits and rates of growth of monetary aggregates were seen as being of key significance. Real and nominal interest rates can provide supplemental information

on the impact of macro-economic policy, and are also important for their direct influence on conditions in foreign exchange markets. It was also thought desirable to pay attention to structural policies and trade and exchange restrictions, though it was recognized that developments in these fields were harder to quantify.

The various indicators noted above could be brought together in an assessment of the sustainability of existing balance of payments patterns and exchange rate positions. The staff proposed an analytical framework in which the medium-term payments positions projected on the basis of current policies and current exchange rates would be compared with balances that would be associated with a "desired" setting of domestic policies and the savings and investment propensities of the private sector. Directors generally felt that this broad approach could be helpful, but that it should be applied in a flexible way, to provide scope for judgmental assessments.

3. Indicators in the World Economic Outlook

The World Economic Outlook papers considered by the Executive Board earlier this month contained a first approach to a more systematic use of indicators. The staff attempted to assess the implications for current account balances of the existing set of real exchange rates, given plausible assumptions about the stance of policies and about the growth of demand and output. The implications of such a pattern of payments balances for the buildup of international creditor/debtor positions were also explored.

Directors generally welcomed the staff analysis and considered that it helped sharpen the focus of their discussion of policy interactions. They encouraged the staff to continue to develop the analytical techniques they had employed. Some Directors expressed the view that indicators should be used as a more specific guide for policy formulation. They felt that it would be useful to develop "norms" for policy indicators, that would both provide guidance for the medium-term orientation of policies and also act as a trigger for discussions when developments diverged from expectations. On the other hand, some other Directors felt that the analytical framework used by the staff was still too uncertain to be a satisfactory basis for reaching policy judgments. For example, it could be considered that domestic savings/investment balances were a largely passive reflection of shifts in external balances caused by other factors. If that were so, a focus on the factors determining domestic savings/investment balances would be misplaced in an analysis aimed at how to correct external deficits and surpluses.

4. Issues for the Committee

These first discussions by the Executive Board of the concept of objective indicators and of its initial implementation in the context of the World Economic Outlook have highlighted the complexities and potential of objective indicators. Guidance from the Committee would be particularly helpful at this stage in directing the further work of the Executive Board and staff in this respect.

A first issue concerns the focus and list of indicators. The approach outlined by the staff and generally endorsed by the Board stresses that international consistency and compatibility of external payments position are the proper focus of surveillance and, thus also, of objective indicators. A specific question in this respect concerns the usefulness of the concept of savings/investment balances, suitably qualified, and of developments in underlying economic variables and policies in providing a helpful perspective on causes of external payments disequilibria.

A second issue concerns the use of indicators. The purpose of objective indicators is to strengthen the process of multilateral surveillance, helping influence governments to adopt policies beneficial not only to themselves but also to the international community. A specific question in this context is whether there is a greater role for "norms" in evaluating the development of policy indicators.

A third issue concerns the possible role of indicators in the implementation of bilateral surveillance under Article IV. Indicators could help assess the consistency of national forecasts and objectives, both internationally against the objectives of other countries and, internally, against the policy measures used to reach those objectives. A question which could be addressed is whether the greater specificity and quantification implied by the use of objective indicators could help strengthen the process of bilateral consultations as well. Apart from the issue of whether "norms" should be developed, the question could also be considered of whether developments in those variables and policies

used as objective indicators could help strengthen the continuous monitoring of members' policies and of their effects.

A fourth issue is whether the use of indicators in the context of the World Economic Outlook should be extended to countries outside the major industrial group.

This list of issues is by no means exhaustive, and Committee members may also wish to comment on related matters of particular interest to them or their constituencies.



Office Memorandum

FILE COPY

EW
STB
IO

*Byrlong Rater
(Surveillance)*

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1986 SEP -8 AM 10: 07

To: Mr. C. David Finch

September 5, 1986

From: François Gianviti *F.G.*

Subject: Termination of Enhanced Surveillance for a Member Country

I have the following comments on your draft of August 28, 1986:

1. Termination of enhanced surveillance can take place in the following circumstances.

(a) Enhanced surveillance will be terminated when the period for which it was approved expires.

(b) As the Fund is performing a service at the request and for the benefit of the member, the member can decide to terminate enhanced surveillance at any time.

(c) An existing procedure would also be terminated if the Fund should approve a new request from the same member for enhanced surveillance.

(d) Approval of a request by the member under enhanced surveillance for use of the Fund's resources would in some cases supersede the prior decision approving enhanced surveillance, but it is preferable to clarify the member's intentions in this regard. For example, enhanced surveillance would normally be terminated or suspended when the member uses Fund resources under an upper credit tranche stand-by or an extended arrangement. This would not be the case for a SAF arrangement, because SAF arrangements are subject to first credit tranche conditionality and hence do not provide for performance criteria and phasing on the basis of which the Fund's certification of purchases assists members with commercial banks and other creditors. The same point applies also to first credit tranche purchases and arrangements.

(e) In certain circumstances, the Fund can terminate enhanced surveillance without the member's consent.

Such would be the case when it has become impossible to implement the agreed procedure, for instance because the member is not cooperating in the preparation of the staff reports for the purposes of enhanced surveillance (such as by refusing to receive Fund missions) or because the member fails to present a quantified policy program.

The Fund could also terminate enhanced surveillance if the MYRA itself has been terminated, since the basis for enhanced surveillance would then have disappeared. If, however, in spite of negative appraisals by the Fund staff, the member's creditors did not take any action to terminate the MYRA, the Fund would not be justified to terminate enhanced surveillance.

A more difficult question is whether an adequate program is a condition, at all times, for the continuation of enhanced surveillance. Obviously, an adequate program is a condition for the initial decision to approve the member's request for enhanced surveillance, but the Fund has not yet considered whether this condition should continue to apply after the initial decision.

Unsatisfactory performance under a program would not justify the termination by the Fund of enhanced surveillance. The Fund would not observe the obligation that it has undertaken when it approved the member's request for enhanced surveillance, if it terminated the procedure against the wishes of the member because the member's policies have deteriorated.

(f) Enhanced surveillance should not be terminated by the Fund solely at the request of the member's creditors. If, however, the creditors terminate the MYRA, it would justify the termination of enhanced surveillance by the Fund.

Different from a request by the creditors is the question of the creditors' consent to the termination of enhanced surveillance. From the point of view of the Fund, the consent of the member's creditors is not required for the termination of enhanced surveillance. At the same time, the member may be in default to its creditors under the MYRA if the continuation of enhanced surveillance was a condition under the MYRA.

2. When the member notifies the Fund of its decision to terminate enhanced surveillance, the Board should be informed of the termination, but no Board decision is necessary. In contrast, a Board decision is required in cases of termination or suspension at the initiative of the Fund.

3. At present there is no decision of the Fund under which a member may make Fund documents on its use of Fund resources available to creditors. If such an authorization were desired by the member, a request to the Executive Board would be appropriate.

cc: Mr. Whittome
✓ Mr. Wiesner
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Beza



Office Memorandum

TO: Mr. Beza

DATE: September 4, 1986

FROM: O. Evans ^(O'Brien)

SUBJECT: Impact of Liberalization of Agricultural Policies
in Industrial Countries

As requested, I have looked into the question of the likely impact of a broad-based liberalization of agricultural policies in industrial countries. This note provides an initial response, which I shall supplement when various World Bank research papers on agricultural policy issues reach my desk, as has been promised to me.

The first question is the extent of protection of agriculture in industrial countries. The simplest measure is the so-called "nominal protection coefficient (NPC)"--the ratio of the domestic price to the border price for a given country and commodity. Because of a variety of measurement difficulties, and because industrial country agricultural policies influence both domestic and world prices, these figures need to be interpreted cautiously. Nevertheless some conclusions can be drawn from NPC figures, which are shown in the attached table. First, dairy, rice, and sugar farmers receive generous support in most industrial countries. Second, Japanese and European farmers are the most highly protected in industrial countries, with those in the United States receiving considerably less protection. These figures do not permit firm conclusions about the impact of across-the-board liberalization of agricultural policies, as such liberalization would not only equalize domestic and border prices but would also markedly influence world prices as well. Nevertheless it is clear that European and Japanese farmers would have more to lose.

One major study of the potential effects of agricultural liberalization was conducted by Valdes and Zietz. ^{1/} It examined the results of a hypothetical 50 percent reduction across the board in tariffs and other trade barriers on 99 agricultural commodities in 17 OECD countries, based on data for 1975-77. Subject to the usual qualifications, the results were that LDC export earnings would rise by about 11 percent above the control solution, or by enough to finance close to 40 percent of LDC cereal imports. The major increases in industrial country agricultural exports would occur in the United States, Canada, Australia, and New Zealand, while France and Italy would experience a substantial reduction in agricultural exports. In addition, Japan, Germany, the United Kingdom, and Italy would undergo a substantial increase in the value of agricultural imports. Since the extent of protection for agriculture has increased substantially since this study, one would expect that the results of a similar study on more current

^{1/} A. Valdes and J. Zietz "Agricultural Protection in OECD Countries: its Cost to Less Developed Countries" Research Report 21 International Food Policy Research Institute, December 1980.

data would indicate even more pronounced effects. The qualitative message is clearly that the chief beneficiaries (in terms of increased exports or reduced imports) of a large scale liberalization of agricultural trade would be the LDCs, the United States, Australia, New Zealand, and Canada, at the expense of Europe and Japan.

A later study by the same authors 1/ examined the potential effects of trade liberalization in wheat, maize, beef, and sugar. The results indicated that trade liberalization in cereals would likely lead to a net welfare loss for LDCs as a whole--though particular countries would of course gain. Most of the gains from trade liberalization in cereals would accrue to the United States, Canada, and Australia, at the expense of the EC countries. Trade liberalization with respect to sugar and beef would by contrast yield substantial welfare benefits to LDCs, with the benefits from trade liberalization in sugar going to LDCs almost exclusively. Among the developed countries, Australia and the United States would have by far the most to gain from trade liberalization in beef. The changes in the pattern of exports and imports across industrial countries would be qualitatively similar to the earlier study.

Another major study 2/ was prepared for the 1986 World Development Report. This paper simulated the effects of unilateral trade liberalizations by individual countries or groups of countries, as well as of simultaneous liberalization by both industrial and developing countries. In particular, the authors examined unilateral liberalization by the EC, Japan, and the United States; multilateral liberalization by all industrial countries and global liberalization. In all cases, the volume of world trade would rise and in most cases world prices would rise. However, the study indicates that U.S. agricultural liberalization would reduce world prices slightly because ending acreage controls would increase output of grains and rice. It is not clear what assumptions were made in the liberalization scenarios about the disposition of current U.S. and European excess agricultural stocks. If liberalization entailed the disposal of these stocks on the world market, presumably over an extended transition period, then one would expect agricultural prices to be substantially lower than otherwise over this period. The study indicates that the main beneficiaries of liberalization would be the liberalizers themselves. Unfortunately, but perhaps not surprisingly, the World Development Report does not tell us about the distribution of the effects as between different groups of industrial countries. Nevertheless, the efficiency gains to industrial

1/ "The Costs of Protectionism to Developing Countries: an Analysis for Selected Agricultural Products" World Bank Staff Working Paper No. 769, January 1986.

2/ Tyers, R. and Anderson, K. "Distortions in World Food Markets: a Quantitative Assessment", background paper prepared for the 1986 World Development Report. Thus far, I have only the Development Report citations of this study; the detailed document itself will apparently be made available soon.

countries as a whole from a liberalization of their own agricultural policies are calculated at \$49 billion (1980 prices). 1/

In sum, the available studies, though subject to various qualifications, provide support for the judgement that a substantial liberalization of industrial country agricultural policies would be likely to produce substantial welfare gains for the world economy as a whole. Because of the inherent inefficiencies of these programs, much of the welfare gains would accrue to the liberalizers themselves though there would be losers as well as gainers. The pattern of world agricultural trade would be shifted in the direction of common sense notions of comparative advantage, with Japan and Europe producing and exporting less, and importing more, while the LDCs as a group--with individual country exceptions--together with the United States, Canada, Australia, and New Zealand would export more and import less.

The studies which have been conducted, while the best available, are necessarily open to various criticisms since they rely largely on numerical simulation of large theoretical models with assumed parameters. The results compare a constructed post-liberalization equilibrium with the pre-liberalization position, and thus do not seem to address directly the issue of how to dispose of existing surplus stocks of agricultural commodities--a question which would be at the forefront of any actual negotiations.

Attachment

cc: Mr. Hernández-Catá (o/r)
Mr. Horiguchi (o/r)

1/ The Report notes that this is almost twice annual ODA spending by these countries over the 1980-84 period.

Table 1. Nominal Protection Coefficients for Producer and Consumer Prices
of Selected Commodities in Industrial Countries, 1980-82

	Wheat		Coarse Grains		Rice		Dairy		Sugar		Weighted Average ^{4/}	
	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC	Producer NPC	Consumer NPC
Australia	1.04	1.08	1.00	1.00	1.15	1.75	1.30	1.40	1.00	1.40	1.04	1.09
Canada	1.15	1.12	1.00	1.00	1.00	1.00	1.95	1.95	1.30	1.30	1.17	1.16
EC ^{1/}	1.25	1.30	1.40	1.40	1.40	1.40	1.75	1.80	1.50	1.70	1.54	1.56
Other Europe ^{2/}	1.70	1.70	1.45	1.45	1.00	1.00	2.40	2.40	1.80	1.80	1.84	1.81
Japan	3.80	1.25	4.30	1.30	3.30	2.90	2.90	2.90	3.00	2.60	2.44	2.08
United States	<u>1.15</u>	<u>1.00</u>	<u>1.00</u>	<u>1.00</u>	<u>1.30</u>	<u>1.00</u>	<u>2.00</u>	<u>2.00</u>	<u>1.40</u>	<u>1.40</u>	<u>1.16</u>	<u>1.17</u>
Weighted average ^{3/}	1.19	1.20	1.11	1.16	2.49	2.42	1.88	1.93	1.49	1.68	1.40	1.43

Source: World Bank World Development Report 1986, pp. 112 and 113.

^{1/} Excluding Greece, Portugal, and Spain.

^{2/} Austria, Finland, Norway, Sweden, and Switzerland.

^{3/} Also including New Zealand.

^{4/} Also including beef and lamb and pork and poultry.



Office Memorandum

1986 SEP -2 AM 9: 58

De Beza
Exchange file
Patent (surveillance)

To: Mr. Finch August 29, 1986
From: L. A. Whittome; *W*
Subject: Termination of Enhanced Surveillance for a Member Country

Thank you for your draft memorandum. The problem is a real one and the draft makes a sensible effort to confront it. I realize your memo is an attempt to put together an interim answer in advance of the upcoming Board discussion, but even so it could with advantage push the thinking further.

(1) First I think that clarity would be helpful if the draft were to separate what in my mind are the three broad reasons which might lead to a desire to discontinue enhanced surveillance:

- (a) restoration of normal relations with creditors, so making enhanced surveillance unnecessary;
- (b) patent noncooperation with the Fund; or
- (c) use of Fund resources.

Virtually all of your draft is concerned with a member who subsequently makes use of Fund resources, whereas the most difficult case is that of noncooperation. I do not mean to suggest that the memo at this stage should seek to cover all eventualities, but virtual silence begs a lot of questions. Noncooperation could either be taken as meaning not following the procedures for enhanced surveillance (as apparently is the case with Venezuela) or following the procedures but continually ignoring the substance, e.g. the policy recommendations. In these circumstances, there is an important prior legal question of whether the Fund could unilaterally decide to cease enhanced surveillance even if the member were to say that it wanted it continued. There is also the further practical question of whether the Board would decide to discontinue enhanced surveillance for reasons of noncooperation if in fact the authorities were to argue for its continuation.

Then there are a series of questions concerning the legal and practical implications that would arise if a member were to seek unilaterally to terminate enhanced surveillance. This could either be because the member considered that normal creditor relations had been restored or because it preferred termination to noncooperation. Presumably the Board could take a legal decision that in essence would acquiesce to the request. This might, however, leave the commercial banks unhappy but that presumably should be treated by us as a matter for the member and the banks unless the banks had grounds for arguing that they were misled by the seeming permanence of enhanced surveillance.

As regards termination because the member makes use of Fund resources, some questions come to mind: (a) should we refer to the fact that use of resources "is requested" or "is granted"? (b) Does use of resources apply equally to SBAs, CFFs, and SAFs? In my own mind, I would see a difference between SBAs and CFFs, with SAFs probably needing to be classified with SBAs, anyway for the time being!

(2) The provision of Fund documents to commercial banks after the termination of enhanced surveillance is a separate issue. Once enhanced surveillance has ended, strictly speaking the Fund's obligation to prepare reports that can be transmitted to the banks has also ended; there are by definition no "enhanced surveillance papers." However, we will continue to be faced with the long standing problem of the fact that consultation and stand-by papers are in some cases made available to the banks and this practice may grow as banks have become accustomed to receiving Fund papers. As you note, in the case of new stand-by arrangements, provision of documents may be crucial to obtain new bank money, and this practice may be very difficult to contain.

cc: Mr. Gianviti
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Wiesner/Mr. Beza

Exchange letter?

EBS/86/197

CONFIDENTIAL

August 22, 1986

To: Members of the Executive Board

From: The Acting Secretary

Subject: Information Notice System - Extension of Monitoring to Countries Without Monthly or Quarterly Price Data and Information Notices for Djibouti and the United Arab Emirates

Attached for the information of the Executive Directors is a paper introducing an extension of the information notice system to countries without monthly or quarterly price data. Information notices for Djibouti and the United Arab Emirates are attached.

Mr. Bélanger (ext. 8671) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

Information Notice System:
Extension of Monitoring to Countries
Without Monthly or Quarterly Price Data
and Information Notices for
Djibouti and the United Arab Emirates

Prepared by the Exchange and Trade Relations Department

(In consultation with the Research Department,
the Legal Department, and Area Departments)

Approved by C. David Finch

August 22, 1986

I. Introduction

The system to monitor developments in real effective exchange rates was established in July 1983. Under that system, significant changes in real effective exchange rates have been brought to the attention of Executive Directors both through quarterly reports and, in cases of changes in real effective exchange rates in excess of 10 percent since the last Board consideration of a member's exchange rate policy, through information notices which analyze and assess recent developments and policies. Six information notices were issued in 1983, 19 in 1984, 30 in 1985 and 37 so far in 1986.

At present, real effective exchange rates are monitored for 128 currencies, including the currencies of 83 percent of Fund members. 1/ Although Directors have noted on earlier occasions the importance of making the coverage of the system as comprehensive as possible, 2/ for 26 members, real effective exchange rates are still not available. For most of these countries, monthly or quarterly price data either are not available or are not considered sufficiently reliable or timely to be used for precise calculations of real effective exchange rates.

1/ Real effective exchange rates are also calculated for the currencies of Hong Kong and Switzerland, which are not members of the Fund. The real effective exchange rate is monitored separately for the currency of the Netherlands Antilles.

2/ See, for example, the "Chairman's Summing Up at the Conclusion of the Review of the Document "Surveillance Over Exchange Rate Policies" and Annual Review of the Implementation of Surveillance," SUR/84/32 (3/23/84).

II. Extension of Monitoring System to Countries
Without Monthly or Quarterly Price Data

For most of the members for which real effective exchange rates are still not available, usable or up-to-date price indices or precise estimates are not thought likely to become available in the near future. Further improvements in the coverage of the monitoring of real effective exchange rates can nevertheless be achieved by modifying the current system to allow for less precise or exact monitoring. Although less precise, the extended monitoring described below will improve the Fund's monitoring of exchange rate developments, allowing for the monitoring to be applied more uniformly to all members, and help highlight for those members whose currencies are added to the system significant changes in their real effective exchange rates.

For those countries without appropriate price data, movements in real effective exchange rates for their currencies relative to the 10 percent appreciation/depreciation thresholds will be monitored on the basis of developments in nominal effective exchange rates and judgmental assessments of inflation relative to trading partners. The judgment concerning the likely range of inflation in each of these countries will be based, inter alia, on the past inflation performance of the country itself, the projected rate of inflation at the time of an earlier consultation, the evolution of money and credit aggregates, and other relevant information available to the staff.

The decision to issue an information notice in these cases will thus involve a greater element of uncertainty (which would be spelled out in the information notice) than is the case for countries with up-to-date price data. In order to avoid issuing information notices when, in retrospect, none would have been needed, it will also be necessary to delay issuing such notices until it is quite clear, on the basis of reasonable judgments concerning inflation, that the 10 percent appreciation/depreciation threshold has been exceeded. 1/

1/ In practice, for all currencies for which a nominal effective exchange rate is calculated at present, an implied rate of inflation can also be calculated which, given rates of inflation in trading partners, would keep the real effective exchange rate within the 10 percent threshold (see Annex). Monitoring will apply in the first instance to this implied rate of inflation. When this implied rate of inflation moves away from the judgmental assessment of the likely rate of inflation, a further review of this latter assessment will provide the basis to decide whether an information notice is warranted.

Also, in the absence of exact or precise estimates of inflation, the quarterly reports on "Indicators of Real Effective Exchange Rates" still will include only nominal effective exchange rate data for these countries.

Monitoring on this basis will expand the coverage of the information notice system to the currencies of 25 more members (listed in the Annex). Monitoring would still not apply to Democratic Kampuchea, for which the trade data necessary to calculate nominal effective exchange rates are not available.

The initial experience with the extended monitoring system will be examined in detail on the occasion of the next annual review of surveillance.

III. Information Notices for Djibouti and the United Arab Emirates

For two countries, Djibouti and the United Arab Emirates, developments in the nominal effective exchange rates for their currencies and rates of inflation in trading partners suggest that the real effective exchange rates for their currencies have changed by more than 10 percent since the date of the most recent Board discussion of exchange rate developments and policy in these countries. The Djibouti franc and U.A.E dirham have likely depreciated by more than 10 percent in real effective terms since the last Board discussion of their exchange rate policies. For these countries, the present paper constitutes an information notice.

Djibouti

The Djibouti franc is pegged to the U.S. dollar and has depreciated by 20.8 percent in nominal effective terms between June 1985 when the most recent Article IV consultation with Djibouti was concluded and May 1986. 1/ The impact of this depreciation on the real effective exchange rate, however, is likely to have been offset in part by the acceleration of inflation in 1985, which is estimated to have increased sharply to about 12 percent by the end of the year following several years of price stability. 2/ The rate of inflation from June 1985 through May 1986 nevertheless likely remained below the rate which would have prevented the real effective exchange rate from depreciating by more than 10 percent (see Annex). The depreciation of the franc since early 1985 has reversed about half of the appreciation in nominal effective terms (of nearly 90 percent) recorded since the late 1970s.

Growing domestic and external imbalances have been increasingly apparent in Djibouti in recent years. In particular, since 1982, growth has been negligible while both the fiscal position and balance of payments deteriorated sharply. In concluding the most recent Article IV consultation with Djibouti in June 1985, Executive Directors noted the significant appreciation of the franc, along with the U.S. dollar, relative to the currencies of trading partners. In acknowledging the special nature of Djibouti's exchange system, Directors stressed the

1/ Chairman's summing up circulated as SUR/85/67 (6/20/85).

2/ Based on the price index for expatriates living in Djibouti.

need for early and sustained efforts in implementing financial policies consistent with the maintenance of Djibouti's financial system and liberal exchange arrangements.

Developments in 1985, which reflected a further intensification of domestic and external imbalances, and the authorities' policy intentions, including exchange rate policy, are reviewed in detail and appraised in the recently issued staff report for the 1986 Article IV consultation (SM/86/159, 7/1/86). The Board discussion concluding the consultation has been tentatively scheduled for August 27, 1986.

United Arab Emirates

The U.A.E dirham is formally pegged to the SDR although, in practice, the dirham has maintained an unchanged relationship with the U.S. dollar since November 1980. The dirham has depreciated in nominal effective terms by 14.7 percent between July 1985 when the most recent Article IV consultation with the United Arab Emirates was concluded and May 1986. ^{1/} Prices in the United Arab Emirates have been declining in recent years (at an estimated average annual rate of 3-4 percent from 1983 to 1985). Unless this trend was reversed sharply in the last few months, the nominal effective depreciation of the dirham since mid-1985 resulted in a depreciation in real effective terms well above 10 percent.

Following a period of rapid expansion financed by rising oil revenues, since mid-1982 the authorities have directed their efforts to adjusting the economy to a steep decrease in oil receipts. In particular, total budgetary outlays were cut by approximately one fourth between 1981 and 1984; the resulting decrease in imports and capital outflows helped maintain the balance of payments in a comfortable position in 1984. In concluding the most recent Article IV consultation with the United Arab Emirates in July 1985, Executive Directors indicated that a restrained fiscal policy stance was appropriate and necessary. Directors, however, also noted that the slowdown in economic activity had highlighted the extent to which activity in the non-oil sector remained dependent on government expenditure and suggested that the authorities might wish to explore the role of exchange rate policy in encouraging autonomous development of private sector activity.

The policy of containing budgetary outlays was continued in 1985; however, the overall budget deficit rose because of the fall in oil revenues. For 1986, in light of the developments in the oil markets, the authorities have announced a further 15 percent reduction in government outlays. The policy of fiscal retrenchment has helped maintain the balance of payments in surplus in 1985 and a surplus is forecast in 1986 as well. However, private sector activity has remained subdued.

^{1/} Chairman's summing up circulated as SUR/85/82 (7/24/85).

The staff considers that the depreciation of the dirham in nominal effective terms since early 1985, which has reversed about half of the appreciation (of nearly 60 percent) recorded since the late 1970s, is appropriate as it will help restrain the demand for imports and promote a more efficient allocation of resources, thus promoting activity in the tradeable goods sector.

Calculation of Implied Rates of
Inflation Consistent with Movements in
Real Effective Exchange Rates of Less
Than 10 Percent

For each currency for which a nominal effective exchange rate is calculated at present, implied rates of inflation can be calculated which, given rates of inflation in trading partners, would keep the real effective exchange rate within the 10 percent appreciation/depreciation threshold. The relevant numerical information underlying the calculation of these implied rates of inflation is shown in Table 1 for the period through May 1986 for those countries for which only nominal effective exchange rates have been monitored so far under the Information Notice System.

For each country, the first two columns show the type and date of the latest Board consideration, column 3 shows the change in the nominal effective exchange rate for the country's currency from the date of the latest Board consideration through the most recent month for which information is available, and column 4 shows the rate of inflation in trading partners during the same period. Column 5 shows the annual rate of inflation below which the real effective depreciation would exceed 10 percent while column 6 shows the annual rate of inflation above which the real effective appreciation would exceed 10 percent. Thus, an estimated rate of inflation outside the range shown in the table would indicate the need for an information notice. The width of the range indicated in the table is determined by the length of time elapsed since the date of the latest Board consideration. The 10 percent real appreciation/depreciation margin is reflected, *pari passu*, in a 20 percentage point range between the lower and higher estimated price levels keeping the real effective exchange rate within the 10 percent appreciation/depreciation threshold. This 20 percentage point range between estimated price levels translates into a range of annualized rates of inflation of, for example, 20 percent in cases where a full year has elapsed since the latest Board consideration and 40 percent when only six months have elapsed.

11
b
.
--
:
3.
11
3
7
8.

Table 1. Countries for which Real Effective Exchange Rates are not Monitored

	Latest Board Consideration		Change From Latest Board Consideration Through May 1986		Range of Inflation Rates Keeping the Real Effective Exchange Rate Within the 10 Percent Threshold <u>2/</u>	
	Type <u>1/</u>	Date	Nominal Effective Exchange Rates	Trading Partner Prices		
<u>African Department</u>						
Algeria	C	9/85	-9.8	3.3	4.8	41.4
Benin	C	4/86	-0.5	0.2	-69.2	242.3
Cape Verde	C	3/85	-7.0	7.7	3.7	23.1
Chad	C	6/86	...	...	...	...
Comoros	C	6/86	...	...	...	...
* Djibouti	C	6/85	-20.8	2.2	17.7	46.4
Equatorial Guinea	R	6/86	...	...	...	...
Guinea	C,R	2/86	-2.3	0.5	-26.4	64.1
Guinea-Bissau	C	9/85	-26.3	4.7	44.8	95.5
Mozambique	C	7/85	-2.0	6.3	-2.9	23.7
Sao Tome & Principe	C	11/84	-5.5	9.0	2.6	17.2
<u>Asian Department</u>						
Bhutan	C	8/85	-1.9	2.7	-7.7	20.7
Kampuchea, Dem.	C	10/73	...	...	...	...
Lao, P.D. Rep.	C	1/86	-3.9	--	-18.0	49.9
Maldives	N	3/86	-4.1	0.1	-31.1	129.5
Viet Nam	C	7/86	...	...	...	...
<u>Middle Eastern Department</u>						
Afghanistan	C	1/86	-7.0	0.3	-8.8	66.7
Iraq	N	11/82	6.6	35.0	3.9	9.9
Lebanon	C	4/86	-17.3	0.2	186.0	3,052.6
Libya	N	5/86	...	...	...	...
Oman	C	6/86	...	...	...	...
Qatar	C	2/86	-4.2	0.3	-21.3	75.7
Syrian Arab Rep.	C	2/86	-3.2	0.7	-23.2	71.3
* United Arab Emirates	C	7/85	-14.7	2.0	9.2	38.9
Yemen Arab Rep.	N	1/86	-8.8	0.4	-2.4	78.1
Yemen P.D. Rep.	C	6/85	-18.8	2.8	15.3	43.5

1/ C: consultation; N: notification of change in exchange system; R: use of Fund resources.

2/ Annual rate, from date of latest Board consideration through May 1986. Lower end of range would keep the real effective depreciation less than 10 percent; higher end of range would keep the real effective appreciation less than 10 percent. A rate of inflation outside the range specified would indicate the need for an information notice.

* Indicates countries for which estimated rate of inflation would indicate a change of more than 10 percent in the real effective exchange rate.



Office Memorandum

EW
STB/10
FILE ✓
PACIFIC
MARITIME

EB

Exchange Rates

TO: The Acting Managing Director

August 22, 1986

FROM: Eduard Brau *EB*

SUBJECT: Dutch Auctions

In connection with a recent memorandum on Zambia in which the staff recommended that we go along with the authorities' request to change the pricing method in the Zambian foreign exchange auction from the marginal pricing approach to the Dutch-bid approach, you posed two questions: (1) are there good substantive reasons for having a bias against Dutch auction systems, and (2) if not, should the guidelines on multiple currency practices be revised to permit such auctions.

As is well-known from theory and empirical observation, in a competitive market for a homogeneous good one price clears the market at any point in time; arbitrage is sure to obtain this result. In foreign exchange auctions, the equivalent pricing principle is the marginal price approach, in which foreign exchange is sold to all participants at the lowest bid price that exhausts the available supply. In a Dutch auction or "multiple price" approach, in contrast, each bidder pays the price actually bid, with foreign exchange sold at different, declining prices until the available supply is exhausted. Three reasons are sometimes advanced for preferring the Dutch pricing method: (a) that this pricing system best approximates the actual working of pricing behavior in competitive markets; (b) that the Central Bank earns profits derived from the margin between the price it buys and sells foreign exchange; and (c) that the appropriation by the Central Bank of the consumer surplus discourages inflated bids for foreign exchange and thereby reduces the possibility of the exchange rate being forced to an artificially depreciated level.

However, it would not seem accurate to view the Dutch auction pricing as the natural method of competitive market pricing; quintessentially, an auction is based on price determination at one point in time. The other two advantages claimed for a Dutch auction presuppose that it is possible to enforce price discrimination in markets for a homogeneous and eminently resaleable commodity, such as foreign exchange. This is normally not possible, of course. Indeed, bidders in the auction have a powerful incentive to collude in their bids in order to appropriate for themselves the consumer surplus sought by the Central Bank. The Dutch auction-system, therefore, tends to drive actual bidding into informal fora and markets other than the official auction, converting the official auction into a recording mechanism for the results of negotiations already concluded between participants, and potentially diverting foreign exchange away from the official market. If, against expectations, the Dutch auction method were actually to result in effective and sustained differential pricing of foreign exchange sales, adverse allocative efficiency repercussions would ensue

from the wedge driven between the cost of obtaining foreign exchange for imports and the price received for foreign exchange derived from exports (the latter being set by the Central Bank at some "fixing rate" approximating the marginal price).

There is reason, therefore, to expect that a Dutch auction approach will not result, over time, in effective price discrimination. This is confirmed by the experience of the Fund in conducting auctions for the sale of part of its gold holdings in the 1970s; at the time, the Fund concluded that there was little difference in outcome between auctions conducted under the Dutch and marginal pricing arrangements. This is further confirmed by alternating use of either pricing arrangement in Jamaica in 1984.

There is little doubt that a Dutch auction to the extent that it does give rise to a spread between exchange rates in excess of 2 percent constitutes a multiple currency practice. However, there seems to be no occasion to revise the guidelines on multiple currency practices to permit such auctions, since this already is the approach we now follow. The reasoning has been that, while a Dutch auction may be a somewhat inefficient method in comparison with the marginal price approach, an auction with the Dutch pricing method is still a very significant advance over previous methods of determining the exchange rate in certain countries, and would therefore be temporarily approved by the Fund to the extent that it does give rise to excessive spreads (which, in fact, normally don't arise since collusion will have worked).

Thus, in summary, the Dutch auction method for conducting foreign exchange sales seems to be a less efficient method than the marginal price method. */sbri5*

cc: The Managing Director (o/r)
Mr. Ouattara
Mr. Brown (o/r)



Office Memorandum

Cory
PMT

TO: Mr. Brau

August 22, 1986

FROM: Poul M. Thomsen *P.M.T.*

SUBJECT: Comments on Draft Memorandum on Dutch Auctions

I agree with the main conclusions in your memorandum. In particular, it is not correct to justify the dutch auction system by claiming that "real" markets do not set a single price but a range of prices. At a given point in time, differences in prices in a perfectly homogenous market like the foreign exchange market must reflect market imperfections such as geographical dispersion of markets which clearly lends no justification for the dutch auction system. I also agree with your conclusion that the staff should take a pragmatic approach and not object to a "dutch auction system" if the authorities insist on it because experience with these systems has shown that the spread between the highest and the lowest successful bid is not very large. However, notice that this might reflect that collusion has taken place. Thus, you rightly mention at the beginning of your memorandum that there is a larger incentive to collude under a dutch auction system, and the observation that the spreads have proved to be low might reflect that bidders have been getting together before an auction in which case we should not take the pragmatic approach.

It is often argued that speculative pressure on the exchange rate will be less under a dutch auction system than under a marginal pricing system. There is some truth to this, reflecting a "flaw" in the auctioning systems that we are setting up. Under "real" auction systems, the bidder knows the market clearing price when he submits his bid. This is certainly the case at Sotheby's but it is also an assumption that is carried over into economic theory: in the Walrasian model there is no trading at nonequilibrium prices as the auctioneer "calls out" prices; collects information on supply and demand; and does not allow trading before he has struck the equilibrium price (this is the famous "price tatonnement assumption"). Thus, everybody will be stating their demand knowing the equilibrium price.

This is not the case in the type of auctions that we are setting up where bidders get "one shot at it" only, as they are required to submit sealed bids before the auction commences. When the bidder does not know the equilibrium price before he bids, he might find that he is unsuccessful because he bid below the equilibrium price and he might also find that he would have been willing to bid higher if he had known the equilibrium price. To avoid such an outcome, the bidder in a marginal-pricing-auction might believe that he can secure a successful bid by bidding high without pushing up the market clearing rate (knowing that his bid is small compared to the size of the market). However, such behavior by several bidders will mean that the equilibrium rate

will indeed increase. The dutch auction system was introduced to discourage such behavior.

The flaw in this argument is that while the currency might depreciate in a single auction if all bidders try to secure a successful bid by bidding high assuming that nobody else does the same, bidders will soon find that the rate is sliding beyond what they are willing to pay and the demand then will be reduced in the following auctions.

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

2
SUR/86/77

CONFIDENTIAL

August 1, 1986

To: Members of the Executive Board

From: The Secretary

Subject: The Chairman's Summing Up at the Conclusion
of the Discussion on Surveillance - Indicators
Relating to Policy Actions and Economic
Performance - EBM/86/115 (7/14/86)

The document on the above subject issued on July 21, 1986 as
Buff document 86/140 should have been issued in the Surveillance series.

A corrected document is attached.

Att: (1)

SUR/86/77

CONFIDENTIAL

August 1, 1986

The Chairman's Summing Up at the Conclusion
of the Discussion on Surveillance - Indicators
Relating to Policy Actions and Economic Performance
Executive Board Meeting 86/115 - July 14, 1986

General Comments

In presenting their views today Directors generally organized their remarks around the three subject areas identified in the staff paper, namely, the analytical focus of the proposed approach to surveillance, the nature of the indicators to be used, and the proposed procedures.

In these short closing remarks I will follow the same order, although I will begin by noting several points of a more general character that deserve emphasis. First, in welcoming today's discussion on the staff paper--which was considered to be of high quality--many speakers underlined its preliminary character. They noted that the process of developing an appropriate role for indicators in Fund surveillance would have to evolve gradually, and that it would be a mistake to be too precise or to stress operational aspects at this early stage. Second, several Directors stressed, as they have on earlier occasions, the paramount need for political will if surveillance is to be effective. As a third general point, many Directors emphasized a point made in the staff paper, namely, that the use of indicators in surveillance should be a useful complement to broad-based judgmental analysis. A fourth general point is that the purpose of the indicators exercise is, as most Executive Directors said, to strengthen the process of multilateral surveillance in order eventually to influence governments so that they will not pursue policies that would be harmful to the international community at large. The indicators exercise is not to be an end in itself.

Analytical Framework

Let me turn now to the first of the three subject areas I mentioned at the outset, the analytical framework. Most Directors agreed with the staff that the central focus of surveillance should be on developments affecting the balance of payments. A few, however, felt that a better focus of analysis would have been to look directly at exchange rates, while others favored primary concentration on domestic policy variables. In general, however, I think that it is fair to say that it was accepted that the monitoring of domestic economic variables would be undertaken in light of their domestic implications as well as in light of their implications for the world economy and for balance of payments flows, and that international consistency and compatibility of external payments

positions in a medium-term framework was the right focus for the surveillance exercise. This notion, which has been confirmed today, is an important one.

Most Directors felt that the saving/investment framework was a helpful vehicle for interpreting international economic interactions. The need to examine the factors influencing saving and investment was also recognized. However, a few Directors, and Mr. Fujino in particular, said that they were not convinced that it was helpful to explain balance of payments developments by their relationship to domestic saving/investment balances. Directors acknowledged that it was difficult to make firm judgments on such complex matters, on which interpretations can vary, but they felt that it would be desirable to make the attempt. Some speakers, however, viewed the analytical structure proposed by the staff as being too constraining and implicitly favored a more eclectic approach to the interpretation of developments in key variables. For example, a number of Directors said that they doubted whether the concept of a sustainable balance of payments, as developed by the staff, could be given a satisfactory empirical content. Directors also noted that calculations of underlying or cyclically adjusted current account positions should be approached with caution.

Choice of Indicators

Most Directors broadly agreed with the list of indicators suggested by the staff, with many speakers offering useful and sometimes critical comments and suggestions on specific indicators. Nearly all speakers expressed some reservations about particular points, although they could agree with the thrust of the staff recommendations. A few Directors questioned the usefulness of the classification system used by the staff. Nevertheless, for convenience I will follow it in this summary. Before I come to the individual variables, I would say that on the whole Directors agreed that indicators should be limited in number, quantifiable, timely, relatively easy to interpret, and comparable from country to country.

Performance Variables

Most Directors agreed with the use of real GDP (or GNP) growth as the primary measure of output, although many speakers considered that it should be complemented by a measure of domestic demand growth. In addition, and with various degrees of emphasis, some Directors expressed the view that nominal variables, including nominal GDP, should be focused on and should at least be incorporated in the analysis.

Most Directors held the view that it would be helpful to use unemployment as an indicator, perhaps together with other measures of capacity utilization. They judged that it was important to know whether a given balance of payments outcome was being achieved consistently with an adequate rate of capacity utilization and that, although unemployment

figures had to be interpreted with caution, they were nevertheless useful. It was also suggested that attention should be paid to employment and other labor market data.

On the subject of inflation, there was a division of views. There was a measure of support for the concept of normalized unit labor costs as a possible measure of underlying cost pressures. For the most part, however, Directors, especially those from larger industrial countries, expressed reservations about this concept of unit labor costs and would appear to prefer a more familiar indicator such as the GDP deflator or the wholesale price index.

In regard to the balance of payments, there was no dissent from the suggestion to use the current account, in a medium-term framework, as a primary indicator. Some speakers felt that this indicator should be complemented by information on the capital account, and by estimates and projections for the terms of trade and relative cyclical positions. The usefulness of movements in foreign reserves as a special indicator was doubted by some Directors.

Policy Variables

On monetary policy, there was broad agreement that the indicator chosen should be the one employed by the authorities of the country concerned, should be expressed in nominal terms, and should be interpreted with great caution.

Regarding fiscal policy, most Directors agreed that the actual fiscal deficit should be the primary indicator. There were some differences of view on how much weight should be given to cyclically adjusted fiscal deficits, with several Directors noting the analytical difficulties that are encountered in making such adjustments. There was relatively little support, at least from the larger countries, for adjusting the fiscal deficit to inflation. Mr. Fujino noted that, while it would be difficult to develop indicators of appropriate medium-term fiscal policy objectives, it would be important to examine possible ways in which to assess fiscal policy in a medium-term perspective.

Directors generally acknowledged that structural policies were difficult to quantify, but it was noted that they were nonetheless important, and several Directors requested that the staff analysis should be as explicit as possible in describing structural policies, including trade policies.

Intermediate Variables

Concerning interest rates and exchange rates, several Directors pointed out that these were market-determined variables and that staff projections of those variables would be extremely sensitive. They cautioned that the staff should not venture beyond making assumptions with respect to these variables and certainly should not publish any material that

would give the impression that we were making forecasts. Other Directors, however, pointed out that an analysis of economic interactions would be incomplete if the implications of alternative exchange rate trends were not adequately explored. These two positions are not mutually inconsistent, because the second position entails assumptions and not forecasts. But discretion is clearly of great importance in this field.

As to measures of savings and investment, several Directors pointed out the statistical shortcomings of estimates of these variables. Some speakers felt that these shortcomings, together with the underlying reservations about the basis of the staff's analysis, made it unwise to attempt to collect estimates and projections for savings and investment. On the whole, however, most Directors supported the staff's proposed approach.

Procedures

Directors generally agreed with the procedures proposed on page 25 of the staff paper. It was noted that these procedures should be considered experimental and subject to change as experience with surveillance was gathered and as guidance was provided by the Board. The role of Article IV consultations as the means of collecting and analyzing national forecasts was stressed. It was assumed that the multilateral discussions of indicators should take place at the same time as the World Economic Outlook discussion, although--and this matter will be further studied--there could be a separate discussion for which separate documentation would be provided. In that context, the analysis in a special WEO chapter or document of policy interrelations among the industrial countries--particularly the G-10 countries--and their international consequences would acquire particular importance. The analysis of other significant country groupings was also advocated by several Directors.

As far as follow-up procedures were concerned, some reservations were expressed about the use of additional information notices or special mini-discussions on the World Economic Outlook. Directors generally seem to favor the Managing Director using his discretion to judge when economic developments had reached a point at which a general discussion or special consultation would be helpful. It was also suggested that the Managing Director should participate in ministerial meetings on surveillance.

This discussion was very interesting and highlighted the complexities and the potential of the indicators exercise. The concept of indicators has indeed broad potential, and indicators could be used at different levels. Indicators can be seen as a means of checking the consistency within a country between performance objectives and the policy measures that are to be used to reach those objectives at a given point in time.

They can also be seen as a means of checking the consistency of the national forecasts and objectives of a particular country with the national objectives and forecasts of other countries.

Indicators can further be seen as providing, in a more ambitious vein, a global model, or, in a less ambitious vein, a limited set of checks in order to provide signals. Indicators could be used to assess the medium-term sustainability of balance of payments developments, including sustainability in the context of an "optimal" pattern of worldwide growth and stability. That is the most ambitious concept. Indicators can be seen as a tool for intellectual analysis or they can be used to encourage policy action and to trigger more effective international cooperation.

The more the international community wants to move toward the ambitious concepts and goals to which I have referred, the more convincing we would have to be, and the more the notions of sustainability, capital movements, and the models that underlie the notions of optimal growth and stability worldwide would have to be understood and would have to be based on firm and valid analysis that is acceptable to the interested members. We are not yet at that point; further elaboration of the notions to which I have referred--particularly balance of payments sustainability in a medium-term framework--is called for. I thank Mr. Polak in particular for his views on this point. Clearly we will need pragmatism, discretion, gradualism, and judgment. No one today has advocated mechanistic or automatic application of a set of indicators. As Mr. Kafka said, a set of indicators cannot of itself make a coherent system. Nor can indicators be used to automatically trigger policy actions. But indicators can and should signal the existence of potential problems for countries and for the system at large. Thus, if indicators cannot trigger direct action, they can at least trigger questions, discussions and, I would hope, eventually consideration of possible policy action.

We will take stock of the important and interesting suggestions made during this discussion. I am particularly grateful to Mr. Lankester, Mr. Polak, and Mrs. Ploix for having circulated their views, and I share Mr. Nimatallah's hope that others--especially Directors from countries that are directly involved in multilateral surveillance--will circulate their statements.

In taking stock of Directors' suggestions I believe that we will gradually, in an evolving process, be able to enrich the WEO exercise. We are in my view at a turning point in that exercise: an excessive focus on indicators could introduce rigidities and weaken the WEO exercise; but, on the other hand, indicators could give new perspectives and perhaps signal things that our classical approach was not signaling--for example, inconsistencies between national concepts, forecasts, or assumptions. In a sense, the WEO exercise is a sanitized exercise: these inconsistencies do not appear--they are eliminated because national projections are made consistent. I think that it would be interesting to present, perhaps in a parallel set of figures, all the national projections, even if they are

inconsistent, and to show how they are inconsistent and how they could be reconciled. Such an exercise should lead to a better understanding of problems and further on to more effective international cooperation.

As Directors and I myself stressed, our discussion today has been a preliminary one. We will move gradually and cautiously in coming months to respond to the Interim Committee's request to study possible indicators. The staff will carefully review Directors' comments and suggestions in the course of preparing the next WEO paper. Any changes in the WEO exercise resulting from those comments and suggestions will be explained in the introduction to the next WEO paper. The Executive Board will thus have an opportunity to review and comment on the next WEO paper--including any innovations in the use of indicators--before the September 1986 meeting of the Interim Committee; those comments by Directors will of course be instrumental in guiding the staff's further work on indicators and the WEO exercise. At the September Interim Committee meeting, I will summarize our work on indicators. In so doing I will draw on my concluding remarks in this discussion and I will supplement those remarks as necessary.

INTERNATIONAL MONETARY FUND

July 30, 1986

Mr. Whittome/Mrs. Junz
Mr. Narvekar
Mr. Beza ✓

A revised version of the indicators
table is attached.

MCD

Attachment

Michael C. Deppler

[Country] : Economic Indicators

(In percent, except where otherwise indicated)

	Annual Averages or Year-on-Year Changes			End of Year (Fourth Quarter) or Through the Year Changes			Memorandum: Latest available quarter or monthly information, if not published 1/
	1985	1986	1987	1985 Q4	1986 Q4	1987 Q4	
1. Growth of demand and output							
In nominal terms: GNP/GDP							
Total domestic demand							
In real terms: GNP/GDP							
Total domestic demand							
2. Balance of payments (in national currency, except where otherwise noted)							
Current account							
Of which: Exports (fob)							
Imports (fob)							
Trade balance (fob/fob)							
Volume of merchandise exports (change, in percent)							
Volume of merchandise imports (change, in percent)							
Capital account, excluding reserve changes 2/							
3. Labor market indicators 3/							
Unemployment rate							
Growth of employment							
4. Inflation rates							
GNP/GDP deflator							
Consumer prices							
Unit labor costs 4/							
5. Monetary growth rates: target or forecasted aggregate (M___) 5/							
6. Fiscal balance							
Central (Federal) government 6/							
In national currency							
In percent of GNP/GDP							
General government 7/							
In national currency							
In percent of GNP/GDP							
7. Change in level of gross reserves 8/							
8. Interest rates							
Short-term 9/--nominal							
--real 10/							
Long-term 9/--nominal							
--real 10/							
9. Exchange rates 11/							
National currency per U.S. dollar							
Nominal							
Real 10/							
Trade weighted or effective 12/							
Nominal							
Real 10/							
10. Savings/investment ratios (in per cent of GNP/GDP)							
Saving 13/							
Investment 13/							
11. Working assumptions--Please state the exchange rate, oil price, world trade, and other assumptions underlying the projections:							

- 1/ Please provide any recent information on variable that might not otherwise be available and that is relevant to the interpretation of the projection.
- 2/ Historical data only. If considered significant, please provide disaggregation of capital account, with definition of components only.
- 3/ Historical data only; may be supplemented by assumptions or forecasts.
- 4/ Please indicate coverage, e.g., manufacturing, private non-farm, etc.
- 5/ If more than one aggregate is used, please select principal aggregate(s). Data should be shown on the same basis as target is formulated.
- 6/ Preferably on a national accounts basis. Please provide definition if otherwise.
- 7/ National accounts basis.
- 8/ Historical data only.
- 9/ Please indicate instrument. A maturity of about 3 months is suggested for the short-term rate.
- 10/ Please indicate method of adjusting nominal to real rates.
- 11/ Historical data and assumptions used for projections. Please state general basis of assumption (e.g., constant nominal rates, etc.).
- 12/ Please state weighting scheme used.
- 13/ Please indicate coverage.

July 21, 1986 - 86/140

The Chairman's Concluding Remarks on the
Discussion on Indicators Relating to
Policy Actions and Economic Performance
Executive Board Meeting 86/115 - July 14, 1986

FILE COPY

General Comments

In presenting their views today Directors generally organized their remarks around the three subject areas identified in the staff paper, namely, the analytical focus of the proposed approach to surveillance, the nature of the indicators to be used, and the proposed procedures.

In these short closing remarks I will follow the same order, although I will begin by noting several points of a more general character that deserve emphasis. First, in welcoming today's discussion on the staff paper--which was considered to be of high quality--many speakers underlined its preliminary character. They noted that the process of developing an appropriate role for indicators in Fund surveillance would have to evolve gradually, and that it would be a mistake to be too precise or to stress operational aspects at this early stage. Second, several Directors stressed, as they have on earlier occasions, the paramount need for political will if surveillance is to be effective. As a third general point, many Directors emphasized a point made in the staff paper, namely, that the use of indicators in surveillance should be a useful complement to broad-based judgmental analysis. A fourth general point is that the purpose of the indicators exercise is, as most Executive Directors said, to strengthen the process of multilateral surveillance in order eventually to influence governments so that they will not pursue policies that would be harmful to the international community at large. The indicators exercise is not to be an end in itself.

Analytical Framework

Let me turn now to the first of the three subject areas I mentioned at the outset, the analytical framework. Most Directors agreed with the staff that the central focus of surveillance should be on developments affecting the balance of payments. A few, however, felt that a better focus of analysis would have been to look directly at exchange rates, while others favored primary concentration on domestic policy variables. In general, however, I think that it is fair to say that it was accepted that the monitoring of domestic economic variables would be undertaken in light of their domestic implications as well as in light of their implications for the world economy and for balance of payments flows, and that international consistency and compatibility of external payments positions in a medium-term framework was the right focus for the surveillance exercise. This notion, which has been confirmed today, is an important one.

Most Directors felt that the saving/investment framework was a helpful vehicle for interpreting international economic interactions. The need to examine the factors influencing saving and investment was also recognized. However, a few Directors, and Mr. Fujino in particular, said that they were not convinced that it was helpful to explain balance of payments developments by their relationship to domestic saving/investment balances. Directors acknowledged that it was difficult to make firm judgments on such complex matters, on which interpretations can vary, but they felt that it would be desirable to make the attempt. Some speakers, however, viewed the analytical structure proposed by the staff as being too constraining and implicitly favored a more eclectic approach to the interpretation of developments in key variables. For example, a number of Directors said that they doubted whether the concept of a sustainable balance of payments, as developed by the staff, could be given a satisfactory empirical content. Directors also noted that calculations of underlying or cyclically adjusted current account positions should be approached with caution.

Choice of Indicators

Most Directors broadly agreed with the list of indicators suggested by the staff, with many speakers offering useful and sometimes critical comments and suggestions on specific indicators. Nearly all speakers expressed some reservations about particular points, although they could agree with the thrust of the staff recommendations. A few Directors questioned the usefulness of the classification system used by the staff. Nevertheless, for convenience I will follow it in this summary. Before I come to the individual variables, I would say that on the whole Directors agreed that indicators should be limited in number, quantifiable, timely, relatively easy to interpret, and comparable from country to country.

Performance Variables

Most Directors agreed with the use of real GDP (or GNP) growth as the primary measure of output, although many speakers considered that it should be complemented by a measure of domestic demand growth. In addition, and with various degrees of emphasis, some Directors expressed the view that nominal variables, including nominal GDP, should be focused on and should at least be incorporated in the analysis.

Most Directors held the view that it would be helpful to use unemployment as an indicator, perhaps together with other measures of capacity utilization. They judged that it was important to know whether a given balance of payments outcome was being achieved consistently with an adequate rate of capacity utilization and that, although unemployment figures had to be interpreted with caution, they were nevertheless useful. It was also suggested that attention should be paid to employment and other labor market data.

On the subject of inflation, there was a division of views. There was a measure of support for the concept of normalized unit labor costs

as a possible measure of underlying cost pressures. For the most part, however, Directors, especially those from larger industrial countries, expressed reservations about this concept of unit labor costs and would appear to prefer a more familiar indicator such as the GDP deflator or the wholesale price index.

In regard to the balance of payments, there was no dissent from the suggestion to use the current account, in a medium-term framework, as a primary indicator. Some speakers felt that this indicator should be complemented by information on the capital account, and by estimates and projections for the terms of trade and relative cyclical positions. The usefulness of movements in foreign reserves as a special indicator was doubted by some Directors.

Policy Variables

On monetary policy, there was broad agreement that the indicator chosen should be the one employed by the authorities of the country concerned, should be expressed in nominal terms, and should be interpreted with great caution.

Regarding fiscal policy, most Directors agreed that the actual fiscal deficit should be the primary indicator. There were some differences of view on how much weight should be given to cyclically adjusted fiscal deficits, with several Directors noting the analytical difficulties that are encountered in making such adjustments. There was relatively little support, at least from the larger countries, for adjusting the fiscal deficit to inflation. Mr. Fujino noted that, while it would be difficult to develop indicators of appropriate medium-term fiscal policy objectives, it would be important to examine possible ways in which to assess fiscal policy in a medium-term perspective.

Directors generally acknowledged that structural policies were difficult to quantify, but it was noted that they were nonetheless important, and several Directors requested that the staff analysis should be as explicit as possible in describing structural policies, including trade policies.

Intermediate Variables

Concerning interest rates and exchange rates, several Directors pointed out that these were market-determined variables and that staff projections of those variables would be extremely sensitive. They cautioned that the staff should not venture beyond making assumptions with respect to these variables and certainly should not publish any material that would give the impression that we were making forecasts. Other Directors, however, pointed out that an analysis of economic interactions would be incomplete if the implications of alternative exchange rate trends were not adequately explored. These two positions are not mutually inconsistent, because the second position entails assumptions and not forecasts. But discretion is clearly of great importance in this field.

As to measures of savings and investment, several Directors pointed out the statistical shortcomings of estimates of these variables. Some speakers felt that these shortcomings, together with the underlying reservations about the basis of the staff's analysis, made it unwise to attempt to collect estimates and projections for savings and investment. On the whole, however, most Directors supported the staff's proposed approach.

Procedures

Directors generally agreed with the procedures proposed on page 25 of the staff paper. It was noted that these procedures should be considered experimental and subject to change as experience with surveillance was gathered and as guidance was provided by the Board. The role of Article IV consultations as the means of collecting and analyzing national forecasts was stressed. It was assumed that the multilateral discussions of indicators should take place at the same time as the World Economic Outlook discussion, although--and this matter will be further studied--there could be a separate discussion for which separate documentation would be provided. In that context, the analysis in a special WEO chapter or document of policy interrelations among the industrial countries--particularly the G-10 countries--and their international consequences would acquire particular importance. The analysis of other significant country groupings was also advocated by several Directors.

As far as follow-up procedures were concerned, some reservations were expressed about the use of additional information notices or special mini-discussions on the World Economic Outlook. Directors generally seem to favor the Managing Director using his discretion to judge when economic developments had reached a point at which a general discussion or special consultation would be helpful. It was also suggested that the Managing Director should participate in ministerial meetings on surveillance.

This discussion was very interesting and highlighted the complexities and the potential of the indicators exercise. The concept of indicators has indeed broad potential, and indicators could be used at different levels. Indicators can be seen as a means of checking the consistency within a country between performance objectives and the policy measures that are to be used to reach those objectives at a given point in time. They can also be seen as a means of checking the consistency of the national forecasts and objectives of a particular country with the national objectives and forecasts of other countries.

Indicators can further be seen as providing, in a more ambitious vein, a global model, or, in a less ambitious vein, a limited set of checks in order to provide signals. Indicators could be used to assess the medium-term sustainability of balance of payments developments, including

sustainability in the context of an "optimal" pattern of worldwide growth and stability. That is the most ambitious concept. Indicators can be seen as a tool for intellectual analysis or they can be used to encourage policy action and to trigger more effective international cooperation.

The more the international community wants to move toward the ambitious concepts and goals to which I have referred, the more convincing we would have to be, and the more the notions of sustainability, capital movements, and the models that underlie the notions of optimal growth and stability worldwide would have to be understood and would have to be based on firm and valid analysis that is acceptable to the interested members. We are not yet at that point; further elaboration of the notions to which I have referred--particularly balance of payments sustainability in a medium-term framework--is called for. I thank Mr. Polak in particular for his views on this point. Clearly we will need pragmatism, discretion, gradualism, and judgment. No one today has advocated mechanistic or automatic application of a set of indicators. As Mr. Kafka said, a set of indicators cannot of itself make a coherent system. Nor can indicators be used to automatically trigger policy actions. But indicators can and should signal the existence of potential problems for countries and for the system at large. Thus, if indicators cannot trigger direct action, they can at least trigger questions, discussions and, I would hope, eventually consideration of possible policy action.

We will take stock of the important and interesting suggestions made during this discussion. I am particularly grateful to Mr. Lankester, Mr. Polak, and Mrs. Ploix for having circulated their views, and I share Mr. Nimatallah's hope that others--especially Directors from countries that are directly involved in multilateral surveillance--will circulate their statements.

In taking stock of Directors' suggestions I believe that we will gradually, in an evolving process, be able to enrich the WEO exercise. We are in my view at a turning point in that exercise: an excessive focus on indicators could introduce rigidities and weaken the WEO exercise; but, on the other hand, indicators could give new perspectives and perhaps signal things that our classical approach was not signaling--for example, inconsistencies between national concepts, forecasts, or assumptions. In a sense, the WEO exercise is a sanitized exercise: these inconsistencies do not appear--they are eliminated because national projections are made consistent. I think that it would be interesting to present, perhaps in a parallel set of figures, all the national projections, even if they are inconsistent, and to show how they are inconsistent and how they could be reconciled. Such an exercise should lead to a better understanding of problems and further on to more effective international cooperation.

As Directors and I myself stressed, our discussion today has been a preliminary one. We will move gradually and cautiously in coming months to respond to the Interim Committee's request to study possible indicators. The staff will carefully review Directors' comments and suggestions in

the course of preparing the next WEO paper. Any changes in the WEO exercise resulting from those comments and suggestions will be explained in the introduction to the next WEO paper. The Executive Board will thus have an opportunity to review and comment on the next WEO paper--including any innovations in the use of indicators--before the September 1986 meeting of the Interim Committee; those comments by Directors will of course be instrumental in guiding the staff's further work on indicators and the WEO exercise. At the September Interim Committee meeting, I will summarize our work on indicators. In so doing I will draw on my concluding remarks in this discussion and I will supplement those remarks as necessary.

July 18, 1986 - 86/137

Statement by Mr. Lundstrom on Indicators
Relating to Policy Actions and Economic Performance
Executive Board Meeting 86/114
July 14, 1986

Mr. Chairman, the staff has produced an illuminating and constructive paper and should be commended for that. My authorities are in broad agreement with the general outline of the analysis and with the general thrust of the conclusions drawn from it, which does not mean that they do not have some important reservations. Like others, I should also like to thank Mr. Polak and Mr. Lankester for their very interesting statements. It has been very helpful to be able to study them in advance.

We agree that, at this stage, it is appropriate to concentrate on the way indicators may be used, with particular emphasis on existing indicators and their application to major industrial countries. Later on, the scope may be widened to include additional countries. Obviously, some questions have had to be left out of the staff paper. One of them is the relationship between indicator based surveillance in the Fund and similar exercises in more limited groups of major countries. It is understandable that the staff has refrained from elaborating on this question at the present stage. So shall I. Let me just say that this relationship between coordination and surveillance exercises in different fora is of course essential, and that, in this context, my authorities attach great importance to the Managing Director's participation in ministerial meetings with multilateral surveillance as their main focus. They further assume that the expertise and capacity of the Fund staff will be drawn on in the preparation of such meetings. But the form of this concertation and cooperation is less important than its objective, which should be to minimize the risk of inconsistency between activities designed to reduce inconsistencies.

Mr. Chairman, my authorities see the role of indicators as an auxiliary one. Surveillance has to retain a largely judgemental character. Accordingly, we agree with those who maintain that indicators should not be used as automatic triggers for policy measures. We, therefore, see no reason for further study of suggestions with that purpose.

As for the analytical framework of the indicators, we endorse the emphasis put on international interaction and international repercussions. We also agree that the focus should be on a medium-term perspective rather than on "fine tuning". Particular importance should be attached to the development of the external balance. We share the view that the staff paper does not seem to pay sufficient attention to the practical problems arising from the use of the

"underlying payments balances". On an earlier occasion, this chair has pointed to the problems of such calculations, for instance difficulties in correcting the cyclical position and in agreeing on the factors determining capital movements. This basic uncertainty remains, despite continuous research in this field. It is particularly difficult to establish criteria for what could be regarded as a sustainable position for individual countries. These problems reduce the immediate practical applicability of the analytical framework recommended by the staff. Therefore, it is important that work in this area be carried forward. In this connection, as suggested by the staff, the assessment of savings and investment balances should be given particular attention, although, here too, there are practical and analytical problems.

Indicators can be used in different ways, some of which may be a little more operational than the staff paper would seem to imply. As earlier suggested by this chair, one indicator may be given a triggering function. But it would not trigger policy measures, only discussions on the possible need for such measures, with a view to bringing about a consensus. There should be no presumption about the choice of measures, nor about the distribution of the adjustment burden. For this purpose, an exchange rate indicator would seem particularly appropriate. It would be easy to read and could give an early indication of inconsistencies in economic policies and economic trends. The present system of information notices on major changes in exchange rates could serve as a basis to build on.

As for the number of indicators, we share the preference of Mr. Sengupta and others for a less ambitious start than suggested in the paper. Along with the experience gained, the system could gradually be enlarged and improved. Generally speaking, more attention should be paid to how a system of indicators can be expected to work in practice than to the ambition, laudable as it may be, to make the system theoretically completely coherent.

Mr. Chairman, I shall now make a few comments on the different indicators suggested. The obvious first step should be to try to determine which indicators should be further explored. In this connection, studies of the various indicators' performance in a historic perspective would be very useful.

An indicator should have the following general properties:

- it should measure the same phenomenon in different countries;
- it should be reported reasonably promptly and regularly and should preferably not be subject to significant revisions;
- it should concern variables with a considerable potential impact on other countries;
- it should be measurable in such a way as to depict developments vis-a-vis other countries.

Against the background of these criteria, it appears reasonable -- as suggested by the staff -- to exclude indicators for employment and structural policy. The staff's list of some ten indicators seems already to be on the long side. This, of course, does not mean that I disagree with Mr. de Groot and others, who have pointed to unemployment figures as an important indicator of economic performance.

It is further essential that the three main types of indicators be given their appropriate relative importance. In this respect, we wish to emphasize the important role that should be accorded to indicators of intermediary variables, maybe in particular the exchange rate. More generally, and in a longer perspective, priority should be given to performance indicators.

Therefore, the objective now should be to identify indicators that could provide rather simple and prompt information on developments. The next step would be a more thorough analysis. The following brief comments on some of the indicators recommended by the staff should be seen against this background.

The current account balance is an evident primary indicator; but it should be assessed together with developments of the counter items on the capital account.

The GNP, as actually computed, is also a natural indicator. But it would be useful mainly as complementary information in a more thorough analysis, as it is published quarterly and only with some lag. Since the composition of the GNP is of crucial importance for an assessment of external repercussions, we support the suggestion to look at final domestic demand as well. For early signals, the latest official forecast may have to be used, perhaps supplemented by some additional, more frequently published indicators, for instance the industrial production.

As for inflation, the suggested GNP deflator can not, for the same reasons, be used to provide the only signals, but may have to be complemented with, for instance, consumer prices. In international comparisons, unit labor costs is a valid indicator. However, it has the drawback of only covering manufacturing and thus omitting other important sectors of the economy subject to international competition. Also, computations of unit labor costs are very shaky and can be produced only relatively late.

We have certain reservations about the money supply as an indicator of monetary policy, because in many instances it has proven increasingly difficult to interpret money stock developments. As a result of these difficulties, even countries using monetary targetting seem to attach less importance to this technique than before. In any case, the use of money growth as an indicator must be seen in conjunction with the development of different interest rate variables and the exchange rate.

With regard to fiscal policy, we support the staff's judgement that a measure of the structural fiscal deficit should be complemented with the actual deficit, particularly when assessing external effects of deficit financing. Furthermore, the relative shares of domestic and external financing of the fiscal deficit is also of vital importance. In addition, there are problems in calculating the structural budget deficit, a concept far from being unambiguous.

As for exchange market policy, we would be hesitant to include changes in gross reserves in a selection of only few, central indicators. At least for countries with floating exchange rates, a pure intervention indicator, combined with the exchange rate, might be an alternative. But also such an indicator is impaired by technical problems which restrict its direct usability.

As for interest rates and exchange rates, we think that the staff's concentration on real magnitudes is going too far. Nominal rates would seem to provide better information, in particular with regard to short-term developments. Although nominal rates, in our opinion, should be given priority, real effective exchange rates constitute a very valuable indicator, while real interest rate differentials should be used only as a supplementary indicator. In this connection, we should not forget the complications of choosing a deflator that correctly reflects inflation expectations.

July 17, 1986 - 86/134

Statement by Mr. Dallara on
Indicators Relating to Policy Actions
and Economic Performance
Executive Board Meeting 86/114
July 14, 1986

F
?
FILE COPY

Introduction

"Among the laws that rule human societies," Alexis de Tocqueville stated, "there is one which seems to be more precise and clear than all others. If men are to remain civilized or to become so, the art of associating together must grow and improve in the same ratio in which the equality of conditions is increased." This quote from Democracy in America perhaps has some relevance for today's discussion, since like de Tocqueville, we are concerned with the art, as well as the science, of associating together -- specifically, how our member countries interact economically. Also, like de Tocqueville, many of you seem to have America uppermost in mind.

As more and more countries become competitive in international markets for various goods and services, as interdependency becomes increasingly evident for more and more sectors of our economies, as the larger, more industrialized developing countries diversify and broaden their product lines, as capital markets move closer to global integration, as the role of the dollar and the U.S. economy are gradually reduced secularly, one might say that we are moving slowly toward a "greater equality of conditions," to use de Tocqueville's words. Perhaps, in fact, we have moved further in that regard than we have moved in perfecting our ability to practice the art of economic association. If that is so, and I tend to believe it is, there is a pressing need for a more effective set of rules and mechanisms to guide our economic relationships. We are here today to consider one possible approach to doing this. It will not be easy to make this approach work; if it is to have a chance, it will require, at a minimum, the commitment of all of the major countries. If it does not work, then we will need to consider other approaches, for economic interdependence marches on as we talk.

These introductory remarks should have already made clear that we view today's discussion as part of an important effort to strengthen the functioning of the international monetary system and to enhance the mechanisms for international economic policy coordination. Multilateral surveillance has considerable potential in this regard. Some might say, however, that multilateral surveillance has had considerable potential for many years. But the difference is that now we have renewed momentum and political commitment, as reflected in the Interim Committee Communique and the Tokyo Economic Declaration. There is a clear willingness to

use economic indicators in an effort to strengthen surveillance, and we have been asked to further that effort in the Board by exploring a set of objective indicators in the context of our regular reviews of the World Economic Outlook (WEO). It should also be recalled, as Mr. Zecchini did, that the Interim Committee also asked us to "consider further whether there are any modifications in the exchange rate system which could contribute to enhancing exchange rate stability." Today's discussion must, therefore, be seen in the context of both of those requests, since we must follow up on both.

In our efforts in the Board, we believe we should take a pragmatic approach, recognizing that we are still at an early stage in what will need to be an evolutionary process, and recognizing that developing a consensus on all aspects will not be easy. But, as Mrs. Ploix suggested, we should not let the absence of full consensus block progress.

We found the staff paper to be helpful in framing our discussion today, and in suggesting possible approaches. An issue that arises in the introductory section of the paper concerns the scope and context for application of indicator-based surveillance. Like the staff, we see application occurring initially in the World Economic Outlook exercise. Over time, we would expect to see some application in single country Article IV consultations, although we believe the multilateral application of indicators should be our priority, particularly at this stage.

Regarding the scope for application, we would see it initially focusing on the G-10 countries, consistent with the recommendations of the G-10 Deputies Report that we prepare a separate chapter of the WEO analyzing the international repercussions of policies in those countries. Such a chapter could be the framework for our initial efforts in applying objective indicators, and might be the basis for the first day of a two-day discussion of the WEO. As Mr. Fujino noted this morning, we have suggested in the past that a second day could center on an interactions chapter covering the developing countries. That chapter could build on the first day's discussion by analyzing the major linkages between industrial and developing countries, along the lines suggested by Mr. Kafka. In addition, we would suggest including a discussion of interactions among the major developing countries themselves, perhaps initially emphasizing policies strengthening the potential for trade flows between those countries. With preparatory work this fall, such an approach could perhaps involve some application of indicators to the 25 largest members of the Fund during the course of the WEO exercise in 1987.

Purposes of Indicators

Turning to the purposes of indicators, we believe the basic purpose is to help promote policies which are internally consistent and internationally compatible in order that they can foster

internationally agreed goals, such as high growth consistent with price stability and viable payments positions, and maintenance of an open, growing trade and payments regime. This is fine, but it is on a such a general plane that the specific question remains -- what can indicators really do in our efforts to strengthen multilateral surveillance. Of course, different indicators perform different functions. Here I would note that we found the categorizations used by the staff generally useful. Viewing indicators collectively for the moment, however, I basically see indicators serving at least four related functions:

1. As a tool to help clarify to a government and to others the objectives and priorities of individual country policies. (Here I would say the extent to which indicators can perform this function will depend in part on the willingness of governments to develop their own forecasts.);
2. As a guide or benchmark to policymakers, against which and through which performance can be assessed and monitored;
3. As an instrument of analysis to facilitate the early identification of imbalances, of inconsistencies and incompatibilities; and
4. To help prompt discussions which can lead to corrective actions, and thereby to help catalyze and crystalize peer pressure.

In connection with most, if not all, of these functions, the ex-ante and ex-post references of the staff could be relevant.

Analytical Framework

Having these purposes and functions in mind, let me now turn to the question of an analytical framework. I would make the following points.

First, I welcome the focus on current account balances, with reference to the medium-term. As Mr. Polak noted, the Fund could play a valuable role in attempting to forecast how the policies of some countries could affect the payments positions of many other countries.

Second, although the balance of payments represents a principal point of interaction among our economies, I would join other Directors who have said, in effect, "so does the exchange rate." Although it is certainly true that the exchange rate is a determinant of relative competitiveness, and thereby a principal factor in influencing current account developments, it is a key variable in its own right, and deserves perhaps more attention in any analytical framework than it is accorded by the staff. In this connection, I would note that the exchange rate appears to

be increasingly viewed by some major industrial countries more as an indicator of economic policy than as an intermediate variable. That may particularly be the case if one modifies the staff's definition of indicators of economic policy as those variables over which authorities have, or seek to have (addition mine), fairly close control. Witness recent public statements by policy officials of major industrial countries toward that end.

Third, with regard to analyzing developments in the balance of payments, we have some comments and reservations concerning the use of the concept of "underlying" and "sustainable" balance of payments positions, as put forward by the staff. On the former, we believe that the objective of arriving at an "underlying" payments position can be accomplished without actually using the concept of underlying payments position, a concept which factors in so-called "cyclical" adjustments, which we believe may not be particularly relevant in current circumstances for this exercise. By forecasting trade and current account positions over a two to three year period, one would capture the lagged effect of earlier exchange rate changes while avoiding the problems that might be inherent in a "cyclically adjusted" approach.

On the question of sustainability, we could agree with the staff that we must proceed gradually in establishing criteria for what should be considered sustainable. But then the staff went some distance in saying that a sustainable position could be defined primarily on the basis of domestic savings and investment positions. While we would agree that savings and investment ratios are important in determining sustainability, we must take care not to use economic identities to explain causal relationships, and not to use an approach that could deflect attention away from consideration of policies that could change the private sector components of these ratios. Moreover, we believe that defining sustainability largely on the basis of these ratios is too narrow, possibly excluding other factors that can effect and help determine sustainability. A number of other Directors have already pointed out many of the limitations of an approach that focuses too heavily on savings/investment ratios, and I shall therefore limit my additional comments on this while associating myself with many of those earlier comments, although I would not go as far as Mr. Fujino did.

Even if the external positions of the major countries were in some sort of "balance," in theory there could be many savings/investment flow configurations consistent with that external "balance." In addition, the paper seems to presume implicitly that savings and investment flows are to a large extent determined by government fiscal positions. These are important, in some cases critical. But the private sector's role in the savings/investment ratio is also obviously important in determining world capital flows as well. And, it needs to be kept in mind that a wide range of government policies can affect the private sector components. Furthermore, the treatment of the

preferences of other countries related to asset accumulation/decumulation as "given" might be seen as deflecting attention from policies that can change these ratios. As Mr. Sengupta suggested, this might not be the most productive approach.

As I mentioned earlier, sustainability can be affected by a range of policies which may not be directly, or easily, captured in the savings/investment ratio. Is the "safe haven" factor, for example, adequately captured by the reference to "corresponding preferences" of other countries? I think not. Another example might be that credibility in a particular monetary authority's policies can have a direct impact on the sustainability of a current account position. In addition, exchange rate changes can affect sustainability, as Mr. Fujino pointed out, not just through effects on the current account, but through their effects on capital flows. For example, an apparent move to a longer run sustainable payments position via an exchange rate depreciation could actually reduce the size of a deficit that could be viewed as sustainable by reducing the relative attractiveness of investing in a particular currency, and thereby reducing capital inflows. One only has to look at current circumstances to see such a possibility. This example also points to the need to give adequate attention to market attitudes and expectations in judging sustainability.

Before concluding my comments on the analytical framework for judging sustainability, I would add that sustainability must also be viewed in a political as well as economic context. Imbalances which may apparently be financially sustainable at least for a time, may not be politically sustainable in the context of maintaining open markets.

Finally, I would stress that no matter how much emphasis is given to the current account, or for that matter the exchange rate, the analytical framework used must ultimately help policy-makers focus on the broad range of underlying policies that can affect external positions and exchange rates and help reduce incompatibilities. If not, then the framework, no matter how well structured, will likely have failed in its task.

Types of Indicators

With regard to the types of indicators, I would make the following comments. First, we believe that a priority should be placed on evaluating and monitoring performance, as well as policies, even in the short-run. Short-run deviations in performance may not signal a long-run trend, as noted in the staff paper, but should nonetheless be considered. This is particularly true since adjustment in performance is generally feasible only with a considerable lag, and requires early attention if problems are to be corrected before they assume major proportions. Second, I have already noted our concerns relating to the framework for use of balance of payments indicators.

With regard to output indicators, we should also look at final domestic demand, as mentioned in the staff paper. Further, we need to be cognizant of the fact that structural rigidities can have a significant impact on potential output. While we recognize the difficulties in developing indicators for structural problems, we are not sure that it is beyond the capacity of the Fund. Regarding an employment measure, we would prefer that the unemployment rate be included as an indicator. On pricing, we would suggest use of other pricing indicators in addition to unit labor costs, such as GNP deflators or consumer price indices.

Regarding the fiscal policy indicator, like Mr. Lankester, we suggest using the actual fiscal deficit, both central and general government budget. As I mentioned earlier, we have doubts about cyclically adjusted indicators.

Exchange rate indicators are a more complicated issue, given the difficulty in forecasting rates. It may be that actual forecasts of exchange rates are not made by many authorities, but many clearly do express their views and preferences from time to time, at least concerning the appropriate level and/or direction of movement in rates. This needs to be factored into our exercise. In any case, one must make assumptions about exchange rates to conduct our analysis of sustainability. As the staff points out, one approach could be to assume that current nominal exchange rates are maintained. Another would be to assume constant real effective exchange rates. A third possibility would be to develop various scenarios of likely or possible exchange rate changes that could reduce imbalances, depending on other possible policy changes. Such scenarios could be based, in fact, in part on the publicly expressed views of authorities, particularly if they suggest the desired direction of movement, or lack of it. I agree with Mr. Lankester that we must be careful with regard to market-sensitive variables. But as was done in last year's Article IV consultation, alternative exchange rate scenarios can be developed without creating the policy difficulties.

Regarding the exchange rate methodology used, we have reservations concerning the use of the MERM in deriving real effective exchange rates. We would prefer to use a real effective exchange rate calculation based on bilateral trade weights.

Procedures for Using Indicators in Surveillance

Regarding procedures for using indicators in surveillance, starting with each country's own forecasts appears appropriate, since those projections would be grounded in the staff's continuing contacts with member country authorities and would be framed against the background of those authorities' own medium-term objectives. Where current data, or forecasts, are not available, staff would need to make their own estimates or projections, so we have as comprehensive a database as possible.

In terms of the monitoring of economic developments, we generally endorse the procedures suggested, including the attempt to highlight international inconsistencies and weaknesses in domestic performance and policies.

It might not be realistic to expect that the monitoring process at this stage could do more than identify problems and suggest possible directions for solutions to these problems. We would endorse the staff suggestion at the top of page 22 that the staff could review the various alternative ways in which inconsistencies can be reconciled. The staff can also play a useful role by identifying the possible economic costs and policy implications of not acting to reduce or eliminate incompatibilities or inconsistencies. Regarding the question of judging the need for follow-on consultations, I agree with others that we should proceed very cautiously at this stage, and concentrate our efforts on developing an appropriate set of indicators and a methodology for using those indicators that can help identify problems, point toward their solutions, and foster a process which encourages policymakers to make needed policy changes. Ultimately, the policymakers must make the decisions -- we should try to provide the soundest analytical basis for those decisions.

In conclusion, Mr. Chairman, let me say that I recognize that like other Directors, we have not made the tasks of the staff any easier by our comments today. But the complications and complexities notwithstanding, we look forward to moving ahead in the process of strengthening multilateral surveillance through the use of indicators. We believe that the Fund must play an important role in that process.

July 15, 1986 - 86/131

Statement by Mr. Massé on Indicators
Executive Board Meeting 86/114
July 14, 1986

The very interesting staff paper before us today provides an initial opportunity to discuss the role of economic indicators in improving international economic cooperation, as a followup to the Interim Committee meeting and the Tokyo Economic Summit. My authorities have reservations about a few aspects of the paper which I will note in a few moments. I will, however, point out that their import will have to evolve over time, and that today's discussion can be no more than preliminary.

We see merit in the general approach outlined by the staff. The Fund is eminently qualified to carry out the further work which will be required. I thus strongly encourage the staff to continue with their work on these issues, since further work will be needed to clarify issues raised today and, more importantly, to improve our understanding of the linkages between countries and of how policies in individual countries interact and affect the broader world economy. Even if the current process only clarifies the basis for individual countries' policy decisions, and helps to identify possible international inconsistencies of individual countries' decisions or forecasts, this in itself can have important educational value and is a necessary first step. Further along the road, there may be possibilities of a common assessment of the causes and nature of imbalances and of agreement on how members should share the burden of adjustment.

To some extent, the World Economic Outlook and Article IV consultations have already begun to examine the question of interdependence and policy interlinkage. We fully support efforts to move this process forward but recognize that it may not, indeed, is unlikely to lead immediately to consensus. The complexity of issues involved and our incomplete understanding of the causal relationships between policy and performance can lead to genuine and legitimate differences of views. In turn, these differences might create different interpretations of whether there are justified reasons for international concern and, perhaps more importantly, different views on the kinds of measures needed to produce better results. Before we move any further down the road, we should be fully aware that these legitimate differences can and will arise.

We should, however, begin to follow the proposed path and see if there is consensus on some of the first markers. We fully agree with the staff that the focus of their analysis should be on the medium term. Given the often lagged response to changes in policy, as well as the potential cumulative effect of policies, too much focus on the short-term could miss the issue of whether policy trends over the medium term are in the appropriate direction. Just as importantly, excessive emphasis on short-term policies could encourage attempts at macroeconomic fine-tuning which could well become counter-productive.

In this context, we have considerable doubts about the suggestion for more frequent monitoring or mini-consultations by the staff than are already used. A move to more frequent consultations might lead to an over-emphasis on short-run economic policy or on short-run changes in intermediate variables, such as interest rate or exchange rate movements, as opposed to the longer term trend. In our view, the major focus of analysis should be the international repercussions of medium-term developments in individual countries, particularly the larger industrial countries that have the greatest impact on the global economy.

The staff has made a useful distinction as between policy indicators, performance indicators and intermediate variables. We endorse the view that it is desirable to limit the number of indicators and to focus on those that are readily known, quantifiable, timely and easy to interpret. We also should remember that since each country's situation is different, additional analysis will normally be required to provide a complete picture of economic developments, especially in structural areas where it may be difficult to find suitable indicators. However, it should be stressed that transitory factors or more fundamental changes such as innovations in financial markets may make some indicators misleading or even contradictory. A mechanistic interpretation of indicators therefore needs to be avoided.

This brings me to the indicators themselves as outlined by the staff. One basic problem we foresee is that most major indicators of interest to policymakers are endogenous variables, and cannot be accurately targeted by governments, even in a closed economy. At the same time, there is a problem of simultaneity in defining the most appropriate indicators, since the choice of indicators is both determined by the extent of policy coordination, yet also determines how closely policies can be monitored. Quite understandably, the staff has focussed on the international interaction of economic policies and performance, and the choice of the current account balance as the primary indicator has some appeal. It is reasonable that variables reflecting the international flow of goods, services and capital be of primary interest, since the Tokyo Summit decision to embark upon an indicators exercise has been prompted primarily by the growing recognition that the present state of international imbalances is not sustainable, both on economic and political grounds. However, the general focus upon defining a set of appropriate indicators and establishing an agreed medium-term conceptual framework against which policies and performance can be measured, and the particular focus on current account imbalances, raises some difficult theoretical and empirical questions. The staff paper recognizes some of these difficulties, but perhaps has not given sufficient weight to the practical problems which will be encountered in solving them.

Let me focus first on the current account imbalance to show the kind of difficulties which we foresee. The concepts of an underlying current account imbalance and of a sustainable current account balance are inherently difficult to define and measure. Sustainability can be influenced by a variety of factors, including political factors, that change over time and may well differ among

countries. For example, determination of the underlying payment balance of the United States and what might be considered a sustainable current account position poses a thorny analytical problem, about which there are likely to be many different views. Without agreement upon an analytical framework, it may well be impossible to reach a consensus on what remedial actions are required, when and by whom, questions the answer to which are the practical objectives of the exercise. In fact, it is not clear that means exist to adequately measure all the factors that could influence sustainability, such as political and market perceptions of what is sustainable, not to mention protectionist pressures.

Moreover, it is not easy to determine the extent of underlying disequilibria in foreign exchange and capital markets, nor the causes of such disequilibria. Even with the benefit of hindsight, it is questionable whether the reasons for the strength of the U.S. dollar during the first part of the 1980's, are fully understood. All this means that establishing accepted criteria for assessing policies and their sustainability, determining the nature of inconsistencies, as well as finding means of reconciling them, will be a very challenging task.

Nevertheless, these problems do not mean that the effort is not worthwhile. We would certainly encourage the Fund staff to undertake further research on the interaction of economic performance and policies, and on international linkages and the effect on the world economy of policies in major countries. Recent staff papers, including the one before us, have implied some sort of analytical framework of how international transmission of imbalances occurs, but a more explicitly outlined theoretical structure would go a long way towards helping our understanding of the path and, more importantly, could help formulate remedies as well as suggesting the limits of remedial action and the speed at which such policy actions might be taken. The staff has made a positive start by outlining the savings and investment framework for the current account imbalances. Since sustainability ultimately must be assessed in terms of savings and investment patterns, we would encourage the staff to continue their work in this area. However, I would caution that expectations of a fully consistent analytical system should not be too high.

Turning to other indicators outlined in the staff paper, it might have been helpful to give stronger analytical justification for any proposed list of indicators. My authorities found the omission of the unemployment rate rather surprising, particularly as this seems to go against the core of analysis presented in the paper. They also do not feel that changes in the level of gross reserves are necessarily a very good measure of exchange market intervention. With regard to structural rigidities and policies to address them, although it no doubt will be difficult to develop meaningful indicators of structural rigidities, particularly across countries, some exploratory work in this area might be undertaken, given the significance of rigidities to economic performance in some major industrial countries. In any event, the problem of rigidities should continue to be an integral part of the Fund's surveillance process.

Another concern is the weight which should be given to various indicators. The intermediate variables which are listed, that is, real interest rates, the real effective exchange rate, and investment and savings ratios, would seem to be key variables if one is attempting to identify emerging problems of international policy consistency. I also wonder whether all of the suggested indicators will be suitable for all countries. For example, the rate of growth of the monetary stock is suggested as an indicator, yet the paper also notes that monetary policy may be managed in light of exchange rate and interest rate developments, rather than to achieve target monetary objectives. As has been recognized during Article IV consultations in a number of industrial countries, the impact of financial innovation and deregulation has clearly made interpretation of movements in monetary aggregates much more difficult and, as a result, less emphasis is being placed on monetary aggregates for major countries. This should warn us about too mechanistic an approach toward indicators.

I come to procedures. In general, the main function of indicators should be to evaluate consistency of policies and performance, without triggering policy action to correct any perceived inconsistencies. The staff has suggested that it might be useful for the Fund to provide a Secretariat through which national forecasts can be collected and analyzed. In our view, such a role for the Fund would be extremely useful. The Fund could attempt to establish procedures to discuss the consistency of objectives and policies and to reconcile discrepancies amongst the forecasts. Of course, for this to be effective, it is crucial that the major industrial countries provide medium-term projections for as many of the agreed upon indicators as possible, together with key assumptions, including assumptions on the external environment and on policies and growth in other countries.

Although we do not disagree with the discussion in the staff paper on further stages of monitoring and procedures, we feel that these suggestions have to be viewed as very preliminary. Before proceeding further, work will be required on determining what indicators should be used, on obtaining national forecasts, and, most importantly, on the criteria to be used in assessing policies and their sustainability, an area where significant differences of views are likely. For now, the Fund should concentrate on these concerns.

Mr. Chairman, our present method of assessing macroeconomic policies makes coordination difficult. It is hard to reach common goals when those goals and the instruments to reach them are not clearly defined. The future depends on overcoming these deficiencies and on a resolution of the cooperative process. It is not sufficient for the policies of domestic decision-makers not to be inimical to other countries; these policies must as much as possible be supportive of and consistent with others. This shift in emphasis has been rendered necessary by the increasing interdependence of the global economy, a process which is not likely to be reversed, and we must now find a mechanism for recognizing explicitly that interdependence. Our challenge is to recognize in advance the costs of policy interaction, and to minimize those costs through cooperation.

July 15, 1986 - 86/130

FILE COPY

Statement by Mr. Zecchini on Indicators Relating
to Policy Actions and Economic Performance
Executive Board Meeting 86/114
July 14, 1986

Introduction

It is useful to start by framing our discussion in a context a little wider than the one mentioned by the staff, by recalling paragraph 5 of the last Interim Committee communique as a supplement to the staff reference to par.6. In fact, par.5 represents the necessary premise to par.6, in so far as it says that ".....it would be of the essence that economic policies be conducted in a sound and mutually consistent way.....". Thereby it is recognized that from the point of view of the world economy it is not sufficient that the policies of a member country are appropriate to its economic needs; instead, they also have to be coherent with those of other major countries in order to create the conditions for a stable monetary system. The recognition of the importance of policy consistency among countries is at the base of the request for improving the multilateral aspects of Fund's surveillance.

To this end we have been asked to explore the possibility of both identifying a set of indicators and using them to achieve our consistency goal. In this respect the staff has offered a concise and neat presentation of the characteristics and limitations of the most widely used macro indicators as well as of the conceptual framework which should guide their use.

While we can broadly agree with the former part of the analysis, we have quite a few remarks to make on the analytical framework which should guide the choice and the use of specific indicators, on the proposed selection of indicators and on the operational phase directed to making use of these indicators to attain more consistency in policies.

The Conceptual Framework

On the framework, the staff rightly points out that the main area of interaction among economies is trade and capital flows and because of this we have to look at their immediate determinants which are relative domestic demand expansion, rates of return on capital, nominal exchange rates and relative inflation rates. However, the staff document presents the harmonization of trends in these variables as functional to the achievement of an international allocation of resources that is consistent with comparative advantages and relative scarcities.

Here we doubt whether this optimal allocation approach is adequate to bring countries closer to the ultimate objectives

of extensive employment of domestic factors of production under conditions of monetary stability. Theoretically, an optimal allocation may be fully compatible with both an expanding world economy and a stagnating one, and this allocation does not necessarily guarantee a progress towards the goal of full factor employment in each country. Moreover, this approach seems difficult to implement because it would require the identification of and the agreement on where the comparative advantage for each country lies, not to mention the difficulty of defining relative scarcities which is tantamount to define sustainable relative prices over the medium-long term in volatile international markets.

In our opinion, it would be more appropriate to complement the "optimal allocation approach" with a "Pareto efficiency condition" which can best be determined by answering the following question. Which economic policies can a member country use to advance towards its economic objectives without at the same time prejudicing other member countries' attainment of their objectives because of the impact on trade and capital flows?

Such a framework presents several advantages over the one proposed by the staff. First, it takes as a benchmark the objectives and their order of priority which individual countries establish. The aim of the compatibility exercise is to ensure the international consistency of the policies that are instrumental to achieve national objectives without relying on the notion of comparative advantage. In econometric language, for a given economy, the exogenous variables which mostly reflect the impact of policies of other major countries will be somewhat endogenized through a process aimed at making them more compatible across countries and therefore more supportive of the objectives of all the economies involved.

If it is recognized that at any given moment no consistency exists among policies, it will be necessary to adjust either the ultimate objectives or the instrumental policies or both in a process that is at the core of the multilateral surveillance procedure. Here we can envisage a variety of situations between two extremes. On the one hand, we might have an inconsistency among national objectives. This was the case in France's experience with reflation in 1981-82. Then, the economic growth objective appeared incompatible with the external equilibrium target given the business cycle stabilization pursued by the other major countries. On the other hand, it is possible to have coherence of ultimate objectives together with international inconsistency or unacceptability of policies. This was the case in the U.S. experience in the 1982-84 period. In those years, the U.S. policy mix led to a monetary policy stance which was more restrictive than the one which was coherent with the objectives of other major industrial countries as well as with those of the developing countries.

A second advantage of our framework lies in the possibility of analyzing the repercussions of the policies of the major countries on the world economy, including other groups of countries.

On the basis of our framework it is also possible to overcome the limitations of the medium-term sustainability criterion which is proposed by the Staff. Undoubtedly, this criterion is important to assess the viability of a given pattern of international payments. However, it has the disadvantage of leaving room for asymmetries and therefore, it is biased. There are several reasons for this.

First, larger economies are better able to sustain external deficits than the others. Second, the U.S. has a unique ability to sustain deficits since it can issue liabilities that are considered international reserves. Third, surplus countries can sustain their disequilibria better and longer than deficit countries. Finally, the preferences of international investors on the composition of their financial portfolios are not exclusively a function of the fundamental trends and policies of the various economies. Sharp shifts in capital movements could make policies which are fundamentally sustainable and consistent unsustainable.

The difficulties of identifying the determinants of and projecting the capital movements make assessing the sustainability of deficits and thereby the consistency of policies rather uncertain if not unstable. However, it is evident that sustainability of deficits also depends on the short-term policies of major countries as well as on the financial support of international institutions, like the IMF.

The Choice of Indicators

Turning now to the choice of indicators within our framework, an optimal choice in the current system of flexible exchange rates would be to select the indicators which point at the need for policy adjustments with at least the same clarity as the one implicit in the deviation of the exchange rate from its parity according to the old Bretton Wood system. Barring the return to less flexible exchange rates for the time being, we must look for the best substitutes of the old parities in their function of signaling if and when policy corrections are advisable.

In this light the emphasis should be placed on instrumental and intermediate variables. Indicators which incorporate ultimate objectives should instead be used differently. These are relevant ex-ante to check both the appropriateness of policy instruments and the possibility of target attainment given the external conditions. The ultimate objectives are also important to verify ex-post the coherence of economic results among countries.

The staff provides us with an extensive list of indicators but fails to analyze the technical coherence of all these indicators. We have the impression of an overdetermination of the number of indicators. This, however, may be a positive feature if it is intended to lay the ground for applying alternative models to verify the consistency of policies. As a guideline, we deem it important to preserve a measure of flexibility in the selection of indicators so as to allow

for differences among countries in the type and role of indicators which are used for policy making. In spite of these discrepancies, the staff should construct the same set of indicators for each country by deriving those that are not specified by the authorities from the specified ones.

Indicators need not be single values but may be expressed in terms of a range of values or a direction of change.

Specific Indicators

Turning to the specific indicators to be selected and in the light of the previous considerations we do not wish to present a restricted list of indicators which excludes indicators irrelevant for some countries but relevant for others. Our comments, far from expressing a specific preference, aim at singling out the most important indicators.

In general, we concur with the Staff on the major properties the indicators should have : they should be timely, quantifiable, easy to interpret and comparable across countries. Furthermore, their "significance", i.e., the capacity of the indicator to capture a relevant phenomenon has to be assessed in order to have meaningful cross country comparisons. This is important, for instance, when we consider the different definitions of monetary aggregates and interest rates which constitute instruments or objectives of monetary policy in different countries. On the individual indicators we can make the following comments.

A) The use of the exchange rate as an intermediate variable might seem inappropriate under certain circumstances since this variable may be used as an instrument, for instance, to accommodate inflation differentials, thereby delaying structural adjustment. In our view it is important to emphasize the objective of exchange rate stability in order to avoid that the exchange rate becomes an instrument for correcting external imbalances by shifting the burden of adjustment on to partner countries. The risk entailed in such policy suggests the opportunity to include the exchange rate among the intermediate variables.

B) Nominal effective exchange rates should be taken into account as an indicator of the compatibility of monetary and fiscal policies across countries. Although indicators of the "target zones" type are not realistic now because of the lack of consensus, it might still be useful to use nominal exchange rates as signals for pointing at the direction of movement.

C) Interest rates are defined by the staff as "intermediate variables", and this may seem somewhat inappropriate since no distinction is made for rates which are directly controlled by the authorities. In our opinion, some interest rates can be usefully considered as indicators of monetary policy and added to the ones based on monetary aggregates to provide policy prescriptions which take properly

into account the distinction between real and financial nature of exogenous shocks. As to Italy, it will be convenient to include explicitly credit aggregates among monetary policy indicators.

D) We have some doubts on the use of real interest rates which are calculated on the basis of GNP deflator, since this is not a good proxy for measuring inflationary expectations. Moreover, a correction is required to allow for different tax treatments of interest rates and hence for their impact on saving/investment decisions across countries.

E) With respect to fiscal policy indicators the staff correctly draws a distinction between the indicators for macroeconomic purposes, based on measures of fiscal deficits, and those for structural purposes, based on the level of taxation and expenditure. However, while in the first case economic theory enables us to define optimal target values, in the second case it is much more difficult to determine the appropriate level of fiscal revenues and expenditures. As to cyclically adjusted fiscal deficit indicators we support their use while we are skeptical about inflation adjusted indicators. A correct appraisal of the latter type indicators requires additional indicators on the share of fixed interest debt, on its average maturity and on the impact of inflation on the revenue side and the expenditure one.

F) Although the staff correctly focuses on the balance of payments as the principal point of interaction between national economies, it omits to include some key indicators of trade and capital flows. We instead suggest to add indicators of export and import quantities, of terms of trade, of capital flows - distinguishing the autonomous flows - and of the relative cyclical position, which is a major determinant of the current account. We also suggest the use of an indicator to measure the share of debt service payments in the invisible flows of the balance of payments.

G) As to output indicators we would add to GNP the measure of domestic demand, since the former is more affected by developments on the external current account. We agree with the staff proposal to include among labor market indicators a measure of the "non-accelerating inflation rate unemployment" in order to properly assess unemployment performance. Finally, inflation indicators should include, in our opinion, private demand or consumption deflators and unit labor costs since GNP deflators are more biased by the changes in the terms of trade.

Procedures

Turning to the procedural aspects, although we agree in general with the staff proposals we would like to make few comments on the three stages of the proposed procedure. With respect to the first stage which deals with the statistical and analytical preparation of indicators, priority should be given to the variables used and projections made by the authorities since the latter are in the best position to take institutional and structural aspects into account.

The second stage aims at analyzing consistency and reconciling policies. The Staff should make projections about indicators to check any inconsistency both between policies and targets within each country and among the policies of the various countries. Technical inconsistencies may be overcome in the Board, while violations of the Pareto optimality condition or of the sustainability condition could be discussed in the Board but should be solved at ministerial level.

The third stage pertains to the follow-up action. Here the emphasis should be placed on prolonged deviations from the projected trajectories rather than on short term deviations. In the face of deviations there are two options: 1) to take corrective action; 2) to draw new trajectories for policy consistency. In both cases the Board can only prepare the debate that has to take place at ministerial level.

In all the three stages, the Board can approach this consistency exercise on the occasion of the discussions of the Art. IV consultations and of the two semi-annual World Economic Outlooks.

Finally, Mr. Chairman, the considerations we presented are intended to be a contribution to debate a complex subject on which my authorities still have an open position. The results of this and other debates will undoubtedly help my authorities to reach a final position.

July 11, 1986 - 86/126

Statement by Mr. Polak on Indicators
Executive Board Meeting 86/114
July 14, 1986

I. Introduction

Multilateral surveillance is a major part of the Fund's tasks, and indicators can play a valuable role to strengthen this surveillance. Careful study by the Fund of the nature and role of indicators can also be of assistance to the surveillance activities undertaken in other fora. We welcome, therefore, this first discussion on this important subject and the material provided by the staff on which to base this discussion.

The staff has presented us with a paper of very high intellectual quality. Most of the judgments it makes on the specifics of indicators have a long tradition in the Fund and can readily be accepted. These relate to such matters as the relative merits, for analytical purposes, of GNP vs final domestic demand, and the need to pay attention to both; the various yardsticks available to measure inflation, especially for purposes of international comparison; the usefulness of understanding movements in the current account of the balance of payments in terms of what happens to flows of savings and investment; as well as a number of other analytical and technical judgments.

The proposed tripartite division of indicators can also be accepted as a refinement of the Tinbergen/Meade dichotomy between instruments and objectives, although I am somewhat uncomfortable with the new names that the staff has chosen: in particular the term "policy indicators" does not convey a clear association with instruments of policy rather than with the objectives of policy. The older, simpler division did indeed produce the difficulty of classifying interest rates and exchange rates squarely as instruments, in spite of the fact that changes in either of these rates have in the past often aroused degrees of public sentiment that would only befit true yardsticks of objectives. However, as the staff also acknowledges, the insertion of an intermediate category is not likely to resolve all issues of classification.

As will be noted in more detail below, the distinction between different categories of indicators has important policy implications. With respect to policy indicators one can endeavor to establish policy norms; the same does not apply to indicators describing objectives. Similarly, any failure of policy indicators to follow the projected path deserves prompt attention, and perhaps action, while deviations in performance with respect to objectives of policy should not necessarily be considered an occasion for corrective action. This latter point is well made in the staff paper.

So far, so good. But of course, the paper is not primarily about indicators as such, but about how to use them in the exercise of international surveillance. After all, the tables in Article IV consultation papers are as full of what we are now going to call "indicators" as the texts of these papers are full of what we might, generously, call "prose".

The same observation holds, broadly, for the WEO papers which have for at least the last ten years served as the main background for the Fund's multilateral surveillance. Here I welcome the staff's intention to deepen the analysis of the current account of the balance of payments along lines used in the past, and also to gain greater insight than has proved possible in the past into the determinants of capital flows, and hence in the determination of exchange rates.

In between the highly competent technical observations on the classification, the analytical interlinkage, and the most efficient definition of various indicators one can locate, here and there, brief observations on certain features of this indicator exercise that does distinguish it from the use of statistics in the Fund's work on major countries in the past - or at least in the recent past. These aspects are dealt with in sections IV, V AND VI below. Before discussing them, I shall want to make some observations on the choice of indicators, and on possible norms for certain policy indicators.

II. Selection of Indicators

I have a number of comments on the choices made by the staff for the indicators to be covered.

(i) The staff pays perhaps too much attention to real variables, at the expense of nominal variables. Specifically, I would like to add the nominal exchange rate and nominal interest rates. Concentration on the real exchange rate tends to abstract from the problem of inflation.

(ii) There are considerable problems with any reserve indicator, which were well documented in the work of the Committee of Twenty (see its 1974 Report). Thus, for a variety of reasons, gross or net reserve movements may or may not be reliable indicators of balance of payments developments or of intervention activities. The value of this indicator is therefore likely to be limited.

(iii) The staff is not clear as to inclusion of unemployment as an indicator. It should in any event be observed that unemployment data are not by themselves usable as a yardstick of the room for expansion, but would need to be complemented for this purpose by indicators on the extent of the use of capacity.

(iv) Finally, while there can probably be no ready indicators of structural measures, it would be desirable if countries could provide short descriptive material on such measures.

III. Norms for Policy Indicators

The surveillance activities of the Fund (as well as those of others) could be further strengthened if it proved possible to develop norms for certain indicators, such as the budget deficit or money supply growth, against which these indicators could be judged. The norm for the fiscal deficit would be derived from the savings and investment equation of the private sector, with the implication that a fiscal deficit in excess of net private saving would find its way into an external imbalance. Or one could think of a more stringent norm, related to the need to limit the ratio of public debt to GNP, as suggested by the Managing Director in his August 1984 speech at Innsbruck. The norm for the money supply could be derived from the medium-term structural growth rate of the economy, with allowance for monetary (price) factors only in so far as they were of external origin; the aim of this approach would be to avoid automatic accommodation of inflationary developments of domestic origin.

Norms such as these could not be seen as binding prescriptions. Their function could not extend beyond presenting certain presumptions: countries could be expected to justify deviations from the norm and partner countries should feel inhibited to suggest policies that would involve transcending the norm.

IV. Sustainability

One crucial issue discussed in the staff paper is sustainability, in particular as regards the balance of payments. Normally, the sustainability of positions has been considered in the Fund for an individual country. In particular, this has been done for payments deficits, where the question has been asked whether the country would, over the medium term, be able to attract foreign resources commensurate with a specified deficit and whether over the longer term it would be able to service the resulting stock of indebtedness. The staff deepens and broadens the definition of sustainability among the main industrial countries by posing the additional questions whether the domestic savings and investment position of the country is sustainable and whether it is compatible with the corresponding preferences of other countries. The broadening - bringing in the preferences of other countries - is perhaps relevant to the US payments deficit. No deficit by any other country could conceivably make an important enough difference to the savings/investment balance of the rest of the industrial world (which would then of course include the United States) for it to be felt there as interfering with national preferences. Even in the case of U.S. deficit sustainability - or rather the absence of it - can probably be readily established without reference to the savings/investment balances either in other industrial countries or in the US. That judgment can be made on traditional grounds, in the sense that the deficit produces an international indebtedness that the US cannot expect to service. A further solid reason against the deficit is the protectionist consequences that it calls forth. A third one is that one component of US domestic dissaving - the budget deficit - will in the long run produce a level of domestic government debt that can no longer be serviced.

Thus it would seem that the traditional (bilateral) way of judging

whether a payments situation is sustainable will normally continue to suffice, even in a framework of multilateral surveillance.

Once it has been established that a particular disequilibrium is not sustainable and will have to be corrected, the question arises as to the counterpart balance of payments adjustments that this will bring about in other countries. This raises the issue of consistency.

V. Consistency

The staff calls international consistency of balance of payments positions "a necessary condition for their sustainability" (p.8). The issue comes back on page 20 where (implicit) concern is expressed about ex ante inconsistency between countries' balance of payments objectives or forecasts. This then leads to the suggestion "to keep track of trends in savings and investment in order to provide advance warning of possible inconsistencies".

These observations raise a wide range of issues.

(i) To take a somewhat technical point first, it is by no means clear that trends in savings and investment (the former often statistically quite defective) could be estimated or forecast with more confidence than the current account itself, or that the causal process runs from an ex-ante desired domestic balance to a foreign balance.

(ii) Consistency (ex post) of current account balances exists of course only "at the global level" and while these words occur in the text, no further attention is paid to the fact that an exercise on the indicators of major industrial countries covers too small a proportion of the world payments to permit judgments on the problem of global balance of payments consistency. For example, the impact that the US deficit had - and that its eventual elimination will have - on developing countries may easily be as important as its effect on other industrial countries. The question of consistency extends beyond the area of payments balances. On p. 21 the staff indicates that it would plan to highlight, as a source of concern, "international inconsistency of objectives or forecasts." This would be possible where countries A and B announced different figures for the A/B exchange rate or the A-B trade balance; but for overall trade deficits, growth rates, etc. such conclusions would frequently not be possible on the basis of figures for the seven major countries. There is thus a major contribution that the Fund can make to surveillance activities among major industrial countries, viz. to set their payments imbalances and their expected correction in the framework of a true multilateral, i.e. a world-wide, framework.

(iii) That, unfortunately, is not an easy task. Any attempt to tackle the problem of consistency in global payments is, for the time being, severely handicapped by the enormous "statistical discrepancy" in world payments statistics which, as the staff mentions in the understatement of the year, "would have to be appropriately allowed for". (page 8, footnote 1).

(iv) The Fund could, nevertheless, play a valuable role in attempting to forecast how the policies of some countries would affect the payments positions of all other countries. This exercise would, of course, not be limited to calculating the effects of, e.g., the needed reduction in the US

deficit; it would involve forecasting the payments positions of all countries, taking into account the policies of all countries. In other words, the Fund must continue to produce a consistent set of current account forecasts for all countries combined.

(v) The "world discrepancy" makes, at least for the time being, moot the issue whether countries should, on a world-wide basis, make a major effort to ensure that their balance of payments objectives are consistent, and how serious the consequences of inconsistent national forecasts are.

A relevant point in this connection is that most industrial countries do not have balance of payments objectives. They may have current account forecasts which - in conjunction with those of all other countries - might be said to be inconsistent if one knew how to handle the statistical discrepancy; but that inconsistency is of no consequence in so far as countries are not hampered in their policy objectives by the likelihood that their current account forecasts will not be realized.

VI. Weaknesses in Performance

Attention needs to be turned finally to the third task that the staff sees for indicators: "to highlight.....weaknesses in domestic economic performance or policy".

This particular aspect of the use of indicators deserves close attention because it raises political issues. The components of the staff's reasoning on this subject are scattered throughout the paper, and it may help to bring them together.

(i) Starting out from the unexceptionable proposition that "all countries have, as ultimate economic objectives, an optimal rate of utilization of existing factors of production, satisfactory growth of output over time, and reasonable price stability"(p. 5), the staff suggests that indicators can be used to define a government's numerical objectives on output, employment, etc. and the policy measures available to foster these objectives, (p.3).

(ii) Having equipped each country with a numerical growth objective, the paper then assumes that this objective needs to be judged: "A more difficult issue... is the establishment of criteria by which objectives with respect to growth are to be judged...." (p. 11). Specifically, judgment is to be based on the sustainability of the targeted growth rate and on the non-inflationary speed with which the gap between existing and potential output levels can - and, it is implied, should - be filled. However, "other objectives (such as fiscal strengthening) that might legitimately constrain governments' freedom of maneuver" are allowed for as a qualification (p. 11).

(iii) When it comes to "Using Indicators in Surveillance" (the title of Section V) the earlier qualifications that apply to judgments tend to be submerged and a country's growth objective or performance can be judged to be inadequate "when domestic economic performance or objectives fall short of what was considered attainable, having regard to a medium-term framework. An example of the latter would be where a country was envisaging economic growth at a pace considered to be below what would be sustainable without rekindling

inflationary pressures" (p. 21) (one might note the absence of any reference to an unsustainably high level of output, or to an unsustainable fiscal policy!) In this connection, it is recognized that performance variables are hard to control in the short run and "fine-tuning" should be avoided (p. 23). For the short run, the emphasis is on keeping the policy variables on track, in the expectation that this will bring the performance variables around over time. However, if this does not happen within a reasonable time, it will be necessary to change the "policy settings". (p. 23)

Apart from the welcome disclaimer of "fine-tuning", the approach of the paper seems to be somewhat removed from the approach to economic policy as it is practiced in the main industrial countries in recent years. Rare are the countries that announce a growth objective for the coming year. True, growth forecasts are made by all governments, but the operational significance of these forecasts is far from clear. Not infrequently, such forecasts tend to be on the optimistic side, - perhaps in the hope that optimism may have some self-fulfilling effect - as evidenced, for example, by the fact that the IMF staff forecasts are often lower. Also, the linkage between these forecasts and policy measures tend to be much less explicit than was the case, say, twenty or perhaps even ten years ago. With more emphasis on structural measures to encourage growth over the medium term, governments are less able to predict or to determine output in any particular year, and less willing to adjust policy variables to bring about the realization of what are, after all, no more than forecasts. An additional relevant consideration is that not all governments have found it possible to achieve the setting of fiscal instruments that they would consider desirable.

To conclude this section: any program to use indicators in connection with the setting and monitoring of national growth performance will require not only good indicators, but also a clear mutual understanding among the participants of the implicit or explicit normative assumptions of the exercise itself.

One particular aspect that needs explicit consideration in this connection is the distinction, already mentioned, between GNP (or GDP) and domestic demand. If one takes as one's starting point - for example in the framework of the requirements of the world debt problem - that every country should do its part in maintaining an adequate rate of growth in world demand, then the relevant "performance criterion" would be each country's growth rate of domestic demand. However, the ability of any country to avoid inflationary pressures in its economy depends on its growth in GNP, which includes the (positive or negative) contribution from the net balance on goods and services. Any international surveillance of the growth performance of the main industrial countries will have to come to terms with this distinction, which involves at the same time the ever elusive question of the distribution of responsibility for bringing about the adjustment of any given disequilibrium situation.

VII. Indicators and Analysis; Procedures

The staff suggests that, to be helpful to the Surveillance process, "indicators must be limited in number, quantifiable, timely and relatively easy to interpret". There is, indeed, merit in presenting those who are engaged in the process of international surveillance with a limited number of

reasonably standardized indicators. The Fund has made considerable progress in this direction. But, however well defined and standardized, indicators will never be self-sufficient. They "might help to identify a need for discussion of countries' policies" (the wording of the April 1986 Interim Committee Communique) but that discussion will then still have to be based on an analysis of these policies. It would be tragic if international judgments - even presumptive judgments - on the adequacy of policy were to be made on the basis of indicators without analysis.

Subject to this constraint I would broadly endorse, on an experimental basis, the staff's procedural proposals on page 25, although for the reasons I have outlined, I would not expect the exercise to be particularly productive on the question of international consistency. National data would be collected and analyzed by the staff in a global framework, using as much as possible existing procedures (such as Article IV Consultations and mini-consultations). They would be presented, mostly in the established forms of documentation, such as the Consultation Reports and the World Economic Outlook. The chapter on policy interrelations among the industrial countries could gain particular importance in this connection. This documentation would then be discussed in the Executive Board and the Interim Committee, with particular attention to the linkages between policies and medium-term objectives. Thereafter, performance would be monitored against projections. One interesting question that arises in this connection--and on which an initial staff reaction would be helpful--would be in how far the procedures proposed would differ from, or improve upon, current practice under the World Economic Outlook exercises.

1986
16
17
18
19
20

July 10, 1986 - 86/125

Statement by Mr. Lankester on Indicators Relating
to Policy Actions and Economic Performance
Executive Board Meeting
July 14, 1986

Introduction

This statement sets out the United Kingdom's views on multilateral surveillance, and relates these to the detailed proposals in the Fund staff paper "Indicators Relating to Policy Actions and Economic Performance" (EBS/86/127).

My authorities have long supported the need for effective measures to improve international policy cooperation. The Chancellor of the Exchequer, Mr. Nigel Lawson, in his speech to the Interim Committee in April set out some specific proposals. Principal among these were that:

- (a) there should be 'quantified analysis by the IMF staff' setting out medium-term economic prospects for each major country together with an assessment of policies;
- (b) those participating in multilateral surveillance would use this analysis as a basis for identifying 'potential inconsistencies and conflicts' and the various policy options that might assist in resolving them;
- (c) there would be subsequent 'discussion at Ministerial level of possible policy commitments designed to produce a more consistent set of policies and a more stable world economy';
- (d) there was 'bound to be a large element of judgment and flexibility in this process. It would not be practical to establish objective indicators as automatic triggers for policy adjustment'.

How to Improve and Develop Policy Coordination

The main purpose of strengthening multilateral surveillance, as my authorities see it, is to facilitate more substantive international discussion of policy with a view to reducing the scope for damaging or unsustainable external imbalances between the major economies. Such imbalances have undoubtedly developed in recent years with disruptive effects that have spread across the world economy. The objective now must be to put in place a system of surveillance that helps remove those imbalances and makes their reemergence in the future less likely.

An improved system of multilateral surveillance must build on the positive achievements of recent years and the policies on which they have been based. Attempts to remove disruptive external imbalances must not prejudice

the very real policy achievements in all the developed economies, including the UK, that have led to a major reduction in inflation and have created the conditions for sustainable growth. Any moves to remove other imbalances at the expense of these hard won achievements would be self-defeating, and any drift back to the policies of the 1970s must be avoided. It is essential that efforts to rectify the adverse international effects of policies of particular countries should not lead to the adoption of undesirable policies elsewhere to the detriment of all. In particular, it will be important for participants to be aware of the behaviour of aggregate measures of demand, trade and prices, and to ensure that surveillance does not encourage the adoption of policies that would rekindle inflationary pressures.

The essence of successful macroeconomic policies in the 1980s has been firm control of nominal magnitudes so as not to accommodate inflation. In the 1970s many governments attempted to target real growth or unemployment. They ended up with unacceptable levels of inflation and poor growth performance. In the UK the government's counter-inflation policies have been formulated in the context of a Medium-Term Financial Strategy. This has many elements in common with successful macroeconomic policies in other countries. The Strategy sets out a satisfactory medium-term path for money GDP together with the evolution of money supply and the fiscal balance that the government considers will be consistent with the achievement of this path. The private sector and financial markets are then fully aware that the government will not accommodate higher inflation by allowing significant overshooting of the money GDP path. Within such a policy framework steady real growth is both possible and--as UK experience since 1981 has demonstrated--likely. For its medium-term figuring the government assumes a feasible path for real GDP, but it does not make explicit medium-term forecasts. Past experience suggests that it is not worthwhile attempting to forecast reversible economic fluctuations beyond about 18 months.

My authorities propose that multilateral surveillance should follow the practice of all governments in the main developed economies in recent years by giving a central role to the control of nominal magnitudes. The starting point would be a set of medium-term projections for the major economies focussed in a nominal framework. Such a forecasting exercise would produce, as the Fund staff's World Economic Outlook (WEO) does already, a range of nominal and real variables, including:

- (i) the growth of nominal domestic demand in each major country;
- (ii) projections for various measures of inflation, including the domestic demand deflator;
- (iii) projections of the growth of real domestic demand implied by those for nominal demand and inflation.

With policy operated as in recent years, projections of real domestic demand (and output) would be contingent on the achievement of appropriately low rates of inflation.

We do not think it is necessary or desirable to have explicit forecasts for market sensitive variables. For example, a 'no change' exchange rates assumption need not prevent identification of emerging undesirable external imbalance. On the assumption of constant nominal exchange rates, it would be

possible to produce the current account projections that should be the central focus of the exercise. These would constitute the baseline material for participants to assess the sustainability of existing policies and exchange rates, and hence to identify any potential inconsistencies and conflicts. There should be particular emphasis on the identification of actual and prospective domestic fiscal and monetary policy mixes which generate undesirable external imbalances. The assumption of constant nominal exchange rates should not impair ability to identify externally disruptive domestic policies.

My authorities see forecasts presented in this way as essential background material for effective policy discussion. Countries would be able to discuss and coordinate policy more effectively. As a result, individual countries would improve their own policy settings in the light of better information on the international environment. More importantly, individual countries might be more inclined to curb policies with undesirable spillover effects on other countries when such effects are more clearly identified.

In the light of the inevitably large element of judgment in such an exercise and the need for flexibility if progress is to be made, it would be inappropriate to accord target status to any of the projected indicators, whether they are direct policy instruments or not. It is, of course, essential that individual countries continue to keep firm control on nominal magnitudes; but this is something best left to national discretion because a fair degree of national flexibility must be preserved for the system to prove workable. Likewise there should be no question of any automatic triggers for policy response since any such arrangements would eventually, in practice, destroy the basis for mutual cooperation on which the exercise is founded.

It is against the foregoing envisaged broad framework that we have assessed the proposals in the staff paper.

Detailed Comments on the Fund Staff's Proposals

(A) Procedures

My authorities' view is that the indicators exercise should begin in a modest and workable way, building on existing IMF staff work and procedures. It can develop thereafter as circumstances and experience dictate. The natural course would be to build on the existing WEO framework:

- the Fund staff should prepare the WEO, augmented as agreed;
- in the course of preparing the WEO the staff would probably find it useful, as now, to consult with national forecasters in certain countries;
- Fund staff papers summarising the work of the WEO should form the basis for discussion in the multilateral surveillance exercise;
- at the end of this process of discussion, the Fund staff should publish the projections and policy assessments in the WEO in the normal way, having taken account both of recent developments and of the policy discussions.

We do not believe it would be wise to base the surveillance exercise on special forecasts prepared by national authorities. To do so would lead to problems of widely different methodology and coverage, and would be too cumbersome to provide an effective background to well focussed discussion of policy between countries.

(B) Classification of Indicators

The proposed three-way classification of performance, policy and intermediate indicators appears to us to be rather misleading. The appropriate classification for many indicators will depend on the particular methods chosen to conduct policy in individual countries. Were classification to be necessary, a distinction between direct policy instruments, intermediate policy objectives (often targeted) and final objectives might be more appropriate, but even here the dividing lines are not sharp. To classify variables in either way does not seem to serve a particularly useful purpose in the context of surveillance.

(C) The Analytical Framework

My authorities agree that the principal role of multilateral surveillance should be to help remove obvious external imbalances, notably in the pattern of current accounts in developed economies. However, we have some difficulties with the specific proposals for identifying undesirable or unsustainable balance of payments positions:

- on the surface, the calculation of 'underlying current account positions' based on projections of domestic activity on existing policies and exchange rates seems acceptable. But conventional IMF staff practice for calculating underlying balances involves an assumption of constant real exchange rates and an allowance for cyclical adjustment, both of which imply some judgment on nominal exchange rate movements. Since it will in our view be essential to be extremely careful in the treatment of market sensitive material, it would be preferable to use constant current nominal exchange rates and omit cyclical adjustment. The very poor record of exchange rate forecasting further bolsters this view;
- the calculation of 'sustainable' balance of payments positions based on medium-term balance of domestic savings and investment would be highly uncertain and limit the practical relevance of the 'underlying/sustainable' comparison to the identification of extremely divergent cases. Such analysis could provide no more than a loose background contribution to policy discussions. Publication of related material would have to be handled carefully to avoid any unwarranted presumptions emerging about future exchange rate realignments;
- there should be more emphasis on the extent to which domestic policies contribute to any projected external imbalances, in particular the contribution of public sector deficits. The exercise must be careful to avoid any presumption that a large imbalance of private domestic savings and investment in a particular country is necessarily a bad thing. It may well reflect efficient intertemporal resource allocation and meet the needs of other countries. On the other hand, large public sector deficits are far less likely to be reasonable against criteria of efficient resource allocation.

(D) Specific Indicators

Bearing in mind our desire for the surveillance exercise to be largely focussed in a nominal framework, we have the following comments on possible specific indicators:

- monetary policy: we agree with the staff that the particular monetary aggregates chosen by national authorities for monitoring or policy purposes be used as an indicator. This is particularly suitable for countries engaging in monetary targeting. We also agree that it is more appropriate to focus on nominal rather than on real money balances. Concentration on the latter could be taken to imply a presumption that inflation should be accommodated;
- fiscal policy: we accept the proposal to use the actual fiscal deficit (with coverage wide enough so that the indicator is not undermined by intra-government transactions), and to steer clear of inflation adjustment (because it gives the wrong message when the aim is to reduce inflation). We do not have any enthusiasm for the use of cyclically adjusted measures. Both underlying (structural) and cyclical components of deficits affect the economy and so the distinction is not particularly useful. Somewhat surprisingly the paper omits reference to the public debt/income ratio. Although measures of this ratio are not useful in deciding what should be the fiscal stance in the short run because they accommodate inflation, they can be important for assessing the sustainability of fiscal policy and interpreting flow data in the medium-term context. Since fiscal deficits comprise the public sector contribution to the domestic savings/investment balance (and hence the net acquisition of overseas assets), their sustainability clearly has international implications; and we would therefore like a measure of the debt/income ratio to be included as an indicator;
- demand/output: we would like to see the main emphasis on nominal domestic demand. The exercise will, as indicated above, produce derived forecasts for real domestic demand and GDP. But it is essential in our view that these forecasts do not in any way acquire normative or target status;
- inflation: the drawbacks of unit labour cost data are sufficiently serious to make us cautious about using such an indicator in the surveillance exercise. Restriction of coverage to manufacturing means exclusion of much of the economy and of important (and growing) sectors engaged in international trade. Data on manufacturing unit labour costs are subject to continued revision and there are problems of definitional differences between countries. All these factors make interpretation of unit labour cost data a difficult task, and the problems are if anything compounded when they are 'normalised', i.e. cyclically adjusted. The identification of 'underlying' labour productivity trends is a most inexact art form. We believe it is important in this exercise to use whole economy inflation indicators such as domestic demand or GNP/GDP deflators;

- unemployment: quite apart from the objections already mentioned to any form of target treatment for real variables, the use of an unemployment indicator in the surveillance exercise would seem to be an unnecessary complication. The derived projections for real demand and GDP/GNP will provide sufficient material on the level of activity when the main focus is to be on external imbalances. Projections for unemployment would not have any direct repercussions for the balance of payments over and above those implied by other proposed indicators. Moreover, unemployment is not the only, and by no means obviously the best, indicator of capacity utilisation. It would have much more of a role to play in policy discussion of structural problems, but at this stage it would not seem sensible for the surveillance exercise to cover these;
- balance of payments flows: we agree that current account balances should be the prime area of focus for the whole surveillance exercise. Whether current balances are regarded as intermediate or final objectives is immaterial. Assessment of the sustainability of current balance projections from the perspective of the balance of domestic savings and investment is of clear relevance, but such calculations are likely to be distinctly lacking in robustness. For reasons spelt out under (C) above, the projections of 'underlying' current balances should be based on current nominal exchange rate assumptions and avoid cyclical adjustment;
- market sensitive variables: it is essential that the exercise treats such variables with care and that no explicit forecasts or assumptions of changes become public:
 - (a) exchange market indicators: market sensitive indicators of nominal exchange rates and exchange reserves should be projected on a 'no change' basis. If the projections are to be acceptable to participating countries, no other form of arrangement is likely to prove satisfactory. Forecasts on such a basis will still effectively show emerging imbalances in payments and exchange rate positions, and will provide a satisfactory background to policy discussions;
 - (b) interest rates (and domestic savings/investment indicators): given the market sensitivity of interest rate forecasts, we would certainly not want to see anything published giving direct information on any projected differential interest rate movements between countries. However, there will need to be some assumptions on real interest rates if the staff are to produce an assessment of medium-term domestic savings/investment balances (which are intended to shed light on the sustainability of projected current account balances). Furthermore, it would be inconsistent to base projections on constant current interest rates when constant current nominal exchange rates had already been used, and the current situation involved nominal interest rate differentials between countries. It might be necessary, therefore, for the Fund staff to assume when structuring the

forecasts some fairly neutral changes in interest rates, e.g. a gradual fall in all rates if the existing levels were high, or the gradual removal of unusual interest rates differentials. But any such assumed changes should not be published nor should it be possible to infer them from any other published material.

Conclusion

My authorities envisage as a suitable basis for effective policy discussions an exercise covering the medium-term (say, three years), with the emphasis on nominal magnitudes and a fairly limited coverage of specific indicators including:

- monetary aggregates
- actual fiscal deficit and the debt income ratio
- nominal domestic demand and output
- whole economy inflation indicators
- current account balances
- domestic savings and investment

Implicit in the projections would be real demand and output paths based on assessment of productive potential and conditional on nominal objectives being met. Fund staff assessment based on these projections would provide the essential background material for policy discussions aimed at better international policy coordination and a reduction in potentially disruptive external imbalances.

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

File

EBS/86/127

CONFIDENTIAL

June 12, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Indicators Relating to Policy Actions and Economic Performance

The attached paper on indicators relating to policy actions and economic performance is scheduled for Executive Board discussion on Monday, July 14, 1986.

Mr. Crockett (ext. 8982) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

INTERNATIONAL MONETARY FUND

Indicators Relating to Policy Actions and Economic Performance

Prepared by the Research Department

(In consultation with the Area Departments, the
Exchange and Trade Relations Department, and the
Fiscal Affairs Department)

Approved by Wm. C. Hood

June 11, 1986

	<u>Contents</u>	<u>Page</u>
I.	Introduction	1
II.	Purpose of Indicators	2
III.	An Analytical Framework for the Use of Indicators in Surveillance	5
	1. Overview	5
	2. Factors influencing the balance of payments	6
	3. Criteria for assessing the sustainability of payments balances	7
IV.	Types of Economic Indicators: Uses, Scope, and Limitations	9
	1. Indicators of economic performance	10
	(a) The balance of payments	10
	(b) Real output	11
	(c) Employment	12
	(d) Inflation	12
	2. Indicators of economic policy	13
	(a) Monetary policy	14
	(b) Fiscal policy	15
	(c) Exchange market policies	17
	(d) Structural policies	18
	3. Indicators of intermediate variables	18
	(a) Interest rates and exchange rates	19
	(b) Saving and investment balances	19
V.	Procedures for Using Indicators in Surveillance	20
	1. Procedures for monitoring indicators	20
	2. Procedures for modifying targets or policies	23
VI.	Issues for Discussion	24

I. Introduction

The April 1986 Interim Committee Communique contains the following reference to the possible usefulness of indicators in implementing Fund surveillance (paragraph 6).

"...To improve the multilateral setting for surveillance, the Committee asked the Executive Board to consider ways in which its regular reviews of the world economic situation could be further adapted to improve the scope for discussing external imbalances, exchange rate developments, and policy interactions among members. An approach worth exploring further was the formulation of a set of objective indicators related to policy actions and economic performance, having regard to a medium-term framework. Such indicators might help to identify a need for discussion of countries' policies. The Committee noted that increased emphasis would be given in the World Economic Outlook to policy interactions among industrial countries in order to strengthen the basis for assessing the international repercussions of the policies and objectives of the major industrial countries, and also to help promote the further development of recent initiatives to enhance policy coordination among these countries..."

In the Tokyo Economic Declaration, the Heads of State or Government of the seven Summit countries, with the representatives of the European Community...

"...reaffirm [ed] the undertaking at the Versailles Summit to cooperate with the IMF in strengthening multilateral surveillance particularly among the countries whose currencies constitute the SDR, and requested that, in conducting such surveillance and in conjunction with the Managing Director of the IMF, their individual economic forecasts should be reviewed, taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates."

This paper is an initial response to the Interim Committee's request, which also takes into account some of the specific suggestions made in the Tokyo declaration. The paper begins, in Section II, by assessing the purposes that indicators might be expected to serve. Section III then presents an analytical framework for discussing policy interactions among countries. In Section IV, some suggestions are offered concerning the nature of the specific indicators that might be helpful in this connection. Section V considers the procedural aspects of extending

the use of indicators in the Fund's surveillance work. Finally, Section VI identifies a number of issues on which further guidance from the Board is needed.

It may be helpful to note at the outset certain restrictions that have been placed on the scope of the present paper. First, the paper is preliminary in nature: it describes an approach to the use of indicators, but it does not attempt to apply the approach. It is expected that application will take place, particularly in the context of World Economic Outlook and Article IV discussions, after the issues raised in the present paper have been thoroughly reviewed. Second, the analysis is developed with the larger industrial countries in mind. This corresponds to the focus in the Interim Committee and Tokyo communiques, and reflects the fact that it is the large countries that have the greatest impact on global economic conditions. Moreover, if indicators are to be discussed from the perspective of international interactions, there is a practical limit to the number of countries that can be covered in an initial assessment. Nevertheless, many of the principles and issues that are discussed have applications for countries outside the major industrial group. Third, no attempt has been made to develop new or unfamiliar indicators. This is largely because the range of indicators that are customarily used in analysis seems broad enough to meet the needs of a more intensified assessment of international interactions of policies and performance. Moreover, since the objective is to develop a procedural and analytical framework that enables issues of coordination to be viewed in a fresh perspective, it seems desirable not to burden the analysis with unnecessary complexity in the choice of variables to be employed.

The limitations placed on the present paper need not, of course, preclude subsequent analytical developments. The staff has already done a considerable amount of work on the interaction of economic performance and policies, some of which has been presented in the context of World Economic Outlook exercises. 1/ Research work is continuing on relationships between economic policies and performance, and this may lead over time to refinements in the use of indicators.

II. Purpose of Indicators

The use of indicators in the assessment of economic performance has a long history, both in the Fund and elsewhere. The basic purpose of economic indicators is to give quantitative content to governments'

1/ See, for example, "Effects of Exchange Rate Changes in Industrial Countries," World Economic Outlook, Staff Study, SM/86/49, Supplement 4; "The Transmission of Economic Influences from Industrial to Developing Countries," World Economic Outlook, Staff Study, SM/86/49, Supplement 5.

economic aims and achievements, both in the realm of policies and performance. Indicators can thereby be used as a guide in helping judge the realism and appropriateness of objectives, and their consistency with international goals such as efficient adjustment, stability in trade flows, and sustainability of capital movements. ^{1/} They can also be used to publicize governments' commitments to a particular course of policy, and thus to improve the basis for private sector decision taking.

The recent statements of the Interim Committee and the Summit participants, as well as the earlier reports of the Group of Ten and Group of Twenty-Four, ^{2/} suggest at least three ways in which existing uses of indicators might be extended: (i) through a more explicit focus on the international repercussions of developments in individual countries; (ii) by casting objectives and policies into a medium-term framework; and (iii) by the development of standards against which developments in the various indicators can be appraised.

Indicators can be used both *ex ante*, in formulating objectives, policies and projections, as well as *ex post*, in monitoring progress toward desired objectives. In a forward-looking sense, indicators can help define a government's economic objectives and the policies through which it hopes to achieve those objectives. Economic objectives include variables such as output, employment, and balance of payments and price stability. The policies which are available to foster these objectives include: fiscal policy, i.e. the level and structure of government revenues and expenditures; monetary policy, i.e., the rate of growth of monetary and credit aggregates and the setting of other monetary instruments; and structural policies, such as the degree of regulation in particular industries and markets. There are, in addition, intermediate variables that are neither ultimate goals of policy nor direct policy instruments, but which nevertheless have an important bearing on the interaction of policies among countries. These variables include real and nominal interest rates, exchange rates, and the relative growth rates of domestic saving and investment. Normally countries will have expectations or forecasts of how such variables might evolve, based on their assumptions about the channels through which policies work to influence the outcome for broader economic objectives.

^{1/} A report prepared for the Committee of Twenty by the Technical Group on Indicators discussed a number of technical problems concerning indicators in the adjustment process. (See "Documents of the Committee of Twenty," pp. 51-77, IMF, 1974.)

^{2/} Report of the Deputies of the Group of Ten on the "Functioning of the International Monetary System" (EBD/85/154, Sup. 1, 6/21/85, and Report of the Deputies of the Group of Twenty-Four on the "Functioning and Improvement of the International Monetary System - Transmitted to the Interim Committee (EBD/85/228, 8/30/85).

A second way in which indicators can be used is in a retrospective or monitoring sense. Indicators can define how the economy has performed in some past period, and what the stance of policies has been. Used in this way, however, they need to be complemented by some standard, or frame of reference, against which to judge whether policies have been appropriate and performance has been successful. Such a standard can be the set of indicators and projections formulated at the outset of a policy period. It has to be recognized, however, that when an expected time path is specified for a large number of interconnected variables, some indicators may show deviations while others remain on track. A framework is therefore required for judging the significance, in particular circumstances, of departures from expected developments.

Both of the purposes of indicators that have just been described can be (and often have been) used in a purely national context without reference to international interactions. However, indicators can also be used for purposes of assessing the intercountry consistency of developments and prospects. In the framework of surveillance, this is likely to be an aspect of indicators that assumes increasing importance. Two kinds of consistency are important from an international standpoint: first, the projections being made by individual countries should be arithmetically consistent with those of other countries, for example, with respect to anticipated rates of growth of exports and imports. Second, and more fundamentally, projected developments should be compatible with the medium-term objectives of a stable system. These objectives would include sustainable balance of payments positions, combined with satisfactory performance with respect to growth and inflation.

A further use of indicators, which will not be dealt with in depth in this paper, is as a triggering or enforcing device, i.e., in requiring automatic or quasi-automatic responses by policy authorities. An example of such a use of indicators is the "hard" version of target zones, whereby a given exchange rate development would require a prescribed form of policy response, such as intervention, or a change in monetary or fiscal policies. Use of indicators in this fashion is feasible only when the primary objective of the authorities is congruent with the indicator being used (e.g., the exchange rate in a fixed rate system). or when there is a strong consensus about the relationship between specific policy actions and a given economic result.

To be effective in serving the purposes of analyzing and interpreting developments, economic indicators must be timely, quantifiable, relatively easy to interpret, and adequately comparable, both across countries and in relation to objective standards. It has to be recognized of course, that few indicators will be satisfactory in all

these respects. In particular, single-valued indicators are generally unable to capture the complexity of the economic situation they are being used to portray. Most economic variables, for example, reflect a combination of underlying and persistent influences, as well as transitory phenomena. It is important in analysis to distinguish between such influences, so that responses are not triggered to developments that eventually prove self-reversing. Thus, while tractability requires a limited number of relatively straightforward indicators, it should be recognized that additional analysis will usually be needed to provide an adequately rounded picture of economic developments, policies and prospects.

III. An Analytical Framework for the Use of Indicators in Surveillance

1. Overview

As noted in the Interim Committee communique, a key objective of the use of indicators in surveillance is to "strengthen the basis for assessing the international repercussions of the policies and objectives of the major industrial countries, and also to help promote the further development of recent initiatives to enhance policy coordination..." Against this background, it seems appropriate to focus explicitly on how developments in the policies and economic performance of individual major countries influence the opportunities and constraints faced by other industrial countries, and the international community at large.

The principal point of interaction between national economies is trade and capital flows. These flows are influenced by the level and structure of demand growth in the various countries, by relative expected rates of return on assets, and by relative national price levels adjusted for exchange rates. The role of multilateral surveillance is to help countries move toward better and more consistent developments for all these variables. Indicators can assist in this process by providing a framework in which the evolution of policies and economic performance can be measured against their desired or expected path.

All countries have, as ultimate economic objectives, an optimal rate of utilization of existing factors of production, satisfactory growth of output over time, and reasonable price stability. However, the achievement of these objectives will be significantly affected by developments in the external sector. Trade in goods and services can help bring about a more efficient allocation of global resources, as countries concentrate production in industries in which they have a comparative advantage. Capital flows can help improve the volume and

distribution of international investment, since they permit flows of real resources from countries where savings exceed investment opportunities to countries where the reverse prevails.

The potential benefits of international trade and investment flows can be reduced, however, when policies and developments among countries are inadequately harmonized. Inappropriate or uncoordinated national policies can lead to trade and capital flows that do not reflect comparative advantage or relative scarcities. Such flows, in turn, can generate volatility and uncertainty concerning the future path of interest rates, exchange rates, and payments flows. Added costs may be incurred when resources have to be shifted back and forth between uses in response to unnecessary or reversible changes in competitive conditions. Lastly, and perhaps most important, protectionist pressures can be created when international trade is perceived to be influenced by factors that seem to be unrelated to more fundamental supply and demand considerations.

In analyzing economic interactions, it is therefore of central importance to distinguish between those developments which promote the efficient international allocation of trade and capital flows and those which give rise to economic adjustments that run counter to efficient resource allocation. A satisfactory conceptual framework for making such a distinction must have at least two components. First it must be able to identify the channels by which domestic policies and developments affect the balance of payments and exchange rates. Second it must provide some basis for judging whether such effects, in given circumstances, are desirable or undesirable from an international standpoint. These two elements of the conceptual framework may be discussed in turn.

2. Factors influencing the balance of payments

The primary determinants of the current account of a country's balance of payments are (i) relative demand levels in the domestic economy and in its trading partners, and (ii) relative competitiveness. This much is not controversial and provides a useful framework for analyzing balance of payments developments--though it has to be recognized that the relevant relationships cannot be established with a high degree of precision. The recent and prospective evolution of the trade and current accounts can be assessed with reference to past and anticipated developments in demand and competitiveness. ^{1/} If forecasts are available for rates of domestic demand growth in the major countries over the relevant time horizon, estimates can be made

^{1/} See "Issues in the Assessment of the Exchange Rates of Industrial countries," IMF Occasional Paper No. 29, July 1984.

of how the current account might evolve (other things held equal). Similarly, given an assumed evolution of domestic costs and prices and the pattern of exchange rates, estimates can be made of how these competitiveness factors will affect payments flows. ^{1/} By adjusting the existing payments position for the estimated effects of lagged changes in exchange rates and of prospective changes in cyclical positions, it is thus possible to come to an assessment of the "underlying" balance of payments. The key indicators needed to make such an assessment are as follows: (i) a measure of economic activity (demand or output); (ii) a measure of domestic inflation (costs or prices); and (iii) a measure of the effective exchange rate.

The first two of these indicators can be projected on a country-by-country basis using standard forecasting techniques. The third (the exchange rate) can be easily observed ex post, but has proved difficult to project in any satisfactory manner. It is nevertheless of considerable interest to develop a framework for analyzing exchange rate developments and prospects, especially if judgments are required concerning whether a given pattern of exchange rates is to be regarded as sustainable and/or desirable. To do this, it is necessary to understand (and try to develop indicators for) the factors that underlie shifts in capital flows so as to provide a more comprehensive account of international economic interactions. This is a difficult exercise, in part because expectations (which are inherently hard to observe or model) play such an important role in determining the desire to acquire or dispose of external assets. A logical place to begin is by looking at the factors that influence the balance of domestic savings and investment (and therefore the net acquisition of foreign assets). These include developments in the fiscal position (which represents the net saving or dissaving of the public sector) as well as developments affecting the willingness of the private sector to save or invest. Indicators that may be useful in this context include: (i) a measure of the overall fiscal position; (ii) gross private savings flows; (iii) gross private investment; and (iv) real interest rates.

3. Criteria for assessing the sustainability of payments balances

The calculation, as described above, of a set of "underlying current account balances" that is implied by existing policies and exchange rates can be a helpful focus in international surveillance. To the extent that such a set of payments balances is felt to be unsustainable,

^{1/} For purposes of projections, the staff often assumes that there will be no change in competitiveness from some base date. It is nevertheless of considerable importance to estimate how the lagged effects of changes in competitiveness that occurred prior to that date will affect balance of payments patterns.

it could trigger discussions of whether remedial action is required. (Remedial action could be of a positive character, in the sense of a deliberate change of policy in one or more countries, or more passive, in the sense of acquiescence in exchange rate movements needed to restore sustainability.)

A key issue in interpreting underlying payments balances is thus how to establish criteria for what should be considered sustainable. This is a particularly difficult analytical subject, on which it will undoubtedly be necessary to proceed gradually. A basis for approaching the issue is provided by the identity which equates the current account position (surplus or deficit) and the balance between domestic saving and investment. A sustainable current account position could therefore be defined as one in which the domestic savings and investment position of a country is sustainable, given the corresponding preferences of other countries, and the need to avoid an excessive buildup of external liabilities or assets.

The domestic saving/investment balance can in turn be decomposed into the net financial balance of the public sector and the net financial balance of the private sector. The former is derived from the fiscal balance, which is an important indicator and policy tool in its own right. The latter is influenced by all the factors that affect private saving and investment decisions, including interest rates, the level and growth rate of real incomes, the return on physical capital, and demographic factors. The determinants of gross private saving and investment are subject to empirical estimation, although it has to be recognized that robust relationships are not always easy to establish.

The foregoing analysis suggests that the appraisal of policy interactions among industrial countries could be based on an analytical framework in which "underlying" current account positions (based on existing policies and exchange rates) would be compared with "sustainable" positions (derived from an assessment of the medium-run determinants of savings and investment). It is to be emphasized that international consistency of balance of payments positions is a necessary condition for their sustainability. 1/

The existence of a large divergence between the underlying and sustainable positions would be a signal that further discussions might be useful. Such discussions might of course lead to the conclusion that either the underlying or sustainable position had been mis-estimated, and that no divergence requiring correction existed.

1/ This means that the "statistical discrepancy" in world balance payments statistics would have to be appropriately allowed for.

Alternatively, it might lead to the conclusion that there was indeed a potential problem, and that remedial action was needed.

The various possibilities for remedial action are suggested by the factors that determine current and capital account flows. These flows may be altered through factors that bring about shifts in competitiveness, changes in relative growth rates, or structural changes that influence trading patterns, as well as by measures that affect domestic saving and investment positions. The choice of the particular means for restoring sustainability will depend on the extent to which, in given circumstances, particular indicators of domestic policies and performance in individual countries diverge from agreed or projected paths.

This last point implies that the setting and monitoring of objectives with respect to domestic variables is a matter of international concern, at least to some extent. The choice of whether a balance of payments disequilibrium should be corrected by exchange rate movement or a shift in relative rates of economic growth requires, for example, a view on the rate of growth in an individual country that should be considered attainable.

IV. Types of Economic Indicator: Uses, Scope, and Limitations

Against the background of the foregoing discussion, this section provides an analysis of various indicators that are useful in assessing the policies and developments that lie behind balance of payments and exchange rate trends. It also considers ways in which such indicators can be adapted to make them more useful for the kind of comparative analysis that is required to improve the effectiveness of multilateral policy discussions among countries. Section V will then offer some more concrete suggestions concerning how surveillance procedures can be adapted to make more effective use of indicators.

Indicators can be classified into three types: indicators of economic performance, which broadly speaking cover the more fundamental objectives of economic policy, i.e., economic growth, employment, and balance of payments and price stability; indicators of economic policy, which cover variables over which the authorities have fairly close control, but which are not themselves components of economic welfare, i.e., monetary growth, exchange market intervention, the fiscal deficit, etc; and indicators of intermediate variables, which are variables through which policies influence performance--savings and investment levels, interest rates, and exchange rates. Although the distinctions between these three different types of variable can sometimes be blurred, it is convenient to discuss them separately.

1. Indicators of economic performance

(a) The balance of payments

The balance of payments can be considered either an objective of policy or an intermediate variable. For the major currencies with floating exchange rates, it is not an objective in the sense that these countries have quantified aims for the structure of their balance of payments. However, most countries would probably subscribe to the objective of restoring or maintaining a "sustainable" external payments structure, so as to limit the dangers of protectionist pressures and to minimise the costs and uncertainties that are involved when an unsustainable position emerges and has to be corrected. Moreover, from the point of view of surveillance, the restoration and maintenance of a balance of payments pattern that is adequately consistent with the domestic policies and priorities of all members must be considered a key objective.

A widely used indicator related to the balance of payments is the current account surplus or deficit, and it seems appropriate that the current account account remain the primary indicator of developments in the external sector. ^{1/} As noted in the previous section, however, a satisfactory analytical framework for judging the sustainability of a given exchange rate pattern would involve an assessment of the "underlying," as well as the actual, current account position. It may be useful, therefore, to include in staff analyses estimates of how the underlying current account balance differs from the recorded or projected position. This would involve making adjustments for the effects of recent exchange rate changes that had not yet been fully reflected in trade flows, for the impact on imports and exports of cyclical divergences from "normal" employment levels, and for any other special factors affecting payments flows in a given period.

Presentation of underlying balance of payments estimates would facilitate multilateral discussions of the sustainability of the external positions implied by current policies and prospects. A sustainable balance of payments position can be defined as one in which the underlying current account surplus or deficit is matched

^{1/} The trade balance is another indicator of external developments that often attracts attention, particularly in the context of the need for trade liberalization and market access. The trade balance is also useful as a leading indicator of developments in the overall current account, since data related to trade are usually available on a more timely basis. In general, however, there seems little economic reason for drawing a distinction between trade in goods and trade in services.

capital outflows or inflows that correspond to a country's desire to accumulate foreign assets or debts, and its capacity to service its external debt out of current foreign exchange earnings. For such a position to be internationally appropriate, it must also be compatible with the savings/investment preferences of other countries, and reasonably full employment of factors of production.

(b) Real output

Concerning domestic economic performance, perhaps the most widely used indicator is the rate of growth of GNP. As an indicator, GNP has the merit of comprehensiveness, widespread familiarity, and comparability across countries. Given the multiplicity of purposes for which it is employed, however, it should not be surprising that it is not equally suited for all purposes. As a measure of welfare, absorption per head would be a better indicator, while as a measure of efficiency, output per unit of factor input might be superior.

For the purpose of analysing the international interaction of trends in output and demand, which is the natural focus of multilateral surveillance, the chief drawback of the GNP indicator is its level of aggregation. In particular, it is often desirable to distinguish the relative contribution of domestic and foreign sources of demand growth to any given change in overall GNP. It is therefore proposed that, while GNP remain the principal indicator of developments in the real economy, it should be supplemented with systematic presentation of developments and prospects in final domestic demand.

A more difficult issue than the choice of which indicator to use is the establishment of criteria by which objectives with respect to growth are to be judged, and performance assessed. Specifically, what rate of growth should be considered sustainable, given the constraints a country faces, its other objectives, and its obligations toward its trading partners? Such a calculation will involve, as a first step, estimation of the underlying rate of growth of productive potential. This is not a simple estimate to make, since it depends not only on the rate of increase in available factors of production (the aggregate supply of labor and capital) but also on hard-to-observe variables such as the quality of factor inputs and the speed of technological progress. A second step would be to judge how large is the gap between existing and potential output levels and how quickly it is feasible to close such a gap. These are also difficult estimates to make, since they depend on factors such as the nature and extent of rigidities in goods and labor markets, the risk of igniting inflationary pressures, and the existence of other objectives (such as fiscal strengthening) that might legitimately constrain governments' freedom of maneuver. However, techniques for making judgments in these

areas exist that enable the attainable rate of growth to be defined as the sum of (i) the growth in underlying capacity and (ii) the rate of absorption of economic slack.

(c) Employment

An indicator of economic performance that is closely related to GNP growth is employment. There are a variety of possible indicators in the employment field. The rate of increase in numbers employed is sometimes used as an indicator of "success in creating jobs." By this token, however, an economy with a rapidly growing population and labor force could appear to be more successful in the employment field than one with a slower growing population, even though the latter might have a lower rate of involuntary unemployment. A measure of labor market conditions that avoids this particular difficulty is the rate of unemployment, which is also in many respects a more visible objective for government policy. It has to be recognized, however, that the rate of unemployment is itself not always an effective measure of involuntary unemployment. There may be categories of discouraged jobseekers (longer-term unemployed, young people remaining in education, women remaining in household work) not captured in published unemployment statistics.

As with GNP growth, a labor market indicator such as the unemployment rate needs a standard by which assessments can be made as to whether changes in the unemployment rate are satisfactory or not. A considerable literature exists on the "natural" rate of unemployment or the "nonaccelerating inflation rate of unemployment" (NAIRU). Although neither of these concepts is easy to apply in practice, they do provide a framework in which, for a given institutional setting, the existing unemployment rate can be judged too high (or, possibly, too low). A medium-term objective of policy would presumably be to move toward the NAIRU, and to do so at a pace that does not have seriously adverse consequences for other economic objectives, such as inflation control. It is also possible that governments may have medium-term objectives to reduce their NAIRU, say by structural measures that improve the flexibility of labor markets, and enable price stability to be maintained with a lower level of joblessness. To the extent that such structural goals can be quantified, it should be possible to factor them into medium-term employment objectives.

(d) Inflation

Another important indicator of economic performance is the rate of inflation. From a domestic standpoint, the key objective in most countries is probably to come as near as practically feasible to stability in consumer prices. Internationally, it may be more important to identify differentials in cost inflation (and where possible, reduce

them), so as to facilitate the task of judging whether movements in nominal exchange rates are appropriate from the perspective of efficient adjustment. While costs and prices often move together, there can be differences in underlying trends. In an economy that is enjoying a more rapid rate of productivity increase in its manufacturing than in its service sector (as was the case, for example, in Japan in much of the postwar period), it is possible that domestic price inflation could be higher than in trading partners, while cost inflation in traded goods industries might be lower. This need not pose insuperable difficulties for the development and use of indicators, provided that the disparities are properly identified and allowed for.

In this connection, efficient adjustment requires that any trend divergence in production costs in traded goods industries be compatible with corresponding exchange rate trends. An inflation measure that has proved particularly useful in analysis is the rate of change of unit labor costs in those sectors of the economy that are most exposed to international competition. Being a measure of costs, it is more relevant to international competitiveness, and thus is better able to identify inflationary trends that have implications for balance of payments flows.

The foregoing discussion suggests that the inflation indicator that would be most useful in discussing external imbalances, exchange rate developments, and policy interactions is not necessarily the one that will be most familiar in a domestic economic context. Movements in the consumer price index contain adventitious elements that are only incidentally related to international competitiveness and underlying inflationary pressures. The GNP deflator is a superior indicator in many respects, although it still does not capture some important elements related to international competitiveness. A measure of labor costs per unit of output, perhaps normalized for differences among countries in cyclical position, would have important advantages. Its main drawbacks would be: (i) such an index is available only for the manufacturing sector of the economy; (ii) the data from which it is compiled are produced with a lag; and (iii) the concept is less familiar to policymakers. To some extent, however, it might be possible to reduce these shortcomings if it were decided to focus on such a measure as a central feature of surveillance.

2. Indicators of economic policy

For expositional convenience, domestic macroeconomic policy can be divided into its monetary and fiscal aspects. In addition, countries that do not maintain either fully floating or rigidly fixed exchange rates have discretion in their management of reserves or exchange rate policies. Finally, the increased focus in recent years on structural

policies suggests that it may be desirable to consider the possibilities of developing indicators in this field also.

(a) Monetary policy

In the area of monetary policy, the most widely used policy indicator in the major industrial countries is the rate of growth of some monetary or credit aggregate. The specific aggregate that is used varies from country to country depending on the institutional characteristics of the country concerned and the robustness of empirical relationships.

Several issues arise in developing meaningful indicators for use in cross-country analysis. The first concerns whether the same measure of the money stock should be employed for all countries. On the one hand, it could be said that different definitions of monetary variables inhibit comparability across countries. Some monetary authorities have selected a monetary target primarily on grounds of controllability; while others have preferred to target an aggregate that is closely linked with developments in the economy, even though the target itself cannot be closely controlled. Differences in criteria for the selection of monetary targets might cause difficulties in circumstances when the monetary authorities were attempting to concert their policy stance - e.g., to keep aggregate growth in the world money supply within some range, or to engage in offsetting policy responses to unwanted exchange rate developments.

Nevertheless, it would seem desirable to adapt the definition of monetary indicators to take account of conditions in particular countries. Generally speaking, when the authorities of a particular country have chosen a monetary aggregate for policy or monitoring purposes, this represents a careful choice based on analysis of the strength and stability of empirical relationships. It is likely to facilitate a meaningful dialogue, without undue loss of effective comparability, if the definitions used for purposes of international surveillance accord with those used for domestic policy formulation.

A second issue in the choice of monetary indicators concerns whether real or nominal variables should be used. It can be argued that it is the real money stock that determines the perceived liquidity of the private sector and therefore influences the willingness to spend. On the other hand, developments in the real money stock can be an ambiguous indicator. Under conditions of rising inflation, wealth-owners will seek to economize on real money balances and the real money stock will be observed to fall. Indeed, a systematic increase in the growth of the nominal money stock, causing an acceleration of inflation, will almost certainly lead to a decline in the

real money stock. For this reason, and because the central goal of monetary policy is to keep inflation in check, it seems more appropriate to define monetary indicators (whether used as targets or as monitoring instruments) in nominal terms.

A third potential issue lies in how to handle unexpected shifts in the demand to hold money balances. If an upward shift in money demand can be identified, measured, and precisely offset by an equivalent adjustment in supply, it could be said that the stance of monetary policy has been kept unchanged. It would therefore be desirable to have an indicator that is adjusted for the effect of known shifts in the demand for money. The difficulty is, of course, that changes in demand are very hard to identify, particularly at the time they are occurring. One possibility would be to use interest rates as an indicator of a change in the balance between supply and demand in money and capital markets. But interest rates are also an ambiguous criterion, since an increase in interest rates may reflect a shift in the demand for money at given income levels, or an increase in credit caused by an incipient increase in nominal output. The implication of the foregoing is that the possible alternatives to the use of money growth rates as a primary indicator of the stance of policy all have drawbacks. A money stock indicator is still probably the best indicator of monetary policy in countries that use monetary targets, but it must be used with caution and in the light of surrounding developments.

Not all countries use monetary targets, of course. In countries with fixed exchange rates, the domestic money stock cannot be closely controlled by the authorities, since liquidity can enter or leave the country via overall balance of payments surpluses or deficits. Even in countries where there is greater freedom for exchange rate movement, monetary policy may be managed in the light of exchange rate and interest rate developments rather than to achieve target monetary objectives. For countries that do not have objectives for monetary aggregates, an alternative indicator of changes in monetary conditions will be necessary. One possibility, which would have the merit of facilitating international comparisons, would be to use interest rate differentials with major international currencies.

(b) Fiscal policy

While the medium-term goal of monetary policy can be defined as the restoration and maintenance of an appropriate degree of price stability, the aims of fiscal policy are both macroeconomic and structural. At the macroeconomic level, governments have objectives for the budget deficit, related to the need for economic stabilization, as well as to a desire to limit the government's claims on the saving

available for private investment. At the structural level, there may also be objectives for the structure and level of taxation and expenditure, with a view to enhancing incentives for efficient resource allocation, and limiting the absolute volume of real resources absorbed by the government.

In choosing how the macroeconomic objective relating to fiscal balance should be defined, a number of questions arise. These include: whether fiscal objectives should be established for the entire public sector, the general government, or for the central government alone; whether the objective should be for the actual fiscal deficit or for the "underlying" deficit (i.e., whether the "policy-induced" fiscal change should be separated from the change attributable to purely cyclical factors); and whether or not the deficit that is monitored should be inflation corrected. Beyond these definitional issues, of course, lies the more fundamental question of what the fiscal objective should be, and whether independently determined objectives (e.g., zero deficits) are internationally consistent in terms of their impact on balance of payments flows.

The choice of whether the fiscal deficit that is measured should extend beyond the central government depends, to a considerable extent, on the scope of public sector activities that fall under the control of the fiscal authorities. Whichever level of government is selected as the primary focus for the fiscal indicator, however, it is important that the value of the indicator not be undermined by shifts in the classification of transactions (e.g., from central to local government) that have substantial effects on the chosen indicator but little economic significance.

Concerning the choice of actual or cyclically corrected fiscal deficits, it is relevant to note that most governments express their aggregate fiscal objective in terms of some stated level for the actual fiscal deficit. This, indeed, is the indicator that most accurately measures the extent of the government sector's claims on financial markets. However, movements in the actual fiscal deficit can give a misleading impression of the thrust of fiscal policy in circumstances where output is growing significantly faster or slower than its medium-term trend. In a phase of relatively rapid cyclical expansion, revenues tend to grow faster than expenditures and thus the budget deficit can shrink, even though policy-related fiscal measures may be tending to increase the deficit. Similarly, when the economy is stagnating, the weakness of tax revenues may cause a budget deficit to widen even though the measures introduced by the authorities may in themselves be tending to strengthen the fiscal position. It seems desirable

therefore to use indicators both of the actual and of the cyclically adjusted fiscal position. 1/

Adjustment for inflation poses some potentially more difficult issues. On the one hand, it can be argued that inflation effectively reduces the value of a government's outstanding debt with effects on wealth-holders that are similar to taxation in an environment of stable prices. On the other hand, inflation adjustment can sometimes define away a real problem, as when the fiscal deficit itself is an important source of the pressures that give rise to inflation. In circumstances when inflation is low and stable, inflation adjustment is not needed to permit a meaningful comparison of fiscal conditions across countries or over time.

A more difficult issue than defining the fiscal deficit to be monitored is that of evolving criteria for assessing the appropriateness of countries' medium-term objectives in the fiscal field. While a country's objective for its fiscal deficit is intimately related with the domestic social and political priorities, it also has international implications. Changes in public sector saving or dissaving have consequences for the overall saving/investment balance in a country, and thus for its balance of payments situation. This is an area in which technical criteria are not easy to establish, and in which, therefore, it will be particularly useful to generate a multi-lateral dialogue.

(c) Exchange market policies

In the area of exchange market policies, possible indicators include the exchange rate and some measure of exchange market intervention. Since most of the major industrial countries pursue flexible exchange rate policies, the exchange rate itself is not regarded as a proximate instrument of policy. It is better viewed as an intermediate variable, and as such it is discussed further in the following section. Exchange market intervention, on the other hand, is a policy instrument that can be measured in terms of the size of reserve movements over given intervals. It should be remembered, however, that exchange market intervention can sometimes take place in ways that do not affect reserves (e.g., through borrowing and lending in foreign exchange by public sector entities). Moreover, the impact of intervention depends importantly on whether it is sterilized or nonsterilized.

Concerning the criteria according to which exchange market intervention is to be assessed, it would seem reasonable to assume that

1/ For a review of the staff methodology for making cyclical adjustments to changes in the fiscal position, see "A Review of the Fiscal Impulse Measure," by Peter S. Heller, Richard D. Haas, and Ahsan S. Mansur, IMF Occasional Paper No. 44, May 1986.

reserve levels would, over time, tend to move toward some stable relation to external transactions (say, imports). For most major countries, it is unlikely that there would be any systematic ex ante intention to accumulate reserves, or run them down, in significant quantities. There would therefore be no prior standard (other than "no change") against which actual reserve movements would be compared. It would, however, be useful to compare intervention activities by one country with any offsetting activity on the part of trading partners; and to view exchange market intervention in the light of accompanying movements in exchange rates and interest rates.

(d) Structural policies

Indicators of structural policies are, by their nature, hard to devise. The structural policies that have been the focus of most attention in recent years have been those relating to deregulation, labor market rigidities, and trade restrictions. With regard to deregulation, it is possible to list the number of regulations eliminated or modified, and it is possible to provide analytical judgements about the effects of deregulation (e.g., in terms of reduced prices or increased volume of transactions in the markets concerned). On the whole, it seems more practical to analyse the process of deregulation through ad hoc empirical studies, rather than through an attempt to devise specific and quantified indicators of objectives and performance. Labor market rigidities are thought to be manifested in a variety of ways, including inadequate flexibility of wages; wage levels that are too high; lack of geographical and occupational mobility; and inadequate training facilities. While many of these factors are not amenable to quantitative measurement through indicators, it does seem desirable to use the indicator of unit labor costs described earlier to help in reaching judgments of whether developments in real wage rates are warranted by movements in labor productivity. As far as trade restrictions and protectionism are concerned, there is again no fully satisfactory way of developing quantitative indicators. There is thus little alternative to continuing to analyse the impact of trade restrictions in qualitative (albeit specific) terms, while to the extent possible including staff judgements of their quantitative significance.

3. Indicators of intermediate variables

The channels by which policy variables affect the ultimate objectives of policy are not direct, nor are they fully predictable. For these reasons, it can be of value to develop indicators of those intermediate variables through which policy works to influence more fundamental objectives. Intermediate variables are not, in general, controlled directly by the policy authorities. However, they can be used to check whether the behavioral assumptions underlying the formulation of policy is an adequate representation of reality, and

whether economic developments are following their anticipated path during the interval before measures have their effect on ultimate objectives. Intermediate variables can also be used to identify emerging problems of international consistency of policies.

(a) Interest rates and exchange rates

An important channel by which policies influence ultimate economic objectives is through their effect in conditions in financial markets. In this connection, a key role is played by money and capital markets and the foreign exchange market. It is therefore of considerable interest to monitor developments in interest rates and exchange rates.

With regard to interest rates, a major determinant of the incentive to save or invest is probably the level of the real interest rate. Notwithstanding the fact that inflationary expectations can only be measured indirectly, it nevertheless seems desirable to use some estimate of the real interest rate as the primary indicator for monitoring purposes. A helpful approximation in this connection, that is generally not seriously misleading, is to deduct from the nominal interest rate the rate of change in the GNP deflator over some recent period. While the level of real interest rates is of importance as an indicator of the incentive to save and invest, it is less significant than interest differentials in determining incentives to capital movements, and therefore exchange rate pressures. In monitoring real interest rates, it is therefore necessary to pay attention to international differentials in rates as well as to absolute levels.

As far as exchange rates are concerned, the indicator that is most relevant for purposes of international competitiveness and adjustment is the real effective exchange rate. This can be obtained by combining a measure of the nominal effective exchange rate (using currency weights derived from, say, the Multilateral Exchange Rate Model) with a relative inflation estimate from the inflation indicator described above.

Since both interest rates and inflation rates are intermediate variables, it would be unrealistic to expect policy authorities to prescribe in advance any precise path for their expected evolution. Nevertheless, to the extent that the analysis of other indicators reveals underlying disequilibria in foreign exchange and capital markets, this analysis could signal the direction of possible changes in interest and exchange rates.

(b) Saving and investment balances

As already implied, movements in interest rates and exchange rates are in turn influenced by underlying shifts in domestic saving

and investment. Indeed, it is movements in interest and exchange rates that give causal content to the identity that makes the current account of the balance of payments equal to the domestic savings minus domestic investment.

Any ex ante inconsistency at the global level between countries' balance of payments objectives or forecasts must be reflected in a similar global inconsistency between projected saving and investment trends. It may therefore be useful to keep track of actual or expected trends in savings and investment, in order to provide advance warning of possible inconsistencies. As noted earlier, the aggregate saving/investment balance of a country can be divided into the balance attributable to the public sector and that attributable to the private sector. The financial position of the public sector is, of course, the fiscal balance and has been discussed above. This can be complemented, for analytical purposes, with supplemental indices of saving and investment in the private sector.

V. Procedures for Using Indicators in Surveillance

The use of indicators to facilitate discussion of international economic interactions has two aspects beyond the development of an analytical framework and the definition of a set of indicators to be used. These additional aspects are: (i) the establishment of procedures that allow indicators to be monitored effectively, both at the initial stage when objectives are being set and subsequently when performance is being assessed; and (ii) the devising of criteria that would help the international community decide when given developments are a matter of concern.

The present paper does not seek to fully resolve these issues. To some extent, it can be expected that the way in which indicators are used will evolve over time, through the accumulation of theoretical and empirical evidence, as well as through experience with their practical application in surveillance. The suggestions made in this section should therefore be seen as preliminary, designed to launch an exercise in the more systematic use of indicators, rather than as a firm set of proposals. The suggestions themselves relate to ways in which indicators might be used in surveillance undertaken by the Fund. They do not address directly the questions of how indicators would be used in other forums, such as those referred to in the Tokyo declaration. Nevertheless, the procedures described below could, if desired, be adapted to these other contexts.

1. Procedures for monitoring indicators

Discussions on the role of Fund surveillance have sometimes drawn a distinction between Article IV consultations, undertaken with all

member countries, and the assessment of global economic developments and interactions undertaken in the context of the World Economic Outlook. It has been recognized, of course, that both kinds of discussions are integral to an effective process of multilateral surveillance. In what follows, however, primary attention is devoted to exploring procedures for the use of indicators in the context of global economic assessments.

It is proposed that assessments of international economic prospects, whether in the World Economic Outlook or other papers, should systematically include projections for the major variables discussed above. These projections would be based, in the first instance, on countries' own forecasts, and grounded in the staff's continuing contacts with member authorities. While the main focus of the projections would inevitably be on their immediate implications for policy, it would be important for the projections to be framed against the background of governments' stated medium-term objectives. To the extent that national forecasts for specific variables were not available, the staff could fill gaps on the basis of judgments about the interrelationships among variables.

In preparing statistical and analytical material for multilateral policy discussions (whether in the Executive Board, at the Interim Committee, or in other forums), the staff would attempt to highlight two possible sources of concern: (i) international inconsistency of objectives or forecasts, and (ii) weaknesses in domestic economic performance or policy. International inconsistency would arise if the anticipated exchange rate or balance of payments consequences of developments projected by one country could not be reconciled with the corresponding projections of its trading partners. Domestic weaknesses could be considered to exist when domestic economic performance or objectives fall short of what was considered attainable, having regard to a medium-term framework. An example of the latter would be where a country was envisaging economic growth at a pace considered to be below what would be sustainable without rekindling inflationary pressures.

Where international inconsistencies exist, a question that arises is how far any set of projections presented by the staff should attempt to include a reconciliation of such inconsistencies. In the World Economic Outlook Exercise, the approach that has traditionally been followed has been to make explicit assumptions about economic conditions (which usually include "unchanged policies," constant exchange rates, etc.), and then adjust the projected path of economic variables in all countries to an internationally consistent (although not necessarily desirable or sustainable) pattern. While it would seem appropriate to retain this approach for short-term forecasts, it

may be possible to experiment with a more "unconstrained" approach in appraising the medium-term framework in which countries are framing their objectives. Thus, the staff could base its statistical presentation on national projections (even where these embodied international inconsistencies), and could focus the surrounding analysis on the various alternative ways in which the inconsistencies could be reconciled.

Discussions among member countries could carry this process a stage further by identifying the developments that would be needed to produce consistency and sustainability in balance of payments patterns. Consistency can be defined as ensuring that projected developments in individual countries are arithmetically compatible, in the sense that international trade and capital flows satisfy necessary adding-up constraints. Sustainability refers to the compatibility of projected developments with medium-term objectives; such as ensuring the stable evolution of the system and promoting efficient international resource allocation.

To be effective in promoting a fruitful dialogue among the major countries on the compatibility of their policies, the analytical material prepared for discussions must satisfy three conditions. First, the projections that are being used must be the ones that countries themselves recognize as reflecting their economic policies and objectives. Second, the criteria for assessing policies and their sustainability must be acknowledged to be broadly appropriate. Third, the nature of possible inconsistencies, as well as alternative means for reconciling them must be clearly set out. To achieve this it may be useful to provide for additional direct contact between key member countries and the staff responsible for preparing the analysis, preparatory to the issuance of a paper for Board discussion. Such contact would serve the purpose both of clarifying the basis on which projections were made and of uncovering concerns that individual countries might feel about policies and developments in major trading and investment partners.

The analysis so far in this section has dealt with the issue of obtaining and presenting projections for the various indicators that have been described. Other issues arise concerning the monitoring of these indicators through time. One avenue for such monitoring is obviously the periodic World Economic Outlook and Article IV consultation discussions. It is to be expected that staff papers for these meetings will include an analysis and evaluation of developments with respect to all the indicators previously discussed. In addition, there could be a more frequent monitoring of developments in certain key variables. (The staff already prepares for internal use a fortnightly

updating of key indicators for the five major countries. ^{1/} This could be given a wider circulation, and, if found useful, extended as necessary to additional countries and indicators.) Other possible avenues include extending the use of information notices to additional variables and more frequent mini-discussions of the world economic situation.

2. Procedures for modifying targets or policies

Beyond the issue of procedures for the monitoring of indicators is the more important question of substance. How is the international community to decide whether a departure from the expected or target value for an indicator constitutes a matter of international concern? Under what circumstances should indicators be changed in response to new evidence?

In judging how to respond to departures from expected values of indicators, it is helpful to make use of the distinction discussed above between policy variables, performance variables, and intermediate variables. Policy variables are those which the authorities can control in the short run. Thus departures from targets or objectives can be presumed to be deliberate, or at least conscious. This differentiates policy variables from performance variables, which are much harder to control in the short run. If a country departs significantly from agreed policy targets during a given short-run period, this would be a prima facie case for consultations, even if there was not yet any evidence of economic performance deviating seriously from expectations. On the other hand, a short-run deviation from expected economic performance (say, a sudden slowdown or acceleration in GNP) would not necessarily be a cause for international concern, provided that economic policies remained on the intended track. Placing emphasis in this way on the stability of policy and on indicators that pertain to major and critical policies would help to avoid the risk of "fine-tuning" that might arise if undue weight was given to ephemeral developments in performance indicators. The use of policy indicators could thus strengthen the consultation process by allowing for a more continuous monitoring of the implementation of the policies described by the member. Supplemental consultation would provide an opportunity for the member to describe (and other members to assess) why a different strategy seems preferable or what actions are being considered to correct the deviations.

Of course, the longer the time period considered, the more important it becomes to ensure that performance is on track rather than policies. A continuing deviation of performance from the desired path, while policies remain on track, indicates that the assumed relationship between policies and outcomes has been misinterpreted, and a revision is necessary in policy settings.

^{1/} These indicators are: GNP; industrial production; consumer prices; unemployment rates; trade and current account balances; effective exchange rates; short-term interest rates; narrow and broad money; and leading economic indicators.

Intermediate variables can be of use in this connection in providing advance indication of changes in assumed relationships. For example, if interest rates and/or the exchange rate rise unexpectedly, this may be taken as an indication that monetary conditions are tighter than expected. Whether a change in policy targets (or at least flexibility in their implementation) is required will depend on a judgment as to whether other factors may have contributed to the observed market developments. However, to the extent that the intermediate variable is itself an object of policy (e.g., the desire to avoid inappropriate exchange rate movements, or undesired fluctuations in interest rates) it may be necessary to manage a policy variable in a more active way, so as to undertake short-term smoothing of market-induced fluctuations.

VI. Issues for Discussion

This paper has identified a number of issues on which the views of Executive Directors will be helpful in developing the use of indicators for surveillance purposes. A first set of issues concerns the analytical framework within which the analysis of indicators is to be set. A second concerns the nature of the indicators that are to be used. And a third concerns the procedural arrangements for discussions.

(a) Analytical focus

The staff has argued that indicators should emphasize the international interactions of economic policies and performance, and should have regard to the medium-term framework in which policy are set. For these reasons, it is proposed that a major focus of analysis should be prospective balance of payments developments and their relationship with a sustainable position. This focus could be assisted by explicit consideration of the determination of domestic saving and investment balances. Directors may wish to give their views on the appropriateness of this emphasis in surveillance.

(b) Nature of indicators to be used

It has been argued that any variable that affects the level, distribution, or price of domestic output has implications for payments balances and exchange rates. Nevertheless, to be helpful in the surveillance process, indicators must be limited in number, quantifiable, timely, and relatively easy to interpret. The staff believes it is useful to distinguish among: policy indicators; performance indicators; and intermediate variables. As policy indicators, it is proposed to use the rate of growth of the monetary stock; the fiscal

deficit ratio (on an actual and a cyclically adjusted basis); and changes in the level of gross reserves. Performance indicators would include the growth of domestic demand and GNP; and the rate of change in the GNP deflator and in unit labor costs; and the current account of the balance of payments. Intermediate variables would be real interest and exchange rates, and the investment and saving ratios. Comments are invited from Directors concerning both the choice of the variables included in the list and the comprehensiveness of the list.

(c) Monitoring and procedures

The monitoring of indicators would appear to involve the following steps:

(i) the development of a mechanism for collecting and analyzing national forecasts.

(ii) the establishment of procedures for discussing multilateral consistency of objectives and policies.

(iii) "follow-up" procedures for discussion when developments diverge from what is desired or expected.

The staff has proposed the following procedures: (i) An initial paper would be prepared, in consultation with member authorities, setting forth the expected evolution of economic developments in member countries. Particular attention would be devoted in this paper to the international consistency of projected developments in individual countries, and to any other aspects of the projection that could be considered grounds for international concern; (ii) Discussion of members' objectives and policies would take place in the Executive Board and the Interim Committee, and would be aimed at improving the consistency of policies with medium-term objectives; and (iii) Subsequently, economic performance would be monitored by comparing actual developments with those targeted or projected. This would take place in subsequent World Economic Outlook or Article IV reports, or in other ways. These subsequent reports would give attention to assessing developments in indicators, considering possible modifications, and "rolling forward" the medium-term horizon.

Directors are asked for their views on whether these procedural arrangements seem appropriate, and for comments on how they might be implemented in practice.

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT
WHEN ALIGNING INTO LINE 23

Surveillance

START ADDRESS IN THE BOX

23 MR. DANIEL LEBEGUE
22 DIRECTION DU TRESOR
21 PARIS, FRANCE
1986 JUN 13 PM 4: 01

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

DISPATCHED IMF

1986 JUN 12 PM 2: 28

MARK XX FOR CODE
() CODE

*EW
STB
IO
LF*

DISTRIBUTION

START TEXT HERE

18 DEAR MR. LEBEGUE:
17 FOR YOUR CONSIDERATION, I AM ATTACHING A NOTE ON THE ROLE
16 THE FUND COULD PLAY IN DEVELOPING AND ANALYZING INDICATORS
15 FOR USE IN G-5 AND G-7 SURVEILLANCE. A RELATED STAFF
14 PAPER ON "INDICATORS RELATING TO POLICY ACTIONS AND
13 ECONOMIC PERFORMANCE" IS BEING ISSUED TO THE EXECUTIVE
12 BOARD THIS WEEK.
11 WITH kindest regards.
10 SINCERELY YOURS,
9 J. de LAROSIERE
8 INTERFUND

N CC: MD
O DMD
MR. HOOD
T MR. WHITTOME
MR. BEZA
MR. NARVEKAR
T MR. VAN HOUTVEN
Y MR. BROWN

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS TEXT MUST END HERE

A

B

C

TELEX NO.:

D

DRAFTED BY Wm. C. HOOD

EXT.: 8977

DEPT.: RES

DATE: JUNE 11, 1986

E

AUTHORIZED BY J. de LAROSIERE

AUTHORIZED BY NAME (TYPE):

**

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE

F Log

F-0318

REV 1
8-82

G

SIGNATURE

(PLEASE KEEP SIGNATURE IN SPACE ALLOWED)

SIGNATURE

IMF OFFICIAL MESSAGE

WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT
WHEN ALIGNING INTO LINE 23

23	MR. MARIO SARCINELLI	D	MARK XX FOR CODE () CODE
22	MINISTRY OF THE TREASURY	O	
21	ROME, ITALY		
20			
19			
18	DEAR MR. SARCINELLI:		
17	FOR YOUR CONSIDERATION, I AM ATTACHING A NOTE ON THE ROLE	N	CC: MD
16	THE FUND COULD PLAY IN DEVELOPING AND ANALYZING INDICATORS	O	DMD
15	FOR USE IN G-5 AND G-7 SURVEILLANCE. A RELATED STAFF	T	MR. HOOD
14	PAPER ON "INDICATORS RELATING TO POLICY ACTIONS AND		MR. WHITTOME
13	ECONOMIC PERFORMANCE" IS BEING ISSUED TO THE EXECUTIVE		MR. BEZA
12	BOARD THIS WEEK.	T	MR. NARVEKAR
11	WITH KINDEST REGARDS.	Y	MR. VAN HOUTVEN
10	SINCERELY YOURS,	P	MR. BROWN
9	J. de LAROSIERE	E	
8	INTERFUND		
7			
6			
5			
4		H	
3		E	
2		R	
1		E	
	↑ TEXT MUST END HERE ↑		
A	SPECIAL INSTRUCTIONS		
B			
C	TELEX NO.:		
D	DRAFTED BY NAME (TYPE):	EXT.: 8977	DEPT.: RES
E	AUTHORIZED BY NAME (TYPE):	AUTHORIZED BY NAME (TYPE):	DATE: JUNE 11, 1986
F	Log	TYPE ** ON LAST OR ONLY PAGE OF MESSAGE	
G	SIGNATURE (PLEASE KEEP SIGNATURE IN SPACE ALLOWED) SIGNATURE		

IF
REQUIRED
INITIAL
BELOW

IMF OFFICIAL MESSAGE
WASHINGTON, D. C. 20431

DO NOT SOFT ROLL EXCEPT
WHEN ALIGNING INTO LINE 23

START ADDRESS IN THE BOX

23 MR. TOMOMITSU OBA
22 MINISTRY OF FINANCE
21 TOKYO, JAPAN
20
19

DISPATCH UNIT

1985 JUN 12 07 13 07

MARK XX FOR CODE) CODE

START TEXT HERE

18 DEAR MR. OBA:
17 FOR YOUR CONSIDERATION, I AM ATTACHING A NOTE ON THE ROLE
16 THE FUND COULD PLAY IN DEVELOPING AND ANALYZING INDICATORS
15 FOR USE IN G-5 AND G-7 SURVEILLANCE. A RELATED STAFF
14 PAPER ON "INDICATORS RELATING TO POLICY ACTIONS AND
13 ECONOMIC PERFORMANCE" IS BEING ISSUED TO THE EXECUTIVE
12 BOARD THIS WEEK.
11 WITH kindest regards.
10 SINCERELY YOURS,
9 J. de LAROSIERE
8 INTERFUND
7
6
4
3
2
1

O
N
O
T
Y
P
E
R
E

DISTRIBUTION

- CC: MD
- DMD
- MR. HOOD
- MR. WHITTOME
- MR. BEZA
- MR. NARVEKAR
- MR. VAN HOUTVEN
- MR. BROWN

IF REQUIRED INITIAL BELOW

SPECIAL INSTRUCTIONS TEXT MUST END HERE

A
B
C
D
E

TELEX NO.: *IMF*

DRAFTED BY NAME (TYPE): Wm. C. HOOD EXT.: 8977 DEPT.: RES DATE: JUNE 11, 1986

AUTHORIZED BY NAME (TYPE): J. de LAROSIERE AUTHORIZED BY NAME (TYPE): _____

Log *B9972*

TYPE ** ON LAST OR ONLY PAGE OF MESSAGE



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1986 JUN -4 AM 10:48

M/s. Wiener/Reza

EW
STB
JD
EHC
F

TO: The Managing Director
The Deputy Managing Director

June 3, 1986

FROM: C. David Finch *DF*

SUBJECT: Indicators Relating to Policy Actions
and Economic Performance

The draft of the above-mentioned paper which Mr. Hood sent you yesterday has taken into account most of the comments from this department on an earlier draft of the paper. There is one remaining concern which I would like to raise for your consideration.

The paper notes on p. 39 that a significant departure "from agreed policy targets 1/ . . . would be a prima facie case for consultations . . .". This is in a sense similar to my earlier proposal to monitor fiscal developments in the United States with a view to triggering a supplemental consultation in case fiscal developments differed from those set out during the Article IV consultation.

The proposal in the draft paper, however, is also broader in application (i.e., applies to all countries, all policies, and presumably favorable as well as unfavorable developments) rather than being focused specifically on those areas which, in light of developments and expectations, are of key concern to the Fund. While recognizing the importance of all of the indicators mentioned, I am concerned that unless the performance-criteria-equivalent indicators providing a prima facie case for consultations are narrowly focused on those areas of clear and immediate concern to the Fund, the basis for triggering such consultations will remain too diffused to facilitate supplemental consultations in those cases where they would be important.

I would like you to consider in this context whether an alternative procedure similar to that which I had outlined earlier for the United States could be presented in the paper. This could be done by deleting the second half of the paragraph on p. 39, starting with "If a country departs significantly from its policy targets . . ." and substituting the following paragraphs.

"Monitoring of the policy indicators could strengthen the continuous monitoring of the implementation of those policies described by the member as part of the consultation process. While practices in this area will evolve with experience, the following procedure could already be implemented on an experimental basis. Evidence of a departure from the authorities' strategy based on the quantitative monitoring or, even earlier, if it is clear that the strategy described in the

1/ i.e., monetary, fiscal and reserves policies.

earlier consultation will be substantially altered would provide the basis for a supplemental consultation with the member, which could be initiated either by the Fund or the member. As is the case for consultations with members following the breach of performance criteria under Fund arrangements, the supplemental consultation would provide an opportunity for the member to explain (and other members to assess) why a different strategy seems preferable or what actions are being considered to correct earlier deviations.

It would not seem either necessary or feasible, however, to apply such monitoring rigidly across quantified indicators or across countries. As is the case for performance criteria under Fund arrangements, the monitoring criteria which would trigger a further review with the Fund should be limited to those which indicate departures from the strategy described earlier by the member which are both important and of sufficient concern to the Fund. Thus, and while the greater specificity and quantification implied by the use of objective indicators would help strengthen the consultation process with all members, only in those cases when Executive Directors consider, in concluding a consultation, a matter to be of sufficient importance to warrant close scrutiny would review-linked monitoring criteria be specified. In those cases, as is done for members with Fund arrangements, a time path should be specified, consistent with the authorities' overall strategy, which would allow continuous monitoring of developments."

cc: Messrs. Hood
Whittome
Ouattara
Shaalan
Tanzi
Narvekar
Van Houtven
Wiesner/Beza
Brown



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

EW
SYB
JO
EHC
FV

TO: Mr. Crockett

1986 JUN -2 PM 12:40 May 30, 1986

FROM: Bruce J. Smith 

SUBJECT: Indicators Relating to Policy Actions and Economic Performance

We welcome the opportunity to review your draft which addresses many of the issues that have been on our minds recently, especially in the weeks since the Tokyo Summit. We are all aware that this is a pathbreaking effort which will likely have a great impact on the shape of the Fund's surveillance activities in the years to come--especially as they relate to the major industrial countries. It is essential, therefore, that we move with care and only after full consideration of the issues. In the present case, the draft was somewhat late coming to us and we have not had the time to give it the consideration it deserves and to reflect fully on the issues it raises. Moreover, Mr. Narvekar has not yet seen the draft and he will, I am sure, have views that he would want taken into account. These comments should, therefore, be taken as our first general reaction, and we might have more to say in due course.

We found ourselves in agreement with much of the argumentation in the paper and our comments are restricted to a few major points. However, as a general comment, we did feel that in some areas, the arguments would be more powerful if put more succinctly. There are a number of issues of detail and refinement, especially in the choices of the types of indicators (Section IV), which can perhaps best be addressed at a later stage. I would make the suggestion at this point, however, that indicators of "structural policies" might be omitted. Not that they are unimportant, of course, but they simply cannot be measured in a way that can be interpreted meaningfully for this purpose. For example, we may be able to develop a quantified measure of "trade liberalization" (although experience in other contexts suggests such measures are, at best, artificial concepts), but we cannot interpret what a certain change in the measure means in relation to the achievement of the principal objectives of policies--e.g., returning the balance of payments to a "sustainable" position, reducing inflation etc. In any case, there is much merit in keeping the indicators to as few a number as possible in order to minimize problems of consistency of forecasts and objectives, and to keep the whole exercise to manageable proportions. Right from the start we should resist efforts (which are probably inevitable) to include a smorgasbord of indicators of everything that is important or (conceivably) relevant. In this context we thought your argument not to include the trade balance, even though this was specifically mentioned in the Tokyo declaration, was right, even though trade imbalances, because of their political visibility, can be important indicators of the "sustainability" of external positions.

We agree that the main focus of analysis should be on the balance of payments position and its likely evolution. The paper goes to some length to define "sustainability" of the balance of payments and identify criteria for the assessment of sustainability. However, upon reflection, we wonder whether sustainability of the balance of payments position of large industrial countries is the most appropriate concept for the purpose of Fund surveillance. Furthermore, we wonder whether the balance of payments position is a fundamental objective in itself. Is it not, rather, that its importance derives from the potential impact the wrong alignment of external balances can have on growth, employment and inflation, both at home and abroad, and the path of these variables over time? We believe that in many instances a balance of payments position may well be sustainable for as far ahead as can reasonably be seen, but it may not be consistent with the achievement of the fundamental growth, employment and price objectives of the country concerned and the rest of the world. It, therefore, seemed to us that a more appropriate concept, especially for the large industrial countries, would be a "desirable" balance of payments position, viewed both from a national and international perspective, that is consistent with the achievement of sustained strong growth and the containment of inflation worldwide.

Having said this, we did also have difficulty with the definitions of sustainability given in the paper. On page 16, a sustainable current account position is defined as "one in which the domestic savings and investment position of a country is sustainable at a given level of world interest rates." In this definition, the key phrase is "the given level of world interest rates." However, interest rates are themselves intermediate targets with important links to the ultimate objectives of policy, and the given level of interest rates may not be the one that is consistent with, say, growth objectives. On page 20, a sustainable position is alternatively defined as "one in which a current account surplus or deficit is matched by capital outflows or inflows that correspond to a country's desire to accumulate foreign assets or debts, and its capacity to service its external debt out of current foreign exchange earnings." With respect to this definition, the current account will always be matched by capital flows and the latter correspond to the desire to accumulate foreign assets (or debts). The crucial issue here is the level of interest and exchange rates necessary to bring about this desire. Again, these may not be consistent with other fundamental objectives. Finally, for the large industrial countries, debt service considerations are probably of only secondary importance.

Thus, in forming a view on the desirable balance of payments (current account) position, consideration should be given to indicators of intermediate variables because of the relationship they bear both to the external position and fundamental objectives. Interest rates are obviously important in this context and so are exchange rates and

saving-investment balances and their sectoral components. Similarly, the conditions listed on page 21 are of relevance ("legitimate objectives of trading and investment partners" presumably mean growth, employment and inflation abroad). Examination of developments in these variables and conditions may not permit quantification of a desirable pattern of balance of payments positions, but it would indicate the direction in which current account balances should move.

Our second principal concern relates to Section V of the draft--that which proposes procedures for using indicators in surveillance. Our strong preference would be to delete this section. The focus of the paper would sharpen were its scope drawn more narrowly, confining it to those issues that require decisions first. The procedures to be adopted will, in any case, depend importantly on how it is decided to resolve these issues. In particular, the aims of the exercise need to be defined more clearly before decisions on implementation can be taken. Section II, at this stage, really goes no further than outlining various possible purposes, and clearly more refining of the aims is needed.

Having said this, we find ourselves in disagreement with much of what is suggested regarding procedures. We cannot agree, for example, to the distinction made (page 37) between "bilateral" surveillance exerted through the Article IV consultation procedure and "multilateral" surveillance organized around the WEO exercise and the Interim Committee meetings. Article IV consultations are bilateral only in the sense that the discussions take place between country authorities and the staff. However, in their content and the context in which they are undertaken, and in the subsequent discussion by Executive Directors, Article IV consultations are essentially multilateral. The focus of Article IV consultations is different from that of the WEO, but it is no less multilateral for that.

It seems to us that Article IV consultations are the key element in the established framework for multilateral cooperation and coordination, and should play a central role in this process as it is extended to include objective indicators. Indeed, the Article IV consultation would be the obvious and most useful starting point in attempting to assess the objectives, policies and projections of the major countries. You suggest (page 38) that projections be based on the countries' own forecasts. Our experience makes it clear that a lot of staff work and discussion will be necessary to develop forecasts that are comprehensive and realistic, and Article IV discussions are the most effective vehicle to achieve this. One might imagine that Article IV consultation reports would adapt in form to contain an explanation of country aims and projections which would, inevitably, be an amalgam of official and staff thinking. We agree that the framework for the projections should have a medium-term focus, but would emphasize that care needs to be taken to keep the policy orientation current and to avoid undue reliance on mechanistic and, we find all too often, unreliable macro models.

Of course, none of this is to deny a central role in the procedures to the WEO, especially in identifying inconsistencies and incompatibilities among countries and refining recommendations for the coordination and redirection of policies. However, we are inclined to see the procedure not as one of establishing at any point a perfectly consistent grid of objectives, policies and forecasts among the major countries as your draft seems to imply. Rather, we see an iterative process in which inappropriate and inconsistent objectives and policies are identified and recommendations for changes are made, utilizing in turn all the established channels of surveillance available to the Fund, and presumably in coordination with the G-5 and G-7.

cc: ~~Mr. Finch~~
~~Mr. Tanzi~~
✓ Mr. Wiesner/Mr. Beza
Mr. Whittome



Office Memorandum

Surveillance

TO: Mr. Crockett

DATE: May 30, 1986

FROM: S.T. Beza *PJB*

SUBJECT: Indicators

As I indicated to you over the telephone, it seems to me that the draft paper does not provide a framework for the use of indicators; notwithstanding Section III and Subsection (a) of page 43. Section III, for example, states that the appraisal of policy indicators among industrial countries would be based on an analytical framework in which the underlying current account positions would be compared with sustainable positions, but it is difficult to find anything in that section that would enable one to arrive at judgments on sustainability. To say that a sustainable current account position is one in which domestic savings and the investment position of a country is sustainable at a given level of world interest rates seems only to state the question but not to answer it.

Another problem we encountered in the draft is that some of the examples in Section III were misleading. For example, on page 11, it seemed to be suggested that a lasting fiscal deterioration might be appropriately financed from abroad. Also, on page 12, it is not clear why so much is made of the monetary policy shift--is it being criticized?--when in the end it all comes to rest as it started.

We found that the draft paid too little attention to the problem of making medium-term projections of consistent sets of indicators across countries. It would seem advisable to acknowledge that departures from any initial set could be the product of a faulty set of projections, and that even with full cooperation between Fund staff and country officials such projections are very difficult to make. Thus, we agree with Mr. Whittome's comment that at various points in the draft it would be helpful to insert caveats about the state of our knowledge and to proceed with more caution in respect of medium-term projections.

We also would agree with Mr. Whittome's remarks regarding the need to clarify "access", "objectives", and "targets." He notes the problem raised by the reference to a "target rate of GNP growth," and some question may be raised about the classification of the balance of payments as an indicator of economic performance. In brief, this is an area in which some further discussion of the conceptual framework would seem to be needed.

As regards the connection between the indicator exercise and Article IV consultations, our view is that at this stage it would be premature to come to conclusions as to how the process might work. Thus, we would favor limiting the references to such linkages. I should note--and here I wish to take up Mr. Beveridge's concern--that I do not regard the draft, at this stage, as settling how either multilateral or bilateral surveillance might be conducted.

cc: Mr. Whittome
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Tanzi
Mr. Van Houtven
Mr. Beveridge



Office Memorandum

The Bera

18

1986 MAY 30 AM 9:18
May 29, 1986

TO: Mr. Crockett

FROM: W. A. Beveridge *WAB*

SUBJECT: Indicators Relating to Policy Actions
and Economic Performance

Your very clear draft provides a useful integrating framework for a discussion of the many indicators being considered. The focus on international interaction through balance of payments effects and saving/investment balances, in particular, helps highlight the key area of concern of the Fund. I have only a few comments on this aspect which are noted below. Our key comments relate to the procedural content of the paper (i.e., Section V).

First, the general procedure outlined which involves the adoption of a "strategy" in the context of the World Economic Outlook exercise and the more detailed specification of policies in subsequent Article IV discussions is much closer to the G-24 model than I believe was intended by the Interim Committee or the earlier Board discussion on surveillance. It would be unfortunate if the objection of major countries to the G-24 two-step negotiation/monitoring model also resulted in a rejection of the possible progress toward greater specificity of policies and objectives inherent in the proposal for objective indicators. The less ambitious alternative use of objective indicators of facilitating the assessment of the consistency of policies and objectives (internally for each country and with those of other countries) and their sustainability should be the purpose of adopting objective indicators highlighted in the paper. It is not clear in this context why the "interactive process of reconciliation" described on p. 38, with staff revisions and discussions with the authorities (except, possibly, to clarify technical issues) are thought necessary.

Second, a related comment is that the proposed preliminary procedures outlines an almost subservient role for Article IV consultations, discussing in more detail the policy strategy agreed as part of the World Economic Outlook exercise. I do not believe that this is either feasible or desirable. While more attention needs to be paid to the multilateral aspect of surveillance, this should be done by improving the framework for discussing the interaction of individual members' policies and objectives; the latter, however, being discussed fully between the member and the staff in the context of Article IV consultations.

Third, and while recognizing the importance of all of the indicators mentioned, the follow-up monitoring need not concentrate on all of them equally. As one Executive Director mentioned during the 1985 Annual Review of Surveillance, regular updatings for the Board of a broad range of indicators would make Directors desk economists. I would

suggest instead that the procedure outlined in Mr. Finch's memorandum to Management of May 9, 1986 (copy attached) for the monitoring of selected performance-criteria-equivalent indicators providing a prima facie case that a review is needed be outlined. The essential elements of the proposal are: (i) determination by the Board of key areas of concern; (ii) the specification of related specific monitoring criteria; (iii) a supplemental consultation when the benchmarks are not observed.

The following specific comments may also be useful.

Page 6, bottom. A minor drafting point is that "comparative" does not capture the meaning of assessing intercountry consistency.

Page 8, middle. Each indicator discussed (in isolation or with others) does have at least some "ambiguous causes or consequences". The criterion seems unnecessarily demanding.

Page 11, bottom. Does not the shift in saving/investment preferences need to represent a permanent and sustainable shift not only in the country itself but also in the rest of the world? The same comment applies at the bottom of p. 20: does not the sustainability of the deficit also depend on the willingness of others to lend?

Page 12, bottom. Does the success of structural policies not also have implications for supply? It is not clear how useful this example is. The reference to nonresidents having a limited willingness to hold domestic claims would seem more topical if related to the temporary nature of fiscal deficits on top of p. 12.

Page 22, middle. Should the reference be to "fiscal consolidation", a politically-charged term, or to the relative roles of the public and private sectors or to future anticipated demands on budget resources.

Page 30, top. It could be useful to add that "international consistency" can be assessed through analysis of the effects on the balance of payments. A related comment on p. 32 is that the focus of the paper on balance of payments and saving/investment balance effects providing the central criterion for the implementation of surveillance leaves one wondering why "criteria are not easy to establish" in assessing targets for public sector saving or dissaving.

Page 33, top. It is not clear why the criterion should be pre-set as "no change" in reserves. Surely, circumstances anticipated in an Article IV consultation could justify some change. The view that markets can do no wrong has not been the gospel of the Fund.

Page 34, top. It is not clear why one would monitor both ULC and real wages. As regards trade restrictions and protectionism, it should perhaps be noted that qualitative can be specific as to measures.

Page 36, top. Does an unsustainable current account balance necessarily imply only that the exchange rate should be changed or may it also imply a need to change the projected path of demand?

Page 41, middle. Why should a departure from the member's target in a direction judged desirable by the Fund lead to a discussion? This is related to the more general comment above of triggering "reviews" only in those cases of significant departures from paths considered desirable by the Fund.

Also, why should there not be a review in a case where the member insisted that its policies were sufficient to achieve a given target relating to a policy outcome (e.g., growth) if the Board doubted that this was the case and considered achievement of the outcome important?

Attachment

cc: Messrs. Hood/Rhomberg
Whittome
Ouattara
Shaan
Tanzi
Tun Thin/Narvekar
Van Houtven
Wiesner/Béza



Office Memorandum

TO: The Managing Director
The Deputy Managing Director

May 9, 1986

FROM: C. David Finch *CF*

SUBJECT: Surveillance

The purpose of this memorandum is to set down the various lessons from our experience with the implementation of conditionality which I believe are relevant to the strengthening of surveillance. This would seem particularly relevant at this time when certain aspects of surveillance will relate to its implementation within a system of objective indicators. The issues discussed below are also relevant for your consideration of the briefing paper for the consultation with the United States.

The essential element which underlies the formulation of policy programs for Fund arrangements is the availability of an appropriately quantified framework to assess the consistency and sustainability of policies. The detailed specification and quantification of the member's policies and analytical framework provide the required basis for the Board's assessment and endorsement of these policies, consistent with the conditional nature of Fund resources.

The key performance criteria relating to total domestic credit, credit to the Government and external borrowing derived within this framework monitor the implementation of agreed policies to keep domestic demand in line with the envisaged availability of resources. These and other performance criteria appropriate in the member's circumstances provide the necessary assurance to the Fund that continued access by the member reflects effective implementation of those policies necessary for the achievement of the programmed balance of payments and other objectives. Provided that the quantified performance criteria are observed, no further review by the Fund is required for drawings by the member. However, failure to observe the performance criteria (or advance indication that the criteria will not be met) is a signal that the position, policies, and prospects of the member should be reviewed, and therefore the member is to consult with the Fund before requesting further drawings.

A similar set of elements would seem relevant for the purpose of strengthening surveillance. In my view, a first essential element is the strengthening of the framework for the assessment of members' policies, both individually and for the purpose of multilateral surveillance. Unless key policy instruments are analyzed in a reasonably fully specified and quantified framework, not only in the short-term but also in the medium-term, the issue of consistency (internally and with the policies of other members) and sustainability cannot be fully assessed. The more detailed specification and quantification of the

member's policies and of the analytical framework would provide the basis for more sharply focused staff analysis and discussion by the Board of key areas of concern and of the size of appropriate adjustment. Progress in specifying more fully policy plans and in developing comprehensive quantified policy frameworks to assess short- and medium-term prospects will thus need to be carried forward.

A second issue concerns the follow-up to the initial assessment of policies. As already agreed by Executive Directors on the occasion of earlier reviews of surveillance, a supplemental consultation could take place if the conclusion of an Article IV consultation left serious doubts about the appropriateness of a member's policies. The Fund also has the authority, in case of subsequent unexpected developments or changes in policies, to initiate further discussions with the member under the supplemental surveillance procedure. While use of the supplemental surveillance procedure has remained exceptional, current interest in objective indicators to monitor and assess developments could provide a basis to develop performance-criteria-equivalent indicators which would facilitate the use of the supplemental surveillance procedure.

Monitoring criteria or benchmarks derived within the quantified policy framework could, as part of surveillance, strengthen the continuous monitoring of the implementation of those policies described by the member as part of the consultation process. Evidence of a departure from the authorities' strategy based on the quantitative monitoring or, even earlier, if it is clear that the strategy described in the earlier consultation will be substantially altered would provide the basis for a supplemental consultation with the member, which could be initiated either by the Fund or the member. As is the case for consultations with members following the breach of performance criteria under Fund arrangements, the supplemental consultation would provide an opportunity for the member to explain (and other members to assess) why a different strategy seems preferable or what actions are considered to correct earlier deviations.

It would not seem either necessary or feasible, however, to apply such monitoring rigidly across quantified "indicators" or across countries. As is the case for performance criteria under Fund arrangements, the monitoring criteria which would trigger a further review with the Fund should be limited to those which indicate departures from the strategy described earlier by the member which are both important and of sufficient concern to the Fund. Thus, and while the greater specificity and quantification outlined earlier would help strengthen the consultation process with all members, only in those cases when Executive Directors consider a matter to be of sufficient importance to warrant close scrutiny would review-linked performance criteria be specified. In those cases, as is done for members with Fund arrangements, a time path should be specified, consistent with the authorities' overall strategy, which would allow continuous monitoring of developments.

Developments which underlay the emergence of major imbalances in recent years and the key concern of the Fund in promoting a stable and orderly international trading and financial environment suggest that fiscal and monetary policies will be central monitoring criteria. In addition, earlier discussions and the communique of the Tokyo Summit have highlighted several other indicators which the forthcoming paper on objective indicators will be examining more fully.

As was noted in Mr. Wiesner's memorandum forwarding the briefing paper for the consultation with the United States, some of the issues discussed above had already been raised within the staff as they relate to the United States. The large fiscal deficit and how to correct it are appropriately singled out in the brief as the key domestic and international policy issue. However, both discussions with the authorities and the Board discussion concluding the consultation may again precede the adoption of a budget for the next year. In light of the importance of developments in this area, this would provide a good opportunity to initiate the procedure described above, building on it on a case-by-case basis and also taking into account the discussion of the broader issue of objective indicators later in the summer.

cc: Heads of Departments
Mr. Brown



Office Memorandum

Mu Beza

Surveillance

EW
SAB
TO
EHC
F

TO: Mr. Crockett
FROM: L. A. Whittome *LAW*
SUBJECT: Indicators Relating to Policy Action and Economic Performance
May 29, 1986

We read your draft on indicators with care not only because of its importance for the conduct of multilateral surveillance but also because it is likely to impinge heavily on our own work. It is a long paper, and I have taken the liberty of suggesting a certain amount of shortening (though one could go further) so as to make it a little more tractable for the management and for Executive Directors. Let me make a number of comments.

First on the substance. The paper sets out an ambitious but plausible objective, namely that of seeking a sustainable balance of payments pattern that is consistent with the domestic policies and priorities of the group of countries covered. If there were to be a large divergence between underlying and sustainable positions then there would follow discussions and remedial actions though the latter seem more designed to alter the "sustainable" external balance than to bring the "underlying" balance into conformity (p. 17). Moreover, the factors referred to that might lead to such a divergence seem to include (pp. 11-12) both policies that can be changed and those whose effects will work out over time and therefore seem to sit curiously with the underlying concept.

This awkwardness appears again in the discussion of the use of indicators (p. 39). One way out could be to go back to the classification of indicators offered the reader in the passage beginning on page 18.

Second, on the presentation. I think the paper suffers from a tone which would be characterized as rather text-bookish or academic, and in the attached copy of the paper you will find a number of suggested omissions which Brian Rose has made in an attempt to safeguard you from such criticism. To sharpen this point, let me call your attention to the first full sentence on page 36: surely the thought contained in this sentence is a little simplistic for the end of such a weighty paper on such a weighty subject?

I also think the draft would benefit from the copious insertion of caveats about the state of our knowledge. There is a general air that we know all the answers and that if only member governments would follow our prescriptions then we would all soon be in an ideal world. Look for example at the second paragraph on page 16 or, for that matter, at the somewhat bland reference to the growth of potential output (page 22) or the NAIRU on page 23. We all know full well that calculations of this kind are tentative and hazardous, and I myself would argue that it would be unwise to give them any great

prominence when establishing policies. Yet the text of the draft seems to speak as if they were solid facts.

I have also marked a number of places where I think the drafting needs tightening up: "aims", "objectives", "targets" are sprinkled liberally through the paper without an effort being made to specify clearly what each of these words mean. More than once this produces results which are to my mind plainly damaging, e.g. on page 22 reference is made to a "target rate of GNP growth". I thought that in the Fund we had eschewed this notion, and I am quite sure that none of the G-5 has a target rate of growth in any strict sense of the word.

A further point, but one which I would ask you to consider more carefully, is the question of "the medium term". In the earlier part of the paper this concept comes in in a fairly low key way but when we get to pages 37-45 it suddenly emerges in a sharp form. The first sentence of the paragraph beginning on page 38 comes as shock: this is surely a proposal from which we should draw back. It is idle to suppose that G-5 countries make such detailed forecasts in the medium term and I can see little purpose in the staff inventing "scenarios" for the variables referred to. The text then goes on from strength to strength so that by the bottom of page 38 "the staff is preparing a paper that would include a revised set of projections for the industrial countries", and at the top of page 40 there is the extraordinary statement that "it is expected that governments would be able to set medium term objectives for government expenditure and taxation as well as rates of monetary growth...". I think, to put it mildly, that this expectation is far fetched.

My next point is that I think you exceed your mandate in bringing Article IV consultations so directly within the purview of this paper. It seems quite clear from the quotations on pages 1 and 2 that the request to us relates to the WEO papers and to multilateral surveillance, essentially among the G-5. Clearly any work we do of this kind should be, and would be, taken into account in the Article IV consultations but I think it would be advisable to delete or much tone down the references to such consultations in this paper (I am not sure that I caught them all but such references appear on pages 3, 8, 37, 38, 40, 45).

Two other general points: I think it would be helpful to remind the reader at an early stage that, no matter what indicators are used, the problem of international comparability is severe. Every time we attempt international comparisons, no matter whether the area is fiscal, monetary or balance of payments, we run into the snag that different national authorities choose to rely on slightly, or even markedly, different statistical presentations and that in some cases we literally cannot produce figures on a strictly comparable basis. We should by all means try, but readers should be warned of the limitations inherent in a particular presentation. We should also recognize that if we do present figures in an internationally comparable form then some

countries will protest that the figures are unfamiliar to them if ever such figures were subject to criticism. Finally, you have--wisely to my mind--not been very precise about the group of countries to be covered by this exercise. On page 3 you refer to "the larger industrial countries" and I have myself chosen to read the paper with the G-7 in mind. If you have thoughts of anything more extensive, I hope you will bear in mind that the amount of extra work involved (be it done in the Research or in the Area Departments) will be very considerable; this would be true even if we were to limit the exercise to the G-7.

I am sending you an annotated copy: while I would not myself subscribe to all the comments in it, I hope that freewheeling comments will be of use to you.

Attachment

cc: ✓ Mr. Beza
Mr. Narvekar
Mr. Ouattara
Mr. Shaalan
Mr. Van Houtven

Mr. Wiesner / Mr. Beza

Sumellane
8W
SYB
IO
EHC
F

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1986 JUN -2 PM 2:36

TO: Mr. Crockett

FROM: Vito Tanzi

SUBJECT: Indicators Relating to Policy Actions
and Economic Performance

May 29, 1986

I have read this important paper with interest and have a few comments. On the general side I believe that a clearer description of the methodology to be followed in the process of building and using the indicators should be provided. While some evidence is given here and there, it is less than complete and is somewhat fragmented. For example, on page 38 it seems that individual countries' own forecasts would be used; on page 14, however, it appears that econometric projections will be undertaken. If the latter, it would seem necessary to give some broad indications of the methodology that would be followed. If medium-term projections are to be made, a rather complex multi-variate, multi-country model may be necessary.

Should the projections given by the countries be understood as targets, supposing that other countries adjust their policies to suit that country, or are they simple projections, assuming no policy changes from other countries? How should the rest of the world (the developing countries in particular) be included in the forecasts? Presumably, even though these countries cannot be included on an individual basis in this exercise, a common set of assumptions regarding their behavior should be included in each industrial country's own forecast. Otherwise, discrepancies in balance of payments estimates could simply reflect differences in assumptions about developing economies.

It is not clear what is exactly meant by balance of payments sustainability. That concept, however, seems to play a central role in the exercise. The definition given on page 16 is not very helpful. What one country may believe sustainable, another country may not... (see U.S. discussion of recent years). It seems that the discussion hinges in particular on assumptions about future changes in fiscal policy which may or may not be credible.

Possible conflicts of interest between countries as to what policy course to follow are not mentioned in the paper. If country A is following a loose fiscal policy and is absorbing in the process country B's and country C's savings, that may be an optimal policy for A and B, given their intertemporal preferences, while it may be optimal for C, given its own preference, to keep its own savings at home. The paper mentions "inappropriate" or "uncoordinated" policies which lead to "inefficient" outcomes, but does not address the issue of conflicting interests.

More specific comments are as follows:

Page 15. The private sector budget constraint is analyzed in terms of savings and investment. Should not capital accumulation by the government also be taken into consideration when analyzing the intertemporal budget constraint of the public sector?

Page 16. Private saving can be invested at home as well as abroad. This would in fact appear as a main rationale for policy coordination. If so, expected exchange rates, and home as well as foreign returns should determine savings and investment.

Page 22. If investment is endogenous, it may be necessary, when estimating the potential rates of growth of output, to differentiate between the current rate of increase of the capital stock and its potential rate of increase.

Page 29. When speaking about the government's claim on available private savings, a distinction should perhaps be made between home and foreign savings, especially when the latter are in the form of official foreign debt. The same remark applies to page 22, where reserve movements are discussed but no mention is made of foreign public borrowing.

Page 36. Changes in output should be included as another key element, besides interest and exchange rates, responsible for adjusting the savings-investment identity.

Page 43. Besides the rate of growth of money and the fiscal deficit ratio, it might be useful to use an additional fiscal indicator actually indicating the degree to which the deficit is being monetized rather than bond financed.

cc: Mr. Hood (o/r)
Mr. Ouattara
Mr. Shaalan
Mr. Van Houtven

Mr. Finch
Mr. Narvekar
Mr. Wiesner/Mr. Beza ✓
Mr. Whittome

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

SM/86/114

CONTAINS CONFIDENTIAL
INFORMATION

May 28, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Recent Experience of Developing Countries with
Floating Exchange Rate Systems

The attached paper reviewing recent experience of developing countries with floating exchange rate systems is circulated for the information of the Executive Directors.

Mr. Quirk (ext. 8520) or Mr. Huh (ext. 8525) is available to answer technical or factual questions relating to this paper.

Att: (1).

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Recent Experience of Developing Countries
with Floating Exchange Rate Systems

Prepared by the Exchange and Trade Relations Department
(In consultation with other departments)

Approved by C. David Finch

May 22, 1986

<u>Contents</u>	<u>Page</u>
I. Experience with Instituting and Operating Market Arrangements	3
1. Reasons for floating	4
2. Choice of floating market arrangements	6
a. Interbank system	6
b. Auction markets	11
c. Issues that have arisen in choice of implementation of floating arrangements	16
3. The role of the Fund in the floating arrangements	21
II. Accompanying Measures in Members' Forward Exchange Markets	25
1. Development of a forward exchange market	25
2. The role of exchange and trade liberalization	26
III. Developments Under Floating Exchange Rate Regimes	29
1. Exchange market developments	29
a. Developments in bilateral and effective exchange rates	29
b. Capital and reserves movements	32
c. Absorption of black exchange markets	33
2. Macroeconomic performance	34
a. Output and trade	34
b. Inflation effects	37
c. Comparison of performance under floating with managed flexibility	38
IV. Summary	40

Contents

	<u>Page</u>
Text Tables	
1. Summary Characteristics of Independently Floating Unitary Exchange Rate Arrangements in Developing Countries	7
2. Fund Programs with Flexible Exchange Rate Policies January 1983-December 1985	22
3. Elements in Fund Programs on Introduction and Maintenance of Independently Floating Arrangements, January 1983-February 1986	24
4. Floating Unitary Exchange Rate Regimes in Developing Countries: Exchange and Trade Liberalization	27
5. Comparison between Performance of Countries with Independently Floating and Managed Flexible Exchange Arrangements under Fund Programs, Compared to Year before the Program	39
Appendix Tables	
1. Selected Indicators of Economic Structure, 1984	57
2. Exchange Rate Arrangements as of December 31, 1985	58
3. Exchange Rate Volatility in Selected Countries in the Pre-Float and Floating Periods, 1976-85	59
4. Volatility of Selected Exchange Rates, 1976-85	60
5. Exponential-Trend-Corrected Volatility of Selected Exchange Rates, 1976-85	61
6. Net Capital Flows, 1980-85	62
7. International Reserves, External Debt, Arrears, and Foreign Currency Deposits, 1980-85	63
8. Growth Performance in Countries with Floating Exchange Rates and Fund Programs	64
9. Comparison of Average Retail Prices for Selected Goods in Uganda, Zaire, and Sierra Leone (First Quarter 1984)	65
10. Macroeconomic Performance of Countries with Real Effective Exchange Rate Rule and Floating Exchange Rates During Fund Programs	66
Appendix Charts	
1. Exchange Rate Developments in Selected Countries January 1976-December 1985	45
2. External Current Account Developments	55
3. Consumer Price Developments	56

INTERNATIONAL MONETARY FUND

Recent Experience of Developing Countries
with Floating Exchange Rate Systems

Prepared by the Exchange and Trade Relations Department
(In consultation with other departments)

Approved by C. David Finch

May 22, 1986

Introduction

In recent years, an increasing number of developing countries have adopted market-determined floating exchange rates. This development has represented a significant step forward in the evolution toward exchange rate flexibility that has taken place in the developing country group since the adoption of generalized floating by industrial countries in 1973. Before 1983 there had been only isolated instances of floating by developing countries in the context of the post-par value regime. Lebanon has had such a floating exchange rate for several years. Other experiences with market-determined unitary floating rates were quite shortlived, lasting for less than one year (Mexico--1976/77, Argentina--1978, Costa Rica--1981, and Chile--1982).

Discussion of the scope for floating exchange rates in developing countries has been characterized by concerns that in most of these countries exchange markets are thin and financial markets in general are underdeveloped, increasing the potential volatility of market-determined rates and the cost of hedging against it. In the literature, the use of flexible management of reserves rather than exchange rate flexibility and the adverse consequences of floating systems for domestic price stability have often been emphasized, and the discussion has questioned the developing countries' capacity to operate market-determined exchange rates. ^{1/} Despite this, within the past four years countries with fairly diverse economic and financial structures have adopted market-determined exchange rate systems. The first step toward the more widespread use of unified floating exchange rate systems by developing countries was the introduction by Uganda in mid-1982 of a secondary auction market for foreign exchange. Uruguay changed to a unified floating rate from a preannounced rate in late 1982. This was followed

^{1/} For recent surveys of the literature on exchange rate regimes in developing countries, see Peter Wickham, "The Choice of Exchange Rate Regime in Developing Countries," Staff Papers, June 1985, and John Williamson, "A Survey of the Literature on the Optimal Peg," Journal of Development Economics, 11 (1982), pp. 39-61.

in close order by Jamaica, Uganda, and Zaïre in the first half of 1984 (in each case involving unification of an existing official market and a free market introduced in the context of a Fund program). The Philippines adopted a system in which the exchange rate is determined in a unified market in October 1984, and was followed by Bolivia, the Dominican Republic, and Zambia in 1985. In January 1986, The Gambia adopted a unified floating market, and Guinea put in place arrangements for transition to a float.

General aspects of exchange rate policies in developing countries were reviewed by the Executive Board in 1982. ^{1/} Developments in exchange rate arrangements on the basis of the Fund's classification system were also examined by the Executive Board in 1982, when the present system of identifying "independently" (market-determined) floating arrangements was established. ^{2/} The role of exchange rate adjustment in Fund programs has also been reviewed in successive annual conditionality reviews. ^{3/} The intention of this paper is not to re-examine these general policy areas, but to focus specifically on recent experience with the adoption of floating exchange rates, including a comparison with the experience of countries which have managed their exchange rates essentially in accordance with relative purchasing power parity. Given that the capacity of developing countries for operating the arrangements for floating exchange rates has been a key issue in these countries, the paper also deals in some detail with technical and institutional aspects of those arrangements in which the Fund staff has been closely involved.

The paper is organized as follows: Section I examines the institutional setting and the form of exchange market arrangements. Problems that have arisen in the process of setting up the markets and in ensuring their efficient operation are also discussed in this section. Section II deals with related actions in the field of exchange and trade liberalization and development of forward exchange markets. The impact of floating exchange market developments is examined in Section III of the paper, including developments in nominal and real effective exchange rates, black markets for foreign exchange, payments arrears, and official and banking system capital flows and foreign exchange reserves. Although the emergence of floating markets is a relatively recent phenomenon in most of these countries, an attempt is made in this section to appraise the macroeconomic aspects of the experience, including a comparison with performance under regimes in

^{1/} "Exchange Rate Policies in Developing Countries," (SM/82/8, 1/11/82).

^{2/} "Exchange Arrangements Maintained by Members" (SM/82/44, 2/24/82), and successive quarterly reports on this subject.

^{3/} "Issues in the Implementation of Conditionality: Improving Program Design and Dealing with Prolonged Use (EBS/85/277, 12/17/85), and "Formulation of Exchange Rate Policies in Programs Supported by the Fund (EBS/84/232, 11/16/84).

which the exchange rate is managed in such a way as to stabilize the real effective rate. Section IV provides a summary of the main issues.

I. Experience with Instituting and Operating Market Arrangements for an Independent Float 1/

Twelve developing country members of the Fund have adopted market-related floating exchange arrangements. Members adopting floating rate systems have represented a variety of economic structures and per capita income levels within the group of developing countries, and also have been geographically dispersed (Appendix Table 1). However, one fairly general characteristic has been the openness of their economies to trade, and therefore the critical importance of the exchange rate. The depth of the financial systems in the economies under study has also varied, broadly in accordance with per capita income.

The developing countries which have adopted independently floating systems 2/ had previously implemented a broad spectrum of arrangements. Bolivia changed from an exchange rate pegged to the U.S. dollar which was changed in an attempt to counteract the effects on competitiveness of rapid domestic inflation. In the Dominican Republic on the other hand, there was a one-to-one parity with the U.S. dollar that had been in place for many years, even before the establishment of a par value in 1948. The Gambia changed from an exchange rate that was fixed against the pound sterling, while the Philippines changed from a system of managed flexibility vis-à-vis the U.S. dollar that involved small but frequent changes, and Uruguay had an exchange rate involving preannounced changes in terms of the U.S. dollar. Zambia had previously fixed its exchange rate in terms of a currency basket.

Several of the countries with an independently floating exchange rate had previously maintained arrangements involving a fixed or managed

1/ Lebanon's special security problems and associated data limitations make it difficult to assess the form and effects of exchange rate flexibility on its economy on a comprehensive basis. The assessment of South Africa's recent arrangements is also complicated by special factors. Exchange arrangements in both countries are therefore discussed to only a limited extent in this paper.

2/ Eight percent of developing country Fund members at present maintain independently floating systems (as of December 31, 1985). In contrast, 20 percent have managed floating arrangements, including those using specific indicators to guide their exchange rate policies, 39 percent maintain pegs or have shown limited flexibility in terms of single currencies (quasi-pegs), and the remaining 33 percent peg to the SDR or some other currency basket (Appendix Table 2). The determination of countries as "independently floating" is based on the limited extent of the authorities' intervention in the exchange market (see SM/82/440).

exchange rate for some transactions combined with a legalized free floating market for other transactions, before merging the two for a unified float (Bolivia, Dominican Republic, Guinea, Jamaica, South Africa, 1/ Uganda, and Zaïre). In three of these countries, the multiple exchange rates were maintained for a short period of time as a transitional device before unification. During the transition period, foreign exchange transactions were shifted to a newly created floating market (Jamaica, Uganda, and Zaïre).

Exchange arrangements including a legal secondary exchange market in which the exchange rate is freely floating are currently maintained by more than 15 Fund members. Although a free secondary market may serve as a basis for early exchange rate unification in accordance with established Fund policies, in most instances the market has been in place for a number of years and was in virtually all instances not adopted with this aim. The experience of Fund members with multiple exchange rate arrangements was discussed by the Executive Board, in April 1984 and February 1985, on the basis of three staff papers. 2/ The focus of the present paper is not on these arrangements; a brief summary of the experience with multiple rates and the treatment in Fund programs of exchange rate policies of members that have unified on the basis of a free secondary market is presented in Section I.3 below.

1. Reasons for floating

Of the developing countries that have adopted floating rates, most did so because of severe balance of payments difficulties reflected in sizable external payments arrears, and in the context of discussions for a Fund-supported program. 3/ The exceptions were Lebanon, South Africa, and Uruguay. In the case of Lebanon, the maintenance of a floating exchange rate was seen as part of the country's commitment to an open and commercially free environment for trade, and reflected the highly developed financial markets in Lebanon. The decision by South Africa to float, at a time of relative balance of payments strength, was influenced at least in part by the desire to improve conditions for monetary control.

Uruguay, which has been one of the few Latin American countries to avoid external payments arrears in recent years, adopted a market-determined rate in 1982 following adverse experience with other relatively flexible arrangements. Prior to 1978, there had been a dual

1/ After abolishing it in February 1983, South Africa reintroduced the dual exchange system in September 1985.

2/ "Review of Experience with Multiple Exchange Rate Regimes" (SM/84/64, 3/19/84) and background paper (SM/84/65, 3/20/84), and "Multiple Currency Practices Applicable Solely to Capital Transactions" (SM/85/19, 1/16/85).

3/ See Section I:3 below for a discussion of Fund program treatment of the systems.

exchange market in which the secondary market was freely operating. After unification in 1978, Uruguay for several years undertook a program of pre-announced exchange rate changes, but this system ultimately caused considerable instability in the capital and current accounts because exchange rate adjustments were insufficient.

In all other cases, the choice of floating exchange rates, all in the context of Fund programs except for Bolivia and The Gambia ^{1/}, has been made by countries with protracted balance of payments problems that included arrears. These problems had previously been addressed by extensive controls on foreign exchange transactions instead of exchange rate adjustments, which had in turn led to disintermediation in official exchange systems. In such circumstances, it was difficult to predict the equilibrium market rate, although the parallel market rate provided some indication. This uncertainty regarding appropriate levels for pegging or managing exchange rates has been an important reason for the adoption of floating arrangements. Also in these circumstances, it has been difficult, given the lack of official foreign exchange resources, to support a pegged rate which has come under market pressure, apart from through the accumulation of arrears. This is another reason why floating has often seemed the only feasible option.

The desire to bring into the open sector a large illegal parallel market in which the local currency was substantially depreciated, coupled with capital flight associated with that market, was an important reason for adoption of the unified floating arrangements (Bolivia, The Gambia, Jamaica, Uganda, Zaïre, and Zambia). The initial depreciation when floating began and subsequent movements to continuously maintain realism of the exchange rate were seen as a major factor in encouraging market participants to repatriate earnings. This was so particularly where the introduction of the floating market was accompanied by liberalization of exchange controls, permitting repatriated earnings either to be used for import needs or to be moved freely abroad. Proximity to a major financial center may provide an added stimulus for adoption of floating.

In the case of Zambia, the primary factors leading to adoption of the foreign exchange auction were a perception that the previous administrative system for allocating foreign exchange had broken down, and that the system would lead to a more efficient allocation, including more effective provision of foreign exchange for critical spare parts.

Another important reason in several instances was the desire on the part of the authorities to shed political responsibility for the

^{1/} The Bolivian system was adopted in the context of discussions for a Fund program. Because of the continued existence of arrears to the Fund, the Gambian floating system was not implemented as part of a Fund-supported program, although technical assistance was provided by the Fund.

adjustment of the exchange rate. Discrete adjustments to a managed or fixed exchange rate usually involved unpopular political connotations. With the rate determined in an open market, the authorities were better able to deflect political criticism and to focus their attention on other areas of economic management.

2. Choice of floating market arrangements

Experience with different forms of free exchange markets is as yet relatively limited, being for the most part of recent origin. The authorities must nevertheless choose the institutional arrangements that are best suited to their economic structure and financial institutions. An important concern in designing a market arrangement and in deciding on the role that the authorities themselves will play in instituting the market and monitoring its performance is to prevent the emergence of destabilizing monopolistic or collusive behavior.

Members contemplating floating exchange rates are faced with essentially two forms of market arrangements (Table 1). In most of the instances under discussion in this paper (The Gambia, the Dominican Republic, Lebanon, the Philippines, South Africa, Uruguay, and Zaïre), as in all developed countries with floating exchange rates, members have opted for a market that is operated within the private sector, by commercial banks and licensed foreign exchange dealers. In other instances, the authorities have felt constrained by institutional or social considerations to use an auction system to ensure a sufficiently competitive market. Foreign exchange is then surrendered to the central bank for auction to the highest bidders (Bolivia, Guinea, Jamaica, Uganda, and Zambia). In an auction market, the central bank conducts the market and serves as the channel for the auction process.

a. Interbank system

The participants in an "interbank" market are commercial banks and, in some instances, foreign exchange dealers (if these are licensed for the purpose). Individuals and firms are permitted to bid through the commercial banks or dealers acting as their agents. Of the seven developing countries that have adopted an interbank system, most already had a sufficient number of commercial banks and foreign exchange dealers operating in the economy to ensure a competitive environment. In other instances, major considerations in the choice of an interbank system were the absence of sufficient manpower and expertise at the official level to conduct auction arrangements, and the belief that, with sufficient freedom of entry into the newly created market, the necessary institutions would develop quickly.

Under this system, the exchange rate is determined in negotiations between banks and their clients and in transactions between the banks. The exchange rate is free to vary from hour to hour and day to day. However, in order to ensure the competitive operation of the market, in all instances except The Gambia, the Philippines, and Uruguay, there are

Table 1. Summary Characteristics of Independently Floating Unitary Exchange Rate Arrangements in Developing Countries

	Number of Commercial Banks in Market	Form of Arrangement	Regulation of Commercial Banks' Position	Rate Determination	Role of Central Bank Intervention	Foreign Exchange Surrender Requirements	Forward Exchange Market: Development and Plans
Bolivia	19	Auction (daily)	Spot position, daily	Successful bidders pay their bid prices ("Dutch" auction)	Possible by adjusting the amount of foreign exchange supplied to auction, within the constraint of reserves, arrears, and external debt obligations. Setting of base price	100 percent of goods to the Central Bank	No plans to implement in the near future
The Gambia <u>1/</u>	3	Interbank	...	Negotiable between banks and their clients	Not specified	100 percent of goods and services to commercial banks except for some tourism proceeds. Receipts of Marketing Board to the Central Bank	No plans to implement in the near future
Dominican Republic	16	Interbank	Spot position, daily	Negotiable between banks and their clients	No intervention to influence the exchange rate	All the export proceeds to the Central Bank through commercial banks, with exceptions of some export proceeds of mining companies and tourism	No plans to implement in the near future
Guinea <u>2/</u>	3	Auction (weekly)	Spot position, weekly	Successful bidders pay clearing rate (marginal price) <u>1/</u>	Possible by adjusting the amount of foreign exchange supplied to auction, within the constraint of reserves, arrears, and external debt obligations	All the export proceeds and invisible proceeds to the Central Bank with minor exceptions for imports of specified goods and services	No plans to implement in the near future
Jamaica	10	Auction (twice a week)	Limit on total forward sales not matched by forward purchases.	Successful bidders pay their bid prices ("Dutch" auction)	Intervention to meet net reserve target	100 percent of all receipts to the Central Bank	Organized market exists, but very few transactions
Lebanon	Many	Interbank	Net foreign position (debit) should be within 15 percent of capital	Negotiable between banks and their clients	Smoothing operations	None	Market exists
Philippines	33	Interbank (telephone market and trading floor at Central Bank)	None	Negotiable between banks and their clients	Net accumulation of international reserves to keep minimum level	100 percent of goods and services to commercial banks	Unorganized market exists, but very few transactions

Table 1 (Concl'd). Summary Characteristics of Independently Floating Unitary Exchange Rate Arrangements in Developing Countries

	Number of Commercial Banks in Market	Form of Arrangement	Regulation of Commercial Banks' Position	Rate Determination	Role of Central Bank Intervention	Foreign Exchange Surrender Requirements	Forward Exchange Market: Development and Plans
South Africa <u>3/</u>	5	Interbank	An open position limit, both spot and forward, equal to 10 percent of the banks capital and reserve funds	Negotiable between banks and their clients	Smoothing operations	100 percent of goods and services to commercial banks	Organized market exists, but number of transactions is limited
Uganda <u>4/</u>	7	Auction (weekly)	None	Successful bidders pay clearing rate (marginal price) <u>1/</u>	Possible by adjusting the amount of foreign exchange supplied to auction	100 percent of goods and invisibles to the Central Bank through commercial banks	No plans to implement in the near future
Uruguay	12	Interbank	None	Negotiable between banks and their clients	No intervention on the interbank market. However, possible influence on rate formation through central banks' transactions with commercial banks, including a government-owned one	None	Organized market exists, but very few transactions
Zaire	10	Interbank	Spot position daily	Negotiable between banks and their clients	Very little intervention on the interbank market. However, possible influence on the rate formation through central banks' transactions with commercial banks	All the export and invisible proceeds to commercial banks. Receipts of mining companies and oil companies to the Central Bank	No plans to implement in the near future
Zambia	6	Auction (weekly)	Transactions subject to existing regulations	Successful bidders pay clearing rate (marginal price)	Possible by adjusting the amount of foreign exchange supply to auction, within the constraint of reserves, arrears, and external debt obligations	All the export proceeds and invisible proceeds to the Central Banks through commercial banks, except for the retention of privileges of the mining company and exporters of non-traditional products	No plans to implement in the near future

Source: Data provided by national authorities.

- 1/ One of the four commercial banks operating in the market at the inception of floating has since ceased operations.
2/ Arrangements described are those envisaged in economic program supported by stand-by arrangement for use of Fund resources.
3/ Arrangements in place prior to reintroduction of dual exchange rate in September 1985.
4/ Arrangements in place prior to introduction of managed floating arrangements.

maximum or minimum limits imposed on commercial bank holdings of foreign exchange. The purpose of such regulations is twofold: first, to prevent major dealers from "cornering the market," or from using inside information to speculate on their foreign exchange operations; second, to prevent imprudently large exposure of banks to exchange risk. Such limits may be particularly important in the initial stages of the market when a minimum volume of trading is necessary to establish confidence. The initial size of the limits may be established by reference to the previous behavior of commercial banks' working balances. Such limits may also be seen as preserving the reserve management responsibilities of the central bank. A second type of regulation on the market would involve an upper limit on the volume of foreign exchange surrendered to each commercial bank, to prevent any bank cornering the market in a flow sense. Such a limit, although not used in arrangements to date, could be necessary in countries where the foreign exchange receipts of the economy accrue to one or a few major transactors who could then direct all of their foreign exchange earnings to one exchange dealer. If constrained by the stock or flow limits, banks must either buy or sell from other banks or, if other banks were also at their limits, transact with the central bank.

Another important form of official involvement in the interbank market is the conduct of a periodic fixing session at which the central bank has representatives present, and may also transact. At the rate fixing sessions, held at least once a week, the commercial banks trade their open positions in foreign exchange and an exchange rate is fixed taking into account the outcome of the previous fixing and subsequent transactions between banks and their customers during the week. The fixing exchange rate is usually set at a level which allows the largest volume of purchase orders to be transacted, and in the course of the fixing session commercial banks trade short and long positions according to their needs at this rate; a minimum volume of transactions may be specified by the central bank. The fixing rate is also used for customs valuation and other official purposes. Particularly in economies marked by a relatively small number of transactors, or by other political or institutional tendencies toward collusion, the fixing session is an important means of providing the authorities with a view into the operation of the system, and thus preventing abuses. In countries where there is an inadequately defined budget for foreign exchange expenditures by the government itself, there may also be rules concerning the entry of the government or government enterprises into the interbank market, either in the course of the week or at the time of the fixing. Such rules may be especially relevant where the floating arrangements are introduced ahead of fiscal adjustment measures.

In most instances, there are official requirements for supply of exchange to the official market. All countries in this group, except Lebanon and Uruguay, have surrender requirements for foreign exchange. In the Philippines, all receipts from exports of goods and services are required to be surrendered to commercial banks. Receipts of the marketing board in The Gambia and receipts of mining companies and oil

companies in Zaïre are required to be surrendered to the central bank. In the Dominican Republic, foreign exchange earnings of traditional exports of goods and services subject to an exchange surcharge (sugar, cocoa, coffee, tobacco, and most services other than tourism) are required to be surrendered to the central bank. The significance of the surrender requirement to government authorities is that, although the government uses the exchange rate determined in the market, it may seek to guarantee the provision of foreign exchange for certain purposes. The surrender requirements are therefore a consequence of official intervention in the allocation of foreign exchange by nonprice methods, e.g. import licenses or exchange restrictions.

In some cases, portions of the supply and demand of foreign exchange are allocated outside the market. Such "extra-market" transactions occur when the central authorities retain exchange surrendered to them for their own use, or when private sector exchange earners are granted "retention privileges" to use or sell the retained amounts outside the market. This results in less information on transactions being channeled through the market, and a consequent loss of efficiency in the floating arrangements. As will be seen below, this has led on occasion to severe instability of the exchange rate, especially when the information is ultimately made available to market transactors, and expectations are corrected suddenly.

Demand for foreign exchange by the public sector, including public enterprises, is met at the prevailing exchange rates either through the commercial banks or through the central bank. In Uruguay the central bank acts as an agent when it is requested by the government to purchase on its behalf foreign exchange from commercial banks. In the Dominican Republic and the Philippines, the central bank sells foreign exchange to the government from receipts surrendered to it. In The Gambia and Zaïre, debt service obligations of the public sector are paid from exchange surrendered to the central bank. However, the government may obtain foreign exchange from commercial banks for other purposes. In most countries severe shortages of foreign exchange for building up depleted reserves and meeting external debt service obligations, including the reduction of arrears, make it very difficult for the central bank to become a net seller to the interbank market. On the other hand, excessive purchases by government would tend to over-depreciate the domestic currency, leading to political and social difficulties. Intervention will therefore usually be limited to very short-run smoothing or seasonal operations and purchases for gradual reconstitution of reserves.

For the efficient and competitive operation of the interbank market, it is important that exchange rates determined in these transactions be widely and openly published so that the possibility of collusive practices by commercial banks is reduced, and the regulations set specific requirements to this effect. The central bank may in addition set maximum commissions that may be charged by commercial banks. Purchasers of foreign exchange may also be required to provide

documentation that the purchase is for transactions in accordance with prevailing exchange and trade controls and income tax regulations.

An important question in setting up a competitive market is the degree of freedom of access. In several countries, transactions are limited to certain groups. In Zaïre, foreign exchange dealing licenses are granted only to commercial banks and hotels. There is no specific information on the network of informal foreign exchange dealers, but it is thought to be small and scattered. In the Dominican Republic, the foreign exchange market is a very broad one owing to the openness of the economy and the prior existence of a secondary market in which some 16 commercial banks and more than 90 foreign exchange houses participated. At the other end of the spectrum is the market in The Gambia, in which only 3 commercial banks participate, and nonbank foreign exchange dealers are not permitted to participate in the fixing session. Generally speaking, the easier are entry requirements into the market, the more competitive and stable it will be.

b. Auction markets

The role of the authorities in an auction system (as conducted by Bolivia, Guinea, Jamaica, Uganda, and Zambia) is a more central one than in an interbank market. Receipts from specified exports and services are surrendered to the central bank at the prevailing exchange rate and are auctioned by the authorities on a regular basis. The central bank decides the amount of exchange to be auctioned, and the minimum reserve price below which it will not accept bids. The minimum amount of the sales may be predetermined as part of a macroeconomic program. The central bank may decide to auction foreign exchange in minimum amounts of, say, US\$50,000, allowing banks to bid on behalf of their customers. All bidders with a valid import license (where licensing requirements are retained) are required to lodge an advance deposit, either partial or equivalent to 100 percent of the foreign exchange they intend to purchase, before the submission of bids. The bids submitted to the auction are then examined and all bids in excess of the highest bid which fully exhausts the available supply of foreign exchange (i.e., the market-clearing price) are accepted. The market-clearing marginal rate (the average exchange rate in Bolivia) becomes the market exchange rate. After the auction, the market exchange rate, the total number of bids received, and the number of successful bidders are announced. The auction-determined exchange rate applies until the next auction date to all exchange transactions, including surrenders for the next auction and any transactions that may not be required to be channeled through the auction market (e.g. transactions of the government). Advance deposits lodged by unsuccessful or partly successful bidders are returned in whole or in part, respectively, but bids are normally not permitted to be withdrawn. If a successful bidder fails to make full payment for his foreign exchange within a specified period, he may be subject to a fine that may be collected from the deposit he has lodged. Spreads between buying and selling rates of individual commercial banks and any limits on commercial bank foreign exchange positions are closely monitored by

the central bank to ensure that collusive practices are not involved, and that they reflect reasonable profit margins.

Perhaps the basic difference between interbank and auction system arrangements is in the treatment of the supply of foreign exchange to the market. An essential feature of an auction market arrangement is that it requires the surrender of foreign exchange to a centralized point, which to date has been the central bank of the country organizing the market. In contrast, in an interbank arrangement, the ownership of foreign exchange may remain diffused in the private sector. In some auction arrangements (as with the interbank arrangements described above) the surrender requirement is less than complete, and retention allowances have been kept for certain export or other foreign exchange earners. Similarly, the supply by the central bank of foreign exchange it has collected may be less than complete, as the central bank retains a certain portion of foreign exchange from the market for the use of government.

In Bolivia, Jamaica, and Uganda, all export proceeds are required to be surrendered to the central bank. In Guinea, however, there are minor exceptions for exports of specified goods and services. In these four countries, all sellers of foreign exchange to the central bank are entitled to receive local currency at the auction market exchange rate for all foreign exchange surrendered. In Bolivia, in order to stimulate surrender, those surrendering foreign exchange were for a short period of time able to obtain an exchange reimbursement certificate in an amount equivalent to 10 percent of the foreign exchange surrendered. In Zambia, the authorities have accepted, on a transitional basis, retention privileges for the mining company and exporters of nontraditional products, reflecting concerns about the availability of foreign exchange. For example, in the latter case, about 50 percent of total export proceeds are estimated to be retained by exporters. However, the Zambian authorities (and the Ugandan authorities also) introduced a policy, whereby the source of foreign exchange earnings is no longer subject to declaration, in order to encourage capital inflows into the system.

Once the central bank obtains the foreign exchange, it may put some portion aside for its own uses--accumulation of reserves, reduction of external arrears, and payments of external debt obligations. In Guinea, Jamaica, Uganda, and Zambia, payments for official imports, such as petroleum and some other payments, are made by the central bank from the surrendered foreign exchange, and the other available foreign exchange is auctioned. The foreign exchange requirements of public enterprises may also be provided at the official exchange rate, or the enterprises may be required to purchase foreign exchange in the auction market (Bolivia, Jamaica, and Uganda). Most of these requirements are, in practice, met outside the auction in Jamaica. The net effect of these arrangements under which government needs are met outside the auction at the market rate is to limit severely the proportion of overall foreign

exchange earnings that is channeled through the auction market. ^{1/} In two cases (Uganda and Zambia), the amount supplied to the market has been largely prespecified in absolute terms, although subject to some variation according to the balance of payments performance (Uganda, Zambia). In the other case (Jamaica), the amount supplied to the market has been larger and has naturally fluctuated with overall balance of payments developments. The retention and sequestering of exchange for official purposes, although undertaken to ensure availability, has often created problems both for the flow of information to the auction market and for the provision of sufficient exchange for orderly discharge of current demands, by reducing confidence in the operation of the market and thus sales to it.

The other aspect of the supply side of the market, namely the exchange rate applying to sales to the central bank, in part for the auction, also marks an important difference from the interbank market system. Under the interbank system the exchange rate may be determined directly and may vary continuously during business hours by negotiation between buyers and sellers, but under the auction system, which functions discretely, surrender occurs in practice at the exchange rate determined in the preceding auction. This may create uncertainty for market participants, and a risk of exchange loss in the interim for participants engaged in both purchases and sales in the market. Of course, the more frequently the auctions are conducted, the less inefficiency in the market clearing process will result from this source. In addition to adding to exchange risk, infrequent auctions could also cause delays in the availability of exchange. Further delays will result if participants' difficulties in assessing the clearing price cause them to make one or two unsuccessful bids before finally obtaining exchange. Auctions take place daily in Bolivia, twice a week in Jamaica, and weekly in Guinea, Uganda, and Zambia.

Eligibility for participating in the auction on the demand side of the market is basically determined by the restrictive system of the country in question (see next section). In addition, there may be technical requirements that must be satisfied in order to establish the ability of a participant to make the local currency payment and to otherwise consummate a successful bid. In Bolivia, any individual or legal institution that wishes to obtain foreign exchange is permitted to submit a bid in the auction, although each bid must have a minimum value of US\$5,000 and must be accompanied by a banker's check in domestic currency equivalent to the bid. In Jamaica, private participants in the market comprise all bona fide importers with valid due or outstanding payments, and other nonbank applicants holding foreign exchange approvals of the central bank. Bids for transactions below US\$50,000 are aggregated and presented by Jamaican commercial banks on behalf of

^{1/} In Jamaica, approximately 47 percent of foreign exchange inflows in 1985 was auctioned. In Uganda and Zambia, the comparable ratio is estimated to be as low as 25 percent.

their clients. In both Bolivia and Jamaica, all public sector institutions must also validate their participation by producing either evidence of deposit of the domestic currency equivalent under the commercial bank deposit scheme (Jamaica), or a banker's check (Bolivia). In Guinea, all transactions of the public sector are conducted at present in the primary exchange market (first window) which handles inter alia external debt service obligations and official petroleum imports. Transactions of the mining companies are also conducted at this window, while all other trade transactions are conducted at the second market window. In the initial stage of operation of the Ugandan market, bids for foreign exchange were limited to imports (excluding oil and essential spare parts and capital goods), to invoices made out by foreign airlines for transportation, and to private sector service and transfer payments. In Zambia, all public enterprises, except the mining enterprise, must bid for their foreign exchange requirements in the auction.

Some of these countries have penalties for the successful bidder who fails to take the bid within a certain period, even though he has deposited with his commercial banks checks against the full local currency value of his foreign exchange application. In the case of Zambia, for example, a penalty not exceeding 10 percent of the amount of the bid will be imposed on the bidder if the Foreign Exchange Committee finds a blatant abuse of the foreign exchange arrangements. A bidder found persistently abusing the arrangements may be placed by the Committee on a black list for up to 12 months, during which time the individual is disqualified from participation in the market. In countries with floating systems that have retained import or capital controls, pre-existing legal penalties for contravention of these regulations may also continue to apply.

An important aspect of auctions is the choice of arrangements for determination of the exchange rate between a "Dutch auction" and a "marginal pricing" approach. Under the Dutch auction system, each bidder whose bid is accepted must pay his bid price for foreign exchange. This system has been applied recently by two Fund members (Bolivia and Jamaica). Participants in this form of auction may pay a price for foreign exchange that is significantly higher than the market clearing price if they assess demand conditions in the market incorrectly, but their bid is successful. Under the marginal price system a single rate--the most appreciated bid price at which the available foreign exchange is exhausted, which is the market-clearing price--is applied to all successful bidders. Bidders who have offered rates more depreciated than the market clearing rate will receive all the foreign exchange they have bid for at the clearing rate. Those who have offered a rate more appreciated than the clearing rate will not receive foreign exchange and those who have offered the marginal rate will receive only part of what they have bid for, on the basis of an allocative rule. Three Fund members (Guinea, Uganda, and Zambia) operate marginal price auctions. In the case of Jamaica, the authorities switched to a Dutch auction from a marginal pricing auction mainly because they were concerned that speculators would act on the belief that the Jamaican dollar would depreciate sharply against foreign

currencies, and that these speculators should pay the full price of their bid. In practice, however, participants in the Jamaican auction have been able to obtain sufficient information regarding each other's bids for the spread between buying and selling rates to remain very narrow. Similarly, in Bolivia, following a settling down period of a month or so after introduction of the Dutch auction, the successful bids in the auction also converged within a narrow (less than 2 percent) range.

A possible difficulty with the Dutch auction system is that it may inhibit entry to the market by participants who fear having to pay a price significantly higher than the clearing price for exchange if their bid is successful, leading to continuous existence of black market and collusion before auction. The risk would be increased if significant spreads actually do emerge between successful bids. For example, an importer could be left with overpriced goods on his hands relative to those held by others bidding in the market. However, the experience of the Jamaican and Bolivian Dutch auction systems to date has been that the spreads in the market have been very small; in part in Bolivia because the illegal parallel market provides a guide. A more basic criticism of the Dutch auction system is that it involves price discrimination, and promotes collusion to ensure that the consumer surplus is not appropriated by those administering the auction, while the marginal approach to auction pricing is the best approximation to normal private markets, in which the consumer surplus is not appropriated. Under a marginal pricing approach, rates of return are free to vary and thus to direct foreign exchange to the most valued uses.

The Dutch auction approach raises questions as to which exchange rate will be relevant to extra-auction market transactions (e.g. government transactions). In Bolivia, the exchange rate struck and announced for this purpose is the weighted average of successful bids, 1/ 2/ while in the case of Jamaica it is the lowest price at which exchange was bought and sold in the auction--that is, the marginal price. 3/ Another aspect of the Dutch auction system is that, to the

1/ It has sometimes been suggested that this weighted average (or a median) approach could also be used to determine the single "market rate," but it would present a problem for those successful bidders who bid below the average price.

2/ Initially, the official exchange rate was calculated by including also the unsold balances valued at the Central Bank's minimum price. The reason for this practice was the Central Bank's concern that exporters might manipulate the exchange rate in their favor in unusually thin exchange markets.

3/ The use of a marginal auction approach for a secondary dual market may also make transition to a unified freely floating market easier to achieve than unification of Dutch auction systems, because of the multiplicity of exchange rates under the latter.

extent that it gives rise to exchange rate spreads of more than 2 percent between the buying and selling rates as a result of official action, a multiple currency practice arises. In the case of Jamaica, the Fund approved the resulting multiple currency practice on a temporary basis; approval is being proposed for the Bolivian practice.

Another consideration in the setting of exchange rates is the use of a reserve price for foreign exchange, i.e., the most appreciated exchange rate at which the central bank will undertake to supply exchange. In general, a reserve price has not been set and should not be necessary, as countries with these systems have generally been in a situation of overall excess demand for foreign exchange. However, in some cases where the market is subject to sporadic supply, including strong seasonality, or where the arrangements have not been in place sufficiently long to ensure adequate knowledge of the system among participants, a reserve price may serve a stabilizing function.

c. Issues that have arisen in the choice and implementation of floating arrangements

The basic objective of auction and interbank market systems is to establish an exchange rate that will move flexibly to equilibrate the supply of and demand for foreign exchange and thus to reduce dependence on exchange and trade restrictions. The choice between the two forms of arrangement in any particular case must take into account the institutional and economic structure of the member concerned. Where a sufficient number of capable commercial banks exists or there is a pre-existing network of operators dealing in the parallel market, the interbank arrangement is likely to be the more efficient, and will require less resources at an official level to ensure its success. However, one question that may be considered open is whether provision for freedom of entry into a floating market, even when the number of capable banks is initially small, will result quickly in sufficient institutional depth. The existence of experienced brokers in often extensive legal and illegal parallel markets suggests that this will normally be the case. One consideration in the choice of the form of floating arrangement is the extent to which collusion among participants may be expected. As discussed earlier, there are ways of ensuring that one or several operators do not corner the market, ^{1/} but in a country that has had a history of commercial domination by a small group, central bank organization of an auction market may be preferable to an interbank arrangement. On the other hand, where a primary consideration of the authorities in choosing to float is their desire to distance themselves from responsibility for the setting of the exchange rate, the administration of the auction by the central bank may run counter to that objective.

^{1/} See the discussion on pages 6 and 9.

In the case of Guinea, an interbank market was considered inappropriate by the authorities because there are only three commercial banks operating in the country and because the public sector is the main source of foreign exchange earnings. Likewise in Uganda, an interbank market was considered unworkable because of the limited number of commercial banks and the danger of collusion. In addition, since coffee was the main source of foreign exchange earnings, and since it was exported by the government, it was thought that an interbank market would not be efficient. Further, profits that the central bank would earn from foreign exchange auctions were seen as an important source of budget revenue that could not be captured by an interbank market. The commercial banks have been the only legally recognized foreign exchange dealers in Uganda.

On the other hand, the authorities in The Gambia chose an interbank arrangement, although there were only four banks operating in the country at the time. The reasons for this were first, that the central bank did not have enough foreign exchange and manpower to conduct the auction; second, that the banks were trusted by the authorities to take a role in allocating foreign exchange efficiently to institutions, including small private traders; and third, that operation of the system was envisaged to be simple but comprehensive. In practice, some difficulties have arisen in ensuring the competitive operation of this market.

Owing to the wide dispersion of commercial banks throughout the Philippines, it has not been considered necessary to legalize foreign exchange dealerships other than commercial banks, but there are many unauthorized dealers specializing in workers' remittances and other small flows. Similarly, the establishment of a market in Zaïre was facilitated by the existence of a well-established commercial banking system with 10 banks. Foreign exchange dealer licenses are granted only to commercial banks and hotels. There is no specific information on the network of foreign exchange dealers either before or after the float, but it is thought to be small and scattered. In the Dominican Republic, the existence before the float of a free secondary market in which 16 commercial banks and more than 90 foreign exchange houses and hotels participated meant that the foreign exchange market was already a relatively broad one.

In the implementation of some floating arrangements, the effects of pre-existing external payments arrears have created difficulties. In Jamaica, the overhang of arrears in the early operation of the market was so large that it adversely affected confidence in the auction market by causing an almost complete cessation of new imports. For this reason, the backlog of arrears was removed from the market and subjected to a phased repayment. This could in principle have been done by purchases from the auction, but it was actually done by setting aside a certain portion of the proceeds of surrender before the auction. Provision was made for all applications relating to previous due dates to be registered with the central bank for rescheduling. The

applications were required to be accompanied by an affidavit from the foreign creditor to the effect that the amounts remained due and payable. Once verified, the arrears would not be permitted direct access to the market; instead, a fixed sum would be set aside on a regular basis by the central bank for the rescheduled payments. An exchange rate guarantee was not provided, and supplementary local currency deposits were required at the rate on the day of actual payment. Modalities for the rescheduling might include cash payment of foreign exchange over a period of years, or investment of the local currency counterpart domestically; in the latter case, liquidation or repatriation of the investment might be permitted only at the end of a fixed period. Provision would be made for blocked counterpart deposits against all the arrears. An important aspect of the handling of the arrears "overhang" problem has been early contacts with creditors to ensure the best possible environment for the start-up of the market (Jamaica, Zaïre, and Zambia).

Questions of the adequacy of international reserves and techniques of foreign exchange "cash flow management" have also been raised in countries considering floating arrangements, and other flexible arrangements for the exchange rate. To assist in providing as stable an environment as possible for the introduction of a floating rate system, and with the aim of minimizing the initial depreciation of the exchange rate after floating, arrangements have been made in several instances for "bridging" finance from donor country official or commercial bank sources ahead of drawings under a Fund stand-by arrangement and rescheduling of existing external obligations. The role of discussions with the World Bank and other donors and creditors has been important at this stage in underpinning confidence in the new market, by providing reasonable assurance that balance of payments financing will be forthcoming. The positive effect on capital account of the floating arrangement itself, as examined in Section III below, may be expected to assist in stabilizing the exchange market.

For example, in the period preceding the establishment of an auction market in Bolivia, the authorities were concerned that, because of the thriving unofficial market, the supply of foreign exchange to the auction would be limited. They saw this problem as being exacerbated by the lack of an effective institutional apparatus to ensure that export proceeds flowed through the official channels. The authorities therefore considered using official reserves and borrowing from official sources abroad to make the foreign exchange market in the initial stages. In the event, this proved unnecessary. The demand for foreign currency in the official market fell initially below supply, reflecting in part the high reserve price, as well as the relatively low demand because of a lack of experience with the market mechanism. As a result, the authorities built up official foreign exchange reserves in the start-up period.

Beyond the start-up period for the floating market, foreign exchange cash flow management to accommodate seasonal or other identi-

liable reversible factors also plays an important role, given the generally low level of international reserves in this group of countries. A problem that is foreseen in the market recently established in The Gambia is the potential instability of both the volume of transactions and the exchange rate. Tourist receipts fluctuate widely from season to season, and exports of groundnuts also have strong seasonality. It will be important for the market to absorb this instability, and accumulation of adequate reserves either by the central bank or in the banking system for use during the lean season is an aim of the arrangement. Tourism receipts are also highly variable in Uruguay.

In the case of Guinea, all banks transacting on behalf of customers credit the central bank with the entire counterpart of any transaction within three working days. Residents must also obtain permission to open convertible foreign currency accounts in order to auction funds through authorized banks; with liberal authorization of these accounts, the auction market could become an important additional source of foreign exchange, but without it, supply could be curtailed.

Certain difficulties have marked the operation of the auction system in Jamaica from time to time. First, owing to political sensitivities there have been tendencies for large importers at times to restrain their demand for foreign exchange. Second, importers were for a time in 1984 not permitted to bid in the auction market for foreign exchange with which to repay letters of credit, and banks would not open letters of credit unless the importer had on deposit the foreign exchange. However, as most letters of credit were required by creditors to be on a prepaid basis (owing to Jamaica's arrears), this documentation requirement effectively meant that market access was denied to the importers. The "vicious circle" problem was addressed for a time by having importers present exchange control documentation following the auction, and by the institution of penalties should proper documentation not be presented. As the market settled down, banks have resumed opening letters of credit on a more normal basis. Third, importers who had no evidence of income tax clearance were for a period of months banned from the auction. Delays in obtaining this clearance were long enough to influence strongly the total demand of the auction, and the exchange rate was virtually fixed while this requirement was in effect. Fourth, sizable official foreign exchange operations outside of the auction have contributed from time to time to the instability of the exchange rate. This has occurred when supply to the market has been increased for a short time through an incurrence of arrears, an unsustainable level of short-term credits by the public sector, or sales of government assets abroad. Subsequently, the demand re-entered the market and the rate depreciated sharply, from a short-term plateau. Since October 1985, the exchange rate has been virtually fixed, at the expense of incurrence of arrears, including nonprovision of exchange for successful bids.

The main difficulty with the operation of the Philippine system has been an unexpected rigidity of the exchange rate in terms of the U.S. dollar for some periods of time, which has been damaging to export industries. In general, this outcome has been explained by tight monetary policies reflecting the authorities' intention to constrain inflation, accompanied by large short-term capital inflows; it has therefore not been a necessary consequence of the exchange rate arrangements themselves. During other periods, most recently during the first quarter of 1986, flexibility in the exchange rate system played an important role in limiting the re-emergence of a black market, and in protecting the balance of payments from rapid domestic monetary expansion.

In Uganda, several problems were experienced during the implementation of the auction arrangements. First, participation in the auction has been subjected to various forms of government intervention such as import license requirements and tax payments certificates. Issuance of import licenses was for a time speeded up, but the issuance continued to be on an ad hoc and discretionary basis. Second, participation in the auction has on occasion been confined to a limited group of influential importers. Third, it has not been possible for participants to verify whether the announced rate was in fact the market clearing exchange rate based on the actual bids submitted. Fourth, although import licenses and other supporting documents have been required of participants in the auction, the use of foreign exchange has not been closely monitored (e.g. the arrival of imports has not been closely checked), so that the foreign exchange said to be purchased for import payments may well have been used for illegal capital transactions. Fifth, initially the auction system required partial counterpart deposits against submitted bids; however, later, the commercial banks decided how much cash and credit were required to back a bid, depending on the creditworthiness of the client.

The major problem in the institution of the Zaïre market was an initial reluctance on the part of commercial banks to release foreign exchange to it. To free up supply, the net foreign exchange position of each commercial bank was limited to a certain proportion of its own resources. The market has since functioned with few problems.

In the period preceding the establishment of Zambia's auction market, the authorities were concerned with the possible effects of a completely free exchange market on the exchange rate and other macroeconomic variables, given the limited supply of convertible foreign currencies. Initially, therefore, the exchange rate was determined on the basis of an auction that involved only a selected group of foreign exchange users. Those excluded from the auction included the commercial banks themselves, the government and government-owned enterprises, as well as the mining company. Importers not excluded had to show documentary evidence to the commercial banks of their import licenses and pro forma invoices for imports. Also in the initial stages of the auction, a number of bidders were unsuccessful in obtaining foreign

exchange if their bid price was judged by the authorities to be too high, or if they had recently obtained foreign exchange through the auction market. The authorities have recently expanded the coverage of the auction to allow the importers who were formerly excluded from obtaining foreign exchange in the auction market, and import licenses are now issued for a fee without restriction.

3. The role of the Fund in the floating arrangements

The need for exchange rate flexibility has been an important ingredient in the design of members' financial programs supported by the use of Fund resources. In the period surveyed here (January 1983-December 1985), most programs included elements to ensure greater flexibility in exchange rate policy, either by managing the rate or by permitting it to adjust in response to market forces. Out of a total of 81 arrangements for 49 members approved by the Fund's Executive Board during the period under analysis (including five extended arrangements), 54 contained elements of exchange rate flexibility ^{1/} (Table 2). Most of these did not involve a formal change in the member's exchange arrangements, such as adoption of floating, but rather an intention to maintain at least the existing level of external competitiveness as measured by the real (inflation-adjusted) exchange rate. This type of objective was present in 36 programs in this period. In 31 instances, the target was linked to frequent exchange rate adjustment in the context of managed floating arrangements. In the other 5 instances, the value of domestic currency was pegged either to the SDR, or to another currency composite, and was to be adjusted periodically.

Frequent adjustment to the exchange rate under managed floating arrangements with the aim of maintaining or increasing competitiveness (as measured by a real effective exchange rate) was therefore the prevalent form of flexible exchange rate policy in the period surveyed (67 percent of programs). ^{2/} Use of market factors in exchange rate policy implementation was involved in 30 percent of the programs--of which 13 percent represented provisions for the transfer of transactions to the free parallel exchange market, and the remaining 17 percent called for the adoption and maintenance of independently floating arrangements.

^{1/} In the case of the 27 arrangements for which no specific commitment of this nature was made, these arrangements were for 14 countries that pegged the value of their currency to a major currency (Belize, Central African Republic, Dominica, Equatorial Guinea, The Gambia, Grenada, Guatemala, Haiti, Ivory Coast, Liberia, Mali, Niger, Panama, and Togo); all but six of them are members of regional monetary unions.

^{2/} Comparisons of the experience with this type of arrangement with the independently floating arrangements are presented in Section III.2.c below.

Table 2. Fund Programs with Flexible Exchange Rate Policies
January 1983-December 1985

	Board Approval	External Competitiveness Target ^{1/}		Other Forms of Flexibility		
		Maintenance of External Competitiveness	Increase in External Competitiveness	Transfer of Transactions to the Free Market	Adoption or Maintenance of Independently Floating Arrangements	Initial Depreciation and Review Clause
Argentina	October 1983	*				
Argentina	December 1984	*				
Bangladesh	March 1983			*		
Bangladesh	December 1985		*			
Brazil	February 1983	* <u>2/3/</u>				
Chile	January 1983	* <u>3/</u>				
Chile	July 1985	* <u>3/</u>				
Costa Rica	March 1985	*				
Dominican Republic	January 1983			*		
Dominican Republic	April 1985				*	
Ecuador	July 1983			*		
Ecuador	March 1985			* <u>3/</u>		
Ghana	August 1984		*			
Hungary	January 1984	*				
Jamaica	June 1984				*	
Jamaica	July 1985				*	
Kenya	March 1983	* <u>2/4/</u>				
Kenya	January 1985	*				
Korea	July 1983		*			
Korea	July 1985	*				
Madagascar	December 1983	* <u>2/4/</u>				
Madagascar	April 1985	* <u>3/</u>				
Malawi	September 1983	* <u>2/4/</u>				
Mauritania	April 1985	* <u>2/3/</u>				
Mauritius	May 1983	* <u>4/</u>				
Mauritius	March 1985	*				
Morocco	September 1983	*				
Morocco	September 1985	*				
Nepal	December 1985	*				
Peru	April 1984	*				
Philippines	February 1983		*			
Philippines	December 1984				*	
Portugal	October 1983	* <u>2/</u>				
Sierra Leone	February 1984					*
Solomon Islands	June 1983	* <u>2/</u>				
Somalia	January 1985			* <u>2/</u>		
Sri Lanka	September 1983	* <u>2/</u>				
Sudan	February 1983			* <u>2/</u>		
Sudan	May 1984			* <u>2/</u>		
Thailand	June 1985	* <u>2/</u>				
Turkey	June 1983	* <u>3/</u>				
Turkey	April 1984	* <u>3/</u>				
Uganda	September 1983			*		*
Uruguay	April 1983				*	
Uruguay	September 1985				*	
Western Samoa	June 1983	* <u>2/</u>				
Western Samoa	July 1984	*				
Yugoslavia	April 1984	* <u>3/</u>				
Yugoslavia	April 1985	* <u>3/</u>				
Zaire	December 1983				* <u>2/3/</u>	
Zaire	April 1985				*	
Zambia	April 1983					*
Zambia	July 1984	*				
Zimbabwe	March 1983	* <u>2/4/</u>				

^{1/} Programs which included elements to either maintain or increase external competitiveness as measured by the relative rate of inflation.

^{2/} Initial devaluation.

^{3/} Fund program included performance criteria on exchange rate developments.

Of the 13 countries that have operated a floating exchange rate regime in the period January 1983 to February 1986, the establishment of a unified floating exchange rate was a prior action for a Fund program under discussion in eight cases (Bolivia, the Dominican Republic, The Gambia, Guinea, Jamaica, the Philippines, Zaïre, and Zambia), and it was a performance criterion under an existing program in four cases (Guinea, Uganda, Uruguay, and Zaïre) (Table 3). 1/ In all these instances, the Fund staff played a role in providing assistance at the level of broad macroeconomic policies, and at a technical level, in formulating and adapting the systems to take account of the individual characteristics of the member's economic and financial structure.

In some instances, the floating market was introduced gradually, by the institution of a secondary market for certain transactions in which the rate was freely determined, which was followed by a transfer of transactions to that market, and finally, by unification. This gradualist approach to adoption of a floating rate system was taken in the Dominican Republic, Guinea, Jamaica, South Africa, and Uganda. In the case of the Guinean, Jamaican, and Ugandan arrangements, the dual market was instituted in the context of the Fund program, with a performance clause for early unification in accordance with Fund policies discussed by the Executive Board in 1983 on the occasion of its review of the experience with multiple exchange rates. 2/ Temporary recourse to multiple exchange rates in some instances reflected a partial depreciation of the exchange rate for certain transactions. The existence of the secondary market was not seen initially as a basis for unification in accordance with the floating rate regime in the Dominican Republic, Jamaica, or South Africa. However, in these instances, the presence of such a market may have made the transition to a unified floating rate system easier to accomplish than otherwise might have been. In Guinea and Uganda, the secondary market represented an explicit transitional step to unification on a floating market. However, the multiple exchange rates were in a number of instances outstanding for considerable periods of time, and during that time, the exchange system was marked by distortions resulting from large implicit taxes on and subsidies to various segments of the economy.

In all programs containing provisions for floating, there was also provision for the reduction or elimination of external payments arrears during the program period. The operation of the floating exchange rate regime facilitated the management of external arrears, by making it possible to avoid new arrears because foreign exchange to settle bona fide obligations could be purchased in the market. Along with adoption of other adjustment measures, it also facilitated rescheduling and the

1/ Four of the members shown in this table did not have a Fund program at the time of, or subsequent to, the float (Bolivia, The Gambia, Lebanon, and South Africa).

2/ "Review of Experience with Multiple Exchange Rate Regimes" (SM/84/64, 3/19/84), and background paper (SM/84/65, 3/20/84).

Table 3. Elements in Fund Programs on Introduction and Maintenance of Independently Floating Arrangements, January 1983-February 1986

Date of Program	Date of Adoption of Unified Float	Treatment of Exchange Rate Policies in Program			Previous Use of Official Multiple Rate System (Introduced Under Program or as Precondition) <u>1/</u>	Length of Time Multiple Rates Maintained	
		Prior Action	Performance Criterion	Objective			
Bolivia	--	August, 1985	Yes <u>2/</u>	Yes <u>2/</u>	Yes <u>2/</u>	Yes (No) <u>3/</u>	8 months
Dominican Republic	April 1985	January, 1985	Yes	No	No	Yes (No)	More than 2 years
The Gambia	--	January, 1986	Yes <u>3/</u>	...	...	No	--
Guinea	February 1986	(Not unified at present; planned for May 1986)	Yes	Yes <u>2/</u>	Yes	Yes (No)	More than 2 years
Jamaica	June 1984	November, 1983	Yes	No	No	Yes (Yes)	6 months
Lebanon	--	1952	...	...	...	No	--
Philippines	December 1984	October, 1984	Yes	No	No	No	--
South Africa	--	February, 1983	...	...	...	Yes	More than 2 years
Uganda	September 1983	June, 1984	No	Yes <u>2/</u>	Yes	Yes (Yes)	22 months
Uruguay	April 1983	Nov. 1982	No	No	No	Yes (No)	More than 2 years <u>4/</u>
Zaire	December 1983	February, 1984	No	Yes <u>5/</u> <u>2/</u>	No	Yes (Yes) <u>3/</u>	5 months
Zambia	July 1984 <u>4/</u>	October, 1985	No	No	No	No <u>3/</u>	--

1/ Reference is to market other than illegal parallel market which was present in most cases at the time of institution of the floating rates; in all cases it was a free secondary market that pre-existed.

2/ Proposed program.

3/ Program was not introduced.

4/ Dual market was de facto unified in October 1978.

5/ Retention allowance for certain receipts (de facto recognition of parallel market).

improvement of relations with creditors. In addition, the authorities found it easier to provide foreign exchange for the settlement of pre-existing payments arrears against which counterpart deposits had been lodged, because of the strengthened reserve position of the central bank. In the countries operating an auction system, the central bank set aside part of surrendered foreign exchange to service payments arrears. Payments arrears excluded from settlement in the auction market were registered with the central bank, and their settlements were arranged on a priority basis with foreign exchange which was withheld from auction. In all of the countries adopting floating arrangements, except Bolivia to date, outstanding payments arrears declined (in most cases substantially), and in three cases (Jamaica, the Philippines, and Uruguay), they were eliminated or avoided.

II. Accompanying Measures in Members' Exchange Markets

1. Development of a forward exchange market

Institution of floating arrangements in the spot market may be important in setting the stage for the establishment of cover facilities that do not involve an official guarantee of an exchange rate and the attendant assumption of exchange risk and possibilities for large losses by the central bank. It may be difficult for a country to establish a forward foreign exchange market in which the exchange rate is market-determined if the spot exchange rate is fixed. One reason for this is that the judgments on the future movement of the spot rate which are an essential ingredient of a forward market become those of predicting the course of official action, and the scope for uncertainty and for abuse of inside information is therefore wide. The setting up of a forward market is, on the other hand, a difficult process that requires close monitoring and sponsorship by the central bank, in particular to ensure that adequate technical information is available to potential participants.

The development of forward exchange market facilities in the developing countries that have adopted floating spot exchange rates is at a relatively early stage. There is no such country at present that could be considered to have an organized and satisfactorily operating forward exchange market. Seven countries (Bolivia, the Dominican Republic, The Gambia, Guinea, Uganda, Zaïre, and Zambia) at this time have no concrete plans for a forward market. A very limited volume of forward transactions has been observed in Jamaica, the Philippines, and Uruguay. In Jamaica a detailed plan has been drawn up for a forward market and the system has been put in place, but there were few transactions, initially because of the inflexibility of interest rates, which made trade financing in domestic currency more attractive. In the Philippines, developments in an unorganized forward market have been subject to generalized uncertainties and few transactions take place. In South Africa, the authorities have encouraged authorized exchange dealers to make a forward market outside the Reserve Bank to the extent

possible. In order to facilitate the development of such a market, the Reserve Bank has itself continued to provide forward cover facilities to authorized dealers, but in diminishing amounts, and the official facilities are to be phased out completely by September 1986.

The exchange systems of these countries also affect the feasibility of forward transactions. Where currencies are subject to exchange controls, their delivery at future dates may be uncertain as it may be prevented by the actions of the authorities. In addition, restrictions on flows of the foreign currency, coupled with rationing of domestic credit, may make it difficult to ascertain the appropriate forward discount or premium, in that the covered interest parity condition will no longer hold with precision.

Because forward markets provide, along with adequate reserves, a means of insulating the real economy from the effects of exchange rate instability, it is important that further work be done on institutional arrangements suited to conditions in developing countries. More basic forms of forward market include one by which the central bank or commercial banks "broker" transactions, matching long and short positions at specific maturities. ^{1/} Another possibility is a forward auction market, run by the central bank. The experience gleaned from the industrial countries, particularly smaller countries, also indicates that for a country considering the institution of a "core" forward exchange market, the major benefits are likely to accrue to the introduction of shorter term facilities, primarily for trade cover. An important function of the authorities in this situation is to ensure that information is available to potential users of the market. Forward markets are typically regarded by those unfamiliar with them as complex, and simple misunderstanding may be a contributing reason for their relatively limited development.

2. The role of exchange and trade liberalization in floating arrangements

The demand for foreign exchange in any market is determined partly by exchange and trade restrictions on import licensing, current transactions, and capital transactions. (Surrender requirements, which affect supply rather than demand, have been considered above.) All developing countries that have adopted a floating exchange rate system have reduced restrictions to some degree, in the process of the change of regime or subsequently. Three countries, (Bolivia, The Gambia, and Uruguay), liberalized their exchange and trade systems virtually completely at or about the time that their flexible arrangements were introduced (Table 4). Thus, in Bolivia, when the auction market in foreign exchange was introduced in August 1985, the system of import

^{1/} The cost of transactions tends to be very small as the bank assumes no risk and therefore charges only a brokerage fee of, say, 1/4 of 1 percent of the value of the transaction.

Table 4. Floating Unitary Exchange Rate Regimes in Developing Countries: Exchange and Trade Liberalization

	Liberalization Since Float			Present Restrictions on		
	Import licensing	Current transactions	Capital transactions	Import licensing	Current transactions	Capital transactions
Bolivia	Yes	Yes	Yes	No	No	No
The Gambia	Yes	Yes	Yes	No	No	No
Dominican Republic	No	Yes	No	Yes	Yes	Yes
Guinea	Yes	Yes	Yes	Partial	Yes	Yes
Jamaica	Yes	Yes	No	Partial	Yes	Yes
Lebanon	...	...	...	Partial	No	No
Philippines	Yes	Yes	No	Yes	Yes	Yes
South Africa	Yes	No*	No*	Yes	Yes	Yes
Uganda	No	No	No	Yes	Yes	Yes
Uruguay	No	Yes	No	No	No	No
Zaire	Yes	Yes	Yes	Yes	Yes	Yes
Zambia	Yes	No	No	Yes	Yes	Yes

* Prior to reintroduction of dual market on September 1, 1985.

licensing and control of allocation of foreign exchange for imports was ended, as were restrictions on the allocation of foreign exchange for invisible payments and capital transfers. In The Gambia, however, there have been some continuing restraints by commercial banks on customers' access to the exchange market. Countries that have switched to floating regimes have liberalized their exchange and trade systems for current payments, particularly imports; and Uruguay, which did not apply any general quantitative restrictions on imports, or restrictions on invisibles, before the floating of its currency, lowered and reformed its system of tariffs shortly after its change of exchange rate regime.

In Jamaica, Guinea, Zaïre, and Zambia, the number of goods whose imports are restricted has been reduced substantially. In Jamaica, the import licensing system was overhauled in March 1984, and most remaining licenses and quotas were eliminated ahead of schedule in April 1985, leaving 30 percent of nonbauxite, non-oil imports subject to restrictions. Zambia liberalized its import licensing system when it adopted a flexible regime, and has a plan for complete import liberalization. The liberalization of import restrictions to date has been more moderate in the Dominican Republic, the Philippines, and Uganda. In the Dominican Republic, a special exchange rate for petroleum imports was eliminated when the dual exchange markets were unified in January 1985, and two months later advance deposit requirements for imports financed under reciprocal credit agreements with Latin American central banks were halved. In the Philippines, the priority system for allocation of foreign exchange for imports was abolished when the peso was floated in October 1984, but a number of quantitative restrictions remain after the recent postponement of further derestricting measures.

Liberalization of restrictions on invisible transactions has been less intensive, by comparison with the treatment of imports following adoption of floating. Jamaica has removed its restrictions, other than maximum allowances for travel. Otherwise, apart from Bolivia, The Gambia, and Uruguay, the countries that have adopted floating have retained some degree of control, especially over the remittance of profits and dividends, the payment of commercial arrears, and travel and expatriate allowances.

Controls on outward capital transfers have been retained by the countries with floating arrangements, other than Bolivia, The Gambia, Lebanon, and Uruguay. In Jamaica, investments abroad by residents and the purchase of local assets by residents from nonresidents require exchange control approval, and this is not granted unless it can be shown that there are tangible benefits for Jamaica. Foreign exchange is not made available to residents to make cash gifts to nonresidents, and nonresidents are not normally permitted to take out security in respect of loans made to Jamaican companies owned or controlled by them, or to raise local mortgages. In the Philippines, all inward and outward capital movements, with some exceptions, are subject to the prior and

specific approval of the Central Bank. In South Africa, outward transfers of capital by residents to destinations outside the rand monetary area require the approval of the Reserve Bank. In Zaïre, with minor exceptions, transfers abroad of capital owned by residents or nonresidents are not authorized. In each of those countries maintaining restrictions, an illegal parallel market continues to exist, limiting the supply of foreign exchange and of monetary data pertinent to the management of the monetary base by the authorities.

III. Developments Under Floating Exchange Rate Regimes

Most of the developing countries that have adopted floating exchange rates have at the same time pursued supporting monetary and fiscal policies, and have liberalized exchange and trade restrictions. Isolating the separate effects of floating is therefore a difficult task. Moreover, because the experience with flexible exchange rates in most of the countries surveyed is recent, inferences that may be drawn must necessarily be regarded as tentative, both because the full effects of flexibility take time to work through an economy and because most of the relevant macroeconomic data are preliminary. These qualifications apply with less force, however, to an examination of the effects of floating on the exchange market itself, on the variables most directly affected by the exchange rate regime. Such an analysis is also helped by the fact that data for exchange rates and certain important exchange market transactions become available with relatively short lags.

This section examines the impact of floating and the accompanying adjustment measures, first on the volatility of the exchange rate itself and on capital account transactions, and second in a broader macroeconomic context. Seven of the countries with floating systems (Bolivia, the Dominican Republic, Jamaica, the Philippines, Uganda, Uruguay, and Zaïre) have sufficient experience with floating for at least some of these questions to be addressed. For each of these countries, the volatility of the exchange rate, vis-à-vis the U.S. dollar and in nominal and real effective terms, is compared between the pre-floating and floating periods. Capital account transactions are examined using the available data from the balance of payments, cross-border bank deposits, external debt, and the extent of absorption of the parallel exchange market. Pre- and post-float developments in inflation and in output and trade are also analyzed in this section.

1. Exchange market developments

a. Developments in bilateral and effective exchange rates

There have been concerns that floating exchange rates in developing countries would tend to be unstable because of the relative thinness of financial markets. First, there has been a fear that the institution of floating arrangements would be followed by "free fall" of the exchange rate, regardless of the stance of domestic policies, as increased uncertainty fed into the rate of domestic inflation and the two

cumulated over time. The second related concern has been that the exchange rate would prove volatile, fluctuating widely in both directions in response to external shocks in commodities markets and capital flows, internal reversible factors such as drought, and to generalized instability in domestic economic policies.

The experience has been that in all seven countries for which adequate data are available in the period in which a floating regime was maintained, the domestic currency initially depreciated in terms of the U.S. dollar (which was the intervention currency in most instances) and also in nominal and real effective terms. ^{1/} The extent of the initial depreciation in each case reflected the magnitude of exchange rate disequilibrium preceding the float and also the extent to which the market was subsequently allowed to operate freely, and within a framework provided by accompanying monetary and fiscal policies and liberalization of exchange and trade controls. Although some of these currencies subsequently appreciated, following the initial correction, all on balance depreciated over the entire period from just before introduction of floating to December 1985, against the U.S. dollar and in nominal effective terms. However, in each of the five countries for which data are available to compare the pre-float unofficial market U.S. dollar exchange rate with the official rate in the early months of floating (Bolivia, Dominican Republic, the Philippines, Uganda, and Zaïre), the domestic currency appreciated in the official market in relation to the exchange rate in the parallel market prior to the float (Chart 1).

Developments in real effective exchange rates since the initial exchange rate correction following floating have varied widely. From the month following the float to December 1985, real effective rates continued their initial depreciation in four countries, at moderate rates (less than 2 percent per month) in Jamaica, Uganda, and Zaïre, and more rapidly in Bolivia's first four months of floating. In the other three cases, the real effective rate appreciated over the corresponding periods, with small average monthly rates of appreciation of 0.1 percent in the Philippines and Uruguay, and under 2 percent in the Dominican Republic. In the case of the Philippines and Uruguay these real appreciations were not sufficient to offset the initial adjustments, but in the Dominican Republic, the real effective rate has appreciated since the institution of floating under the influence of tight monetary policies.

In order to gauge the pre- and post-float developments in exchange rate variability, four measures were calculated, each being applied to

^{1/} In calculating the effective exchange rate, a composite exchange rate series was used in the period preceding unified exchange float for the Dominican Republic, Jamaica, the Philippines, Uganda, and Zaïre. The weights used in these composites are the estimated values of transactions in each multiple market.

bilateral rates vis-à-vis the U.S. dollar and to nominal and real effective rates. 1/

First, with regard to bilateral rates vis-à-vis the U.S. dollar, the comparison was made for the seven currencies between the variability of the official rate prior to the float and the subsequent variability of the unified floating rate. For four of the countries examined (Jamaica, the Philippines, Uganda, and Zaïre), the trend-corrected measures (2) and (4) indicated that the variability of the floating rate in terms of the U.S. dollar was less than that of the official rate prior to the float. 2/ The Dominican peso showed an expected unambiguous increase in variability, the results for the Uruguayan peso were mixed, and for the Bolivian peso most measures indicated no significant outcome. Without trend-correction, most tests for the six countries showed increased variability in terms of the U.S. dollar. (Appendix Tables 3, 4, and 5).

Statistical tests conducted on the data for nominal and real effective exchange rates show a statistically significant reduction in the variability of five out of the seven nominal effective rates by measures (2) and (4), i.e., the measures of variability obtained with correction for trend. The outcome of the measures for the other two countries (Bolivia and Uruguay) was mixed. Without trend-adjustments--that is, on the basis of measures (1) and (3)--the evidence of a reduction in variability is less clear, as statistical tests indicate that variability declined in the Dominican Republic and Zaïre, remained virtually unchanged in Bolivia and the Philippines, and deteriorated in the remaining three countries.

The outcome of the tests for the real effective exchange rate is similar to that for the nominal effective rates. In terms of the trend-adjusted exchange rate data, which may be argued to be the more relevant of the measures employed, the variability of the real effective rate increased in the floating period only in the case of Uruguay. The data without trend-adjustment, using statistical tests for significance, indicate that the variability of the real effective exchange rate increased in the case of Jamaica and Uruguay, declined in Zaïre, and showed no statistically significant change in the remaining four countries.

1/ The variability of the exchange rate itself was measured by:
(1) Mean monthly absolute percentage change;
(2) Average absolute percentage deviation from a fixed log-linear time trend;
(3) Standard deviation of monthly absolute percentage changes; and
(4) Standard deviation of the absolute deviations from a fitted log-linear trend.

2/ Significant at 95 percent probability level.

To sum up these results, statistical measures suggest that two-way variability (i.e., with trend correction) of exchange rates against the U.S. dollar has declined in the floating period, but that continuing adjustment of the exchange rate has been reflected in increased unidirectional changes (i.e., without trend correction). For the nominal and real effective exchange rates, based on experience to date, there is evidence that the exchange rate movements have been generally smoother than under the previous managed and fixed-rate regimes. This may be attributed to a number of factors, but especially to the support provided by monetary and fiscal policies: First, exchange markets in the floating periods have not been entirely free of central bank intervention to stabilize the rates, as described earlier. Second, reduced exchange rate volatility in the post-float periods may have reflected reduced instability at that time in overall economic conditions--for example, volatility in primary commodity prices. Third, it could be argued that exchange rates in a pegged-rate regime are especially susceptible to destabilizing speculative activity, and that they eventually require relatively large step adjustments.

b. Capital and reserve movements

Introduction of exchange rate flexibility and the accompanying liberalization of the exchange system may be expected both to affect official foreign exchange reserves and capital flows through the following channels. Floating the exchange rate removes the need for official intervention to defend the value of the domestic currency, so that reserve losses, official over-borrowing, and external payments arrears may be avoided. Private capital flows are also likely to respond positively and directly, first, to the removal of the risk of a step devaluation of the domestic currency from an unrealistic level, second, to liberalization of exchange controls on the repatriation of capital or investment income: Inward direct investment increases, the rescheduling of debt is facilitated, ^{1/} and outward capital flight is stemmed. Third, there is the role of monetary policies. Capital reflows will, of course, require domestic interest rates to be comparable with foreign rates, but even so they may not need to be as high as before the float, since they then had to compensate for expectations of devaluation.

The measurement of many of these effects is problematical. First, they may not be apparent in the data because of the simultaneous operation of other factors. For example, increased repayments of previously contracted external debt may become due at the time floating is introduced. Second, most data for short-term capital flows are unreliable under the best of circumstances, and capital flight is by its nature not directly measurable. Such activities as smuggling (of financial assets, real assets, and commodities), underinvoicing of

^{1/} In recent years, a number of creditors have insisted on exchange reforms as a precondition for debt rescheduling.

exports, and overinvoicing of imports are by their nature not observed by the agencies collecting balance of payments data. However, such transactions will be reflected as net errors and omissions in the balance of payments to the extent that they have recorded transactions as a counterpart. It is often assumed that the net errors and omissions provide a reasonable indicator of capital flight, although being the balancing item, they also incorporate transactions unrelated to capital flight (including valuation changes in official reserves).

In all six countries, combined net short-term capital inflows and errors and omissions have increased since floating. (Appendix Table 6.) ^{1/} The turnaround appears to have been the largest in Jamaica and Uruguay--corresponding to over 30 percent of annual imports. In the Dominican Republic, the Philippines, and Zaïre, the short-term capital reversal was somewhat smaller (of the order of 5-10 percent of imports) and it was negligible in Uganda. Other indicators of capital flight or reflow, in the form of bank deposits held abroad by nonbank domestic residents or foreign-currency denominated deposits held onshore, are inconclusive (Appendix Table 7). The accumulation of deposits abroad appears to have been stemmed after floating in the Philippines and Uganda, but to have gathered pace in the Dominican Republic, Uruguay, and Zaïre. Data on foreign currency-denominated deposits with domestic banks, which may indicate flight out of the domestic currency or reflow, although not a balance of payments item, are available only for Uruguay and Zaïre. Foreign currency-denominated deposits fell in both Uruguay and Zaïre during the floating period.

Movements in gross official international reserves indicate that the need to intervene in the foreign exchange market did indeed diminish with floating, as would be expected. Reserves increased in all countries except Uganda, where the level remained unchanged; the increases in a number of instances were targeted under Fund programs. The data for Uganda are explained by the fact that the authorities have intervened quite heavily to support the level of the exchange rate for sustained periods. As regards the other elements of official financing "below the line," external payments arrears have declined to date in all countries except Bolivia following the introduction of floating.

c. Absorption of black exchange markets

In those countries in which exchange and trade controls have been liberalized, the illegal parallel market has been absorbed, or its scope much reduced. In Bolivia, although purchasers are not required to specify their reasons for obtaining foreign exchange in the auction market, there has been from time to time after floating a thriving

^{1/} Data for identified short-term capital flows (i.e., as distinct from errors and omissions which are generally believed to represent disguised capital flows) are available for only three of the six countries, and for only one country (the Philippines) in 1985.

unofficial parallel market operated by exchange houses and by some banks, as well as by individuals transacting for themselves or for others as agents. There are three explanations for the continued existence of the parallel market in Bolivia. First, bids in the official market are required to be the equivalent of US\$5,000 or a multiple thereof. Second, obtaining funds in the official market may be seen as a cumbersome process. Third, some dealers in illicit commodities prefer to operate totally outside the official sphere. With complete derestriction of the exchange and trade systems, however, arbitrage has generally functioned to ensure the same rate for legal transactions. Available information suggests that there is no black market in the Dominican Republic, the Philippines, and Uruguay, which maintain relatively liberal exchange and trade regimes, nor in Jamaica.

In Zaïre, the spread between parallel market rates and the official exchange rate has also narrowed considerably after unification and floating, to no more than 12 percent--the peak reached in January 1984. Transactions in the parallel market are related primarily to tax evasion and smuggling.

In Uganda and Zambia, which have the least liberalized restrictive systems of the group of countries surveyed here, incentives for widespread parallel market transactions have remained considerable. Following the unification of the market in Uganda, the scope for illegal transactions narrowed considerably when the auction system was operating effectively. However, the premium in the black market generally remained about 30 percent above the auction determined exchange rate, because only current transactions, including debt servicing, were permitted to be effected through the auction market and there was demand for foreign exchange for capital flight. The spread has since widened substantially with the de facto fixing of the rate (to a factor of 2.7:1 in November 1985), as the unofficial market began once again to play an important role. According to available information, a sizable discount remains also in the newly formed auction market in Zambia, although it has been substantially less than the discount in the pre-float period.

2. Macroeconomic performance

a. Output and trade

The impact on economic growth of an initial depreciation resulting from the floating of the exchange rate does not, in principle, vary from the impact from exchange rate changes which occur under other flexible exchange rate regimes, and depends critically on the support provided by demand management and supply policies. The six countries with floating exchange rates during Fund programs that are surveyed in this section have all suffered from serious balance of payments problems and overabsorption. Floating the exchange rate in conjunction with adoption of appropriate adjustment policies may therefore have an initial contractionary impact on growth, which may be partly offset by improved

financing arrangements with creditors, while in the medium term growth would be assisted. A real effective depreciation has an immediate negative impact on domestic absorption as it reduces real wealth through its impact on the price level and real income, unless wages fully accommodate the impact of the depreciation. However, the effects of the real effective depreciation in switching expenditures toward more competitive industries are ultimately growth enhancing. ^{1/} The role of macroeconomic policies in supporting the floating exchange rate systems is crucial, and differences in performance should not be attributed to the system per se but rather to the real effective exchange rate adjustment that took place and the full package of measures of which the adoption of the float is a part. The experience of these six countries is too short to gauge the growth and balance of payments responses because of the usual lags involved in the supply response to the change in relative prices. Moreover, the pertinent question is how these countries would have performed in the absence of floating and the associated Fund program, which, by its nature, is not directly measurable. Also, as noted earlier, balance of payments developments cannot be attributed solely to exchange rate movements. However, in general, floating exchange rates appear to have contributed to favorable and envisaged macroeconomic effects or have contained a further deterioration in the external position.

In most of the six countries adopting floating exchange rate arrangements, there has been a sharp contraction of imports, reflecting the combined result of the change in relative prices, the monetary and fiscal adjustment measures, and continuing use of import controls (Appendix Table 8). On the supply side, the real effective depreciation that has ensued may be expected to promote exports and import substitution through the change in relative prices. In addition, the real effective depreciation might increase exports recorded in national output figures, as smuggled exports are replaced by exports through customs. However, the countries under review have suffered from structural problems as a result of their exports being concentrated in relatively few commodities that have been subject to both excess world market supply and to protectionist measures (e.g. bauxite/aluminum, meat, sugar, and wool products), and diversification of exports has also been handicapped by the delayed effects of an unrealistic exchange rate. Although exports of traditional commodities have been made more profitable in those countries in which floating has led to a real effective depreciation of the exchange rate, the stimulus has primarily been to nontraditional exports and services, which have expanded from a small base. Exports appear to have performed positively following the real effective depreciation of the currencies and the package of economic measures which preceded or followed floating in the Dominican

^{1/} For a discussion of the transmission mechanisms of exchange rate adjustment, see Mohsin S. Khan and Malcolm D. Knight, "Fund-Supported Adjustment Programs and Economic Growth," IMF Occasional Paper No. 41, November 1985.

Republic, Uganda and Zaïre, while they have performed disappointingly in Jamaica, the Philippines, and Uruguay. In the Dominican Republic, the depreciation of the currency which preceded floating has primarily stimulated nontraditional exports and tourism, while in Uganda both traditional exports (mainly coffee) and nontraditional exports were boosted. In Uganda and Zaïre, part of the increase in recorded exports since floating has been due to a shift from the unofficial to the official sector. On the other hand, Uruguayan exports have expanded hardly at all, despite the substantial depreciation of the peso since floating in November 1982, owing to problems facing traditional trading partners in Latin America and in the Middle East, and to protectionist practices in industrial country markets. Nevertheless, there has been some diversification into nontraditional export commodities and increased repatriation of foreign exchange earnings. Overall export performance has been similarly disappointing in Jamaica, in the face of a substantial real depreciation of the currency, largely because of delayed effects on the profitability of major exports (bauxite and alumina) that led to shutdowns in the industry. Political uncertainties have also recently dampened tourism receipts, following an initial stimulus. However, some positive effects have been evident in much stronger performance of nontraditional exports. In the Philippines, the peso appreciated initially after the float under the influence of tighter monetary conditions, contributing to a contraction of exports in 1985, although services receipts have showed some buoyancy as a result of a shift of transactions from the black market to the official market.

Imports have declined substantially in the Dominican Republic, Jamaica, the Philippines and Uruguay as a result of the domestic recession as well as, with the exception of the Philippines, the change in relative prices following the depreciation. There has been some evidence of import substitution of domestic products for imported products. In Zaïre, imports had been constrained by the lack of foreign exchange before floating. As a result, after floating and the liberalization of foreign exchange restrictions, imports have increased moderately in volume terms, despite the substantial depreciation. Further, in all cases, the flow of imports was affected by the availability of financing and as part of the adjustment program.

Data for external current account balances show that the deficit (as a ratio of GDP) declined in Jamaica, the Philippines, Uganda and Uruguay, with the largest reductions occurring in the Philippines and Uruguay (Chart 2). The current account deficit remained stable during Fund programs in the Dominican Republic and Zaïre. The trade balance has accounted for the major part of the improvement in the current balance of payments in Jamaica, and the Philippines, although the service and transfer balances have also made a positive contribution in the Philippines. By contrast, the service and transfer balance accounted for the larger part of the improvement in the Dominican Republic and in Uganda. The improvement in trade balances has primarily reflected the declines in imports discussed above.

b. Inflation effects

The impact on the rate of inflation of a switch to floating has depended crucially on the monetary and fiscal economic policies that have influenced the subsequent direction of the exchange rate changes. Domestic price liberalization has also constituted an important policy measure supplementing the floating of exchange rates in most cases, owing to extensive price controls (e.g. on agricultural and energy products) or price distortions resulting from public sector pricing policies that were in place. In most of these countries, the freeing of the exchange rate was accompanied by complete or partial removal of price controls and adjustments of public sector prices. Although the immediate impact of price liberalization has been an increase in prices, in the longer run this impact may be more than mitigated by an improvement in resource allocation resulting from correct price signals to enterprises and consumers reflecting the opportunity cost of the goods affected as well as by the stimulus to domestic production (e.g. the effect of appropriate grain pricing on agriculture).

Liberalization of price controls has taken place in Bolivia, The Gambia, the Philippines, South Africa, Uganda, and Zaïre shortly before or after the introduction of floating exchange rates. In Bolivia and the Philippines, all remaining price controls on consumer goods were removed--these had previously affected more than 40 percent of consumer goods in Bolivia ^{1/} and ten important consumer items, mainly food products, in the Philippines. Prices for all consumer goods except petroleum products and public sector tariffs were liberalized in Uganda. In the Dominican Republic, The Gambia, Guinea, Jamaica, Zaïre, and Zambia, floating of the exchange rate was accompanied by increases in administered and controlled prices, especially petroleum prices and public sector tariffs, to reflect the exchange rate adjustment. Moreover, in the Dominican Republic, The Gambia, Zaïre, and Zambia, the authorities committed themselves to adjusting administered prices in line with changes in costs more frequently and extensively than in the past.

Four of the countries for which sufficient post-float data is available (the Dominican Republic, Jamaica, the Philippines, and Zaïre) experienced a decline in the rate of inflation after an initial surge following the float (Chart 3). However, inflation has decelerated to a rate below the pre-float level only in the Philippines and Zaïre. The decline in inflation in Zaïre, from a 12-month increase peaking at 123 percent toward end-1983 to about 10-15 percent a year, was particularly striking. It resulted from the sharp tightening of monetary and fiscal policies that occurred at the same time that

^{1/} Price controls had not been successfully enforced in Bolivia.

economic growth recovered. Recently, inflation has picked up again somewhat because of a relaxation of monetary policy. In the Dominican Republic, the decline in inflation reflected mainly the very tight stance of monetary and fiscal policies maintained during 1985.

Uganda is a good example of a country in which domestic prices at the consumer level had already reflected the black market exchange rate prior to floating. ^{1/} The gradual depreciation of the official rate and transfer of transactions to the parallel market up to mid-1984 therefore had no visible impact on the rate of inflation. The subsequent surge of inflation from mid-1984, when the exchange markets were unified, was in response to a relaxation of fiscal policy in connection with a sharp increase in wages and salaries of civil servants, which was followed in turn by a marked increase in credit to the public sector and the rate of monetary expansion.

In Uruguay, in the immediate aftermath of the floating of the exchange rate, there was a 40 percent depreciation of the peso and the rate of inflation picked up considerably. Prior to floating, exchange rate policy had been deliberately used to dampen the rate of inflation at a time when there was a marked weakening in financial policies. The authorities' initial attempts at adjustment following the floating were complicated by the large losses that began to be incurred by the Central Bank mainly as a result of its portfolio purchase scheme to shore up the domestic banking system. More recently, however, fiscal and monetary policies have been considerably tightened with a view to bringing down inflation from the relatively high rates of the past three years.

c. Comparison of performance under floating
with managed flexibility

As noted earlier, in the arrangements from the Fund that were concluded between January 1983 and December 1985, the major alternative to floating exchange rate arrangements was managed flexibility aimed at maintaining or increasing competitiveness by reference to a real effective exchange rate indicator. A comparison between the macro-economic developments under these two groups of arrangements is shown in Table 5. It must be stressed that any differences in performance are the combined result of exchange rate developments, external events, and domestic policies. Moreover, the sample of countries with adequate data on the experience with floating exchange rates (6 countries with 9 programs) is considerably smaller than that of countries with the managed arrangements (26 countries with 36 programs).

The comparisons show that the external current account balance either improved or remained unchanged during the program year in all

^{1/} This effect is directly observable in data for several specific consumer goods comparing post-float prices in Uganda and Zaire with the same goods in Sierra Leone (Appendix Table 9).

Table 5. Comparison between Performance of Countries with Independently Floating and Managed Flexible Exchange Arrangements under Fund Programs compared to Year before the Program

(In percent of countries in either group of countries)

	External <u>1/</u> Current Account Balance		Overall <u>1/</u> Fiscal Balance	
	Floating	Flexible	Floating	Flexible
Improvement	67	67	67	50
Unchanged	33	17	22	31
Deterioration	—	<u>17</u>	<u>11</u>	<u>19</u>
	100	100	100	100
	Broad Money <u>2/</u>		Prices <u>2/</u>	
	Floating	Flexible	Floating	Flexible
Deceleration	56	44	56	28
Unchanged	—	14	11	11
Acceleration	<u>44</u>	<u>42</u>	<u>33</u>	<u>61</u>
	100	100	100	100
	Exchange and Trade System <u>3/</u>			
	Floating		Flexible	
Liberalization	56		46	
Unchanged	33		46	
Intensification	<u>11</u>		<u>8</u>	
	100		100	

1/ Any change in the external current accounts or overall fiscal balances in excess of 0.5 percent of GDP is considered an improvement or deterioration in the balance (See Appendix Table 10 for data).

2/ Any increase (decrease) in the rate of inflation or growth of broad money above 10 percent of the rate is considered acceleration (deceleration) in the magnitudes.

3/ Based on an overall evaluation of the restrictiveness of the exchange and trade system during the program year.

countries with floating exchange rates, while it worsened in one fifth of those countries with managed flexible exchange arrangements. ^{1/} The difference in these outcomes was probably attributable to fiscal performance, as the overall fiscal balance improved in two thirds of the countries with floating arrangements compared to only half of the countries with flexible rates. However, measured in terms of the size of changes in relation to GDP, the median improvement was larger for the managed arrangements.

The inflation performance, measured as the change in the 12-month average increase in consumer prices before and after the approval of the Fund program (or latest available information), was better in countries with floating arrangements than in those with flexible exchange rates. There were 11 countries in the latter group which undertook a depreciation of their currencies at the beginning of the program. However, there was no difference in the inflation performance of the flexible exchange rate countries which initially depreciated their currencies and those which did not. With respect to monetary policy, no significant difference is apparent between the floating and managed flexible exchange arrangements. The liberalization of the exchange and trade systems was more extensive under floating than under flexible exchange arrangements, which might have contributed to differences in the inflation record.

IV. Summary

The experience with flexible exchange arrangements in the specific form of floating exchange rates in developing countries since the advent of generalized floating by industrial countries in 1973 is relatively limited, although in recent years an increasing number of developing country members have adopted such systems. The early experience indicates that floating exchange rate systems can function satisfactorily in developing countries with relatively diverse economic structures, despite the limited depth of their financial systems. However, they have to be adapted to the institutional strengths and weaknesses of the individual countries. Most particularly, these freely floating exchange market arrangements have to be supported by the sustained pursuit of appropriate domestic economic policies to ensure their efficient operation over time. Such arrangements are often also the only alternative to restrictions, arrears and controls to insulate the balance of payments from domestic economic mismanagement. However, from an efficiency viewpoint, it must be stressed that a floating exchange rate cannot substitute for appropriate economic policies.

Developing countries have adopted floating rates for a variety of reasons, but most did so because of severe balance of payments difficulties that had resulted in external payments arrears. In fact, flexible exchange rate arrangements, including the floating exchange

^{1/} For definitions of these movements, see footnote 1 in Table 5.

rate systems on which this report has focused, may be the realistic option for members with severe balance of payments difficulties reflected in low official reserves and persistence of arrears, and insufficient room for maneuver in domestic policies. In a number of the countries, protracted balance of payments problems had previously been addressed by extensive controls on foreign exchange transactions that had led to disintermediation. A major aim of the market-determined floating arrangements has therefore been to bring back into the official sector the extensive illegal parallel markets in which exchange rates were substantially depreciated, as well as to encourage the repatriation of capital flight which, in a number of cases, had become a major problem. Another reason for the introduction of market-related floating in several instances was the desire on the part of the authorities to shift the determination of the exchange rate from the authorities to market forces. With the rate determined in an open market, the authorities were better able to focus decision-making on other areas of economic management.

Arrangements that were in effect before the adoption of market floating ranged from a managed float in which the exchange rate in relation to the intervention currency was changed frequently in an attempt to counteract the effects on competitiveness of rapid domestic inflation, to relatively fixed exchange rate arrangements against a major currency. In many cases, arrangements in effect before free market floating also have included multiple exchange rates. In some of these instances, the introduction of the freely floating market for exchange rate determination involved transitionally the existence of a secondary market for certain transactions in which the rate was freely determined, followed by a progressive transfer of transactions to that market until complete unification of the markets was effected. Typically, where this approach was taken in the context of a Fund-supported program, it was understood that the rates would be unified within a relatively short period of time.

An important choice facing a developing country in instituting a floating exchange market is whether it should take the form of an auction or an interbank market. The experience to date has been that markets operated by the commercial banking sector have been less subject than officially operated auction markets to destabilizing intervention in the form of inappropriate official purchases and sales or ad hoc controls on access to the market. In addition, it has been possible in using interbank markets to build on the existing expertise of banks and foreign exchange dealers operating in formal or informal parallel markets. Interbank markets also function on a continuous basis while auctions are periodic by their nature and therefore less efficient as clearing mechanisms. The less frequent are the auctions (they are conducted daily in only one country), the less efficient and smooth will be the clearing process, as delays in obtaining foreign exchange will be longer and uncertainty and risk involved in the exchange transaction will be greater, the longer the interval between supply to the central bank and the actual auction itself. Interbank market arrangements have

been the more common setting for freely floating exchange rates in developing countries to date; seven developing countries have adopted interbank arrangements and five auctions arrangements. In these and other instances, the Fund has assisted in formulating the systems by transferring experience among members concerning the design and implementation of specific market modalities.

A major consideration in setting up the floating markets has been the need to incorporate safeguards against destabilizing speculation and the establishment of monopoly positions. In several instances, limits have been put on the foreign exchange positions of commercial banks and other dealers, both to ensure that the market is not "cornered," and to limit excessive exposure to exchange risk. The limits have generally been set with reference to norms derived from experience in the management of foreign exchange working balances. Freedom of entry into the exchange market has been an important factor in ensuring its competitive operation, particularly where the number of commercial banks is small.

Under auction arrangements where foreign exchange must be surrendered to the central bank, often the volume of foreign exchange transactions in the market has been sharply diminished as a result of the accumulation of reserves at the market-determined rate or "extra market" allocations of foreign exchange by the central bank. These latter are largely for official uses or for the reduction of external arrears, (including payments for external debt obligations). In some countries, the exchange requirements of public enterprises have been met outside the auction, and retention privileges have been granted to private sector concerns, also with the aim of guaranteeing the availability of foreign exchange. As a result of the setting aside of foreign exchange for these purposes, the proportion of foreign exchange receipts accruing to the economy as a whole that has actually been auctioned by the central bank has been as low as one quarter. This has created problems for the effective functioning of the market and for the provision of sufficient exchange for orderly discharge of current import demands.

Steps to introduce forward exchange markets have also been taken by a few countries with floating spot markets. Forward market cover is important in developing countries to facilitate external financing, and to insulate the productive sector from some of the effects of market volatility. However, the development of forward exchange market facilities in these developing countries is at a relatively early stage, with only a very limited volume of forward transactions. Further work is needed to determine institutional arrangements suited to conditions in developing countries--including possible brokering arrangements by the central bank or more limited forward market arrangements for short-term facilities, primarily for trade cover.

In most cases, floating exchange rate systems have been introduced with Fund assistance in formulating technical aspects, as part of Fund

supported adjustment programs. In fact, in several instances, the implementation of the floating system was one of the first steps taken in such programs and set the stage for the formulation of the underlying macro-economic framework and other supporting policies. Although it can be argued that such a sequence could in principle lead to an early "overshooting" of the rate and subsequent reversal of the initial depreciation, in practice this has not been the case. On the other hand, the new realism in the exchange rate policies in the countries adopting floating rates has helped to create a more favorable climate for comprehensive adjustments to domestic policies as well as for discussions with foreign donors and creditors, particularly in the period leading up to discussions on debt rescheduling. It is, of course, critically important for the effective functioning of a floating market exchange rate that it be supported by effective implementation of appropriate policies of demand restraint and structural change and by increased external resource inflows especially of a kind that can be readily fed into the exchange market. In several instances, to assist in providing as stable an environment as possible for the introduction of floating, and with the aim of minimizing the initial depreciation of the floating rate, arrangements have been made for "bridging" finance from donor countries or commercial banks ahead of Fund drawings under a stand-by arrangement and rescheduling of existing external obligations.

Successful operation of an exchange rate float will be helped by strengthened confidence in the economy and more particularly in its external payments outlook. In this context, the outlook for increased foreign exchange receipts and current and capital accounts will be critical. Usually the measured effects of the initial depreciation associated with floating on the output of tradable goods (exports and import substitutes) have been subject to lags, but the absorption of black market inflows and the incentives created for reducing capital flight have led to some relatively early significant beneficial effects on the capital account. The curbing of capital flight, and the encouragement of greater repatriation of foreign exchange earnings and capital reflow have, in fact, been a major aim of some authorities in adopting floating systems. This implies, for countries where the onset of balance of payments difficulties seems imminent--as often indicated by a rising premium on foreign exchange in the parallel market and foreign exchange cash flow problems, that the adoption of a floating rate may serve to prevent the difficulties intensifying into an actual accumulation of arrears.

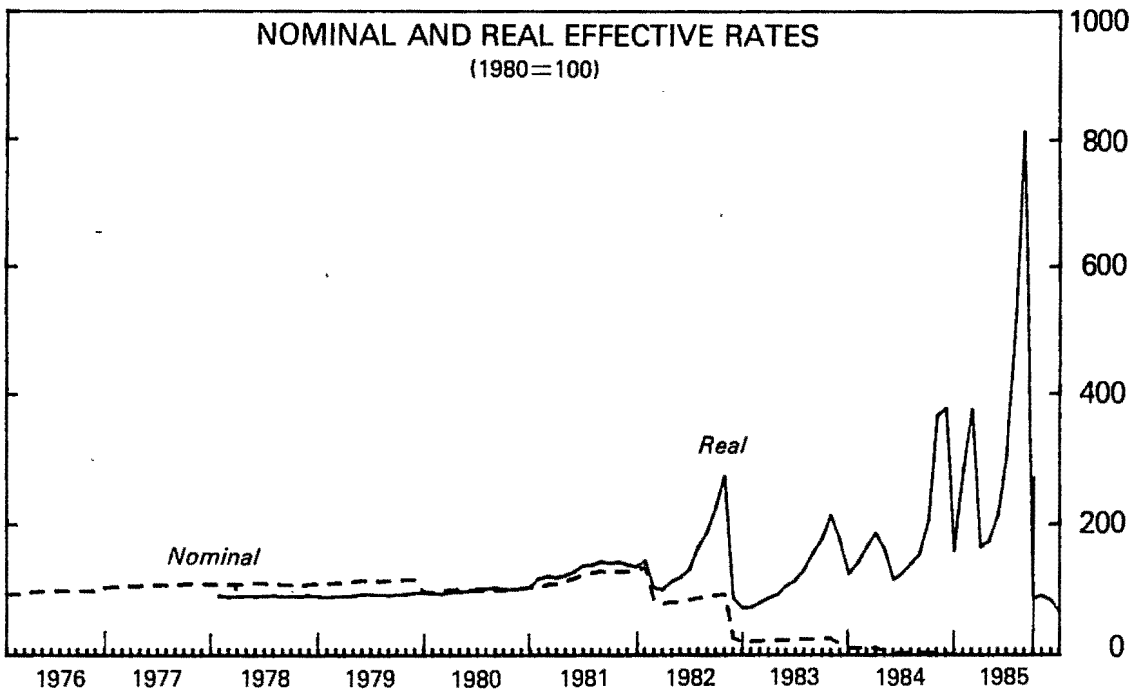
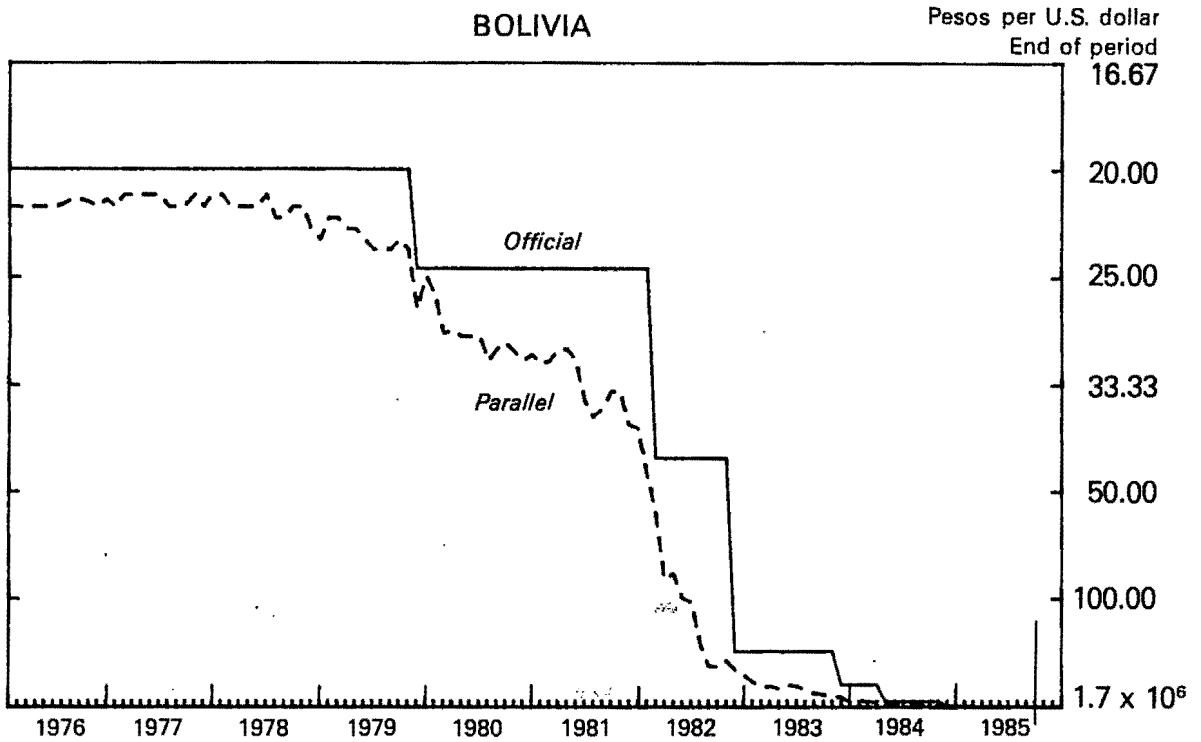
However, to the extent that exchange controls are retained following the exchange market reform, incentives will remain for evasion through, for example, underinvoicing of export receipts and over-invoicing of goods and services imports. In fact, most members adopting floating rates have substantially liberalized their exchange and trade systems, and from available data on capital flows it seems that liberalization and floating have led to decreased capital flight in all surveyed countries, and to some short-term reflow. However, the data on which these observations are based are yet weak. In addition, given the

prolonged balance of payments problems experienced by the countries adopting floating systems, confidence is understandably slow to rebuild. It requires a perception that the adjustment policies are likely to be lasting and that there are an increased resource availability and an improved external balance. The lack of such confidence has probably limited the extent of the capital reflows observable to date. In any event, the adoption of floating exchange rate systems should normally take place in the context of a broad program of exchange and trade liberalization, which has been the case with those members that have introduced such systems to date.

A concern that has been voiced about the adoption of floating exchange rate systems by developing countries--at least before the more extensive use of such regimes in recent years--is that they could lead to "free fall" of the exchange rate, thereby contributing to a cumulation of inflationary forces. Another concern has been that floating rates would be relatively unstable because of the limited depth of financial markets. Such concerns, however, are misplaced in that they attribute the "free fall" or the instability of the exchange rate to the particular modality of exchange rate determination and overlook the critical relationship between developments in market-determined exchange rates and the quality of domestic economic policies. Indeed, the evidence surveyed in the paper, covering between one and three years' experience in the individual countries, does not appear to support these concerns. In one or two countries, the domestic currency has actually appreciated after floating, partly in response to the effect of higher domestic interest rates in generating net capital inflows. In other countries, the official exchange rate has depreciated sharply with the introduction of floating, but in these cases the black market exchange rate prior to the action appears to have provided a floor for the initial movement. Subsequently, the rate has tended to move over time generally in accordance with relative inflation rates. Further, the two-way volatility of exchange rates to date in countries adopting floating rate systems has in most instances been less than that prior to floating, especially in terms of the real effective exchange rate.

As might have been expected, the correction of the exchange rate following floating has led to price level increases through cost-push effects. The rise in the inflation rate, however, has been considerably less than implied directly by the share of imports and the magnitude of the depreciation. Two reasons may be adduced for this. First, the cost-push effect has not to a degree been accommodated by monetary policies, and second, many prices at the consumer level had already adjusted to reflect the shortage of exchange for imported goods reflected in the black market exchange rate. To a large degree then, the price corrections were confined to the official sector and to goods subject to official price controls--notably, imported foodstuffs and oil. Following the initial surge corresponding to the exchange rate correction and the freeing of controlled domestic prices, in many of the countries both exchange rate movements and inflation have tended to recede rather than gain momentum.

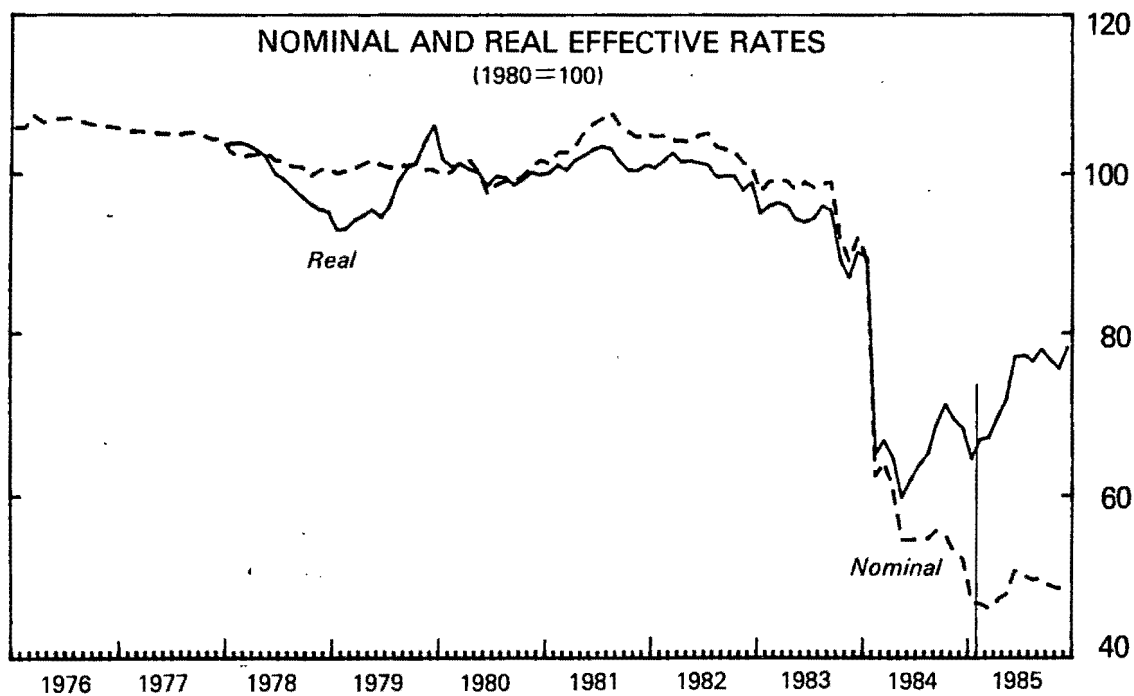
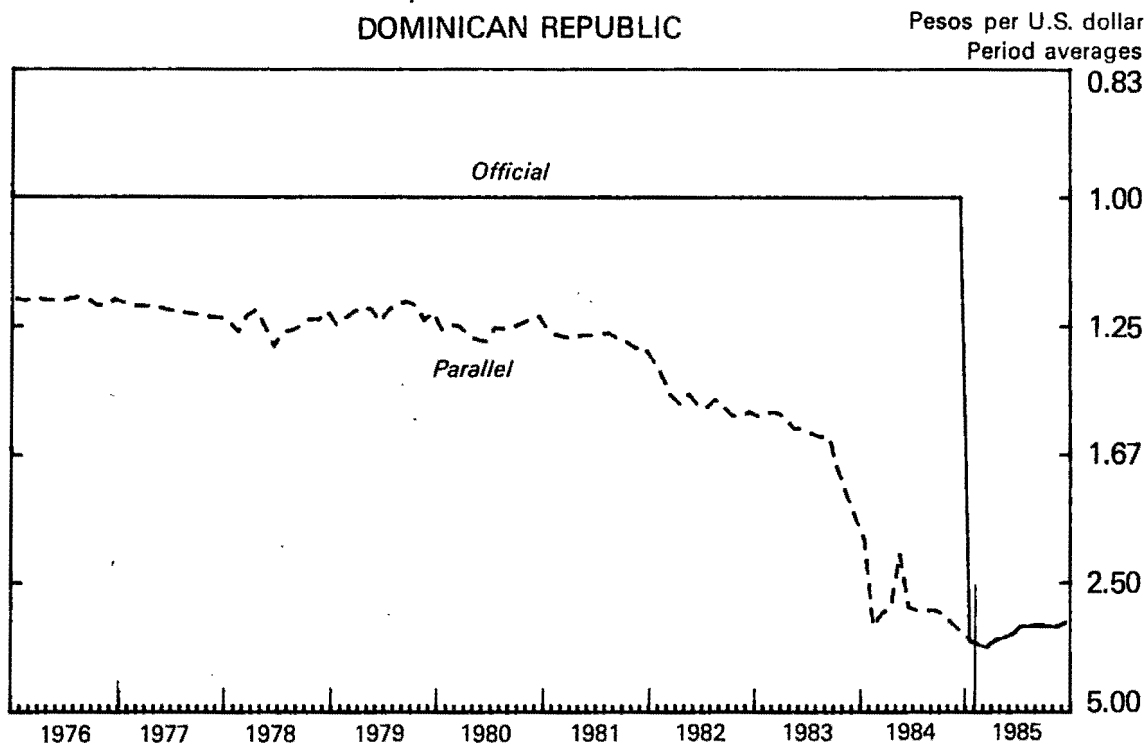
CHART 1
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹



Sources: National authorities; International Currency Analysis, Inc., 1984 World Currency Yearbook; and staff.

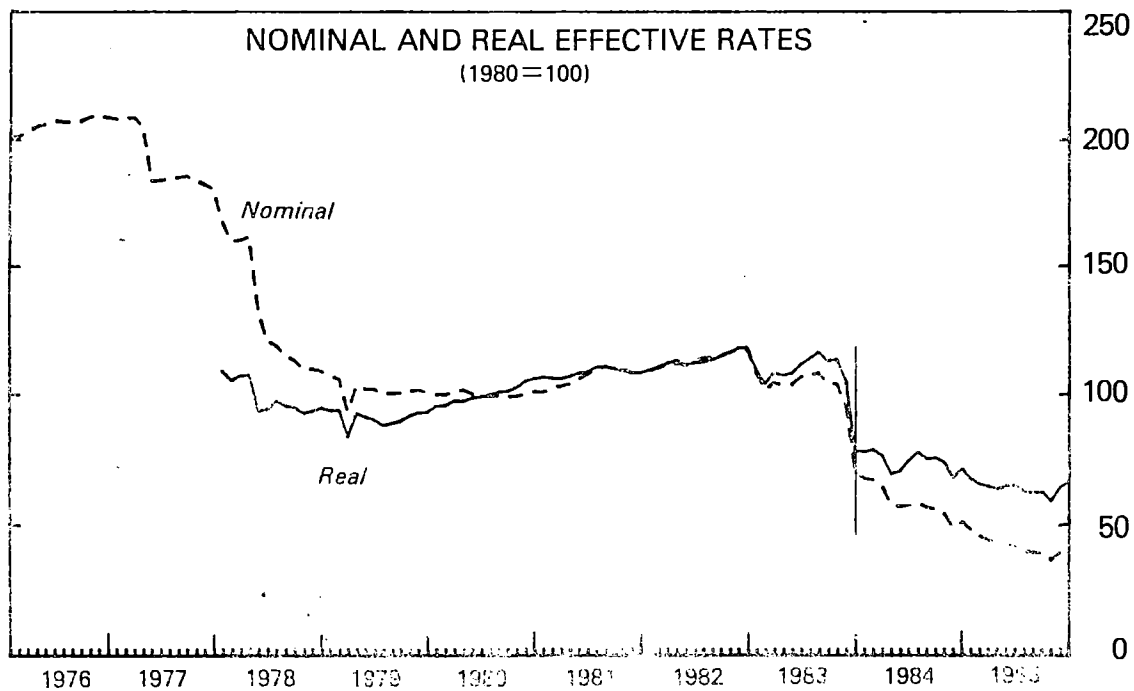
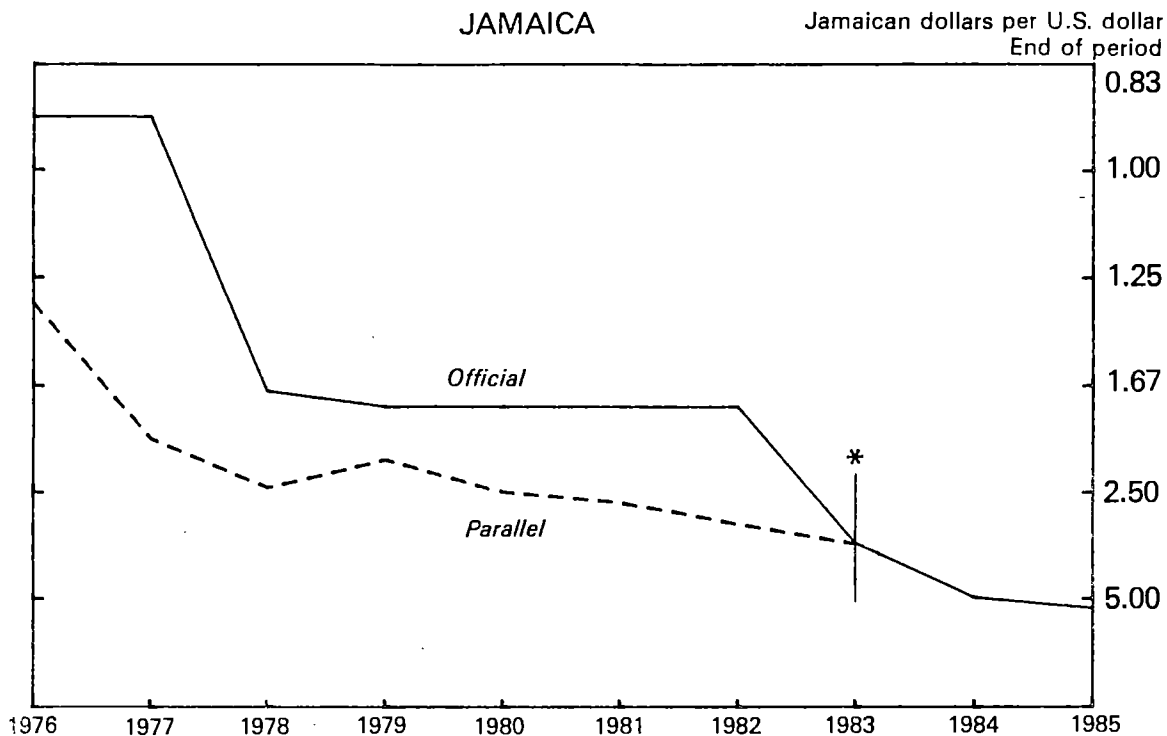
¹Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
DOMINICAN REPUBLIC



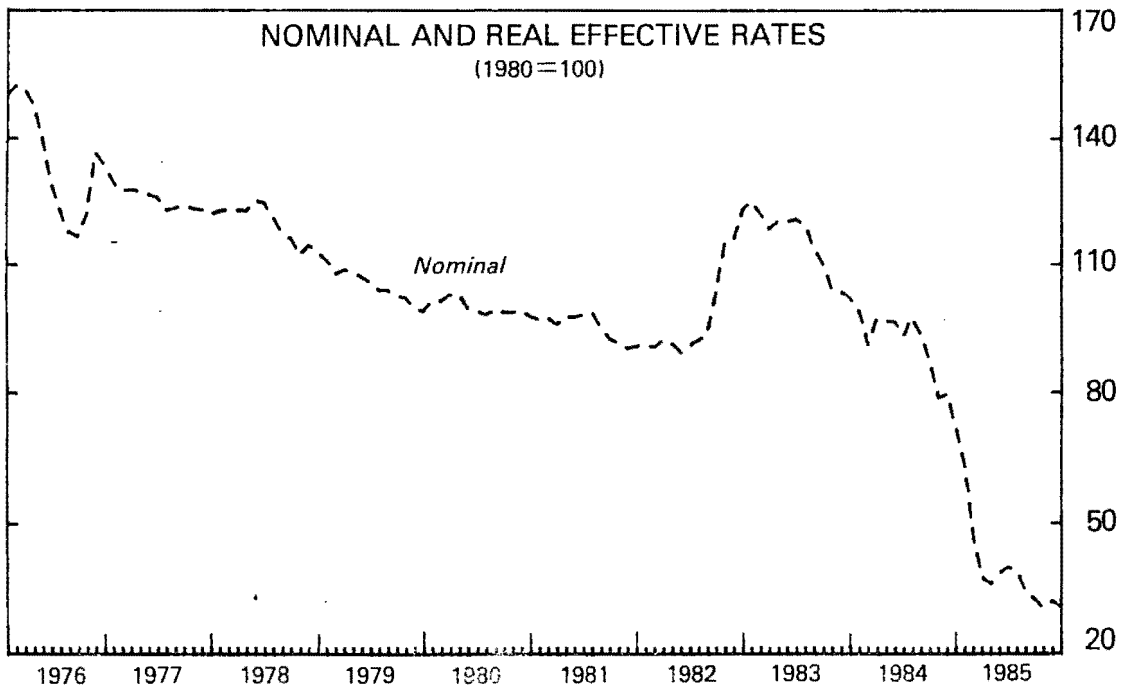
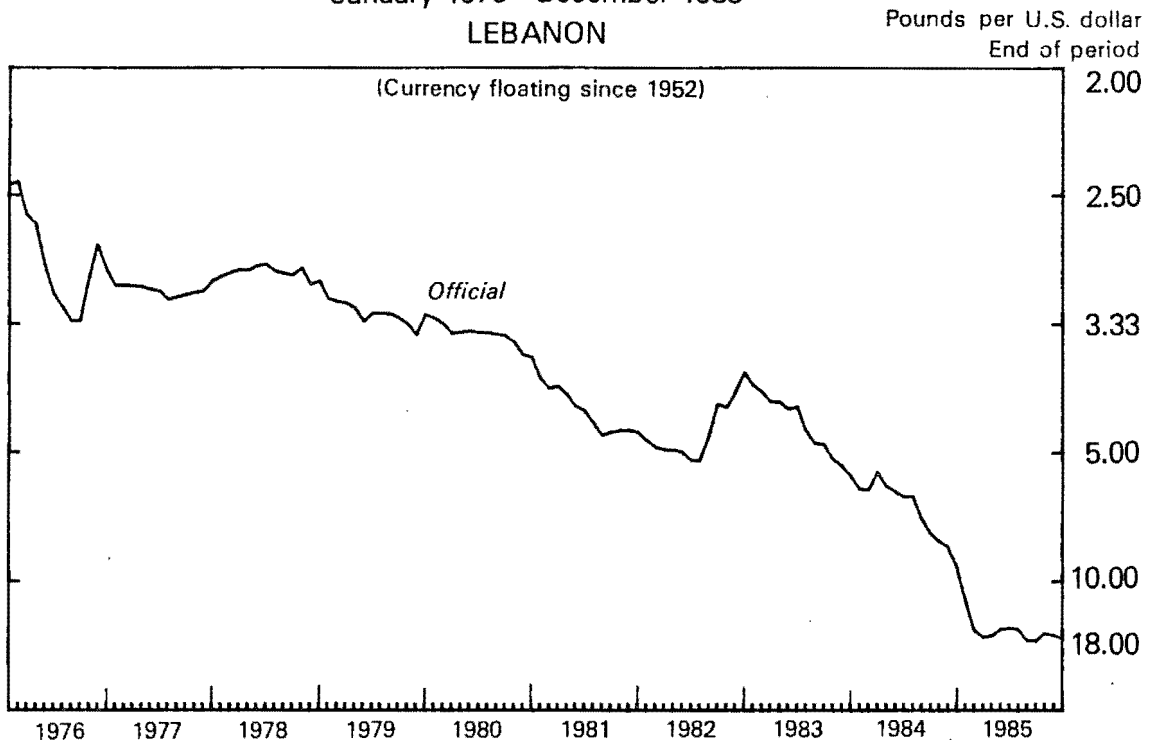
¹Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
JAMAICA



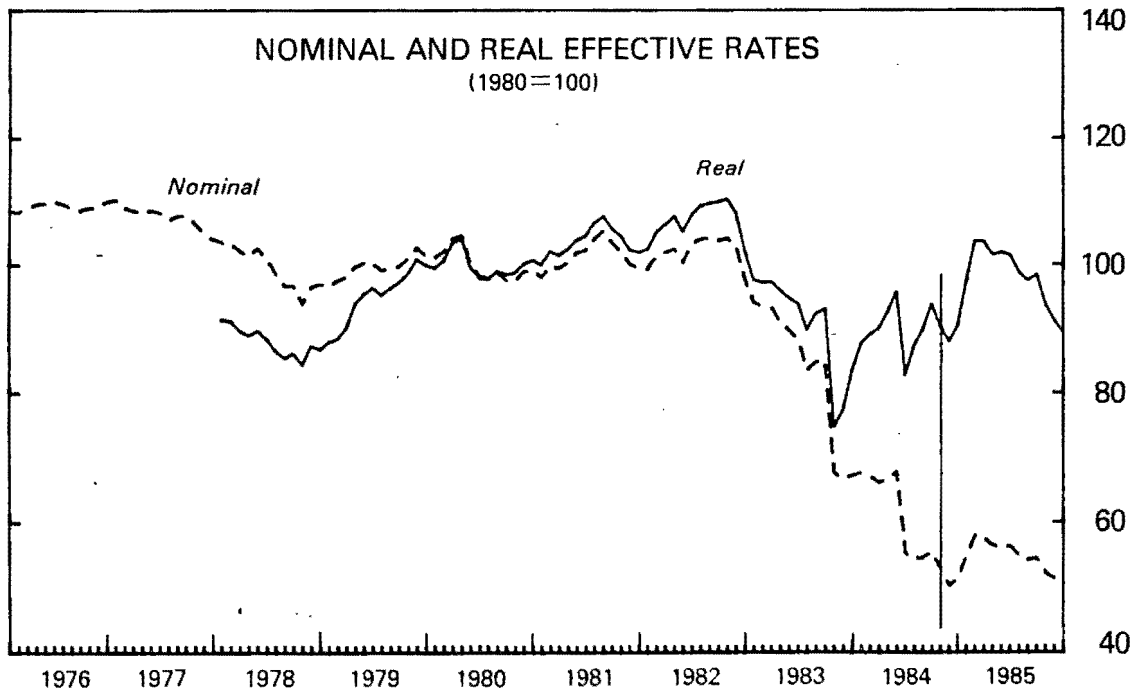
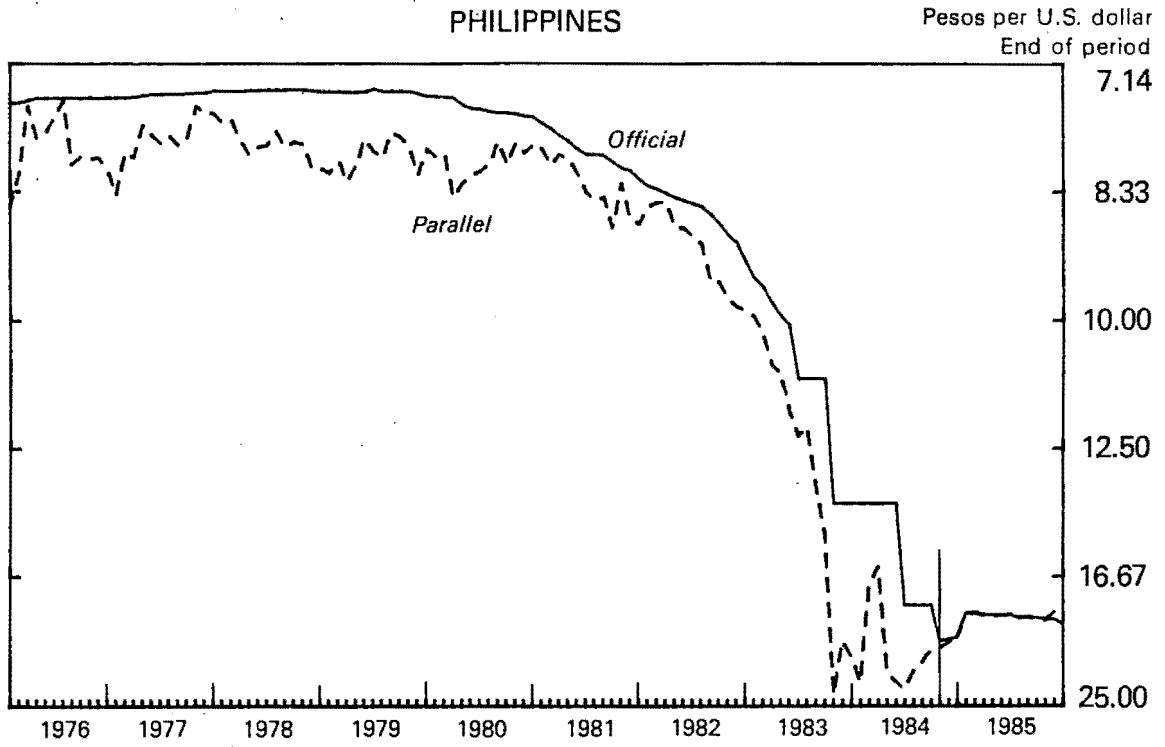
¹ Increases in the charts represent appreciation of the domestic currency; while slant lines indicate the month of floating of exchange rates.
* December 1983

CHART 1 (Continued)
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
LEBANON



¹ Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
PHILIPPINES

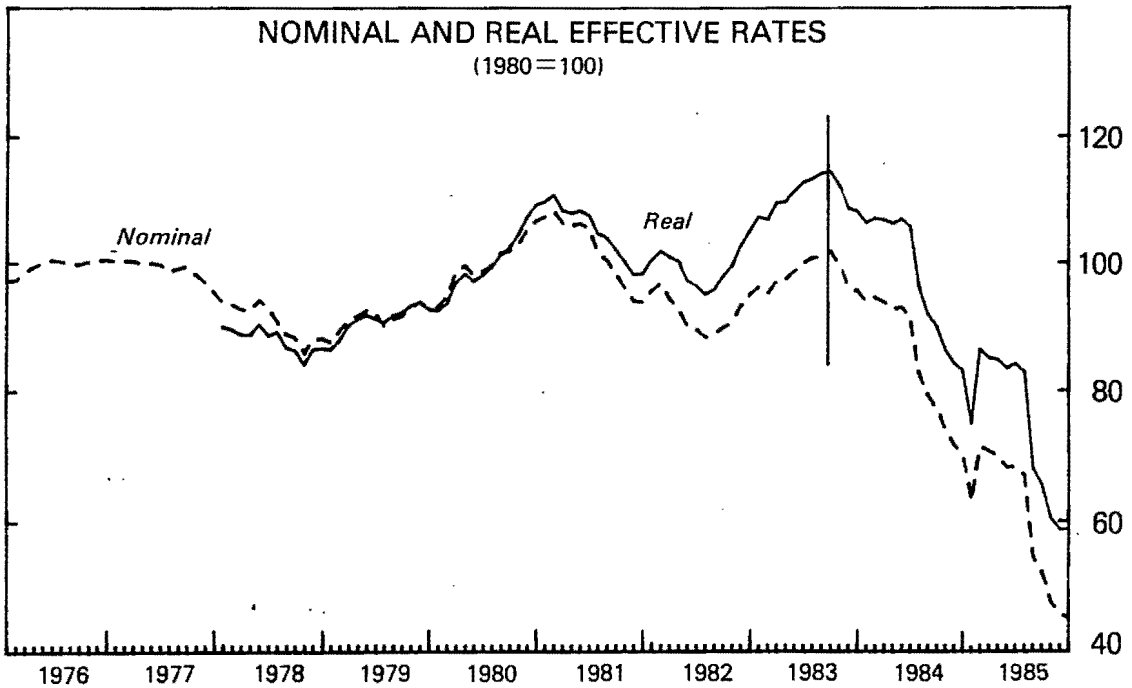
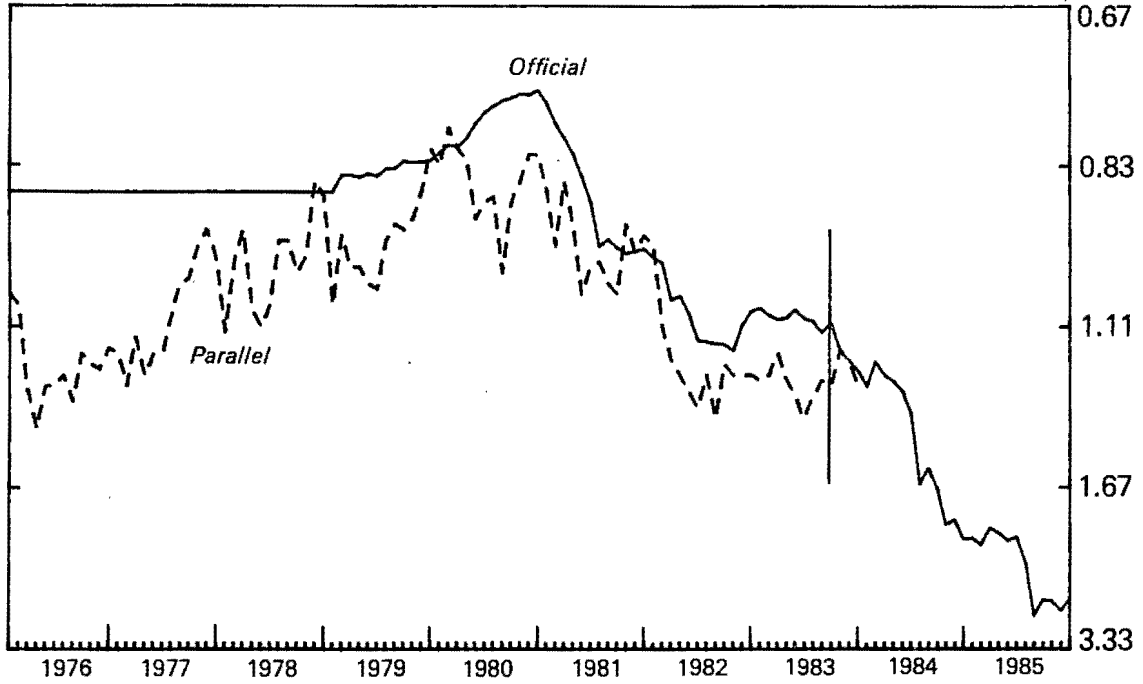


¹Increases in the charts represent appreciation of the domestic currency, while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)

**FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹**
SOUTH AFRICA

Rands per U.S. dollar
End of period



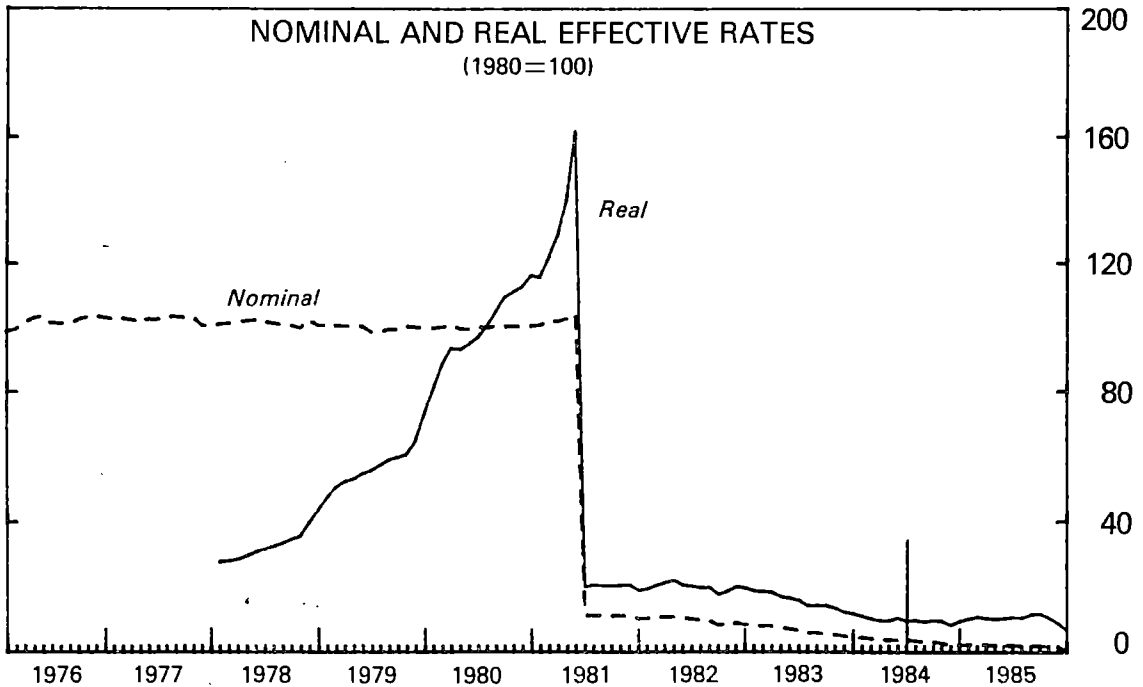
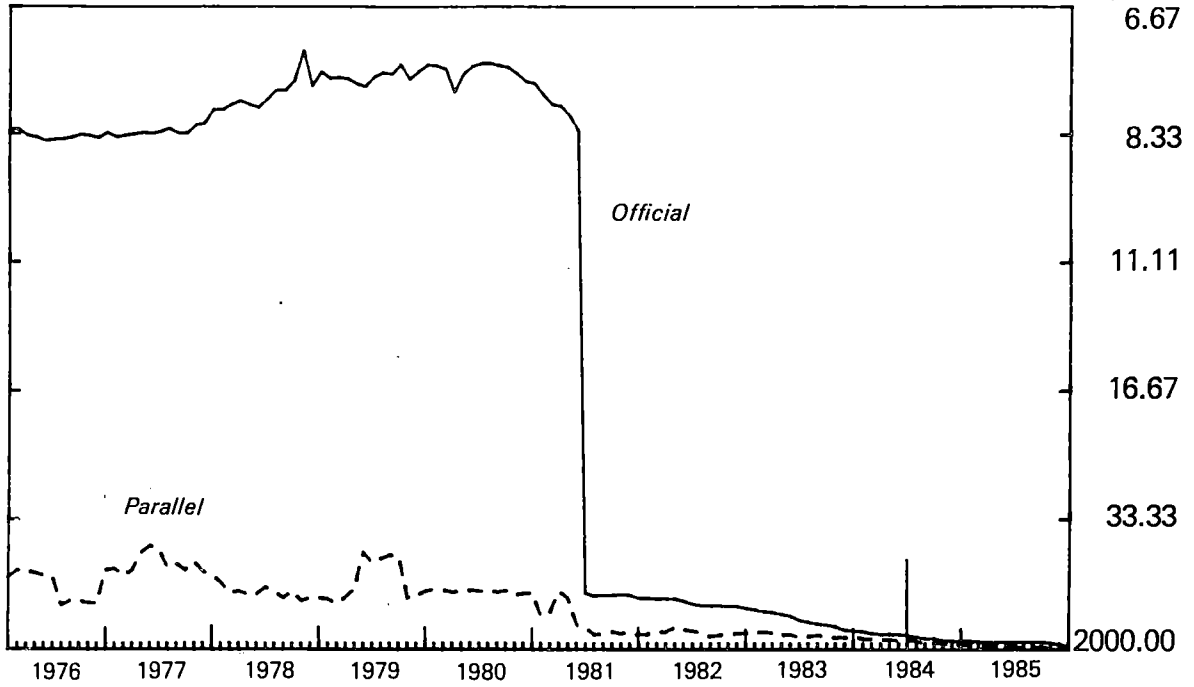
¹Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)

FLOATING EXCHANGE REGIMES: EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES, January 1976 - December 1985¹

UGANDA

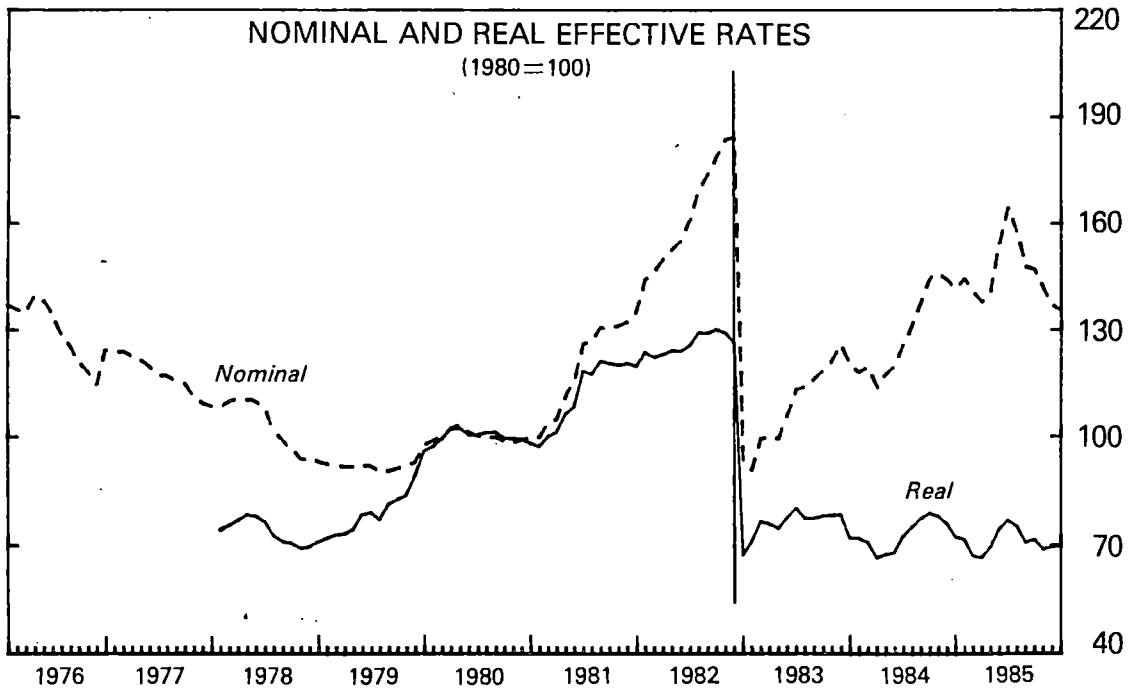
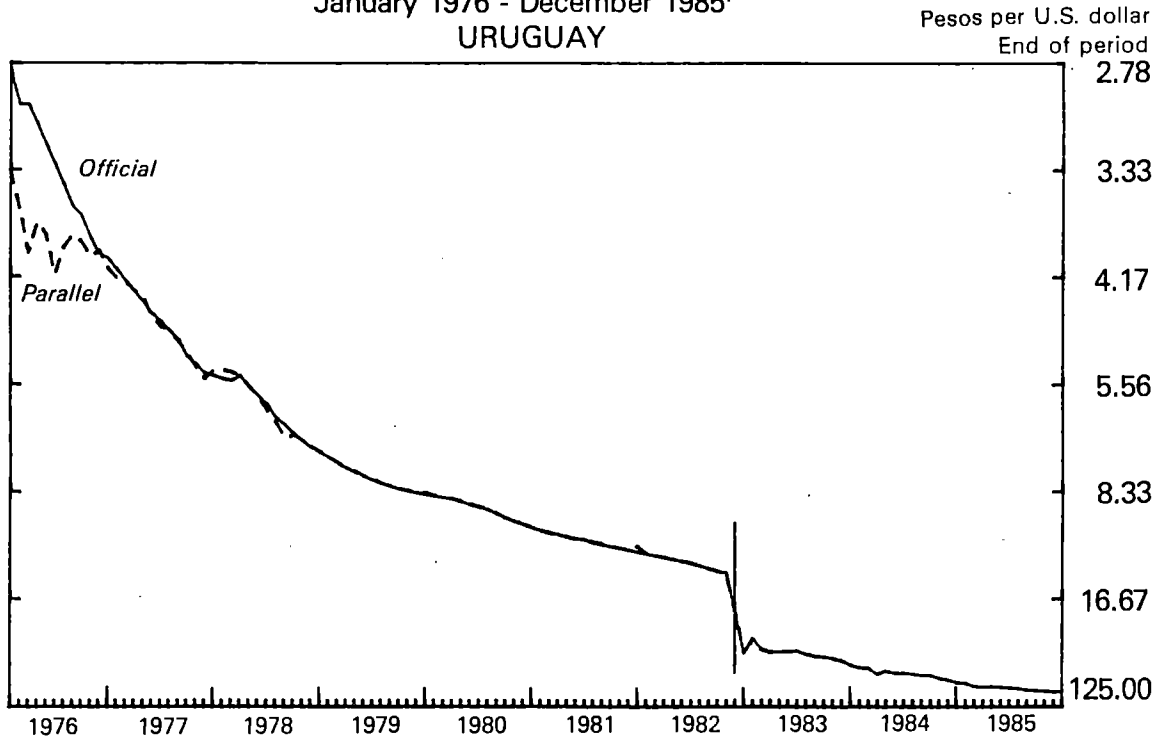
Shillings per U.S. dollar
End of period
6.67



¹ Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)

FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
URUGUAY



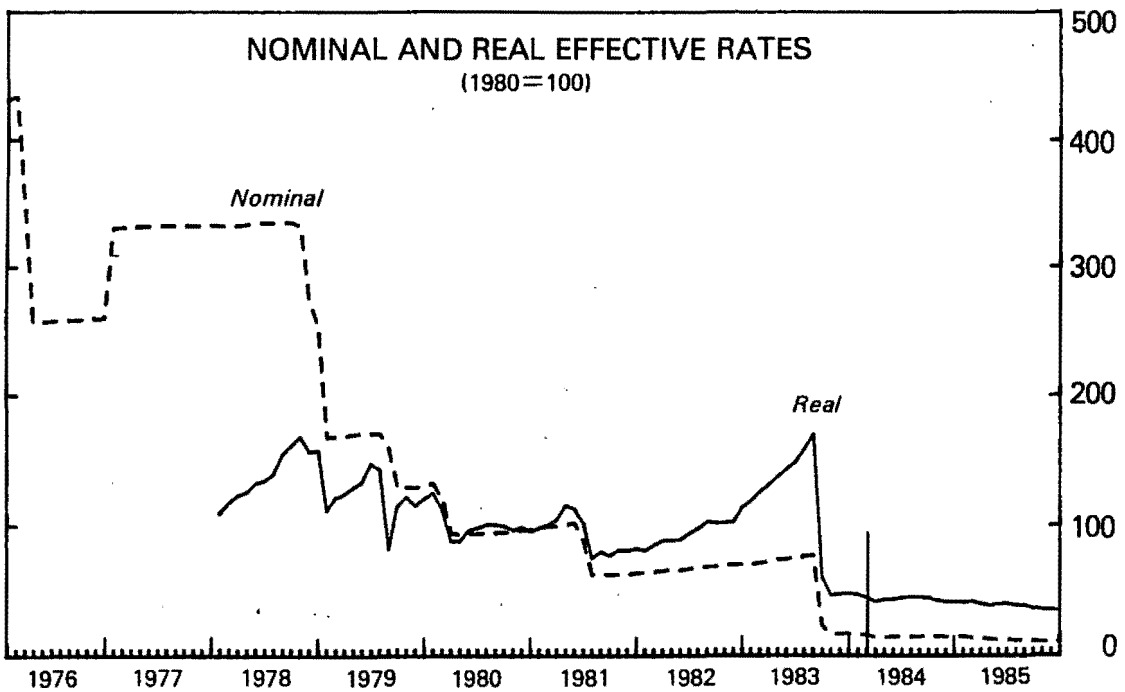
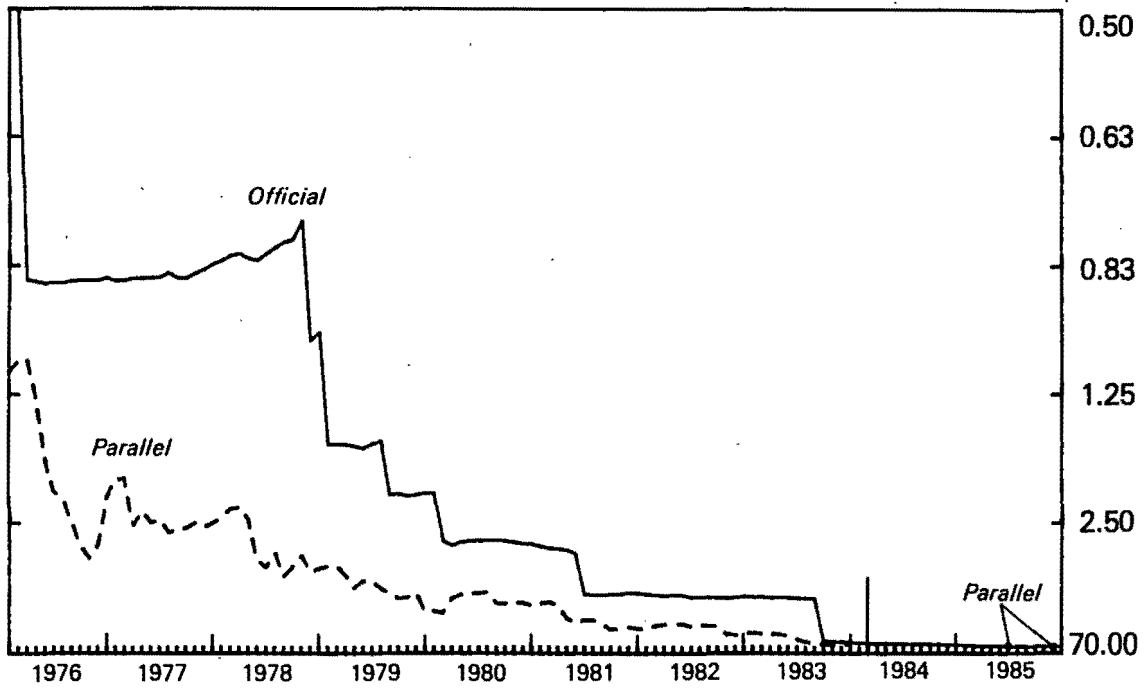
¹Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Continued)

FLOATING EXCHANGE REGIMES: EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES, January 1976 - December 1985¹

ZAIRE

Zaires per U.S. dollar
End of period

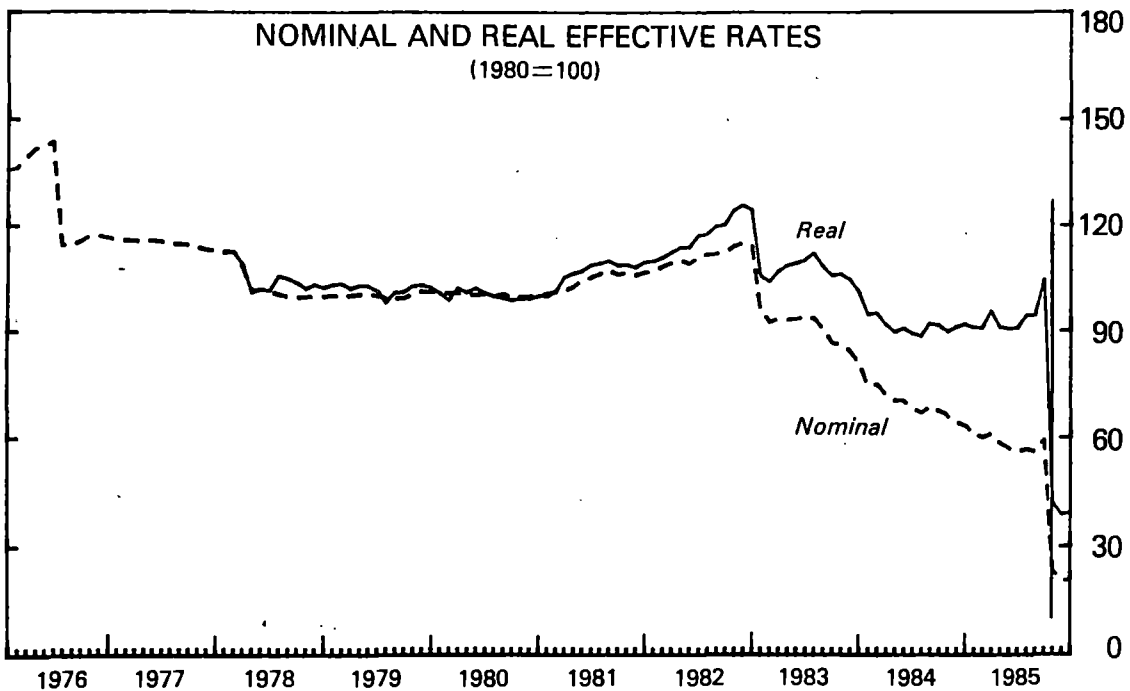
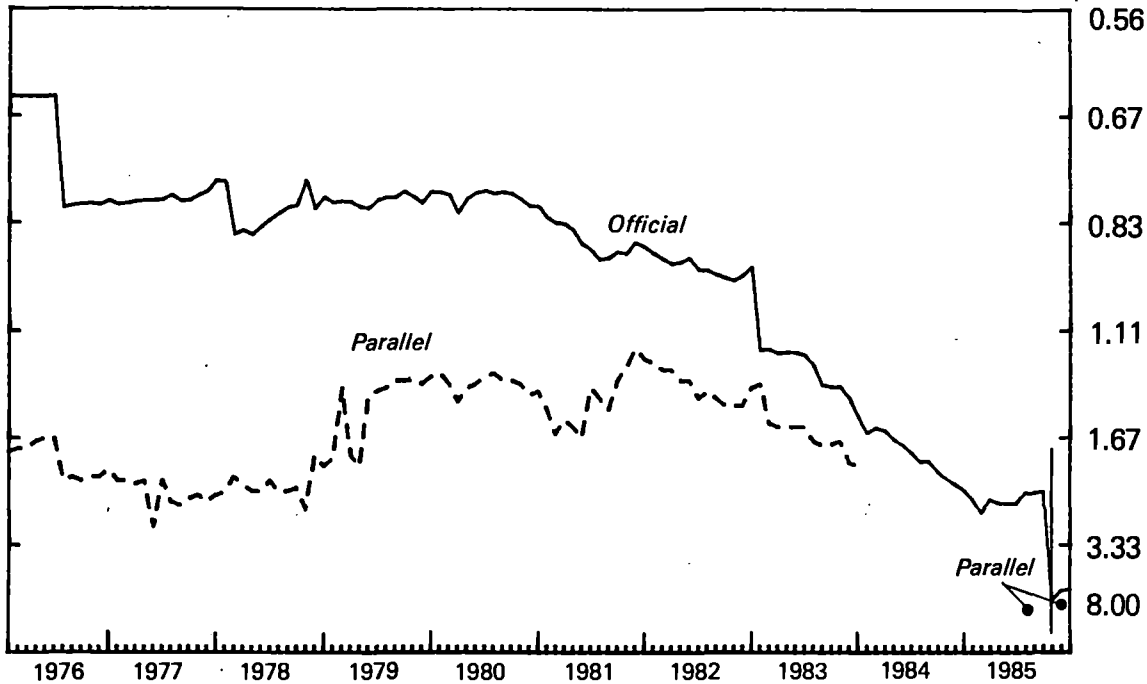


¹ Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

CHART 1 (Concluded)

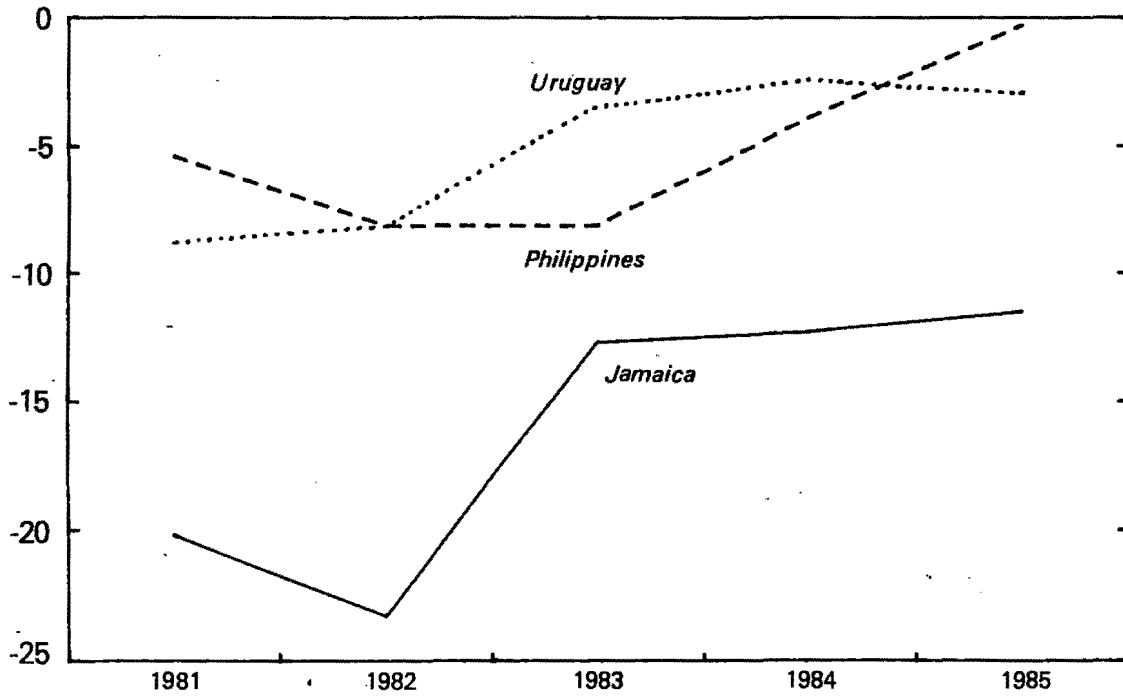
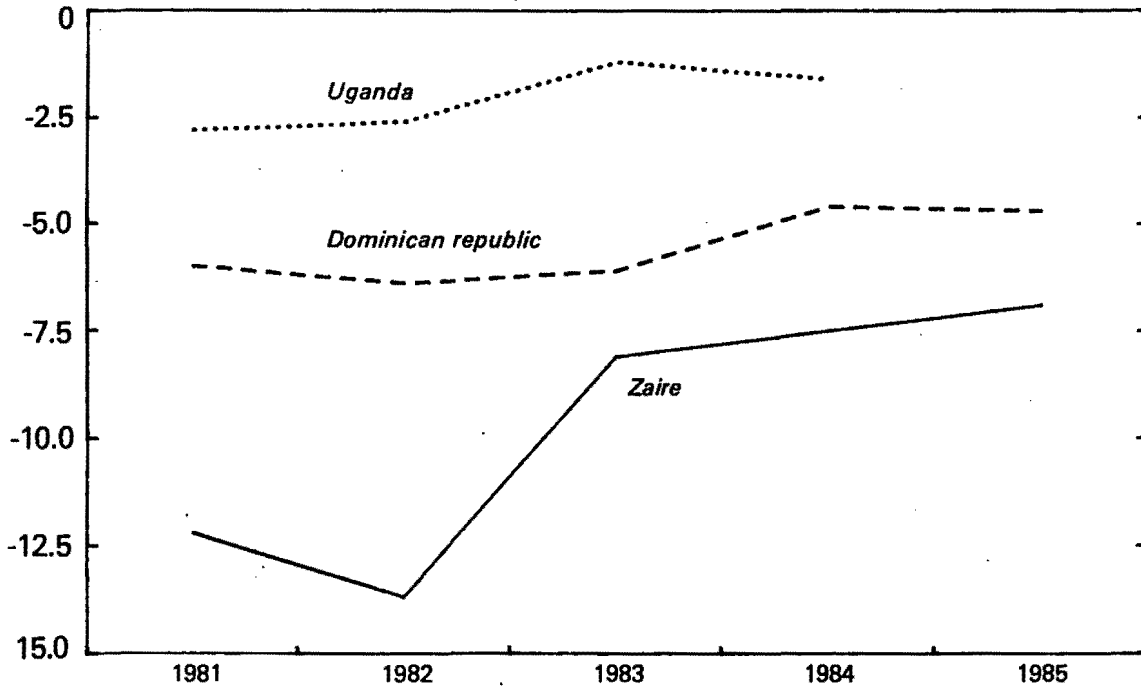
FLOATING EXCHANGE REGIMES:
EXCHANGE RATE DEVELOPMENTS IN SELECTED COUNTRIES,
January 1976 - December 1985¹
ZAMBIA

Kwachas per U.S. dollar
End of period



¹ Increases in the charts represent appreciation of the domestic currency; while slashes indicate the month of floating of exchange rates.

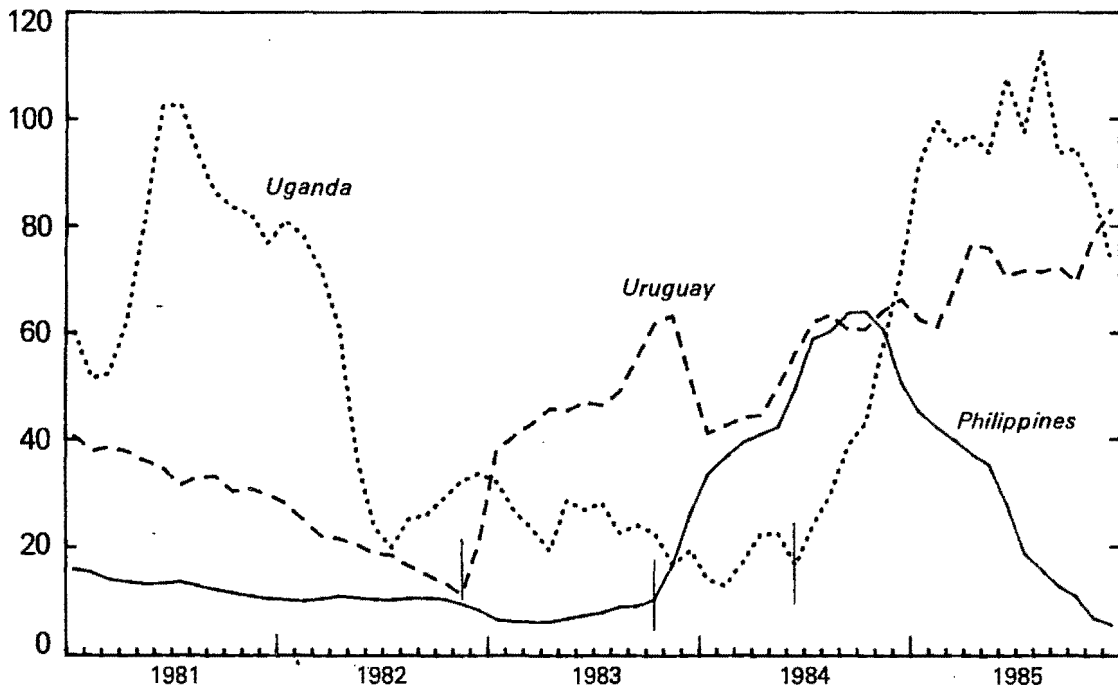
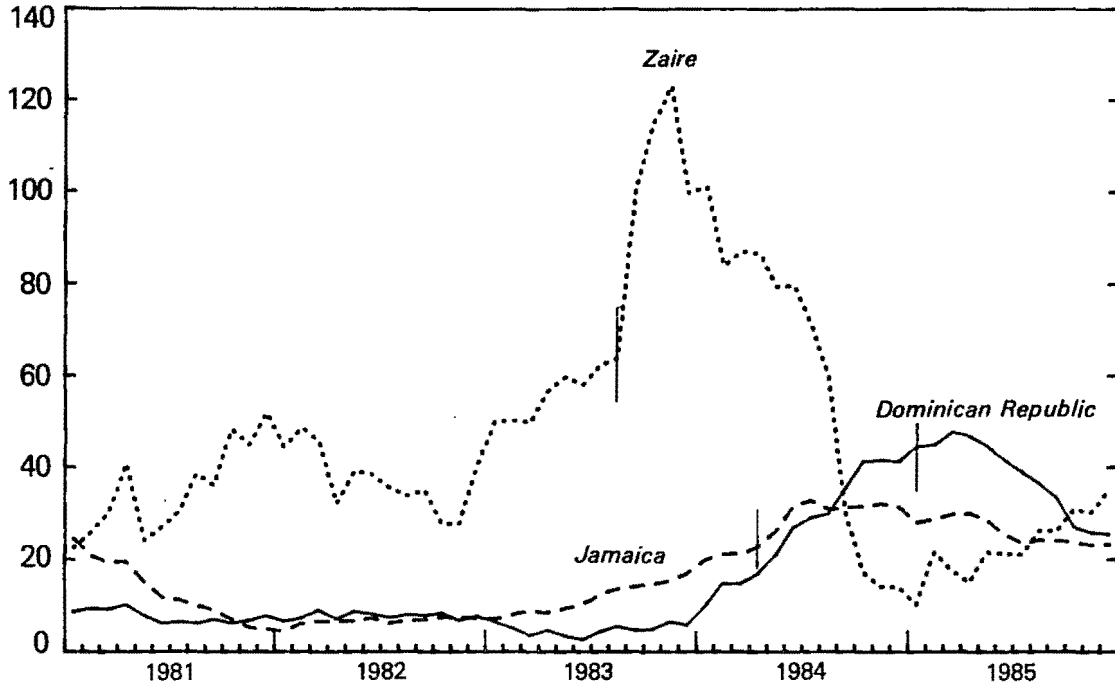
CHART 2
EXTERNAL CURRENT ACCOUNT DEVELOPMENTS
(In percent of GDP/GNP)



Source: Fund papers.

CHART 3 CONSUMER PRICE DEVELOPMENTS

(Percentage change; 12 month increase in consumer prices)¹



Source: IMF, International Financial Statistics.

¹Slash in chart indicates the beginning of floating of exchange rates.

Table 1. Selected Indicators of Economic Structure, 1984

	Per Capital GDP (US \$)		Ratio of money plus quasi-money to GDP ^{1/}	Ratio of total trade in goods and nonfactor services to GDP ^{1/}	Ratio of imports of goods and nonfactor services to GDP ^{1/}	Ratio of manufactures to total imports	Ratio of manufactures to total exports	Exports concentration ^{2/}	Imports concentration ^{2/}
	At official exchange rate	At parallel exchange rate							
	<u>In percent</u>								
Bolivia	1,305.0 (1,251.1) ^{4/}	384.3 (368.4) ^{4/}	20.4	16.9	7.5	40.6 ^{3/}	--	Metals (46.1) and gas (49.4)	Raw materials and intermediate goods (51.1), capital goods (37.9) and consumption goods (9.8)
Dominican Republic	1,797.7 (1,744.0)	656.7 (637.1)	26.0	53.4 ^{5/}	28.4 ^{5/}	51.0 ^{6/}	68.9	Raw sugar (31.5), ferronickel (12.4) and gold alloy (14.0)	Fuels (40.4), consumer goods (27.9), intermediate goods (21.4), and capital goods (10.3)
Gambia, The ^{7/}	237.4	118.7	20.9	106.2 ^{8/}	64.5 ^{9/}	37.6	--	Groundnut products (32.1) and fish and fish products (3.1)	Manufactures (37.6), food and live animals (35.3), and mineral fuels (14.1)
Guinea	357.0	21.5	35.0 ^{10/}	51.0 ^{8/}	27.3 ^{9/}	...	--	Bauxite (76.7) and alumina (21.7)	...
Jamaica	1080.0	...	38.2	126.2	65.6	26.1 ^{3/}	26.0	Bauxite and alumina (65.2), manufactures (26.0) and agricultural goods (2.8)	Raw materials (32.4) fuels (29.5) and capital and durable consumer goods (26.1)
Lebanon ^{11/}	1,646.4 (2,100.1)	1,646.4 (2,100.1)	314.4	102.3 ^{12/}	84.5 ^{13/}	...	39.0 ^{14/}	Agricultural products, foodstuffs, and beverages (33.0)	...
Philippines	613.8 (601.4)	609.9 (597.5)	20.1	63.8	34.9	18.9 ^{15/}	24.6 ^{16/}	Electronics (24.6), coconut oil (10.8) and sugar (4.6)	Raw materials and intermediate goods (43.4), mineral fuels and lubricants (27.2) and capital goods (18.9)
South Africa	2,320.0	...	38.6	56.3 ^{17/}	29.0 ^{17/}	81.6 ^{18/}	12.0 ^{19/}	Gold (47.2), semi-fabricated goods of mining origin (15.9) and crude materials of mining origin (12.8)	Intermediate goods (41.0) and capital goods (40.6)
Uganda ^{7/}	154.1	94.7	11.1 ^{20/}	45.1 ^{8/}	25.7 ^{9/}	19.1 ^{21/}	--	Coffee (90.1), cotton (3.6) and tea (1.1)	Mineral fuels (24.5) and manufactured goods, n.e.s. (12.0) ^{10/}
Uruguay	1,721.5 (1,604.5)	1,721.5 (1,604.5)	56.9	54.7	27.5	30.5 ^{22/}	13.2 ^{23/}	Meat (23.0), wool (16.1) and textile manufactures (9.4)	Intermediate goods (81.0) and capital goods (13.0) ^{10/}
Zaire	157.7 (154.9)	...	10.4	82.3	43.9	...	--	Copper (35.7), crude oil (17.1), diamonds (11.7) and coffee (11.2)	...
Zambia	409.7	...	36.0	73.1 ^{24/}	41.3 ^{25/}	...	--	Copper (81.8) and Cobalt (8.9)	Petroleum (23.3) and fertilizer (6.4)

Sources: National authorities and staff estimates.

^{1/} Except as footnoted below. The GDP estimate is at market prices, and the ratio of money plus quasi-money is based on end-of-period data. Ratios of foreign trade to GDP have been calculated in each case using the official exchange rate, except for the Dominican Republic (see footnote 5).

^{2/} Figures in parentheses refer to percentages.

^{3/} Capital and durable consumer goods.

^{4/} Figures in parentheses refer to per capita GNP.

^{5/} Ratios of foreign trade to GDP have been calculated using an exchange rate of RDS2.0 per U.S. dollar.

^{6/} Data refer to 1983 for capital and durable consumer goods, and fuels.

^{7/} Data for 1984 has been obtained by averaging data for fiscal 1983/84 and 1984/85, where appropriate.

^{8/} Ratio of exports and imports plus net services and private transfers.

^{9/} Ratio of imports plus net services and private transfers.

^{10/} Ratio refers to 1983.

^{11/} All data refer to 1983.

^{12/} Ratio of commodity exports and imports.

^{13/} Ratio of commodity exports.

^{14/} Chemicals, rubber, and related products (10); metals and metal products (9); cement, glass, ceramics, and related products (8); machinery, equipment, and electrical equipment (8); and transport equipment (4).

^{15/} Only import of capital goods.

^{16/} Only export of electronic goods.

^{17/} Includes factor services.

^{18/} Only imports of capital and intermediate goods.

^{19/} Only export of fabricated goods.

^{20/} Data for money plus quasi-money is for end-September 1984.

^{21/} Ratio in 1983 for the sum of manufactured goods, n.e.s (12.0) and machinery and transport equipment (7.1).

^{22/} Includes metal and metal products (4.5), machinery and equipment (19.1), transport equipment (5.0) and precision instruments (1.9).

^{23/} Ratio of textile and leather manufactures to total commodity exports in 1983.

^{24/} Ratio of commodity exports and imports plus net services.

^{25/} Ratio of commodity imports plus net services.

Table 2. Exchange Rate Arrangements as of December 31, 1985 1/

Pegged						Flexibility Limited vis-à-vis a Single Currency or Group of Currencies		More Flexible		
Single currency		Currency composite				Single currency 2/	Cooperative arrangements	Adjusted according to a set of indicators	Managed floating	Independently floating
U.S. dollar	F. franc	Other	SDR	Other						
Antigua & Barbuda	Lao P.D. Rep. 3/	Benin	Bhutan	Burma	Algeria 3/	Afghanistan 3/	Belgium 3/	Brazil 4/	Argentina	Australia
Bahamas 3/	Libya	Burkina Faso	(Indian rupee)	Burundi	Austria	Bahrain 5/	Denmark	Chile 3/4/	Costa Rica 3/	Bolivia
Barbados	Nicaragua 3/	Cameroon	Central The Gambia	Guinea 3/	Bangladesh 3/	Qatar 5/	France	Colombia	Ecuador 3/	Canada
Belize	Oman	African Rep.	(L stg.)	Iran, Islamic Rep. of	Botswana	Saudi Arabia 5/	Germany	Portugal	El Salvador 3/	Dominican Republic
Djibouti	Panama	Chad		Cape Verde	China, P.R.	United Arab Emirates 5/	Ireland	Somalia 3/6/	Greece	Jamaica
Dominica	Paraguay 3/	Comoros	Lesotho 3/	Jordan	Cyprus		Luxembourg 3/		Guinea-	Japan
Egypt 3/	Peru 3/	Congo	(SAR)	Kenya 8/	Fiji		Netherlands		Bissau	Lebanon
Ethiopia	St. Christopher and Nevis	Equatorial Guinea	Swaziland (SAR)	Rwanda	Finland 8/				Iceland	New Zealand
Ghana	St. Lucia	Gabon	Tonga	Sierra Leone 3/	Guyana				India 9/	Philippines
Grenada		Ivory Coast	(Australian dollar)		Hungary				Indonesia	South Africa 3/
Guatemala 3/				Sao Tomé & Principe	Kuwait				Israel	
Haiti	St. Vincent and The Grenadines	Mali		Madagascar					Korea	United Kingdom
Honduras	Suriname	Niger		Malawi					Mexico 3/	
Iraq	Syrian Arab Rep. 3/	Senegal		Malaysia 8/					Morocco	United States
	Trinidad & Tobago	Togo		Maldives					Nigeria 3/	Uruguay
	Venezuela 3/			Malta					Pakistan	Zaire
	Yemen Arab Rep.			Mauritania					Spain	
	Yemen P.D.R.			Mauritius					Sri Lanka	Zambia
				Mozambique 3/					Turkey	
				Nepal					Uganda	
				Norway					Western Samoa	
				Papua New Guinea					Yugoslavia	
				Romania						
				Singapore						
				Solomon Islands						
				Sudan 3/						
				Sweden 10/						
				Tanzania						
				Thailand						
				Tunisia						
				Zimbabwe						

1/ No current information is available relating to Democratic Kampuchea.

2/ In all cases listed in this column, the U.S. dollar was the currency against which exchange rates showed limited flexibility.

3/ Member maintains dual exchange markets involving multiple exchange arrangements. The arrangement shown is that maintained in the major market.

4/ Member maintains a system of advance announcement of exchange rates.

5/ Exchange rates are determined on the basis of a fixed relationship to the SDR, within margins of up to ± 7.25 percent. However, because of the maintenance of a relatively stable relationship with the U.S. dollar, these margins are not always observed.

6/ The exchange rate is maintained within overall margins of ± 7.5 percent about the fixed shilling/SDR relationship; however, the exchange rate will be re-evaluated when indicative margins of ± 2.25 percent are exceeded.

7/ Margins of ± 6 percent are maintained with respect to the currencies of other countries participating in the exchange rate mechanism of the European Monetary System.

8/ The exchange rate is maintained within margins of ± 2.25 percent.

9/ The exchange rate is maintained within margins of ± 5 percent on either side of a weighted composite of the currencies of the main trading partners.

10/ The exchange rate is maintained within margins of ± 1.5 percent.

APPENDIX

Table 3. Floating Exchange Regimes: Exchange Rate Variability
in Selected Countries in the Pre-Float and Floating Periods, 1976-85 1/

	Bilateral		Nominal effective rate,		Real effective rate,	
	U.S. dollar rate, floating compared to pre-float period		floating compared to pre-float period		floating compared to pre-float period	
	Trend adjusted	Without trend	Trend adjusted	Without trend	Trend adjusted	Without trend
Bolivia	I <u>2/</u>	D <u>3/</u>	I <u>2/</u>	U	I <u>2/</u>	U
Dominican Republic	D	D	I	I <u>4/</u>	I	U
Jamaica	I	D <u>3/</u>	I	D <u>3/</u>	I <u>2/</u>	D <u>3/</u>
Philippines	I	U	I	U	I <u>2/</u>	U
Uganda	I	D <u>3/</u>	I	D <u>3/</u>	I	U
Uruguay	D <u>5/</u>	D	... <u>6/</u>	D	D <u>5/</u>	D
Zaire	I	I <u>4/</u>	I	I <u>4/</u>	I	I

Sources: Appendix Tables 4 and 5.

1/ Comparison of volatility between pre- and post-floating periods is on the basis of appropriate statistical tests at 95 percent confidence interval. The symbols in the table denote the following: I = improvement (reduced volatility in floating period), U = volatility unchanged, and D = deterioration (increased volatility in floating period).

2/ No significant difference by measure (2), volatility reduced by measure (4) (see text).

3/ No significant difference by measure (3), volatility increased by measure (1).

4/ No significant difference by measure (1), volatility reduced by measure (3).

5/ No significant difference by measure (2), volatility increased by measure (4).

6/ Volatility increased by measure (4), volatility reduced by measure (2).

Table 4. Floating Exchange Regimes: Variability of Selected Exchange Rates, 1976-1985 ^{1/}

	Mean Monthly Absolute Percentage Change ^{2/}			Variance of Monthly Absolute Percentage Change ^{3/}			Sample Size		
	Offi- cial US\$ (end of month)	Nominal Effec- tive	Real Effec- tive ^{4/}	Offi- cial US\$ (end of month)	Nominal Effec- tive	Real Effec- tive ^{4/}	Offi- cial US\$ (end of month)	Nominal Effec- tive	Real Effec- tive ^{4/}
<u>Bolivia</u>									
Jan. 1976-Aug. 1985	4.07	6.04	12.25	259.46	200.78	321.14	116	116	92
Sept. 1985-Dec. 1985	12.84	12.61	10.03	135.38	112.93	48.73	4	4	4
<u>Dominican Republic</u>									
Jan. 1976-Dec. 1984	--	1.18	1.72	--	9.85	10.21	108	108	84
Jan. 1985-Dec. 1985	1.29	1.63	2.52	1.86	2.38	3.82	12	12	12
<u>Jamaica</u>									
Jan. 1976-Nov. 1983	1.09	1.78	1.91	31.98	8.86	6.31	95	95	71
Dec. 1983-Dec. 1985	3.27	3.61	3.37	9.92	7.87	7.75	25	25	25
<u>Philippines</u>									
Jan. 1976-Sept. 1984	0.83	1.44	2.15	9.64	7.48	7.95	105	105	81
Oct. 1984-Dec. 1985	0.95	2.49	2.62	3.61	4.55	4.87	15	15	15
<u>Uganda</u>									
Jan. 1976-May 1984	2.94	2.66	5.47	83.45	82.32	102.96	101	101	77
June 1984-Dec. 1985	7.93	7.96	7.52	94.47	79.89	49.52	19	19	19
<u>Uruguay</u>									
Jan. 1976-Oct. 1982	1.94	1.91	1.87	1.13	3.48	3.71	82	82	58
Nov. 1982-Dec. 1985	6.53	4.63	4.18	70.42	62.37	57.34	38	38	38
<u>Zaire</u>									
Jan. 1976-Jan. 1984	3.99	3.97	7.23	124.37	101.16	113.27	97	97	73
Feb. 1984-Dec. 1985	2.49	2.49	2.22	3.45	5.07	3.30	23	23	23

Sources: IMF, International Financial Statistics and Information Notice System; and staff.

^{1/} Exchange rates are expressed as the foreign currency price of a domestic currency unit.

^{2/} Volatility measure (1) (see text). In the post-floating periods, the first month in each case is the month of floating exchange rates.

^{3/} Volatility measure (3).

^{4/} Real effective exchange rate data for all countries are calculated from January 1978.

Table 5 . Floating Exchange Regimes: Exponential-Trend-Corrected Variability of Selected Exchange Rates, 1976-1985 ^{1/}

	Mean Monthly Absolute Percentage Change ^{2/}			Variance of Monthly Percentage Changes ^{3/}			Sample Size		
	Offi- cial US\$ (end of month)	Nominal Effec- tive	Real Effec- tive ^{4/}	Offi- cial US\$ (end of month)	Nominal Effec- tive	Real Effec- tive ^{4/}	Offi- cial US\$ (end of period)	Nominal Effec- tive	Real Effec- tive ^{4/}
<u>Bolivia</u>									
Jan. 1976-Aug. 1985	147.34	117.15	21.95	24,054.37	14,661.52	1,218.54	116	116	92
Sept. 1985-Dec. 1985	4.64	5.90	6.26	14.10	4.55	0.06	4	4	4
<u>Dominican Republic</u>									
Jan. 1976-Dec. 1984	--	10.31	9.07	--	79.50	31.73	108	108	84
Jan. 1985-Dec. 1985	1.37	1.86	2.63	0.84	1.91	2.90	12	12	12
<u>Jamaica</u>									
Jan. 1976-Nov. 1983	14.90	15.75	4.26	56.23	44.09	14.19	95	95	71
Dec. 1983-Dec. 1985	4.54	3.40	3.39	16.48	5.05	5.64	25	25	25
<u>Philippines</u>									
Jan. 1976-Sept. 1984	11.99	8.46	6.81	56.64	53.84	20.30	105	105	81
Oct. 1984-Dec. 1985	2.17	4.01	4.97	1.70	4.83	6.03	15	15	15
<u>Uganda</u>									
Jan. 1976-May 1984	82.54	70.35	63.78	7,425.86	5,417.54	6,439.75	101	101	77
June 1984-Dec. 1985	11.96	9.16	9.10	88.64	85.30	68.35	19	19	19
<u>Uruguay</u>									
Jan. 1976-Oct. 1982	5.89	15.45	5.00	19.27	101.46	10.45	82	82	58
Nov. 1982-Dec. 1985	5.46	7.35	5.85	36.37	141.75	88.84	38	38	38
<u>Zaire</u>									
Jan. 1976-Jan. 1984	24.23	24.49	19.37	423.09	408.23	390.81	97	97	73
Feb. 1984-Dec. 1985	2.27	4.47	2.83	2.11	7.88	3.07	23	23	23

Sources: IMF, International Financial Statistics and Information Notice System; World Currency Yearbook 1984; and staff estimates.

^{1/} A simple time trend was fitted for all exchange rates and for all countries. The exchange rates are expressed as the foreign currency price of a domestic currency unit.

^{2/} Volatility measure (2) (see text). In the post-floating periods, the first month in each case is the month of floating exchange

^{3/} Volatility measure (4).

^{4/} Real effective exchange rate data for all countries are calculated from January 1978.

Table 6. Floating Exchange Regimes: Net Capital Flows, 1980-85

(In percent of imports plus net service payments)

	1980	1981	1982	1983	1984	1985	Average of 1980 to the Year of Float <u>1/</u>	Average of the Post-Float Periods
<u>Dominican Republic</u>								
Medium and long-term capital	17.33	13.06	13.53	1.70	7.52	-9.27	10.63	-9.27
Short-term capital <u>2/</u>	11.88	3.95	-6.49	4.24	-2.84	2.18	2.15	2.18
<u>Jamaica</u>								
Medium and long-term capital	18.38	15.95	33.0	22.84	44.81	39.88	22.54	42.35
Short-term capital <u>2/</u>	-10.76	0.17	2.72	-26.41	8.11	12.86	-8.57	10.49
<u>Philippines</u>								
Medium and long-term capital	11.44	18.26	17.97	18.27	-2.71	-20.30	12.65	-20.30
Short-term capital <u>2/</u>	5.13	-6.23	-3.02	-12.19	-0.61	-0.16	-3.38	-0.16
<u>Uganda</u>								
Medium and long-term capital	7.91	4.75 <u>3/</u>	-27.17 <u>3/</u>	-0.18 <u>3/</u>	10.23	8.90	-0.89	8.90
Short-term capital <u>2/</u>	-16.50	11.29 <u>3/</u>	-4.91 <u>3/</u>	-3.93 <u>3/</u>	-9.63	-2.14	-4.74	-2.40
<u>Uruguay</u>								
Medium and long-term capital	41.29	34.07	29.79	51.98	10.47	-43.27	35.05	6.39
Short-term capital <u>2/</u>	8.23	-6.28	-55.38	-38.42	-13.73	--	-17.81	-17.38
<u>Zaire</u>								
Medium and long-term capital	-0.93	-7.77	-7.69	-9.79	-13.93	-13.51	-6.55	-13.72
Short-term capital <u>2/</u>	8.43	6.91	10.23	-2.93	4.82	8.08	5.66	6.45
Memorandum Items:								
<u>Errors and omissions</u>								
Dominican Republic <u>4/</u>	6.21	6.09	-6.29	9.96	-0.88	...	3.02	...
Philippines	1.14	-5.89	-4.26	-2.04	-0.10	6.08	-2.23	6.08
Uruguay	7.70	-11.08	-96.50	-8.94	-10.00	...	-33.29	9.47 <u>5/</u>
<u>Debt rescheduling <u>6/</u></u>								
Dominican Republic	--	--	--	10.69	--	25.97		
Uganda	...	1.39 <u>3/</u>	12.08 <u>3/</u>	6.79 <u>3/</u>	2.07	3.06		
Uruguay	--	--	--	41.8	11.1	25.2		
Zaire	67.85	17.13	7.36	48.35	22.47	18.58		

Source: National authorities and staff estimates.

1/ Except in the case of Zaire: although the zaire was floated in 1984, for the purpose of calculating averages in this table 1984 is considered to be a post-float year.

2/ Includes errors and omissions.

3/ Data for fiscal year ending in June.

4/ Comprises private short-term capital, commercial banks' working capital, and errors and omissions.

5/ Average of 1983 and 1984.

6/ Not included in the capital flows data above.

Table 7. Floating Exchange Regimes: International Reserves, External Debt, Arrears, and Foreign Currency Deposits, 1980-85

(In percent of imports plus net service payments; end of period) 1/

	1980	1981	1982	1983	1984	1985
<u>Bolivia</u>						
Gross official international reserves	10.0	7.2	14.5	16.2	25.6	15.9
External debt outstanding 2/	237.6	195.1	279.5	372.8	388.6	342.0
External payments arrears outstanding	1.6	3.6	13.7	20.2	82.9	117.4
Currency deposits abroad by non-bank residents	...	...	...	45.4	42.9	41.6 3/
<u>Dominican Republic</u>						
Gross official international reserves	11.1	12.6	9.1	12.2	19.2	26.5
External debt outstanding 2/	92.8	102.5	140.1	174.4	200.8	249.6
External payments arrears outstanding	8.1	17.5	30.6	35.8	58.2	57.5
Currency deposits abroad by non-bank residents	...	39.7	46.4	26.8	63.5	74.5 3/
<u>Jamaica</u>						
Gross official international reserves	6.8	5.1	7.2	6.0	7.9	14.1
External debt outstanding 2/	142.2	154.2	204.1	251.2	272.1	370.0
External payments arrears outstanding	9.3	3.9	--	16.5	3.1	--
Currency deposits abroad by non-bank residents	...	7.8	10.5	12.2	13.6	17.4
<u>Lebanon</u>						
Gross official international reserves	41.8	39.9	74.5	51.4	23.2	59.7
External debt outstanding 2/	4.9	6.1	7.6	6.5	6.3	9.9
External payments arrears outstanding	--	--	--	--	--	--
Currency deposits abroad by non-bank residents	...	112.4	124.7	135.6	191.3	340.1
<u>Philippines</u>						
Gross official international reserves	35.2	25.1	11.4	11.6	12.4	30.1
External debt outstanding 2/	212.3	253.1	283.4	320.7	390.3	523.4
External payments arrears outstanding	--	--	--	19.4	31.1	--
Currency deposits abroad by non-bank residents	...	5.7	5.9	9.5	15.5	21.9
<u>Uganda</u>						
Gross official international reserves	0.5	8.5	14.4	19.7	10.2	11.5
External debt outstanding 2/	95.7	121.5 4/	107.7	115.2	134.4	150.9
External payments arrears outstanding 4/	35.8	31.5	28.8	22.2	12.4	14.6
Currency deposits abroad by non-bank residents	...	14.2	11.8	16.1	18.9	17.1
<u>Uruguay</u>						
Gross official international reserves	22.1	25.6	8.1	16.8	13.6	15.8
External debt outstanding 2/	85.8	121.5	212.6	279.6	369.6	344.4
External payments arrears outstanding	--	--	--	--	--	--
Currency deposits abroad by non-bank residents	...	51.7	76.1	120.9	175.0	177.0
<u>Zaire</u>						
Gross official international reserves	8.6	7.0	1.8	2.3	3.6	4.5
External debt outstanding 2/	184.9	204.1	220.9	225.5	233.7	219.4
External payments arrears outstanding	24.1	28.4	45.9	14.4	9.5	6.6
Currency deposits abroad by non-bank residents	...	22.6	21.9	23.3	24.6	26.3
Memorandum items:						
<u>Foreign currency deposits with domestic banks in</u>						
Philippines	37.1	47.2	50.2	50.6	53.8	...
Uruguay	68.9	72.2	125.1	126.8	146.9	...
Zaire	2.1	1.5	1.9	0.3	0.4 3/	...

Sources: National authorities; IMF, International Financial Statistics; and staff estimates.

1/ Except data for Lebanon is in percent of imports; and certain data for Uganda refer to fiscal year ending in June, as footnoted below.

2/ Coverage of external debt data differ among countries, and therefore the debt ratios may not be comparable between countries.

3/ As of September.

4/ Ending in June.

Table 8. Growth and Foreign Trade Performance in Countries
With Floating Exchange Rates and Fund Programs

(Percentage change, in volume terms)

	1981	1982	1983	1984	1985
GNP/GDP					
Dominican Republic	3.9	1.7	4.0	0.5	-1.2
Jamaica <u>1/</u>	2.4	0.5	1.1	-0.2	-3.8
Philippines	3.4	2.7	1.3	-5.3	-4.0
Uganda <u>1/</u>	6.0	8.0	6.0	5.0	0.6
Uruguay	1.9	-9.7	-5.8	-2.4	0.6
Zaire	2.8	-2.2	1.2	2.8	2.5
Developing countries	2.2	1.6	1.3	4.1	3.1
Merchandise exports					
Dominican Republic	10.9	-25.7	-1.4	6.3	-11.0
Jamaica <u>1/</u>	-11.4	-14.8	5.8	-0.7	-8.0
Philippines	1.1	5.6	-5.0	-2.3	-7.0
Uganda <u>1/</u>	52.0	15.0	-12.0	-10.0	-10.0
Uruguay	15.1	-5.0	8.9	-11.1	0.9
Zaire	-14.6	10.9	8.8	0.7	-0.2
Developing countries	-5.7	-8.2	2.9	7.1	0.4
Merchandise imports					
Dominican Republic	-10.8	-14.7	2.2	-7.7	1.4
Jamaica <u>1/</u>	18.3	-9.1	-15.8	-0.3	-12.2
Philippines	-8.0	14.1	-4.0	-28.6	-12.0
Uganda <u>1/</u>	-3.0	12.0	-4.0	8.0	-12.0
Uruguay	-12.0	-32.0	-23.8	-3.9	-5.0
Zaire	-9.6	-12.2	-7.6	-0.4	4.2
Developing countries	7.1	-4.2	-3.2	2.2	-0.3

Sources: IMF, World Economic Outlook, February 1986; Executive Board Documents; and staff estimates.

1/ Fiscal years.

Table 9. Comparison of Average Retail Prices
for Selected Goods in Uganda, Zaire,
and Sierra Leone (First Quarter 1984)

(In U.S. dollars per unit)

	Units	Uganda	Zaire	Sierra Leone
Sugar	1 Kg.	1.26	0.74	2.40
Tea	1 Kg.	3.84		20.00
Salt	1 Kg.	0.39	0.28	1.14
Rice	1 Kg.	0.79	0.57	0.57
Kerosene	1 Liter	0.51		0.19 <u>1/</u>
Soap	1 Kg.	2.24		6.22
Cloth	1 meter	1.20		3.10
Memorandum: Exchange Rate (per US\$1)		292.06	35.288	2.50

Source:

1/ Pre-January 4, 1985 price.

Table 10. Macroeconomic Performance of Countries with Real Effective Exchange Rate Rule and Floating Exchange Rates During Fund Programs

Country	Date	Exchange rate system 1/	Real effective exchange rate 2/	Consumer prices; percentage change 3/		Current account in percent of GNP/GDP 4/		Fiscal balance in percent of GNP/GDP 5/		Broad money percentage change 6/		Exchange and Trade Restrictions 7/
				Before 12 month	After 12 month	Year before	Program year	Year before	Program year	Year before	Program year	
Argentina	10/83	Flexible	19.0	288.2	554.7	-4.0	-3.6	-18.6	-11.2	354.6	526.8	U
Argentina	12/84	Flexible	-9.8	608.0	735.0	-3.6	-1.9	-11.2	-4.2	526.8	429.0	Lib
Bangladesh	12/85	Flexible	...	10.5	...	-8.3	-6.9	-8.3	-7.4	25.6	15.9	Lib
Brazil	2/83	Flexible	-20.5	96.5	163.9	-6.5	-2.9	-15.8	-18.5	113.5	149.3	Lib
Chile	1/83	Flexible	-18.1	9.9	27.3	-9.5	-5.4	-3.4	-3.0	9.8	15.5	Int
Chile	7/85	Flexible	-25.8	25.3	30.7	-10.7	-8.3	-4.4	-3.1	31.4	52.1	U
Costa Rica	3/85	Flexible	-2.7	8.7	10.2	-6.4	-2.8	-1.9	-1.5	11.2	12.0	U
Dominican Republic	4/85	<u>Floating</u>	14.9	35.4	35.3	-4.6	-4.7	-5.2	-2.3	30.2	15.2	U
Ghana	8/84	Flexible	-23.6	87.2	8.5	-1.9	-2.9	-1.8	-2.1	39.3	31.7	Lib
Hungary	1/84	Flexible	1.4	7.3	8.4	0.2	1.3	0.8	3.4	3.8	5.2	Lib
Jamaica	6/84	<u>Floating</u>	-24.9	17.4	30.4	-12.7	-12.3	-15.2	-6.4	24.7	22.3	Lib
Jamaica	7/85	<u>Floating</u>	-14.6	29.8	23.5	-12.3	-11.5	-6.4	-4.7	22.3	18.6	Lib
Kenya	3/83	Flexible	-4.5	19.3	10.9	-2.3	-3.2	-3.1	-4.2	11.3	11.4	Lib
Kenya	1/85	Flexible	-1.5	10.2	13.3	-3.2	-4.7	-4.2	-5.1	11.4	11.7	Lib
Korea	7/83	Flexible	-4.9	4.5	2.3	-3.7	-2.2	-1.6	-1.4	15.2	10.6	Lib
Korea	7/85	Flexible	-11.9	2.3	2.8	-2.2	-1.1	-1.4	-1.5	10.6	18.2	Lib
Madagascar	12/83	Flexible	-14.3	20.7	10.0	-10.9	-10.2	-6.7	-4.8	-1.5	18.3	U
Madagascar	4/85	Flexible	-4.5	9.9	10.8	-10.2	-10.1	-4.8	-4.7	18.3	5.1	U
Malawi 8/	9/83	Flexible	1.0	11.3	11.7	-9.5	-7.8	-8.1	-5.8	10.2	-1.1	U
Mauritania	4/85	Flexible	-10.5	10.6	12.8	-24.3	-14.1	-10.9	-4.0	9.0	24.1	U
Mauritius	5/83	Flexible	-2.7	8.6	5.2	-5.2	-2.5	-9.5	-6.4	10.0	17.5	U
Mauritius	3/85	Flexible	-3.2	8.1	6.3	-2.8	-0.8	-5.5	-5.0	16.5	16.8	Lib
Morocco	9/83	Flexible	-7.5	5.1	12.5	-5.6	-9.0	-10.4	-8.4	17.4	10.3	Lib
Morocco	9/85	Flexible	-12.2	8.4	8.4	-3.2	0.3	-7.3	-5.9	16.5	11.0	U
Nepal	12/85	Flexible	...	7.0	...	-4.1	-4.5	-8.0	-6.9	17.6	22.0	Lib

Table 10 (concluded). Macroeconomic Performance of Countries with Real Effective Exchange Rate Rule and Floating Exchange Rates During Fund Programs

Country	Date	Exchange rate system 1/	Real effective exchange rate 2/	Consumer prices; percentage change 3/		Current account in percent of GNP/GDP 4/		Fiscal balance in percent of GNP/GDP 5/		Broad money percentage change 6/		Exchange and Trade Restrictions 7/
				Before 12 month	After 12 month	Year before	Program year	Year before	Program year	Year before	Program year	
Peru	4/84	Flexible	-5.3	119.6	113.9	-5.3	-2.7	-11.7	-8.1	96.9	144.7	Int
Philippines	2/83	Flexible	-15.8	9.9	12.2	-8.1	-8.1	-5.3	-3.2	16.1	18.6	Lib
Philippines	12/84	<u>Floating</u>	10.2	48.4	26.7	-4.5	-0.3	-3.0	-2.7	7.3	9.5	Lib
Portugal	10/83	Flexible	-0.9	21.8	31.1	-7.2	-2.3	-15.1	-17.6	20.3	27.4	Lib
Solomon Islands	6/83	Flexible	-7.8	10.4	7.4	-13.4	-13.3	-11.3	-10.8	22.6	19.4	U
Sri Lanka	9/83	Flexible	7.5	6.9	19.4	-12.4	-4.3	-10.6	-6.9	21.7	16.8	U
Thailand	6/85	Flexible	-13.0	0.4	3.2	-5.1	-3.8	-4.9	-6.2	20.2	10.2	U
Turkey	6/83	Flexible	-4.8	27.7	35.9	-1.8	-3.8	-6.5	-8.0	69.8	17.8	Lib
Turkey	4/84	Flexible	2.1	33.1	53.2	-3.8	-2.8	-8.0	-8.5	37.8	50.0	Lib
Uganda	9/83	<u>Floating</u>	-37.0	27.2	20.2	-2.6	-1.2	-3.4	-4.0	51.0	70.0	Int
Uruguay	4/83	<u>Floating</u>	-30.9	23.4	49.0	-8.3	-4.0	-18.4	-16.4	16.1	18.0	Lib
Uruguay	9/85	<u>Floating</u>	-8.3	68.0	75.9	-2.5	-2.7	-9.3	-6.6	49.9	91.2	U
Western Samoa	6/83	Flexible	-1.5	13.8	19.7	-17.1	-11.2	-14.6	-2.2	35.4	16.6	U
Western Samoa	7/84	Flexible	-9.0	19.4	9.0	-11.2	-11.2	-2.2	-4.6	16.6	9.0	Lib
Yugoslavia	4/84	Flexible	-0.2	45.8	57.1	0.5	2.0	--	--	67.5	64.5	U
Yugoslavia	4/85	Flexible	-4.5	57.1	76.2	2.0	1.0	--	--	66.8	59.3	U
Zaire	12/83	<u>Floating</u>	-62.2	70.9	60.4	-8.1	-7.5	-3.0	-3.5	74.8	14.2	Lib
Zaire	4/85	<u>Floating</u>	-13.9	35.7	25.2	-7.5	-6.9	-3.5	-2.2	34.2	27.3	U
Zambia	7/84	Flexible	-7.9	20.4	25.1	-6.4	-10.2	-7.4	-7.3	11.1	18.0	Int
Zimbabwe	3/83	Flexible	-9.2	16.3	20.4	-11.1	-8.4	-9.2	-10.9	25.3	0.3	U

1/ The classification of the exchange rate system refers to the program period. Flexible arrangements include exchange rate systems where the real effective exchange rate is kept constant or changed and crawling peg systems.

2/ The real effective exchange rate is calculated as the change in the 12-month period beginning with the month of program approval compared to the 12-month period preceding the program.

3/ The rate of increase in consumer prices before is measured as the average increase in the 12 months preceding the month of program approval on a year-over-year basis while after refers to the average inflation rate in the first 12 months of the program. Where a period of less than 12 months has occurred after the program, the inflation figure refers only to the relevant number of months for which data is available, with December 1985 being the last month of consumer price information for all countries.

4/ The current account balance (including official transfers and, if applicable, after rescheduling) as percent of GNP/GDP refers to the calendar or fiscal year balance before and during the program year.

5/ The fiscal balance in percent of GNP/GDP comprises the broadest concept of fiscal balance (after rescheduling) for each country and refers to the calendar or fiscal year before and during the program year.

6/ Average annual change in broad money in the calendar year before and after program approval. In certain countries the increase refers to end-of-period increase.

7/ An overall evaluation of the changes in restrictiveness of the trade and payment system during the program period.

8/ Malawi has an Extended Arrangement; the program year refers to the second program year.

U = Unchanged

Int = Intensification

Lib = Liberalization



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1986 MAY -9 PM 6: 18

Ms. Wiener
Senior Staff
F. ✓

TO: The Managing Director
The Deputy Managing Director

May 9, 1986

FROM: C. David Finch *CD*

SUBJECT: Surveillance

The purpose of this memorandum is to set down the various lessons from our experience with the implementation of conditionality which I believe are relevant to the strengthening of surveillance. This would seem particularly relevant at this time when certain aspects of surveillance will relate to its implementation within a system of objective indicators. The issues discussed below are also relevant for your consideration of the briefing paper for the consultation with the United States.

The essential element which underlies the formulation of policy programs for Fund arrangements is the availability of an appropriately quantified framework to assess the consistency and sustainability of policies. The detailed specification and quantification of the member's policies and analytical framework provide the required basis for the Board's assessment and endorsement of these policies, consistent with the conditional nature of Fund resources.

The key performance criteria relating to total domestic credit, credit to the Government and external borrowing derived within this framework monitor the implementation of agreed policies to keep domestic demand in line with the envisaged availability of resources. These and other performance criteria appropriate in the member's circumstances provide the necessary assurance to the Fund that continued access by the member reflects effective implementation of those policies necessary for the achievement of the programmed balance of payments and other objectives. Provided that the quantified performance criteria are observed, no further review by the Fund is required for drawings by the member. However, failure to observe the performance criteria (or advance indication that the criteria will not be met) is a signal that the position, policies, and prospects of the member should be reviewed, and therefore the member is to consult with the Fund before requesting further drawings.

A similar set of elements would seem relevant for the purpose of strengthening surveillance. In my view, a first essential element is the strengthening of the framework for the assessment of members' policies, both individually and for the purpose of multilateral surveillance. Unless key policy instruments are analyzed in a reasonably fully specified and quantified framework, not only in the short-term but also in the medium-term, the issue of consistency (internally and with the policies of other members) and sustainability cannot be fully assessed. The more detailed specification and quantification of the

member's policies and of the analytical framework would provide the basis for more sharply focused staff analysis and discussion by the Board of key areas of concern and of the size of appropriate adjustment. Progress in specifying more fully policy plans and in developing comprehensive quantified policy frameworks to assess short- and medium-term prospects will thus need to be carried forward.

A second issue concerns the follow-up to the initial assessment of policies. As already agreed by Executive Directors on the occasion of earlier reviews of surveillance, a supplemental consultation could take place if the conclusion of an Article IV consultation left serious doubts about the appropriateness of a member's policies. The Fund also has the authority, in case of subsequent unexpected developments or changes in policies, to initiate further discussions with the member under the supplemental surveillance procedure. While use of the supplemental surveillance procedure has remained exceptional, current interest in objective indicators to monitor and assess developments could provide a basis to develop performance-criteria-equivalent indicators which would facilitate the use of the supplemental surveillance procedure.

Monitoring criteria or benchmarks derived within the quantified policy framework could, as part of surveillance, strengthen the continuous monitoring of the implementation of those policies described by the member as part of the consultation process. Evidence of a departure from the authorities' strategy based on the quantitative monitoring or, even earlier, if it is clear that the strategy described in the earlier consultation will be substantially altered would provide the basis for a supplemental consultation with the member, which could be initiated either by the Fund or the member. As is the case for consultations with members following the breach of performance criteria under Fund arrangements, the supplemental consultation would provide an opportunity for the member to explain (and other members to assess) why a different strategy seems preferable or what actions are considered to correct earlier deviations.

It would not seem either necessary or feasible, however, to apply such monitoring rigidly across quantified "indicators" or across countries. As is the case for performance criteria under Fund arrangements, the monitoring criteria which would trigger a further review with the Fund should be limited to those which indicate departures from the strategy described earlier by the member which are both important and of sufficient concern to the Fund. Thus, and while the greater specificity and quantification outlined earlier would help strengthen the consultation process with all members, only in those cases when Executive Directors consider a matter to be of sufficient importance to warrant close scrutiny would review-linked performance criteria be specified. In those cases, as is done for members with Fund arrangements, a time path should be specified, consistent with the authorities' overall strategy, which would allow continuous monitoring of developments.

Developments which underlay the emergence of major imbalances in recent years and the key concern of the Fund in promoting a stable and orderly international trading and financial environment suggest that fiscal and monetary policies will be central monitoring criteria. In addition, earlier discussions and the communique of the Tokyo Summit have highlighted several other indicators which the forthcoming paper on objective indicators will be examining more fully.

As was noted in Mr. Wiesner's memorandum forwarding the briefing paper for the consultation with the United States, some of the issues discussed above had already been raised within the staff as they relate to the United States. The large fiscal deficit and how to correct it are appropriately singled out in the brief as the key domestic and international policy issue. However, both discussions with the authorities and the Board discussion concluding the consultation may again precede the adoption of a budget for the next year. In light of the importance of developments in this area, this would provide a good opportunity to initiate the procedure described above, building on it on a case-by-case basis and also taking into account the discussion of the broader issue of objective indicators later in the summer.

cc: ~~Heads~~ of Departments
Mr. Brown



Office Memorandum

sm/86/114

FILE COPY

checked against
comments of 5/2 and

5/6/86 . May 8, 1986

Some were taken,
many were not

Fv B

TO: The Managing Director
The Deputy Managing Director

FROM: C. David Finch *CF*

SUBJECT: Experience of Developing Countries with
Floating Exchange Rate Systems

I attach, for your consideration and approval, a paper for the information of the Executive Board on developing countries' recent experience with floating exchange rate systems. The paper has benefitted from suggestions and detailed comments provided by area and other functional departments.

I think that the experience gathered in recent years with the use of floating systems by developing countries provides an adequate basis for further examination of the potential for the systems in other developing countries. As the paper notes, there had been concerns regarding the capacity of developing countries for managing the systems, given their limited institutional depth. The outcome of the examination of the experience with the design and implementation of interbank and auction markets is that the main problems have come from inappropriate intervention by authorities to limit the openness and freedom of the markets. Where the markets have been left to function as intended, they have generally done so effectively. This points up the necessity of close monitoring of the arrangements.

In addition to addressing the problems of actually implementing the systems, the paper reviews the experience with their performance to date against certain expectations. The main concerns had been that the floating exchange rates would prove volatile in these countries and would add to inflationary pressures. Also examined in the paper on the basis of available data are the main benefits that were expected from floating exchange rates; namely, that they would assist in absorbing parallel exchange markets and thus curb capital flight, and that they would prevent the incurrence of new arrears and end the drain on official reserves resulting from official intervention to manage the rate. It seems clear from the available data that the fears regarding the instability of the systems have not been well-founded. There is some evidence that capital flight has been curbed by the systems, that reserves use has been curtailed and even some build-up achieved, and that inflation has tended to recede rather than to gain momentum. However, the evidence is still very recent and of relatively short duration, and the paper accordingly takes a low-key approach in presenting it.

In this latter area, you may wish to be aware that concern was expressed on certain paragraphs in the paper, particularly in Section III, that relate to general economic performance in countries with the floating rate systems, both before and after the float and in

relation to managed floating countries. We recognize that such comparisons have to be qualified and interpretations of their appropriateness differ. On balance, we felt that they contained relevant information and have retained them with the appropriate qualifications. Your reactions and guidance on these points would be welcome.

Finally, it might be useful to note that the paper could run into the objection that the Fund is advocating floating rate systems for developing countries at a time when industrial countries are heading towards more managed arrangements. However, the paper also makes it clear that the case for floating in developing countries is very much a function of low reserves and arrears, and political difficulties in maintaining correct rates through fixed or managed arrangements; characteristics that are generally not present in industrial countries. There is also the point that, in a sense, the two groups are converging.

cc: Heads of Departments, AFR, ASD,
CBD, EUR, LEG, MED, RES, WHD
Mr. Brown



Office Memorandum

Files

F

TO: Mr. Quirk

DATE: May 6, 1986

FROM: F. van Beek *FVB*

SUBJECT: Experience of Developing Countries with Floating Exchange Rate Systems

This draft paper presents a useful summary of the recent experience with floating exchange rates in developing countries in respect of the institutional and practical elements of the system and the role of the Fund in implementing them. However, the part of the paper reviewing the outcome of these systems in a "broader macro-economic context" (Section III) does not, in our view, deal adequately with the experiences of the individual countries and hence does not serve as a basis for the conclusion that a floating exchange rate cannot substitute for appropriate economic policies or that a floating rate system is better than other types of exchange arrangements. To some extent, this problem reflects the relative shortness of the sample period. More importantly, however, it would seem to be inherent in the approach that was adopted, which is to deal separately with inflation, output, balance of payments results, etc., and to examine how each of these variables behaved in the sample countries.

In order to do justice to the experiences of the various countries, it would be necessary, we believe, to analyze more fully, for each country separately, the circumstances that gave rise to floating, and the pre- and post-floating developments in policies and in the main economic variables. Such an approach would, for example, allow the paper to deal more adequately with the inflation experience in Uruguay (p. 65)--as it stands that discussion does not go anywhere, and we suggest that it be dropped. It would also allow more insight into the inflation experience in the Dominican Republic than is offered by the one-sentence observation that "...the decline in inflation partly reflected the real effective appreciation of the peso after floating" (p. 64). And it would help provide some insight into the divergent behavior of the real effective exchange rate in the various countries that is noted on p. 52, and into the divergent behavior of foreign-currency denominated deposits in Uruguay and Zaire that is noted on p. 57.

Some other points that contributed to our unease about Section III are:

1. The analysis of exchange rate developments (pp. 51-52) starts off by making a number of generalizations that do not seem to be borne out by the charts. It is not clear that in all countries the nominal and real effective exchange rates initially depreciated (p. 51), and it is not correct that in all countries the nominal effective exchange rate depreciated on balance from the introduction of floating to the end of 1985 (p. 52). Also, it does not seem very useful to

compare the behavior of the official exchange rate before and after floating (p. 51) in cases where the exchange rate in the parallel market had already depreciated substantially, and the market was then unified. In the conclusion, a reference is made to "overshooting" of the rate, but the discussion does not really address that issue.

2. The discussion of movements in reserves before and after floating (p. 57) does not consider the possibility that the countries' programs with the Fund may have called for an increase in gross reserves.

3. The discussion of the impact on economic growth of floating exchange rates (pp. 59-60) could be shortened considerably. After all, the only point to make here is that the experience is too short. In general, the discussion of export and import behavior in the different countries does not allow one to judge how the trade performance related to the economic policies which these countries pursued.

4. The comparison of performance under floating with managed flexibility leaves the clear impression that floating is superior. However, as the paper itself notes (p. 66), there is a problem of sample size, and no attempt is made to separate out the roles of domestic policies and external events. Also, the question arises whether, and under what conditions, the impact of a floating exchange rate is distinct from that of the depreciation which it may facilitate; this question is touched upon, but is not addressed as such. Would it not be better to leave these issues for a separate study?

Three small points: (1) the term "black" or "illegal" market is used repeatedly to refer to a group of countries that includes at least one--the Dominican Republic--where the parallel market was never black and was de facto legalized before floating began; it would help if this term were not used at all or used only for references to countries where such markets were or are in existence; (2) given that the official exchange rate of the Dominican peso had been unchanged since 1947, it is to be expected that the peso showed "an unambiguous increase in volatility" (p. 53); and (3) in principle, valuation changes in official reserves are not an unidentified transaction, as is implied on p. 56.

Country-specific comments on Bolivia, the Dominican Republic and Uruguay were sent already on Friday, May 2. Comments on Jamaica are being forwarded separately today.

cc: Mr. Finch
Mr. Hood
Mr. Whittome
Mr. Gianviti

Mr. Ouattara
Mr. Shaalan
Mr. Tun Thin
Mr. Zulu



Office Memorandum

TO: Mr. van Beek

DATE: May 2, 1986

FROM: Hans Flickenschild

SUBJECT: Comments on "Experience of Developing Countries with Floating Exchange Rate Systems"

Some comments by Mr. Kohnert on the above draft are attached. I agree with him that the presentation of the descriptive material is at times tedious and that too little emphasis is given to the importance of supporting policies in gauging the success of floating rate systems in achieving such external and internal objectives as exchange rate and price stability and economic growth.

Given the tight review deadline, our comments on the text references on Bolivia are too numerous to permit their inclusion in this memorandum. The text pages with our pencilled comments are attached instead.

Attachments

cc: Mr. Loser (on return)



Office Memorandum

TO: Mr. Flickenschild

DATE: May 2, 1986

FROM: Peter Kohnert *PK*

SUBJECT: Comments on Draft Paper: Experience of Developing Countries With Floating Exchange Rate Systems

General Comments:

1. The description of the institutional setting contains very useful material. However, since the expected issues of discussion are whether and to what extent an exchange arrangement in the form of an auction system or an interbank system is useful for the stabilization and economic development of a developing country, I would suggest to put these descriptions into an appendix.

2. One would expect in such a paper a broader economic analysis of the experience of the relevant countries with floating exchange rates. However, no deeper insights are presented in this paper as is demonstrated by the following three examples:

a. Page 52, second paragraph

In this paragraph, it is mentioned that, after the initial exchange rate correction, in some countries the exchange rate depreciated, while in others it appreciated. No reference is made as to whether changes in economic policies or purely speculative behavior of market participants were the reasons for the different exchange rate movement. For example, in Bolivia the exchange rate depreciated shortly after the initial depreciation in reaction to a marked terms of trade loss which occurred in the wake of the collapse of the international tin agreement.

b. Page 57, first paragraph 1

The statement that "Foreign currency-denominated deposits fell in Uruguay in the floating period, and increased in Zaire" is by itself meaningless. No reference is made to the relationship between interest rate and exchange rate policy.

c. Page 59, last paragraph

On the impact of floating on output and trade a textbook statement is made:

"A depreciation has an immediate negative impact on domestic absorption as it reduces real wealth through its impact on the price level and real incomes, unless wages fully accommodate the impact of the depreciation."

No analysis is offered whether this condition is applicable to the developing countries under study.

I think it is crucial to discuss these issues in greater detail and within a broader framework of economic analysis in order to be able to evaluate the pros and cons of a flexible exchange rate policy.



Office Memorandum

TO: Mr. van Beek

DATE: May 2, 1986

FROM: J. Gonzalez *JEG*

SUBJECT: Experience of Developing Countries with Floating Exchange Rates

The following are comments on the above-mentioned draft paper insofar as it relates to the Dominican Republic:

Page 5, lines 6-8. The initial par value of the Dominican peso was established at 1:1 to the U.S. dollar in February 1948 (37 years before floating), and the 1:1 parity had been in effect for many years prior to that date.

Page 17, lines 5-7. Remittances from nonresidents are also exempt from surrender in the Dominican Republic. It is more correct to say that only traditional exports of goods and services subject to the exchange surcharge (sugar, cocoa, coffee, tobacco, and most services other than tourism) are subject to surrender requirements.

Page 40 (Table 3). The first part of footnote 1 is confusing, and if I understand its meaning correctly, it does not apply to the Dominican Republic where an illegal parallel market never existed in recent history (except for a very brief period in late 1983-early 1984). The parallel market in the Dominican Republic, while never fully authorized until late 1982, has always been tolerated.

Pages 51-52. The paragraph starting at the bottom of page 51 lacks in precision because it does not specify at the start that the behavior of the newly floating rate is measured against the pre-existing official rate. The statement in lines 2-5 on page 52 is incorrect, since Chart 1 shows that the nominal effective exchange rate of the Dominican peso has appreciated on balance from the introduction of floating till December 1985.

Page 58, lines 9-12. As noted before, there was no black market in existence in the Dominican Republic prior to the introduction of the float.

Page 62. The reader is left confused because without explanation the last paragraph speaks of an improvement in the current balance of payments in the Dominican Republic in 1985 (which is correct in terms of U.S. dollar amounts), while the preceding paragraph says the balance was unchanged (which is correct in relation to GDP). Also in the last paragraph, the reference to the elements behind the improvement in the current balance is misleading for the Dominican Republic, where the improvement in U.S. dollar terms reflected an increase in the balance on services and transfers offset in large part by a worsening of the trade balance.

Page 64, first full paragraph. The second sentence is incorrect, since Chart 2 shows inflation in the Dominican Republic also to have decelerated below the rate prevailing before the float. The last sentence should be balanced by adding a reference to the very tight stance of monetary and fiscal policies that was maintained during most of the year.

Page 90 (Table 1). The calculation of ratios of foreign trade to GDP depends critically on the exchange rate used, which is not identified in the table; the ratios shown here are quite different from those presented in the latest country document (EBS/86/65), which uses an implicit exchange rate of RD\$2 per U.S. dollar for 1984. Also, the definition of manufactured exports (footnote 6) seems unduly restrictive, since manufactured nontraditional exports are excluded.

Page 97 (Table 8). The figures presented for 1985 are program projections rather than the preliminary actuals. A copy of the table with corrections is attached.

Page 99 (Table 10). We cannot identify the figures given for broad money.

Attachment

cc: Mr. Pujol

tbfer8tbl

Table 8. Growth Performance in Countries With Floating Exchange Rates and Fund Programs

(Percentage change, in volume terms)

	1981	1982	1983	1984	1985
GNP/GDP					
Dominican Republic	3.9	1.7	4.0	0.5	2.0 → 1.2
Jamaica 1/	2.4	0.5	1.1	-0.2	-3.8
Philippines	3.4	2.7	1.3	-5.3	-4.0
Uganda 1/	6.0	8.0	6.0	5.0	0.6
Uruguay	1.9	-9.7	-5.8	-2.4	0.6
Zaire	2.8	-2.2	1.2	2.8	2.5
Developing countries	2.2	1.6	1.3	4.1	3.1
Merchandise exports					
Dominican Republic	10.9	-25.7	-1.4	5.7 6.3	0.3 -11.0
Jamaica 1/	-11.4	-14.8	5.8	-0.7	-8.0
Philippines	1.1	5.6	-5.0	-2.3	-7.0
Uganda 1/	52.0	15.0	-12.0	-10.0	-10.0
Uruguay	15.1	-5.0	8.9	-11.1	0.9
Zaire	-14.6	10.9	8.8	0.7	-0.2
Developing countries	-5.7	-8.2	2.9	7.1	0.4
Merchandise imports					
Dominican Republic	-10.0 8	-14.6 7	2.2	-7.0 7	9.0 1.4
Jamaica 1/	18.3	-9.1	-15.8	-0.3	-12.2
Philippines	-8.0	14.1	-4.0	-28.6	-12.0
Uganda 1/	-3.0	12.0	-4.0	8.0	-12.0
Uruguay	-12.0	-32.0	-23.8	-3.9	-5.0
Zaire	-9.6	-12.2	-7.6	-0.4	4.2
Developing countries	7.1	-4.2	-3.2	2.2	-0.3

Sources: IMF, World Economic Outlook, February 1986; Executive Board Documents; and staff estimates.

1/ Fiscal years.



Office Memorandum

INTERNATIONAL MONETARY FUND
ATMOSPHERE DEPT.
1986 MAY -5 AM 9:40

Mr. Wisner

(10)
5/16
20
F✓

To: Mr. Finch

May, 2, 1986

From: A. S. Shaalan *AS*

Subject: Experience of Developing Countries with
Floating Exchange Rate Systems

In general, the paper provides an interesting and informative review of the experience of the relatively few developing countries that have adopted floating exchange rate regimes in the past few years. The descriptive material, especially that relating to the institutional arrangements for the implementation of a floating exchange rate is very useful. We have the following specific comments.

1. The actual exchange market practices described in the paper are much different from the expectations engendered by the first sentence which speaks of "market determined floating exchange rates." In fact, all the case studies covered in the paper involve varying degrees of central bank intervention in the exchange market's operations, whether it be an interbank or an auction market, and the reasons for this are amply demonstrated in the paper itself (e.g., Table 1). Accordingly, it would seem appropriate to qualify the concept of "market-determined" exchange rates.

2. The reasons for floating, outlined in Section I.1. give the somewhat misleading impression that different countries arrived at the same policy conclusion on the basis of independent evaluations of various exchange rate options. On page 39, however, one is reminded that in nearly all cases, the Fund's influence was an important, if not overriding, consideration. It would, perhaps give a clearer picture of the circumstances in which floating exchange rates were adopted by the countries under review if these two elements were linked.

3. Since it is not immediately apparent why the U.S. dollar is used as the basis for comparing pre- and post-float variability (Section III.1.a), it would be helpful to specify that the sample countries' currencies were initially pegged to the U.S. dollar.

4. The assertion (p. 42) that "when market participants perceive that the exchange rate is realistic, positive developments in the capital account may be anticipated," should be further qualified. Since most of the countries covered in the paper suffered political instability and economic mismanagement over a long period, the move to a realistic exchange rate would surely not by itself be sufficient to rebuild confidence and change expectations overnight.

5. Some of us were uneasy with the section dealing with macroeconomic performance, feeling that despite the qualifications, one was left with the impression that too much credit was being given to

floating exchange rates and not enough weight to other policies, including fiscal and monetary restraint. Given a determination to follow restrained fiscal and monetary policies, it could be shown that managed exchange rates are equally effective. Thus, the point, made a little awkwardly on page 69, that could be stressed more forcefully is that for exchange rate policy (managed or floating) to be effective, it must be supported by other policies that promote economic growth and stability.

6. The assertion (p. 69) that "flexible exchange rate arrangements ... may be the only realistic option for members with severe balance of payments difficulties ..." should be qualified. As it is now expressed, it is open to challenge on theoretical grounds as well as on practical grounds by those who claim it is unrealistic to expect a developing country to float its currency.

7. The characterization of the Lebanese pound as floating for more than three decades (p. 1) is of dubious validity. In fact, the exchange rate of the Lebanese pound was quite stable during the 1950s and early 1960s before large inflows of remittances and capital from neighboring countries forced the authorities' to allow the currency to appreciate gradually. It is only in the last decade following the start of the civil war that the authorities have allowed the value of the currency to decline. We would suggest that the reference be rephrased to indicate that the Lebanese pound has been floating for "several years."

8. The tables accompanying the paper require a few small corrections:

a. Table 1 (p. 11)--with regard to forward exchange market developments, Lebanese banks already offer such facilities.

b. Table 3 (p. 40)--since Lebanon has never had a program with the Fund, it is suggested that the relevant indications in the table be changed from "No" to "Not Applicable."

c. Chart 1 (p. 81)--we are not aware of the existence of any parallel rates in Lebanon as indicated in the chart.

cc: Heads of Departments (AFR, ASD, CBD, EUR, LEG, RES, WHD)
Mr. Quirk

Files



Office Memorandum

TO: Mr. Quirk

DATE: May 2, 1986

FROM: F. van Beek *FvB*

SUBJECT: Experience of Developing Countries with Floating Exchange Rate Systems

In order to help expedite the task of finalizing this draft paper, I am sending you the country-specific comments for Bolivia, the Dominican Republic, and Uruguay (Jamaica is still pending), in advance of some general comments we are preparing.

In the case of Bolivia, I would draw your attention especially to the continued existence of the parallel market, which makes it inappropriate to speak of a "unified float" (page 5) and "absorption of the parallel market" (pages 57-58). In this connection, it might help to define precisely the concept of a unified float. Please note also that the Pacific Division has raised a question about the reference to Chile (page 1) as an early example (since the floating rate arrangement in 1982 lasted less than two months), and about some of the figures shown for Chile and Peru in Table 10 (pages 99-100).

In the case of Uruguay, we have great difficulty with the paragraph on page 65 discussing the inflation experience. We suggest that it be dropped, or else redrafted along the lines that may be found in recent staff reports.

Attachments



Office Memorandum

TO: Mr. van Beek

FROM: Desmond Lachman *DL*

SUBJECT: Experience of Developing Countries
with Floating Exchange Rates

DATE: May 1, 1986

The following are the comments I have on the above mentioned paper insofar as it relates to Uruguay. I would draw special attention to the comment about the reference to Uruguay on page 65.

1. On page 5 it is suggested that Uruguay had a dual exchange market prior to the floating of its exchange rate in November 1982. This is rather misleading as the two exchange markets were unified de facto in October 1978.

2. On page 6 Uruguay should be included among those countries which adopted a floating rate because of acute balance of payments difficulties and in particular because of massive capital flight. Accordingly, I would also suggest the suppression of the discussion at the top of page 7.

3. On page 32 in discussing problems emanating from wild seasonal fluctuations in tourist receipts, the case of Uruguay might also be mentioned.

4. On page 38 (Table 2) and on page 39 it is not correct that the establishment of a unified floating exchange system was a performance criterion under an existing program. Under the 1985 program with Uruguay, the authorities are committed to not intervening in the exchange market and there is an international reserve test. This, however, is not equivalent to having the floating of the exchange rate as a performance criterion, since there is nothing stopping the authorities from accumulating additional international reserves in the event of upward pressure on the rate.

5. At the bottom of page 39 one cannot really describe Uruguay's move to a floating system as gradual given the abrupt move in November 1982 from a preannounced schedule of depreciation to a floating rate and the subsequent 40 percent decline in the value of the currency within a few weeks.

6. On page 41 I am not sure what this sentence is saying in the Uruguayan context.

7. On page 59. The exception of Uruguay from the category of countries having serious balance of payments problems prior to floating is not accurate.

8. On page 65. The discussion of Uruguay as "an example of a country in which it has not been possible to prevent a continuous acceleration in prices" is inaccurate and gratuitous. I would suggest that it be dropped.



Office Memorandum

TO: Mr. van Beek

DATE: May 2, 1986

FROM: J. Gonzalez *JG*

SUBJECT: Experience of Developing Countries with Floating Exchange Rates

The following are comments on the above-mentioned draft paper insofar as it relates to the Dominican Republic:

Page 5, lines 6-8. The initial par value of the Dominican peso was established at 1:1 to the U.S. dollar in February 1948 (37 years before floating), and the 1:1 parity had been in effect for many years prior to that date.

Page 17, lines 5-7. Remittances from nonresidents are also exempt from surrender in the Dominican Republic. It is more correct to say that only traditional exports of goods and services subject to the exchange surcharge (sugar, cocoa, coffee, tobacco, and most services other than tourism) are subject to surrender requirements.

Page 40 (Table 3). The first part of footnote 1 is confusing, and if I understand its meaning correctly, it does not apply to the Dominican Republic where an illegal parallel market never existed in recent history (except for a very brief period in late 1983-early 1984). The parallel market in the Dominican Republic, while never fully authorized until late 1982, has always been tolerated.

Pages 51-52. The paragraph starting at the bottom of page 51 lacks in precision because it does not specify at the start that the behavior of the newly floating rate is measured against the pre-existing official rate. The statement in lines 2-5 on page 52 is incorrect, since Chart 1 shows that the nominal effective exchange rate of the Dominican peso has appreciated on balance from the introduction of floating till December 1985.

Page 58, lines 9-12. As noted before, there was no black market in existence in the Dominican Republic prior to the introduction of the float.

Page 62. The reader is left confused because without explanation the last paragraph speaks of an improvement in the current balance of payments in the Dominican Republic in 1985 (which is correct in terms of U.S. dollar amounts), while the preceding paragraph says the balance was unchanged (which is correct in relation to GDP). Also in the last paragraph, the reference to the elements behind the improvement in the current balance is misleading for the Dominican Republic, where the improvement in U.S. dollar terms reflected an increase in the balance on services and transfers offset in large part by a worsening of the trade balance.

Page 64, first full paragraph. The second sentence is incorrect, since Chart 2 shows inflation in the Dominican Republic also to have decelerated below the rate prevailing before the float. The last sentence should be balanced by adding a reference to the very tight stance of monetary and fiscal policies that was maintained during most of the year.

Page 90 (Table 1). The calculation of ratios of foreign trade to GDP depends critically on the exchange rate used, which is not identified in the table; the ratios shown here are quite different from those presented in the latest country document (EBS/86/65), which uses an implicit exchange rate of RD\$2 per U.S. dollar for 1984. Also, the definition of manufactured exports (footnote 6) seems unduly restrictive, since manufactured nontraditional exports are excluded.

Page 97 (Table 8). The figures presented for 1985 are program projections rather than the preliminary actuals. A copy of the table with corrections is attached.

Page 99 (Table 10). We cannot identify the figures given for broad money.

Attachment

cc: Mr. Pujol

tbfer8tbl

Table 8. Growth Performance in Countries With Floating Exchange Rates and Fund Programs

(Percentage change, in volume terms)

	1981	1982	1983	1984	1985
GNP/GDP					
<u>Dominican Republic</u>	3.9	1.7	4.0	0.5	2.0 → 1.2
<u>Jamaica 1/</u>	2.4	0.5	1.1	-0.2	-3.8
<u>Philippines</u>	3.4	2.7	1.3	-5.3	-4.0
<u>Uganda 1/</u>	6.0	8.0	6.0	5.0	0.6
<u>Uruguay</u>	1.9	-9.7	-5.8	-2.4	0.6
<u>Zaire</u>	2.8	-2.2	1.2	2.8	2.5
Developing countries	2.2	1.6	1.3	4.1	3.1
Merchandise exports					
<u>Dominican Republic</u>	10.9	-25.7	-1.4	5.7 6.3	0.3 -11.0
<u>Jamaica 1/</u>	-11.4	-14.8	5.8	-0.7	-8.0
<u>Philippines</u>	1.1	5.6	-5.0	-2.3	-7.0
<u>Uganda 1/</u>	52.0	15.0	-12.0	-10.0	-10.0
<u>Uruguay</u>	15.1	-5.0	8.9	-11.1	0.9
<u>Zaire</u>	-14.6	10.9	8.8	0.7	-0.2
Developing countries	-5.7	-8.2	2.9	7.1	0.4
Merchandise imports					
<u>Dominican Republic</u>	-10.0 ⁸	-14.6 ⁷	2.2	-7.0 ⁷	9.0 1.4
<u>Jamaica 1/</u>	18.3	-9.1	-15.8	-0.3	-12.2
<u>Philippines</u>	-8.0	14.1	-4.0	-28.6	-12.0
<u>Uganda 1/</u>	-3.0	12.0	-4.0	8.0	-12.0
<u>Uruguay</u>	-12.0	-32.0	-23.8	-3.9	-5.0
<u>Zaire</u>	-9.6	-12.2	-7.6	-0.4	4.2
Developing countries	7.1	-4.2	-3.2	2.2	-0.3

Sources: IMF, World Economic Outlook, February 1986; Executive Board Documents; and staff estimates.

1/ Fiscal years.

4/28/86

INTERNATIONAL MONETARY FUND

Recent Experience of Developing Countries
with Floating Exchange Rate Systems

Prepared by the Exchange and Trade Relations Department
(In consultation with other departments)

Approved by C. David Finch

April , 1986

Introduction

In recent years, an increasing number of developing countries have adopted market-determined floating exchange rates. This development has represented a significant step forward in the evolution toward exchange rate flexibility that has taken place in the developing country group since the adoption of generalized floating by industrial countries in 1973. Before 1983 there had been only isolated instances of floating by developing countries in the context of the post-Bretton Woods regime. Lebanon has had such a floating exchange rate for more than three decades. Other experiences with market-determined floating rates were quite shortlived, lasting for less than one year (Mexico--1976/77, Argentina--1978, Costa Rica--1981, and Chile--1982).

Discussion of the scope for floating exchange rates in developing countries has been characterized by concerns that in most of these countries exchange markets are thin and financial markets in general are underdeveloped, increasing the potential volatility of market-determined rates and the cost of hedging against it. In the literature, the use of

Leil
work including
Chile?
Aug 5 - Sep 1, 25
1982

?

flexible management of reserves rather than exchange rate flexibility and the adverse consequences of floating systems for domestic price stability, have often been emphasized, and the discussion has questioned the developing countries' capacity to operate market-determined exchange rates. 1/ Despite this, within the past four years countries with fairly diverse economic and financial structures have adopted market-determined exchange rate systems. The first step toward the more widespread use of floating exchange rate systems by developing countries was the introduction by Uganda in mid-1982 of a secondary auction market for foreign exchange. Uruguay adopted a unified floating rate in late 1982. This was followed in close order by Jamaica, Uganda, and Zaire in the first half of 1984 (in each case involving unification of an existing official market and a free market introduced in the context of a Fund program). The Philippines adopted an interbank exchange market in October 1984, and was followed by Bolivia and the Dominican Republic in 1985. In January 1986 both The Gambia and Zambia adopted unified floating markets, and Guinea put in place arrangements for transition to a float.

General aspects of exchange rate policies in developing countries were reviewed by the Executive Board in 1982. 2/ Developments in exchange rate arrangements on the basis of the Fund's classification

1/ For recent surveys of the literature on exchange rate regimes in developing countries, see Peter Wickham, "The Choice of Exchange Rate Regime in Developing Countries," Staff Papers, June 1985, and John Williamson, "A Survey of the Literature on the Optimal Peg," Journal of Development Economics, 11 (1982), pp. 39-61.

2/ "Exchange Rate Policies in Developing Countries," (SM/82/8, 1/11/82).

MS!
Bolivia does not have an interbank market. This gives the wrong impression.

The nine developing countries which had adopted independently floating systems ^{1/} had previously implemented a broad spectrum of arrangements. Bolivia changed from a managed float in which the exchange rate against the intervention currency was changed frequently in an attempt to counteract the effects on competitiveness of rapid domestic inflation. In the Dominican Republic on the other hand, there had been a one-to-one parity with the U.S. dollar for over twenty years. The Gambia changed from an exchange rate that was fixed against the pound sterling, while the Philippines changed from a system of managed flexibility vis-à-vis the U.S. dollar that involved small but frequent changes, and Uruguay had an exchange rate involving preannounced changes in terms of the U.S. dollar. Zambia had previously fixed its exchange rate in terms of a composite currency basket.

Several of the countries with an independently floating exchange rate had previously maintained arrangements involving a fixed or managed exchange rate for some transactions combined with a free floating market for other transactions, before moving to a unified float (Bolivia, Dominican Republic, Guinea, Jamaica, South Africa, Uganda, Uruguay, and Zaire). In three of these countries, the multiple exchange rates were maintained for a short period of time as a transitional device before unification. During the transition period foreign exchange transactions

^{1/} The determination of countries as "independently floating" is based on the limited extent of the authorities' intervention in the exchange market (see SM/82/440). In contrast, 20 percent have managed floating arrangements, including those using specific indicators to guide their exchange rate policies, 39 percent maintain pegs or have shown limited flexibility in terms of single currencies (quasi-pegs), and the remaining 33 percent peg to the SDR or some other currency basket (Appendix Table 2).

*no; B. was
the extreme
case of
exchange rate
flexibility. It
was
classified
as a
US\$
pegger.*

*A definite
is necessary
to say
that float
exchange rates
are still
+ the balance
system.
What is
unified
float?*

Uruguay, which has been one of the few Latin American countries to avoid external payments arrears in recent years, adopted a market-determined rate in 1982 following adverse experience with other relatively flexible arrangements. Prior to 1978, there had been a dual exchange market in which the secondary market was freely operating. After unification in 1978, Uruguay for several years undertook a program of pre-announced exchange rate changes, but this system caused considerable instability of the capital account.

In all other cases, the choice of floating exchange rates, all in the context of Fund programs except for Bolivia, has been made by countries with protracted balance of payments problems, including arrears, that had previously been addressed by extensive controls on foreign exchange transactions instead of exchange rate adjustments, which in turn had led to disintermediation in official exchange systems. In such circumstances, it was difficult to predict the equilibrium market rate, although the parallel market rate provided some indication. This uncertainty regarding appropriate levels for pegging or managing exchange rates has been an important reason for the adoption of floating arrangements. Also in these circumstances, it has been difficult, given the lack of official foreign exchange resources, to support a pegged rate which has come under market pressure, apart from through the accumulation of arrears. This is another reason why floating has often seemed the only feasible option.

*Bolivia did
it in
order to
qualify
for a
Fund
program*

The desire to bring into the official sector a large illegal parallel market in which the exchange rate was substantially depreciated, coupled with capital flight associated with that market,

was a major reason for adoption of the unified floating arrangements
 (Bolivia, Jamaica, Uganda, Zaïre, and Zambia). The initial depreciation
 when floating began and subsequent movements to continuously maintain
 realism of the exchange rate ^{are} as a major factor in encouraging market
 participants to repatriate earnings. This was so particularly where the
 introduction of the floating market was accompanied by liberalization of
 exchange controls, permitting repatriated earnings either to be used for
 import needs or to be moved freely abroad.

*the one is Bolivia
 not a unified
 (although it is
 not clear
 to me
 what it
 means
 precisely
 by
 unified)*

Another important reason in several instances was the desire on the
 part of the authorities to shed political responsibility for the
 adjustment of the exchange rate. Discrete adjustments to a managed or
 fixed exchange rate usually involved unpopular political connotations.
 With the rate determined in an open market, the authorities were better
 able to deflect political criticism and to focus their attention on
 other areas of economic management.



2. Choice of floating market arrangements

Experience with different forms of free exchange markets is as yet
 relatively limited, being for the most part of recent origin. The
 authorities must nevertheless choose the institutional arrangements that
 are best suited to their economic structure and financial institutions
 An important concern in designing a market arrangement and in deciding
 on the role that the authorities themselves will play in instituting the
 market and monitoring its performance, is to prevent the emergence of
 destabilizing monopolistic or collusive behavior.

Table 1. Summary Characteristics of Independently Floating Unitary Exchange Rate Arrangements in Developing Countries

Number of Commercial Banks in Market	Form of Arrangement	Regulation of Commercial Banks' Position	Rate Determination	Role of Central Bank Intervention	Foreign Exchange Surrender Requirements	Forward Exchange Market: Development and Plans	
<u>Bolivia</u>	19	Auction (daily) ✓	Spot position, daily ✓	Successful bidders pay their bid prices ("Dutch" auction) ✓	Possible by adjusting the amount of foreign exchange supplied to auction, within the constraint of reserves, arrears, and external debt obligations.	100 percent of goods and services to the Central Bank ✓	No plans to implement in the near future ✓
The Gambia	4	Interbank	...	Negotiable between banks and their clients	No intervention to influence the exchange rate <i>setting of base price</i>	110 percent of goods and services to commercial banks receipts of Marketing Board to the Central Bank	No plans to implement in the near future
<u>Dominican Republic</u>	16	Interbank	Spot position, daily	Negotiable between banks and their clients	No intervention to influence the exchange rate	All the export proceeds to the Central Bank through commercial banks, with exceptions of some export proceeds of mining companies and tourism	No plans to implement in the near future

An important question in setting up a market to ensure its competitive operation is the degree of freedom of access. In several countries transactions are limited to certain groups. In Zaïre, foreign exchange dealing licenses are granted only to commercial banks and hotels. There is no specific information on the network of informal foreign exchange dealers, but it is thought to be small and scattered. In the Dominican Republic the foreign exchange market is a very broad one owing to the openness of the economy and the prior existence of a secondary market in which some 16 commercial banks and more than 90 foreign exchange houses participated. At the other end of the spectrum is the market in The Gambia, in which only 4 commercial banks participate, and nonbank foreign exchange dealers are not licensed. Generally speaking, the easier are entry requirements into the market the more competitive and stable it will be.

b. Auction markets

The role of the authorities in an auction system (as conducted by Bolivia, Guinea, Jamaica, and Uganda) is a more central one than in an interbank market. Receipts from specified exports and services are surrendered to the central bank at the prevailing exchange rate and are auctioned by the authorities on a regular basis. The central bank decides the amount of exchange to be auctioned, and the minimum reserve price below which it will not accept bids. The minimum amount of the sales may be predetermined as part of a macroeconomic program. The central bank may decide to auction foreign exchange in minimum amounts of, say, US\$5,000, allowing banks to bid on behalf of their customers. All bidders with a valid import license (where licensing requirements

*In Bolivia,
only minimal
export receipts
need to be
submitted*

*yes, but price
people can
participate*

are retained) are required to lodge an advance deposit, either partial or equivalent to 100 percent of the foreign exchange they intend to purchase, before the submission of bids. The bids submitted to the auction are then examined and all bids in excess of the highest bid which fully exhausts the available supply of foreign exchange (i.e., the market-clearing price) are accepted. The market-clearing marginal rate becomes the market exchange rate. After the auction, the market exchange rate, the total number of bids received, and the number of successful bidders are announced. The auction-determined exchange rate applies until the next auction date to all exchange transactions, including surrenders for the next auction and any transactions that may not be required to be channeled through the auction market (e.g. transactions of the government). Advance deposits lodged by unsuccessful or partly successful bidders are returned in whole or in part, respectively, but bids are normally not permitted to be withdrawn. If a successful bidder fails to make full payment for his foreign exchange within a specified period, he may be subject to a fine that may be collected from the deposit he has lodged. Spreads between buying and selling rates of individual commercial banks and any limits on commercial bank foreign exchange positions are closely monitored by the central bank to ensure that collusive practices are not involved, and that they reflect reasonable profit margins.

BOLIVIA
no, away

Perhaps the basic difference between interbank and auction system arrangements is in the treatment of the supply of foreign exchange to the market. An essential feature of an auction market arrangement is that it requires the surrender of foreign exchange to a centralized

point, which to date has been the central bank of the country organizing the market. In contrast, in an interbank arrangement, the ownership of foreign exchange may remain diffused in the private sector. In some auction arrangements (as with the interbank arrangements described above) the surrender requirement is less than complete, and retention allowances have been kept for certain export or other foreign exchange earners. Similarly, the supply by the central bank of foreign exchange it has collected may be less than complete, as the central bank retains a certain portion of foreign exchange from the market for the use of government.

✓ Bolivia

✓ Bolivia

In Bolivia, Jamaica and Uganda, all the export proceeds of goods and services are required to be surrendered to the central bank. In Guinea, however, there are minor exceptions for exports of specified goods and services. In these four countries, all sellers of foreign exchange to the central bank are entitled to receive local currency at the auction market exchange rate for all foreign exchange surrendered. In Bolivia, in order to stimulate surrender, those surrendering foreign exchange may also obtain an exchange reimbursement certificate in an amount equivalent to 10 percent of the foreign exchange surrendered. In Zambia, the authorities have accepted on a transitional basis retention privileges for the mining company and exporters of nontraditional products, reflecting concerns about the availability of foreign exchange. For example, in the latter case, about 50 percent of total export proceeds are estimated to be retained by exporters. However, the Zambian authorities also introduced a policy whereby the source of foreign exchange earnings is no longer subject to declaration, in order to encourage capital inflows into the system.

NO

NO, was abolished in file 1985.

Jamaican dollar would depreciate sharply against foreign currencies, and that these speculators should pay the full cost of their bid. In practice, however, participants in the Jamaican auction have been able to obtain sufficient information regarding each other's bids for the spread between buying and selling rates to remain very narrow.

Similarly, in Bolivia, following a settling down period of a month or so after introduction of the Dutch auction, the successful bids to the auction also converged within a narrow (less than 2 percent) range.

A possible difficulty with the Dutch auction system is that it may inhibit entry to the market by participants who fear having to pay a price significantly higher than the clearing price for exchange if their bid is successful. The risk would be increased if significant spreads actually do emerge between successful bids. For example, an importer could be left with overpriced goods on his hands relative to those held by others bidding in the market. However, the experience of the Jamaican and Bolivian Dutch auction systems to date has been that the spreads in the market have been very small. A more basic criticism of the Dutch auction system is that it involves price discrimination, while the marginal approach to auction pricing is the best approximation to normal private markets, in which the consumer surplus is not appropriated by government.

The Dutch auction approach also raises questions as to which exchange rate will be relevant to extra-auction market transactions (e.g. government transactions). In Bolivia, the exchange rate struck and announced for this purpose is the weighted average of successful

Since the parallel market moved on a par with

2) bids 1/ ~~and of unsold amounts valued at the central bank's minimum price,~~ while in the case of Jamaica it is the lowest price at which exchange was bought and sold in the auction--that is, the marginal price. 2)3) Another aspect of the Dutch auction system is that, to the extent that it gives rise to exchange rate spreads of more than 2 percent between the buying and selling rates as a result of official action, a multiple currency practice arises. In the cases of Bolivia and Jamaica, the Fund approved the resulting multiple currency practice on a temporary basis.

1/0

No, I'd get approved, proposed under stand-by arrangement

Another consideration in the setting of exchange rates is the use of a reserve price for foreign exchange, i.e., the most appreciated exchange rate at which the central bank will undertake to supply exchange. In general, a reserve price should not be necessary, as countries with these systems have generally been in a situation of overall excess demand for foreign exchange. However, in some cases where the market is subject to sporadic supply, including strong seasonality, or where the arrangements have not been in place sufficiently long to ensure adequate knowledge of the system among participants, a reserve price may serve a stabilizing function.

in their favor in manually their exchange market.

1/ It has sometimes been suggested that this approach could also be used to determine the single "market rate," but it would present a problem for those successful bidders who bid below the average price.

2)2) The use of a marginal auction approach for a secondary dual market may also make transition to a unified freely floating market easier to achieve than unification of Dutch auction systems, because of the multiplicity of exchange rates under the latter.

2) Initially, the official exchange rate was calculated by including also the unsold balances valued at the central bank's minimum price. The reason for this practice was the central bank's concern that exporters might manipulate the exchange rate.

reasonable assurance that balance of payments financing will be forthcoming. The positive effect on capital account of the floating arrangement itself, as examined in Section III below, may be expected to assist in stabilizing the exchange market.

For example, in the period preceding the establishment of an auction market in Bolivia, the authorities were concerned that, because of the thriving unofficial market, the supply of foreign exchange to the auction would be limited. They saw this problem as being exacerbated by the lack of an effective institutional apparatus to ensure that export proceeds flowed through the official channels. The authorities

? unclear

therefore considered using official reserves and borrowing from official sources abroad to make the foreign exchange market in the initial stages. In the event, this proved unnecessary. The demand for foreign currency in the official market fell initially below supply, reflecting in part the high reserve price, as well as the relatively low demand

because the change in exchange arrangement was a cover provided by a comprehensive stabilization package. On the contrary,

~~because of a lack of experience with the market mechanism. As a result,~~

the authorities built up official foreign exchange reserves in the

startup period. *As residents reduced their holdings of U.S. dollars and their stocks of imports held for precautionary and speculative reasons.*

Beyond the start-up period for the floating market, foreign exchange cash flow management to accommodate seasonal or other identifiable reversible factors also plays an important role, given the generally low level of international reserves in this group of countries. A problem that is foreseen in the market recently established in The Gambia is the potential instability of both the volume of transactions and the exchange rate. Tourist receipts fluctuate widely from season to season, and exports of groundnuts also

rate policy implementation was involved in 30 percent of the provisions for flexibility--of which 13 percentage points represented provisions for the transfer of transactions to the free parallel exchange market, and the remaining 17 percentage points were program provisions for the adoption and maintenance of independently floating arrangements.

Of the 13 countries that have operated a unified floating exchange rate regime in the period January 1983 to February 1986, the establishment of a unified floating exchange rate was a precondition for a Fund program in eight (Bolivia, the Dominican Republic, The Gambia, Guinea, Jamaica, the Philippines, Zaïre, and Zambia), and it was a performance criterion under an existing program in three (Guinea, Uganda, and Uruguay) (Table 3). In all these applications, the Fund staff played a role in providing assistance at the level of broad macroeconomic policies, and at a technical level, in formulating and adapting the systems to take account of the individual characteristics of the member's economic and financial structure.

M.D. SBA has
not been
approved
yet.



In some instances the floating market was introduced gradually, by the institution of a secondary market for certain transactions in which the rate was freely determined, which was followed by a transfer of transactions to that market, and finally, by unification. This gradualist approach to adoption of a floating rate system was taken in the Dominican Republic, Guinea, Jamaica, South Africa, Uganda, and Uruguay. In the case of the Guinean, Jamaican, and Ugandan arrangements, the dual market was instituted in the context of the Fund program, with a performance criterion for early unification in accordance with Fund policies discussed by the Executive Board in 1983

tbfer3tbl

Table 3. Provisions in Fund Programs for Introduction and Maintenance of Independently Floating Arrangements, January 1983-February 1986

not clear
to me

Date of Program	Date of Adoption of Unified Float	Treatment of Exchange Rate Policies in Program			Previous Use of Official Multiple Rate System (Introduced Under Program or as Precondition) ^{1/}	Length of Time Multiple Rates Maintained	
		Precondition	Performance Criterion	Objective			
Bolivia	August, 1985	Yes ⁶⁾	Yes ⁶⁾	No ⁶⁾	Yes (no) ✓	8 months	
Dominican Republic	April 1985	Yes	No	No	Yes (No)	More than 2 years	
The Gambia	January, 1986	Yes	—	—	No	—	
Guinea	February 1986	(Not unified at present; planned for April 1986)	Yes	Yes ^{5/}	Yes	Yes (No)	More than 2 years
Jamaica	June 1984	March, 1984	Yes	No	No	Yes (Yes)	10 months
Lebanon	—	1952	No	No	No	No	—
Philippines	December 1984	October, 1984	Yes	No	No	No	—
South Africa	—	July, 1984	No	No	No	Yes (No)	More than 2 years
Uganda	September 1983	June, 1984	No	Yes ^{5/}	Yes	Yes (Yes)	22 months
Uruguay	April 1983	Nov. 1982	No	No	No	Yes (No)	More than 2 years
Zaire	December 1983	January, 1984	Yes	Yes ^{2/ 5/}	No	Yes (Yes) ^{3/}	4 months
Zambia	July 1984 ^{4/}	October, 1985	No	No	No	No ^{3/}	—

^{1/} Reference is to market other than illegal parallel market which was present in all cases at the time of institution of the floating rates; in all cases it was a free secondary market that pre-existed.

^{2/} Retention allowance for certain receipts (de facto recognition of parallel market).

^{3/} Minimum volume of sales.

^{4/} Following the completion of the first program review (November 1984), the performance criterion (second program review which included understanding on exchange rate policy) was not observed and purchases were interrupted. The introduction of the floating system (in October 1985) met the performance criterion with respect to exchange rate policy, but purchases could not be resumed due to overdue obligations to the Fund. By January 6, 1986, all overdue obligations were discharged, and the negotiation for a new stand-by arrangement was resumed.

^{5/} In all three cases, the performance criterion was observed without the need for modification or waiver.

⁶⁾ Proposed program

within a framework provided by accompanying liberalization of exchange and trade controls. Although some of these currencies subsequently appreciated, following the initial correction, all on balance depreciated over the entire period from introduction of floating to December 1985, against the U.S. dollar and in nominal effective terms. However, in each of the five countries for which data are available to compare the pre-float unofficial market U.S. dollar exchange rate with the official rate in the early months of floating (Bolivia, Dominican Republic, the Philippines, Uganda and Zaïre), the domestic currency appreciated in the official market in relation to the exchange rate in the parallel market prior to the float (Chart 1).

Developments in real effective exchange rates since the initial exchange rate correction following floating have varied widely. From the month following the float to December 1985, real effective rates continued their initial depreciation in four countries, at moderate rates (less than 2 percent per month) in Jamaica, Uganda, and Zaïre, and more rapidly in Bolivia's first two months of floating. In the other three cases the real effective rate appreciated over the corresponding periods, with small average monthly rates of appreciation of 0.1 percent in the Philippines and Uruguay, and under 2 percent in the Dominican Republic. In the case of the Philippines and Uruguay these real appreciations were not sufficient to offset the initial adjustments, but in the the Dominican Republic the real effective rate has appreciated since the institution of floating.

In order to gauge the pre- and post-float developments in exchange rate variability, four measures were calculated, each being applied to

Ma
D.R.

No!
In
October
(2nd
month
there
was
an
appreciation
1/4
EBS/
80/52

onshore, are inconclusive (Appendix Table 7). The accumulation of deposits abroad appears to have been stemmed after floating in the Philippines and Uganda, but to have gathered pace in the Dominican Republic, Uruguay, and Zaire. Data on foreign currency-denominated deposits with domestic banks, which may indicate flight out of the domestic currency or reflow, although not a balance of payments item, are available only for Uruguay and Zaire. Foreign currency-denominated deposits fell in Uruguay in the floating period, and increased in Zaire.

} no
what?
what is
the reason
for offset
development?

Movements in gross official international reserves indicate that the need to intervene in the foreign exchange market did indeed diminish with floating, as would be expected. Reserves increased in all countries except Uganda, where the level remained unchanged. The data for Uganda are explained by the fact that the authorities have intervened quite heavily to support the level of the exchange rate for sustained periods. As regards the other elements of official financing "below the line," external payments arrears declined in all countries following the introduction of floating, and in two, the Philippines and Zaire, the outstanding stock of external debt also fell.

no; in Bolivia,
official debt
arrears
kept increasing

c. Absorption of black exchange markets

In those countries in which exchange and trade controls have been liberalized, the illegal parallel market has been fully absorbed. In Bolivia, although purchasers are not required to specify their reasons for obtaining foreign exchange in the auction market, a thriving unofficial parallel market was operated for a time after floating by exchange houses ~~and by some banks, as well as~~ by individuals transacting for themselves or for others as agents. There are three explanations

no; this
market
was known
to exist.

for the continued existence of the parallel market ~~at that time~~. First, bids in the official market are required to be the equivalent of US\$5,000 or a multiple thereof. Second, obtaining funds in the ² ~~commercial~~ official market may have been seen initially as a cumbersome process. Third, some dealers in illicit commodities preferred to operate totally outside the official sphere. With complete derestriction of the exchange and trade systems, however, arbitrage has since functioned to ensure the same rate in the two exchange markets. Available information also suggests that the black market was ~~also~~ absorbed by the floating arrangements in the Dominican Republic, the Philippines and Uruguay, which maintain a relatively liberal exchange and trade regimes.

X
Confidence factor

✓
in Bolivia's parallel market has not been "absorbed"

There is believed to be an illegal market in Jamaica involving a premium for foreign exchange that has fluctuated between 5 and 10 percent since the floating began. In Zaire, the spread between parallel market rates and the official exchange rate after unification and float has also narrowed considerably, to no more than 12 percent-- the peak reached in January 1984. Transactions in the parallel market are related primarily to tax evasion and smuggling.

In Uganda and Zambia, which have the least liberalized restrictive systems of the group of countries surveyed here, incentives for widespread parallel market transactions have remained considerable. Following the unification of the market in Uganda, the scope for illegal transactions narrowed considerably when the auction system was operating effectively. However, the premium in the black market generally remained about 30 percent above the auction determined exchange rate,

b. Inflation effects

The impact on the rate of inflation of floating exchange rates has depended crucially on the economic policies that have accompanied the exchange rate changes. In particular, domestic price liberalization has constituted an important policy measure supplementing the floating of exchange rates in most cases, owing to extensive price controls (e.g. on agricultural and energy products) or price distortions resulting from public sector pricing policies that were in place. In most of these countries, the freeing of the exchange rate was accompanied by complete or partial removal of price controls and adjustments of public sector prices. Although the immediate impact of price liberalization has been an increase in prices, in the longer run this impact is likely to be more than mitigated by an improvement in resource allocation resulting from correct price signals to enterprises and consumers reflecting the opportunity cost of the goods affected as well as by the stimulus to domestic production (e.g. the effect of appropriate grain pricing on agriculture).

Liberalization of price controls has taken place in Bolivia, The Gambia, Jamaica, the Philippines, South Africa, Uganda, and Zaire shortly before or after the introduction of floating exchange rates. In Bolivia and the Philippines, all remaining price controls on consumer goods were removed--these had previously affected more than 40 percent of consumer goods in Bolivia and ten important consumer items, mainly food products, in the Philippines. Prices for all consumer goods except petroleum products and public sector tariffs were liberalized in Uganda. In the Dominican Republic, The Gambia, Guinea, Jamaica, Zaire,

At the time of floating in fact price controls were not successfully enforced in Bolivia

program, it was understood that the rates would be unified within a relatively short period of time.

An important choice facing a developing country in instituting a floating exchange market is whether it should take the form of an auction or an interbank market. The experience to date has been that markets operated by the commercial banking sector have been less subject than officially operated auction markets to destabilizing intervention in the form of inappropriate official purchases and sales or ad hoc controls on access to the market. In addition, it has been possible in using interbank markets to build on the existing expertise of banks and foreign exchange dealers operating in formal or informal parallel markets. Interbank markets also function on a continuous basis while auctions are periodic by their nature and therefore less efficient as clearing mechanisms. The less frequent are the auctions (they are conducted daily in only one country) the less efficient and smooth will be the clearing process, as delays in obtaining foreign exchange will be longer, and uncertainty and risk involved in the exchange transaction will be greater the longer the interval between supply to the central bank and the actual auction itself. Interbank market arrangements have been the more common setting for freely floating exchange rates in developing countries to date; seven developing countries have adopted interbank arrangements and three auctions arrangements. In these and other instances, the Fund has assisted in formulating the systems by transferring experience among members concerning the design and implementation of specific market modalities.

p. 19
names
G. J. U...

A major consideration in setting up the floating markets has been

*Seems larger,
about 30%?*

Seems low

APPENDIX

aptblifer

Table 10. Macroeconomic Performance of Countries with Real Effective Exchange Rate Rule and Floating Exchange Rates During Fund Programs

Country	Date	Exchange rate system 1/	Real effective exchange rate 2/	Consumer prices; percentage change 3/		Current account in percent of GNP/GDP 4/		Fiscal balance in percent of GNP/GDP 5/		Broad money percentage change 6/		Exchange and Trade Restrictions
				Before 12 month	After 12 month	Year before	Program year	Year before	Program year	Year before	Program year	
Argentina	10/83	Flexible	19.0	288.2	554.7	-4.0	-3.6	-18.6	-11.2	354.6	526.8	U
Argentina	12/84	Flexible	-9.8	608.0	735.0	-3.6	-1.9	-11.2	-4.2	526.8	429.0	Lib
Bangladesh	12/85	Flexible	...	10.5	...	-8.3	-6.9	-8.3	-7.4	25.6	15.9	Lib
Brazil	2/83	Flexible	-20.5	96.5	163.9	-6.5	-2.9	-15.8	-18.5	113.5	149.3	Lib
Chile	1/83	Flexible	-18.1	9.9	27.3	-9.5	-5.4	-3.4	-3.0	9.8	15.5	Int
Chile	7/85	Flexible	-25.8	25.3	30.7	-10.7	-8.3	-4.4	-3.1	31.4	52.1	U
Costa Rica	3/85	Flexible	-2.7	8.7	10.2	-6.4	-2.8	-1.9	-1.5	11.2	12.0	U
Dominican Republic	1/83	Flexible	-6.9	7.8	4.7	-6.4	-6.1	-6.6	-4.6	6.8	15.1	U
Dominican Republic	4/85	Floating	14.9	35.4	35.3	-4.6	-4.7	-5.2	-2.3	23.5	17.9	U
Ghana	8/84	Flexible	-23.6	87.2	8.5	-1.9	-2.9	-1.8	-2.1	39.3	31.7	Lib
Hungary	1/84	Flexible	1.4	7.3	8.4	0.2	1.3	0.8	3.4	3.8	5.2	Lib
Jamaica	6/84	Floating	-24.9	17.4	30.4	-12.7	-12.3	-15.2	-6.4	24.7	22.3	Lib
Jamaica	7/85	Floating	-14.6	29.8	23.5	-12.3	-11.5	-6.4	-4.7	22.3	18.6	Lib
Kenya	3/83	Flexible	-4.5	19.3	10.9	-2.3	-3.2	-3.1	-4.2	11.3	11.4	Lib
Kenya	1/85	Flexible	-1.5	10.2	13.3	-3.2	-4.7	-4.2	-5.1	11.4	11.7	Lib
Korea	7/83	Flexible	-4.9	4.5	2.3	-3.7	-2.2	-1.6	-1.4	15.2	10.6	Lib
Korea	7/85	Flexible	-11.9	2.3	2.8	-2.2	-1.1	-1.4	-1.5	10.6	18.2	Lib
Madagascar	12/83	Flexible	-14.3	20.7	10.0	-10.9	-10.2	-6.7	-4.8	-1.5	18.3	U
Madagascar	4/85	Flexible	-4.5	9.9	10.8	-10.2	-10.1	-4.8	-4.7	18.3	5.1	U
Malawi 8/	9/83	Flexible	1.0	11.3	11.7	-9.5	-7.8	-8.1	-5.8	10.2	-1.1	U
Mauritania	4/85	Flexible	-10.5	10.6	12.8	-24.3	-14.1	-10.9	-4.0	9.0	24.1	U
Mauritius	5/83	Flexible	-2.7	8.6	5.2	-5.2	-2.5	-9.5	-6.4	10.0	17.5	U
Mauritius	3/85	Flexible	-3.2	8.1	6.3	-2.8	-0.8	-5.5	-5.0	16.5	16.8	Lib
Morocco	9/83	Flexible	-7.5	5.1	12.5	-5.6	-9.0	-10.4	-8.4	17.4	10.3	Lib
Morocco	9/85	Flexible	-12.2	8.4	8.4	-3.2	0.3	-7.3	-5.9	16.5	11.0	U
Nepal	12/85	Flexible	...	7.0	...	-4.1	-4.5	-8.0	-6.9	17.6	22.0	Lib

Table 10 (concluded). Macroeconomic Performance of Countries with Real Effective Exchange Rate Rule and Floating Exchange Rates During Fund Programs

too high

Country	Date	Exchange rate system 1/	Real effective exchange rate 2/	Consumer prices; percentage change 3/		Current account in percent of GNP/GDP 4/		Fiscal balance in percent of GNP/GDP 5/		Broad money percentage change 6/		Exchange rate restriction
				Before 12 month	After 12 month	Year before	Program year	Year before	Program year	Year before	Program year	
Peru	4/84	Flexible	-5.3	119.6	113.9	-5.3	-2.7	-11.7	-8.1	96.9	144.7	In
Philippines	2/83	Flexible	-15.8	9.9	12.2	-8.1	-8.1	-5.3	-3.2	16.1	18.6	Li
Philippines	12/84	Floating	10.2	48.4	26.7	-4.5	-0.3	-3.0	-2.7	7.3	9.5	Li
Portugal	10/83	Flexible	-0.9	21.8	31.1	-7.2	-2.3	-15.1	-17.6	20.3	27.4	Li
Solomon Islands	6/83	Flexible	-7.8	10.4	7.4	-13.4	-13.3	-11.3	-10.8	22.6	19.4	
Sri Lanka	9/83	Flexible	7.5	6.9	19.4	-12.4	-4.3	-10.6	-6.9	21.7	16.8	
Thailand	6/85	Flexible	-13.0	0.4	3.2	-5.1	-3.8	-4.9	-6.2	20.2	10.2	
Turkey	6/83	Flexible	-4.8	27.7	35.9	-1.8	-3.8	-6.5	-8.0	69.8	37.8	Li
Turkey	4/84	Flexible	2.1	33.1	53.2	-3.8	-2.8	-8.0	-8.5	37.8	50.0	Li
Uganda	9/83	Floating	-37.0	27.2	20.2	-2.6	-1.2	-3.4	-4.0	51.0	70.0	In
Uruguay	4/83	Floating	-30.9	23.4	49.0	-8.3	-4.0	-18.4	-16.4	16.1	18.0	Li
Uruguay	9/85	Floating	-8.3	68.0	75.9	-2.5	-2.7	-9.3	-6.6	49.9	91.2	
Western Samoa	6/83	Flexible	-1.5	13.8	19.7	-17.1	-11.2	-14.6	-2.2	35.4	16.6	
Western Samoa	7/84	Flexible	-9.0	19.4	9.0	-11.2	-11.2	-2.2	-4.6	16.6	9.0	Li
Yugoslavia	4/84	Flexible	-0.2	45.8	57.1	0.5	2.0	—	—	67.5	64.5	
Yugoslavia	4/85	Flexible	-4.5	57.1	76.2	2.0	1.0	—	—	66.8	59.3	
Zaire	12/83	Floating	-62.2	70.9	60.4	-4.1	-4.5	-2.1	-0.7	74.8	34.2	Li
Zaire	4/85	Floating	-13.9	35.7	25.2	-4.5	-4.6	-0.7	1.2	34.2	27.3	
Zambia	7/84	Flexible	-7.9	20.4	25.1	-6.4	-10.2	-7.4	-7.3	11.1	18.0	In
Zimbabwe	3/83	Flexible	-9.2	16.3	20.4	-11.1	-8.4	-9.2	-10.9	25.3	0.3	

1/ The classification of the exchange rate system refers to the program period. Flexible arrangements include exchange rate systems where the real effective exchange rate is kept constant or changed and crawling peg systems.

2/ The real effective exchange rate is calculated as the change in the 12-month period beginning with the month of program approval to the 12-month period preceding the program.

3/ The rate of increase in consumer prices before is measured as the average increase in the 12 months preceding the month of program approval on a year-over-year basis while after refers to the average inflation rate in the first 12 months of the program. Where a period less than 12 months has occurred after the program, the inflation figure refers only to the relevant number of months for which data is available, with December 1985 being the last month of consumer price information for all countries.

4/ The current account balance (including official transfers) as percent of GNP/GDP refers to the calendar or fiscal year balance before and during the program year.

5/ The fiscal balance in percent of GNP/GDP comprises the broadest concept of fiscal balance for each country and refers to the calendar year before and during the program year.

6/ Average annual change in broad money in the calendar year before and after program approval. In certain countries the increase or end-of-period increase.

7/ An overall evaluation of the changes in restrictiveness of the trade and payment system during the program period.

8/ Malawi has an Extended Arrangement; the program year refers to the second program year.

U = Unchanged
Int = Intensification
Lib = Liberalization

February 24, 1986 - 86/35

Statement by Mr. Dallara on IMF Surveillance
Executive Board Meeting 86/29
February 19, 1986

Introduction

I welcome today's discussion of Fund surveillance, including, as it does on this occasion, the biennial review of the 1977 surveillance decision. This year's discussion takes on added significance, in light of the broad interest which is emerging in strengthening the international monetary system and, in particular, the exchange rate system, of which Fund surveillance is an integral part.

As I noted during our discussion last week, the current exchange rate system, although it has provided needed flexibility to deal with the economic shocks of the 1970s, has not been as stable as we would have liked, nor as stable as many might have expected in light of the convergence that has occurred toward lower rates of inflation in recent years. The fact that inflation performance has, on the whole, improved, while exchange rates have shown considerable variability, is a point to which I will return in my statement when discussing the need for a broad range of factors to be evaluated when assessing the causes of exchange rate problems.

As many Directors noted last week, exchange rates have not only been characterized by considerable short-run variability, but also at times have not fully reflected underlying fundamentals and policy commitments. Related to both of these is the fact that, under the current system, policies of member countries have not been as sound or consistent, nor performance as convergent, as would have been preferable. The extent to which this is due to inadequacies in the system is, of course, unclear. But, to the extent that there is a view that the system could have prompted, in some instances, sounder policies at an earlier stage, then we must look to how the system could have done this in the past, and could do it in the future.

This brings me to the subject of surveillance, since it is firm IMF surveillance in the current system that is to help prompt sound policies and international cooperation. It has generally been agreed that closer international economic cooperation, particularly among major countries, is a necessity for strengthening the current international monetary system. Surveillance can be an important mechanism to promote sound policies and such cooperation, perhaps by helping to strengthen the political will to follow sound policies which are consistent with national and international interests, and to prompt the need for discussion and action. Any effort to strengthen the current exchange rate system should begin, therefore, with an effort to strengthen surveillance. How this can be done, and whether and how we might need to go beyond that, are, of course, among the important questions that we need to address.

Secretary Baker, in his address to the G-10 Finance Ministers last June, reiterated the U.S. commitment to surveillance and our desire to strengthen surveillance, with the goal of promoting more sound and compatible policies among members in an environment of low inflation and growth. He noted at the time that the provisions for IMF surveillance had not been fully developed, and that he was somewhat disappointed that the G-10 Deputies had not gone further in suggesting additional measures to improve surveillance. He felt that if surveillance were to be effective, we needed to implement promptly the measures recommended in the G-10 report, and to look beyond them, as we continue our efforts to improve the capacity of the system to encourage and foster the kinds of policies that will produce greater international economic stability.

We have an opportunity today to further that effort, by examining the specific measures proposed in both the G-10 and G-24 reports to improve surveillance procedures, as well as to consider possible revisions in the Principles as part of the biennial review of surveillance.

Background

Before I discuss specific measures to improve surveillance, I would like to comment briefly on some points raised in the beginning of the document on the Biennial Review of the 1977 Surveillance Document (SM/86/3). First, I found it helpful to review the underlying premises of surveillance, and how the changing nature of the system has altered the thrust of surveillance. One basic premise of surveillance, however--in fact a basic philosophical underpinning of the amended Articles -- has not changed; that is, as the staff states on page 9, "the expectation that restoration of stability in domestic economies of member countries would be the main requirement for restoring better stability in the international exchange system more generally." This is as applicable today as when the Articles were amended in 1978.

In the evolution of surveillance -- and the evolution of thinking which has motivated surveillance -- one can see a broadening of the focus beyond "manipulation" of exchange rates, and indeed a general broadening of the notion of what constitutes exchange rate policies.

As the staff paper points out for example, the identification of certain actions such as prolonged one-way intervention, excessive borrowing, etc., originally conceived of in the context of exchange rate manipulation, became part of surveillance in a somewhat broader context as constituting developments "which might indicate the need for a discussion with a member." This list, of course, includes a range of policy areas such as, for example, the pursuit for balance of payments purposes of monetary and other domestic financial policies that provide abnormal encouragement or discouragement of capital flows.

I will return to this list later in my statement, but refer to it here to indicate how the early evolution of surveillance involved a broadening of the concept of exchange rate policies. This has, of course, been borne out increasingly in, inter alia, the Article IV consultation process with individual member countries.

I might take the opportunity to point out here that the need to take such an approach was not only reflected in the drafting of the Principles of Fund surveillance over exchange rate policies, but was foreseen by some of the analysts of the day. Two experts, writing in a May 1978 article on surveillance, stated:

Because of the real divergence in interests among countries and the many uncertainties inherent in the appraisal of exchange-rate policies -- in particular, the difficulty of assessing the appropriateness of an exchange rate for the longer term -- such surveillance cannot be based on a single objective indicator or even on any precise set of rules. Thus, in arriving at a judgment as to whether a country's exchange-rate policies constitute an unwarranted hindrance to the proper working of the international adjustment process, the Fund must make a comprehensive appraisal of these policies. These points have been taken into account in the new Article IV and in the Fund decision of April 1977.

We have the benefit of knowing that one of these authors, Andrew Crockett, has not changed his mind, since he and his colleagues tell us in the current paper on page 18 of SM/86/3 that "to be effective, surveillance must be extended to all policies having such effects" -- that is, effects on exchange rates and stability of the system.

Efforts to Improve Surveillance

Efforts to improve surveillance could take a number of forms and directions. For purposes of organization, I will discuss the ways to strengthen surveillance under four different headings:

1. Amendments to the General Principles of Surveillance;
2. Amendments to the Principles for Guidance of Member's Exchange Rate policies;
3. Amendments to the Principles of Fund Surveillance over Exchange Rate Policies;
4. Measures to strengthen surveillance procedures, including possible amendments to the Procedures for Surveillance.

These possible approaches dealing with the three sets of Principles, as well as the Procedures for Surveillance, are not, of course, mutually exclusive; it is conceivable that each, in fact, could serve in some way to increase the effectiveness of surveillance.

I. General Principles

There is no doubt that domestic policies and their international interaction do have an impact on exchange rates, other members, and the stability of the system as a whole. Therefore, surveillance should focus -- and indeed has increasingly focused -- on a broad range of policies, including domestic policies. The Fund clearly does have explicit surveillance responsibilities over domestic policies as they relate to the international system, as set forth in Article IV Section 3(a) which calls on the Fund to oversee the compliance of each member with its obligations under Section 1 of Article IV. As the staff paper points out, Article IV, Section 1, of course, outlines not just exchange rate obligations, but members' general obligations to, inter alia, ensure that they endeavor to direct economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability.

As noted above, and as we have observed in this Board on so many occasions, surveillance over domestic policies has been carried out increasingly in the context of individual Article IV consultations, and in the World Economic Outlook as well as on other occasions. The question is whether it would be necessary, helpful or appropriate to codify existing practice and to affirm more explicitly the Fund's broad surveillance responsibilities. We do not think it is absolutely essential to do this, but are inclined to believe that it may be both helpful and appropriate. Therefore, we would suggest that the staff provide us with draft language for possible revisions of the General Principles in this direction, perhaps for our consideration when we return to this issue after the spring Interim Committee meeting, if this were consistent with Interim Committee guidance.

II. Principles for Guidance of Members' Exchange Rate Policies

The weaknesses in the current system imply that, as the staff states on page 15, "the current principles for the guidance of members' exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability". This points to the possible need for the Fund to provide more specific guidance to members with respect to their exchange rate and related economic policies.

We would agree with the premise taken in the staff paper that any amendments to the Principles for Guidance of Members' Exchange Rate Policies should focus on the first Principle, section A, and not Principles B or C. Principle A currently reads

that "a member shall avoid manipulating exchange rates for the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

The staff paper presents three approaches (on page 18) which go in the direction of amending these Principles for the Guidance of Members' Exchange Rate Policies with the goal of providing more specific guidance. The first approach involves the establishment of target zones. This was discussed at some length during our recent Board meeting on the exchange rate system. It clearly raises a number of fundamental issues which would have to be addressed before the concept of target zones could be incorporated into surveillance principles. Since I believe those issues are perhaps more appropriately considered in discussions focussing more directly on the exchange rate system, I will not comment further in detail on them today, but rather at the time of our next discussion of these issues. I would, however, make one point in this regard that might help focus the issue, as I believe it is relevant for today's discussion. Regardless of whether one supports the concept of target zones as many did last week, or perhaps the notion of target directions, as Mr. de Groote outlined, or whether one can support neither, there is broad recognition, including by my authorities, that the exchange rate can be a useful variable as an indicator, or barometer, of policies and performance in two or more countries. Whether it is the best or only indicator, however, is another question.

This question is addressed in part by the staff's second proposal -- which would involve the establishment of limits on certain domestic policy variables. I could not endorse the precise formulation of the staff, but I do believe that the general direction of thinking embodied in this approach may have some merit -- that is, a focus on underlying policies, and I would add performance. This could help focus attention on the main problems which underly divergences of economic performance and exchange rate problems. Such an approach is, of course, consistent with -- although not necessarily linked to -- the thought outlined earlier of developing general principles for members' economic policies, not just exchange rate policies. It is also consistent with the G-10 Report which called for more explicit analysis of domestic policies so that inter-dependencies and mutual repercussions could be fully brought out and taken into account.

There are many questions that would need to be addressed in considering the practical possibilities of such an approach, such as: (1) how to incorporate structural policies or developments into this approach; (2) what would be the appropriate degree of quantification; (3) what would be the appropriate setting for discussions (e.g., bilateral or multilateral); (4) would any quantification represent general goals or, as the staff paper suggests, "limits" on the development of certain variables, a

notion which I suggest may be too precise in this context; and (5) should any variables focus on policy outcomes or policy instruments? These are only a number of the questions that arise.

Staff suggests that focusing on instruments, such as the stance of domestic fiscal or monetary policy, would be preferable. I am not so sure. I wonder if the staff might not wish to do further work on this question with less emphasis on "targets" or "limits" per se, and with some attention to the identification of the range of policy areas, as well as perhaps some consideration to the feasibility and/or desirability of using notional ranges for final economic outcomes or objectives, in such areas as growth, inflation, employment, and -- extending into the external sector -- current account positions. In this approach, a basis for considering the need for discussions could be a substantial deviation from the notional range of a particular outcome in one of these areas. In considering how to approach any additional work along these lines, I would stress the need for economic and political realism. To be frank, we should be searching for a system that actually has a chance of working with major countries.

III. Principles of Fund Surveillance Over Exchange Rate Policies

This brings me to a third means of strengthening Fund surveillance, as mentioned by the staff, which might be to modify the Principles of Fund Surveillance over Exchange Rate Policies to include a wider range of developments which might indicate the need for discussion with a member, or I would say perhaps members. Under this approach, consideration could be given to adding to the list of "negative indicators" currently contained in Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies. Such additions might comprehend, explicitly, such areas as fiscal, monetary, wage, and structural policies. Such an approach need not, at least at the early stages, involve any quantification, consistent with the emphasis in the G-10 Report on judgmental assessments.

It would be helpful if the staff could provide a paper, or section of a paper, outlining policy areas, with specific language suggestions that might be added to Section 2 in the Principles of Fund Surveillance over Exchange Rate Policies. Of course, if new, broader general principles of Fund surveillance were developed, this would have implications for how this section of the Principles of Fund Surveillance would be modified.

In a final thought on this section, I would agree with the suggestion that the phrase "for balance of payments purposes" is not needed in the various subsections of Section 2. It is clear that economic policies enacted for other than balance of payments reasons can also affect the economies of other members and the system as a whole.

IV. Proposals for Changes in Procedures

I will briefly summarize our views on the particular points presented in the G-10 and G-24 reports relating to strengthening surveillance procedures (as summarized on page 12 of SM/86/4). First, I will comment on proposals to improve the analytical basis of surveillance.

1. Proposals Related to the Analytical Basis for Surveillance

Regarding data, we strongly support the effort of the Fund and member countries to improve the availability, coverage and accuracy of data, including those related to structural developments. Subsumed in that latter category would be labor market developments such as wages, employment and regulations; and financial market developments including policy tools and institutional characteristics. Without accurate and timely data, the task of economic policy formulation is made difficult, and the danger arises that inappropriate policies may be implemented. We welcome and lend further encouragement to the Fund's efforts to improve data collection.

Regarding the policy coverage of Surveillance, As I have indicated earlier, we believe the areas covered should be extensive. Here I would fully associate myself with the G-10 report which states in paragraph 43:

The Deputies agree that Article IV consultations should continue to be primarily concerned with the broad range of macroeconomic policies, including exchange rate policies, bearing on a country's external position and on international adjustment. Within this overall framework, they propose that consultations should also give more emphasis to analysis of capital account developments, government policies which hinder the efficient operation of exchange and capital markets, and, more generally, impediments to the international adjustment mechanism caused by trade restrictions and other protectionist measures, such as policies to provide special incentives to exports or discourage imports, other market-distorting policies and structural rigidities. In order to achieve greater consistency and continuity of action, policy analyses and recommendations should be viewed in a medium-term framework.

This paragraph might have some useful ideas for the staff as they go about developing various alternative drafts of possible amendments to the Fund's principles, as I discussed earlier. It could be relevant, for example, to an effort to extend the "negative list" incorporated into Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies.

One further comment on this issue relates to the statement on the bottom of page 13 of SM/86/4, where it is suggested that the "discussions be tailored to reflect the relative importance of the urgency of corrective actions in various areas of policy." While I would not disagree that discussions must be focused and must involve a sense of priorities, we should avoid focusing so narrowly on immediate problems that we lose sight of the longer term policy implications of specific actions, actions, which may only appear to have effect with considerable lag, such as policy measures in the structural/institutional arena. After all, a medium-term framework is not just a financing framework, but one to outline policies and performance over the medium-term as well.

This brings me to the next point, the time horizon for reviewing prospects and policies. We have been pleased to see the growing inclusion of medium-term outlooks in staff papers, and view them as being helpful to us both as a member of the Board exercising surveillance over other countries, and as the representative of the largest member country. We agree that the emphasis should be on policy sustainability, and in this regard we believe that stronger emphasis should be placed on structural inadequacies in member countries, including those relating to tax policies, while continuing to analyze and make suggestions on the macroeconomic policies reviewed by the Fund. I stress this since, while structural misalignments may not appear to be the direct cause of a balance of payments problem or inadequate growth, it is clear that in many countries' structural rigidities are contributing to delayed exposure to domestic and foreign competition and to slower growth and diversification. This can damage export prospects, impede resolution of debt problems, heighten protectionist pressures, and erode confidence in and the attractiveness of a member's currency.

Finally, we would welcome more detailed presentation of assumptions and of the analytical framework underlying the medium-term outlooks, especially since this will increase the usefulness of such an exercise to the member's authorities. This is particularly important in the 25 largest countries, and with respect to any policy areas in those countries where there may be differences of view regarding the economic relationship between policy actions and economic outcomes.

Turning to the suggestions made for improving policy assessment, we agree that major policy inconsistencies should be clearly identified in a medium-term context. In fact, a strong emphasis on the medium-term implications of action, or lack of action, can bring home more forcefully the need for immediate action and furthermore, can perhaps help generate a broader base of support for unpopular actions if positive benefits over the medium-term can be more clearly identified. The identification of policy trade-offs may also help to focus attention on the policy options realistically available.

The final set of suggestions relating to staff presentation of specific policy recommendations to a member's authorities deserves our full support. In particular, we would place a high priority on the staff presenting, where appropriate, precise policy steps to help achieve generally agreed-upon policy goals. We would recommend precision with regard to both the content and timing of specific policy actions recommended by staff.

2. Proposals Related to the Multilateral Setting of Surveillance

Let me begin by recognizing the work done by the G-24 in formulating specific proposals regarding multilateral surveillance. We understand the basic objectives of their suggested approach, and share some of the general interest reflected in developing multilateral surveillance. However, we find that the specific proposal put forth in their report goes too far; it is in our view too ambitious and unworkable, involving, as it would, not only multilateral discussions, but negotiations on a mutually consistent set of objectives and policies to achieve these objectives. We believe that it would not be feasible at one point in time to expect to be able to reach a uniformity of views among so many countries, in such a precise fashion, that could lead to specified actions.

The ideas put forth in the G-10 report regarding multilateral surveillance are less ambitious, and could serve as a useful starting point for further efforts in this area. In particular, the World Economic Outlook currently discusses developments in the major groupings of countries. This discussion could be broadened to form two separate chapters. One would review the policies of the major industrial countries, and here I refer to the G-10, highlighting interrelationships and any possible inconsistencies between national policies and broadly agreed objectives. For example, in current circumstances one could assess whether the policies of the United States, Germany and Japan are mutually supportive of the agreed objective of reducing external imbalances in an acceptable timeframe.

We believe that a comprehensive discussion of this WEO chapter in the Board -- on a separate day -- could increase the awareness among members of the international and ultimate domestic implications of their policies, particularly in the medium-term. In the next Board Meeting, following this discussion on the basis of a separate chapter, we could envision a discussion of the 10-15 major developing countries, considering not only the effect of industrial countries' policies and performance on these developing countries, but also with emphasis on the collective and individual roles of the largest developing countries in affecting world economic performance, including their impact on performance in the industrial countries.

Some additional possibilities come to mind, including one preliminary thought that any time the Fund might engage, under the provisions of supplemental consultations, in supplemental consultations with a single member (an area I will address in a moment), we might consider the possibility of conducting some limited additional discussions with those countries most closely linked, either through trade, investment or financial flows, with that particular member. This may involve some practical difficulties, but we believe it merits further consideration.

I would like to make a final point. While the Fund Board can -- and indeed must -- play a central role in strengthening multilateral surveillance in the system, it is not the only fora. Currently, multilateral surveillance occurs, for example, in Working Party 3 of the OECD. Furthermore, there may be occasions, some involving limited groups of countries, when multilateral surveillance cannot most productively take place in the Fund Board. Perhaps on such occasions the Managing Director could play a role.

3. Proposals Related to Strengthening the Influence of the Consultation Process

At last year's discussion on surveillance, I was supportive of various proposals to strengthen the influence of the consultation process. This year, I can reiterate that support and make a few additional suggestions.

Regarding the follow-up to consultations, since staff assessments should be candid, we believe that a comprehensive review of economic performance measured against the recommendations of the Board made at the close of an Article IV consultation should be included in the next consultation report. Such an assessment would be particularly important for the 25 largest members of the Fund, both industrial and developing countries, that have important roles in the world economy. We envision that this comprehensive review in the next Article IV staff report would go beyond the short summary paragraph currently included in most staff reports, and could encompass detailed references in both the summary of economic developments and the discussion of policy implementation in the period since the last Board review.

We agree that internal publicity within the member government should be enhanced; in particular, it would be useful if the Fund team met uniformly with high policy-level officials. Then perhaps an improved effort could be made to ensure that these same high level officials see the final staff report, and the Chairman's summing up.

Furthermore, we continue to believe that IMF surveillance would be strengthened if Management met with the Minister of Finance at the end of the discussions, not just in those instances where there appears to be an "urgent" problem, but in

those 25 or so large countries whose policies and performance are of greatest concern to the world economy. This could help indicate to those most influential members the far-reaching impact of their performance and policies on the rest of the world, and would go beyond the staff suggestion that the MD just "communicate directly" with the Minister of Finance. We recognize the need for flexibility in implementing this policy in order to avoid an undue time and travel burden on Management. Perhaps such meetings in some cases might not always be held on the occasion of the staff level consultations. In some cases, use could be made of the presence of Ministers of Finance in Washington during Interim Committee and Annual meetings.

We could also envision these largest countries preparing a report, as part of the annual consultation process, (G-10 report, paragraph 45) "outlining the measures introduced or considered to deal with the problems identified by the IMF and to respond to specific policy suggestions." Thus in our view, the staff suggestions on page 20 of SM/86/4 are too restrictive in that they would appear to apply only to those countries in which serious differences of view emerged. Even in those countries where there was apparent general agreement on the future direction of policies, follow-up reviews and reports by members' authorities could strengthen the implementation of those policies.

Such reports could be prepared by the authorities within, say six months, of the conclusion of the Article IV. The response of the authorities in that report to the specific recommendations made earlier by the staff and the Fund Board could perhaps in a few cases lead to a supplemental discussion, if the Managing Director found the report to indicate that serious differences of view or problems remained. These problems could, perhaps, be gauged by use of the negative list of indicators I mentioned earlier, which would build on Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies. Such a procedure could perhaps lead to a brief oral report to the Board of the Managing Director's discussions, and would not necessarily require further analysis by the staff. We would not, of course, wish such "6-monthly" reports to lead to, in effect, semi-annual consultations for the major countries, and would need to avoid that in implementation of 6-monthly reports.

We would also welcome a variation of a proposal included in the G-24 report that the Fund broaden its coverage included in information notices to a more comprehensive grouping of policy changes, not just exchange rate and trade policy developments. While such information notices would not necessarily be discussed by the Board -- and we do not see them leading to supplemental consultations -- they would serve to inform all members of important changes in domestic and external policies and performance in members. We would welcome staff and other Directors' views on this possibility.

With regard to external publicity, we continue to believe that a release at the end of a Board discussion of an Article IV consultation with one of the larger industrial or developing country members of a statement that would "give a brief assessment of a country's policies and prospects and would indicate the broad direction of suggested policy changes" (G-10, paragraph 48) could be quite useful in strengthening the surveillance process. We also support release of some parts of the REDs, although not the full staff report. I remain somewhat puzzled by some of my colleagues who believe that some publicity will compromise the basic confidentiality of the consultation process. We believe that confidentiality should be preserved, and can be maintained by limited publicity. Such publicity could improve the accountability of national authorities regarding the international implications of their policies.

We have previously expressed interest in greater use of the supplemental surveillance procedure on the occasion of "exchange rate and other developments that may be important or may have important effects on other members, or that have implications for the operation of the international monetary system," (G-10, paragraph 46), or in relation to developments which might indicate the need for discussion with members. It is clear that these other developments should include a broad array of economic developments and, as such, also encompass various structural and institutional developments. We would not preclude some degree of quantification that might help prompt the need for discussion, but such quantification should be broadly based, and we would continue to rely heavily on judgmental assessments.

One aspect of Procedures which is not dealt with in the staff papers and which perhaps needs more attention relates to strengthening the influence of the consultation process. I have the impression that, too often, the main practical result of consultations is an exchange of information on economic developments and policies, and that a lively, genuine give-and-take on existing policies and policy recommendations may be missing in some cases. If that is the case, it may well be due to the attitudes of the authorities, and not the approach of the staff. Regardless, it is important that the staff present their analysis, projections and arguments for preferred policies clearly and precisely to the authorities. These must be founded on a spelled-out analytical base. Staff should then use their not-inconsiderable persuasive powers--with charts, tables, etc., to back them up-- to seek consideration of what they consider to be the proper policy course.

I am not suggesting a confrontational approach. But, I do think that it may be easy in some cases, particularly those involving the largest members, not just the United States, for both the staff and the authorities of the member country to engage primarily in exchange of information and policy opinions. On the side of the national authorities, it is not a bad thing for them to hear an outside view of a country's problems and policy options in the context of a clear set of

arguments on how a desired economic outcome might be most readily achieved, based on a sound analytical base. A consultation scenario which might favor such an outcome could involve a fairly clear separation between the information-gathering phase of consultations and the policy dialogue phase, with a sufficient period in between to allow for careful consideration of economic prospects and policy implications gleaned from the information-gathering phase.

In this connection, I would like to suggest that staff prepare a short paper, drawing on actual experience from several regional departments, on how the actual process and procedures of consultations have worked, at what level, to what extent, principal information exchanged, etc.

Conclusion

As I said at the beginning of my statement, the true test of our surveillance efforts will be whether they succeed in helping to bring about better economic policies in our member countries and a more stable system. I recognize that the larger members of this institution, both industrial and developing, have the largest impacts on the world economy and on the international monetary system, and that they have special responsibilities. But all countries share these responsibilities and all countries must be willing to participate in any reinforced surveillance effort. One sometimes gets the impression that the support for stronger surveillance is focused on stronger surveillance of the "other fellow" and not of one's own country.

I cannot promise that my own authorities will always concur in the economic analysis and policy prescriptions which emerge from the IMF and its members. But, they are more likely to be inclined to participate in a strengthened surveillance process with an open mind if they believe that it is part of a general strengthening of surveillance to which all countries commit themselves, with all countries accepting the idea of exposing their policies to the light of foreign criticism based on careful economic analysis.

In closing, Mr. Chairman, I would like to return to the issue of political will. Stronger surveillance, as well as possibly other approaches, could help strengthen political will. But there must be a base of political will there, in order to bring about greater international cooperation. There have been many ideas put forward in today's, and last week's, discussions toward increasing the effectiveness of the exchange rate system. Some of them are rather ambitious ideas. One could argue that the willingness of countries to commit themselves to, and to implement, a system of genuinely strengthened surveillance could provide a good indication of the willingness and ability of political systems in national capitals to adhere to other forms of international cooperation.

Thank you, Mr. Chairman.

SUR/86/16

CONFIDENTIAL

February 24, 1986

The Chairman's Summing Up Following the
Discussion on Surveillance over Exchange Rate Policies
Executive Board Meeting 86/30 - February 19, 1986

1. General points

This was an extremely important and useful discussion. Directors agreed that enhancing the effectiveness of surveillance is essential to improving the international monetary system, whatever the particular modalities of the exchange rate system itself. They also agreed that domestic policies of members--particularly major countries--can have significant repercussions on other countries' economies and on the working of the international monetary system, and that the Fund has a unique role to play in carrying out its surveillance function: it should seek to promote higher quality and more mutually consistent economic policies by encouraging national authorities to take into account as fully as possible the international consequences of their domestic policies.

Directors noted that the effectiveness of surveillance had been far from adequate in recent years, as major payments imbalances had developed and the functioning of the exchange rate system had been characterized by substantial volatility and misalignments.

A number of Directors considered that surveillance has been marred by a deep asymmetry: they noted that the conditionality on the use of Fund resources significantly affected developing countries--whose economies generally did not have a substantial impact on the rest of the world--while surveillance had had little practical effect on the countries that had a major impact on the world economy. Thus, in the view of a number of Directors, the objectives of surveillance had not been met. More important, the situation had considerably deteriorated in this respect since the beginning of the floating system and the introduction of the surveillance principles and procedures. A number of Directors felt that the inadequacies of surveillance had complicated the task of those countries which had had no option to adjusting to external circumstances and in the process had compounded the difficulties in the adjustment mechanism itself.

Many Directors stressed that the causes of these shortcomings were to be found in the fundamental changes that had occurred in the international financial and economic environment, as well as in the lack of sufficient political will among governments to adapt their domestic policies to a set of consistent international objectives. In other words, the shortcomings were caused more by those phenomena than by the inadequacy of the surveillance guidelines and principles, and of the way in which they had been implemented. Some of the Directors who made those points also stressed that no set of surveillance guidelines and procedures can

be effective unless all members, recognizing their interdependence within the international monetary system and their mutual self-interest in the smooth operation of the system, are willing to sacrifice a portion of their national sovereignty to ensure that surveillance will be effective.

However, a number of Directors considered that the implementation of surveillance had also been faulty in some respects and had, to some extent, negatively affected the functioning of the system. Directors mentioned several shortcomings of the surveillance mechanism. First, some Directors said that the mechanism has relied excessively on a bilateral concept or the juxtaposition of a number of bilateral approaches, and that not enough emphasis had been given to analyzing interactions of economic policies and to designing an international framework for surveillance which would favor greater consistency of policies. Second, some Directors mentioned that the surveillance mechanism, as it had been implemented, had failed to assess the importance of a major component of the international system, namely, unsustainable capital flows. A third criticism was that the surveillance mechanism had not captured some major exchange rate misalignments and economic policy inconsistencies at a sufficiently early stage. Another criticism, which was made by a number of Executive Directors from developing countries, was that the surveillance mechanism had not sufficiently taken into account the fact that some countries have a greater influence on the system than others and have to be treated accordingly within the framework of surveillance. In that connection, some Directors stressed the need for more even-handed surveillance. In their view, the Fund, in carrying out its surveillance function, had been very demanding in its response to the exchange rate policies of smaller countries and had been relatively easy in its assessment of the exchange rate policies of major industrial countries.

Another view was that one should not underestimate the importance, for the system, of a number of developing countries. A number of those countries do have an impact on trends in the world economy.

Given those observations, I think that it is fair to say that all Directors agreed that a strengthening of surveillance is essential at the present juncture. The proposals or ideas mentioned by Directors today to strengthen the effectiveness of surveillance were clearly colored by the more general attitudes expressed by Directors on the related question, discussed last week, of the exchange rate system. Some Directors felt that automatic quantitative indicators, or targets, or systems of reference were needed to trigger consultations and possibly policy actions. Others considered that what is of the essence is to improve the practical effectiveness of surveillance without creating unnecessary, or perhaps undesirable, mechanical triggers that could lead, in their view, to an excessively heavy work load rather than to a more effective application of the surveillance mechanism.

Despite the differences of view on these matters, the discussion today was heartening in the sense that all Directors--and I wish to stress the unanimity of views in this respect, although there were some differences on the precise modalities involved--agreed on the following fundamental points.

First, the surveillance mechanism should be strengthened in order, as one Director said, to get more bite and not more bureaucratic work. Second, there is a need to broaden the coverage of policies that are subject to surveillance and, in particular, to integrate, through more precise analysis, exchange rate assessments and the assessments of fiscal, monetary, and structural policies within a medium-term framework. Third, the multilateral framework of the exercise of surveillance should be improved. The lack of an adequate multilateral framework has been one of the main weaknesses of the surveillance mechanism and should be a focus of attention for action in the future. Fourth, the follow-up mechanism should be improved, so that deviations can be spotted early and appropriate action taken quickly.

In the light of those observations, I would like to deal next with the more precise points that were covered by the staff papers and on which Directors commented today.

2. The biennial review of the 1977 document on surveillance

First, the three-step work program outlined in SM/86/3 was accepted by most Directors. It is clear that the Interim Committee's guidance should be sought on the ideas contained in the G-10 and G-24 reports that Directors discussed today. It is also clear that this will take some time, as Mr. Sengupta stressed. He would like us to assess more systematically the practicability of the different specific proposals before we crystalize our views in a report and seek the guidance of the Interim Committee. Other Directors said that we should not lose too much time on drafting, and that in any event drafting should not delay action.

Second, some Directors said that they wished to revise the present text of the general principles of surveillance to include the principles of oversight by the Fund over members' economic policies which, as Mr. Polak in particular noted, are stipulated in Article IV, Section 3(a). We will therefore start considering how those general principles could be revised. But, as Mr. Polak correctly stressed, the revision will not involve just a few words of the text here and there; it should be more systematic and fundamental.

Third, in commenting on the principles for the guidance of members' exchange rate policies Directors restated the positions that they had taken last week on target zones and indicators. While the target zone idea is favored by Directors with only a minority (less than 30 percent) of the total voting power, I was interested to note today a growing momentum in favor of the notion of indicators--not necessarily quantified, rigid indicators, but more systematic guidelines that could be used to characterize a stance of policies and to help the Fund to detect deviations and inconsistencies. Although this was not a majority view, there was an inclination to explore what we could do in a practical and flexible way. In stressing the need for surveillance to focus on domestic policies, Mr. Dallara asked the staff to explore the feasibility of what he called notional ranges for the outcome in such policy areas as growth, employment,

inflation, and the external current account. Mr. Dallara further suggested that any substantial deviations from the notional range of outcomes in a country in any one of those policy areas could be a basis for considering the need to hold discussions with the member.

In their comments on principles of surveillance over exchange rate policies, Directors expressed some interest in extending the coverage of indicators used to trigger consultations to include policies that are not necessarily adopted "for balance of payments purposes." However, there were divided opinions on the suggestion to delete the reference to policies adopted "for balance of payments purposes." The final decision on the disposition of those words should perhaps be taken in the light of the final position on other important aspects of the 1977 document. Some Directors suggested extending the list of "negative indicators" in Section 2 of the current principles of surveillance to include fiscal, monetary, wage, and structural policies.

3. Possible improvements in surveillance procedures

Most Directors called for an improvement in the quality, timeliness, and coverage of data. As far as policy coverage is concerned, I thought that there was a broad consensus--which reflected the positions in the G-10 and G-24 reports--that all policies which affect the performance of members and the international system, including of course structural and trade policies, should be included in the coverage of our surveillance exercise. Mr. Dallara mentioned that paragraph 43 of the G-10 report gives a good indication of the possible broader policy coverage of surveillance. He suggested that the text of paragraph 43 1/ could be relevant for an effort to extend the list of "negative indicators" in Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies.

This suggestion is in line with the emphasis placed by a number of other Directors on the potentially significant role of surveillance in identifying members' policies that impede the achievement of economic growth objectives and should therefore be avoided to the extent possible. These ideas complement another proposal for strengthening surveillance

1/ The text of paragraph 43 reads, in part, as follows: "...Article IV consultations should continue to be primarily concerned with the broad range of macroeconomic policies, including exchange rate policies, bearing on a country's external position and on international adjustment. Within this overall framework...consultations should also give more emphasis to analysis of capital account developments; government policies which hinder the efficient operation of exchange and capital markets; and, more generally, impediments to the international adjustment mechanism caused by trade restrictions and other protectionist measures, such as policies to provide special incentives to exports or discourage imports, other market-distorting policies, and structural rigidities. In order to achieve greater consistency and continuity of action, policy analyses and recommendations should be viewed in a medium-term framework."

that was mentioned by Mr. Zecchini in particular: the surveillance exercise could include a careful examination of the continuity of a member's policy efforts over time. In that context, Mr. Dallara suggested that the current Article IV consultation report for a member could include a comparison of the member's recent policy decisions with the Fund's recommendations concerning the policies that the member should adopt or avoid in order to promote economic growth, policy consistency, and exchange rate stability. Some Directors also remarked that in presenting its suggestions to a member's authorities the staff should include, where appropriate, precise policy steps to help achieve generally agreed policy goals; in their view, priority should be given to precision in both the content and timing of specific policy actions recommended by the staff.

All Directors agreed on the importance of the medium-term analytical framework that has been introduced in recent years, and some Directors asked the staff to be more precise in presenting the underlying assumptions behind medium-term scenarios. One Director made the interesting suggestion that the use of medium-term scenarios should be extended to all industrial countries that had a substantial and growing external debt and to all industrial countries with large external surpluses. In addition, there was a strong call for more candid and specific presentations in the staff appraisal for Article IV consultation reports of the staff's assessment of a government's policies and of any differences of views between the staff and the authorities. Directors also said that a staff report for an Article IV consultation should to the extent possible provide precise suggestions for policy changes, although, as Mr. Rye rightly reminded us, we have to exercise some modesty in this respect because we might not know all the intricacies of each member's situation. I also noted a call for more specific and fuller indications in staff reports of Fund/Bank collaboration and, where relevant, of the World Bank's views on a member's policies.

Directors also commented on proposals related to the multilateral setting of surveillance. Indeed, as I mentioned, this was a focal point of the discussion. The Group of Twenty-Four's proposed two-step procedure was supported by a number of Directors. They stressed what they considered was the inherent logic of negotiating a framework of mutually consistent objectives and policies for the major industrial countries and then following that up by assessing individual policies in the context of that framework in the course of the Article IV consultations with those members. However, a number of other Directors considered that such an approach, and in particular the first leg of that approach--the negotiation of an agreed set of consistent objectives and policies--would not be practicable and would entail excessive complications and rigidities. They advocated instead a separate chapter in the World Economic Outlook paper which would provide the sort of framework that the Group of Twenty-Four favors but in a less rigid way and without the complication of negotiations; the chapter would provide a framework within which to discuss the international repercussions and interactions of the policies and objectives of the major industrial countries. Mr. Polak suggested that, by developing a consistent set of underlying balance of payments calculations as a part

of the World Economic Outlook exercise, the Fund could make a unique analytical contribution to the process in the major countries of devising policies in the light of their international effects. Those calculations would not involve the definition of a set of equilibrium exchange rates. A number of Directors considered that a discussion on the G-10 countries within the framework of each World Economic Outlook paper would be more effective if the Managing Director were to make a report at the subsequent G-10 meeting on the discussion in the Board. Mr. Dallara made an interesting suggestion, which was picked up by a few Directors, that another World Economic Outlook chapter could focus on the interactions and international repercussions of the policies of 10 to 15 major developing countries.

In their comments on the multilateral setting of surveillance a number of Directors said that the meetings of the G-5 countries were a welcome manifestation of the desire of those countries to increase international economic cooperation. But a large number of Directors today noted that it would be important for the effectiveness of the Fund's surveillance function to have the Managing Director attend G-5 meetings so that the Fund's perspectives, as reflected in Board discussions, could be conveyed to the G-5 countries.

Considerable emphasis was placed today on the use of supplemental surveillance. A number of Directors would like more supplemental surveillance consultations to be held. They noted that the supplemental surveillance procedure had not been used in the past, and they underscored the significant potential usefulness of that procedure in certain circumstances. Some of you remarked that the number of cases in which supplemental surveillance would be necessary was likely to be very small. In addition, care would be needed to keep from drifting into a pattern of semiannual consultations as a result of the excessive application of the supplemental surveillance procedure. My sense of the discussion is that, on the whole, Directors would rely heavily on the discretion of management to determine when supplemental consultations are needed.

Emphasis was also placed on the importance of follow-up procedures. Considerable attention was given to the suggestion that after the completion of an Article IV consultation with a member whose views differed from the thrust of the staff appraisal, the country would be asked to produce a separate report stressing its views; the report could conceivably be integrated into a further Board discussion.

There were two basic views on the frequency of Article IV consultations. One group of Directors would like a more flexible attitude toward countries that do not pose major problems to the system, do not face immediate economic and financial problems, and are not using Fund resources; they were willing to have a longer consultation cycle--say, 24 months--for those countries. Some other Directors, however, said that a number of those countries might have good reasons to rely on frequent, annual Article IV consultations, and that they would be reluctant to increase the consultation cycle for those countries.

My personal view is that we should leave open the options for that group of countries. If any of those countries is not interested in an annual Article IV consultation, I see no reason why we should not move toward an 18-24 month rule for such members. If, on the contrary, any of the countries concerned feels that it is important for that country to benefit from the advice of the Fund through an annual consultation, I think that we should probably go along with the member; we may wish to use smaller staff teams in handling some of these consultations.

On the whole, I did not sense much change in Directors' views on publicity since the previous discussion on surveillance. However, I noted with great interest Mr. Dallara's position, as he has stated it today, which I think has alleviated much of the concern that many Directors had felt about wider external publicity. There appears to be broad agreement that external publicity in the form of the publication of full consultation reports would not be consistent with the great importance that members and Directors attach to maintaining confidentiality. The main question at this stage is whether the Managing Director should make, on his own responsibility, a short statement on the outcome of a Board discussion in concluding an Article IV consultation. On this matter I have heard some positive views, including the opinion of some Directors that so-called internal publicity could help decision makers in individual countries to identify all the available policy courses as well as inconsistencies in policies. But this is not a majority view. Considerable attention was devoted to information notices, which is consistent with the interest that Directors showed today in achieving more precision in the carrying out of surveillance. Information notices are a useful tool to which we should give further attention. Such notices could occasionally be discussed by the Executive Board. The discussions could conceivably be helpful to the Managing Director in reaching his decision whether or not a supplemental consultation was warranted. To that end, information notices would be particularly useful if they were to concentrate on a member's deviations from the Fund's policy recommendations. There was some interest in the notion of wider indicators, and we will continue to work on that idea.

As to Mr. Sengupta's suggestion to have a quarterly paper on an ideal or optimum grid of exchange rates, there were a number of views that showed some sympathy for that idea, but there were also warnings and a counsel of prudence by several Directors which could perhaps be synthesized in the following way: the staff could explore balance of payments patterns, rather than make quarterly assessments of exchange rates, which present considerable difficulties because of quarterly fluctuations and members' sensitivities about information on rates. I thought that Mr. Polak made an interesting suggestion on how we might proceed in that respect, and I will consult him on a bilateral basis to gain a better understanding of his idea. There was also an interesting suggestion to have the staff discuss in a paper the nature, level, and effectiveness of its contacts with the authorities in individual countries during Article IV consultation discussions.

February 12, 1986 - 86/25

FILE COPY

Statement by Mr. Nimatallah on
Review and Assessment of the System of
Floating Exchange Rates
Executive Board Meeting 86/25
February 12, 1986

Mr Chairman, it is important to maintain a distinction from the outset between the causes of exchange rate variability and misalignments, on the one hand, and the impact of the variability and misalignments on the developing countries and small industrial countries, on the other.

Coming now to the G-10 and G-24 reports. I am heartened to see that both groups agree, in principle, that the present system of exchange rates needs to be improved. They both are concerned about the short-run variability and the long-run misalignments of exchange rates. Furthermore, they both conclude that the major underlying elements behind the volatility and misalignments of exchange rates of key currencies are the unsound and inconsistent policies, and the related divergencies in economic performances among major industrial countries.

The key questions faced by both groups were:

1. How to introduce more stability into the present system ?
2. How to ensure that key-currency countries pursue sound and consistent policies ?

In this respect, I am pleased to note that the two groups agree that surveillance is crucial as a basic tool for promoting policy convergence in an environment of sustainable non-inflationary growth; that exchange rate intervention cannot be the primary instrument for achieving exchange rate stability, though it can be useful in playing a complementary role; and most importantly, that the return

to a rigid, fixed exchange rate system is neither desirable nor feasible at the present time.

However, the two groups differ in degree in their search for the one additional step that is needed, a "missing link" if you will, to improve the functioning of the present exchange rate system. I think the roots of these differences lie in the two groups' respective assessment of the extent to which exchange rate variability and long-run misalignments affect developing countries and small industrial countries. It is true, as maintained in the G-10 Report, that various hedging techniques and forward markets have been developed, improving the ability of large countries and large companies to reduce their exposure to foreign exchange risk. It is also true, however, that the majority of countries, unfortunately, are still unable to avoid that risk. It is quite clear from the records of the IMF that many countries have suffered a considerable loss of income due to reduced exports partly as a result of serious misalignments of key currencies. For example, when the U.S. dollar sharply appreciated, many developing countries who had adopted realistic pricing policies, were nonetheless forced to augment their export volumes so as to maintain export receipts. In so doing, not only were their incomes reduced, but, in the process they had to adopt more difficult adjustment measures.

Therefore, I have no difficulty, Mr. Chairman, in answering, in the affirmative, the first staff question on page 6 and I quote - "Does short-run volatility of major currency exchange rates impact more seriously on the developing countries and on smaller less diversified firms?" Another staff question, also on page 6, raises interesting issues about the effects of exchange rate volatility on international trade. I quote: "Are there kinds of risk or uncertainty that have eluded the existing econometric tests on the links between exchange rate volatility and the volume of international trade?" As far as I can see, it is not so much a question of the volume of international trade as it is a question of the distribution of that volume. I think exchange rate volatility leads to a redistribution of income in favor of the larger countries and companies which can influence demand and reduce their exposure to risk.

This leads me, Mr. Chairman, to the conclusion that the cost of exchange rate volatility to most countries is sizable and unnecessary. I feel it would be in the best interests of the large countries if, in the long run, the

incomes of the many small and vulnerable countries were not exposed to these arbitrary reductions. A stable environment would enhance their ability to import from the industrial countries, increasing the latter's income and employment through the multiplier effect. One good way of improving the stability and even the growth in the incomes of developing and small industrial countries is by introducing more stability into the present exchange rate system.

Another area where the two groups differ somewhat, pertains to their respective assessment of the contribution of the lack of discipline, as well as the level and frequency of macroeconomic policy coordination among large industrial countries to the volatility and misalignments of key-currencies. It is generally argued that the lack of fixity in major exchange rates has greatly reduced discipline on macroeconomic policies. It is further argued that unsound and inconsistent policies have produced historically high real interest rates, low commodity prices, and sluggish economic growth. This has had adverse spillover effects on developing countries' export earnings and growth performance. Moreover, under the present system, efforts aimed at better discipline and policy coordination have not been initiated on a regular and frequent basis. Rather, they have been, for the most part, triggered by the threat of crises.

The events that followed the September 22 meeting of the G-5 officials in New York, have demonstrated that concerted actions by the key currency countries do work. They also proved the desirability and, indeed, the need for a trigger mechanism other than the threat of crises for enhanced dialogue and policy coordination among the major industrial countries.

It is certainly true that, during the par value era, domestic macroeconomic policies were fully subordinated to, and constrained by, the maintenance of the exchange rate in a sense that "the tail was wagging the dog." Because of this inflexibility and the lack of control over domestic macroeconomic variables, domestic economies during that era have suffered a great deal. Now that "the dog is wagging the tail," which is a more natural mechanism, the world forgets that the tail has to be connected to the dog for it to be wagged and for the wagging to serve any useful purposes to the dog. The point is that the tail cannot be severed, as some might imagine the floating exchange rate system to be.

Mr. Chairman, there is ample evidence that the major causes of exchange volatility and misalignments are not only the low level of coordination and discipline but also the lack of regularity and automaticity in carrying out even the present level of policy coordination.

Our experience with the present system clearly suggests that the "the missing link" in the process of enhancing the level of discipline and policy coordination through more frequent and regular consultations among the major industrial countries is a trigger mechanism. Such a mechanism would have to move the present system in the direction of more automaticity and more centralization in policy adjustment and coordination. The central question is, therefore, what is the most appropriate, practical, and acceptable tool for ensuring that unsoundness and/or inconsistencies are detected early enough to be dealt with in a timely fashion? Put differently, how can the international community ensure that the key currency countries address individually and collectively exchange rate problems before too much damage is inflicted on the world economy?

The answer to this question, Mr. Chairman, hinges on finding and incorporating the "missing piece" in the structure of the present exchange rate system. The "missing piece," in our view, is a trigger mechanism that plays the role of "an early warning light." Such a mechanism, we feel, should have the following desirable features:

1. It should be automatic in the sense of triggering automatic discussions and consultation at the national and international levels but not mechanical in the sense of coercing key-currency countries into a course of action.

2. It should be flexible and amenable to frequent revisions.

3. It should be widely acceptable and its implementation should not be cumbersome.

4. It should not aim at "fine tuning" exchange rate relationships. Our knowledge in this area is far too imperfect.

After reviewing the proposals in the staff paper, namely: (1) hard target zones; (2) soft target zones; (3) objective indicators; and (4) improvements of the existing institutional setting, I came to the conclusion that soft target zones have the most to offer in that they combine some of the desirable features of a trigger mechanism I mentioned earlier with most of the advantages of the present floating exchange rate system.

Let me explain why. Soft target zones are characterized by wide, frequently revised, confidential zones, and need monetary policies that pay only limited attention to the level of exchange rates. What they introduce is only a more explicit and formal framework for defining the appropriate pattern of exchange rates and for specifying the links between exchange rates and macroeconomic policies. As these soft target zones have to be negotiated, they can improve the international consistency of macroeconomic policies, thus ending the present practice of letting the exchange rates be determined as residuals of other policy actions. It is true that soft target zones may not be helpful in reducing short-term variability or in identifying small real exchange rate misalignments. However, I think they would be at least helpful in preventing large and persistent misalignments, thus introducing some discipline. Unfortunately, unannounced soft target zones may not provide the anchor that some might want for greater stability. They will, however, help introduce more frequency and regularity in policy coordination and increase the responsibility of those large countries with the greatest spillover effects on the world economy.

To conclude, Mr. Chairman:

1. The present floating exchange rate system has not failed; it only needs improvement.

2. A return to a rigid par-value system is undesirable and unfeasible at this time.

3. Within the efforts of searching for feasible ways to improve the present system, one should benefit from the experience of the EMS.

4. While "soft" target zones are not much different from what took place in, and subsequent to, the New York meeting of September 22, they do add the desirable element of regularity, and, therefore, enhanced incentives for more frequent policy

coordination among the large industrial countries. After all, the Summit Conference of the G-7 seems to be held on a regular basis, so why not do the same for Finance Ministers and Governors?

5. For all practical purposes, and because the initial discussions for establishing the initial target zones can be difficult and time consuming, I think the Board should recommend to the Interim Committee to advise members to initiate such discussions anyway, and as soon as possible, even if there is no full agreement yet on adopting soft target zones.



Office Memorandum

TO: Mr. van Beek

DATE: May 1, 1986

FROM: Desmond Lachman *DL*

SUBJECT: Experience of Developing Countries
with Floating Exchange Rates

The following are the comments I have on the above mentioned paper insofar as it relates to Uruguay. I would draw special attention to the comment about the reference to Uruguay on page 65.

1. On page 5 it is suggested that Uruguay had a dual exchange market prior to the floating of its exchange rate in November 1982. This is rather misleading as the two exchange markets were unified de facto in October 1978.

2. On page 6 Uruguay should be included among those countries which adopted a floating rate because of acute balance of payments difficulties and in particular because of massive capital flight. Accordingly, I would also suggest the suppression of the discussion at the top of page 7.

3. On page 32 in discussing problems emanating from wild seasonal fluctuations in tourist receipts, the case of Uruguay might also be mentioned.

4. On page 38 (Table 2) and on page 39 it is not correct that the establishment of a unified floating exchange system was a performance criterion under an existing program. Under the 1985 program with Uruguay, the authorities are committed to not intervening in the exchange market and there is an international reserve test. This, however, is not equivalent to having the floating of the exchange rate as a performance criterion, since there is nothing stopping the authorities from accumulating additional international reserves in the event of upward pressure on the rate.

5. At the bottom of page 39 one cannot really describe Uruguay's move to a floating system as gradual given the abrupt move in November 1982 from a preannounced schedule of depreciation to a floating rate and the subsequent 40 percent decline in the value of the currency within a few weeks.

6. On page 41 I am not sure what this sentence is saying in the Uruguayan context.

7. On page 59. The exception of Uruguay from the category of countries having serious balance of payments problems prior to floating is not accurate.

8. On page 65. The discussion of Uruguay as "an example of a country in which it has not been possible to prevent a continuous acceleration in prices" is inaccurate and gratuitous. I would suggest that it be dropped.



Th. Wasner
Exchange Rate
Office Memorandum

EW
STB
TO
MB
F

TO: The Managing Director
The Deputy Managing Director

April 10, 1986

FROM: C. David Finch *CD*

SUBJECT: Information Notice System

I refer to my note on this subject (dated March 31, 1986) and to Mr. Shaalan's note dated April 4, 1986. We believe that Mr. Shaalan has made a very constructive suggestion for implementation of the new procedure for monitoring exchange rate developments in the 26 countries for which the lack of adequate price data prevents the calculation of real effective exchange rates under the information notice system. Following his suggestion, we propose to prepare a brief paper jointly with the appropriate area departments, which would explain to the Board the procedures being followed in the 26 cases in question. The paper could also note that longer or delayed consultation cycles may give rise to a greater chance of a notification. The paper would incorporate notifications for the countries in question. Based on calculations through February 1986 (see attached table), this would appear to be necessary for six countries for which the rate of inflation, based on the best available estimates, is clearly outside the limits of the range that would keep the change in the real effective exchange rate within the 10 percent threshold. These countries include Bahrain, Djibouti, Iraq, Lebanon, People's Democratic Republic of Yemen, and Viet Nam.

Attachment

cc: Heads of Departments: AFR, ASD, ~~EUR~~
MED, RES, ~~WHD~~

Mr. Brown

Table 1. Countries for which Real Effective Exchange Rates are not Monitored

	Latest Board Consideration		Change in Nominal Effective Rate Since Latest Board Consideration	Range of Inflation Rates Keeping the Real Effective Exchange Rate Within the 10 Percent Threshold <u>2/</u>	
	Type <u>1/</u>	Date			
<u>African Department</u>					
Algeria	C	9/85	-8.2	1.7	64.7
Benin	C	3/85	5.0	-12.1	9.4
Chad	C	4/85	4.9	-13.0	10.7
Comoros	C	2/85	3.9	-10.3	9.6
* Djibouti	C	6/85	-18.1	18.8	60.5
Equatorial Guinea	R	12/85	0.9	-43.9	86.9
Guinea	C,R	2/86	...	...	...
Guinea-Bissau	C	9/85	-19.8	43.1	131.6
Sao Tome & Principe	C	11/84	-5.1	2.0	19.8
<u>Asian Department</u>					
Bhutan	C	8/85	-1.5	-13.0	30.0
Kampuchea, Dem.	C	10/73	...	...	...
Lao, P.D. Rep.	C	1/86	-2.2	-61.9	323.3
Maldives	N	3/86	...	...	...
* Viet Nam	N	9/85	-88.7	1,533.8	2,472.4
<u>Middle Eastern Department</u>					
Afghanistan	C	1/86	...	...	...
* Bahrain	C	3/85	-19.5	22.5	52.5
* Iraq	N	11/82	10.8	2.6	9.1
* Lebanon	C	2/85	-48.0	82.8	123.4
Libya	N	3/86	...	...	...
Oman	N	2/86	...	...	...
Qatar	C	2/86	...	...	...
Syrian Arab Rep.	C	2/86	...	...	...
United Arab Emirates	C	7/85	-11.2	5.8	49.3
Yemen Arab Rep.	N	1/86	-5.4	-43.2	531.4
* Yemen P.D. Rep.	C	6/85	-15.4	-13.8	53.7
<u>Western Hemisphere Department</u>					
Belize	R	3/86	...	...	...

1/ C: consultation; N: notification of change in exchange system; R: use of Fund resources.

2/ Annual rate. Lower end of range would keep the real effective depreciation less than 10 percent; higher end of range would keep the real effective appreciation less than 10 percent. A rate of inflation outside the range indicated would indicate the need for an information notice.

* Indicates countries for which estimated rate of inflation would indicate a change of more than 10 percent in the real effective exchange rate.



Office Memorandum

Mr. Beza F

To: The Managing Director
The Deputy Managing Director

From: A.S. Shaalan *SS*

Subject: Information Notice System

April 4, 1986

Mr. Finch's memorandum to you of March 31 on this topic referred to Bahrain for which it is proposed that an information notice be issued although there has been no price data for the country for over a year.

The MED staff continues to have reservations regarding the reliance of the Information Notice System on estimated price data covering relatively long periods for a substantial number of member countries. As Mr. Finch's memorandum pointed out, for non-core countries (about 110 member countries), the January 1986 real effective exchange rate exercise involved price estimations for January for nearly 80 percent of these countries and for the three months October-December 1985, 30-55 percent of these countries; for about 15 percent, estimated price data was also being used for the August and September REER estimates. Our reservations in this regard are based on concerns regarding the possible reactions of member countries to issuance of a notification based on estimated price data in cases where the subsequently available actual data indicates that a notification was not called for.

On the specific case of Bahrain, our reservations regarding the new proposal to use an estimated inflation range as the basis for a notification centered about the authorities' reaction to being singled out for non-uniform treatment. Until Mr. Finch's memorandum of March 31, the Exchange and Trade Relations Department had been focusing on Bahrain and indicated that they were looking into the feasibility of using a similar approach for other countries for which price data were lacking. If the proposal for judgmental notifications is to be generalized, as we understand from the March 31 memorandum, so that the principle of uniform treatment is broadly applied we would have no objection to Bahrain being included simultaneously along with all other countries that have so far been excluded. It would appear from Table 1 of Mr. Finch's memorandum that other countries would also currently be candidates for notification. We would suggest a joint paper explaining the new system and incorporating notifications for all the countries that are candidates. The paper should also explain that longer (or delayed) consultation cycles give rise to greater chance of a notification. For Bahrain this would be important since the authorities would likely ask why notifications had not been issued for some neighboring countries who are also members of the GCC. If the new proposal is adopted, we would also suggest that a sufficient margin be allowed for error in judgment so that cases of unwarranted notifications are avoided.

cc: Mr. Finch
✓ Mr. Beza
Mr. Brown



Office Memorandum

Mr. Roza
F

TO: The Managing Director
The Deputy Managing Director

March 31, 1986

FROM: C David Finch

SUBJECT: Information Notice System

There are two issues concerning the information notice system on which we would appreciate your guidance. The first issue concerns the practice of including a "staff appraisal" in the information notices and was highlighted recently in the cover note seeking your approval of the information notice for the United States. The second issue concerns the treatment of countries for which the lack of price data has prevented the monitoring of real effective exchange rates, which has arisen recently in discussions with the staff of the Middle Eastern Department.

1. Staff appraisals

The Chairman's summing up of the original Board discussion which led to the establishment of the information notice system included the following statement on the content of information notices: ". . . Directors recommended a flexible approach and invited management to exercise discretion in deciding when to provide analysis and an appraisal." ^{1/} In practice, the rule followed has been that unless a staff report for an Article IV consultation or the use of Fund resources had just been issued or was to be issued shortly, a staff appraisal should be included or the absence of an appraisal should be brought to management's attention. This latter was done recently, for example, in the case of South Africa where it was considered appropriate to omit a staff appraisal as the erratic behavior of the rate reflected primarily political factors. In the case of the United States, we went along with the Western Hemisphere Department because it was clear that, even without a section explicitly labeled staff appraisal, the information notice would include staff comments and a de facto assessment in the final paragraph. The general arguments raised by WHD staff in the cover note seeking approval of the draft information notice for the United States (copy attached), however, raise the issue of whether formal staff appraisals are appropriate in information notices.

We would, of course, agree with WHD staff that a report for an Article IV consultation which can deal more fully with the complex issues often involved provides a stronger basis for a comprehensive appraisal. We also understand that the formulation of such appraisals without the benefit of discussions with the authorities may be difficult and could result in assessments reflecting an incomplete understanding

^{1/} "The Chairman's Summing Up at the Conclusion of the Annual Review of the Implementation of Surveillance, Executive Board Meeting 85/55-- March 28, 1983," Buff 83/92 (4/7/83).

of the importance of certain developments or actions. Nevertheless, the Fund has an ongoing responsibility of monitoring and assessing policy problems and desired actions in all member countries. Shying away from presenting assessments or appraisals labeled as such would be a clear step backward, at a time when both the G-10 and G-24 seek a strengthening and more continuous implementation of surveillance. It would be odd, at a time when both the G-10 and G-24 encourage the staff to be more candid and specific in its assessments and policy recommendations, to decide that the staff cannot formulate views, except once a year and only with the benefit of discussions with the authorities.

If some feel that too strong a connotation has come to be attached to the term "appraisal," words such as "assessment" or "judgment" could readily be substituted. We strongly believe, however, that the use of a separate heading serves a useful purpose of separating the descriptive/analytical and assessment portions of the information notices, allowing management and staff to express a view (and to be seen as doing so) on the developments and actions to which the papers are addressed. Also, in practice, without a formal label, the clarity and effectiveness of assessments could easily suffer as more difficult judgments are avoided. Without appropriate assessments or appraisals, the information notices or other papers issued between Article IV consultations (exchange arrangements and exchange systems papers, and trade information notices) would not provide the Board with the element of judgment useful for its own assessment of the measures and their significance; or member countries with the reactions of the management and staff to developments and actions in the areas to which the papers are addressed.

For these reasons, my recommendation is to continue the uniform practice of including a formal staff appraisal (or assessment/judgment) section. The reasons for omitting the appraisal or assessment in individual cases and on an exceptional basis would continue to be brought to your attention. Your guidance on this issue would be appreciated.

2. The treatment of countries without price data

There are at present 26 countries for which the lack (or, in the staff's judgment, poor quality) of price data prevent the monitoring of real effective exchange rates. These countries are shown in Table 1. Although Directors have mentioned on occasion that efforts should be made to expand the coverage of the exchange rate monitoring exercise, usable price indices or staff estimates are still not available for these countries, and for most of them, are not likely to become available in the near future.

One country, Bahrain, was recently added to this group as no CPI data have been available since December 1984 following the decision of the authorities to discontinue the compilation of the index while a

new index is being prepared. The latter index had been expected to be available by the end of 1985 but has been delayed and it is not clear when the new data will be ready. The issue arises most clearly in this case because even though both the Bahrain dinar and Saudi Arabian riyal have been pegged (or de facto pegged) to the U.S. dollar, an information notice was recently issued for the latter highlighting the real effective depreciation since early 1985 but not for Bahrain for which the lack of CPI data has not allowed precise calculations to be made. Nevertheless, it is likely that the dinar has also depreciated in real effective terms by much more than 10 percent. Given the size of the nominal effective depreciation for the Bahrain dinar (16.6 percent since March 1985, the date of the most recent Article IV consultation) and inflation rates in trading partners, the rate of inflation in Bahrain would have had to exceed 19.1 percent (annual rate) since March 1985 in order to keep the depreciation in real effective terms below the 10 percent threshold. Although the depreciation of the dinar may have resulted in some acceleration of inflation since early 1985, inflation likely remains well below the 19 percent required to have kept the real depreciation below 10 percent. 1/

Our proposal in the case of Bahrain and other countries for which the staff does not feel confident in providing precise price estimates for use in the information notice system would be to monitor developments in the nominal effective exchange rate, inflation in trade partners and the implied rate of inflation in the country itself which would keep the change in the real effective exchange rate within the 10 percent (appreciation or depreciation) threshold. When the implied rate of inflation clearly moves outside the range of reasonable estimates, (based on available information, including, for example, the evolution of money and credit aggregates, projected rates of inflation at the time of an earlier Article IV consultation, foreign inflation and past inflation performance of the country itself) an information notice would be issued. These implied rates of inflation (for calculations through January 1986) are shown in Table 1.

MED staff object to this procedure. In particular, in the case of Bahrain, since new price data may be available in the near future, MED argues that it would not be advisable to have issued a notification which contained staff inflation estimates which were substantially different from the actual data. More generally, they question whether it is advisable to rely too much on estimated price data for the information notice system. A separate objection concerns

1/ This judgment is based, inter alia, on the record of low inflation in Bahrain in preceding years which has remained at or below 3 percent (year on year) from early 1983 through late 1984, and continuing low rates of inflation in neighboring countries in 1985. During the 12-month period ending September 1985, domestic credit fell by nearly 40 percent while narrow and broad money increased by 3 percent and 11 percent, respectively.

the appropriateness of applying the same monitoring procedures and thresholds to countries on longer consultation cycles, since the longer interval between consultations may result in a greater incidence of information notices for these countries.

As regards the first point, we had agreed earlier with MED staff to hold the information notice in abeyance through the end of 1985 when the new CPI data were to become available. As indicated earlier, however, the authorities have indicated that preparation of the new index has been delayed and it is not clear when it will be available. It should be noted in this context that the approach suggested would not require the inclusion in the information notice of a precise estimate of inflation but only an indication of the staff's judgment that inflation since March 1985 has likely been well below 19 percent (annual rate); no information notice would be issued if reasonable estimates suggested that inflation could be higher.

As regards the broader issue of reliance on estimates as part of the general operation of the information notice system, lags in the preparation and receipt of CPI data from member countries require in many cases that preliminary data, estimates and, in some cases, extrapolations of the seasonally adjusted CPI be used for the calculations. The number of cases for which such practices were required as part of the exercise completed a few weeks ago (for calculations through January 1986) is shown in Table 2. ^{1/} Since, in the absence of shocks, the trend behavior of prices is likely to be more stable than exchange rates, we do not consider that the use of such estimates invalidates the monitoring exercise. We would expect that known shocks are reflected in estimates provided by desk economists. The fact that the lack of current data would make the exercise approximate was recognized from the outset and has not led to objections by Executive Directors. In any event, it should be noted that whenever calculations indicate that the 10 percent threshold was exceeded, the first step involved always is to review the estimates and, where possible, obtain more up-to-date information.

In sum, for countries for which real effective exchange rates for their currencies are monitored at present under the information notice system, we see no alternative to current practices nor do we

¹ Actual or preliminary price data were available through January for nearly half of the 36 "core" countries and through December for 90 percent of these countries. These countries are particularly important since they are the trade partners used in the calculations for other countries. For other countries, lags are longer: actual or preliminary data were available through January for only 25 percent, and through November and December for about half. Calculations for these countries thus rely to a significant extent on staff estimates for the three most recent months (and extrapolations for the most recent month).

think that necessary estimates and approximations invalidate the exercise. For countries for which no precise estimates of inflation are available, we would propose to follow the procedure outlined for Bahrain. While the decision to issue an information notice in these cases would thus involve a greater judgmental element (which would have to be spelled out in the information notice), such a procedure would allow more comprehensive coverage of real exchange rate monitoring and make it possible to apply this monitoring more uniformly to all members. Careful and continuous monitoring should apply to all members, including (perhaps especially) those for which regular contacts are less frequent.

Messrs. Beza and Shaalan may wish to send you a further elaboration of their own views on these issues.

Attachment

cc: Mr. Beza
Mr. Shaalan

Table 1. Countries for which Real Effective Exchange Rates are not Monitored

	Latest Board Consideration		Change in Nominal Effective Rate Since Latest Board Consideration	Range of Inflation Rates Keeping the Real Effective Exchange Rate Within the 10 Percent Threshold <u>2/</u>	
	Type <u>1/</u>	Date			
<u>African Department</u>					
Algeria	C	9/85	-6.2	-5.0	73.5
Benin	C	3/85	4.4	-12.7	11.1
Chad	C	4/85	4.7	-14.1	12.3
Comoros	C	2/85	3.1	-10.4	11.5
Djibouti	C	6/85	-14.9	13.8	60.6
Equatorial Guinea	R	12/85	0.3	-67.8	257.0
Guinea	C,R	2/86	...	...	...
Guinea-Bissau	C	9/85	-13.0	21.3	121.4
Mozambique	C	7/85	...	...	...
Sao Tome & Principe	C	11/84	-4.0	1.1	20.1
<u>Asian Department</u>					
Bhutan	C	8/85	-1.0	-15.5	36.7
Kampuchea, Dem.	C	10/73	...	...	...
Lao, P.D. Rep.	C	1/86	...	...	...
Maldives	N	7/85	-12.4	8.6	62.3
Viet Nam	N	9/85	-88.3	480.7	878.5
<u>Middle Eastern Department</u>					
Afghanistan	C	1/86	...	...	...
Bahrain	C	3/85	-16.6	19.1	51.5
Iraq	N	11/82	14.9	1.3	7.9
Lebanon	C	2/85	-42.3	72.0	114.1
Libya	C	6/85	-14.1	14.4	61.4
Oman	N	2/86	...	...	...
Qatar	C	2/86	...	...	...
Syrian Arab Rep.	C	2/86	...	...	...
United Arab Emirates	C	7/85	-8.5	0.6	50.3
Yemen Arab Rep.	N	1/86	...	...	...
Yemen P.D. Rep.	C	6/85	-12.4	9.0	53.7
<u>Western Hemisphere Department</u>					
Belize	C,R	6/85	-4.9	-5.4	33.5

1/ C: consultation; N: notification of change in exchange system; R: use of Fund resources.

2/ Annual rate. Lower end of range would keep the real effective depreciation less than 10 percent; higher end of range would keep the real effective appreciation less than 10 percent. A rate of inflation outside the range indicated would indicate the need for an information notice.

Table 2. Information Notice System: Status of
Consumer Price Data for Calculations through January 1986

(In percent of total)

	1986		1985			
	January	December	November	October	September	August
<u>36 core countries</u>						
Extrapolation	3	3	--	--	--	--
Estimate	53	8	--	--	--	--
Preliminary	22	11	3	3	--	--
Actual	22	78	97	97	100	100
<u>Noncore countries</u>						
Extrapolation	40	14	10	7	6	3
Estimate	38	39	30	20	10	10
Preliminary	4	2	2	3	2	2
Actual	18	45	58	70	82	85
<u>All countries</u>						
Extrapolation	29	11	7	5	4	2
Estimate	43	30	21	14	7	7
Preliminary	9	5	3	3	2	2
Actual	19	54	69	78	87	89

Table 3. Change in Member Countries' Prices Required to Produce Real Effective Exchange Rate Changes Greater than 10 Percent Between Month of Latest Board Consideration of Members' Exchange Rate Policies and February 1986

(Based on Consumer Prices)

Latest Board Consideration	Type	Date	Percentage Change in Exchange Rate Indices		Percentage Change in CPI Required to Produce REER Change Greater than 10 %			
			1/	2/	REER	Trading Partner Prices	REER Appreciation	REER Depreciation
			NEER		of 10 % Change in per	ANN.	of 10 % Change in per	ANN.
African Department								
Algeria	C	9/85	-8.2	2.7	23.1	64.7	0.7	1.7
Benin	C	3/85	5.0	3.6	8.6	9.4	-11.2	-12.1
Chad	C	4/85	4.9	3.8	8.8	10.7	-11.0	-13.0
Comoros	C	2/85	3.9	3.5	9.6	9.6	-10.3	-10.3
Djibouti	C	6/85	-18.1	2.0	37.1	60.5	12.2	18.8
Equatorial Guinea	R	12/85	0.9	1.8	11.0	86.9	-9.2	-43.9
Guinea	C,R	2/86	n	n	n	n	n	n
Guinea-Bissau	C	9/85	-19.8	3.4	41.9	131.6	16.1	43.1
Sao Tome & Principe	C	11/84	-5.1	8.2	25.3	19.8	2.6	2.0
Asian Department								
Bhutan	C	8/85	-1.5	2.8	14.8	31.8	-6.1	-11.8
Kampuchea, Dem.	C	10/73	...	n	n	n	n	n
Lao P. D. Rep.	C	1/86	-2.2	0.3	12.8	323.3	-7.7	-61.9
Maldives	C	3/86	n	n	n	n	n	n
Viet Nam	N	9/85	-88.7	1.9	895.0	***	714.1	***
Middle Eastern Department								
Afghanistan	C	1/86	...	n	n	n	n	n
Bahrain	C	3/85	-19.5	7.8	47.2	52.5	20.5	22.5
Iraq	N	11/82	10.8	33.8	32.9	9.1	8.7	2.6
Lebanon	C	2/85	-48.0	5.7	123.4	123.4	82.8	82.8
Libya	N	3/86	n	n	n	n	n	n
Oman	N	2/86	n	n	n	n	n	n
Qatar	C	2/86	n	n	n	n	n	n
Syrian Arab Rep.	C	2/86	n	n	n	n	n	n
United Arab Emirates	C	7/85	-11.2	2.0	26.4	49.3	3.4	5.9
Yemen Arab Rep.	N	1/86	-5.4	0.3	16.6	531.1	-4.6	-43.2

Yemen, P. D. Rep.	C	6/85	-15.4	2.5	33.2	53.7	9.0	13.8
-------------------	---	------	-------	-----	------	------	-----	------

Western Hemisphere Department

Belize	R	3/86	n	n	n	n	n	n
--------	---	------	---	---	---	---	---	---

1/ C = discussion at the Board of an Article IV consultation; R = discussion at the Board of use of Fund resources (requests or reviews of stand-by or extended arrangements, and requests for upper tranche drawings under the CFF); N = notification to the Board in respect of exchange rate changes or notification of changes in the exchange system which includes a substantive discussion of the exchange rate; I = information notice.

2/ Month in which the Board discussion took place; for notification or information notices not discussed by the Board, month in which issued.

3/ n = latest Board consideration took place in or after February 1986, ... = index not calculated (for Hong Kong and Switzerland no data are shown as there are no Board discussions). An increase in the value of the indices denotes appreciation.

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**IMMEDIATE
ATTENTION**

SM/86/4
Supplement 2

CONTAINS CONFIDENTIAL
INFORMATION

March 28, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Implementation of Procedures for Surveillance - Review

It is not proposed to bring the attached draft decision to the agenda of the Executive Board for discussion unless an Executive Director so requests by the close of business on Tuesday, April 1, 1986. In the absence of such a request, the draft decision will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Att: (1)

Other Distribution:
Department Heads

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**IMMEDIATE
ATTENTION**

SM/86/3
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

March 28, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Surveillance over Exchange Rate Policies - Review

It is not proposed to bring the attached draft decision to the agenda of the Executive Board for discussion unless an Executive Director so requests by the close of business on Tuesday, April 1, 1986. In the absence of such a request, the draft decision will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Att: (1)

Other Distribution:
Department Heads

The following decision is proposed for adoption by the Executive Board:

Surveillance over Exchange Rate Policies: Review

The Executive Board has reviewed the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as required by paragraph 2 of that decision. The next review of the document shall be conducted not later than April 1, 1988.



OFFICE OF THE
MANAGING DIRECTOR

INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

CABLE ADDRESS
INTERFUND

March 6, 1986

MEMORANDUM

To: The Deputy Managing Director
Mr. Hood
Mr. Whittome
Mr. Beza ✓
Mr. Narvekar
Mr. Crockett
Mr. Goldstein

From: Robert M. G. Brown *RmgBrown*

Subject: Meeting on Underlying Payments Balances and
Equilibrium Exchange Rates

The Managing Director would like to hold a meeting in his office on Tuesday, March 11 at 9:30 a.m. to discuss the wisdom of, and possible approaches to, the calculation of equilibrium payments balances for major industrial countries. A proposal to this effect was made by Mr. Polak at the Executive Board meetings on Target Zones and on Surveillance. A further point for consideration at the meeting is how such calculations and the analytical framework underlying them could contribute to the discussions in G-5 multilateral surveillance meetings, and in the meetings of our own Surveillance Committee. Ideas on Mr. Sengupta's proposal (equilibrium exchange rates) would also be welcomed.

cc: Managing Director

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.
1986 MAR -6 AM 11:52

STB
F

March 3, 1986 - 86/43

The Chairman's Summing Up Following the Discussion on the Special Review
of the Fund's Income Position and of the Remuneration Coefficient
Executive Board Meeting 86/38 - February 27, 1986

Although a number of Directors prefer to reduce charges now, with effect November 1, 1985 or February 1, 1986, there is not the necessary majority to take that decision at this meeting.

However, there is a general, I would say unanimous, willingness to lower the rate of charge for the last quarter or the last half of financial year 1986 on the basis of excess net income evident at the end of FY 1986, and to deem part of that excess income as income for FY 1987 so as to cushion possible income shortfalls in that year.

A number of Directors would prefer to announce now the Board's intention to reduce the rate of charge retroactively if there is excess net income in FY 1986. However, the majority does not wish to do so and prefers instead to state clearly today the principle that a reduction in the rate of charge would occur in the context that I just mentioned. The majority view is that a formal decision to reduce the rate of charge retroactively should not be considered until the income position for FY 1986 as a whole is clear, by the latter part of April 1986, at which time a meeting to consider a decision will take place.

Many Directors emphasized that there must be no cash payments to members in arrears to the Fund as a result of a decision to reduce the rate of charge retroactively.

The Board agreed to review the remuneration coefficient again in late April 1986. If a reduction of that coefficient is decided at that time, it is my understanding that many of you think that it should apply as of May 1, 1986.

The staff is to examine a number of legal and operational issues raised by Mr. Zecchini and others, including the question of an offset provision, which is to be the subject of a staff paper for the Board's consideration. While the Fund is, under its present practice, not offsetting its financial obligations to a member against overdue financial obligations of that member to the Fund, the staff believes that it is legally possible to introduce a provision under which this could be done. Several Directors also referred to their interest in the forthcoming staff paper on loan loss provisioning.

The study on a possible offset provision will help the Board to decide whether a reduction in the rate of charge should take effect on November 1, 1985--which seemed to be the clear preference in the Board today--instead of February 1, 1986. The latter date was supported by some Directors who saw it as a way to avoid the need to make refunds to members in arrears following a decision to reduce the rate of charge retroactively. If we can solve that problem, as the staff suggested that we could, then I think that we would be looking at an effective date of November 1, 1985, which, as several Directors stated, would be the logical and fairest approach.

Review Staff
Exchange Rates

February 19, 1986 - 86/31

The Chairman's Concluding Remarks Following the
Discussion on Review and Assessment of the System
of Floating Exchange Rates and Target Zones
Executive Board Meeting 86/26 - February 12, 1986

FILE COPY

1. General points

There is clearly widespread concern among Executive Directors about the way in which the exchange rate system has operated in recent years. In this connection, I wish to make several points.

First, there was broad agreement that, in present circumstances, a return to a fixed exchange rate system would be impracticable and undesirable. Given the magnitude of the external shocks that the world economy has suffered over the past ten years or so, and given the size, the openness and the integration of capital markets, Directors considered that an element of flexibility in the working of the exchange rate system has been--and remains--essential, as it has helped to preserve an open trading system. Its flexibility has contributed to the absorption of shocks by the system.

Second, it was widely recognized that the floating system has not functioned without substantial problems. Massive balance of payments imbalances have developed, there has been excessive short-term exchange rate volatility, and, perhaps more important, significant and persistent misalignments in exchange rates have appeared. These problems have entailed substantial costs in terms of market uncertainty, misallocation of resources, and protectionist pressures. A number of Directors considered that these costs have been particularly acute for developing countries--which have greater difficulty than industrial countries in utilizing hedging mechanisms--and for small, open countries, which are more vulnerable to external shocks stemming from exchange rate volatility and/or misalignment. The staff was asked to study further the possible differences in the impact of exchange rate variability and misalignment on the various groups of members.

Third, a number of Directors considered that the payments imbalances, exchange rate volatility, and exchange rate misalignments were not due directly to the floating rate regime itself; rather they were the reflection of the divergent and sometimes incompatible economic policies of the major industrial countries. However, a large number of Directors recognized that the way in which the floating regime had operated has some systemic implications. Indeed, the system had not helped to promote discipline and coordination in the setting of economic and financial policies in the major industrial countries. Moreover, the system had not--as had been hoped by some before the launching of the system--fully protected monetary policy autonomy. In sum, there was a clearer recognition that exchange rates do count, and that a more "active approach" toward improving the system was called for. The Plaza Agreement of September 22, 1985 and President Reagan's recent statement on currencies in his State of the Union Address are manifestations of the need for that approach.

2. Improving the functioning of the system

In the light of those general points, the question naturally arises what is to be done to improve the functioning of the system? A number of interesting views were expressed.

Directors generally agreed that the potential improvements in the exchange rate system rely heavily on the extent to which individual major industrial countries in particular will show the political will to increase policy discipline and pursue more internationally consistent policies. In other words, the basic questions are whether the international consequences of domestic policies will be taken more fully into account by the interested authorities when they formulate and implement those policies, and how the exchange rate system can enhance such mutual consistency.

The practical suggestions that have been presented and analyzed by the staff have to be looked at in the light of the objective of improving the functioning of the exchange rate system in order to achieve better policy coordination and consistency.

Twelve Directors said that they have an open mind on or a favorable attitude toward some form of target zones. The basic idea behind that line of thought is that target zones would introduce an automatic or quasi-automatic mechanism which would enhance the discipline in the system. There were some nuances of opinion among those who held that basic view. But several Directors were interested in a target zone system that would have the following characteristics: it would consist of a version of "soft" targets, at least at the start; it would give at least an indication of the direction of appropriate exchange rate movements, if not a precise pattern; it should trigger discussions in the event of emerging misalignments or other problems; it should provide a framework for regular discussions among major countries with a view to preventing problems; and the exchange rate indicator would be only one element of a broader set of criteria to be utilized in assessing the position of economic policies of different countries. Some Directors felt that an expanded version of the EMS was worth considering.

Other Directors were skeptical about, or had reservations on the idea of, setting a pattern of exchange rates and using that pattern as an operational mechanism. They made in particular the following points. First, it would be very difficult, if not impossible, to reach an agreement on a pattern of equilibrium exchange rates. Second, such a system could in some circumstances facilitate or foster destabilizing speculation. Third, and perhaps more important, concentrating on one indicator, the exchange rate, as a guide for policy adjustments, and using only monetary policy--the most flexible instrument--to maintain a predetermined pattern of exchange rates, could together result in inappropriate policy responses in some circumstances; monetary policy could become excessively subservient to the attainment of external policy objectives, and the system could then encourage inflation or deflation.

Whatever the mechanism, most Directors agreed that, without sound and consistent economic policies, a target zone system would not be an appropriate tool in itself, and could send misleading signals.

Most--if not all--Directors considered that the September 22, 1985 Plaza Agreement was a favorable--although belated in the view of several--development, as it was a manifestation of closer convergence of economic policies and had encouraged a more rational pattern of exchange rate developments. Most Directors also agreed that improved cooperation among the largest players in the exchange rate markets--especially the major industrial countries--was crucial for the successful working of any exchange rate regime. Most Directors further agreed that the appropriateness of exchange rates should be one, but only one, of the elements involved in the exercise of multilateral surveillance.

I come now to the possible role of objective indicators in the conduct of surveillance. A number of Directors stressed what they felt were the imperfections of the peer pressure mechanism and of the present surveillance procedures. They urged the Fund to adopt a negotiated set of broad objective indicators that could trigger policy discussions or even policy actions. But many Directors were skeptical or had reservations--indeed, some of them had strong reservations--about the mechanical use of such indicators, because of the complexity and possible shortcomings of such an exercise. In any event, several of them doubted whether it would be practicable to attain a consensus on such a complex array of indicators. But all agreed that the efficiency of surveillance should be reinforced, and I expect that to be the major theme of next week's discussion on surveillance.

In concluding I would note 11 precepts that were mentioned during the discussion. (1) The existence of a broad political will to take appropriate actions is a prerequisite for the successful working of any exchange rate system. The needed political will would be fostered by an appreciation by policymakers of how their own actions can affect the exchange rate system and in turn their own economies. (2) The major currency centers must maintain stable, anti-inflationary, sound and balanced economic policies if any exchange rate system is to work. (3) Surveillance must be reinforced and should encompass a wide range of indicators, including exchange rates. (4) The Fund must play a central role in the operation of and surveillance over the exchange rate system. (5) Directors should build on the strengths of the present system and correct its imperfections. (6) Whatever system is devised, it must have sufficient flexibility. (7) Directors should not overemphasize the significance of the differences in the various possible approaches to obtaining improvements in the exchange system; they should concentrate on the basic substantive objectives of those improvements. (8) The Fund should study more deeply the merits and limits of the EMS system as an aid in assessing possible improvements in the overall exchange rate system. (9) The improvements should aim, in particular, at avoiding the major misalignments that

have marred the present system in recent years. (10) In discussing these matters we should not have in mind ideal, textbook situations and solutions. Instead, we should consider proposals and actions that are realistic and which are based on an understanding of how the markets function and are likely to react to changes in the exchange rate system. (11) We should do nothing that might encourage trade and payments restrictions.

SM/86/4
Supplement 1

CONTAINS CONFIDENTIAL
INFORMATION

January 28, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Surveillance over Exchange Rate Policies - Annual Review -
Background Material

The attached paper provides factual information on the implementation of surveillance procedures in 1985, as well as background material for the annual review of surveillance, which has been scheduled for Wednesday, February 19, 1986.

Mr. Belanger (ext. 8671) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Surveillance Over Exchange Rate Policies--
Annual Review: Background Material

Prepared by the Exchange and Trade Relations Department

(In Consultation with Other Departments)

Approved by C. David Finch

January 28, 1986

<u>Contents</u>	<u>Page</u>
I. Introduction and Summary of Main Issues	1
II. Article IV Consultations in 1985	3
1. Membership coverage	3
2. Specification of the interval between consultation	3
3. Delays in concluding consultations and problem cases	5
4. Time elapsed between missions and Executive Board conclusion of consultations	5
5. Application of the three-month rule	6
6. Resources devoted to Article IV consultations	7
a. Staff travel	7
b. The Executive Board	7
7. Length of staff reports and papers on recent economic developments	7
III. Aspects of Article IV Consultation Reporting	24
1. Projections	24
2. Policy coverage	26
a. Exchange rate policies	26
b. Fiscal policies	27
c. Monetary policies	29
d. Structural policies	31
e. Trade policies	33
f. Other	34
3. Consultation follow-up	35
4. Reporting on World Bank activities	36
IV. Monitoring of Exchange Rates and Exchange Arrangements	44
1. Periodic reviews	44
2. Information notice system	44
3. Monitoring of exchange rate and restrictive system policies in member countries	45

<u>Contents</u>		<u>Page</u>
a.	Notification of changes in exchange arrangements	46
b.	Notification of changes in exchange systems	47
c.	Format and content of notifications	47
V.	Coverage of Selected Surveillance Topics In the General Work of the Fund	52
Text Tables		
1.	Article IV Consultations--Membership Coverage, 1981-85	9
2.	Frequency of Article IV Consultations, 1981-85	10
3.	Countries on Standard 12-Month Consultation Intervals	11
4.	Countries on Longer Consultation Intervals	13
5.	Countries for Which Timing Has not Been Specified for Next Consultation	14
6.	Countries Exceeding Specified Consultation Intervals in 1985	15
7.	Article IV Consultations--Period from Termination of Initial Discussions to Board Conclusion, 1981-85	17
8.	Reasons for Requests for Extension of the Three-Month Period for the Conclusion of Article IV Consultations, 1981-85	18
9.	Requests for Extension of Three-Month Period for Conclusion of Article IV Consultations in 1985	19
10.	Size of Article IV Consultation Missions, 1981-85	20
11.	Professional Staff Participation in Article IV Consultation Missions by Area and Functional Departments, 1981-85	21
12.	Country Items in Executive Board Meetings, 1981-85	22
13.	Length of Reports in Connection with Article IV Consultations, 1981-85	23
14.	Short-Term Projections in Reports for Article IV Consultations in 1985	38
15.	Medium-Term Scenarios in Reports for Article IV Consultations in 1985	39
16.	Exchange Rate Policy Discussion in Reports for Article IV Consultations in 1985	40
17.	Views on Exchange Rate Policies in Staff Reports for Article IV Consultations Concluded in 1985	41
18.	Analytical Coverage of Fiscal and Money/Credit Policy in Reports for Article IV Consultations in 1985	42
19.	References to World Bank in Reports for Article IV Consultations with Nonindustrial Countries in 1985	43
20.	Information Notices Issued, 1983-85	48
21.	Information Notices Issued in 1985	49
22.	Notifications of Exchange Arrangements Issued in 1985	50

<u>Contents</u>	<u>Page</u>
23. Notifications of Exchange System Changes Issued in 1985	51
24. Coverage of Selected Surveillance Topics in 1985	54
25. Executive Board Documents Issued in 1985 Providing Information on Specific Policy Measures and Economic Developments	57
26. Article IV Consultations Concluded in 1985	58

I. Introduction and Summary of Main Issues

Under Article IV, section 3, the Fund is to exercise firm surveillance over the exchange rate policies of members. In order for the Fund to perform its functions in this regard, the Executive Board adopted the principles and procedures for surveillance set forth in the document entitled "Surveillance over Exchange Rate Policies." ^{1/} Paragraph VI of the section on procedures states that the Executive Directors shall review annually the general implementation of surveillance. This paper is intended to provide factual information on the implementation of surveillance procedures in 1985, as background for the annual review which is to be completed not later than April 1, 1986.

A second purpose of the paper is to provide a more extensive survey than hitherto of the content of staff reports for Article IV consultations, providing a basis against which to assess recent recommendations for improvements in staff reports. Such recommendations, most notably in the reports of the G-10 and G-24 Deputies, ^{2/} have related in particular to the analytical basis of staff assessments, and to the specificity of assessments and policy recommendations.

Solid staff preparation, comprehensive discussions and complete and analytically sound reports are essential elements for the effective implementation of the Fund's surveillance responsibilities. Requests for a greater range of topics to be covered in consultation reports and for a more analytic treatment of some of these topics have increased demands on staff time and resources. In assessing possible ways of further strengthening the implementation of surveillance procedures, careful attention needs to be paid to the still greater demands that may be implied in the recommendations made. As noted in SM/86/4, these issues arise in connection with the frequency of consultations, the coverage of staff reports and the adoption of new (formal or informal) procedures.

Section II reviews the implementation of surveillance procedures through Article IV consultations with individual members in 1985. As noted in recent reviews of the implementation of surveillance, there has been a substantial increase in the number of Article IV consultations concluded annually following the widespread and rapid emergence of severe debt servicing difficulties in 1982, and the recognition that a determined effort was needed to ensure a more regular flow of

^{1/} Executive Board Decision No. 5392-(77/63), adopted April 29, 1977, Selected Decisions of the International Monetary Fund and Selected Documents, Eleventh Issue, pp. 10-14.

^{2/} "Report of G-10 Deputies on the Functioning of the International Monetary System," circulated as EBD/85/154, Supp. 1 (6/21/85) and "Report of the Deputies of the Group of Twenty-four on the Functioning and Improvement of the International Monetary System--Transmittal to the Interim Committee," circulated as EBD/85/228, (8/30/85).

information to the Fund on developments and policies in member countries. This trend continued in 1985 as the number of consultations concluded increased further to 131 from 119 in the preceding year.

Section III examines, on the basis of a survey of staff reports for Article IV consultations concluded in 1985, current practices regarding the content of staff reports. A conclusion of the survey is that the policy coverage of Article IV staff reports has been quite extensive. In recent years, problems of external debt and protectionism have increasingly been important elements of staff discussions with members. Most consultation reports, in particular reports for almost all countries where external debt is a significant issue, include a description of the medium-term external debt or payments outlook for the country concerned. Problems of fiscal policy and structural adjustment, including in particular the pressing need to increase the efficiency of labor markets, are also being stressed in many consultations. The survey also reviews current practices as regards the inclusion of specific policy assessments and recommendations in staff reports for Article IV consultations, providing background for the discussion of related proposals in the report of G-10 Deputies.

Section IV reviews the implementation in 1985 of regular practices for the monitoring of exchange rates and exchange arrangements. Notifications to the Executive Board of changes in exchange arrangements and information notices relating to large changes in real effective exchange rates continued to bring to the Board's attention a large number of significant changes in exchange rates. Directors have generally considered at the time of earlier annual reviews that experience with the two parallel monitoring systems had been broadly satisfactory.

Section V provides a brief overview of major Board discussions in 1985 related to surveillance.

II. Article IV Consultations in 1985

1. Membership coverage

The number of Article IV consultations continued to increase in 1985. A total of 131 consultations were concluded, involving 85 percent of Fund membership 1/ compared with about 120 consultations in each of 1983 and 1984 (Table 1). Consultations were concluded with all of the G-10 countries and with all but two of the non-G-10 industrial countries. Consultations were also concluded with 84 percent of the nonindustrial countries in 1985, compared with 77 percent in 1984.

For members concluding consultations, the average period between consultations fell from 15 months in 1984 to 13.5 months in 1985, compared with more than 19 months in both 1982 and 1983 (Table 2). The continuing decline reflected the ongoing application of the system of specifying, when concluding a consultation, the interval until the next consultation, as well as the normalization of the consultation process for most countries for which consultations had previously been long overdue. Only four countries had not had consultations within the past 24 months at the end of each of the last two years compared with six at the end of 1983 and 19 at the end of 1982.

2. Specification of the interval between consultations

The guidelines established by the Executive Board at the time of the 1983 Surveillance Review state that Article IV consultations should be conducted annually for members whose economic developments have a substantial impact on other countries, 2/ for members with programs involving use of Fund resources, and for members for which there are substantial doubts about medium-term balance of payments viability. For other countries, the interval between consultations may extend up to two years. Directors have also considered that smaller members for which longer intervals between consultations would otherwise be appropriate should be entitled to request annual consultations.

A standard 12-month interval between consultations had been specified for 127 countries as of the end of 1985, 87 percent of the cases for which the interval until the next consultation had been established (Table 3). 3/ Standard 12-month intervals had been specified for 85 percent of the industrial countries and for 87 percent of the

1/ Two Article IV consultations each were concluded by the Board for three countries in 1985, and separate consultations were concluded with the Netherlands and Netherlands Antilles. The number of members covered was thus 127 in 1985, compared to 117 in 1983 and 118 in 1984.

2/ Interpretation of this criterion was made more specific at the time of the 1985 annual review of surveillance by noting that it should apply to "at least the 25 largest members" (SUR/85/36, 3/28/85).

3/ Includes Netherlands Antilles for which a separate consultation is specified.

nonindustrial countries. In addition to countries with the largest Fund quotas, 1/ a standard 12-month interval had been specified for one country considered important at the regional level; 51 countries with a Fund stand-by or extended arrangement, or for which such an arrangement has either recently ended or is being considered; 46 countries whose situation indicates a need for close scrutiny; and 5 countries for which an interval of 12 months was specified at the request of the authorities. Of the 19 cases in which longer intervals had been specified, 16- to 19-month intervals had been specified in 17 cases while 24-month intervals had been specified in two cases (Table 4).

During 1985, the interval until the next consultation was changed in 12 cases from that which had been specified earlier. Twelve-month intervals were specified for Lebanon and Chad (for which no specific time had been set earlier owing to security problems) and for Austria, Benin, Djibouti, Jordan, the Netherlands Antilles, the Seychelles, and Solomon Islands (for which a longer interval had previously applied). The specification of a twelve-month interval in the cases of Djibouti and the Seychelles was at the request of the authorities, while Austria is among the 25 largest member countries. The interval until the next consultation was lengthened from 12 to 18 months for Grenada and the United Arab Emirates while, in the case of Luxembourg, a longer interval of 24 months was specified (instead of the earlier outer limit of 18 months). Decisions concerning the interval until the next consultation were taken for the first time in six cases: twelve-month intervals were specified for Comoros, Mozambique, and Yugoslavia while longer intervals were specified for Cape Verde, Libya, and St. Christopher and Nevis.

Accommodation of members' desires to hold consultations at a particular time of year has, at times, been accomplished by use of the grace period. For example, in the case of Greece, for which a standard 12-month cycle applies, this was done explicitly by noting that the next consultation would take place in about 15 months (making use of the three-month grace period). 2/ In a few cases, changing of the timing of the consultation has been achieved by extending the specified interval until the next consultation. In the case of Belgium, for which a standard 12-month cycle applies, it was noted that, exceptionally, the next consultation would be concluded in about 16 months. 3/ In the case of Qatar, management approved an extension of the interval until the next consultation from 18 months to 24 months to permit the next consultation mission to take place at the same time of the year as the previous

1/ At present, the criterion applies to members with the 24 largest quotas. In the case of Norway, which has the 25th largest quota, a 19-month interval until the next consultation was specified at the conclusion of the most recent Article IV consultation in December 1984.

2/ "Chairman's Summing Up at the Conclusion of the 1985 Article IV Consultation with Greece," SUR/85/87 (6/11/85).

3/ "Chairman's Summing Up at the Conclusion of the 1984 Article IV Consultation with Belgium," SUR/85/3 (1/14/85).

one. In one case (Venezuela) for which special monitoring procedures under enhanced surveillance are being applied, it was decided at the request of the authorities that the next regular Article IV consultation would take place in about six months and that the special midyear consultation would take place in about one year. 1/

3. Delays in concluding consultations and problem cases

Consultation intervals have been specified for all but four countries (Table 5). Tonga, which became a Fund member on September 13, 1985, is expected to conclude its first Article IV consultation in 1986. The other three cases are instances of long-standing difficulties: Democratic Kampuchea, no contacts; Iraq, security problems; Islamic Republic of Iran, security problems.

Twenty-two of the consultations which, on the basis of the interval specified, had been expected to be concluded in 1985 either have exceeded or are likely to exceed the specified interval by more than the three-month grace period (Table 6). However, in contrast with the more lengthy delays experienced earlier, recent delays have been a matter of a few days or weeks, or at most a few months. These delays in concluding consultations have been generally attributable either to continuing discussions on the use of Fund resources or to difficulties in fielding the staff mission (sometimes as a result of staff involvement in missions to other countries). Executive Directors have stressed on several occasions that consultations should not be delayed because of discussions on the use of Fund resources. In contrast with experience in several earlier cases, however, recent cases in which delays have occurred because of continuing discussions for the use of Fund resources have involved only short delays aimed at avoiding successive Board discussions within a brief interval.

4. Time elapsed between missions and Executive Board conclusion of consultations

The period from termination of initial consultation discussions to conclusion by the Executive Board which had averaged 104 days in the two preceding years fell to 97 days in 1985 (Table 7). 2/ Most of this decline was in the average period between the termination of initial discussions and issuance of the staff report, which fell to 66 days in 1985 from 71 days in 1984. This decline reflected shorter delays in cases of consultations requiring multiple missions. While the number of

1/ "Chairman's Summing Up at the Conclusion of the 1985 Article IV Consultation with Venezuela," SUR/85/132 (12/19/85).

2/ The terms "initial" and "final" discussions are used to refer to cases where the conclusion of consultation discussions with the authorities requires multiple missions or further discussions with the authorities at headquarters, generally associated with concurrent discussions of use of Fund resources. In the more usual cases of single missions, "initial" and "final" discussions are the same.

cases requiring multiple missions declined only slightly from 20 in 1984 to 19 in 1985, associated delays fell sharply to 9 days, on average, from 19 days in 1984. There was a slight offsetting increase in the average period from the termination of final discussions to the issuance of staff reports from 52 days in 1984 to 57 days in 1985.

The average period from issuance of staff reports to Board conclusion of the consultation also declined, falling from 33 days in 1984 (and 37 days in 1983) to 31 days in 1985. This decline was attributable to a rise in the percentage of papers being considered by the Board at or near the minimum circulation period for which an Executive Board waiver is not required. 1/ The percentage of Article IV consultations concluded within 30 days following the issuance of the staff report rose from 54 percent in 1984 to 68 percent in 1985.

5. Application of the three-month rule

Under the Procedures for Surveillance (Decision No. 5392-(77/63), Procedure II), the Executive Board is required to conclude an Article IV consultation not later than three months after the completion of discussions between the member country and the staff. 2/ If Executive Board consideration of an Article IV consultation report is expected to be delayed beyond the three-month period, a paper is issued seeking Board approval for an extension of the period for concluding the Article IV consultation.

The number of extensions of the three-month period fell from 27 in 1984 to 24 in 1985 (Tables 8 and 9). Brief delays in order to discuss the Article IV consultation jointly with a member's request for the use of Fund resources or with reviews of existing Fund-supported arrangements remained the most frequent reason for extensions beyond the three-month period. Other frequent reasons were difficulties in scheduling Board meetings, the need to provide sufficient time for official comments on staff reports, staff commitments to other missions, and the need to seek additional information from the authorities.

1/ Staff reports for Article IV consultations with all members are normally required to be circulated at least three weeks in advance of the Board discussion. For members using the Fund's resources in the upper credit tranches or those whose consultations would have an important bearing on the Fund's surveillance functions under Article IV, the normal minimum circulation period is four weeks. Shorter circulation periods are permissible with an Executive Board waiver.

2/ A detailed discussion of procedures followed in this respect is provided in the 1983 Surveillance Review paper (SM/83/43, 3/1/83).

6. Resources devoted to Article IV consultations

a. Staff travel ^{1/}

The number of consultation missions, which fell from 130 in 1983 to 123 in 1984, is estimated to have increased to 134 in 1985 (Table 10). The increase was attributable to a rise in the number of Article IV consultations that was initiated during the year, as the number of multiple missions was little changed. The sharply increasing trend noted in the number of consultation missions in the African and Western Hemisphere Departments continued in 1985. The size of missions remained stable, averaging 4.7 professional staff. Eighty-four percent of all missions included four or five professional staff. ^{2/} The total number of staff member trips in connection with Article IV consultations is estimated to have increased from 588 in 1984 to 636 in 1985 (Table 11).

b. The Executive Board

Executive Board time devoted to country items increased sharply in 1985 and was primarily responsible for the concurrent increase in the total time spent in Board discussions (Table 12). The Executive Board devoted 323 hours (62 percent of total) to discussions of country items in 1985, compared with 298 hours in 1984. The rise was attributable about equally to the increase in the number of consultations concluded in 1985 and to the longer period of time devoted to each consultation. The average time spent on Article IV consultations or consultations combined with use of Fund resources increased from 1.6 hours in 1984 to 1.8 hours in 1985. Miscellaneous country items, which had accounted for only a small proportion of Board time previously, increased sharply in 1984 and remained high in 1985 (mainly on account of discussions of overdue financial obligations).

7. Length of staff reports and papers on recent economic developments

The trend toward longer consultation reports noted in earlier annual reviews continued in 1985. The average length of the main text of staff reports rose slightly from 20.6 pages in 1984 to 21.2 pages in 1985 (Table 13). Although there was a slight increase in the percentage of reports incorporating requests for the use of Fund resources and reviews of Fund-supported arrangements, the increase was mainly the

^{1/} Data on the size of Article IV missions and participation in Article IV missions by area and functional departments are based on actual data for January-October 1985 and staff estimates for November and December 1985. Data on duration of business travel by purpose and by department for 1985 will be available early in February and will be circulated as a supplement before the Board meeting.

^{2/} In addition, a number of Article IV consultation missions included an IBRD staff member; the number of IBRD staff is not included in these calculations.

result of more extensive reporting, including medium-term scenarios, and discussions of protectionism and structural policies.

The average length of papers on recent economic developments (including supplements) also increased, from 99.5 pages in 1984 to 103.6 pages in 1985. While there was a slight rise in the number of very short RED papers (50 pages or less) in 1985, this was more than offset by an increase in the percentage of long RED papers (over 100 pages) to 53.6 percent in 1985, continuing the trend toward longer papers noted in preceding years; the number of RED papers of 150 pages or more increased from two in 1984 to eight in 1985. The increase in length reflects in part the expanding practice of including special appendices on a wide variety of analytical and institutional issues (at the request of, and often commented favorably upon by, the Executive Board), as well as the provision of more complete information on external indebtedness, trade policies, and the impact of protectionism.

Table 1. Article IV Consultations--
Membership Coverage, 1981-85 1/

	1981	1982	1983	1984	1985
Consultations completed	<u>86</u>	<u>82</u>	<u>120</u>	<u>119</u>	<u>131</u>
Industrial countries	13	13	16	19	18
Group of 10	(8)	(8)	(8)	(10)	(10)
Other	(5)	(5)	(8)	(9)	(8)
Nonindustrial countries	73	69	104	100	113
Of which:					
Program countries <u>2/</u>	28	30	42	29	31
Membership coverage (percent)	<u>61</u>	<u>57</u>	<u>80</u>	<u>80</u> <u>3/</u>	<u>85</u> <u>3/</u>
Industrial countries	65	65	80	95	90
Group of 10	(80)	(80)	(80)	(100)	(100)
Other	(50)	(50)	(80)	(90)	(80)
Nonindustrial countries	60	55	80	77	84
Of which:					
Program countries <u>2/</u>	55	57	90	88	91
Memorandum items:					
Staff reports issued	83	98	118	114	135
Consultation missions <u>4/</u>	88	106	130	123	134 <u>5/</u>

Source: Exchange and Trade Relations Department.

1/ Excludes supplemental consultations under enhanced surveillance. A complete listing of countries concluding Article IV consultations in 1985 is provided in Table 26.

2/ Countries with stand-by or extended arrangements in effect at end of year.

3/ Two Article IV consultations were discussed by the Board within a single calendar year for one country in 1984 and for three countries in 1985, and separate consultations were concluded with the Netherlands and the Netherlands Antilles in 1985. The number of members covered was thus 118 in 1984 and 127 in 1985.

4/ Includes multiple missions for individual consultations.

5/ Based on actual data through October 1985 and estimates prepared by the Administration Department for the remainder of 1985.

Table 2. Frequency of Article IV Consultations, 1981-85

	1981	1982	1983	1984	1985
1. Countries concluding consultations during year					
Average interval since last consultation (months)	<u>18.0</u>	<u>19.7</u>	<u>19.3</u>	<u>15.0</u>	<u>13.5</u>
Industrial countries	18.3	17.7	17.0	13.8	13.7
Group of 10	(17.9)	(14.4)	(14.8)	(12.7)	(12.9)
Other	(19.3)	(23.0)	(19.2)	(14.9)	(14.7)
Nonindustrial countries	17.9	20.1	19.4	15.2	13.4
Of which: program <u>1/</u>	18.2	22.1	20.0	14.4	14.5
2. Countries not concluding consultations during year <u>2/</u>					
Number of countries	58	62	29	28	21
Of which: program <u>1/</u>	(23)	(23)	(5)	(4)	(3)
Number without consultations for:					
15-24 months	36	27	12	10 <u>3/</u>	4 <u>4/</u>
More than 24 months	14	19	6	4	4

Source: Exchange and Trade Relations Department.

1/ Countries with stand-by or extended arrangements at end of year.

2/ Excludes new members which had not yet held their first consultation.

3/ Includes six countries on longer consultation intervals for which no consultation was scheduled in 1984.

4/ Includes one country on a longer consultation interval for which no consultation was scheduled in 1985.

Table 3. Countries on Standard 12-Month Consultation Intervals

(As of January 27, 1986)

Country	Date by Which Next Consul- tation to be Concluded <u>1/</u>	Country	Date by Which Next Consul- tation to be Concluded <u>1/</u>
<u>African Department</u>			
Algeria	09/09/86	Madagascar	01/08/87
Benin	03/08/86	Malawi	05/22/86
Botswana	04/10/86	Mali	05/03/86
Burkina Faso	10/19/85 <u>2/</u>	Mauritania	11/01/86
Burundi	05/08/86	Mauritius	09/18/86
Cameroon	08/26/86	Morocco	09/12/86
Central African Republic	09/23/86	Mozambique	07/03/86
Chad	04/26/86	Niger	07/08/86
Comoros	02/25/86	Nigeria	06/17/86
Congo	11/04/86	Rwanda	01/15/87
Cote d'Ivoire	06/03/86	Sao Tome and Principe	11/19/85 <u>2/</u>
Djibouti	06/17/86	Senegal	01/16/86 <u>3/</u>
Equatorial Guinea	10/12/85 <u>2/</u>	Seychelles	04/24/86
Ethiopia	06/14/86	Sierra Leone	12/04/86
Gabon	03/15/86	Somalia	08/09/86
Gambia, The	09/20/86	Swaziland	07/31/86
Ghana	09/13/86	Tanzania	12/09/85 <u>3/</u>
Guinea	10/31/85 <u>4/</u>	Togo	05/17/86
Guinea-Bissau	09/04/86	Tunisia	11/12/86
Kenya	10/21/86	Uganda	02/08/86
Lesotho	11/20/86	Zaire	04/24/86
Liberia	07/24/86	Zambia	10/30/86
		Zimbabwe	09/18/86
<u>Asian Department</u>			
Bangladesh	12/02/86	Malaysia	07/24/86
Burma	03/01/86	Maldives	01/23/86 <u>3/</u>
China, Peoples Republic of	11/08/86	Nepal	12/23/86
Fiji	12/20/86 <u>5/</u>	Papua New Guinea	08/07/86
India	02/22/86	Philippines	09/25/86
Indonesia	02/08/86 <u>4/</u>	Solomon Islands	08/28/86
Japan	03/04/86 <u>4/</u>	Sri Lanka	05/22/86
Korea	07/12/86	Thailand	06/14/86
Lao, P.D.R.	01/03/87	Vietnam	07/01/86
		Western Samoa	02/04/86
<u>European Department</u>			
Australia	02/20/86 <u>4/</u>	Italy	05/24/86
Austria	05/22/86	Netherlands	05/01/86
Belgium	... <u>6/</u>	Netherlands Antilles	02/15/86
Cyprus	12/19/85 <u>3/</u>	New Zealand	06/10/86
Denmark	03/18/86	Portugal	09/09/86
France	07/29/86	Romania	10/28/86
Germany	08/02/86	South Africa	06/07/86
Greece	06/11/86 <u>7/</u>	Spain	09/23/86
Hungary	01/13/87	Sweden	08/07/86
Iceland	01/13/87	Turkey	01/13/87
Ireland	09/10/86	United Kingdom	03/06/86 <u>4/</u>
Israel	05/24/86	Yugoslavia	04/29/86

Table 3 (Concluded). Countries on Standard 12-Month Consultation Intervals
(As of January 27, 1985)

Country	Date by Which Next Consul- tation to be Concluded <u>1/</u>	Country	Date by Which Next Consul- tation to be Concluded <u>1/</u>
<u>Middle Eastern Department</u>			
Afghanistan	01/24/87	Saudi Arabia	07/26/86
Egypt	08/07/86	Sudan	12/19/85 <u>3/</u>
Jordan	06/26/86	Syrian Arab Republic	09/10/85 <u>2/</u>
Lebanon	02/20/86	Yemen Arab Republic	11/20/86
Pakistan	02/27/86	Yemen, P.D.R.	06/10/86
<u>Western Hemisphere Department</u>			
Argentina	09/04/85 <u>2/</u>	Guatemala	06/21/86
Bahamas	06/12/86	Guyana	11/20/86
Barbados	10/25/86	Haiti	11/25/86 <u>5/</u>
Belize	06/28/86	Honduras	01/27/87
Bolivia	09/23/86	Jamaica	07/17/86
Brazil	08/28/86	Mexico	06/07/86
Canada	02/27/86 <u>4/</u>	Nicaragua	03/04/86
Chile	07/15/86	Panama	07/15/86
Colombia	07/26/86	Paraguay	12/11/86 <u>5/</u>
Costa Rica	09/10/86	Peru	12/21/85 <u>2/</u>
Dominica	07/15/86	Suriname	03/22/86
Dominican Republic	11/27/86	Trinidad and Tobago	05/01/86
Ecuador	09/20/86	United States	08/05/86
El Salvador	12/27/86	Uruguay	04/08/86
		Venezuela	06/13/86

Source: Exchange and Trade Relations Department.

1/ On basis of specified 12-month interval. Conclusion of consultation within the grace period of three months after the date specified would be considered in compliance with the guideline.

2/ See Table 6.

3/ Conclusion date is expected to be within grace period permitted by guidelines.

4/ Executive Board meetings to conclude the Article IV consultation are tentatively scheduled for these countries: Australia (3/7/86); Canada (2/14/86); Guinea (2/3/86); Indonesia (2/14/86); Japan (3/10/86); and United Kingdom (2/24/86).

5/ Two consultations were concluded with Fiji, Haiti and Paraguay in 1985. A standard cycle was specified at the conclusion of both consultations.

6/ Exceptionally, the Board agreed that the next consultation would be concluded in May 1986, one month beyond the end of the normal three-month grace period.

7/ The Board, however, noted in concluding the 1985 Article IV consultation that the next consultation would be completed by August 1986, within the three-month grace period.

Table 4. Countries on Longer Consultation Intervals
(As of January 27, 1986)

Country	Date by which Next Consultation to be Concluded <u>1/</u>	Interval (Months) <u>2/</u>
<u>African Department</u>		
Cape Verde	(09/20/86)	18
<u>Asian Department</u>		
Bhutan	(02/28/87)	18
Singapore	06/30/86	(17)
Vanuatu	(05/04/87)	18
<u>European Department</u>		
Finland	(01/17/87)	18
Luxembourg	(06/17/87)	24
Malta	(10/29/86)	18
Norway	07/31/86	(19)
<u>Middle Eastern Department</u>		
Bahrain	(09/06/86)	18
Kuwait	(07/16/86)	18
Libya	(06/03/87)	24
Oman	06/30/86	(16)
Qatar	(06/14/85) <u>3/4/</u>	18
United Arab Emirates	(01/22/87)	18
<u>Western Hemisphere Department</u>		
Antigua and Barbuda	11/30/86	(18)
Grenada	(06/18/87)	18
St. Christopher and Nevis	06/30/86	(17)
St. Lucia	04/30/87	(18)
St. Vincent	01/31/86 <u>4/</u>	(18)

Source: Exchange and Trade Relations Department.

1/ Date specified in summing up or if in parentheses, date derived from specification in summing up in terms of number of months.

2/ Parentheses indicate that number of months is derived from date specified in summing up.

3/ To accommodate the authorities' preference regarding the timing of the mission, management approved an extension of the specified 18-month interval to 24 months.

4/ Executive Board meetings to conclude the Article IV consultation are tentatively scheduled for St. Vincent (2/5/86) and Qatar (2/5/86).

Table 5. Countries for which Timing Has not
Been Specified for Next Consultation 1/

(As of January 27, 1986)

Country	Date of Last Consultation	Comments
<u>Asian Department</u>		
Kampuchea, Democratic	10/31/73	No contacts.
<u>Middle Eastern Department</u>		
Iran, Islamic Republic of	10/06/78	Security problems. <u>2/</u>
Iraq	02/29/80	Security problems. <u>2/</u>

Source: Exchange and Trade Relations Department.

1/ Not including Tonga which became a Fund member on September 13, 1985. The first Article IV consultation with Tonga is expected to be concluded in 1986.

2/ "Security problems" refers to cases where the member, in a situation of armed conflict, has declined to receive a consultation mission, or where the security of the mission cannot be assured.

Table 6. Countries Exceeding Specified Consultation Intervals in 1985 1/

	End of Grace Period	Date Concluded	Explanation
<u>African Department</u>			
Algeria	7/18/85	9/9/85	Delay in fielding mission due to staff involvement in missions to other countries and delays experienced in scheduling Board discussion.
Burkina Faso	1/19/86	May 1986 <u>2/</u>	Delay in fielding mission to allow authorities time to prepare for discussion of use of Fund resources.
Equatorial Guinea	1/12/86	April 1986 <u>2/</u>	Delay in fielding mission due to extensive preparation required for Paris Club meeting and authorities' preference to have mission after Annual Meeting and completion of bilateral debt negotiation.
Kenya	8/16/85	10/21/85	Delay in fielding mission due to authorities' preference to have mission after budget preparation period.
Liberia	7/6/85	7/24/85	Delay in issuance of staff report due to continuing discussions on use of Fund resources.
Morocco	7/9/85	9/12/85	Delay associated with continuing discussions on use of Fund resources.
Nigeria	5/13/85	6/17/85	Issuance of staff report delayed by staff involvement in missions to other countries.
Sao Tome and Principe	2/19/86	May 1986 <u>2/</u>	Delay in fielding mission due to authorities' preference to have mission after aid donor meeting in December 1985.
Somalia	7/31/85	8/9/85	Delay associated with discussions on use of Fund resources.
Zambia	10/18/85	10/30/85	Delay to allow preparation of staff report supplement on recent policy actions.
<u>Asian Department</u>			
Bangladesh	10/20/85	12/2/85	Delay to permit concurrent Board discussion of request for use of Fund resources.
Thailand	5/15/85	6/14/85	Issuance of staff report delayed by continuing discussions on use of Fund resources.
<u>European Department</u>			
Italy	4/27/85	5/24/85	Delay in fielding mission due to staff involvement in missions to other countries.
Malta	4/18/85	4/29/85	Delay due to Interim Committee meeting.

Table 6 (Concluded). Countries Exceeding Specified Consultation Intervals in 1985 1/

	End of Grace Period	Date Concluded	Explanation
<u>Middle Eastern Department</u>			
Afghanistan	12/14/85	1/24/86	Delay to enable authorities to convey their comments on the staff report.
Qatar	9/14/85	2/5/86 <u>2/</u>	Extension of 18-month interval approved by management to accommodate authorities' preference to have mission at same time of year as the previous one.
Syria	12/10/85	Feb. 1986 <u>2/</u>	Earlier timing for mission could not be agreed with the authorities.
<u>Western Hemisphere Department</u>			
Argentina	12/4/85	Feb. 1986 <u>2/</u>	Delay associated with continuing discussions on use of Fund resources.
Brazil	8/9/85	8/28/85	Delay associated with continuing discussions on use of Fund resources.
Dominican Republic	11/8/85	11/27/85	Delay associated with continuing discussions on use of Fund resources.
Peru	2/21/86	May 1986 <u>2/</u>	Earlier timing for mission had not been agreed with authorities.
Venezuela	11/30/85	12/13/85 <u>2/</u>	Delay in fielding mission to allow authorities more time to revise quantified economic program.

Source: Exchange and Trade Relations Department.

1/ Countries for which the timing specified for the next consultation (excluding grace period) fell within calendar 1985.

2/ Expected date of conclusion.

Table 7. Article IV Consultations--Period from Termination of Initial Discussions to Board Conclusion, 1981-85 1/

	1981	1982	1983	1984	1985
Termination of initial discussion to issuance of staff report <u>2/</u>					
Average in calendar days	63	59	67	71	66
Percentage distribution					
40 days or less	13	10	7	13	12
41-50 days	22	30	20	21	15
51-60 days	21	21	26	25	24
61-70 days	20	19	20	18	24
71-80 days	9	10	7	2	9
81 days or more	15	10	20	21	16
Issuance of staff report to Board conclusion					
Average in calendar days	26	39	37	33	31
Percentage of distribution					
20 days or less	47	7 <u>3/</u>	10 <u>3/</u>	8 <u>3/</u>	7 <u>3/</u>
21-30 days	25	41	51	46	61
31-40 days	14	19	18	30	20
41-50 days	6	19	8	8	6
51-60 days	6	3	3	6	2
61 days or more	1	11	10	2	4
Total: termination of initial discussion to Board conclusion					
Average in calendar days	89	99	104	104	97
Percentage distribution					
70 days or less	22	10	9	13	14
71-80 days	17	17	16	15	12
81-90 days	22	20	23	26	26
91-100 days	10	19	17	14	27
101-110 days	9	14	10	9	4
111-120 days	10	6	3	3	4
121 days or more	10	14	22	20	13
Memorandum item:					
Termination of final discussion to issuance of staff report					
Average in calendar days	...	...	59	52	57

Source: Exchange and Trade Relations Department.

1/ Recorded in year in which consultation concluded.

2/ The terms "initial" and "final" discussions are used to refer to cases where the conclusion of consultation discussions with the authorities requires multiple missions or further discussions with the authorities at headquarters, generally associated with concurrent discussions of use of Fund resources. In the more usual cases of single missions, "initial" and "final" discussions are the same.

3/ The Executive Board agreed to waive the circulation period in these cases.

Table 8. Reasons for Requests for Extension of the Three-Month Period for the Conclusion of Article IV Consultations, 1981-85

(Number of cases) 1/

	1981	1982	1983	1984	1985 <u>2/ 3/</u>
Difficulties in scheduling Board meetings <u>4/</u>	1	19	7	7	4
Desire to discuss jointly use of Fund resources and Article IV consultations	5	8	16	10	8
Delays to allow official comments on staff papers before Board discussion	5	7	3	5	4
Additional information or discussion required, e.g., policy or institutional changes	1	3	6	4	4
Staff committed to other missions	--	1	2	1	4
Request of the authorities <u>5/</u>	7	3	--	--	--
Total	<u>19</u>	<u>41</u>	<u>34</u>	<u>27</u>	<u>24</u>

Source: Exchange and Trade Relations Department.

1/ Individual countries may have had more than one request for extension in a given year.

2/ Table 9 lists the 1985 requests for extensions.

3/ Excludes the request for extension associated with the supplemental consultation with Venezuela on 5/30/85 under enhanced surveillance procedures.

4/ Mostly on account of heavy Executive Board schedules, often around the time of the Interim Committee and Annual Meetings, but also including cases where the Executive Director elected by the member concerned was unable to be present. Prior to 1984, many extension requests took place because the three-month period expired during a period when the Executive Board normally would not meet; however, since June 1983, such delays no longer require a request for extension.

5/ Starting with 1983, extensions at the request of the authorities have been classified in other categories, reflecting the reason underlying the request.

Table 9. Requests for Extension of Three-Month Period
for Conclusion of Article IV Consultations in 1985 1/

Country	Document Number	Date
Afghanistan	EBD/85/320	12/27/85
Algeria	EBD/85/222	08/26/85
Bangladesh	<u>2/</u>	10/21/85
Benin	EBD/85/54	02/21/85
Cameroon	EBD/85/204	08/05/85
Chile	EBD/85/133	05/20/85
Chile	EBD/85/133, Supp. 1	07/01/85
Colombia	EBD/85/158	06/24/85
Comoros	EBD/85/46	02/07/85
Congo	EBD/85/260	10/17/85
Côte d'Ivoire	EBD/85/115	05/02/85
Gabon	EBD/85/56	02/22/85
Honduras	EBD/85/31	01/25/85
Mali	EBD/85/109	04/29/85
Mauritius	EBD/85/236	09/06/85
Morocco	EBD/85/205	08/05/85
Morocco	EBD/85/205, Supp. 1	09/06/85
Niger	EBD/85/163	07/02/85
Nigeria	EBD/85/123	05/10/85
Rwanda	EBD/85/290	11/13/85
Spain	EBD/85/230	09/03/85
Tunisia	EBD/85/282	11/01/85
Yugoslavia	EBD/85/78	03/19/85
Zambia	EBD/85/249	09/23/85

Source: Exchange and Trade Relations Department.

1/ Requests for extension issued in 1985.

2/ Request by Executive Director at EBM/85/154

Table 10. Size of Article IV Consultation Missions, 1981-85 ^{1/}

	1981	1982	1983	1984	1985 ^{2/}
(Number of missions)					
<u>All missions</u>	<u>88</u>	<u>106</u>	<u>130</u>	<u>123</u>	<u>134</u>
3 or less staff	5	4	4	4	2
4 staff	33	40	54	43	51
5 staff	43	45	50	53	62
6 staff	7	11	18	20	18
7 staff	--	6	4	2	--
8 staff	--	--	--	1	1
<u>African Department</u>	<u>20</u>	<u>32</u>	<u>37</u>	<u>37</u>	<u>43</u>
3 or less staff	1	--	1	2	--
4 staff	9	14	14	8	21
5 staff	9	18	15	22	18
6 staff	1	--	7	5	4
7 staff	--	--	--	--	--
8 staff	--	--	--	--	--
<u>Asian Department</u>	<u>13</u>	<u>21</u>	<u>21</u>	<u>20</u>	<u>21</u>
3 or less staff	1	1	1	1	--
4 staff	8	11	12	9	10
5 staff	4	3	4	6	6
6 staff	--	3	4	4	5
7 staff	--	3	--	--	--
8 staff	--	--	--	--	--
<u>European Department</u>	<u>16</u>	<u>17</u>	<u>28</u>	<u>20</u>	<u>23</u>
3 or less staff	--	--	1	--	2
4 staff	6	5	14	10	9
5 staff	9	6	9	7	11
6 staff	1	4	2	3	1
7 staff	--	2	2	--	--
8 staff	--	--	--	--	--
<u>Middle Eastern Department</u>	<u>14</u>	<u>13</u>	<u>13</u>	<u>14</u>	<u>13</u>
3 or less staff	1	--	--	1	--
4 staff	5	7	7	9	7
5 staff	6	3	4	1	6
6 staff	2	3	1	3	--
7 staff	--	--	1	--	--
8 staff	--	--	--	--	--
<u>Western Hemisphere Department</u>	<u>25</u>	<u>23</u>	<u>31</u>	<u>32</u>	<u>34</u>
3 or less staff	2	3	1	--	--
4 staff	5	3	7	7	4
5 staff	15	15	18	17	21
6 staff	3	1	4	5	8
7 staff	--	1	1	2	--
8 staff	--	--	--	1	1
Memorandum item:					
Average staff per mission ^{3/}					
African Department	4.5	4.6	4.8	4.8	4.6
Asian Department	4.2	4.8	4.5	4.7	4.8
European Department	4.7	5.2	4.7	4.7	4.5
Middle Eastern	4.6	4.7	4.7	4.4	4.5
Western Hemisphere	4.8	4.7	4.9	5.2	5.2
Total	4.6	4.8	4.7	4.8	4.7

Source: Administration Department.

^{1/} Excluding secretaries; EPs included in their assigned departments. Multiple missions in connection with the same consultation are counted as separate missions.

^{2/} Based on actual data through October 1985 and estimates prepared by the Administration Department for the remainder of 1985.

^{3/} Assuming that the smallest mission size is three staff members.

Table 11. Professional Staff Participation in Article IV Consultation Missions by Area and Functional Departments, 1981-85 1/

(Number of staff trips)

	1981	1982	1983	1984	1985 <u>2/</u>
<u>African Department</u>	<u>90</u>	<u>146</u>	<u>176</u>	<u>177</u>	<u>198</u>
AFR staff	61	97	119	119	144
Other staff	29	49	57	58	54
<u>Asian Department</u>	<u>55</u>	<u>101</u>	<u>95</u>	<u>92</u>	<u>100</u>
ASD staff	35	67	70	64	70
Other staff	20	34	25	28	30
<u>European Department</u>	<u>75</u>	<u>88</u>	<u>130</u>	<u>93</u>	<u>102</u>
EUR staff	66	74	116	85	93
Other staff	9	14	14	8	9
<u>Middle Eastern Department</u>	<u>65</u>	<u>61</u>	<u>61</u>	<u>61</u>	<u>58</u>
MED staff	50	50	50	53	49
Other staff	15	11	11	8	9
<u>Western Hemisphere Department</u>	<u>118</u>	<u>107</u>	<u>152</u>	<u>165</u>	<u>178</u>
WHD staff	101	85	117	126	134
Other staff	17	22	35	39	44
Total	<u>403</u>	<u>503</u>	<u>614</u>	<u>588</u>	<u>636</u>
Area departments	313	373	472	447	490
Functional departments	90	130	142	141	146
ETR	(41)	(60)	(59)	(50)	(62)
FAD	(30)	(41)	(46)	(47)	(51)
RES	(7)	(8)	(7)	(9)	(6)
CBD	(4)	(4)	(4)	(5)	(5)
STAT	(2)	(8)	(13)	(13)	(11)
Other	(6)	(9)	(13)	(17)	(11)

Source: Administration Department.

1/ Excluding secretaries; EPs included in their assigned departments.

2/ Based on actual data through October 1985 and estimates prepared by the Administration Department for the remainder of 1985.

Table 12. Country Items in Executive Board Meetings, 1981-85

	1981	1982	1983	1984	1985
Total number of Board meetings <u>1/</u>	190	211	203	202	205
Total number of country items	151	142	181	192	203
Consultations alone	59	62	75	93	103
Consultations combined with use of Fund resources <u>2/</u>	27	20	45	26	28
Use of Fund resources alone	51	52	50	46	36
Miscellaneous <u>3/</u>	14	8	11	27	36
Total Board hours	440	511	501	480	518
Total Board hours on country items <u>4/</u>	204 (46.4)	261 (51.1)	273 (54.5)	298 (62.1)	323 (62.4)
Of which:					
Consultations alone	84 (19.1)	108 (21.1)	95 (19.0)	139 (29.0)	170 (32.8)
Consultations combined with use of Fund resources	45 (10.2)	53 (10.4)	104 (20.8)	57 (11.9)	63 (12.2)
Use of Fund resources alone	71 (16.1)	94 (18.4)	70 (14.0)	82 (17.1)	63 (12.2)
Miscellaneous <u>3/</u>	4 (0.9)	6 (1.2)	4 (0.8)	20 (4.2)	27 (5.2)

Source: Secretary's Department.

1/ Comprising Board meetings, seminars, informal sessions, and meetings of the Committee of the Whole.

2/ Use of Fund resources covers approvals of stand-by and extended arrangements, reviews of such arrangements, CFF and other purchases, and modifications and waivers of performance criteria.

3/ Includes items such as schedule changes, notifications of changes in exchange arrangements, discussions of overdue financial obligations, etc., which are not included in the other three subcategories.

4/ Figures in parentheses indicate percentage of total Board hours.

Table 13. Length of Reports in Connection with
Article IV Consultations, 1981-85

	1981	1982	1983	1984	1985
Staff reports <u>1/</u>					
Average length (pages)	14.3	16.4	18.8	20.6	21.2
Percentage distribution					
9 pages or less	7.6	8.7	2.5	0.8	--
10-14 pages	48.1	32.5	29.7	16.5	14.1
15-19 pages	34.2	32.5	29.7	36.4	37.8
20 pages or more	10.1	26.3	38.1	46.3	48.1
Reports on Recent Economic Developments					
Average length (pages)	90.1	88.7	95.1	99.5	103.6
Percentage distribution					
50 pages or less	5.1	6.3	5.9	1.7	3.2
51-60 pages	3.8	8.7	3.4	1.7	--
61-70 pages	11.5	8.7	5.9	11.0	7.2
71-80 pages	14.1	11.3	15.1	8.5	7.2
81-90 pages	16.7	15.0	13.4	13.6	12.0
91-100 pages	15.4	20.0	16.0	17.8	16.8
101 pages or more	33.3	30.0	40.3	45.8	53.6

Source: Exchange and Trade Relations Department.

1/ Main text only. Excludes decision and all appendices.

III. Aspects of Article IV Consultation Reporting

The reports of the G-10 and G-24 Deputies include several recommendations related to the focus or content of surveillance. In particular, both reports stress the need for taking into account all policies affecting trade, capital movements, external adjustment and the effective functioning of the international monetary system, including fiscal and monetary policies, structural policies and policies affecting openness to international trade flows. Both reports also note the need for analysis and assessments to be conducted in a medium-term framework. Other recommendations to strengthen the implementation of surveillance include providing more candid assessments and precise suggestions for policy changes, making clear both the empirical and analytical basis of policy judgments and differences of view between the staff and the authorities.

This section provides a review of current practices, as reflected primarily in a sample of staff reports for Article IV consultations concluded in 1985, 1/ as background for the discussion of the specific recommendations of the G-10 and G-24 Deputies. Current practices regarding the provision of quantified projections in staff reports are reviewed in Section 1, followed by a more detailed discussion in Section 2 of the analysis, assessments and recommendations in various areas of policy. Sections 3 and 4 provide, respectively, brief reviews of practices related to consultation follow-up and the coverage of issues related to the World Bank.

1. Projections

Staff reports normally include short-term projections of developments covering a wide range of variables. With few exceptions, staff reports for Article IV consultations in 1985 included such projections for the balance of payments and external debt, economic growth, inflation and the budget (Table 14). 2/ Staff reports for Article IV consultations with industrial countries also frequently included projections for wage developments, productivity and employment, as well as for savings, investment and other components of aggregate demand. Projections of the latter variables were less common in nonindustrial countries, reflecting in part the absence of a reliable or up-to-date

1/ The discussions of practices regarding quantification and exchange rate policies are based on a review of all staff reports for Article IV consultations concluded in 1985. The discussion on other aspects of policies is based on the review of staff reports for a sample of countries only. The sample includes all 18 industrial countries which concluded consultations in 1985 and 19 nonindustrial countries, including the 3-4 members with the largest Fund quotas within each geographical area.

2/ There were two reports for Article IV consultations in 1985 in which severe data constraints meant that short-term projections could not be provided for any of the major policy areas.

statistical base in these areas in many countries. Consultation reports for nonindustrial countries, on the other hand, typically included more detailed short-term projections of the balance of payments and of external debt and debt service than was the case for industrial countries. In a few cases (both industrial and nonindustrial countries), when assessments differed, independent staff projections were included in staff reports together with those of the authorities. Such a practice, not followed, however, in all cases where differences in assessment were apparent, helped clarify the nature and size of disagreements.

Projections of developments in monetary aggregates were less common, being included in only about half of the reports (both for industrial and nonindustrial countries). Projections for some money/credit aggregates were included in 54 percent of the reports for nonindustrial countries while projections or target ranges were included in 8 of 18 reports for industrial countries. ^{1/} This may have reflected to some extent the difficulty of preparing reliable forecasts, in part as a result of structural changes which have increased the difficulty of interpreting developments in monetary aggregates in many countries.

Consistent with the recommendations of Executive Directors during the reviews of surveillance in both 1984 and 1985, the inclusion of medium-term scenarios in staff reports has become increasingly common and the breadth of such scenarios has increased. There were also a number of cases in which reports contained an extensive discussion of medium-term prospects (external and internal) across a wide range of policy areas, even though there was only limited quantification of the analysis. The external sector, including the outlook for the balance of payments and for external debt and debt service, was the focus of nearly all medium-term scenarios. Eighty-seven percent of staff reports for Article IV consultations in 1985 included medium-term scenarios (compared with about 75 percent in 1984), a significant increase over earlier years (Table 15). Scenarios were included in reports for all but three of the industrial countries and for 99 of the 113 other countries concluding consultations in 1985. In most cases, the scenario covered a period of 4-5 years beyond the end of the year in progress. Projections for longer periods were included in a few instances.

Scenarios frequently (though not always) specified underlying assumptions about various components of the balance of payments, economic growth, and international price and interest rate developments, as well as (although less frequently) additional factors including the budget, the rate of inflation, or the level of investment. The presentation of alternative scenarios or an analysis of the sensitivity of the results to variations in major assumptions was a feature of nearly all industrial country reports containing medium-term projections for the external sector and of about half of the reports for nonindustrial countries. Alternative scenarios for the industrial countries

^{1/} In the cases in which targets were provided, however, it was not always clear that the targets were expected to be met.

frequently included a different assumed rate of growth (generally reflecting, in some cases implicitly, a different assumed stance of major policies). In the case of nonindustrial countries, alternative assumptions on exogenous variables (often the price of a major export or the level of international interest rates) were more common.

There was considerable variation among reports in the extent to which the assumptions regarding policies were presented explicitly. Some policy assumptions, typically reflecting a continuation of the current stance of policies, were explicit in about half of the reports in which medium-term scenarios were provided. In some instances, however, there was a clear indication that extensive policy changes had been assumed, but the nature of these changes was often described in only very general terms (e.g., "pursuit of appropriate adjustment policies"). Only in a few cases (e.g., United States) was there an extensive discussion of both the policy assumptions and the exogenous parameters underlying the scenario. It was unclear in many reports whether or not the medium-term scenario had been discussed with the authorities, and whether or not they agreed with the results.

2. Policy coverage

The content of Article IV consultation reports has continued to be adapted in recent years to sharpen the focus of analysis on emerging problems faced by members and to reflect concerns related to the evolution of the international economy. In particular, the close attention paid to the appropriateness of members' exchange rate policies has continued. Given their importance for the overall balance of payments, domestic financial policies have always been given special attention in such assessments. There has also been an increasing emphasis in staff reports on trade policies and on issues of structural adjustment, including, in particular, policies to eliminate institutional rigidities and to increase the efficiency of labor markets, as well as general wage and price policies.

a. Exchange rate policies ^{1/}

The trend noted in earlier annual reviews of the implementation of surveillance of including more explicit assessments of exchange rate policies in Article IV staff reports was continued in 1985. Most staff reports issued in 1985 commented on the appropriateness of the exchange rate or exchange rate policies. The few exceptions (11 cases) were reports for members of currency unions.

^{1/} For ease of presentation, individual policy areas are discussed under separate headings in this chapter. This approach does not, however, allow the many interdependencies between various areas of policy to be reflected fully. This is the case, in particular, for exchange rate policy which cannot be assessed independently of the stance of policies in other areas.

In most countries, key factors highlighted in the analysis of exchange rate policy were the strength of the overall balance of payments and its components (in several cases, taking explicitly into account both the short- and longer-term outlook), and trends in the real effective exchange rate index (Table 16). Developments in real effective exchange rates were examined in 89 percent of cases. In more than one third of the reports, the analysis of such broader indicators of competitiveness was supplemented by a discussion of the competitiveness or profitability of particular tradable goods or sectors; this was more often the case for nonindustrial countries, for which dependence on one or a few sectors is more common. Such analysis was of particular importance in the evaluation of exchange rate policy for a number of major oil producing countries, where developments in the profitability of the non-oil sector were judged to be a critical indicator of the adequacy of the exchange rate. The analysis of the appropriateness of the exchange rate also frequently included a review of the relationship between the restrictiveness of the exchange and trade system and the exchange rate. Finally, developments in legal or unofficial parallel exchange markets were carefully examined, where these were relevant.

The exchange rate policies of members were commended in 32 staff reports issued in 1985, while assessments were neutral in 14 cases and the policies followed, taking into account developments and policies in other areas, were questioned in 74 cases (Table 17). The broad distribution of assessments, ranging from critical at one end to favorable at the other end, was thus similar to that in 1984 when exchange rate policies were commended in 21 cases, but questioned in 67 cases. The 1984 review noted that one reason for the generally critical approach taken in staff reports had been the number of currencies that were either pegged to the U.S. dollar or in practice showed limited flexibility against it despite the dollar's general strength. This continued to be the case in 1985, as exchange rate policies were questioned in 90 percent of those cases where members maintained an unchanged peg to the U.S. dollar.

Beyond general assessments of the appropriateness of the level of the exchange rate, several reports commented on the appropriateness of exchange arrangements. In particular, several reports suggested that a move to a more flexible exchange arrangement might be considered, including pegging to a basket. In a few cases, where pegging to an inappropriate currency basket had resulted in an unwarranted real effective appreciation, the staff recommended adopting a different basket in combination with a currency depreciation.

b. Fiscal policies ^{1/}

Analyses and assessments of the appropriateness of fiscal policies were included in nearly all Article IV consultation reports in 1985 and

^{1/} Based on the sample of staff reports for 37 members concluding consultations in 1985.

were particularly specific. In most cases this reflected the importance attached to reducing fiscal deficits, which have persisted in many countries following large increases in the late 1970s. In several of these cases, despite progress recently achieved in lowering fiscal deficits, the need for a further reduction was emphasized. The focus of the discussion was generally the accounts of the central government (Table 18), supplemented by an analysis of developments at other levels of government (more common in the industrial countries) and of public enterprises (more often the case in nonindustrial countries). Cyclical effects or the influence of special factors or transactions (e.g., the impact of North Sea oil on the United Kingdom budget) were discussed explicitly in more than half of the reports for industrial countries, although the impact of these factors was not always quantified; detailed discussions of the influence of such factors on fiscal developments were less frequent in the reports for nonindustrial countries included in the sample.

The sustainability of the stance of fiscal policy over the medium term provided the background for the policy discussions in a majority of the consultations for both industrial and nonindustrial countries (though less frequently in the latter). Considerations relating to the sustainability of the deficit or of specified items of revenues and expenditures were also raised in several other cases in which overall fiscal developments were not analyzed explicitly in a medium-term framework. The frequent adoption of a medium-term framework reflects in part the practice in many countries in recent years of establishing medium-term fiscal targets. Typically, in those cases in which the authorities had established medium-term fiscal targets, the targets provided a basis against which to assess recent developments and policy intentions. In only a few cases (e.g., Canada, United States, Mexico), however, were the medium-term fiscal targets or outlook analyzed explicitly within an overall savings/investment framework.

The nature of the fiscal policy recommendations contained in the staff reports varied considerably across members, ranging from general statements about the desired direction of change in the overall deficit to relatively detailed suggestions for revenue measures or expenditure cuts. A review of assessments of the stance of members' fiscal policies in staff reports for countries included in the sample indicates that assessments were typically candid. While expressed so as to take account of the sensitive nature of the issues involved, assessments for the 37 countries in the sample reflected some degree of criticism of policies in 23 cases, including 11 cases in which assessments could be considered strongly critical. Typically, for countries in this latter group, staff assessments stressed the need for strong and early measures to achieve a sustained reduction of large or widening deficits. The significance of such assessments differed from country to country depending on whether the authorities agreed with the need for action and, in some cases, may already have set objectives for medium-term adjustment. However, while typically clear about the direction of adjustment required in those cases in which some criticism had been lodged, few of these reports provided quantified assessments of the size

of the adjustment needed. In some cases, a more forceful presentation, including a somewhat greater degree of quantification, could have helped highlight the importance of problems identified.

In all cases where the fiscal deficit was judged to be too large, a reduction in expenditures was recommended. The use of complementary revenue measures was also recommended in many cases. In only a few cases were specific items of expenditure identified for reduction, and these mostly in nonindustrial countries (e.g., wages and subsidies). In a few instances, again mostly in nonindustrial countries, specific recommendations to strengthen the tax base were made, such as broadening the coverage of taxation to non-oil activities and strengthening tax administration.

Although the assessments contained in the reports frequently called for further adjustment, there was a considerable measure of agreement between the staff's views and those of the authorities in such cases. Differences of view tended to center on the speed of adjustment required or on the appropriateness of specific recommendations, rather than on the need for adjustment in general. More serious differences of view arose on a few occasions as the authorities emphasized the impact on already high levels of unemployment of withdrawing fiscal stimulus.

c. Monetary policies 1/

Monetary developments and policy were given prominent attention in most staff reports for Article IV consultations in 1985 (Table 18). Discussions typically focused on the consistency of monetary policy with the objective of reducing the rate of inflation or sustaining low rates that had already been achieved and on the impact of credit expansion on the balance of payments. References to the international repercussions and linkages of monetary policy were discussed mainly in the case of industrial countries, usually in the context of an analysis of the impact of high interest rates or of considerations related to the need for coordination of policies with other countries under the EMS arrangement.

Of the 18 consultations concluded with industrial countries, 17 reports focused explicitly on the behavior of one or more monetary aggregates. 2/ In most of these cases, the reports included explicit assessments and recommendations about the rate of growth of monetary aggregates. Frequently, for countries which target monetary aggregates, the assessment related to observance of the targets. Detailed analysis of the appropriateness of the targets themselves were less frequent; in some cases, this reflected an explicit endorsement of the targets by the staff.

1/ Based on the sample of staff reports for 37 members concluding consultations in 1985.

2/ For Luxembourg, the openness of the economy and monetary association with Belgium preclude an independent monetary policy.

The behavior of money or credit aggregates received considerable attention in nonindustrial countries also, being discussed in 17 of the 19 cases reviewed. There were fewer explicit assessments of the appropriateness of monetary growth, but this may reflect the primary focus on controlling credit in these economies, many of which operate with fixed or less than fully flexible exchange rates. Staff reports for nonindustrial countries also frequently paid particular attention to issues concerning the allocation of credit, notably the share of credit expansion preempted by the financing needs of the public sector.

Structural changes in the financial system and their implications for policy were also frequently discussed. The discussion in the case of industrial countries generally focused on the effect of financial deregulation on monetary aggregates, as several countries abandoned or considered abandoning strict monetary targetting as a guide to policy. A few reports (e.g., Canada, Denmark, United States) included a detailed analysis of the stability of the relationship of selected monetary aggregates to underlying determinants. Such analysis helped clarify the basis for assessments of the feasibility of monetary targetting in prevailing circumstances.

Beyond the behavior of aggregates, the adequacy of monetary statistics and the instruments of monetary policy were frequently commented on, leading to recommendations in several cases that some policy and/or institutional changes were warranted. Interest rate policy, in particular the adequacy of the level of interest rates, was examined carefully in most cases where rates are set administratively. Other recommendations included stressing the need for more timely and accurate statistics (e.g., Algeria and Zaire); broadening the range and effectiveness of instruments of monetary or credit control (e.g., Algeria, Egypt, Indonesia); and tighter control on the lending activities of specialized banks (e.g., China).

The same general comments concerning the specificity and candid nature of assessments, noted earlier for assessments of fiscal policy, apply in the case of money/credit policies as well. Favorable assessments regarding the current and anticipated rates of growth for broad money/credit aggregates were frequently tempered by observations that significant further progress was needed toward improving the functioning of financial markets. Overall, assessments for countries in the sample reflected some degree of criticism in 19 cases, including four cases in which assessments could be considered strongly critical. In these latter cases, the circumstances were typically those in which a substantial tightening of money or credit policies was needed to reduce balance of payments pressures or inflation.

The staff reports noted that members were not always in agreement with the staff's assessment. Differences in this area frequently reflected divergent views concerning the appropriate rate of growth of nominal aggregate demand and money or differences in interpreting the effects of money growth on economic activity (particularly when deregulation of the financial system was believed to have affected the

behavior of money or near-money). In several instances, particularly in industrial countries, the staff reports also noted differences of view with the authorities concerning the relative contribution of domestic (typically, continuing fiscal deficits) and external factors to the persistence of high real rates of interest.

d. Structural policies ^{1/}

The increasing recognition in recent years of the contribution of structural rigidities to impeding the recovery of economic activity, employment and trade has led to a sharply strengthened focus on structural issues in staff reports, both for industrial and nonindustrial countries. Discussions of structural issues covered diverse areas of policy. For industrial countries, reflecting the persistence of high rates of unemployment in several countries, the examination of structural issues was frequently focused on labor markets. For nonindustrial countries, the issues examined typically reflected a broader range of concerns, including inefficiencies in both the goods and financial markets.

Assessments and policy recommendations in industrial countries focused, in particular, on reducing employment costs through the removal of regulatory constraints and other impediments to the efficient operation of labor markets. Such policy recommendations included the modification of indexation practices (e.g., Australia, Italy, Luxembourg and Spain); the reduction or abolition of employment-based taxes (e.g., Spain and Sweden); and the adjustment of minimum wages, especially of entry-level wages (e.g., France, Italy and Mexico). Other specific recommendations included the reform of legal frameworks inhibiting the flexible hiring or management of the work force (e.g., France, Italy, Netherlands, South Africa and Spain); and reforms of the tax/subsidy structure to increase work incentives or labor mobility (e.g., Ireland, Netherlands).

The adjustment of specific prices or broader reforms of domestic pricing systems were typically central to policy recommendations aimed at improving the smooth functioning of goods markets. Although energy prices have already been adjusted substantially in most countries in response to earlier large increases in world prices, specific recommendations for further adjustment of domestic energy prices or to maintain realistic prices still were included in 1985 in staff reports for Article IV consultations with several countries (e.g., Brazil, Canada, China, Egypt, Italy, Kuwait, ^{2/} Nigeria). The need for remunerative producer prices in support of efforts to promote production and exports were reflected in recommendations for adjusting specific prices or a broad range of such prices in several cases (e.g., Algeria, Egypt and Nigeria). Other recommendations for adjustment of specific prices

^{1/} Based on the sample of staff reports for 37 members concluding consultations in 1985.

^{2/} Electricity.

included certain basic consumer goods (e.g., Egypt, Morocco), and fertilizer (Indonesia). Recommendations were also made in several cases for broader reforms of pricing systems aimed at increasing the flexibility and rationality of prices, frequently related, in particular, to prices for goods and services provided by public enterprises (e.g., Algeria, Brazil, China, Egypt, Hungary, Mexico, Morocco, Zaire).

Recommendations aimed at improving the efficiency of goods markets also frequently included measures to strengthen the operations of public enterprises. Such recommendations included the reduction of labor hoarding (e.g., Austria); the reduction of subsidies to unprofitable enterprises (e.g., Egypt and Hungary); and reforms or reassessment of public sector investment programs (e.g., Egypt, Malaysia and Morocco).

In several cases, recommendations were directed at improving the profitability or regulatory framework to promote efficient investment and industrial diversification. Specific recommendations included the relaxation of trade or payments restrictions (e.g., Algeria, Egypt, Hungary, India, Mexico and Nigeria); the reduction of rigidities in the planning system limiting private activities (e.g., Algeria); and the relaxation of restrictions on foreign investment (e.g., Kuwait).

Analyses and assessments of the impact of government regulations or restrictions were also reflected in several cases in specific recommendations aimed at improving the functioning of financial markets. Such recommendations included: the elimination of specified institutional constraints to a further liberalization of the financial system (e.g., Japan); improvements in financial intermediation (e.g., Hungary and Saudi Arabia); narrowing the scope and insulation of regulated markets (e.g., Finland); reducing the reliance on or rigidity of quantitative controls (e.g., France, Morocco, and Yugoslavia).

Frequently, staff reports indicated the broad agreement, at least in principle, of the countries' authorities with the assessments and policy recommendations in structural areas, particularly regarding the need for wage flexibility and measures to improve the efficiency of labor markets. In several cases, initial steps had been taken to address the problems identified. However, a gradual approach was frequently judged necessary by the authorities, especially where changes in legislation or practices required the emergence of a social consensus. Similar issues were frequently raised in connection with recommendations for reform of financial systems. Agreement was less frequent on the need for more flexible pricing policies, reforms of exchange and payments systems and recommendations for specific trade liberalization. Concerns were often expressed that such reforms would increase inflationary pressures or, in the case of trade restrictions, that their removal would further strain balance of payments difficulties or already depressed employment possibilities in affected sectors.

e. Trade policies ^{1/}

The coverage of trade policies in reports has increased sharply in recent years. Such policies were discussed in most of the staff reports for countries in the sample. In some cases, assessments were supported by extensive documentation of the major legislation and there have been increasing attempts at quantification of the impact of such policies (e.g., Australia, Japan and United States). Quantification, however, has been the exception rather than the rule, reflecting to some extent the inherent difficulties in this area, including the absence of well documented information on the extent of restrictions.

Assessments and recommendations concerning trade policy included both general recommendations to avoid or reverse protectionist measures as well as recommendations about specific aspects of a member's policy. In several cases, where protectionist policies have been widespread for many years, staff reports have urged a general reduction in the extent of these policies and a greater reliance on the price mechanism, supported by realistic exchange rate policies, to allocate resources. Such recommendations included, in particular, liberalizing the system of import licensing and exchange controls, and lowering and rationalizing import tariffs and quantitative restrictions (e.g., Algeria, China, Indonesia, Morocco and Nigeria). In several nonindustrial countries (e.g., Mexico, Hungary and Pakistan), recommendations were directed at phasing out reliance on quantitative restrictions and encouraging a greater use of tariff policy, or at lowering tariff rates. This included consolidating recent progress in tariff reform, establishing or extending a list of commodities which could be imported freely and reducing restrictions on trading rights which limited trading authority to certain state enterprises. In other cases, where measures have been taken to limit certain imports or promote particular exports, for example, staff reports have commented on the desirability of action in these areas.

Specific assessments of trade policies were also included in several staff reports for industrial countries. Staff reports noted in a few cases that recent measures intensifying restrictions or increasing or broadening the scope of subsidies to domestic sectors were at odds with the members' expressed intention to pursue more open trading policies (e.g., textiles, footwear and automobiles in the case of Canada; and voluntary restraints on steel exports in the case of the United States). In the case of Japan, the importance of reducing agricultural protection, removing remaining barriers to manufactured imports and improving the transparency of regulations that affect imports were stressed. The staff report for the United States noted the need to resist protectionist pressures: to the extent that the exchange rate reflected the fiscal situation, correction of the latter would be the

^{1/} Based on the sample of staff reports for 37 members concluding consultations in 1985.

most appropriate way to alleviate the difficulties of domestic producers; to the extent that the strength of the dollar reflected other factors, such as a favorable climate for investment and safe-haven effects, the appropriate response would be to allow adjustment and not impose trade barriers.

In accordance with suggestions made by Executive Directors, individual staff reports on members of the European Community have examined both a member's trade measures at the national level and policies resulting from Community membership. In selecting the issues to be highlighted with respect to the latter in an individual report, the staff has focused on policy areas that appear to be of particular relevance for the member in question. For example, the application of subsidies and quotas, and the related policy stance of the individual member in sectors such as agriculture, steel, coal, ships, aircraft, and electronics, have been variously featured in the reports on France, Germany, and the United Kingdom. In some cases, the staff report proposed a removal or reduction in the intensity of such measures, or encouraged their reformulation to take better account of domestic adjustment needs and the interests of trading partners. In formulating the recommendations in staff reports, the staff has endeavored to emphasize both the need to maintain or improve open, liberal policies at the national level and, in the case of the major Community members, for the authorities to assume a stronger leadership position within the Community to promote liberalization in the common external policy.

f. Other

Several other issues or policies received frequent attention in staff reports for Article IV consultations. For many of these, related issues and Fund policies and practices are reviewed in detail in periodic reports to the Executive Board.

Staff reports typically include a detailed review and discussion of practices subject to Fund jurisdiction under Article VIII. All such actions are subject to Fund approval and generally require a specific Executive Board decision to that effect. Typically, staff reports include specific language appraising the policies regarding exchange restrictions and multiple currency practices as a basis for the recommendation of approval or nonapproval by the Executive Board. Related issues and policies have been discussed in detail in several staff papers issued to the Board on a periodic basis: including "Review of Bilateral Payments Arrangements, 1976-1981," SM/82/169 (8/17/82), "Review of Experience with Multiple Exchange Rate Regimes," SM/84/64 (3/19/84), and "External Payments Arrears of Fund Members, 1982-83," EBS/84/155 (7/30/84).

In addition to the discussion of the sustainability of trends in the growth of external debt and debt service which were, in most cases, the explicit focus of analyses of medium-term prospects (see section III. 1 above), staff reports for Article IV consultations addressed several other issues related to external debt management.

These included the appropriateness of monitoring and approval procedures and the appropriateness of terms for the contracting of new debt. Some discussion of developments in this area and related issues was included in more than half of the reports for nonindustrial countries resulting, in several cases, in specific recommendations for improvements in debt management policies. These ranged from the elaboration of steps necessary to improve reporting and approval procedures to recommendations to avoid nonconcessional financing or to tailor the terms of new lending more closely to the gestation period of projects. General issues related to external debt policies and management were discussed in detail in 1985 at EBM/85/45 and EBM/85/46 on the basis of staff papers on "Developing Countries' External Indebtedness to Commercial Banks," SM/85/61 (2/20/85) and "Developing Countries' External Indebtedness to Official Creditors," SM/85/62 (2/21/85).

Staff reports for Article IV consultations also typically include statements on statistical issues. Following the Board meeting on "Review of Fund Statistics" (EBM/85/71, 5/6/85), staff reports for Article IV consultations have included an appendix on statistical issues covering the status of the country's data in IFS. In addition, staff reports include explicit references, as appropriate, to the quality of statistics used in reports and to major statistical problems affecting the analysis. Related issues will be the subject of further discussion by the Board in the near future ("Review of the Fund's Statistics," currently scheduled for mid-March 1986).

3. Consultation follow-up

The effectiveness of the Article IV consultation process is determined, in part, by the extent to which it influences policy decisions in member countries. This, in turn, is partly a function of the attention that policy makers give to discussions with the Fund. Staff missions met with government officials at the Ministerial level in connection with 112 (85 percent) of the consultations concluded in 1985; in a number of these cases, the mission also met with the head of Government.

The actual impact on policy is difficult to assess. One indication of such influence of the consultation process is the extent to which policies were consistent with previous recommendations. For this reason, the practice was adopted in recent years of including a summary of the Fund's conclusions from the prior consultation in staff reports for Article IV consultations. This practice has not, however, yet been fully implemented in all staff reports. Forty-four percent of staff reports for Article IV consultations in 1985 included such a summary. Another five percent of reports, while not including a complete summary, referred to certain elements highlighted in an earlier consultation in connection with the discussion of specific areas of policy. In most cases, the summary took the form of a brief paragraph near the beginning of the report, noting the views previously expressed by Directors, with major issues sometimes again highlighted in the section of the report discussing the relevant policy areas.

In several cases, the subsequent implementation of policies consistent with the recommendations at the conclusion of an earlier consultation was noted. Conversely, some staff reports noted explicitly continuing discrepancies relative to policies advocated in the previous Article IV consultation. However, explicit references of the latter type were rare. Typically, the analysis and discussion of developments in staff reports, against the background of the summary of the previous Board discussion (in those cases where such a summary was included), left it to the reader to assess the importance of continuing differences as regards specific recommendations as well as in terms of the overall stance of a member's policies.

4. Reporting on World Bank activities

In their recent discussion of ways in which enhanced collaboration between the Fund and the World Bank could be more effective in helping member countries to resolve their problems, 1/ Executive Directors indicated that the Fund should extend and deepen the discussion in staff reports of the Bank's involvement in a given country. Against this background, this section describes the coverage of these issues in staff reports for Article IV consultations concluded in 1985. Only explicit references to the World Bank are reported. 2/

Relations with the World Bank were described in some form in virtually all 1985 reports for countries that had outstanding loans from the Bank; there was generally no reference to the Bank in other cases (Table 19). A statement of the amount and sectoral distribution of outstanding borrowing from the Bank, along with a description of other aspects of financial relations, was provided in staff reports for about three-fourths of all the nonindustrial countries, generally in the form of an appendix to the main report. The impact of Bank loans and technical assistance in enhancing the effectiveness of policies and facilitating their implementation was also explicitly commented on in about a third of the reports. Many of these described in some detail the policy conditionality of one or more bank loans.

Views of the Bank staff on major policy issues were also frequently reported. This was most common with regard to views on the level and composition of the investment program, which were described in reports for nearly half of the nonindustrial countries. Descriptions generally took the form of a brief reference to the general agreement or disagreement of the Bank staff with the thrust of the investment program. In a few cases, comprehensive statements prepared by the Bank staff on their overall policy views and the objectives of their lending program were also included (e.g., Egypt, Uganda and Zaire).

1/ At EBM/84/170-171 (11/28/84). The Chairman's Summing Up was circulated as Buff 84/195 (12/6/84).

2/ It should be noted that, in many cases, collaboration between the two institutions has resulted in the incorporation of Bank views into the report without explicit reference.

Technical aspects of collaboration between the staffs of the two institutions were also reported in many cases. While collaboration between the two institutions results in the taking into account of Bank policy views across a wide range of issues, the technical work of the Bank staff or the results of technical studies supported by Bank loans were cited explicitly as the basis for Fund staff policy views in reports for more than a quarter of all nonindustrial countries. Recommendations on the tariff structure, pricing policies of public enterprises, and specific investment projects were the most common policy areas in which this occurred. Finally, there were also 12 cases in 1985 in which one or more Bank staff members participated in the Fund staff mission for the consultation discussions.

Table 14. Short-Term Projections in Reports
for Article IV Consultations in 1985 ^{1/}

	Industrial Countries	Nonindustrial Countries	All Countries
	<u>(Number of Reports)</u>		
Reports with short-term projections (percent of total)	18 (100)	111 (98)	129 (98)
Reports without short-term projections	—	2	2
Total reports	<u>18</u>	<u>113</u>	<u>131</u>
	<u>(In percent) ^{2/}</u>		
Coverage of projections			
Balance of payments	94	98	98
External debt and debt service	56	90	85
Economic growth	100	86	88
Inflation	100	74	78
Savings and investment	100	46	53
Fiscal accounts	94	93	93
Monetary aggregates	44	54	53
Employment	67	5	13
Wages	44	5	11
Productivity	22	2	5
Other	17	63	57

Source: Exchange and Trade Relations Department.

^{1/} Short-term projections are defined as forecasts for periods of approximately one year or less from date of staff mission.

^{2/} As percent of reports including short-term projections.

Table 15. Medium-Term Scenarios in Reports
for Article IV Consultations in 1985

	Industrial Countries	Nonindustrial Countries	All Countries
	<u>(Number of Reports)</u>		
Reports with medium-term scenarios (percent of total)	15 (83)	99 (88)	114 (87)
Reports without medium-term scenarios	3	14	17
Total reports	<u>18</u>	<u>113</u>	<u>131</u>
	<u>(In percent) 1/</u>		
Coverage of scenarios			
Balance of payments	80	96	94
External debt and debt service	80	92	90
Economic growth <u>2/</u>	67	63	63
Inflation <u>2/</u>	33	26	27
Savings and investment	20	10	11
Fiscal accounts	47	13	18
Monetary aggregates	13	1	3
Other	27	34	33
Alternative scenarios	87	47	53
Economic growth rate	60	9	17
Other <u>3/</u>	53	45	46

Source: Exchange and Trade Relations Department.

1/ As percent of reports with scenarios.

2/ Typically, assumptions.

3/ Includes cases with discussion of sensitivity to alternative assumptions of one or more variables included in scenario.

Table 16. Exchange Rate Policy Discussion in Reports
for Article IV Consultations in 1985

(In percent of total reports) 1/

	Industrial Countries	Nonindustrial Countries	All Countries
Coverage of analysis			
Balance of payments	89	66	69
Effective exchange rate index	100	95	95
Of which: nominal index only	(--)	(7)	(6)
Profitability of major commodity or sector	22	43	40
Parallel exchange market developments	6	26	23
Restrictiveness of exchange and trade system	22	46	43
Other	39	27	28

Source: Exchange and Trade Relations Department.

1/ Based on reports for all consultations concluded in 1985.

Table 17. Views on Exchange Rate Policies in Staff Reports
for Article IV Consultations Concluded in 1985

(Number of Reports)

	Favorable	Neutral	Mildly Critical	Strongly Critical	No Assessment	Total
All consultations	32	14	34	40	11	131 <u>1/</u>
Of which:						
Program countries <u>2/</u>	(11)	(4)	(10)	(2)	(6)	(33)
Distribution by country classification and exchange arrangement						
Industrial	9	5	3	1	--	18
Pegged <u>3/</u>	(5)	(4)	(2)	(--)	(--)	(11)
More flexible	(4)	(1)	(1)	(1)	(--)	(7)
Nonindustrial	23	9	31	39	11	113
Pegged <u>3/</u>	(15)	(3)	(24)	(38)	(11)	(91)
More flexible	(8)	(6)	(7)	(1)	(--)	(22)

Source: Exchange and Trade Relations Department.

1/ Includes two consultations for three members and a separate consultation with the Netherlands Antilles.

2/ Countries with upper tranche stand-by arrangements or extended arrangements in place at the time of the conclusion of the 1985 consultation.

3/ Includes "Flexibility Limited".

Table 18. Analytical Coverage of Fiscal and Money/Credit Policy in Reports for Article IV Consultations in 1985

(In percent of sample reports) 1/

	Industrial Countries	Nonindustrial Countries	All Countries
Coverage of fiscal analysis			
Central government	100	100	100
Other levels of government	83	47	65
Public enterprises	44	74	59
Other <u>2/</u>	50	32	41
Cyclical factors	67	11	38
Special factors or transactions	28	11	19
Coverage of monetary analysis			
Monetary aggregates	94	89	92
Credit expansion	39	89	65
Interest rates	94	95	95
Credit allocation	22	53	38
Other policy instruments	56	68	62
Financial innovation or structural change	72	74	73
Monetary targeting	67	11	38
Other	33	21	27

Source: Exchange and Trade Relations Department.

1/ Based on reports for a sample of 37 countries concluding consultations in 1985.

2/ Includes social security system and other decentralized agencies.

Table 19. References to World Bank in Reports for
Article IV Consultations with Nonindustrial
Countries in 1985 1/

(In percent of total reports)

	Nonindustrial Countries
No reference to Bank	12 <u>2/</u>
Summary of financial relations	75
Technical assistance role	35
Policy conditionality of loans	21
Evaluation of investment program	37
Comprehensive policy views	8
Explicit basis for Fund staff views	26
Mission participation	11

Source: Exchange and Trade Relations Department.

1/ There was no reference to the World Bank in any of the reports for Article IV consultations with industrial countries in 1985.

2/ Of the total of 14 nonindustrial country reports with no reference to the World Bank, six were for countries for which no Bank loans were outstanding.

IV. Monitoring of Exchange Rates and Exchange Arrangements

A basic element of surveillance is the monitoring of developments in exchange rates and exchange arrangements. This section describes the implementation of practices with respect to such monitoring in 1985.

1. Periodic reviews

Several periodic reports were issued as usual in 1985 which provided a comprehensive description of each member's exchange arrangements and of changes in these arrangements. The main such report was the Annual Report on Exchange Arrangements and Exchange Restrictions. In addition, quarterly papers to the Executive Board summarized developments in members' exchange arrangements, listed the latest classification of exchange arrangements and indicated changes in members' exchange rates, including those following more flexible arrangements. Summary tables on exchange arrangements were also provided in International Financial Statistics.

Other regular reports included monthly charts on exchange rates and related developments; (daily, weekly and monthly) reports on developments in foreign exchange and financial markets; and quarterly reports on real effective exchange rates.

2. Information notice system

The information notice system is designed to monitor the real effective exchange rates of member countries. ^{1/} At present, real effective exchange rates are monitored for 125 currencies. For 29 members, real effective exchange rate indices are still not available. For most of these countries, available price data are rather sketchy or no price index of any kind is available.

Information notices are issued to the Executive Board when changes in a member's real effective exchange rate since the last occasion on which the Board had an opportunity to consider the member's exchange rate policy exceed 10 percent. In 1985, there were 30 information notices. This compares with 19 notices in 1984 and 6 notices between April 1983 (when the system was initiated) and December 1983. As indicated in Table 20 information notices for nonindustrial countries predominated in all three years. There have been only three information notices for two industrial countries and these occurred in 1985. ^{2/}

^{1/} The background paper to last year's annual review of surveillance (SM/85/65, Supplement 1) provides a detailed description of the operation of the information notice system, as well as the exchange rates, weighting system, and price indices used in the INS. There have been no major changes in INS methodology since then. A new weighting system is scheduled to be introduced in the near future.

^{2/} The two information notices on the United Kingdom were for movements in opposite directions, a real effective depreciation notified on 3/5/85 and a real effective appreciation notified on 8/26/85.

In 1983 and 1984 most information notices were issued for members whose currencies were pegged to a single currency, but in 1985 the notices were approximately evenly divided between those countries with pegged exchange rates and those with more flexible arrangements, mostly following independent floats.

Ten of the 30 information notices issued in 1985 were triggered by a real effective depreciation. In seven of these cases, the depreciation in real effective terms reflected primarily downward pressure on an exchange rate (unified or as part of a multiple rate system) determined by market forces. In one case (Peru), the real effective depreciation resulted from a policy of accelerating the rate of nominal depreciation against the U.S. dollar, while in the cases of Ethiopia and Swaziland the currencies depreciated as a result of a weakening of the currencies to which they are pegged (respectively, the U.S. dollar and the South African rand).

Of the 20 information notices issued for countries whose currencies had appreciated in real effective terms, nine were for countries with currencies pegged to the U.S. dollar, one was a case in which the currency was pegged to the SDR and one was for a currency pegged to another basket. In these 11 cases, the major factors underlying the real effective appreciations were domestic inflation in excess of major trading partners, and in some cases, the strength of the U.S. dollar. Information notices issued for the remaining nine countries with more flexible exchange arrangements (including six countries with freely fluctuating exchange rates) stemmed mainly from an appreciation of the currency in response to a strengthening of underlying confidence (including a few cases where the adjustment policies leading to the strengthening confidence were supported by the use of Fund resources). The information notice for the United States pointed to a number of factors which had resulted in a sustained strengthening of the U.S. dollar.

3. Monitoring of exchange rate and restrictive system policies in member countries

As in 1984, the widespread need for adjustment of exchange rate policies in 1985 was reflected in the fact that there were 48 notifications to the Executive Board of changes in exchange arrangements (of which 32 related to discrete changes in exchange rates), in accordance with Article IV, Section 2(a), and 27 notifications of changes in restrictive exchange systems in accordance with Article VIII, Section 5(xi). The corresponding figures for 1984 were 51 and 29, respectively.

a. Notification of changes in exchange arrangements

As noted in SM/82/44 "Exchange Arrangements Maintained by Members" and the subsequent annual surveillance reviews, about one fifth of the changes in exchange arrangements notified to the Fund by members and reported to the Executive Board in separate papers have generally resulted in a change in the classification of the arrangements according to the degree of their flexibility. The remainder have normally dealt with changes in the exchange rate vis-à-vis the peg or intervention currency, or other changes in arrangements not leading to reclassification. In 1985, the pattern of notifications of changes in exchange arrangements was similar. Of the total of 48 changes notified in 1985 (Table 22), 10 resulted in a change in the classification of the member's exchange arrangement, including 3 instances of discrete changes in exchange rates in combination with the change in classification. ^{1/} Twenty-six notifications represented discrete changes in members' exchange rates which did not entail a change in the classification of the arrangement. Other notifications related to various modifications including changes in the frequency with which the exchange rate is adjusted, the introduction of new currencies, changes in the calculation of a currency basket, and changes in multiple exchange rates (including in one case, discontinuance of an internal settlement rate).

Seven of the ten changes in the classification of members' exchange arrangements in 1985 represented a continuation of the trend noted in recent years toward greater flexibility in members' exchange arrangements. Two nonindustrial countries and one industrial country adopted independently floating exchange rates and, concurrently, liberalized their exchange and trade systems. In addition, three countries moved from the de facto pegging category of "Limited Flexibility in Terms of a Single Currency" (the U.S. dollar in two instances) to a currency basket other than the SDR, and one country moved from a currency peg to a managed float. ^{2/}

As of September 30, 1985, 32 percent of Fund members were maintaining more flexible arrangements, compared with 27 percent at end-1981, when the present classification (which includes the category "Limited Flexibility in Terms of a Single Currency" that had been grouped with more flexible arrangements) was adopted. Over the same period, the

^{1/} In addition, there was one notification of the exchange arrangement for a new member.

^{2/} Bringing the total number of nonindustrial country members with exchange rates classified as "independently floating" to 10. A staff paper, "Experience with Exchange Rate Flexibility in Developing Countries," planned to be issued in March 1986, will review the experience since 1982 with exchange rate flexibility in certain developing countries, and, in particular, the technical aspects of the various exchange arrangements.

number of members with "Independently Floating" arrangements increased from 7 percent to 10 percent of the total membership.

Of the 26 discrete changes in exchange rates notified to the Executive Board in 1985, all but six involved nominal depreciations; Ireland, France, Denmark, the Netherlands, the Federal Republic of Germany, Belgium and Luxembourg appreciated their currencies vis-à-vis the ECU in a realignment of the European Monetary System.

b. Notification of changes in exchange systems

Closely related to developments in members' exchange rates are changes in their system of exchange control and multiple exchange rates as these latter measures in members' exchange system practices frequently substitute for adjustment of the exchange rate. Communications from members dealing with significant actions affecting exchange controls (not otherwise reported within a brief interval in consultations or use of Fund resources reports) are notified separately to the Board. In 1985, 27 such papers were issued informing the Executive Board of changes in members' exchange and payments systems, of which 11 were included in notifications described above of changes in exchange arrangements (Table 23).

c. Format and content of notifications

In the documentation transmitting the changes in exchange arrangements and exchange systems to the Executive Board, the staff continued to clarify and to give context to the measures. In 28 of 62 notification papers in 1985, the staff paper included an appraisal of the measure, in the light of the views of the Fund on the member's policies expressed at the time of the latest Article IV consultation discussion with the member. In the majority of the instances in which no appraisal was explicitly stated, the staff paper pointed out that discussion of the same measure was to be taken up shortly in the broader context of a consultation report in preparation at the time.

Table 20. Information Notices Issued, 1983-1985

	1983	1984	1985
Total	<u>6</u>	<u>19</u>	<u>30</u> ^{1/}
Distribution by country classification			
Industrial countries	--	--	3
of which: G-10	--	--	3
Nonindustrial countries	6	19	27
Distribution by exchange arrangement			
Pegged			
To a single currency or the SDR	3	11	15
To a currency composite	1	2	2
Flexibility limited			
Single currency	--	--	--
Cooperative arrangements	--	--	--
More flexible			
Adjusted according to indicators	1	1	--
Managed floating	1	4	2
Independently floating	--	1	11

^{1/} Two information notices were issued for Bolivia, Ethiopia, Sierra Leone, the United Kingdom and Uruguay and three were issued for Nicaragua. See Table 21.

Table 21. Information Notices Issued in 1985

Country	Report Number	Date
Australia	EBS/85/161	June 26
Bolivia	EBS/85/68	March 22
Bolivia	SM/85/233, Sup.1	September 18
Burundi	EBS/85/29	February 1
Cape Verde	<u>1/</u>	March 20
Dominican Republic	EBS/85/260	November 25
El Salvador	EBS/85/166	July 9
Ethiopia	EBS/85/131	May 17
Ethiopia	EBS/85/292	December 27
Guatemala	EBS/85/156	June 20
Mexico	EBS/85/99	April 23
New Zealand	EBS/85/259	November 25
Nicaragua	EBS/85/43	March 1
Nicaragua	EBS/85/179	July 31
Nicaragua	EBS/85/273	December 11
Paraguay	EBS/85/236	October 25
Peru	EBS/85/134	May 23
Philippines	EBS/85/102	April 24
Sierra Leone	EBS/85/77	March 28
Sierra Leone	EBS/85/247	November 6
South Africa	EBS/85/78	March 28
Swaziland	EBS/85/79	March 28
Tanzania	EBS/85/285	December 19
Uganda	EBS/85/24	January 29
United Kingdom	EBS/85/44	March 5
United Kingdom	EBS/85/203	August 26
United States	EBS/85/69	March 21
Uruguay	EBS/85/91	April 5
Uruguay	EBS/85/215	September 10
Venezuela	EBS/85/136	May 24

Source: Exchange and Trade Relations Department.

1/ Staff statement at EBM/85/45.

Table 22. Notifications of Exchange Arrangements Issued in 1985

Country	Report Number	Date
Argentina	EBD/85/155	June 21
Belgium/Luxembourg	EBD/85/191	July 24
Bolivia <u>1/2/</u>	EBS/85/68	March 22
Bolivia <u>1/</u>	EBS/85/140	June 3
Botswana	EBD/85/21	January 16
Botswana	EBD/85/237	September 10
Chile	EBS/85/54	March 4
China, P.R.	EBD/85/3	January 3
China, P.R.	EBD/85/16	January 14
Denmark	EBD/85/192	July 24
Dominican Republic <u>1/</u>	EBS/85/76	March 27
El Salvador <u>1/2/</u>	EBS/85/166	July 9
Equatorial Guinea	EBD/85/38	January 28
European Monetary System	SM/85/213	July 29
France	EBD/85/194	July 25
Germany	EBD/85/189	July 23
Ghana	EBS/85/232	October 21
Greece	EBD/85/257	October 15
Guatemala	EBD/85/10	January 11
Guinea	EBD/85/275	October 25
Ireland	EBD/85/196	July 29
Israel <u>1/</u>	EBS/85/190	August 13
Israel	EBD/85/233	September 4
Italy	EBD/85/193	July 24
Kenya	EBS/85/86	April 4
Kenya	EBD/85/226	August 29
Lesotho <u>1/</u>	EBD/85/255	September 27
Madagascar	EBD/85/9	January 10
Madagascar	EBS/85/81	March 29
Madagascar	EBD/85/172	July 12
Maldives	EBD/85/175	July 15
Malta	EBD/85/304	December 6
Nepal <u>1/</u>	EBD/85/303	December 6
Netherlands	EBD/85/190	July 24
New Zealand	EBD/85/70	March 8
Peru	EBD/85/130	May 21
Peru <u>1/</u>	EBD/85/217	August 20
Sierra Leone <u>1/2/</u>	EBS/85/77	March 28
South Africa <u>1/</u>	EBD/85/214	September 9
South Africa	EBD/86/267	October 8
Sudan <u>1/</u>	EBD/85/121	May 9
Sudan	BUFF/85/178	September 26
Tonga	EBD/85/292	November 15
Vanuatu	EBD/85/91	April 4
Viet Nam	EBD/85/247	September 23
Western Somoa	EBS/85/60	March 14
Yemen Arab Republic	EBD/85/55	February 4
Zambia	BUFF/85/179	October 10

Source: Exchange and Trade Relations Department

1/ Also notification of exchange system.

2/ Also information notice.

Table 23. Notifications of Exchange System Changes Issued in 1985

Country	Report Number	Date
Bolivia <u>1/2/</u>	EBS/85/68	March 22
Bolivia <u>2/</u>	EBS/85/140	June 3
Denmark	EBD/85/144	June 12
Dominican Republic <u>2/</u>	EBS/85/76	March 27
Ecuador	EBS/85/263	December 2
Egypt	EBS/85/59	March 13
El Salvador <u>1/2/</u>	EBS/85/166	July 9
France	EBD/85/74	March 12
France	EBD/85/272	October 23
France	EBD/85/311	December 11
Greece	SM/85/300	November 7
Honduras	EBS/85/158	June 24
Israel <u>2/</u>	EBS/85/190	August 13
Italy	EBD/85/284	November 5
Lesotho <u>2/</u>	EBD/85/255	September 27
Mexico	Buff/85/99	June 6
Mexico	EBS/85/188	August 9
Nepal <u>2/</u>	EBD/85/303	December 6
Nicaragua <u>1/</u>	EBS/85/43	March 1
Paraguay	EBD/85/82	March 21
Peru <u>2/</u>	EBD/85/217	August 20
Sierra Leone <u>1/2/</u>	EBS/85/77	March 28
South Africa	EBD/85/225	August 28
South Africa	EBD/85/235	September 5
South Africa <u>2/</u>	EBD/85/214	September 9
South Africa	EBD/85/313	December 16
Sudan <u>2/</u>	EBD/85/121	May 9

Source: Exchange and Trade Relations Department

1/ Also information notice.

2/ Also notification of exchange arrangements.

V. Coverage of Selected Surveillance Topics
in the General Work of the Fund During 1985 ^{1/}

Several staff papers and Board discussions in 1985 dealt with issues related to surveillance. Apart from the staff reports and Board discussions concluding Article IV consultations with individual members, the main such discussions were, as usual, the two discussions of the World Economic Outlook in April and September and the 1985 annual review of the implementation of surveillance in March [A:1; B:1; B:2]. In addition to the usual documentation, and in support of the emphasis on medium-term prospects and the sensitivity of the medium-term outlook to changes in assumptions, supplementary background notes were prepared in the context of the World Economic Outlook on developments and prospects in primary commodity prices, trends in capital flows to developing countries, structural policies, the growth potential of industrial countries and the effects of U.S. fiscal policy. Also of broader interest, a staff note was issued in December 1985 on the September 22 announcement of G-5 Ministers [A:4].

Continuing concerns with the external debt situation of developing countries were reflected in several related Board discussions. External debt issues were considered, in particular, in March, on the basis of staff papers on developing countries' indebtedness to commercial banks and official creditors and on export credit cover policies [C:1]; and in September on the basis of a staff paper on "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors" [C:2]. In addition, several papers reported on the progress achieved, in collaboration with other international agencies (OECD, BIS, Berne Union and IBRD) and the International Compilers' Working Group of External Debt Statistics, in the monitoring of external debt and lending flows [D:1; D:2; D:3].

The overall assessment of Directors through these discussions was that encouraging progress had been made in addressing debt servicing difficulties. Directors, however, cautioned against complacency, noting that the progress of individual countries in restoring a viable balance of payments position and growth had been uneven. Directors stressed that the key elements for a solution of the debt problem remained the adoption of appropriate adjustment policies by debtor countries, the continued collaboration between debtors and creditors in order to provide orderly and adequate financing and the achievement of a satisfactory rate of growth of the world economy.

Directors generally stressed the appropriateness of continuing the case-by-case approach of tailoring the mix between adjustment and financing to a country's circumstances and prospects, and they considered that the Fund would continue to have a major role to play in this regard. The review of criteria and practices for enhanced surveillance, in September, reaffirmed and clarified procedures for the Fund's

^{1/} References in brackets are to documents listed in Table 24.

involvement in helping debtor countries having shown a good record of adjustment progress further toward normalized access to financial markets. Most Directors felt that enhanced surveillance could be undertaken when the four following conditions are met: first, at the request of a member country, who must initiate the procedures; second, in cases where a good record of adjustment has been shown; third, in cases in which a multiyear restructuring agreement (MYRA) is needed to normalize market relations and to facilitate the return to voluntary or spontaneous financing; and fourth, in cases where the member is in a position to present an adequate quantified policy program in the framework of consultations with the Fund staff.

External debt issues were discussed further in November against the background of developments in commercial lending, the structure of financial markets and the debt strategy, on the basis of a staff paper on "International Capital Markets--Developments and Prospects, 1985" [C:3]. The discussion provided a first opportunity to examine the initiative by United States Treasury Secretary Baker, stressing the importance of coordinated efforts by all parties involved--governments, multilateral agencies, and commercial banks. Directors welcomed the United States initiative as an important and timely signal to the international community toward renewing the momentum in dealing with the debt problem.

The strategy to address the debt servicing difficulties faced by many developing countries has highlighted the need to maintain adequate rates of growth of economic activity and trade. Trade issues were addressed by Executive Directors on several occasions in 1985, in particular in March on the basis of a staff report on "Trade Policy Issues and Developments" [E:1]. Directors expressed serious concern about the continued drift toward protectionism in recent years. They regretted that the onset of world economic recovery had not yet led, in spite of some limited initiatives, to an easing of protectionist measures. Directors hoped that new multilateral trade negotiations would provide the basis for significant trade liberalization. Directors also welcomed the strengthened treatment of trade policy issues in Article IV consultations and agreed to the preparation of information notices on major trade policy decisions: two information notices were issued subsequently, "Japan: Recent Trade Measures" SM/85/256 (9/4/85); and "United States: Trade Policy Developments in the Footwear Sector" SM/85/268 (10/16/85).

Other Executive Board discussions related to surveillance in 1985 included the consideration in July, in a seminar, of a staff paper on the "Global Effects of Fund-Supported Adjustment Programs" [I:2]; and the discussion in February of "Multiple Currency Practices Applicable Solely to Capital Transactions" [F:1]. While not taking a view on the Fund's jurisdiction over multiple currency practices applicable solely to capital transactions, Executive Directors considered that a full analysis of such practices should continue to be provided in the framework of the Fund's surveillance activities.

Table 24. Coverage of Selected Surveillance Topics in 1985

<u>Executive Board Meeting</u>		Document	Document Number	Date Issued
Number	Date			
A. Surveillance--General				
1.	EBM/85/47 3/22/85 EBM/85/48 3/22/85 EBM/85/49 3/25/85	a. Review of the document "Enhancing the Effectiveness of Surveillance: The 1985 Annual Review of the Implementation of Surveillance"	SM/85/65	2/22/85
		b. Annual Review of the Implementation of Surveillance--Background Material	SM/85/65 Supp. 1	2/28/85
		c. Chairman's Summing Up	SUR/85/36	3/28/85
2.	-- --	a. Tokyo-Communique of the Ministers and Governors of the Group of Ten	EBD/85/154	6/21/85
		b. Report of G-10 Deputies on the Functioning of the International Monetary System	EBD/85/154 Supp. 1	6/21/85
3.	-- --	Report of the Deputies of the Group of Twenty-four on the Functioning and Improvement of the International Monetary System--Transmittal to the Interim Committee	EBD/85/228	8/30/85
4.	-- --	a. Joint Statement issued by the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States.	EBD/85/27	1/22/85
		b. Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom and the United States.	EBD/85/246	9/23/85
		c. Staff Note on the Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom and the United States.	SM/85/318	12/2/85
B. World Economic Outlook				
1.	EBM/85/51 4/1/85 EBM/85/52 4/1/85 EBM/85/53 4/3/85 EBM/85/54 4/3/85 EBM/85/55 4/5/85	a. The World Economy to 1990: Prospects and Issues	EBS/85/47	3/11/85
		b. World Economic Outlook: Current Situation and Short-term Prospects	EBS/85/48	3/11/85
		c. World Economic Outlook: Medium-term Scenarios	EBS/85/49	3/11/85
		d. World Economic Outlook: Statistical Appendix	EBS/85/50	3/11/85
		e. World Economic Outlook: Supplementary Note 1--Fiscal Policy in the Major Industrial Countries	SM/85/70	3/11/85
		f. World Economic Outlook: Supplementary Note 2--Monetary Developments in Major Industrial Countries	SM/85/71	3/11/85
		g. World Economic Outlook: Supplementary Note 3--Non-oil Primary Commodity Price Developments and Prospects	SM/85/72	3/11/85
		h. World Economic Outlook: Supplementary Note 4--World Oil Situation	SM/85/73	3/11/85
		i. World Economic Outlook: Supplementary Note 5--Economic Developments in Eastern Europe and the U.S.S.R.	SM/85/74	3/11/85
		j. World Economic Outlook: Supplementary Note 6--Estimating Growth Potential in Industrial Countries	SM/85/75	3/11/85
		k. World Economic Outlook: Supplementary Note 7--Domestic and International Effects of the U.S. Fiscal Position	SM/85/76	3/11/85
		l. World Economic Outlook: Supplementary Note 8--Structural Policies in Industrial Countries	SM/85/77	3/11/85
		m. World Economic Outlook: Supplementary Note 9--Developing Countries: Impact of the External Environment and Domestic Policies on Economic Performance	SM/85/78	3/11/85
		n. World Economic Outlook: Supplementary Note 10--Trends in Capital Flows to Developing Countries	SM/85/79	3/11/85

Table 24 (Continued). Coverage of Selected Surveillance Topics in 1985

<u>Executive Board Meeting</u>		Document	Document Number	Date Issued
Number	Date			
		o. World Economic Outlook: Supplementary Note 11-- Medium-term Projections by Staffs of the Bank and the Fund: Note on Differences in Methodology and Assumptions	SM/85/80	3/11/85
		p. Chairman's Summing Up	SUR/85/37	4/5/85
2.	EBM/85/143 9/16/85	a. World Economic Outlook--General Survey	EBS/85/201	8/26/85
	EBM/85/144 9/16/85	b. World Economic Outlook--Statistical Appendix	EBS/85/201	8/26/85
	EBM/85/145 9/18/85		Supp. 1	
		c. World Economic Outlook--Technical Note on the Sensitivity of Staff Projections to Changes in Certain Key Assumptions	EBS/85/201	8/28/85
			Supp. 2	
		d. Chairman's Summing Up	Buff 85/170	9/20/85
C.	External Debt, International Capital Markets and Enhanced Surveillance			
1.	EBM/85/45 3/20/85	a. Export Credit Cover Policies and Payments Difficulties	SM/84/272	12/18/84
	EBM/85/46 3/20/85			
		b. Developing Countries' External Indebtedness to Commercial Banks	SM/85/61	2/20/85
		c. Developing Countries' External Indebtedness to Commercial Banks--Supplemental Information	SM/85/61	3/6/85
			Supp. 1	
		d. Developing Countries' Indebtedness to Official Creditors	SM/85/62	2/21/85
		e. Developing Countries' Indebtedness to Official Creditors--Supplemental Information	SM/85/62	3/1/85
			Supp. 1	
		f. Chairman's Concluding Remarks	Buff 85/60	3/27/85
2.	EBM/85/130 8/30/85	a. The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors	EBS/85/173	7/23/85
	EBM/85/131 9/4/85			
	EBM/85/132 9/4/85	b. The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors-- Supplementary Material.	EBS/85/173	8/13/85
			Supp. 1	
		c. Chairman's Summing Up	Buff 85/152	9/6/85
3.	EBM/85/165 11/13/85	a. International Capital Markets--Developments and Prospects, 1985	SM/85/267	9/27/85
	EBM/85/166 11/13/85			
		b. International Capital Markets--Developments and Prospects, 1985--U.S. Treasury Initiative on Debt	SM/85/267	11/1/85
			Supp. 1	
		c. International Capital Markets--Recent Developments, 1985	SM/85/280	10/17/85
		d. International Capital Markets--Recent Developments 1985--Statistical Supplement	SM/85/280	10/18/85
			Supp. 1	
		e. Chairman's Summing Up	Buff 85/198	12/3/85
D.	Statistical Issues			
1.	EBM/85/71 5/6/85	Review of Fund Statistics	SM/85/63	2/21/85
2.	-- --	International Compilers' Working Group on External Debt Statistics--Release of Information	EBD/85/127	5/16/85
3.	-- --	International Compilers' Working Group on External Debt Statistics (Report on June 1985 meeting).	SM/85/239	8/20/85
E.	Trade Policy			
1.	EBM/85/43 3/18/85	a. Trade Policy Issues and Developments	SM/85/60	2/20/85
	EBM/85/44 3/18/85	b. Trade Policy Issues and Developments-- Supplemental Material	SM/85/60	2/25/85
			Supp. 1	
		c. Trade Policy Issues and Developments-- Statistical Annex	SM/85/60	2/25/85
			Supp. 2	
		d. Chairman's Summing Up	Buff 85/57	3/25/85
2.	-- --	Information Notices on Trade Policy--Suggested Features	SM/85/225	8/8/85
F.	Exchange Rate Policies			
1.	EBM/85/23 2/13/85	a. Multiple Currency Practices Applicable Solely to Capital Transactions	SM/85/19	1/16/85
		b. Chairman's Summing Up	Buff 85/34	2/25/85

Table 24 (Concluded). Coverage of Selected Surveillance Topics in 1985

<u>Executive Board Meeting</u>		Document	Document Number	Date Issued
Number	Date			
G. Consultation Procedures				
1.	--	Frequency of Article IV Consultations-- Semi-Annual Report	SM/85/249	8/28/85
H. International Reserves				
1.	EBM/85/42	3/15/85	a. Allocation of SDRs in Current Basic Period-- Renewed Consideration b. Chairman's Summing Up	SM/85/50 Buff 85/42 3/15/85
2.	EBM/85/129	8/30/85	a. Implications of U.S. External Current Account Deficits for the Volume of International Reserves b. SDR Allocations in the Current Basic Period-- Review of Pertinent Considerations c. Chairman's Summing Up	SM/85/218 SM/85/219 Buff 85/157 8/2/85 8/2/85 9/9/85
I. Other				
1.	--	--	a. Bank/Fund Collaboration--President Clausen's Summing up b. Bank/Fund Collaboration--Excerpt of Bank Board Minutes	EBD/85/79 EBD/85/79 Supp.1 3/19/85 5/1/85
2.	Seminar	7/22/85	Global Effects of Fund-Supported Adjustment Programs	SM/85/97 4/4/85
J. Periodic Documentation				
1.	--	--	Charts on Exchange Market Developments	(monthly)
2.	--	--	Foreign Exchange and Financial Markets <u>1/</u>	(monthly)
3.	--	--	Indicators of Real Effective Exchange Rates	(quarterly)
4.	--	--	Exchange Rate Arrangements Maintained by Members	(quarterly)
5.	--	--	International Banking Activity	(quarterly)
6.	--	--	Annual Report on Exchange Arrangements and Exchange Restrictions	(annual)
7.	--	--	Annual Report	(annual)

Source: Exchange and Trade Relations Department.

1/ In addition, the Treasurer's Department issues weekly and daily reports on foreign exchange and financial markets.

Table 25. Executive Board Documents Issued in 1985 Providing Information on Specific Policy Measures and Economic Developments

Country	Document	Document Number	Date Issued
Italy	Monetary Measures	EBD/85/11	1/10/85
Federal Republic of Germany	Monetary Measures	EBD/85/42	2/01/85
Netherlands	Interest Rates	EBD/85/43	2/01/85
OECD	Communique of the OECD Ministers	EBD/85/100	4/15/85
Belgium	Decision on Interest Rates	EBD/85/126	5/17/85
Sweden	Decision on Interest Rates	EBD/85/135	5/22/85
New Zealand	Budget Announcement	EBD/85/151	6/19/85
Sweden	Decision on Interest Rates	EBD/85/174	7/12/85
Viet Nam	Economic Measures	EBD/85/173	7/15/85
Federal Republic of Germany	Monetary Measures	EBD/85/212	8/16/85
Netherlands	Interest Rates	EBD/85/213	8/16/85
Austria	Decision on Interest Rates	EBD/85/214	8/19/85
South Africa	Suspension of Trading on South African Currency Market and Johannesburg Stock Exchange	EBD/85/225	8/28/85
France	Provisions Relating to Export Credits	EBD/85/272	10/22/85
Italy	Monetary Measures	EBD/85/287	11/12/85
Sweden	Modification of Credit Control System	EBD/85/299	11/25/85
Belgium	Interest Rate Policy	EBD/85/327	12/24/85

Source: Exchange and Trade Relations Department.

Table 26. Article IV Consultations Concluded in 1985

Country	EBM Number	EBM Date	Staff Report Number	Staff Report Date	RED Number	RED Date	Summing Up Number	Summing Up Date
Algeria	EBM/85/134	09/09/85	SM/85/185	06/27/85	SM/85/202	07/18/85	SUR/85/99	09/12/85
Antigua & Barbuda	EBM/85/88	06/03/85	SM/85/128	05/08/85	SM/85/136	05/16/85	SUR/85/62	06/14/85
Australia	EBM/85/26	02/20/85	SM/85/30 Supp. 1	01/29/85 02/15/85	SM/85/35	02/05/85	SUR/85/17	02/25/85
Austria	EBM/85/78	05/22/85	SM/85/114	04/24/85	SM/85/124	05/07/85	SUR/85/53	05/28/85
Bahamas	EBM/85/94	06/12/85	SM/85/126	05/08/85	SM/85/143	05/20/85	SUR/85/60	06/13/85
Bahrain	EBM/85/36	03/06/85	SM/85/45	02/07/85	SM/85/57	02/19/85	SUR/85/26	03/11/85
Bangladesh	EBM/85/173	12/02/85	SM/85/264	09/23/85	SM/85/276	10/08/85	SUR/85/129	12/05/85
Barbados	EBM/85/156	10/25/85	SM/85/262	09/19/85	SM/85/274	10/04/85	SUR/85/114	10/29/85
Belgium	EBM/85/5	01/11/85	SM/84/271	12/14/84	SM/84/279	12/26/84	SUR/85/3	01/14/85
Belize	EBM/85/101	06/28/85	EBS/85/135	05/24/85	SM/85/164	06/12/85	SUR/85/71	07/03/85
Benin	EBM/85/38	03/08/85	SM/85/49	02/11/85	SM/85/68	02/28/85	SUR/85/30	03/14/85
Bhutan	EBM/85/127	08/28/85	SM/85/216	07/31/85	SM/85/220	08/08/85	SUR/85/95	09/04/85
Bolivia	EBM/85/149	09/23/85	SM/85/233 Supp. 1	08/15/85 09/18/85	SM/85/253	09/06/85	SUR/85/108	09/25/85
Botswana	EBM/85/57	04/10/85	SM/85/86	03/12/85	SM/85/88	03/18/85	SUR/85/39	04/12/85
Brazil	EBM/85/128	08/28/85	EBS/85/178	07/31/85	SM/85/229	08/14/85	SUR/85/98	09/11/85
Burma	EBM/85/32	03/01/85	SM/85/32	01/31/85	SM/85/55	02/15/85	SUR/85/24	03/05/85
Burundi	EBM/85/72	05/08/85	SM/85/111	04/17/85	SM/85/117	04/26/85	SUR/85/47	05/09/85
Cameroon	EBM/85/126	08/26/85	SM/85/201	07/10/85	SM/85/221	08/08/85	SUR/85/97	09/05/85
Canada	EBM/85/31	02/27/85	SM/85/28	01/28/85	SM/85/43	02/11/85	SUR/85/21	03/01/85
Cape Verde	EBM/85/45	03/20/85	SM/85/67	02/26/85	SM/85/82	03/08/85	SUR/85/34	03/25/85
Central African Rep.	EBM/85/148	09/23/85	EBS/85/204	08/27/85	SM/85/259	09/09/85	SUR/85/111	09/26/85
Chad	EBM/85/63	04/26/85	SM/85/93	04/01/85	SM/85/95	04/04/85	SUR/85/44	05/03/85
Chile	EBM/85/106	07/15/85	EBS/85/122 Supp. 1	05/13/85 07/12/85	SM/85/150	05/24/85	SUR/85/77	07/17/85
China	EBM/85/162	11/08/85	SM/85/266 Supp. 1	09/27/85 11/04/85	SM/85/272 Supp. 1	10/24/85 10/25/85	SUR/85/123	11/18/85
Colombia	EBM/85/114	07/26/85	EBS/85/149 Supp. 1	06/12/85 06/14/85	SM/85/172	06/19/85	SUR/85/93	08/12/85
Comoros	EBM/85/29	02/25/85	SM/85/37	02/01/85	SM/85/46	02/11/85	SUR/85/18	02/26/85
Congo	EBM/85/160	11/04/85	SM/85/241	08/22/85	SM/85/263	09/23/85	SUR/85/120	11/08/85
Costa Rica	EBM/85/136	09/10/85	SM/85/223	08/07/85	SM/85/247	08/28/85	SUR/85/104	09/18/85
Cote d'Ivoire	EBM/85/87	06/03/85	EBS/85/113	05/02/85	SM/85/146	05/21/85	SUR/85/55	06/07/85
Denmark	EBM/85/43	03/18/85	SM/85/51	02/12/85	SM/85/66	02/28/85	SUR/85/33	03/21/85
Djibouti	EBM/85/98	06/17/85	SM/85/138	05/14/85	SM/85/156	05/31/85	SUR/85/67	06/20/85
Dominica	EBM/85/107	07/15/85	SM/85/173	06/20/85	SM/85/184	06/28/85	SUR/85/79	07/18/85
Dominican Rep.	EBM/85/172	11/27/85	EBS/85/237	10/30/85	SM/85/291	11/05/85	SUR/85/128	12/03/85
Ecuador	EBM/85/147	09/20/85	EBS/85/202 Supp. 1	08/23/85 09/18/85	SM/85/255	09/06/85	SUR/85/112	09/27/85
Egypt	EBM/85/123	08/07/85	SM/85/177 Supp. 1	06/24/85 08/05/85	SM/85/198	07/10/85	SUR/85/90	08/09/85
El Salvador	EBM/85/188	12/27/85	SM/85/315	11/26/85	SM/85/329	12/16/85	SUR/86/1	01/07/86

Table 26 (Continued). Article IV Consultations Concluded in 1985

Country	EBM Number	EBM Date	Staff Report Number	Staff Report Date	RED Number	RED Date	Summing Up Number	Summing Up Date
Ethiopia	EBM/85/96	06/14/85	SM/85/151	05/23/85	SM/85/160	06/04/85	SUR/85/66	06/20/85
Fiji <u>1/</u>	EBM/85/11 EBM/85/185	01/25/85 12/20/85	SM/84/273 SM/85/309	12/18/84 11/18/85	SM/85/1 SM/85/312	01/02/85 11/29/85	SUR/85/8 SUR/86/3	01/29/85 01/07/86
Finland	EBM/85/108	07/17/85	SM/85/178	06/24/85	SM/85/189	07/02/85	SUR/85/80	07/23/85
France	EBM/85/115	07/29/85	SM/85/175 Supp. 1	06/21/85 07/24/85	SM/85/195	07/10/85	SUR/85/87	08/06/85
Gabon	EBM/85/42	03/15/85	SM/85/52	02/12/85	SM/85/69	03/01/85	SUR/85/32	03/19/85
Gambia, The	EBM/85/147	09/20/85	SM/85/244 Supp. 1	08/23/85 09/18/85	SM/85/258	09/06/85	SUR/85/110	09/26/85
Germany	EBM/85/119	08/02/85	SM/85/194	07/05/85	SM/85/204	07/17/85	SUR/85/88	08/07/85
Ghana	EBM/85/141	09/13/85	EBS/85/211	08/30/85	SM/85/252	09/04/85	SUR/85/102	09/18/85
Greece	EBM/85/75	05/17/85	SM/85/116 Supp. 1	04/25/85 05/13/85	SM/85/122	05/03/85	SUR/85/57	06/11/85
Grenada	EBM/85/183	12/18/85	SM/85/313	11/25/85	SM/85/317	12/04/85	SUR/85/133	12/23/85
Guatemala	EBM/85/99	06/21/85	SM/85/153	05/28/85	SM/85/162	06/07/85	SUR/85/74	07/15/85
Guinea-Bissau	EBM/85/132	09/04/85	SM/85/226	08/09/85	SM/85/236	08/19/85	SUR/85/103	09/18/85
Guyana	EBM/85/168	11/20/85	SM/85/287	10/30/85	SM/85/295	11/07/85	SUR/85/126	11/26/85
Haiti <u>1/</u>	EBM/85/18 EBM/85/169	02/04/85 11/25/85	EBS/85/2 SM/85/292	01/04/85 11/04/85	SM/84/275 SM/85/306	12/21/84 11/13/85	SUR/85/12 SUR/85/127	02/08/85 11/29/85
Honduras	EBM/85/21	02/11/85	SM/85/22	01/18/85	SM/85/26	01/28/85	SUR/85/15	02/13/85
Hungary	EBM/85/37	03/08/85	SM/85/10 Supp. 1	01/07/85 03/06/85	SM/85/15	01/18/85	SUR/85/29	03/13/85
India	EBM/85/28	02/22/85	SM/85/27	01/25/85	SM/85/41	02/18/85	SUR/85/19	02/27/85
Indonesia	EBM/85/20	02/08/85	SM/85/20	01/18/85	SM/85/25	01/24/85	SUR/85/13	02/12/85
Ireland	EBM/85/135	09/10/85	SM/85/230	08/14/85	SM/85/240	08/23/85	SUR/85/100	09/12/85
Israel	EBM/85/80	05/24/85	SM/85/118 Supp. 1	04/26/85 05/23/85	SM/85/129	05/10/85	SUR/85/54	06/05/85
Italy	EBM/85/80	05/24/85	SM/85/119	04/26/85	SM/85/127 Supp. 1	05/10/85 05/22/85	SUR/85/51	06/03/85
Jamaica	EBM/85/108	07/17/85	EBS/85/162	06/27/85	SM/85/200	07/10/85	SUR/85/81	07/24/85
Japan	EBM/85/34	03/04/85	SM/85/33	01/31/85	SM/85/56 Supp. 1 Supp. 2	02/15/85 02/19/85 03/01/85	SUR/85/28	03/12/85
Jordan	EBM/85/100	06/26/85	SM/85/159	06/03/85	SM/85/161	06/06/85	SUR/85/70	07/02/85
Kenya	EBM/85/154	10/21/85	EBS/85/217	09/13/85	SM/85/260	09/24/85	SUR/85/113	10/23/85
Korea	EBM/85/105	07/12/85	EBS/85/151	06/14/85	SM/85/176	06/27/85	SUR/85/76	07/16/85
Kuwait	EBM/85/7	01/16/85	SM/85/268	12/11/84	SM/85/2	01/02/85	SUR/85/5	01/22/85
Lao, P.D. Rep.	EBM/85/31	02/27/85	SM/85/42	02/06/85	SM/85/53	02/13/85	SUR/85/20	03/01/85
Lebanon	EBM/85/25	02/20/85	SM/85/9	01/07/85	SM/85/34	02/04/85	SUR/85/16	02/25/85
Lesotho	EBM/85/168	11/20/85	SM/85/283	10/23/85	SM/85/288	11/04/85	SUR/85/124	11/25/85
Liberia	EBM/85/112	07/24/85	SM/85/188	06/28/85	SM/85/191	07/08/85	SUR/85/83	07/29/85
Libya	EBM/85/87	06/03/85	SM/85/132	05/13/85	SM/85/142	05/20/85	SUR/85/56	06/10/85
Luxembourg	EBM/85/97	06/17/85	SM/85/152	05/24/85	SM/85/157	06/03/85	SUR/85/65	06/20/85
Malawi	EBM/85/77	05/22/85	EBS/85/101	04/24/85	SM/85/121	05/06/85	SUR/85/50	05/24/85
Malaysia	EBM/85/111	07/24/85	SM/85/180	06/26/85	SM/85/196	07/10/85	SUR/85/85	07/31/85

Table 26 (Continued). Article IV Consultations Concluded in 1985

Country	EBM Number	EBM Date	Staff Report Number	Staff Report Date	RED Number	RED Date	Summing Up Number	Summing Up Date
Maldives	EBM/85/10	01/23/85	SM/85/4 Supp. 1	01/02/85 01/18/85	SM/85/11	01/09/85	SUR/85/10	02/06/85
Mali	EBM/85/70	05/03/85	SM/85/91 Supp. 1	03/27/85 04/30/85	SM/85/109	04/17/85	SUR/85/48	05/14/85
Malta	EBM/85/66	04/29/85	SM/85/99	04/05/85	SM/85/106	04/15/85	SUR/85/43	05/02/85
Mauritania	EBM/85/159	11/01/85	EBS/85/239	10/01/85	SM/85/270	10/18/85	SUR/85/119	11/05/85
Mauritius	EBM/85/145	09/18/85	EBS/85/205	08/28/85	SM/85/257	09/05/85	SUR/85/106	09/24/85
Mexico	EBM/85/92	06/07/85	EBS/85/123	05/13/85	SM/85/148	05/23/85	SUR/85/69	06/26/85
Morocco	EBM/85/140	09/12/85	EBS/85/157 Supp. 1 Supp. 2	06/21/85 06/24/85 09/06/85	SM/85/193	07/03/85	SUR/85/105	09/18/85
Mozambique	EBM/85/103	07/03/85	SM/85/158 Supp. 1	06/03/85 06/28/85	SM/85/169	06/14/85	SUR/85/73	07/10/85
Nepal	EBM/85/186	12/23/85	EBS/85/264	12/03/85	SM/85/326	12/10/85	SUR/85/134	12/26/85
Netherlands	EBM/85/68	05/01/85	SM/85/104	04/10/85	SM/85/110	04/17/85	SUR/85/46	05/07/85
Netherlands Antilles	EBM/85/24	02/15/85	SM/85/21 Supp. 1	01/22/85 02/13/85	SM/85/24	01/25/85	SUR/85/22	03/04/85
New Zealand	EBM/85/93	06/10/85	SM/85/139	05/14/85	SM/85/145	05/21/85	SUR/85/58	06/12/85
Nicaragua	EBM/85/34	03/04/85	SM/85/48	02/11/85	SM/85/58	02/20/85	SUR/85/25	03/07/85
Niger	EBM/85/104	07/08/85	EBS/85/143 Supp. 1	06/05/85 07/05/85	SM/85/165	06/13/85	SUR/85/75	07/16/85
Nigeria	EBM/85/98	06/17/85	SM/85/149	05/21/85	SM/85/155	05/31/85	SUR/85/68	06/21/85
Oman	EBM/85/39	03/11/85	SM/85/47	02/11/85	SM/85/64	02/25/85	SUR/85/31	03/15/85
Pakistan	EBM/85/31	02/27/85	SM/85/29 Supp. 1	01/29/85 02/26/85	SM/85/31	02/04/85	SUR/85/23	03/05/85
Panama	EBM/85/107	07/15/85	EBS/85/152	06/17/85	SM/85/179	06/27/85	SUR/85/78	07/17/85
Papua New Guinea	EBM/85/123	08/07/85	SM/85/207	07/18/85	SM/85/211	07/26/85	SUR/85/91	08/12/85
Paraguay 1/ 12/11/85	EBM/85/5 EBM/85/178	01/11/85 12/11/85	SM/85/276 SM/85/301	12/19/84 11/08/85	SM/84/274 SM/85/302	12/28/84 11/14/85	SUR/85/4 SUR/85/131	01/16/85 12/17/85
Philippines	EBM/85/151	09/25/85	EBS/85/182 Supp. 1	08/08/85 09/20/85	SM/85/251	09/06/85	SUR/85/116	10/01/85
Portugal	EBM/85/133	09/09/85	SM/85/237	08/19/85	SM/85/242	08/26/85	SUR/85/101	09/17/85
Romania	EBM/85/157	10/28/85	SM/85/243 Supp. 1	08/23/85 10/23/85	SM/85/275	10/07/85	SUR/85/115	11/01/85
St. Christopher and Nevis	EBM/85/15	01/30/85	SM/84/280 Supp. 1	12/21/84 01/28/85	SM/85/3	01/04/85	SUR/85/9	02/04/85
St. Lucia	EBM/85/157	10/28/85	SM/85/265	09/24/85	SM/85/277	10/09/85	SUR/85/117	11/01/85
Saudi Arabia	EBM/85/113	07/26/85	SM/85/187	06/28/85	SM/85/197	07/09/85	SUR/85/84	07/30/85
Senegal	EBM/85/7	01/16/85	EBS/84/267 Supp. 1	12/21/84 01/14/85	SM/85/13	01/10/85	SUR/85/7	01/24/85
Seychelles	EBM/85/62	04/24/85	SM/85/90	03/26/85	SM/85/100	04/10/85	SUR/85/41	05/01/85
Sierra Leone	EBM/85/174	12/04/85	SM/85/307	11/04/85	SM/85/314	11/25/85	SUR/85/130	12/09/85
Singapore	EBM/85/8	01/18/85	SM/84/278	12/20/84	SM/85/7	01/04/85	SUR/85/6	01/22/85
Solomon Islands	EBM/85/127	08/28/85	SM/85/215	07/30/85	SM/85/228	08/14/85	SUR/85/96	09/05/85
Somalia	EBM/85/125	08/09/85	SM/85/203 Supp. 1	07/15/85 08/08/85	SM/85/214	07/30/85	SUR/85/94	08/26/85

Table 26 (Concluded). Article IV Consultations Concluded in 1985

Country	EBM Number	EBM Date	Staff Report Number	Staff Report Date	RED Number	RED Date	Summing Up Number	Summing Up Date
South Africa	EBM/85/92	06/07/85	SM/85/120	05/01/85	SM/85/140	05/16/85	SUR/85/61	06/13/85
Spain	EBM/85/149	09/23/85	SM/85/248	08/27/85	SM/85/254	09/09/85	SUR/85/109	09/26/85
Sri Lanka	EBM/85/78	05/22/85	SM/85/101	04/09/85	SM/85/112	04/25/85	SUR/85/52	05/28/85
Suriname	EBM/85/47	03/22/85	SM/85/59	02/20/85	SM/85/84	03/11/85	SUR/85/35	03/26/85
Swaziland	EBM/85/117	07/31/85	SM/85/186	06/27/85	SM/85/206	07/17/85	SUR/85/86	08/01/85
Sweden	EBM/85/123	08/07/85	SM/85/205	07/16/85	SM/85/210	07/24/85	SUR/85/92	08/12/85
Thailand	EBM/85/96	06/14/85	EBS/85/128	05/15/85	SM/85/154	05/30/85	SUR/85/63	06/17/85
Togo	EBM/85/74	05/17/85	EBS/85/94	04/15/85	SM/85/125	05/03/85	SUR/85/49	05/21/85
Trinidad & Tobago	EBM/85/68	05/01/85	SM/85/92	03/29/85	SM/85/105	04/15/85	SUR/85/45	05/06/85
Tunisia	EBM/85/163	11/12/85	SM/85/261	09/19/85	SM/85/281	10/24/85	SUR/85/122	11/15/85
Uganda	EBM/85/20	02/08/85	SM/85/14 Supp. 1	01/14/85 02/06/85	SM/85/23	01/23/85	SUR/85/14	02/13/85
United Arab Emirates	EBM/85/110	07/22/85	SM/85/181	06/26/85	SM/85/192	07/08/85	SUR/85/82	07/24/85
United Kingdom	EBM/35/36	03/06/85	SM/85/44 Supp. 1	02/06/85 03/05/85	SM/85/54	02/14/85	SUR/85/27	03/12/85
United States	EBM/85/121	08/05/85	SM/85/199 Supp. 1	07/08/85 08/01/85	SM/85/209 Supp. 1	07/22/85 07/22/85	SUR/85/89	08/08/85
Uruguay	EBM/85/56	04/08/85	SM/85/83	03/11/83	SM/85/89	03/20/85	SUR/85/38	04/09/85
Vanuatu	EBM/85/160	11/04/85	SM/85/278	10/07/85	SM/85/269	10/18/85	SUR/85/121	11/12/85
Venezuela	EBM/85/181	12/13/85	SM/85/308	11/15/85	SM/85/316	12/02/85	SUR/85/132	12/19/85
Viet Nam	EBM/85/102	07/01/85	EBS/85/147	06/10/85	SM/85/170	06/17/85	SUR/85/72	07/03/85
Western Samoa	EBM/85/17	02/04/85	EBS/85/4 Supp. 1	01/07/85 01/31/85	SM/85/18	01/18/85	SUR/85/11	02/08/85
Yemen Arab Rep.	EBM/85/168	11/20/85	SM/85/271	10/22/85	SM/85/286	11/01/85	SUR/85/125	11/25/85
Yemen, P.D. Rep.	EBM/85/93	06/10/85	SM/85/133	05/13/85	SM/85/147	05/23/85	SUR/85/59	06/13/85
Yugoslavia	EBM/85/66	04/29/85	EBS/85/85 Supp. 1	04/01/85 04/26/85	SM/85/108	04/15/85	SUR/85/42	05/02/85
Zaire	EBM/85/61	04/24/85	EBS/85/74 Supp. 1	03/26/85 04/17/85	SM/85/107	04/12/85	SUR/85/40	04/26/85
Zambia	EBM/85/158	10/30/85	SM/85/273 Supp. 1	10/01/85 10/29/85	SM/85/279	10/09/85	SUR/85/118	11/05/85
Zimbabwe	EBM/85/145	09/18/85	SM/85/238 Supp. 1	08/20/85 09/13/85	SM/85/234	08/19/85	SUR/85/107	09/25/85

Source: Exchange and Trade Relations Department.

1/ For Fiji, Haiti and Paraguay, both the 1984 and the 1985 Article IV consultations were concluded in 1985.



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1985 JAN 21 PM 5:37

dh. Wiesner

EW
S-1B
FO
F

TO: The Managing Director
The Deputy Managing Director

FROM: L.A. Whittome ^{BR for LAM}

SUBJECT: Surveillance Over Exchange Rate Policies--
Annual Review: Background Material

January 21, 1986

I should like to draw your attention to one particular feature of this paper which, as stated in Mr. Finch's cover note, disturbs me. In an effort to respond to the proposal of the G-10 Deputies to provide "candid assessments" of policies, ETR has compiled, in consultation with area departments, Tables 19 and 20, which provide a sort of capsule judgment of fiscal and monetary policies. These tables are referred to in the text on pages 37 and 41.

In my view this attempt to meet one of the proposals of the G-10 Deputies is at one and the same time simplistic and damaging, and I doubt that it is what the Deputies had in mind in asking for "candid assessments". We try to ensure that the policy sections of staff reports and the corresponding parts of the staff appraisal are phrased in prose that, besides being candid and analytical, is carefully weighed and nuanced. The essence of such material simply cannot be captured by the sort of simplistic device contained in Tables 19 and 20, which really do no more than reduce staff appraisals to the level of multiple choice questions.

I would suggest that we drop these tables.

cc: Mr. Finch
Mr. Hood
Mr. Gianviti
Area Department Heads
Mr. Brown

INTERNATIONAL MONETARY FUND

Surveillance

1/22

✓ Mr. Beza
Mr. Narvekar
Mr. Chabrier
Mr. Artus

In case you have not seen them, I am attaching a copy of the comments made by the Managing Director on Mr. Finch's cover note to the paper "Surveillance Over Exchange Rate Policies--Annual Review: Background Material".

Attachment

Brian Rose ^{BR}



Office Memorandum

1986 JAN 17 PM 6:01

To: The Managing Director
The Deputy Managing Director

January 17, 1986

OFFICE OF
THE MANAGING DIRECTOR

From: C. David Finch *CF*

Subject: Surveillance Over Exchange Rate Policies--
Annual Review: Background Material

Attached for your comments and approval is a draft of the above-mentioned paper.

The paper has benefited from comments from all departments concerned. One issue, however, needs to be brought to your attention. The European Department objects strongly to the inclusion of Tables 19 and 20 which attempt to provide an overview of current practices as regards assessments of monetary and fiscal policy in staff reports. They are concerned that these tables cannot capture the carefully weighed and nuanced nature of assessments. We share this concern (as do several other departments) but have attempted to guard against misuse of the necessarily simplified representation of assessments in these Tables by including explicit warnings in the text. We are also concerned, however, that the discussion by Executive Directors of the proposal by G-10 Deputies to provide "candid assessments" of policies would not, without such information, sufficiently reflect current practices regarding staff assessments and could leave us with insufficient guidance as to changes considered desirable by the Board.

Heads of Departments: ADM, AFR, ASD, EUR, EXR, FAD, LEG, MED, RES, SEC, STAT, TRE, WHD
Mr. Brown

Mr. Finch

I don't understand? →
If they want us to be even more candid, we will be so. We don't to present in a simplified way, the assessment that G-10 already make. I would much prefer to eliminate tables 19, 20. They are not, in my view, indispensable to the conduct of the exercise - and so the conduct of the last report. What you could do is to sum up the following way: (1) assessments - in words, (2) strong, (3) without mentioning the names of countries. If that leads to any further action, we will do it. There is no better

Attachment
of 10/10/85
what all indicators

as done in table 17
be names of countries
to ask for an individualizing
see also 37-41. 50-75

Jan 20.86

FOR
AGENDA

SM/86/6

January 10, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Target Zones

Attached for consideration by the Executive Directors is a paper on target zones which is an accompanying piece to the paper on review and assessment of the system of floating exchange rates (SM/86/6, 1/10/86) which has been scheduled for discussion on Wednesday, February 12, 1986.

Mr. Goldstein (ext. 7678) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Target Zones

Prepared by the Research Department

(In consultation with other departments)

Approved by Wm. C. Hood

January 9, 1986

Contents

	<u>Page</u>
I. Introduction	1
II. The Meaning of and Rationale for Target Zones	3
1. What are target zones?	3
A. How does a system of target zones differ from other exchange rate regimes?	3
B. How can "hard" and "soft" versions of target zones be defined?	4
2. What considerations underlie the call for the adoption of target zones?	5
A. Exchange rates have been highly volatile and unpredictable	6
B. Exchange rates have been subject to large and persistent misalignments	6
C. Under the existing exchange rate system, macro-economic policies in major industrial countries have been undisciplined and uncoordinated	7
D. IMF surveillance under the existing exchange rate system has been largely ineffective in respect of major industrial countries, resulting in asymmetry in the international adjustment mechanism	8
3. How would the introduction of target zones for the major currencies remedy these four perceived deficiencies of the existing exchange rate system?	8

	<u>Page</u>
A. Restoring an anchor for medium-term exchange rate expectations	8
B. Restoring discipline and coordination to the conduct of macroeconomic policies	9
C. Increasing the effectiveness of IMF surveillance and reducing the asymmetry in the adjustment process	10
D. Escaping the same fate as the Bretton Woods system	11
4. What factors are behind much of the skepticism about and opposition to target zones?	11
A. Has the existing system failed?	12
(1) exchange rate volatility	13
(2) exchange rate misalignment	13
(3) discipline and coordination	14
B. Would the introduction of target zones improve matters?	16
(1) would target zones provide an anchor?	16
(2) would target zones provide discipline?	17
(3) would target zones enhance coordination and strengthen surveillance?	19
(4) could target zones escape the fate of the Bretton Woods system?	21
III. Operational Questions Associated with the Possible Implementation of Target Zones	21
1. How would target zones be calculated?	21
2. What currencies should be included in the system of target zones?	28
3. How wide should the target zones be and how frequently should they be revised?	30

	<u>Page</u>
4. How would exchange rates be kept within the zones and with what consequences for other policy objectives?	32
5. How would initial misalignments be handled in a transition to a target zones system?	35
IV. Selected Bibliography	37

I. Introduction

At its meeting in Seoul on October 6-7, 1985, the Interim Committee requested the Executive Board "... to study the issues raised in these reports [the reports on the international monetary system presented by the Group of Ten and the Group of Twenty-Four] with a view to facilitating a substantive consideration by the Committee at its next meeting." 1/ This paper, and the overview paper on "Review and Assessment of the System of Floating Exchange Rates," (SM/86/5), are among a series of papers prepared in response to that request. The present paper identifies key issues surrounding the advisability and practicality of adopting "target zones" for the exchange rates of major currencies.

After weighing the target-zone proposal, the majority (of Deputies) in the Report of the Group of Ten (hereafter, the G-10 Report) 2/ agreed that "... the adoption of target zones is undesirable and in any case impractical in current circumstances." 3/ Some other Deputies, however, felt that "... there could be merits in this proposal and suggested that the technical aspects of a target zone approach should be further explored at an appropriate time." 4/ The Report of the Group of Twenty-Four (hereafter, the G-24 Report) was considerably more favorably disposed to the target-zone proposal. 5/ It concluded that "the adoption of target zones for the exchange rates of major currencies could help achieve the objective of exchange rate stability and sustainable levels of payments balances. The proposal needs to be further studied and pursued in order to gain general acceptance." 6/

The prevailing wide differences in view about the desirability and practicality of adopting target zones reflect at least three factors: first, different assessments of the performance of the existing exchange rate system; second, different evaluations of whether a system of target zones could indeed remedy the perceived weaknesses of the existing system; and third, different conceptions of the preferred form of target zones.

1/ "Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund," paragraph 10. International Monetary Fund, Press Release No. 85/33, October 7, 1985.

2/ "The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Deputies of the Group of Ten," June 1985, circulated as EBD/85/154, Supplement 1.

3/ G-10 Report, paragraph 32.

4/ G-10 Report, paragraph 31.

5/ "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 1985, circulated as EBD/85/228.

6/ G-24 Report, paragraph 5.

The purpose of this paper is not to make the case either for or against the adoption of target zones. Rather, the intention is to raise and discuss factors that should be considered in any serious discussion of the topic. As such, the paper not only outlines potential strengths and potential weaknesses of various versions of the target zone approach, but also confronts operational questions that would have to be faced if the target zone approach to exchange rate management were adopted.

The rest of the paper is organized as follows. Section II addresses four fundamental questions concerning the definition of and the rationale for target zones: first, what is generally meant by a "target zone" approach to exchange rate management and how can "hard" and "soft" versions of this approach be defined; second, what are the perceived deficiencies in the existing exchange rate system which motivate the call for the adoption of target zones; third, how might target zones remedy these deficiencies; and fourth, what factors are behind much of the skepticism over and opposition to target zones. Some of the ground covered in this section will be familiar to Directors from earlier debates on fixed versus flexible exchange rate systems, from recent appraisals of the present exchange rate system (IMF [1984c] and the G-10 and G-24 Reports themselves), and from the discussion in the overview paper, "Review and Assessment of the System of Floating Exchange Rates," (SM/86/5). Nevertheless, the issues raised are central to an evaluation of the advisability of adopting target zones.

Section III deals with a series of operational questions and issues of a more technical and specific nature that weigh heavily on the practicality of implementing a target zone approach. The issues discussed are the following: how would the target zones be calculated; what currencies would be included in the system of target zones; how wide should the target zones be and how frequently should they be revised; what policy instruments would be employed to keep actual exchange rates within the target zones, and what are the likely consequences for other policy objectives; how could a target-zone approach be incorporated into G-5 multilateral surveillance; and how would initial misalignments be handled in a transition to target zones? A reading list on target zones and on related subjects appears as Section IV of the paper.

Finally, four caveats relevant to the nature and scope of this study should be mentioned. First, there should be no presumption that advocates of target zones see this as the only proposal for improving exchange rate stability. Indeed, most advocates of target zones would also rely on stronger surveillance of a broader nature to help reach that objective. Second, since the paper does not attempt to compare the target-zone proposal to other proposals (presented in the G-10 and G-24 Reports) for improving exchange rate stability, there should likewise be no presumption that the strengths and weaknesses outlined here are more or less significant than those associated with other proposals. In this connection, it is perhaps useful to indicate that the main overview paper

on "Review and Assessment of the System of Floating Exchange Rates," (SM/86/5) contains a discussion not only of the target zone proposal but also of several other proposals for improving exchange rate stability. Third, since many of the precise operational features of a system of target zones remain largely conjectural (e.g., which currencies would be included, how target zones would be calculated, etc.), the views expressed on these operational features should be seen more as aids to discussion and debate than as definite conclusions. Fourth, although the paper focusses on the issues raised in the G-10 and G-24 Reports, it also considers views on target zones from other sources. For this reason, terms such as "proponents," "supporters," "skeptics," and "opponents" should not necessarily be associated with the G-10 and G-24 Reports unless specifically indicated.

II. The Meaning and Rationale for Target Zones

1. What are target zones?

Target zones mean different things to different people. Perhaps the easiest way to think of them is as a hybrid exchange rate system that combines some of the attributes and characteristics of both pegged and flexible exchange rate systems. 1/

A. How does a system of target zones differ from other exchange regimes?

Target zones differ from a pure system of clean floating in that the authorities are permitted (and indeed are likely) to intervene in the exchange market, and more generally, are encouraged "to take a view" on the desirable level of the exchange rate. Target zones differ from the present system of managed floating in at least two principal respects: 2/ (i) the authorities establish a target zone for the exchange rate for some future period; and (ii) the authorities are expected to keep more of an "eye" on the exchange rate in the conduct of monetary policy

1/ In the G-10 Report, target zones are described as follows: "... the authorities concerned would define wide margins around an adjustable set of exchange rates devised to be consistent with a sustainable pattern of balances of payments." (paragraph 31).

2/ Another way of summarizing the difference between a system of target zones and the present system of managed floating would be as follows. Under target zones, authorities must come to a mutually agreed view on the appropriate zones for major-currency exchange rates. In contrast, under the present system, authorities have not generally expressed their own view on appropriate zones for exchange rates, let alone come to a common view with other authorities.

so as to keep the actual exchange rate within the target zone. ^{1/} Compared to the adjustable peg system, target zones need not entail a formal commitment to intervene in all circumstances in the exchange market to keep actual rates within the zone. Indeed, the only concrete intervention guideline that is typically mentioned is that the authorities refrain from "destabilizing intervention," i.e., buying their own currency when it is above the top of the zone and selling it below the bottom of the zone. This specific guideline was also included in the Fund's 1974 "Guidelines for the Management of Floating Exchange Rates." Finally, target zones differ from a pure system of rigidly fixed exchange rates in that, in addition to the lack of a formal intervention obligation, the zones themselves are to be occasionally reviewed and changed if deemed necessary.

B. How can "hard" and "soft" versions of target zones be defined?

In general, various versions of target zones can be distinguished by reference to the following four characteristics:

(i) width of the target zone (outside of which the exchange rate is viewed as "out of line");

(ii) the frequency of changes in the target zones;

(iii) the degree of publicity given to the zones. In this context, one may distinguish between public announcement of the target zones and confidential disclosure in official circles (for purposes of exchange rate surveillance, intervention, multilateral policy coordination, and consultation), i.e., "loud zones" versus "quiet zones;" and

(iv) the degree of commitment to keeping exchange rates within the zone.

^{1/} Target zones are intended to reflect estimates of real equilibrium exchange rates because it is the real exchange rate that is most relevant for resource allocation decisions and for balance of payments adjustment; however, it is usually assumed that for operational purposes, these real rate calculations would be translated into nominal exchange rate zones. The assumption is that the authorities can alter real rates by operating on nominal rates. Also, whereas a breach of the target zone is expected to initiate a review of the whole range of a country's macroeconomic and structural policies, most target zone proposals assume that monetary policy will carry the primary responsibility for managing the exchange rate.

Obviously, these characteristics define a spectrum of possible approaches to target zones. At one end, a "hard" version of target zones might entail a monetary policy that is heavily geared to maintaining the exchange rate within the narrow, infrequently revised, and publicly-announced zone. At the other end of the spectrum, lies a "soft" version of target zones that might be characterized by a monetary policy paying only limited attention to the level of the exchange rate, and by zones that are wide, frequently revised, and kept confidential. The hard and soft poles, in turn, may serve as useful benchmarks for the analysis and evaluation of intermediate versions of target zones.

The "hard" version of target zones shares some of the attributes of the existing European Monetary System (EMS). In particular, hard target zones can be considered a close relative of the EMS' fixed but adjustable rates with narrow margins and a "divergence indicator." However, unlike the EMS, hard target zones do not entail a formal commitment for exchange rate intervention; nor need there be an analogue to the credit facilities of the EMS. The "soft" version of target zones differs from existing Fund surveillance procedures (e.g., the requirement for reporting real exchange rate changes in excess of 10 percent to the Executive Board) in that the former introduces a more explicit and formal framework for defining the appropriate pattern of exchange rates and for establishing the links between exchange rates and macroeconomic policies. 1/

2. What considerations underlie the call for the adoption of target zones?

Proponents of target zones proceed from two basic perceptions: first, that the present system of managed floating has exhibited serious deficiencies; 2/ and second, that the adoption of a system of target zones could remedy at least some of these deficiencies. 3/

Among the alleged deficiencies, four have received the most attention:

1/ Existing procedures do not, of course, rely on the assessment of appropriate zones but rather use as a starting point the last occasion on which exchange rate developments were brought to the attention of the Executive Board. Also, this reporting and monitoring procedure has not led to any Board discussions.

2/ "The experience with the present exchange rate system has not been satisfactory." G-24 Report, paragraph 2.

3/ "Adoption of target zones... could help achieve the objective of exchange rate stability and sustainable levels of payments balances." G-24 Report, paragraph 5.

A. Exchange rates have been highly volatile and unpredictable

Whether measured in real or nominal terms, bilateral or effective terms, the short-run variability of exchange rates over the period of managed floating has been high--indeed, significantly higher than during the previous Bretton Woods system. In addition, most exchange rate changes have been unpredictable (as suggested by market indicators like forward exchange rates). While high short-term volatility and unpredictability of exchange rates is usually deemed to be less serious than longer-term "misalignments," this volatility is still regarded as costly because it generates uncertainty, and hence leads to lower levels of investment and trade. 1/ Further, developing countries are alleged to be especially hurt by this volatility because they do not have well-developed financial markets (particularly forward cover arrangements). 2/

B. Exchange rates of major currencies have been subject to large and persistent misalignments

A second complaint against the present system is that exchange rates of major currencies have been subject to large and persistent "misalignments" over the past dozen years. Such misalignments are commonly measured by cumulative departures from purchasing-power parity, or by the sheer magnitude of changes in real exchange rates themselves, or by departures from more comprehensive concepts of the "equilibrium" real exchange rate (e.g., the exchange rate that yields a cyclically-adjusted current-account balance equal to normal net private capital flows). Not surprisingly, charges of misalignment have been particularly pronounced over the past four years. A representative estimate of misalignment is provided by Williamson [1985]. He estimates that by the end of 1984, the extent of misalignment in the real effective exchange rate was 39 percent (overvaluation) for the U.S. dollar and 19 percent (undervaluation) for the Japanese yen. Such misalignments are, in turn, deemed costly because they impact adversely on resource allocation, induce adjustment costs (including unemployment), distort optimal levels of capital formation, and encourage protectionism. 3/

1/ "It [volatility of exchange rates] has discouraged investment and trade by adding to financial risks for investors and traders." G-24 Report, paragraph 61.

2/ "Exporters and importers in these countries (developing countries) are exposed to high exchange risks in the absence of well-developed financial markets, especially forward cover arrangements," G-24 Report, paragraph 63.

3/ "Misalignment inevitably produces either idle resources or wasteful shifts back and forth between tradable and nontradables. It becomes a potent source of pressures for protectionism," G-24 Report, paragraph 62.

C. Under the existing exchange rate system, macroeconomic policies in major industrial countries have been undisciplined and uncoordinated ^{1/}

Perhaps the chief criticism by the proponents of target zones is that the existing system of floating exchange rates lacks an effective mechanism for ensuring policy discipline and coordination. ^{2/3/} As supporting evidence, the critics cite, inter alia, the doubling of industrial-country average inflation rates as between 1963-72 and 1973-85, and the tripling of the ratio of industrial countries' government fiscal deficits to GNP over the same period. On lack of coordination, they point to the frequent conflicts among the major industrial countries on both the stance and mix of macroeconomic policies, as well as on the need for structural reform. Also, despite the efforts made at coordination, critics emphasize the absence of binding agreements during the floating-rate period on either rates of monetary expansion or exchange rate norms. Undisciplined and uncoordinated policies, in turn, are said to be costly because such behavior is incompatible with financial stability and sustainable growth, and also because such policies are the main driving force behind both short-term volatility and longer-term misalignment of exchange rates. ^{4/}

^{1/} In what follows, coordination may be thought of an encompassing all international influences on domestic policy-making; see Polak [1981]. Although discipline and coordination are distinct concepts, this paper follows the practice in the G-10 and G-24 Reports and discusses them together.

^{2/} "a mechanism has to be devised to enhance policy coordination among the major industrial countries." G-24 Report, paragraph 5. "... the system has not promoted sound and consistent policies." G-10 Report, paragraph 15.

^{3/} It might be regarded as the chief criticism because short-term volatility and longer-term misalignment of exchange rates are generally regarded as manifestations of this lack of discipline and coordination.

^{4/} "It [the present exchange rate system] has not prevented inadequate policies and divergent economic performance which have contributed to a high degree of short-term volatility of nominal exchange rates and to large medium-term movements in real exchanges rates." G-10 Report, paragraph 5. "This [improved functioning of the exchange rate system] implies greater effort on the part of the developed countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies." G-24 Report, paragraph 65.

- D. IMF surveillance under the existing exchange rate system has been largely ineffective in respect of major industrial countries, resulting in asymmetry in the international adjustment mechanism

Yet a fourth alleged weakness of the existing system is that IMF surveillance has not been sufficiently effective in respect of the very industrial countries whose policies have the most significant "spillover effects" on the world economy, thereby producing, among other things, an asymmetric distribution in the burden of adjustment. As evidence for this position, the critics cite the magnitude and persistence of current account imbalances in the United States and Japan, especially over the past three years. The seeming inability of surveillance to bring about a correction of the structural U.S. budget deficit is regarded as another striking example of this lack of symmetry. Further, it is argued that an inappropriate mix of macroeconomic policies in the major industrial countries during the early 1980s resulted in high real interest rates and in sluggish economic activity. A consequence of this was that developing countries faced (during 1981-83) a sharp increase in debt-service requirements, a significant decline in export earnings, a compression of their imports, and unusually slow growth. ^{1/} Thus, so it is argued, adverse "spillover effects" from poor policies in industrial countries were substantial, and the burden of adjustment fell disproportionately on the developing countries.

3. How would the introduction of target zones for the major currencies remedy these four perceived deficiencies of the existing exchange rate system?

A central argument advanced by proponents of target zones (see, for example Roosa [1984]) is that their introduction would restore some of the useful characteristics of the Bretton Woods system without being subject to the flaws that led to the collapse of that system.

- A. Restoring an anchor for medium-term exchange rate expectations

It is often argued that one reason why exchange rates have been so volatile under the present exchange rate system is that market participants lack an "anchor" for medium-term expectations about exchange rates. In such an environment, new information, rumors, or announcements can lead to large revisions of expectations about the future which in turn induce

^{1/} "In the recent past, their [industrial countries] uncoordinated efforts to disinflate led to excessive emphasis being given to monetary restriction relative to other instruments. The result was a halting process of recovery with high real interest rates and low commodity prices having particularly adverse effects on the developing countries." G-24 Report, paragraph 72.

"large" changes in current exchange rates. Furthermore, under some circumstances, such events may set the stage for the emergence of "band-wagon" effects and speculative "bubbles," that can dominate the evolution of the exchange rate and divorce it increasingly from "fundamentals".

It is claimed that target zones will reduce exchange rate volatility and misalignment on two counts. First, the obligation (albeit an informal one) or the intention to keep the exchange rate within the zone provides market participants with useful information about the likely conduct of future macroeconomic policies, especially monetary policy. The easier it is to make an informed judgment about the future course of policies, the less one can expect the erroneous extrapolation of short-term events and the more forgiving will be the market of short-term deviations of policy.^{1/} Second, the publication of target zones provides market participants with information on the authorities' collective estimate of future equilibrium exchange rates. Therefore, it is said to reduce the risk that market participants use the "wrong model" in translating (even perfectly foreseen) future policy changes into forecasts of future exchange rates.^{2/}

B. Restoring discipline and coordination to the conduct of macro-economic policies

Target zones are said to restore discipline to macroeconomic policy-making for two reasons. First, if exchange rates are maintained within the target zones, then macroeconomic policies, again particularly monetary policy, are disciplined by the exchange rate constraint. Second, even if the authorities opt to alter the target zone rather than their policies, they would still be obliged both to negotiate a new zone and to explain why a new zone is appropriate. These obligations themselves are said to introduce stronger peer pressure into policy formation.

Turning to the coordination of policies, two points are noteworthy. First, the very fact that a system of target zones has to be negotiated and must display mutual consistency of cross exchange rates is said to enhance the degree of international policy coordination.^{3/} Under a system of target zones, so it is argued, the exchange rate implications of alternative stances and mixes of policies would be directly confronted,

^{1/} "They [some deputies] further believe that credible commitments to target zones would contribute to stabilizing market expectations." G-10 Report, paragraph 31.

^{2/} "Some Deputies made the proposal to introduce target zones... because they believe that convergence of economic performance, while necessary, may not always be sufficient to achieve lasting exchange rate stability." G-10 Report, paragraph 31.

^{3/} "... commitment to [target zones]... would promote greater international policy consistency." G-24 Report, paragraph 66.

thereby ending the undesirable current practice whereby exchange rates emerge as a "residual" of other policy actions of individual countries. ^{1/} Second, the requirement that target zones be negotiated and mutually agreed is said to reduce the risk of competitive devaluations.

And to the extent that target zones do restore discipline and coordination to the conduct of macroeconomic policy, they will reduce misalignment and volatility of exchange rates.

C. Increasing the effectiveness of IMF surveillance and reducing the asymmetry in the adjustment process

Proponents of target zones argue that the need to negotiate, to ensure consistency, and to revise the zones could provide a natural focal point for multilateral IMF surveillance. Just as important, such surveillance procedures when applied to target zones will be aimed at the policies of the major industrial countries that, in turn, are likely to constitute the membership of the target zone system. It is alleged therefore that target zones will remove the Achilles heel of the present surveillance procedures, namely, the inability to effect a meaningful change in policies of large industrial countries. Since the asymmetry of adjustment is said to depend critically on policy behavior in industrial countries, more effective surveillance of them would also produce more symmetrical adjustment.

The remedial properties of a target zone approach would obviously depend on the particular version adopted. The "harder" versions, by virtue of being closer images of the Bretton Woods regime, clearly offer a stronger dose of external pressure on domestic policy. But, as is discussed in subsequent sections, the alleged benefits associated with the harder versions may also entail higher costs.

Proponents of the "softer" versions of the target zone approach argue that their adoption would enhance the surveillance process for at least three reasons. First, even if the zones were wide and were frequently revised, they would exert some disciplinary force on the most flagrant and persistent cases of inappropriate policies. Thus, while soft target zones may not do much to catch misalignments on the order of 10 percent or less, they will, so their supporters argue, catch the 20-40 percent real exchange rate misalignments that do most damage to the system. Second, even if the

^{1/} They [target zones] could "... trigger consultations that would induce step by step, more direct links between domestic policies and exchange rate considerations." G-10 Report, paragraph 31. "Exchange rate stability should be an important objective of policy instead of being a residual of other policy actions of individual countries, as is the case at present." G-24 Report, paragraph 65.

zones were not announced to the public, they still are likely to provoke helpful discussion and analysis of policy interdependence among officials of participating members. Also, such "quiet" zones provide another channel for peer pressure against inappropriate policies. Third, since the Fund's current practices in any case involve evaluating the appropriateness of members' exchange rates, supporters argue that even unpublished zones may prove useful in generating a more concrete framework for evaluating exchange rate implications of alternative macroeconomic policies. 1/

D. Escaping the same fate as the Bretton Woods system

Supporters of target zones acknowledge that many of the factors associated with the collapse of Bretton Woods have not gone away (e.g., high international mobility of capital, larger financial resources for private speculators than for central banks, existence of large and suddenly changing interest rate differentials across countries, etc.). Nevertheless, they contend that a system of target zones can survive pressure from "hot money" flows. They argue that so long as policy adjustments are made when necessary or so long as the target zones are revised frequently to reflect inflation differentials and needs for real exchange rate adjustment, expectations of large and discontinuous exchange rate adjustments that provide the motive for speculative attacks will seldom arise. In their view, the viability of the EMS provides testimony that it is possible to operate an adjustable peg system in the 1980s provided that there is sufficient political commitment, active exchange market intervention policies, and a presumptive indicator for adjustment. Since a target zone system shares many of these characteristics, it too is viable. 2/

4. What factors are behind much of the skepticism about and opposition to target zones?

Opposition to the adoption of target zones stems from: first, a more sanguine appraisal of the performance of the existing system; second, doubts about the capacity of target zones to remedy alleged deficiencies; and third, concerns that target zones would introduce new problems. Each of these elements is discussed in turn.

1/ "... arriving at a judgment about the appropriateness of the exchange rate of a currency is part of the current practices of the IMF." G-10 Report, paragraph 31.

2/ See Ungerer et al. [1983] for a review of the EMS experience during the 1979-82 period. Most studies of the EMS conclude that it has contributed to greater stability of nominal and real exchange rates of member countries. Its effect on convergence of financial and economic policies is more controversial.

A. Has the existing system failed?

(1) Exchange rate volatility

While the short-run volatility of both nominal and real exchanges has indeed been high during the period of managed floating, this begs the question of whether that volatility was "excessive." In this connection, opponents of target zones raise two points.

First, the period since 1973 has witnessed great turbulence in the world economy and great uncertainty about the future course of economic and political events. In this environment, all asset prices, not only exchange rates, have shown high volatility. In fact, exchange rate changes have been smaller than changes in prices of other assets (e.g., national stock market prices, changes in short-term interest rates, changes in commodity prices). As such, conclusions about the excessive nature of exchange rate fluctuations depend upon the specific yardstick selected.

Second, they note that there is an intrinsic difference between asset prices on the one hand and wages and goods prices on the other hand. The former are auction prices that depend heavily on expectations about the future whereas the latter are more sticky in the short run, reflecting in large part contractual arrangements made in the past. Thus, wages and prices of national output may not serve as a proper yardstick for assessing exchange rate volatility. Indeed, some would say that it precisely because wages and prices are so slow to adjust to current and expected economic conditions that it is desirable to allow for "excessive" adjustment in exchange rates.

As regards the unpredictable nature of exchange rate changes under the present system, opponents of target zones note that the foreign exchange market is one in which risk can be covered relatively easily (e.g., via access to forward markets, options markets, etc.). 1/ For this reason, it is argued that it may be preferable to concentrate the disturbances in this market rather than transfer them to other markets, such as labor markets, where dealing with them would be more difficult.

Turning to the cost of short-run volatility of exchange rates, opponents point to the sporadic nature of the evidence linking exchange rate volatility to the volume of international trade and investment. 2/

1/ "... foreign exchange markets appear to have developed effective hedging techniques available to most operators to reduce the risks associated with exchange rate volatility, generally at comparatively little cost." G-10 Report, paragraph 16. In addition, it might be argued that so long as developing countries have sufficient access to well-developed financial markets (e.g., the eurocurrency market), they can hedge against exchange risk even if they themselves don't have such markets.

2/ IMF [1984a].

They also argue that it is doubtful that the system of pegged rates could have survived in the turbulent environment of the last 15 years without severe limits on trade and capital movements being imposed by many countries. ^{1/} Such restrictions on trade and capital flows could well, in turn, have been more costly for the world economy than the short-run volatility of exchange rates experienced under the present system.

(2) Exchange rate misalignment

Almost all observers, even many staunch opponents of target zones, agree that there have been serious misalignments of major-currency exchange rates during the last few years, particularly as regards the sharp real appreciation of the U.S. dollar. Opponents of target zones suggest however that in evaluating both the extent and the cost of such misalignments, several factors ought to be recognized.

First, changes in real economic conditions requiring adjustments in the relative prices of different national outputs occur all the time (e.g., continuing inter-country differences in growth of labor productivity, permanent changes in the terms of trade, inter-country shifts in both the marginal productivity of capital and the propensity to save, etc.). Under a system of pegged rates, relative price adjustments are achieved through the slow changes of national price levels and through occasional changes of parity. Under floating rates, adjustments in the relative price of different national outputs occur rapidly and in anticipation of changes in economic conditions rather than after the need for adjustment has become apparent. In the absence of an explicit specification of relative costs, there is no general presumption that slow adjustment of relative prices is preferable to rapid adjustment, or that price adjustments should not occur in anticipation of events requiring such adjustments. Hence, what may seem to be misalignments may in part represent equilibrating changes. ^{2/}

Second, critics of target zones argue that one should not overlook the fact that significant misalignment of major currency exchange rates also occurred during the Bretton Woods period, especially in its later years. In this connection, they caution that misalignment of real exchange rates can derive from too little nominal exchange rate flexibility as well as from too much. The frequency of misaligned real

^{1/} See, for example, Bryant [1983] and Obstfeld [1985].

^{2/} "Changes in real exchange rates are appropriate when they facilitate desirable adjustments by reflecting changes in underlying economic conditions and in inducing corrections in policies." G-10 Report, paragraph 17.

exchange rates in countries with "pegged" exchange arrangements, where there is often a reluctance to alter nominal rates in the face of large inflation differentials, should stand as a warning to the dangers involved. 1/

Third, the size of the current misalignment in major-currency exchange rates is, according to defenders of the present system, highly uncertain. To take but one example, calculations of misalignment done by Williamson [1985] and others are strongly affected by the assumption that "normal" net capital flows are zero for the United States. This assumption is important because the equilibrium exchange rate is defined in such calculations as the exchange rate that would produce a current account balance equal to the assumed normal net private capital flow. But a country that is a "normal" net capital exporter under one set of macroeconomic policies, tax considerations, and political events abroad may become a natural importer under others. In this connection, a judgment that normal net private capital flows for the United States were say, \$30 billion annual inflow (to reflect high expected profitability, relatively low domestic savings, and safe-haven considerations) rather than zero, would reduce the estimated misalignment considerably; 2/ yet the theoretical reasons for preferring the latter estimate to the former are, so the critics argue, debatable at best.

Fourth, defenders of the present system argue that explanations that attribute misalignment of the U.S. dollar to a speculative bubble are highly questionable. They point out that the (narrow) theoretical models that are frequently used to generate a speculative bubble in the exchange rate (i.e., a fully expected continuous price change not justified by fundamentals) also imply that such a bubble could prevail for only a short period of time--certainly not for four years or so (i.e., since 1981).

(3) Discipline and coordination

Defenders of the current exchange rate system question the allegation that it exerts less discipline than regimes with greater fixity of exchange rates. As a theoretical matter, it is pointed out that changes in exchange rates are highly visible and are transmitted promptly into domestic prices. As a result, the consequences of undisciplined macroeconomic policies are readily apparent. In contrast, undisciplined policies under fixed exchange rates show up only in reserve changes, and then usually become public only after a significant delay. Therefore, it is argued, the supposed superior disciplining force of a

1/ "... Deputies are fully aware that attempts to maintain exchange rates at levels not in line with economic fundamentals and market forces can be very damaging, both to the countries concerned and to their trading partners." G-10 Report, paragraph 21.

2/ This assumes that such an order of magnitude is compatible over the long run with a reasonable build up of debt and with an acceptable maturity profile.

fixed rate regime is not obvious. Furthermore, as an empirical matter, the 1979-83 policy experience in industrial countries can be viewed as evidence that anti-inflationary discipline can be restored without fixed exchange rates. Indeed, the deceleration in growth rates of narrow and broad money that took place in the face of high unemployment in most of the major industrial countries in 1979-82 coincided with relatively high variability of both nominal and real exchange rates.

As for coordination, defenders of the present system note that there have been some successful coordination efforts during the past decade. In this context, they mention the U.S. dollar support package of November 1, 1978, agreements on short-term exchange rate management policies (e.g., intermittent joint countering of disorderly market conditions), the agreements of the Bonn economic summit of 1978, and most recently (September 22, 1985), the Group of Five agreement in New York on foreign exchange intervention and other policies. 1/

In addition, it can be argued that the optimal degree of coordination is less than complete. For example, the perception of independent monetary policy may be necessary in some countries for sustaining confidence that monetary policy will not be inflationary in the long run (particularly if not all potential partners in a target zone system have a track record of consistently sound monetary policy). 2/

In sum, the very point of departure for the proponents of target zones, namely, the overall appraisal that the existing system has failed, is itself not universally accepted. Opponents of target zones acknowledge that the present system has weaknesses but do not see these weaknesses as more serious than those demonstrated by earlier systems. In addition, opponents emphasize that the present system has demonstrated some "valuable strengths." Specifically, exchange rate changes are viewed as having made a positive contribution to securing effective external payments adjustment over the medium to long run. 3/ The present system is also credited with having maintained a mechanism of conflict resolution (namely, the foreign exchange market) that has not involved either suspension of currency convertibility or large-scale restrictions on trade and capital flows; 4/ indeed, supporters of the present system claim that floating

1/ Critics of the present system might reply that the G-5 New York agreement was a reaction to the absence of coordination and the large misalignments fostered by the present system.

2/ See Solomon [1982] on this point.

3/ "Exchange rate flexibility has made a positive contribution to external payments adjustment." G-10 Report, paragraph 14.

4/ "Exchange rate flexibility has made a positive contribution to ...the maintenance of an open trade and payments system in a period of massive external shocks." G-10 Report, paragraph 14.

rates allowed the removal of certain restrictions. Furthermore, it is argued that independent monetary policy, facilitated by the existing exchange rate system, permitted the application of successful disinflationary policies. 1/ Finally, it is argued that no exchange rate regime would have emerged unscathed from the combination of shocks, portfolio shifts, and structural and institutional changes that occurred during the years of managed floating. 2/

B. Would the introduction of target zones improve matters?

(1) Would target zones provide an anchor?

As noted earlier, one of the central arguments for the introduction of target zones is that such zones would provide an anchor for medium-term exchange rate expectations. But would it, and at what costs? Skeptics make the following points.

First, if the absence of an anchor stems from lack of information about future government policies, then it is not clear that publication of target zones, rather than announcement of the future course of policies themselves, is the preferred way to provide that information. Obviously, if the zones are not published (i.e., quiet zones), then their adoption will not alleviate the policy uncertainty-problem at all. 3/

Second, if the source of uncertainty is that market participants do not possess information on the model linking government policies with the consequent levels of exchange rates, then target zones (loud zones) do indeed provide the missing information. This presupposes, however, either that the government has superior information about the "true model" or that the government carries enough credibility to convince market participants that it will adjust its policies to consistently maintain exchange rates within the announced zone (i.e., it will adjust its policies to make the exchange rate forecast come true). Opponents of target zones see no evidence that governments have such superior information or knowledge about such a model. Further, they point out that experience with pre-announced exchange rate targets in Latin America suggests that countries would probably find it difficult to adhere to such targets. 4/

1/ "It [exchange rate flexibility] can help countries, especially the larger ones, to insulate their domestic price levels from inflation abroad, and can facilitate the pursuit of sound monetary policies, geared more directly to domestic conditions." G-10 Report, paragraph 14.

2/ "... it is questionable whether any less flexible system could have survived the strains of the past decade..." G-10 Report, paragraph 14.

3/ Some observers also doubt whether in practice quiet zones could be quiet for long. They argue that it is not possible for the Fund and national authorities to know what target zones are without this information leaking out.

4/ See Calvo [1983].

Third, even if the target zones were credible for some period of time, critics argue that the occasional need for revision of the target zones will invite the same type of one-way bet for speculators that ultimately felled the Bretton Woods system. ^{1/} Of course, since governments are not formally committed to defend the target zones, they may choose to allow exchange rates to depart from the zone (while subsequently announcing a revised zone). But in that case, the zones themselves would soon lose their credibility.

Fourth, even if the zones are announced, critics contend that "soft" versions of target zones characterized by wide and frequently revised zones are not likely to provide a strong and reliable anchor because they will not sufficiently narrow expectations about the future rate. ^{2/} Yet such wide and frequently revised zones are said to be necessary (by critics) to account for our measure of ignorance about the equilibrium exchange rate and for changing real conditions.

Fifth, even if the anchor is credible and durable, its introduction may be costly. The argument here is that the volatility or misalignment of exchange rates is not the likely source of difficulties but rather a manifestation of the prevailing package of macroeconomic policies. Without introducing a significant change into the conduct of policies, a manipulation of exchange rates to satisfy the zones may not improve matters at all. In fact, the absence of the exchange rate as a market gauge for assessing policies will then only confuse matters and reduce the information essential for policy-making.

(2) Would target zones provide discipline?

It is widely agreed that misalignment of real exchange rates arises to a large extent from undisciplined and uncoordinated macroeconomic policies. Hence, the ability of target zones to reduce misalignment rests in good measure on their ability to enhance discipline. Skeptics put forward five points.

First, experience suggests to them that national governments are unlikely to adjust appreciably the conduct of domestic policies so as to satisfy the constraints imposed by the exchange rate regime. Rather, it is argued, it is more likely that the exchange rate regime adjusts to

^{1/} "Markets would inevitably test the zones, thereby adding to instability, and efforts to maintain exchange rates at levels incompatible with market sentiment could prove costly and ultimately unsuccessful."
G-10 Report, paragraph 32.

^{2/} "Given our imperfect knowledge of the determinants of exchange rate movements, the target zones would have to be too wide to serve as an anchor for expectations." G-10 Report, paragraph 32.

whatever discipline national governments choose to have. As an illustration, it is pointed out that other external pressures aimed at restoring discipline to policy in major industrial countries (e.g., individual Article IV consultations, IMF Executive Board discussions of the World Economic Outlook, G-5 surveillance meetings, OECD country reports, and the like) have met with only limited success. Why then should target zones succeed where other similar measures have produced such limited results?

Second, evidence from earlier periods during which exchange rates were more rigid does not suggest that greater fixity of exchange rates induced either lower average external imbalances, or more rapid adjustment of such imbalances, or greater symmetry of adjustment as between either surplus and deficit countries, or between reserve and non-reserve currency countries. 1/ Why then should target zones provide the impetus to discipline when exchange regimes with greater formal commitment have not consistently done so?

Third, in a related vein, it is argued that by focusing attention on exchange rates rather than on the root cause of misalignment, namely, the stance and mix of macroeconomic policies, one may lessen the pressures for corrective action on the ultimate sources of the problem.

Fourth, critics argue that if the nominal target zones reflect rigid targets for real exchange rates, they can destabilize the price level. Take, for example, the case of a country that experiences an unexpected wage push that raises its price level relative to that abroad. Its real exchange rate will then have appreciated relative to its initial level. If the authorities attempt to restore the original real exchange rate by announcing a more depreciated nominal target zone, then the implied expansion in monetary policy (needed to keep the actual exchange rate within the new target zone) will increase the price level. In short, critics warn that while a rigid real exchange rate may be helpful for preventing trade balance deteriorations due to eroding competitiveness, it can also present new dangers for controlling inflation. 2/ More broadly, monetary policy is not the appropriate policy response to all types of disturbances.

1/ See IMF [1984c], Tables 2 and 3.

2/ "Above all, the constraints imposed on domestic policies by target zones might undermine sound and stable policies in a medium-term framework." G-10 Report, paragraph 32.

Fifth, critics point out that while target zones can supply information on inter-country divergences in policy, they don't provide guidance on the right stance of policy within a country. For example, if two countries each inflate at 10 percent, the exchange rate may be stable but few would argue that monetary policy in either country was appropriate. Again, so the critics argue, target zones do not ensure discipline.

(3) Would target zones enhance coordination and strengthen surveillance?

In appraising the effects of the adoption of target zones on policy coordination and on IMF surveillance, skeptics make the following observations.

First, whatever the exchange rate regime, there are strong barriers to coordination for at least two reasons: (i) exchange rates are by their very nature "competitive" in the sense that one country's gain is frequently the other's loss; (ii) various compromises on growth, inflation, and income distribution at the national level often leave little room for further compromise on policies at the international level. 1/ Target zones, so say their critics, cannot overcome these barriers.

Second, the process of negotiating target zones could produce dangerous frictions among the negotiating parties and could lead ultimately to a reduced level of coordination in this and other areas.

Third, one cannot rule out the possibility that the cumbersome negotiation of target zones would land the system back in the management delays of the latter days of the Bretton Woods system, with adverse effects on the desired flexibility of real exchange rates. 2/ 3/ With target zones, one loses the "safety valve" provided by the market place for foreign exchange as an "objective" method for resolution of conflicts.

Fourth, to the extent that the adoption of target zones results in a significant loss in independence in the conduct of domestic monetary policy, the authorities may be tempted to adopt discriminatory trade practices and other measures of protectionism in order to compensate for the loss of a powerful policy instrument.

1/ See Polak [1981].

2/ "Most Deputies, however, are of the view that reaching a consensus on the range of desirable exchange rates [for target zones] would prove extremely difficult." G-10 Report, paragraph 32.

3/ Proponents of target zones might reply that the recent (September 22, 1985) Group of Five agreement in New York reduces the strength of this argument.

Finally, the use of target zones as a possible focal point for IMF surveillance raises three related potential problems. First, the use of the exchange rate as a primary indicator of disequilibria in macroeconomic policies could send misleading signals. Critics note that the more general Fund practice as applied to adjustment programs and financial programming is to employ a whole set of macroeconomic indicators for diagnostic purposes. These indicators, in addition to the exchange rate, include the rate of domestic credit expansion, the budget deficit, wage-price movements, structural rigidities, etc. Put in other words, would exchange rate movements vis-a-vis the target zone constitute a "sufficient statistic" for monitoring macroeconomic policies? If one believes that the answer to that question is negative, then orienting Fund surveillance around that single indicator, in addition to possibly diverting attention from the root causes of disequilibria, may jeopardize the quality of surveillance. 1/

The second problem raised by skeptics is that the target zone approach is agnostic about which policy instruments should be used to respond to departures of exchange rates from the zone. The usual presumption is that it will be monetary policy. 2/ However, if the root cause of the disequilibrium is an inappropriate monetary-fiscal policy mix, then an excessive emphasis on monetary policy could produce compliance with the target zones and yet leave the fundamental problem unsolved. In short, critics argue that the calculation of the target zones would have to be based on an appropriate and broad set of indicators to avoid sending false signals about both the need for adjustment and the appropriate corrective measures.

Third, critics contend that target zones do not resolve the problem of how to allocate and enforce the burden of adjustment among member countries. When more than one member's (effective) exchange rate leaves the zone, it will be necessary to specify who does what if an effective and coordinated policy response is to take place. But target zones, so its critics argue, offer no solution to this "N-1 problem."

1/ "... a wide range of factors beyond exchange rate developments should also be taken into account in assessing national policies and the need for consultation and policy discussion." G-10 Report, paragraph 30.

2/ Most proposals for target zones (e.g., Williamson [1985]) assume that fiscal policy is not well suited to be an instrument of exchange rate policy because it is too inflexible and because its (alleged) comparative advantage (vis-a-vis monetary policy) is in influencing domestic demand rather than the balance of payments.

(4) Could target zones escape the fate of the Bretton Woods system?

Opponents of the target zone approach to exchange rate management remain unconvinced that target zones could escape the fate of Bretton Woods. They make essentially three arguments. First, technological advances in transferring funds across national boundaries, in combination with absence of parallel growth in official reserves, means that the capital mobility problem (hot money flows) is now even more formidable than in the early 1970s. Second, difficulties associated with negotiating mutually-consistent target zones would as before produce large discontinuous changes in exchange rates, thus motivating strong speculation. In addition, if the timing of exchange rate changes were done unpredictably to prevent such speculation, this would destroy the *raison d'etre* of the target zone scheme itself. Third, the viability of the EMS owes much to the unusual political commitment behind it, to capital controls imposed by some members, and to the structural characteristics of its members. 1/ None of these factors would, according to the critics, necessarily transfer to an exchange rate arrangement among a larger and more heterogeneous group of countries. 2/ As such, to them, the viability of the EMS does not imply much about the viability or desirability of a target zone system.

III. Operational Questions associated with the Possible Implementation of Target Zones

1. How would the target zones be calculated?

An important implicit assumption in the target zone approach to exchange rate management is that the authorities can identify the equilibrium (real) exchange rate to a useful degree of approximation. But what methods or techniques are available for doing so? Three methods deserve explicit consideration.

The first method is the purchasing-power-parity (PPP) approach. If the authorities can identify a base period when the country was in external

1/ See Ungerer [1984] for a discussion of the implications of the EMS for the likely success of a return to a system of fixed but adjustable exchange rates.

2/ "... the Deputies recognize that the system [the EMS] cannot be dissociated from the particular political and economic environment in which it operates and therefore cannot be readily extended to a broader and more heterogeneous context characterized by the presence of a plurality of reserve currencies. Such a system would run a much greater risk of being exposed to pressures similar to those which arose during the final phase of the par value system." G-10 Report, paragraph 24.

balance, then the equilibrium value for the nominal exchange rate in the current period is the value of the exchange rate in the base period adjusted for the inter-country difference in inflation rates as between the current and base periods. This is equivalent to restoring the value of the real exchange rate in the base period. Since the real exchange rate, in turn, is often viewed as a measure of the country's competitive position, the PPP approach can be regarded as analysis of competitiveness as well.

The exchange rate used for such calculations would typically be an index of effective exchange rates using bilateral trade weights or more sophisticated combinations of trade weights and trade price-elasticities (e.g., MERM weights). Inflation differentials could be measured by consumer price indices, or more likely, by indices of either unit labor cost or prices in manufacturing.

The PPP approach carries the advantage of simplicity and ease of computation. Arrayed against this however, are several rather serious disadvantages for use in a target zone context.

First, PPP will be a suitable indicator of the equilibrium exchange rate when all disturbances between the base and current periods are monetary in origin. In this case, general price levels will be altered but relative prices (of imports and exports, or of tradables and nontradables, or of individual tradables like food or fuel) will not. In contrast, when disturbances are real and do alter relative prices, then it will be desirable to have a departure from PPP (i.e., a change in the real exchange rate). This point is relevant because there have been numerous real disturbances over the past 13 years of managed floating (e.g., large changes in oil prices, changes in savings and investment propensities, etc.), and there is little reason to believe that such real disturbances will not occur in the future. This means that if a PPP formula were used to compute the equilibrium rate in a target zone, there would probably have to be a manual "override option" to permit departures from PPP whenever there were real disturbances to the system. But this override option robs PPP of its simplicity and computational facility. On the other hand, if one doesn't override PPP whenever there are real disturbances, then the PPP method will yield the wrong answer.

A second disadvantage of the PPP approach is that actual exchange rates of major currencies during the 1970s and early 1980s have not followed the paths implied by PPP--and this both for the short and long run. 1/ To most observers, the empirical failure of PPP in the

1/ See Frenkel [1981]. Of course, to the extent that actual exchange rates have been subject to misalignments, one would not want the actual rates to closely follow a PPP path. However, divergencies from PPP have so marked and so persistent as to raise doubts about the credibility of exchange rate forecasts based on PPP.

short-run is attributable to an intrinsic difference between exchange rates and prices of national outputs. The former are jumpy, forward-looking, auction prices that move in anticipation of future events whereas the latter are sticky, backward-looking, administered prices that largely reflect previous events. In the long-run, structural changes and permanent supply shocks may cause PPP to miss the mark. In any case, the poor empirical track record of PPP suggests that exchange rate forecasts based on PPP might not be credible to market participants.

Yet a third difficulty with PPP is that the results themselves appear to be quite sensitive to the choice among alternative price indices and base periods, to the income levels and income growth rates of the countries involved in the comparison (i.e., the so-called productivity-bias in PPP), 1/ and to the level of aggregation in the data (manufacturing versus the entire economy). 2/ Such sensitivity, in turn, makes it difficult to speak with confidence about all but very large misalignments.

A second method of calculating equilibrium exchange rates for target zones is to employ an estimated structural model of exchange rate determination that relates the (nominal) exchange rate to "fundamentals." Two popular such models are the monetary model and the portfolio balance model. In the monetary model, the change in the exchange rate is usually explained by changes in the ratio of home to foreign money supplies and by changes in the ratio of the demand for money at home to that abroad (where the demand for money is a function of, inter alia, real income, nominal interest rates, etc.). The portfolio balance model relates the (nominal) exchange rate to the stocks of assets denominated in the home and foreign currency (where these asset stocks include money supplies as well as interest-bearing securities). Since the stocks of financial assets can be related to cumulative budget deficits, cumulative current account imbalances, open-market operations, and exchange market intervention, the portfolio balance model provides a direct role for such policies in influencing exchange rates. In the monetary model, such policies affect exchange rates only to the extent that they affect the supply or demand for money.

Given estimates for such a structural model of exchange rates, the equilibrium exchange rate could be defined as the rate corresponding to the desired path of the explanatory fundamentals in the equation (i.e., money supplies, real income, interest rates, budget positions, etc.). This estimate of the equilibrium nominal exchange rate, combined with some assumed consistent path for prices at home and abroad, could then be translated into an estimate of the equilibrium real exchange rate.

1/ See Balassa [1964].

2/ See IMF [1984b].

This structural approach has three advantages: (i) it is forward-looking and thus compatible with the intrinsic nature of the price behavior of assets such as securities denominated in different currencies; (ii) it provides a direct link between macroeconomic policy variables and exchange rates; and (iii) it recognizes that in today's world of high international mobility of capital, the proximate determinants of exchange rates, at least in the short run, probably lie in asset markets rather than goods markets. At the same time, the structural-exchange rate equation approach is subject to at least two serious deficiencies.

The first and most serious shortcoming is that all known structural models of exchange rate determination have been shown to have very limited forecasting ability. In fact, extensive empirical testing over the past few years has demonstrated that the out-of-sample performance of structural exchange rate models is frequently no better than that yielded by "naive" models (e.g., a random-walk model). ^{1/} With the benefit of hindsight, it seems that the key reason for the poor performance of the various models is the nature of exchange rates as asset prices. As indicated above, exchange rates are very sensitive to expectations concerning future events and policies. Periods that are dominated by rumors, announcements, and "news" which alter expectations are likely to induce a relatively large degree of exchange rate volatility. Since by definition "news" cannot be predicted on the basis of past information, it follows that by and large the resulting fluctuations of exchange rates are unpredictable. In a way, this asset market perspective suggests that one should not expect to be able to forecast accurately exchange rate changes with the aid of simple structural models. The role of the simple structural models is to account for the systematic component of the evolution of exchange rates. In cases where the systematic, predictable component is relatively small, one may expect to account for only a small fraction of the variability of exchange rates. The main message of all this is that target zones based on exchange rate forecasts from such models might not carry sufficient credibility to act as an anchor.

The second problem with the structural exchange rate models is that the explanatory variables can be difficult to measure and interpret on a timely basis. For example, the portfolio balance model requires measurement of asset stocks by currency, by country of issuance, and by residence of the holder. But such data only become available much after the fact and estimates based on extrapolation of benchmark figures may introduce substantial error into the calculations. Similarly, in the monetary model one faces the problems of which monetary aggregate to use (in view of financial market innovations), how to forecast that aggregate over the relevant time horizon, and how to distinguish short-term movements in velocity from trends. For these reasons, the prospects of obtaining timely forecasts (target zones) from these models are not encouraging.

^{1/} Meese and Rogoff [1982].

The third method for calculating equilibrium exchange rates is the underlying balance approach. In this approach, the (real) equilibrium exchange rate is defined as the rate that would make the "underlying" current account (i.e., the actual current account adjusted for temporary factors) equal to "normal" net capital flows during the next two or three years, given: (i) anticipated macroeconomic policies in the subject countries, (ii) the delayed effects of past exchange rate changes, and (iii) a number of other expected developments. Furthermore, the equality between underlying current accounts and normal capital flows must not be achieved either by wholesale unemployment, or by artificial incentives to incoming or outgoing capital, or by undue restrictions on trade. 1/ If after accounting for these factors, "underlying" current accounts are calculated to be quite different from "normal" capital flows, the implication is that either planned macroeconomic policies or present exchange rates need to change to prevent such undesirable balance of payments scenarios from taking place.

This underlying balance approach to exchange rate assessment was developed by the Fund staff in the early 1970s (see IMF [1984b]); it similarly serves as the framework for calculation of "misalignments" in Williamson [1985]. The inputs for the calculations come from various sources. Estimates of "anticipated macroeconomic policies," and their associated real growth and inflation paths, can be obtained from national projections or from World Economic Outlook projections. Estimates of "normal" net capital flows typically come from an analysis of past trends adjusted for expected future structural developments (e.g., capital liberalization measures). Finally, estimates of the effect of exchange rate changes on current accounts can be derived from either of the Fund's two operating trade models, namely the Multilateral Exchange Rate Model (MERM) or the World Trade Model (WTM). 2/

For application in a system of target zones, the underlying balance approach carries three advantages. First, it recognizes that judgments about the appropriateness of current exchange rates cannot be divorced from either future anticipated macroeconomic policies, or from delayed effects of past exchange rates that are not yet visible but are likely to emerge in the future, or from particular factors (e.g., dock strikes) that are temporary in nature. In this sense, it not only focuses attention on the root cause of misalignment (i.e., inappropriate policies) but also addresses the "time dimension" in the misalignment problem.

1/ This description of the real equilibrium exchange rate is a close relative of those outlined in Nurkse [1945], IMF [1970], and the G-24 Report, paragraph 69.

2/ See Artus and McGuirk [1981] and Deppler and Ripley [1978].

Second, the underlying balance approach appreciates that a desirable or sustainable payments position need not imply a zero current account balance. Specifically, it recognizes that a country with a relatively low domestic savings rate but with relatively attractive domestic investment opportunities can run a persistent current account deficit by drawing on foreign savings if: (i) it invests those foreign savings wisely; and (ii) the return on domestic investments is not artificially high (because of special incentives for or restrictions on international capital flows, or because of unsustainably high government borrowing).

A third advantage of the underlying balance approach is that, at least in principle, it ensures that the computed equilibrium exchange rates are consistent across countries. ^{1/} This is so because the trade models that underlie such exchange rate calculations are specifically designed to be used in a multilateral setting. Since target zones must be mutually consistent, this is not a trivial consideration.

Moving to the negative side of the ledger, the underlying balance approach is subject to a number of problems.

First and foremost, the concept of "normal" net private capital flows is a particularly ambiguous one; yet estimates of these capital flows play a key role in the estimate of the equilibrium real exchange rate. The reasons why the concept is so slippery include the following: (i) While private saving rates are reasonably stable over time and across countries, the geographic loci of perceived investment opportunities are not; the latter depend on a wide set of expected policies in both the origin and host countries--many of which can change precipitately. (ii) Various controls on capital flows make it difficult to determine what is "normal," especially when these controls change over time. (iii) Acquisition of foreign assets subjects the holder to risks (e.g., expropriation risk) that are fundamentally different from those associated with domestic assets, and therefore consideration of such risks may limit exposure even when average real rates of return on foreign assets are high. (iv) Large changes in government fiscal positions, and drastic shifts in private portfolio composition, can lead to large swings in observed capital flows, the duration of which is highly uncertain. The end result of all this is that estimates of "normal" net capital flows for the likely participants in a target zone system are subject to a considerable margin of error.

^{1/} This advantage must be qualified in view of the large global discrepancy in current account positions. This discrepancy makes it harder to reach agreement on what constitutes an equilibrium pattern of current account positions.

A second problem with the underlying balance approach is that it is not well suited to the analysis and diagnosis of the mix of macroeconomic policies. In general, macroeconomic policies influence the equilibrium exchange rate in this approach via their effect on anticipated real output and inflation paths over the next two to three years. Thus, the model will produce different estimates of the equilibrium exchange rate for different real output and inflation paths. But it cannot distinguish among policy mixes that yield the same output and inflation paths. This must be regarded as a shortcoming since the cause of misalignment may lie more with an inappropriate mix of policies (e.g., overly loose fiscal policy cum overly tight monetary policy) than with an inappropriate stance of policies (e.g., excessively expansionary monetary and fiscal policy).

The third difficulty with the underlying balance approach is that it is operationally complex. Data requirements are substantial, computations depend on large-scale trade models, the rationale behind some of the calculations is not transparent, and estimates of some key parameters (e.g., short and long-run trade elasticities) are uncertain. ^{1/} All of this, in turn, might be burdensome for agreement on, and continuous revision of, target zones.

Fourth, the large-scale trade models that are likely to be used in this approach do not pay sufficient attention to either financial variables or to the important distinction between expected and unexpected values of key economic variables. These omissions render this approach somewhat remote from the mechanisms usually associated with the determination of market exchange rates. Therefore, target zones based on forecasts from the underlying balance approach may again be questioned by market participants.

To summarize, each of the three methods of calculating equilibrium exchange rates has strengths and weaknesses. It might however not be necessary to follow just one method. Instead, one could construct a "consensus" forecast on the basis of estimates from several methods. Such an exercise would also provide information on the comparative performance of each method which, in turn, could aid in the ultimate selection of the proper calculation method. Finally, in appraising the methods of calculating equilibrium exchange rates, it is important to recognize that such methods are already being applied to some degree whenever the Fund "takes a view" on the appropriateness of major-currency exchange rates. In this sense, the problems raised are not new ones. The differences are that in a system of target zones (especially the "harder" versions) the method of calculating equilibrium exchange rates would be more explicit and subject to greater scrutiny, and that the results of such calculations would be shared with the market.

^{1/} See, for example, Goldstein and Khan [1984].

2. What currencies should be included in the system of target zones?

Another central issue for a system of target zones is the number and choice of currencies to be included. Four considerations seem paramount.

First, for administrative efficiency, it is desirable that membership should be kept fairly small. This is because the complexity of negotiations, and the danger of conflicts that might bring about a collapse of the system, can be said to increase rapidly as the number of partners rises. This position is consistent with the view that centralized management of exchange rates is feasible only when the number of decisions to be made is reasonable small. 1/ In this connection, it is useful to recall that although a large number of currencies were managed under the Bretton Woods system, countries took the initiative for par value changes, the Fund could only concur with or object to par value changes proposed by a number, and par values were changed rather infrequently. 2/ Similarly, the present system of managed floating is a decentralized system that permits "market-based" decisions to act as a safety valve when more centralized decisions about adjustment responsibilities and exchange rate alignments do not prove possible. In short, since international decision-making on exchange rates is likely to be difficult, one should not unduly burden the system with too many players.

Second, for a target zone system to have an appreciable impact on conditions in foreign exchange markets, it is desirable that the membership include major-currency countries. Although the vast majority of countries currently maintain some form of "pegged" exchange arrangements, the largest trading countries maintain either "limited flexibility" (e.g., the EMS) or "more flexible" exchange arrangements, including "independent floating" by 4 of the largest industrial countries (Canada, Japan, the United Kingdom, and the United States). 3/ Reflecting this, it has been estimated that about two thirds to four fifths of world trade is conducted at floating rates. 4/ The key to progressing toward more

1/ Of course, exchange rates established in a target zone would have clear implications for nonparticipants to which they would have to adjust and/or react.

2/ The Bretton Woods system also had the U.S. dollar as the numeraire. With the dollar as anchor, exchange rate decisions could take place one-at-a-time. When this was no longer the case (e.g., August-December 1971), negotiations over exchange rates were much more difficult. It is not clear what currency or currency-basket would serve as numeraire in a target zone.

3/ It is worth recalling that the currencies of EMS members float against currencies of many non-members.

4/ See IMF [1984c] and the G-10 Report, paragraph 9.

fixity in exchange rates therefore lies not in inducing many countries to adopt constraints on exchange rate flexibility--this is already a fact of life--but rather in inducing the largest trading countries to accept such constraints. This consideration has no doubt influenced the leading proposals (e.g., Roosa [1984]) that the key members of a target zone be either the three largest industrial countries or the G-5 countries.

The third consideration is the characteristics of the potential member countries. These characteristics, emphasized in the literature on so-called optimal currency areas, are relevant not for choosing the right number of countries for a target zone but rather for assessing the likely membership.

The more important country characteristics are the following:

(i) the openness of the economy - This criterion suggests that relatively open economies should prefer greater fixity of exchange rates because exchange rate fluctuations induce larger domestic price changes in more open economies, thereby complicating the task of domestic stabilization policies.

(ii) the size of the economy - Small economies are said to be more inclined to join currency unions because, in the absence of such monetary integration, their effective economic size would be sub-optimal. This of course begs the question of to whom to peg.

(iii) the degree of commodity diversification - Highly diversified economies are deemed more likely candidates for greater fixity of exchange rates because their diversification provides some natural insulation against a variety of shocks; hence, there is less need for the insulation properties of a flexible exchange rate.

(iv) the degree of factor mobility - Countries between which there is a high degree of factor mobility are viewed as better candidates for currency unions because factor mobility provides a substitute for exchange rate flexibility in promoting external adjustment. Since factor mobility is in turn likely to diminish with geographic distance, this criterion is often used to justify currency unions between small neighboring states.

(v) similarity of inflation rates - The argument here is that countries with similar tastes for inflation--and more important, similar histories of inflation--will tend to prefer greater fixity of exchange rates. There is however a chicken-and-egg problem: do member countries of a currency union have similar inflation rates because they belong to the union, or have they joined the union because of their similar capacities to combat inflation?

Obviously, these country characteristics do not all point in the same direction. For example, the criteria of openness, size, and factor mobility suggest that the United States, the Federal Republic of Germany, and Japan would have relatively weak incentives to join a target zone, relative say, to the smaller European countries that are members of the EMS. On the other hand, the criteria of commodity diversification and similarity of inflation rates lean perhaps the other way.

The fourth and final consideration is the relationship to existing currency blocs. In thinking about the potential membership of a target zone system, it is important to recognize that most countries are already part of a currency bloc, be it via pegging to a single currency or currency basket, or via participation in an arrangement with limited exchange rate flexibility (e.g., the EMS). This raises three points: (i) in cases where members of the target zone system are also members of other (regional) currency blocs, provision would have to be made for ensuring consistency of cross exchange rates and for coordinating intervention practices between the "core" target zone and "satellite" currency blocs; (ii) countries that already have non-exchange-rate linking arrangements (e.g. a customs union) may be reluctant to undertake additional linkages (i.e. target zones) for fear of restricting too tightly their room for independent action; and (iii) if the most natural and profitable opportunities for currency union are exploited first, then it is likely that a target zone system among major-currency countries may have to operate with more flexibility (e.g., wider margins and more frequent revision of central rates) than satellite currency blocs.

3. How wide should the target zones be and how frequently should they be revised?

The equilibrium exchange rate--also sometimes referred to as the central rate--represents only one of several parameters that characterize target zones. Two others are the width of the zones surrounding the central rates and the frequency by which the zones are revised. What considerations bear on the determination of these latter two parameters?

Concerning the width of the zones, four factors are relevant. First, the zones must be wide enough to accommodate transitory disturbances that do not alter long-run equilibrium real exchange rates. In this sense, the zone may be viewed as providing a buffer. The buffer not only guards against costly shifts in resources due to excessively frequent changes in central rates but also provides the authorities with breathing space to sort out permanent from transitory shocks. Second, the zone should be wide enough to reflect uncertainties about the equilibrium central rate itself. As noted earlier, there are various approaches to calculating the real equilibrium exchange rate and there are uncertainties about the parameter values in each

model. To many observers, little is gained by acting as if equilibrium exchange rates could be assessed with great precision. Recognizing this, some proposals for target zones recommend initial zones on the order of 10 percentage points on each side of the central rate (see, for example, Williamson [1985]). The third factor to be considered is speculation. A well-known weakness of fixed exchange rates is that frequently they offer speculators "one-way bets" about the direction of changes in parities. Target zones must therefore be sufficiently wide to allow for occasional changes in central rates within the zone without provoking one-way speculation. Fourth, if central rates were specified in terms of a numeraire currency, then the width of the target zone linking non-numeraire currencies will in general be different to that between each currency and the numeraire.

Also, there is no reason why the width of the zones should be constant over time. For example, if uncertainty about the equilibrium real exchange rate and about the nature of disturbances diminished with experience, then narrower zones could be adopted. On the other hand, if turbulence increased over time, wider zones could be adopted. Finally, as a corollary of the above arguments, there is no logical presumption that the width of the zone should be the same for all members. In this connection, it is relevant to note the experience of the EMS in which the currency of Italy, a country that has had relatively high inflation in the past, is subject to wider margins than other currencies. Similarly, it has been suggested that if the United Kingdom were to join the EMS, special provision should be made in the form of wider margins for the pound sterling to reflect the influence of oil price developments on the exchange rate.

Turning to the frequency of adjustment, five points need to be considered. To begin with, the frequency with which the central rates (and zones around them) are adjusted should reflect the frequency of changes in real economic conditions, as well as, of course, the size of inflation differentials across member countries. Examples of changes in real economic conditions would include permanent changes in the terms of trade, continuing inter-country differences in labor productivity, and inter-country shifts in saving and investment propensities. Because such changes in real economic conditions generally do not occur at close intervals, they are unlikely to induce frequent changes in the target zones. The size of inflation differentials depends primarily on how successful target zones are in inducing harmonization of members' macroeconomic and structural policies, particularly monetary policy. The second factor governing the desired frequency of adjustment is the flexibility of macroeconomic policy instruments. Specifically, since a change in real economic conditions can be reconciled either by a change in macroeconomic policies with an unchanged zone or by a change in the zone

with unchanged policies, it follows that inflexible policies call for higher frequency of zone adjustment, and vice-versa. Third, there is the credibility issue. Frequent revisions in the zones reduce credibility of the zones and thereby reduce their value as an anchor for expectations. On the other hand, frequent changes in macroeconomic policies designed to sustain the zones may also reduce credibility--but this time of the policies. 1/ Therefore, the optimal frequency of adjustment from a credibility viewpoint involves balancing between these two considerations. Fourth, some have argued that if target zones are adjusted frequently for inflation differentials and the need for balance of payments adjustment, speculative attacks will be discouraged since they are motivated by large discrete changes in exchange rates. Fifth, the frequency of adjustment must obviously be constrained by the availability of the data necessary for computations.

4. How would exchange rates be kept within the zones and with what consequences for other policy objectives?

For a system of target zones to operate successfully, it is necessary that exchange rates be kept within the agreed zones, at least most of the time. But how would participating countries assure this result? Four policy instruments should be considered.

The first and most obvious instrument is domestic monetary policy. Indeed, as indicated in Section II, a differentiating characteristic of target zones is that the authorities pay more attention to the exchange rate in the conduct of domestic monetary policy than they do under the present system of managed floating. What this means is that participating members will have to seek greater coordination of monetary policies, with a consequent reduction in the ability to independently control the money supply. For example, a member of the system that sees its nominal exchange rate fall to the bottom of the zone would be expected to slow its money growth rate and to increase its domestic interest rate vis-a-vis those of other members; 2/ in this way, it

1/ A counter-argument is that changes in macroeconomic policies in response to real changes in the economy could act at times to enhance the credibility of policy if they were perceived as responsive to these changes.

2/ It is not clear what form monetary intervention would take. Members could intervene in domestic financial markets (exchanging money for debt of the same currency of denomination) or in international financial markets (exchanging monies of different currency denomination). If the latter were envisaged, questions could arise about the adequacy of intervention assets and about sterilization operations.

would induce an appreciation in its nominal exchange rate, thereby keeping its exchange rate within the target zone. Assuming that the pass-through of nominal exchange rate changes into domestic prices is less than complete, the same monetary policy action would allow the member to satisfy its target for the real exchange rate as well. 1/

There is little doubt about the ability of major industrial countries to influence nominal and real exchange rates in the medium term using domestic monetary policy. 2/ The key question concerns the willingness to do so given the implied reduction in their ability to then use domestic monetary policy for internal objectives. To many observers, it is simply naive to believe that the United States, Japan, and the Federal Republic of Germany would be willing to override internal objectives for exchange rate targets in the formulation of domestic monetary policy. Under this view, "soft" target zones are the strongest commitment one can reasonably envisage for the three largest potential members. Others argue, however, that the independence of monetary policy is far from complete under the present system, even for those countries classified by the Fund as "independently floating." To take but one recent example, the U.K. authorities reacted to the large decline in the dollar/pound rate in early 1985 by encouraging large increases in domestic interest rates--and this even though there was strong domestic pressure for lower interest rates to help reduce unemployment. For this reason, supporters of target zones argue that all countries already have implicit target zones beyond which they are willing to sacrifice internal objectives for the exchange rate. It is argued therefore that the loss of monetary independence at the margin would be minimal.

A second possible policy instrument for keeping exchange rates within target zones is sterilized exchange market intervention (i.e., exchange market intervention that leaves the monetary base unchanged). Its main attraction of course is that, if effective, it would permit the authorities to influence exchange rates while simultaneously maintaining control of the domestic money supply.

1/ Obstfeld [1985] reports that month-month correlations between nominal and real exchange rates for the 1976-85 period were above .95 for the U.S. dollar, the Japanese yen, and the deutsche mark.

2/ In the long run (say, three to five years), the ability to use monetary policy to affect the real exchange rate will be more modest. Also, even in the medium-term, this ability will be lower for the smaller, more-open, more highly-indexed industrial countries than for the larger, less-open, less-indexed ones. See Goldstein and Khan [1984] for a survey of estimates of these "pass-through" effects.

Unfortunately, the prognosis for using sterilized exchange market intervention as the primary instrument for controlling exchange rates is not favorable. 1/ The Jurgensen Report [1983], for example, supports the view that sterilized intervention by itself is unlikely to be an effective tool for influencing the level of the exchange rate over the medium or long-term. 2/ Similarly, recent empirical work on exchange-rate-determination indicates that while domestic and foreign-currency assets may well be imperfect substitutes--a necessary condition for sterilized exchange market intervention to be effective--risk premia in exchange markets are not well explained by relative asset supplies (the very variables affected by exchange market intervention). 3/ In short, the effects of sterilized intervention on market exchange rates are likely to be small and uncertain in size. Nevertheless, sterilized intervention may have a useful role to play in dampening short-term volatility of exchange rates, in countering disorderly market conditions, in complementing and supporting other policies, and in expressing an attitude toward exchange markets.

Capital controls represent a third instrument for keeping exchange rates within target zones. This is however generally not regarded as an attractive option for two reasons. 4/ First, even aggressive capital control programs, such as those of the early 1970s, were not able to stem private capital flows, and the subsequent development of offshore banking markets suggests even lower effectiveness today. Second, capital control programs are most effective in altering exchange rates when they cover all types of capital transactions. But in that case, there is no presumption that the resource allocation costs of impeding the international flow of capital would be less serious than departures of exchange rates from the zones themselves.

The preceding discussion suggests that the primary instrument for keeping exchange rates within target zones is likely to be monetary policy. If this is so, then a second relevant question emerges: with monetary policy geared more to external objectives, what policy instruments will be assigned to internal balance (i.e., price stability and high employment)?

1/ "Neither capital controls nor intervention can be relied upon to attain lasting stability of exchange rates." G-10 Report, paragraph 27.

2/ "Intervention will normally be useful only when complementing and supporting other policies." Jurgensen Report [1983], p. .

3/ See, for example, Dooley and Isard [1983].

4/ "The Deputies agree that controls on international capital flows do not offer a desirable or effective means of achieving greater exchange rate stability." G-10 Report, paragraph 25.

One logical answer is fiscal policy. ^{1/} Here, the key question is not so much whether fiscal policy can affect aggregate demand in major industrial countries. Experience suggests that it can. Rather, the issue is whether fiscal policy is a sufficiently flexible policy instrument to be used for stabilization policy in a world in which some countries have medium-term targets for reducing the share of government expenditure in overall economic activity, some are contemplating large structural changes in their tax system, some are committed to given levels of social programs and defense spending, some are wedded to preannounced public-sector borrowing requirements, and some are facing legislatures that can take years (not months) to enact significant cuts in budget deficits.

A second policy option (favored for example by Meade [1984]) is to use labor-market policy for internal balance. In brief, the idea is to lower the money wage rate in any sector which has excess supply of labor and to raise it where there is excess demand. The problem of course, recognized by supporters, is that the implementation of such a policy would involve the substantial reform of labor-market institutions. In short, although sound in its internal logic, it begs the central question of how to bring such a labor-market policy into being in advanced industrial economies. The slow progress in reducing structural rigidities in European labor markets bears testimony to the difficulties involved.

In sum, because of the limitations of other policy instruments, monetary policy is often called on to serve both external and internal objectives. If a move to target zones were made, it would require shifting more of the emphasis toward external objectives. This might not create a major problem if all members of the target zone geared monetary policy toward price stability; or if coordinated, sterilized exchange-market intervention could ease the external obligations of monetary policy; or if fiscal policy could be made flexible enough to deal effectively with internal balance. However, since none of these three outcomes is likely to be fully realized, members of a target zone system would probably still be faced with serious conflicts between external and internal balance. At the same time, the constraints on macroeconomic policies induced by a target zone system might make a contribution to the realization of these three outcomes.

5. How would initial misalignments be handled in a transition to a target zone system?

The operational issues discussed thus far are relevant for the possible implementation of target zones. There is the additional issue however of how a transition to a target zone system might be managed.

^{1/} Fiscal policy also has a role to play in achieving a given real exchange rate on a sustainable basis.

This is especially relevant in present conditions of apparent large misalignment of several key-currency exchange rates. Two options are noteworthy.

The first option would be to impose preconditions that must be satisfied prior to the implementation of the target zone system. Specifically, it could be required that each country's actual exchange rate fall within the calculated target zone prior to the formal adoption of the system. For some countries, this would imply a significant change in the mix of current and anticipated macroeconomic policies, and just as important, the reflection of such policy changes in market exchange rates.

The logic for such preconditions is threefold: (i) it would provide an early test of the seriousness that member countries attach to the commitments involved in participating in a target zone system; (ii) it would avoid saddling the new system with large initial disequilibrium that could lead to early collapse for reasons unrelated to the system itself; and (iii) it would generate an early reading of how large differences in estimates of central rates and of target zones would be, and of how such differences could be resolved. A possible disadvantage is that when current misalignments are very large, they may exaggerate the difficulties involved in operating such a system under more normal circumstances.

The second option would be to gradually phase-in the target zone system by allowing for a transition period during which problem countries have wider zones and more frequent adjustment of central rates. ^{1/} The logic behind this option is: (i) it recognizes that large turnarounds in macroeconomic policy, particularly fiscal policy, are difficult to accomplish in the short-term; (ii) it still may provide some impetus to discipline in the conduct of macroeconomic policies; and (iii) the wider zones, and possibilities for more frequent adjustment, would reduce the frictions associated with the uncertainty and diversity of estimates about the equilibrium central rate. The disadvantages are that it may slow down the necessary adjustment of policies, that it may raise questions about "equal treatment" of members, and that it would not provide an early test of government commitment.

^{1/} "Target zones would be phased in progressively." G-10 Report, paragraph 31.

IV. Selected Bibliography ^{1/}

Artus, Jacques R., and Andrew D. Crockett, Floating Exchange Rates and the Need for Surveillance, Essays in International Finance, No. 127 Princeton University (Princeton, New Jersey: Princeton University Press, 1978).

_____ and Anne Kenney McGuirk, "A Revised Version of the Multilateral Exchange Rate Model," IMF Staff Papers, (June, 1981).

_____ and John H. Young, "Fixed and Flexible Rates: A Renewal of the Debate," IMF Staff Papers, (December 1979), pp. 654-98.

Bergsten, C. Fred, and John Williamson, "Exchange Rates and Trade Policy," in Trade Policy in the 1980s, ed. William R. Cline, (ed.), Washington: Institute for International Economics, 1983.

Bergstrand, Jeffrey, "Is Exchange Rate Volatility 'Excessive'?" New England Economic Review, (September/October 1983), pp. 5-14.

Bryant, Ralph C., "Comments and Discussion" on "Floating Exchange Rates After Ten Years," Brookings Papers on Economic Activity: 1 (1983), The Brookings Institution (Washington), pp. 71-79.

Calvo, Guillermo, "Trying to Stabilize: Some Theoretical Reflections Based on the Case of Argentina," in P. Aspe, R. Dornbusch, and M. Obstfeld, (eds.), Financial Policies and the World Capital Market: The Problem of Latin American Countries, (University of Chicago Press), 1983, pp. 199-216.

Cline, William R., International Monetary Reform and the Developing Countries (Washington: The Brookings Institution, 1976).

Deppler, Michael, and Duncan M. Ripley, "The World Trade Model: Merchandise Trade," IMF Staff Papers (March 1978), pp. 147-206.

* Deputies of the Group of Ten, "The Functioning of the International Monetary System: A Report to the Ministers and Governors of the Group of Ten," June 1985, circulated as EBD/85/154, Supplement 1.

* Deputies of the Group of Twenty-Four, "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 1985, circulated as EBD/85/228.

Dornbusch, Rudiger, "Exchange Rate Economics: Where Do We Stand," Brookings Papers on Economic Activity, 1980:1, pp. 143-85.

^{1/} References with an asterisk may be of particular interest.

Dunn, Robert, "Exchange Rate Rigidity, Investment Distortions, and the Failure of Bretton Woods," Essays in International Finance, No. 97, Princeton University (Princeton, New Jersey: Princeton University Press, 1973).

Emminger, Otmar, Exchange Rate Policy Reconsidered, Occasional Paper No. 10 (New York: Group of Thirty, 1982).

_____, The Dollar's Borrowed Strength, Occasional Paper No. 19 (New York: Group of Thirty, 1985).

- * Ethier, Wilfred, and Arthur I. Bloomfield, "Managing the Managed Float," Essays in International Finance, no. 112. (Princeton, New Jersey: Princeton University Press, 1975).

Frenkel, Jacob A., "The Collapse of Purchasing Power Parities During the 1970s," European Economic Review, Vol. 16, (May 1981), pp. 145-166.

_____, "Flexible Exchange Rates, Prices and the Role of News: Lessons from the 1970's" Journal of Political Economy, (August 1981), pp. 665-705.

Frenkel, Jacob A., and Joshua Aizenman, "Aspects of the Optimal Management of Exchange Rates," Journal of International Economics, (November 1982), pp. 231-56.

Frenkel, Jacob A., and Michael L. Mussa, "The Efficiency of Foreign Exchange Markets and Measures of Turbulence," American Economic Review (May 1970), pp. 374-81.

- * _____, "Comments on Exchange Rate Arrangements in the Eighties," in Federal Reserve Bank of Boston, The International Monetary System, Boston, May 1984, pp. 119-25.

- * Genberg, Hans, "On Choosing the Right Rules for Exchange Rate Management," The World Economy (December 1984), pp. 391-406.

Goldstein, Morris, Have Flexible Exchange Rates Handicapped Macroeconomic Policy? Princeton Special Papers in International Economics, no. 14. Princeton, N.J., 1980.

_____, and M. Khan, "Income and Price Effects in Foreign Trade," in R. Jones and P. Kenen (eds), Handbook of International Economics, Vol. II, North-Holland Publishing Co., 1985, pp. 1041-1105.

Group of Thirty, The Foreign Exchange Markets Under Floating Rates, a Study in International Finance by the Exchange Markets Participants' Study Group (New York: Group of Thirty, 1980).

- * _____, The Problem of Exchange Rates (New York: Group of Thirty, 1983).

- * Helleiner, Gerald K., Towards a New Bretton Woods: Challenges for the World Financial and Trading System, Report by a Commonwealth Study Group (London: Commonwealth Secretariat, 1983).

- International Monetary Fund, The Role of Exchange Rates in the Adjustment of International Payments: A Report by the Executive Directors (Washington: IMF, 1970).

- * _____, International Monetary Reform: Documents of the Committee of Twenty (Washington: IMF, 1974).

- * _____, "Guidelines for the Management of Floating Rates" in Annual Report of the Executive Directors of the International Monetary Fund, 1974, Washington, IMF, 1974).

- _____ (1984a), Exchange Rate Rate Volatility and World Trade, a study by the Research Department of the International Monetary Fund, Occasional Paper No. 28 (Washington: IMF, July 1984).

- * _____ (1984b), Issues in the Assessment of the Exchange Rates of Industrial Countries, a study by the Research Department of the International Monetary Fund, Occasional Paper No. 29 (Washington: IMF, July 1984).

- * _____ (1984c), The Exchange Rate System: Lessons of the Past and Options for the Future, a study by the Research Department of the International Monetary Fund, Occasional paper No. 30 (Washington: IMF, July 1984).

- Jurgensen Report, Report of the Working Group on Exchange Market Intervention. Washington: U.S. Treasury, 1983.

- Kenen, Peter, "Reforming the International Monetary System," paper prepared for presentation to New York Academy of Sciences, September 1985.

- McGuirk, Anne Kenney, "Oil Price Changes and Real Exchange Rate Movements among Industrial Countries," IMF Staff Papers, (December 1983) pp. 843-884.

- McKinnon, Ronald, An International Standard for Monetary Stabilization (Washington, Institute for International Economics, 1984).

- * Meade, James, "A New Keynesian Bretton Woods," Three Banks Review (June 1984), pp. 8-25.
- * Meese, Richard, and Kenneth Rogoff, "Empirical Exchange Rate Models of the Seventies: Do They Fit Out of Sample?" Journal of International Economics, (February 1983), pp. 3-24.
- * Mikesell, Raymond and Henry Goldstein, "Rules for a Floating-Rate Regime," Essays in International Finance, No. 109, Princeton University (Princeton, New Jersey: Princeton University Press, 1975).

- Mussa, Michael, "Empirical Regularities in the Behavior of Exchange Rates and Theories of the Foreign Exchange Market," in Theory Policy, Institutions: Papers from the Carnegie-Rochester Conferences on Public Policy, ed. by Karl Brunner and Allan H. Meltzer (Amsterdam: North-Holland; U.S. and Canada: Elsevier Science Publishers, 1983), pp. 165-312.

- Mussa, Michael, 1981. The Role of Official Intervention. Group of Thirty Occasional Paper, No. 6, New York.

- Nurkse, Ragnar, Conditions of International Monetary Equilibrium, Essays in International Finance, No. 4, Princeton University (Princeton, New Jersey: Princeton University Press, Spring 1945).

- * Obstfeld, Maurice, "Floating Exchange Rates: Performance and Prospects," Brookings Papers on Economic Activity, forthcoming, 1985.

- Polak, Jacques J., Coordination of National Economic Policies, Occasional Paper No. 7 (New York: Group of Thirty, 1981).

- * Roosa, Robert V., "How to Create Exchange Rate Target Zones," Journal of Commerce, 3 June, 1983.

- * _____, "Exchange Rate Arrangements in the Eighties," in Federal Reserve Bank of Boston, The International Monetary System: Forty Years After Bretton Woods, Boston, May 1984, pp. 104-118.

- * Shafer, Jeffrey R., and Bonnie E. Loopesko, "Floating Exchange Rates After Ten Years," Brookings Papers on Economic Activity: 1 (1983), The Brookings Institution (Washington), pp. 1-70.

- Solomon, Anthony M., "International Coordination of Economic Policies: I. The Role of Economic Summitry; II. Coordinating Monetary Policy?" The David Horowitz Lectures at Tel Aviv University, Tel Aviv, and Hebrew University, Jerusalem, March 4 and 5, 1982 (unpublished).

Solomon, Robert, Reforming the Exchange-Rate Regime, International Economic Letter, RS Associates, Inc. (Washington), Vol. 3, No. 7 (July 18, 1983).

Tobin, James, A Proposal for International Monetary Reform, Cowles Foundation Paper No. 495, Cowles Foundation for Research in Economics (New Haven, Connecticut: Yale University Press, 1980).

- * Ungerer, Horst, Owen Evans, and Peter Nyberg, The European Monetary System: The Experience, 1979-82, Occasional Paper No. 19 (Washington: International Monetary Fund, May 1983).
- * _____, "The European Monetary System and the International Exchange Rate System," Departmental Memorandum, DM/84/3, IMF, January 1984.
- * Willett, Thomas D., Floating Exchange Rates and International Monetary Reform, American Enterprise Institute Studies in Economic Policy (Washington: American Enterprise Institute for Public Policy Research, 1977).
- * Williamson, John, The Exchange Rate System, (Washington, Institute for International Economics, 2nd edition, 1985).

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

SM/86/3

CONTAINS CONFIDENTIAL
INFORMATION

January 10, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Surveillance over Exchange Rate Policies -
Biennial Review of 1977 Document

Attached for consideration by the Executive Directors is the paper on surveillance over exchange rate policies - biennial review of 1977 document.

This paper, together with the paper on surveillance over exchange rate policies - annual review of surveillance and review of proposals for changes in procedures (SM/86/4, 1/10/86) has been scheduled for Executive Board discussion on Wednesday, February 19, 1986.

Mr. Crockett (ext. 8982) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Surveillance Over Exchange Rate Policies--
Biennial Review of 1977 Document

Prepared by the Research Department and
the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by Wm. C. Hood and C. David Finch

January 10, 1986

Contents

I. Introduction	1
II. Background to the 1977 Document	3
1. The 1974 "Guidelines for Floating"	3
2. The 1977 document	6
a. The global economic environment in 1977	6
b. The lessons of the early experience with floating	7
c. Implications for surveillance	8
III. The Working of the Exchange Rate System Since 1977	10
1. The changing nature of the issues facing policymakers	10
2. Weaknesses in the working of the exchange rate system	12
3. Implications for surveillance principles	14
IV. Possible Changes in the Surveillance Document	15
1. The objectives of surveillance in current circumstances	15
2. Main features of the document	17
3. General principles	17
4. Principles for the guidance of members' exchange rate policies	18
5. Principles of Fund surveillance over exchange rate policies ..	23
6. Procedures	24
V. Future Program of Work and Issues for Discussion	26
1. Future program of work	26
2. Issues for discussion	27
APPENDIX	
Executive Board Decision 5392-(77/63) - Surveillance over Exchange Rate Policies	29
Executive Board Decision 6026-(79/13) - Surveillance Procedures ...	32

Surveillance Over Exchange Rate Policies--
Biennial Review of 1977 Document

I. Introduction

The decision adopting the document "Surveillance Over Exchange Rate Policies" (Decision No. 5392-(77/63), April 29, 1977) provides for a review of the document every two years. The document itself acknowledges that the principles and procedures it sets forth "are not necessarily comprehensive and are subject to reconsideration in the light of experience." The present paper constitutes the basis for the biennial review of the surveillance principles. It also serves to review and discuss the proposals made in the reports of the Group of 10 and the Group of 24 that would involve changes to the text of the 1977 document. A companion paper ^{1/} considers those proposals in the G-10 and G-24 reports that affect the implementation of surveillance without necessarily requiring changes in the text of the 1977 document.

The Second Amendment, which introduced the provisions on surveillance, became effective on April 1, 1978, and the first biennial review of the surveillance document was therefore scheduled to take place not later than April 1, 1980. There have thus far been three reviews of the document (in 1980, 1982, and 1984). There have also been reviews of the implementation of surveillance on seven occasions, three of which coincided with the above-mentioned reviews of the basic document.

The reviews that have taken place have resulted in a number of modifications in the way in which the Fund's surveillance activities are conducted, including the adoption, in 1979, of a "Supplemental Surveillance Procedure" intended to facilitate discussion of exchange rate developments considered to be important or to have important effects on other members. The basic document "Surveillance Over Exchange Rate Policies" has not been amended as a result of any of the three reviews that have taken place, despite the expectation at the time the Decision was adopted that the principles and procedures would be subject to reconsideration in the light of experience.

The fact that the Surveillance document has not been changed does not, of course, reflect a feeling of satisfaction with the way in which surveillance has operated. In fact, the annual and biennial reviews have revealed widespread concern that the objectives of Fund surveillance are not being fully met. However, Directors have generally felt that the source of the problem lies not so much with the principles and procedures

^{1/} "Surveillance over Exchange Rate Policies--Annual Review of Surveillance and Review of Proposals for Changes in Procedures," SM/86/4, 1/10/86. See also "Surveillance over Exchange Rate Policies--Annual Review: Background Material." (To be issued.)

themselves as with the willingness of members, individually and collectively, to carry them into effect. It has been considered that the language of the 1977 Decision is sufficiently widely drawn to permit the Fund to express views on the whole range of policies affecting international economic developments. At the same time, it has been feared that greater specificity in prescribing policies would meet with disagreement and might not be in accordance with the requirement of the Articles of Agreement that... . "these Principles shall respect the domestic social and political policies of members, and in applying these principles, the Fund shall pay due regard to the circumstances of members." 1/

For several reasons, the current review of the Surveillance document is an opportune occasion for a more thorough-going reappraisal of the basic principles of surveillance than has taken place in earlier reviews. In the first place, concerns about exchange rate variability have, if anything, intensified in the period since the last review. Exchange rate variability has been a more troubling feature of international economic relationships than was expected at the time the Decision was adopted. This applies both to short-run exchange rate volatility and, more particularly, to longer-term exchange rate swings. Second, it is clear that management of the debt difficulties facing developing countries can be hampered by inappropriate policies affecting exchange rates or unpredictable exchange market developments. This applies both to exchange rate policies of heavily indebted countries themselves, and to exchange rate developments among their industrial country trading partners. These latter can have major implications for the real cost of servicing debt, as well as for the strength of protectionist sentiment.

A third reason for reconsidering the surveillance document is the attention given to the functioning of the exchange rate system and the subject of surveillance in the recent reports of the G-10 and the G-24. Both of these reports devote considerable attention to the subject of surveillance, and make recommendations for improvements. The G-10 report notes that surveillance has not been as effective as desirable in bringing about needed policy changes. The appropriate response to these shortcomings is felt to lie in a strengthening of existing mechanisms for encouraging better policies rather than in major changes in the institutional structure for surveillance itself. Nevertheless, the report invites the Board to review the 1977 and 1979 decisions with a view to facilitating greater use of supplementary surveillance procedures, and makes a number of other suggestions that could involve changes in the text of the 1977 document. In addition, some deputies from G-10 countries expressed interest in exploring the technical aspects of target zone proposals. More generally, it is for consideration whether changes in the underlying surveillance document could play a constructive role in contributing to the objectives set out in the G-10 report.

1/ Article IV, Section 3(b).

The report of the G-24 goes further than that of the G-10 in suggesting changes to the existing mechanisms of surveillance, and contains several proposals that would require changes in the language of the surveillance document. Paragraph 77 of the G-24 report states that: "Surveillance...should be explicitly recognized as surveillance of the international adjustment process." Paragraph 66 proposes the use of "target zones" for exchange rates as a means for achieving greater exchange rate stability, and paragraph 68 puts forward the concept of exchange rate misalignment as a criterion or trigger for multilateral consultations. All these proposals would require changes in the 1977 Decision and supporting document to give them effect.

The plan of the rest of the paper is as follows: Section II sets out the background to the 1977 Decision, indicating the prevailing view of international economic interactions at the time that decision was adopted, and the perceived scope and limitations of the surveillance mechanism. (As part of this background, this section also covers earlier experience with the "Guidelines for Floating" which were adopted in 1974 and effectively lapsed with the adoption of the 1977 Decision.) Section III of the paper considers developments in the nine years or so since the Surveillance document was adopted. The purpose of this is to identify those aspects of the world economy that have differed from the evolution that was foreseen in 1977, and to consider the implications of these differences for the content and role of exchange rate surveillance. Section IV considers ways in which the existing surveillance document might be changed in the light of the preceding analysis. It does not propose specific language, but rather attempts to consider the issues raised in giving effect to some of the proposals that have been made concerning the exchange rate system. This section also considers those procedural suggestions that would involve changing the language of the 1977 decision. Lastly, Section V discusses the future organization of work on the issues raised in this paper. It considers the nature of the guidance that might be sought from the Interim Committee on the major substantive issues involved, and the means by which such guidance could be used to make further progress toward a revised decision. The Appendix to the present paper reproduces the 1977 Decision, and the supplemental procedure introduced in 1979.

II. Background to the 1977 Document

1. The 1974 "Guidelines for Floating"

During the period of the par value system, the Fund had frequently expressed views on members' economic policies in general, and on the effectiveness of their adjustment policies in particular. A body of experience had been accumulated concerning how to define what constituted

a "fundamental disequilibrium" that would justify exchange rate action. However, little attention had been devoted to developing a code for economic policy-making that would be applicable in circumstances where most major currencies were floating. The need for such a code became apparent during 1973-74, when it grew clear that flexible rates among major currencies would probably endure for a considerable period.

The "Guidelines for the Management of Floating Exchange Rates" were adopted on June 13, 1974. ^{1/} They were based on an analytical view of the world in which:

(i) it was considered possible to make an operationally meaningful distinction between policies being used for balance of payments purposes, and policies being used for other purposes;

(ii) balance of payments equilibrium could be defined as a situation in which the current account surplus or deficit was equal to "normal" capital flows plus reserve accumulation;

(iii) "normal" capital flows could be identified on the basis of slow-moving historical trends;

(iv) current account flows were a fairly predictable function of relative prices and the relative cyclical position of the countries concerned; and

(v) short-term capital (or "hot money") was considered liable to move in an unpredictable way in response to speculative or interest rate factors.

In this view of the world, three types of dangers were perceived to be important. First, the volatility of short-term capital was thought likely to give rise to undesirable short-term fluctuations in exchange rates. (A related fear was that in the absence of short-term stabilizing speculation, individual large current account transactions might themselves introduce instability into day-to-day rates.) A second fear was that short-term swings in a country's balance of payments (e.g., for seasonal reasons) might lead to unnecessary exchange rate shifts unless "buffered" by reserve changes. And a third fear was that longer lasting swings in the current account position (caused, for example, by cyclical factors) might give rise to exchange rate movements that would have to be reversed at some future date. This could be particularly damaging if weakness in the domestic economy led to a strengthening of the current account and if, as was widely believed at the time, a strengthening of

^{1/} Executive Board Decision No. 4232-(74/67), 6/13/74.

the current account tended to push up the exchange rate. Such exchange rate appreciation would tend to further unbalance relative cyclical positions.

The "Guidelines for Floating" addressed each of these three concerns. The first guideline stated that members should intervene to prevent or moderate short-term (day-to-day and week-to-week) fluctuations in rates. The second guideline permitted members to act ("through intervention or otherwise") to moderate month-to-month and quarter-to-quarter movements. The third guideline dealt with target zones. If countries wished to establish target zones, or exchange rate "norms", for their currencies, they could do so, but would have to consult with the Fund. If a country did not establish a target zone, the Fund itself could find that its rate had moved outside the "range of reasonable estimates of the medium term norm for that rate." It could then encourage the member to either permit the rate to move back toward the range, or to take action to moderate further divergence from the range. A member would not be asked to resist strong market pressure, and it was accepted that "on occasion, the market view [of an exchange rate] may be more realistic than the official view..." ^{1/}

The central focus of the policy actions discussed in the guidelines was the exchange market. The "Commentary" that accompanied the guidelines gave the following definition of exchange rate policies.

"'Action to influence an exchange rate' includes, besides exchange market intervention, other policies that exercise a temporary effect on the balance of payments and hence on the exchange rate, and that have been adopted for that purpose. Such policies may take the form of official forward exchange market intervention, official borrowing, or lending, capital restrictions, separate capital exchange markets, various types of fiscal intervention, and also monetary or interest rate policies. Monetary or interest rate policies adopted for demand management purposes or other policies adopted for purposes other than balance of payments purposes would not be regarded as action to influence the exchange rate."

The "Guidelines for Floating" did not contain specific procedures for monitoring, or for the exercise of surveillance. During the course of 1974-75 various proposals for the implementation of surveillance were developed but these did not lead to a formal decision by the Board, and by early 1976, the guidelines were effectively superseded by the agreement in principle reached in Jamaica on a revised Article IV. For much of the period during which the Guidelines were in effect, the major countries provided reserves information that permitted a judgment to be reached as

^{1/} See SM/74/75, Supplement 1, 6/21/74.

to whether intervention was moderating month-to-month or quarter-to-quarter movements in rates. Confidential information was also provided to show how intervention was used to counteract short-term volatility. Concerning the third guideline, however, no country with a floating exchange rate chose to consult with the Fund concerning a medium-term target zone, nor did the Fund use its powers to find that a country's rate had moved outside the range of reasonable estimates of a medium-term norm. Nevertheless, the staff did make regular calculations of the underlying balance of payments position of the major countries with floating rates, and provided qualitative assessments of the direction and broad magnitude of the exchange rate changes needed to restore equilibrium.

2. The 1977 document

As just noted, the effort to improve the implementation of the 1974 guidelines was effectively suspended in January 1976, with agreement in principle on a new Article IV at the Jamaica meeting of the Interim Committee. This agreement emphasized the central importance of stable domestic policies in providing the basis for a stable international monetary system. ^{1/} Thus, the obligations placed on members in the amended Article IV gave emphasis to the need to foster orderly underlying economic and financial conditions, and to direct policies toward the objective of fostering orderly economic growth with reasonable price stability. Members' obligations with respect to exchange policies were to "avoid manipulating exchange rates or the international monetary system" and to "follow exchange policies compatible" with their other obligations. The amended Articles left to the Executive Board the working out of "specific principles for the guidance of all members with respect to those policies."

a. The global economic environment in 1977

The Executive Board began consideration of principles for the guidance of members' exchange rate policies shortly after the agreement reached at Jamaica. At that time, three years had elapsed since the end of fixed rates and the adoption of floating by most major currencies. These three years had been characterized by: a major international recession; a four-fold increase in oil prices; a major shift in payments balances on current account; a surge of inflation; and a considerable degree of variability in exchange rate relationships.

Of particular note was the extreme variability of inflation, both across countries and over time. In 1975, for example, the average rate of increase in the GNP deflator of the seven largest industrial countries

^{1/} See IMF Survey, January 19, 1976.

was 10 1/2 percent, with a range running from about 7 percent in Germany to 28 percent in the United Kingdom. Within countries, changes in inflation performance were also dramatic. In Japan, for example, inflation touched 26 1/2 percent (at an annual rate) in the first half of 1975, but had fallen back to 6 percent by the first half of the following year. In the United Kingdom, inflation fell from some 32 percent in the first half of 1975 to 12 1/2 percent in the first half of 1976.

Also noteworthy were the sharp shifts in balance of payments positions that accompanied the substantial changes that were taking place in the international economic environment. The U.S. current account was in small surplus in 1973 and 1974, then moved into record surplus in 1975, before shifting back toward deficit in 1976. Japan, by contrast, was in substantial deficit on its current account in 1974 before swinging strongly back into surplus in 1976.

Reflecting these developments, exchange rates also moved substantially. The U.S. dollar depreciated by 13 percent in the first seven months of 1973 then recovered by 12 percent in the ensuing six months. The currencies of countries affected by high inflation rates (especially the pound sterling and the Italian lira) exhibited a general tendency to depreciate through most of the early years of the floating period. The countries with relatively good inflation performances throughout this period (e.g., Germany and Switzerland) showed a general tendency to appreciate, though with interruptions of one or two quarters. The Japanese yen, after having appreciated up to early 1974, then fell sharply as price increases in Japan accelerated.

b. The lessons of the early experience with floating

It is not easy to characterize the lessons which policy makers in 1976 felt had been learned from the early experience with floating. Nevertheless, certain conclusions having relevance for the design of surveillance principles seem possible. Four are of particular importance.

First, it was recognized that it had become considerably more difficult to estimate the underlying current account balances associated with a particular pattern of exchange rates. This was partly because there was more uncertainty about what constituted "normal" cyclical positions. It had become difficult to interpret indices of capital utilization, since part of the capital stock had been rendered obsolete by the increase in energy prices. Moreover, traditional notions of full employment had become unrealistic as a guide to normal employment levels over a standard business cycle. A further difficulty in estimating underlying current account balances was created by the sharp movements that had occurred in terms of trade and relative costs. Since these factors affected current

account positions with uncertain and distributed lags, and since they had fluctuated substantially during the previous several years, it was difficult to estimate the relevant elasticities for the medium and longer run.

Second, it was recognized that normal capital flows had become considerably harder to estimate. With the significant increase in the balance of payments surpluses of oil countries, the disposition of capital flows in the world economy became much more dependent on the portfolio allocation decisions of the major oil-exporting countries. Not only that, prospective capital flows depended to a substantial extent on how, and how quickly, the surpluses of oil exporters would be absorbed in higher imports. With this uncertainty about the prospective level of "normal" capital flows for the major industrial countries, the current account position that was associated with overall equilibrium was also uncertain.

Third, the role of expectations in influencing exchange market developments was increasingly apparent. These expectations related both to factors that affected the current account directly, and to developments that could have a more general effect on overall economic performance. Movements in oil prices, for example, could affect currency relationships among industrial countries depending on the relative extent to which such price changes were expected to affect their payments positions. And shifts in inflation prospects resulting, say, from wage bargaining agreements, could affect exchange rates before showing up in actual cost differentials.

Fourth, the early experience with floating appeared to be consistent with the view that relative price performance (both actual and prospective) was perhaps the most important single determinant of exchange rate developments, at least over the medium term. The countries with the best price performance (Germany and Switzerland) had consistently appreciating rates; those with the worst price performance (Italy and the United Kingdom) had experienced depreciation; and the country with the most volatile inflation (Japan) had appreciated during the period when its performance was better than average and had depreciated when its inflation rate rose above the average. (It should be noted, however, that there were also substantial movements in exchange rates that could not be related to price developments.)

c. Implications for surveillance.

If the above lessons were indeed those that could be drawn from the initial experience with a regime of floating rates, they carried the following implications for the design of surveillance principles: first, it would be hard, if not impossible, to base exchange rate principles on the concept of an agreed equilibrium exchange rate; second, instability in exchange rates was the result of instability in the surrounding economic environment; third, a major source of instability in the surrounding environment was high and volatile inflation.

For these reasons, neither the amended Article IV nor the surveillance document adopted subsequently, makes any reference to the concept of "normal" or equilibrium exchange rates. The basic philosophy of the amended Article IV is that members should follow stable domestic policies that will contribute to "orderly" economic growth and reasonable price stability. Members are not expected to take specific actions with regard to exchange rate policies, but rather to avoid manipulation and to follow policies compatible with the other undertakings of Article IV. The expectation was that the restoration of stability in the domestic economies of member countries would be the main requirement for restoring better stability in the international exchange rate system more generally.

The amended Article IV provided, in Section 3(b), for the Executive Board to adopt "specific principles for the guidance of all members" with respect to their exchange rate policies. However, the "specific principles" contained in the surveillance document go little farther than the text of the Article itself. They provide for intervention to counter "disorderly" market conditions, and enjoin countries to take account in intervention of the interests of the country issuing the intervention currency, but otherwise simply repeat the obligation to avoid manipulation.

The fact that the main principle of exchange rate policies is the need to "avoid manipulation" carries two implications that are worthy of note. The first is that, in the absence of manipulation, the pursuit of the other obligations of Article IV (namely the fostering of orderly underlying economic and financial conditions) is expected to lead to a broadly satisfactory outcome for the exchange rate. The second is that some guidance is needed to recognize manipulation.

Identifying "manipulation" occupied a considerable part of the time devoted by the Executive Board to the formulation of the Surveillance document. It was recognized early on that a wide range of economic policies affected exchange rates. However, as an early staff paper noted, ^{1/} some limitation was needed on those policies that would be considered "exchange rate policies" if the necessary focus was to be provided for the Fund's surveillance activities. Therefore, attention was directed to policies that had a rather direct impact on conditions in the foreign exchange market. (Other policies would be reviewed by the Fund under its obligation to "oversee" members' compliance with their obligations to foster orderly underlying conditions rather than as an aspect of surveillance over exchange rate policies per se).

^{1/} "Surveillance of Members' Exchange Arrangements Under the Amended Draft Article IV: A Discussion Paper," SM/76/176, 7/30/76.

It was also recognized at an early stage that policy actions that might constitute manipulation under one set of circumstances would not necessarily have a similar connotation under other circumstances. Early drafts of the surveillance document carried the implication that certain actions--e.g., prolonged one-way intervention, excessive borrowing or lending or abnormal current or capital controls--would be considered prima facie evidence of manipulation. Eventually, however, it was agreed that such developments should be no more than "pointers", to be taken into account by the Managing Director in reaching a judgment on whether the possibility of a need for discussion with a member existed. It was also agreed that in addition to the specific "pointers" that could indicate the need for discussion with a member, any behavior of the exchange rate that appeared to be unrelated to underlying economic and financial conditions could also create the basis for supplementary consultation.

In brief, the conclusion was that, while manipulation could not be defined in the abstract, it could be identified in specific cases. It was therefore envisaged that, with the accumulation of a body of experience, it would become clearer, both to the Fund and to its member countries, what constituted manipulation. This approach dictated the structure of the document that was eventually adopted. Since it was not possible to develop "specific principles for the guidance of members" that went much beyond the language of the Articles, an indication was needed as to how such guidance would evolve over time. Thus in the document the principles for the guidance of members, which are rather general, are accompanied by principles for the guidance of the Fund, which attempt to illustrate circumstances in which a dialogue about the appropriateness of exchange rate policies should occur. There is then a section on procedures which specifies how that dialogue should be conducted and concluded.

III. The Working of the Exchange Rate System Since 1977

1. The changing nature of the issues facing policymakers

The main issues that have arisen in the working of the exchange rate system over the past nine years have differed somewhat from those that were foreseen at the time the surveillance document was adopted. First, manipulation of the kind envisaged in the document has not been a serious problem. Second, although much greater price stability has been restored among the major countries, shifts in exchange rates have been substantial. Third, capital flows have proved to be larger and more volatile than could have been foreseen in 1977. And lastly, the procedure that provides for additional or special consultations (procedure V) has never been invoked, so that no "case law" has been built up that could help make members' obligations in the field of exchange rate policies more specific. Each of these features warrants some elaboration:

-Exchange rate manipulation. For much of the period since 1977, although exchange rates were certainly strongly influenced by divergences in policy mix, major industrial countries did not seek to affect conditions in the foreign exchange market directly, other than in the context of the EMS. This choice reflected a number of factors, including the belief that market forces would be effective in bringing about an appropriate exchange rate, a recognition that the resources at the disposal of private market participants were much larger than those of the authorities, the view that sterilized intervention would have only a transitory influence on market conditions, and the belief that unsterilized intervention would require an undesirable loss of control over domestic monetary conditions. Nevertheless, intervention has been felt to be useful in certain circumstances, particularly when the authorities have believed a particular pattern of rates to be sustained by artificial factors and to be unrelated to fundamental factors. Concerted intervention has occurred on a number of occasions since 1977, including November 1978, September 1984, February 1985, and most recently in the past few months following the September 1985 G-V meeting in New York. On these occasions, the intervention, being coordinated (or at least agreed) among the countries directly involved, has not involved policy conflicts and has been felt to be useful in influencing exchange rates in an appropriate direction. The substance of the new policies has been communicated to the Fund by the members concerned.

-Inflation and exchange rates. The period since the mid 1970s has also witnessed a considerable reduction in inflationary pressures in industrial countries, and a narrowing in the dispersion of inflation rates about their mean level. In 1974-76, inflation had averaged 10 percent in the industrial countries as a group, with a standard deviation of 4 1/2 percentage points about this rate. By 1984-85, the average inflation rate had fallen below 4 percent with a standard deviation of less than 3 percentage points. The convergence of inflation rates toward a lower level did not, however, bring about the expected reduction in exchange rate variability, whether exchange rate movements are measured in the short or longer term. Quarter-to-quarter movements in key exchange rate relationships were considerably greater in 1984-85 than they had been in 1975-76. Medium-term exchange rate swings have also had greater amplitude. This is particularly evident for the U.S. dollar, whose real effective exchange rate (measured as a quarterly average) fluctuated within a range of 10 percent during 1974-76, but moved by more than 50 percent during the four years to the first quarter of 1985. There have also been striking movements in the exchange rates of other major currencies. The real effective rate of the Japanese yen, for example, fell by over 25 percent between late 1978 and early 1980, and the deutschemark depreciated by a similar amount over the five years to early 1985. In both cases, the exchange rate movements were significantly larger than those that occurred in the first four years of floating.

-Capital flows. One of the reasons for these unexpectedly wide movements in key exchange rates is to be found in the growing importance of divergences in economic policy mix in creating incentives for capital flows. While it has been recognized for some time that the foreign exchange market should be viewed largely as an asset market, it was generally felt that the determinants of market participants' willingness to hold assets in different currencies would be affected by many of the same factors that influenced the evolution of current account positions. It has become clear, however, that the volume of internationally mobile capital is sufficient to finance current account imbalances that are considerably larger and more prolonged than was earlier considered possible.

-Use of supplementary consultations. The fact that "manipulation" has rarely occurred, at least in the restrictive sense envisaged in the surveillance document, has meant that the specific provisions for supplementary consultations have not been invoked. 1/ The realization that it would be difficult for the Managing Director to initiate special discussions under the surveillance decision, because it would be interpreted as overt disagreement with a member's policies, gave rise to the 1979 decision on supplemental surveillance procedures. These were intended to provide a neutral basis for discussions, by permitting consultations to take place following any exchange rate development that "may be important or may have important effects on other members." 2/

2. Weaknesses in the working of the exchange rate system

The features of the international economic environment described above have led to three kinds of development that are of concern from the point of view of the international exchange rate system. First, short-term exchange rate volatility among major currencies has created a climate of uncertainty that is felt to impede the balanced expansion of trade and investment. Second, medium-term exchange rate swings of these currencies have been associated with a balance of payments structure that cannot be considered sustainable in a longer-term context. And third, many countries with fixed exchange rates developed unsustainable current account deficits, financed by excessive borrowing from commercial sources. Such overborrowing culminated in the debt crisis when access to capital inflows was curtailed. These concerns may be considered in turn.

Short-term exchange rate volatility became much larger after the advent of generalized floating and, contrary to some expectations, has not shown any tendency to diminish with the passage of time. The average

1/ A special mission was sent to Sweden after the 1982 devaluation of the Swedish Krone, but it was decided not to use the powers of the surveillance decision as the basis for the mission.

2/ Decision No. 6026-(79-13), 1/22/79. (See Appendix.)

of daily changes in the rates of five major currencies against the U.S. dollar, which had been well under 0.1 percent during the decade of the 1960s, averaged 0.3 percent during 1974-76, and was 0.5 percent in 1983-85. A similar picture emerges when monthly rates are considered. Average movements in monthly average exchange rates were around 0.1 percent in the 1960s, 1.6 percent in 1974-76, and 2.4 percent in 1983-85. However, while this volatility undoubtedly introduces an additional degree of uncertainty into the finance of international trade, neither a priori reasoning nor empirical evidence suggests that the effects of short-term exchange rate movements on the volume of international trade have been substantial. Well-developed forward markets exist for short-term maturities in all major currencies, and the cost of purchasing forward cover in these markets (measured as the spread between bid and offer prices) remains small. It is true that forward markets are less available for the currencies of developing countries, but this cannot be attributed mainly to the volatility of rates among major currencies. With relatively few exceptions, empirical studies on the effects of short-term exchange rate volatility on trade have concluded that there is little evidence to support the contention that such effects are of major importance. ^{1/}

The same cannot be said of the longer-lasting swings in exchange rates that have also characterized the floating rate period. Such exchange rate movements, unlike the short-term volatility discussed above, last long enough to affect resource allocation decisions. They give rise to shifts in profitability that can induce major reallocation of resources between traded and nontraded goods industries. The prospect of such profitability shifts can reduce the attractiveness of capital formation (particularly in longer-lived assets). When relative costs do change, unemployment can result, as well as the other costs involved in transferring resources to new activities. Moreover, when unemployment appears to be due to the capricious behavior of the foreign exchange market, it can more easily generate pressures for protectionism. Lastly, when large exchange rate movements are associated with the buildup of unsustainable current account imbalances, uncertainty is created about when and how the eventual reversal of these imbalances will be brought about.

The third concern about the functioning of the exchange rate system relates not to variability of exchange rates in industrial countries but to the way in which developing countries have been able to use excessive

^{1/} See, IMF, "Exchange Rate Volatility and World Trade," Research Department, July 1984; Akhtar, M.A., and R.S. Hilton, "Exchange Rate Uncertainties and International Trade"; Research Paper No. 8403, Federal Reserve Bank of New York, May 1984; Gotur, Padma, "Effects of Exchange Rate Volatility on Trade: Some Further Evidence," IMF Staff Papers, September 1985, pp. 475-512.

external borrowing to delay needed balance of payments adjustment. The size of resulting imbalances financed through reliance on unsustainable capital inflows in the period leading up to 1982 meant that the loss of creditworthiness that occurred in that year had more severe consequences for the economies concerned than need otherwise have been the case. The responsibility for the crisis that emerged in 1982 must be shared by countries which over-borrowed, creditors which over-lent, and the institutional arrangements that permitted such developments to occur. In the three years 1979-81, the group of countries which later experienced debt-servicing difficulties increased their borrowing from commercial banks at an average annual rate of 24 percent. In 1984-85, their net borrowing grew at a rate of only 2 percent, and would have shrunk by a substantial amount had it not been for major packages of concerted lending under rescheduling arrangements. With the benefit of hindsight, it is possible to see that these countries were enabled to maintain unsustainable exchange rate and current account positions through excessive official borrowing--even though such borrowing was not specifically undertaken for balance of payments purposes.

3. Implications for surveillance principles

The foregoing discussion carries a number of important implications for the design of principles for the conduct of members' exchange rate policies. Six seem particularly worthy of note.

a. The absence of manipulation is a necessary, but not a sufficient, condition for the emergence of a satisfactory underlying balance of payments position. There have been few if any instances where major countries have for balance of payments purposes adopted policies that could reasonably be said to hamper the working of the adjustment process. Yet there has been considerable volatility in exchange rates, and currency values have moved to levels that are unsustainable in the longer run.

b. The restoration of domestic price stability is not in itself sufficient to restore exchange rate stability. This result is contrary to a number of expectations that were entertained at the time the surveillance document was adopted. At that time, the high level of inflation, and the prevailing uncertainty about future price trends, were considered to be the major factors behind the unexpected degree of exchange rate variability in the early years of floating. In recent years, however, the average rate of inflation has fallen dramatically, and the dispersion of price increases has narrowed, but the amplitude of exchange rate swings has increased.

c. The principal determinants of medium-term exchange rate swings in industrial countries are fluctuations in domestic saving/investment balances. These induce capital flows which in turn give rise to exchange

rate movements and generate the shift in current account positions that is the counterpart of the change in domestic saving/investment balances. Thus, if it is desired to diminish the amplitude of exchange rate movements, actions must be taken to stabilize saving/investment balances.

d. Government policies, and in particular the mix of monetary and fiscal policy, are a major determinant of shifts in national saving and investment levels. At the same time, the effectiveness of policy in promoting a conducive environment for saving and investment in the private sector can also be important. These policies have not thus far been framed with exchange rate objectives in mind, but exchange rate considerations would need to become more important if exchange rate stability is accorded greater priority as a policy objective.

e. The current principles for the guidance of members' exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability. Since the choice of policy mix through which members seek to create "orderly domestic economic and financial conditions" is left to the individual member, it is possible for divergent choices to lead to undesired exchange rate patterns. The procedures that exist for policy mixes to be discussed are useful but fall short of being a mechanism for effective reconciliation of policy objectives.

f. The role of intervention in exchange rate management is a limited one. Experience has led the major countries to the conclusion that sterilized intervention cannot have a major or lasting impact on the exchange rate determined by fundamental economic factors. ^{1/} It is recognized, however, that intervention can play a helpful role on occasions where market exchange rates appear to have diverged from the pattern implied by economic fundamentals, or when the authorities wish to communicate to the market their determination to pursue a particular policy course with respect to fundamentals.

IV. Possible Changes in the Surveillance Document

1. The objectives of surveillance in current circumstances

The fundamental objective of the Fund's activities in the field of surveillance remains the efficient operation of the international monetary system. This purpose is stated clearly at the outset of Article IV:

^{1/} See "Report of the Working Group on Exchange Market Intervention" (chaired by P. Jurgensen), January, 1983.

".... the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth...."

The language of Article IV goes on to state that a principal objective is the development of orderly underlying conditions, and requires members to collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates. All these purposes remain equally valid in today's circumstances, as do the objectives of promoting economic growth and reasonable price stability and avoiding harmful manipulation of exchange rates.

Nevertheless, it can be argued that the individual pursuit of these objectives by member countries has not been as successful as could be hoped in promoting "a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth," and has been unsuccessful in promoting a stable system of exchange rates. Exchange rate variability has created damaging uncertainties, and wide fluctuations in flows of funds between countries have required costly reallocation of resources. Moreover, the weakness of the surveillance mechanism and the way capital flows have operated helped to precipitate the debt servicing crisis from which the world economy is still recovering.

It is widely agreed that the correction of these deficiencies in the functioning of the international monetary system should be an important objective of policy. Efforts in this direction can follow two approaches (which are not mutually exclusive): (i) the guidance given to members and to the Fund itself through decisions of the Executive Board can be amended; and (ii) the manner in which guidance is implemented can be improved. Since it has been argued in this paper (and also on the occasion of previous reviews of the surveillance document) that the principles set forth in the document remain valid, any amendment to the existing language would presumably be in the direction of clarifying, extending, or making more specific the guidance given to members with respect to their exchange rate policies. Amendments could also be made so as to indicate more precisely circumstances in which the Fund would be expected to invoke the consultation procedures provided for in the document. These possibilities, which would require a change in the Executive Board's 1977 decision, are examined in the remaining part of this Section. Changes in procedures for the implementation of surveillance can to some extent be considered separately from the specific guidance given to members, and are discussed in the companion paper SM/86/4.

2. Main features of the document

Before proceeding to a discussion of the changes in the Surveillance document that could be suggested by the proposals made in the G-10 and G-24 reports, it is useful to have a clear idea of the structure and scope of the 1977 decision. The document itself contains four sections. The first, entitled "General Principles", defines the limits of the document: it underlines its objective to deal only with the topic of exchange rate policies. The second section of the document provides principles for the guidance of members. The third section sets forth principles to guide the Fund in its exercise of surveillance over members' exchange rate policies. And the fourth section provides for certain procedures to be followed, pertaining both to multilateral and to bilateral review of exchange rate policies. In addition to the provisions contained in the document, an Executive Board decision of 1979 provides for supplemental surveillance procedures, and the periodic reviews of the implementation of surveillance have led to a number of developments in practice.

3. General principles

The section of the document entitled "General Principles" defines the scope of the document as a whole. It limits the coverage of the principles and procedures to exchange rate policies, thus excluding domestic economic policies (regarding which the Fund also has oversight responsibilities under Article IV, Section 3(a)). It is recognized that there is a close relationship between domestic and international economic policies, although the language of the document does not indicate how this relationship should be taken account of by the Fund in the exercise of its surveillance responsibilities.

The key issue in connection with the General Principles is whether the surveillance that the Fund is called on to exercise over exchange rate policies should involve examination of members' compliance with the obligations covered in Section 1 of Article IV, regarding the objective of fostering stable economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The justification for such an extension would be the increasing recognition that exchange rate movements that cause international concern are more often the unintended result of divergences and inadequacies in domestic policies rather than the deliberate consequences of policies aimed at influencing conditions in the foreign exchange market. It is clear from Article IV, Section 1, that members have obligations in the field of domestic economic policies, in particular, the obligation of seeking to promote stability by fostering orderly underlying economic and financial conditions. Under Article IV, Section 3(a), the Fund has a duty to oversee the international monetary system in order to ensure its effective operation, and to oversee the compliance of each member with its obligations under Section 1. Of course,

the Articles do not give the Fund powers of surveillance in areas where members' policies do not affect the interest of other members. Judgment is therefore necessary in deciding where the line should be drawn. Nevertheless, the experience of recent years is abundantly clear: domestic policies and their international interaction do have an impact on exchange rates and on the stability of the system. To be effective, surveillance must be extended to all policies having such effects.

4. Principles for the guidance of members' exchange rate policies

The section "Principles for the Guidance of Members' Exchange Rates Policies" contains three principles. Two relate to short-term intervention to counter disorderly market conditions and, being uncontroversial, are not considered further here. The other guidance provided is a repetition of the obligation, in Article IV, to avoid manipulation of exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members. The rather general nature of this language has the advantage of flexibility, since it permits judgment to be exercised according to the circumstances of individual cases. It has the drawback, however, of providing relatively little concrete guidance, and permitting conflicting interpretations. As events have shown, such guidance has not in practice prevented the emergence of exchange rate swings that have created international concerns. If it were felt desirable to introduce more specific guidance, the possible approaches would fall under three main headings:

a. Members could be encouraged to establish limits to the zone of fluctuations for their currency, and to undertake certain actions, or at least to consult, as the value of their currency moved outside the zone.

b. Members could be encouraged to establish limits on the development of certain domestic policy variables which, together with guidance covering intervention in the foreign exchange market, would be presumed to help establish a "sustainable" exchange rate.

c. The kind of behavior that constitutes manipulation, and that is therefore proscribed, could be more precisely and meaningfully defined. Such a definition would presumably extend beyond actions narrowly directed at the exchange market.

If none of these approaches were to meet with favor, a fourth approach would be to retain the present rather general guidelines, and to focus on procedural mechanisms for improving policy formulation and coordination.

Each of the suggestions just noted can be found, explicitly or implicitly, in either the G-10 or the G-24 Report. The G-24 Report favors target zones for the major currencies on the grounds that it would help

achieve the objective of exchange rate stability and sustainable levels of payments balances. The G-10 Report, by contrast, opposes the establishment of a target zone system (with some Deputies dissenting). The principal reasons given are that it would prove extremely difficult in practice to reach a consensus on the range of desirable exchange rates, that market behavior that was inconsistent with zones would add to instability, and that the constraints imposed by zones on domestic policies might undermine efforts to pursue sound and stable policies in the medium term.

The theoretical and practical aspects of the target zone proposal are discussed in some detail in the staff's paper on that subject (SM/86/4). The adoption of some variant of this proposal as the basis for the operation of the exchange rate system would have clear implications for the principles and implementation of Fund surveillance over exchange rate policies. Among the issues that would need to be decided are the following: (i) Should the adoption of target zones be mandatory or optional? (Mandatory target zones would of course require amendment of the Articles, since the existing Articles give members freedom, subject to certain limitations, to maintain exchange arrangements of their choice); (ii) In what forum would a multilateral grid of rates or zones for the largest currencies be decided?; (iii) How wide should target zones be? (iv) What procedures should be applied for changing target zones? (v) What undertakings ^{1/} would countries make with respect to zones? (Should they undertake to act to prevent their currencies moving outside the zone or simply to consult with respect to the reasons for the departure?). (vi) Should target zones be publicly announced or rather used as a basis for confidential discussions among the countries concerned?

The issue of undertakings with respect to target zones raises a further series of questions concerning the nature of the guidance to be given, through surveillance principles, to members and to the Fund. For example, if it were felt that members should act to prevent currencies moving outside target zones (or to limit the extent of such a movement) should the principles for the guidance of members' policies specify the type of policies that can be employed for this purpose? This could be done with varying degrees of precision. At one extreme, there could be an undertaking analogous to that of the Bretton Woods system to intervene in exchange markets to prevent any departure from the established zones. Then, if countries wished to avoid undesired monetary consequences from such interventions, they would have to take steps to ensure that other economic policy instruments were deployed in a manner consistent with the commitment to the exchange rate zone. Alternatively, the guidance given to countries could be somewhat looser, involving either encouragement to take action that would move the currency back inside the zone, or to

^{1/} In what follows, the word "undertaking" is used in its general, rather than in its specific legal, sense.

abstain from actions of a kind that would lead to a further departure. Even more loosely, the undertaking could simply be one of consulting with the Fund, which would then raise questions concerning how such consultation would proceed, and how disagreements would be resolved. These questions would have to be dealt with under the section of the surveillance document that deals with procedures (see below).

The possibility of establishing indicators covering domestic policy performance is mentioned in the G-10 Report. This proposal has at its base the view that undesirable exchange rate variability is mainly the result of inappropriate domestic policies, and that any attempt to promote more stable exchange rates should focus directly on national policy formation. There has been relatively little discussion, in either official or academic circles, of what form such "domestic policy-oriented targets" might take. ^{1/} Questions exist concerning (i) whether such targets should be expressed in terms of policy outcomes or policy instruments; (ii) how wide a range of policy outcomes or instruments should be subject to targets; (iii) how such policies might be quantified; (iii) how agreement could be reached on appropriate targets or zones; and (iv) what action would be called for in the event that the target zones were not adhered to.

Despite the importance of promoting satisfactory and convergent economic performance, there are some practical difficulties in basing surveillance on undertakings with respect to economic outcomes (such as, for example, economic growth or the rate of inflation). Economic outcomes can certainly be influenced by the authorities through the setting of policy instruments, but they are also subject to unexpected exogenous developments. From a practical viewpoint, therefore, there would be advantages in confining domestic economic targets to the setting of policy instruments. The key issue is which instruments should be subject to such control. It seems clear that the aggregate stance of domestic fiscal and monetary policies is an important element in overall economic and financial policies, and therefore should be a part of any such targets that are arrived at. However, it could also be argued that structural policies are important in creating exchange rate movements. Countries that are unsuccessful in removing structural rigidities are likely to experience difficulties in preventing capital outflows, and thus may experience a depreciation in the value of their currency relative to that of countries where superior economic performance tends to attract capital inflows.

When it comes to quantifying domestic macroeconomic policies, the most widely used indicators are some measure of growth in the domestic money supply, and an indicator of the size of the government's fiscal

^{1/} For a discussion of these issues, see "Review and Assessment of the System of Floating Exchange Rates," SM/86/5, 1/10/86.

deficit. Judgment would have to be exercised, however, in picking a precise measure for these variables. Most of the large industrial countries use several different measures of the money supply as a means of monitoring the evolution of monetary policy. These measures can move in a somewhat different manner, particularly over short periods. Moreover, the behavior of the demand for money, and thus the appropriate path for the money stock, can be influenced by developments such as financial innovation and changes in the regulatory environment. For these reasons, several major countries have adopted an eclectic approach to the assessment of monetary conditions, involving attention to a variety of financial indicators. With regard to fiscal policy, there is a similar variety of possible indicators. The fiscal deficit or surplus can be measured at the central or general government level, and can be left unadjusted, or adjusted for cyclical factors. There is also the possibility of adjustment for other factors of a systematic nature (e.g., inflation) or of a more ad hoc nature (e.g., large non-recurring transactions). Lastly, other types of fiscal indicator could include the level of government expenditure, and the level and incidence of taxation. The variety of possible measures of the fiscal and monetary stance complicates the task of developing meaningful and comparable indicators of domestic policy stance, but it does not make it impossible, provided adequate flexibility is employed in expressing objectives with respect to these policies. For example, zones rather than specific targets could be established, or undertakings could be expressed in terms of the avoidance of large (or sudden, or disruptive) changes in the chosen measure.

With regard to the issue of how to give operational content to domestic policy undertakings, several possibilities exist. Members could be called upon to set out quantified objectives for monetary and fiscal policies for a given period ahead. This could occur at the time of an Article IV consultation and be subject to review by (or the concurrence of) the Executive Board. Deviations from expressed objectives, as endorsed by the Board, could then be a trigger for a review by the Board of the circumstances in which the deviation had occurred. An alternative would be to express countries' undertakings more loosely as being to avoid sudden disruptive shifts in monetary and fiscal policies, or to formulate such policies so as to promote the efficient working of the adjustment process. The Fund would then have to exercise judgment, during Article IV consultations and at other times, about whether actual policies were consistent with the guidance that had been given.

In assessing what consequences should follow from any departure from the expressed objectives of monetary and fiscal policies, it would have to be recognized that deviations from targets could occur for a variety of reasons. For example, an unexpected shift in velocity could render a previously existing money supply target unrealistic. In the field of

fiscal policy, a target for the central government borrowing requirement might be missed because of unexpected weakness (or strength) in economic activity. Given the variety of circumstances which could cause a deviation from domestic policy targets, it would not be wise to prescribe too closely the response called for in such circumstances. One possibility would be to simply provide for consultation with the Fund. This would permit the country concerned to explain its perception of the causes of the developments that had occurred, and other countries to express concerns they might feel; it would not bind the member to any particular course of action. Another possibility would be to call upon the member not to undertake discretionary action that would cause a further deviation of the policy instrument from its target until consultation with (and/or the concurrence of) the Fund had occurred.

Clearly, the development of principles based on guidance with respect to members' domestic policies raises a large number of practical issues that cannot be developed in detail in a short space. In order to adequately explore how such issues could be resolved, it would be necessary to evolve precise language and to discuss in depth the implications of such language. It would not seem fruitful to do this, however, unless Executive Directors gave indications that some likelihood existed that such an approach could provide the basis for useful progress.

The third broad approach, noted above, to changing the "Principles for Guidance of Members' Exchange Rate Policies," is to introduce greater specificity into the description of policies that are to be avoided. This approach had been attempted in the early stages of drafting the 1977 document, when it was suggested that certain kinds of foreign exchange market actions, such as large-scale direct intervention, official borrowing or lending, or the use of controls, could create a presumption that "manipulation" was occurring. ^{1/} In the event, this approach did not meet with favor, as it was felt that the kinds of actions described could be desirable in certain circumstances and it would not be justified to create any presumption about their appropriateness. It was seen, furthermore, as involving an element of discriminatory treatment, as countries with floating exchange rates were less likely to find themselves intervening in exchange markets than countries with fixed rates.

Now that more experience has been gained with the operation of the current exchange rate system, it is possible to identify certain types of policy that have led to difficulties in the operation of the adjustment process. For example, divergences in fiscal/monetary mix among major industrial countries have led to patterns of exchange rates and current

^{1/} "Surveillance of Members' Exchange Rate Policies under the Amended Draft Article IV: A Discussion Paper," SM/76/176, 7/30/76.

account balances that could not be considered sustainable over the longer term. And heavy borrowing by a number of developing countries in the period up to 1982 led to a crisis situation when less favorable prospects for export market growth and the future course of real interest rates caused a reappraisal of creditworthiness. In both cases, problems arose because capital flows were allowed or encouraged to continue to a point where they affected adversely the efficient working of the adjustment process. It would be possible for the "Principles for the Guidance of Members...." to include provisions encouraging countries to avoid policies that led to such results. Such provisions could be couched with varying degrees of specificity. If it were difficult to reach agreement on the precise nature of policy actions to be avoided, it could be provided that members should avoid measures that were inconsistent with the goal of promoting balance of payments adjustment in the medium term. This would require judgments to be reached concerning the type of policies needed for effective adjustment, which could perhaps be adapted from appraisals made during the course of Article IV consultations.

5. Principles of Fund surveillance over exchange rate policies

This section of the document is a list of developments "which might indicate the need for discussion with a member." As noted earlier, the section evolved out of an attempt to develop a list that would create the presumption of manipulation; the hesitant tone of the language eventually agreed reflects the wish of the Board not to create such a presumption in the finally-agreed wording. Nevertheless, the purpose of the section is to give some guidance to the Fund in how to judge whether a member has (or might have) acted inconsistently with the guidance provided in the previous section.

The first such indicator is protracted large-scale exchange market intervention in one direction. The next three indicators are the use, for balance of payments purposes, of current or capital controls, external borrowing and lending, or monetary and other financial policies. The last indicator is "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions..."

A first issue in relation to the continuing appropriateness of these indicators is whether it remains sufficient to limit the indicators described to actions undertaken "for balance of payments purposes." The section does state, in a later paragraph, that any appraisal by the Fund should take place within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and should recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. Nevertheless, the deletion of the proviso "for balance of payments purposes" from some of the policy developments listed in the section could help broaden the scope

of the Fund's responsibility. For example, large-scale official borrowing by heavily indebted countries contributed to the subsequent emergence of the debt crisis, but it could be argued that such borrowing was not specifically undertaken "for balance of payments purposes." Equally, the large capital flows among industrial countries that produced large exchange rate movements resulted from policies that were not primarily oriented to balance of payments objectives. The fact that inappropriate policies are not undertaken specifically for balance of payments purposes does not, of course, prevent the Fund from expressing its views on them during the course of the consultation process.

A second issue relates to the possibility of extending the list of indicators, or making it more precise. Since, as noted above, unsustainable capital flows have been a major source of subsequent difficulties in the international economic system, the emergence of such flows could be used as an additional explicit indicator of the need for special consultations. Other possible additions to the list of indicators would depend, to a considerable extent, on the outcome of decisions with respect to the principles for the guidance of members' policies. The Managing Director should presumably be directed to initiate discussions in circumstances where principles established for members' policies have not been observed.

A final issue covers the degree of judgment to be exercised by the the Managing Director in initiating discussions under the surveillance decision. Since the exchange rate developments listed under the "Principles of Fund Surveillance" are not defined precisely, and in any event are only to be considered as indicators, considerable judgment remains with the Managing Director, although he is required to "[take] into account any views that may have been expressed by other members." One consequence of this is that the formal procedures (see below) for initiating a special consultation under Article IV, Section 3b, have never been invoked (although informal contacts have been held on a number of occasions). A rather more more specific set of guidelines for Fund action would make the surveillance somewhat more automatic.

6. Procedures

Surveillance procedures of different kinds are provided for in the 1977 document, and in subsequent decisions of the Executive Board.

(i) The 1977 document provides for "regular" consultations between the Fund and member countries under Article IV. These consultations are to include both the observance by members of specific principles with respect to exchange rate policies, and obligations under Article IV, Section 1.

(ii) The document provides for the continuation of periodic review of exchange rate developments within the framework of the World Economic Outlook exercise.

(iii) The document provides for special procedures to be invoked if the Managing Director believes, in the interval between Article IV consultations, a member's policies may not be in accord with the exchange rate principles.

(iv) A decision on supplemental surveillance procedures, adopted in January 1979, provides for consultations to take place in certain circumstances where important exchange rate developments have occurred, but no presumption exists that the exchange rate principles have not been observed.

(v) Beginning in 1983 (Decision No. 7374 (83/55), 3/28/83) the staff has provided Quarterly Reports on indicators of real effective exchange rates and has issued "Information Notices" when the real effective exchange rate for an individual currency moves by more than 10 percent from the date of the last consultation.

A number of the procedural proposals made in the G-10 and G-24 reports relate to the way in which the procedures just described are implemented. As such, their adoption would not require any change in the basic surveillance document. These proposals are discussed at more length in the companion paper which reviews the implementation of surveillance (SM/86/4). Other proposals would, however, require changes, either in the text of the procedures section of the 1977 surveillance document, or in the 1979 decision establishing the supplemental surveillance procedure.

Perhaps the key aspect of any modification to existing decisions concerns the degree of discretion the Managing Director is called upon to exercise in invoking specific consultations. It can be argued that such discretion provides for a desirable element of judgment in the assessment of whether a particular exchange rate development requires further investigation. On the other hand, experience suggests that the Managing Director may find it invidious to single out countries for special discussions, and thus special or supplemental consultations at the level of the Executive Board may not take place. The G-10 deputies noted that "it could be helpful if the IMF made greater use of supplemental surveillance procedures" and the G-24 report made a similar suggestion in almost identical language.

The adoption of target zones for exchange rates, or "indicators" for domestic policy variables, would provide an automatic trigger for the review of a member's policies by the Fund. The procedural issues that would arise would be those related to how to proceed once such a review had been set in train. Specifically, should the exercise of "peer pressure" during the review process, as suggested by the G-10, be the main sanction at the disposal of the Fund, or should other steps be envisaged? Additional steps could involve, for example, a finding by the Fund that a member's policies were inconsistent with the guidance given under the surveillance decision.

If target zones or policy indicators were not in existence, other means would have to be sought to trigger a review by the Fund of a member's policies. It might be possible to specify that, when a member's policies departed from those found by the Executive Board to be appropriate on the occasion of the last Article IV consultation, as expressed in the Chairman's summing up, the Managing Director should be required to bring such a departure to the attention of the Executive Board, either through an information notice, or through the tabling of a paper for the agenda. An alternative would be to retain the present system of information notices (perhaps with a different threshold of exchange rate movement) and to provide for more automatic discussion. For example, the staff could be required to make an appraisal in each information notice of whether the exchange rate change described in it was of a kind likely to promote the working of the adjustment process. Where such a statement could not be made on the basis of the information available to the staff, it could be provided that a Board meeting would automatically ensue. Care would need to be taken, however, to avoid a proliferation of meetings on exchange rate developments of marginal significance.

Another aspect in which it might be necessary to modify the existing language of the surveillance decision concerns the role of the World Economic Outlook (WEO) exercise. The desire expressed in both Reports that the WEO should pay more explicit attention to international interactions of policies can be accommodated within the framework of the existing decision. However, if, as suggested by the G-24 report, the WEO is to serve as background for multilateral consultations about a mutually consistent set of objectives and policies for major countries, and if such consultations were to lead to specific objectives being developed for individual member countries, this would constitute a widening of the WEO's current role. Such a widening could be given explicit backing in the procedures section of the surveillance document.

V. Future Program of Work and Issues for Discussion

1. Future program of work

A possible strategy for considering issues related to surveillance would involve three stages:

(i) A discussion of the present paper, together with the accompanying paper on procedures, in the Executive Board, with Executive Directors giving preliminary views on the substantive questions raised.

(ii) A report to the Interim Committee that identified the central issues on which guidance from the Committee was needed.

(iii) On the basis of such guidance, the preparation of draft language that would be considered by the Board in the period leading up to the 1986 Annual Meeting.

(Depending on the complexity of the issues remaining to be resolved after Stages (i) and (ii), Stage (iii) might be more protracted, and might involve the need for further guidance from the Interim Committee.)

2. Issues for discussion

As a guide to Executive Directors in structuring their interventions, this section identifies the broad areas in which it would be useful to have views at the present stage.

(i) General strategy - Does the broad approach to consideration of the topic, as outlined immediately above, seem appropriate?

(ii) "General principles" of surveillance - Would it be desirable to revise the language of this section so that exchange rate surveillance applies clearly to all policies having significant effects on other members, rather than, as at present, only to policies deemed to be "exchange rate policies"?

(iii) Principles for the guidance of members' exchange rate policies - Directors may care to comment on which of the three broad approaches to revising this section offers the best prospect of progress. The three approaches, described in more detail in Section IV above, are

(a) Defining the guidance given to members in terms of seeking to observe some exchange rate target or zone.

(b) Defining guidance in terms of observing quantitative or qualitative objectives for domestic policy instruments.

(c) Defining guidance in terms of actions to be avoided, but introducing more specific language than simply the avoidance of manipulation.

A fourth option would be to leave the guidance to members essentially unchanged, and to focus on other ways of enhancing the implementation of surveillance.

(iv) Principles of Fund surveillance over exchange rate policies - Should the indicators used to trigger consultations extend to policies that are not necessarily adopted "for balance of payments purposes"? Should the list of indicators extend to domestic policies, and should the indicators be made more specific?

(v) Procedures for surveillance - Should the procedures for initiating special or supplemental surveillance consultations be made more automatic and less dependent on the exercise of judgment by the Managing Director?

The above questions are among those that emerge from the analysis presented in this paper. It is recognized, however, that they are not necessarily comprehensive, and that Directors may wish to raise other issues, or use a different framework for discussing the questions involved.

As specified in Decision No. 7645-(84/40) taken March 12, 1984, the biennial review of the document "Surveillance Over Exchange Rate Policies" is to be conducted not later than April 1, 1986. Draft decisions will be proposed for adoption following Board consideration of the present paper and the companion paper on the annual review of the implementation of surveillance. Such decisions are necessary to complete the two concurrent reviews by April 1, 1986. Also, these draft decisions will identify matters for consideration at a later date.

Executive Board Decision No. 5392-(77/63), April 29, 1977

SURVEILLANCE OVER EXCHANGE RATE POLICIES

1. The Executive Board has discussed the implementation of Article IV of the proposed Second Amendment of the Articles of Agreement and has approved the attached document entitled "Surveillance over Exchange Rate Policies." The Fund shall act in accordance with this document when the Second Amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled "Surveillance over Exchange Rate Policies" at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

Attachment

Surveillance over Exchange Rate Policies

General Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the Fund in order to perform its

functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: "Recognizing . . . that a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Member's Exchange Rate Policies

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly condition which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;

- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or
- (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and
- (v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

Procedures for Surveillance

I. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

III. Board developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

IV. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

SURVEILLANCE PROCEDURES

1. Review The Executive Board has reviewed the procedures relating to the Fund's surveillance over members' exchange rate policies. These procedures, and the procedures for regular consultations under Article IV, will be reviewed again by the Executive Board in December 1979. The Executive Board will review the document "Surveillance over Exchange Rate Policies" at an appropriate time not later than April 1, 1980, as provided for in paragraph 2 of Decision No. 5392-(77/63), adopted April 29, 1977 . . .

2.*

3. Supplemental surveillance procedure . . . Whenever the Managing Director considers that a modification in a member's exchange arrangement or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members, whatever the member's exchange arrangement may be, he shall initiate informally and confidentially a discussion with the member before the next regular discussion under Article IV. If he considers after this prior discussion that the matter is of importance, he shall initiate and conduct an ad hoc consultation with the member and shall report to the Executive Board, or informally advise the Executive Directors, on the consultation as promptly as the circumstances permit after conclusion of the consultation. This procedure will supplement the proceedings in Executive Board Decision No. 5392-(77/63), adopted April 29, 1977.

Decision No. 6026-(79/13)

January 22, 1979

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

**FOR
AGENDA**

SM/86/4

CONTAINS CONFIDENTIAL
INFORMATION

January 10, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Surveillance over Exchange Rate Policies - Annual Review of
Surveillance and Review of Proposals for Changes in Procedures

The attached paper provides background for discussion of the various proposals for changes in the procedures of surveillance and also provides the basis for the annual review of the implementation of surveillance.

This paper, together with the paper on surveillance over exchange rate policies - biennial review of the 1977 document (SM/86/3, 1/10/86) has been scheduled for Executive Board discussion on Wednesday, February 19, 1986.

Mr. Belanger (ext. 8671) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Surveillance Over Exchange Rate Policies - Annual Review
of Surveillance and Review of Proposals
for Changes in Procedures

Prepared by the Research Department and the
Exchange and Trade Relations Department

(In consultation with other departments)

Approved by Wm. C. Hood and C. David Finch

January 9, 1986

<u>Contents</u>	<u>Page</u>
I. Introduction	1
II. Background	2
III. Implementation of Surveillance Procedures	3
1. Formal procedures	3
2. Evolution of the implementation of procedures	4
a. World Economic Outlook	4
b. Article IV consultations	5
c. Information notice system	7
3. Implementation of procedures in 1985	8
4. Issues related to the frequency of consultations	9
IV. Proposals for Changes in Procedures	11
1. Proposals related to the analytical basis of surveillance	13
2. Proposals related to the multilateral setting of surveillance	16
3. Proposals related to strengthening the influence of the consultation process	19
V. Summary of Main Issues	22
 <u>Text Table</u>	
1. Summary of G-10/G-24 Proposals to Enhance Surveillance Procedures	12

I. Introduction

Several proposals have been made recently, notably in the reports of the G-10 and G-24 Deputies, 1/ to enhance the effectiveness of surveillance. Some of these proposals, in particular those involving target zones and the use of objective indicators, are discussed extensively in the companion papers "Review and Assessment of the System of Floating Exchange Rates" (SM/86/5, 1/10/86); "Target Zones" (SM/86/6, 1/10/86); and "Surveillance Over Exchange Rate Policies - Biennial Review of 1977 Document" (SM/86/3, 1/10/86). This paper provides background for a discussion of the various other proposals for changes in the procedures of surveillance and also provides the basis for the annual review of the implementation of surveillance. Detailed factual information on the implementation of surveillance in 1985 is presented in a separate background paper. 2/

Some of the proposals made by the G-10 and G-24 Deputies are less procedural (in a narrow sense) than substantive, in particular those dealing with the content or focus of surveillance, and those dealing with the enhancement of the multilateral setting of surveillance. In considering these proposals for changes in surveillance procedures, it is useful to review first the motivation which underlay such proposals, including developments in the international economy and in the perception of the functioning of the international financial system since the adoption of the document "Surveillance Over Exchange Rate Policies" 3/ in 1977. This is done briefly in Section II, drawing from the broader review and assessment of the functioning of the international financial system in companion papers and highlighting the implications for the implementation of surveillance procedures.

Section III reviews the formal surveillance procedures and the evolution in their implementation since 1977. A brief overview of the implementation of surveillance procedures in 1985 is included. Issues related to the frequency of consultations, which have been raised by some Directors on several occasions in recent years, are also discussed.

1/ "The Functioning of the International Monetary System, A Report to the (G-10) Ministers and Governors by the Group of Deputies," June 1985, circulated as EBD/85/154, Supp. 1 (6/21/85); and "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," 8/21/85, circulated as EBD/85/228, (8/30/85).

2/ "Surveillance Over Exchange Rate Policies--Annual Review: Background Material" (SM/86/4, Supp. 1).

3/ Executive Board Decision No. 5392-(77/63) adopted April 29, 1977, Selected Decisions of the International Monetary Fund and Selected Documents, Eleventh Issue, pp. 10-14.

The more recent proposals for changes in the procedures of surveillance in the reports of the G-10 and G-24 Deputies are discussed in Section IV against the background of the examination of possible changes in the surveillance document, 1/ earlier considerations of proposed changes in procedures by Executive Directors and current practices. The main issues addressed in this paper are summarized in Section V.

II. Background

As discussed in the companion papers reviewing the experience with floating exchange rates and the surveillance document, the major surveillance objectives of promoting orderly underlying economic and financial conditions and a stable system of exchange rates require that, in assessing developments in members' exchange rates, close attention be paid not only to external but also to domestic economic and financial policies. For example, two critical areas of strain in the international economy in recent years have been the emergence of widespread debt servicing difficulties since mid-1982 and of a large and growing U.S. current account deficit. In both cases, policies adopted not for balance of payments purposes but primarily for domestic reasons underlay the build-up of substantial imbalances financed by international capital flows. In both cases, as well, the maintenance of such policies for an extended period greatly increased the eventual cost of adjustment.

These recent experiences have shown that the integration of capital markets and the increased availability of capital from commercial sources have made it possible for inappropriate policies to be pursued for an extended period. Capital flows have permitted countries (developing countries now facing severe debt servicing difficulties as well as some industrial countries) to finance excessive budget deficits for an extended period with a limited impact on domestic interest rates, thus deferring at least part of the domestic cost of such policies. The eventual increase in debt service and/or the curtailment of capital flows resulted in widespread and severe debt servicing difficulties. Also, continuing fiscal imbalances coupled with tighter monetary policies aimed at reducing inflation have contributed to the emergence and persistence of sharply higher real interest rates on world capital markets. 2/ Such pronounced swings in real interest rates, which contributed at times to excessive borrowing, brought sharply into focus the vulnerability of net debtors to sudden changes in the availability and cost of capital. In some cases, external payments positions which

1/ As discussed in "Surveillance Over Exchange Rate Policies - Biennial Review of 1977 Document," op. cit.

2/ As noted in the World Economic Outlook, April 1985, "there is no fully satisfactory explanation for the behavior of interest rates ..., although ... monetary and fiscal policies ... were undoubtedly important factors" (p. 31). Several other considerations were examined, in particular in Supplementary Note 2.

could be financed when real interest rates were low or negative became unsustainable in circumstances characterized by high real rates.

The key lessons in this experience for the implementation of surveillance are: (i) the importance of focusing at an early stage not only on a country's overall balance of payments position but also on the sustainability of the structure of the balance of payments; (ii) against this background, the importance of paying particular attention in assessing developments in members' exchange rates to the broad range of members' domestic economic and financial policies as well as external policies; and (iii) the sensitivity of some countries' positions to conditions created in the world economy by other members' policies. All of this points to the need to strengthen the exercise and influence of surveillance.

III. Implementation of Surveillance Procedures

1. Formal procedures

The formal procedures for surveillance specified in the basic document include several components. These comprise the initial notification of members' exchange arrangements and of changes in such arrangements; regular consultations under Article IV; special discussions with members which may be initiated by the Managing Director; Executive Board reviews of broad developments in exchange rates, e.g., those coming within the purview of the World Economic Outlook (WEO) and other special assessments; and Board review of important exchange policy measures.

The general objective of these procedural arrangements was to ensure that the Fund exercised firm surveillance over the compliance of all members with the principles developed for the guidance of exchange rate policies. Since it was recognized that it would not be possible in practice for the principles guiding exchange rate policies to be very detailed, combining a broad form of guidance with a reasonably flexible and discretionary set of procedures appeared to offer the best prospect for a workable system of surveillance over exchange rate policies.

The design of these procedures was based primarily on those in existence prior to the adoption of the Second Amendment, providing for periodic consultations with each member (similar to the previous regular consultations under Article VIII and Article XIV) and for additional consultations and reviews if, in the period between consultations, "the member's policies were thought to be in conflict with the principles." In addition to annual consultations with each member individually, discussions in the multilateral framework of the World Economic Outlook exercises provided the opportunity to deal with important exchange rate developments, especially for major currencies, at shorter intervals.

Extensive discussions preceded the adoption of these procedures and led to several changes in the formulation of the proposed components. One important change concerned the formulation of the procedure for additional special consultations (Procedure V) which the staff had originally proposed be linked to developments in indicators of real effective exchange rates, establishing an automatic counterpart to the requirement before the Second Amendment to consult before making a change in the level of the exchange rate. ^{1/} In the end, however, it was thought that specific quantitative triggers would not be appropriate because such triggers might not adequately reflect the wide spectrum of policies and developments that might indicate the need for a special consultation.

Except for the adoption of the supplemental surveillance procedure in 1979, no changes have been made to the formal surveillance procedures. The supplemental procedure adopted by the Executive Board in January 1979 (Decision No. 6026-(79/13), 1/22/79) authorized the Managing Director to initiate informal and confidential discussions with a member if he considered that a modification in the member's exchange arrangements or exchange rate policies or the behavior of the exchange rate might be important or might have important effects on other members. If, after prior discussion with the member, he considered that the matter was of importance, he was to initiate an ad hoc consultation. This procedure, which was modeled on the procedure followed when the United States informed the Fund of important exchange policy measures in late 1978, ^{2/} was intended to permit the Fund to look into exchange rate developments or situations of importance without the presumption that the member in question had not complied with its obligations under Article IV.

2. Evolution of the implementation of procedures

Although the formal surveillance procedures have remained unchanged since their adoption in 1977, there has been considerable evolution in their implementation. Major elements of this evolution have included, in particular, changes in the content of both the World Economic Outlook exercise and staff reports for Article IV consultations, in the frequency of consultations, and in the monitoring of policies and developments during the interval between consultations.

a. World Economic Outlook

As envisaged in the Procedures, the World Economic Outlook has increasingly provided the basic analytical framework for the Fund's review of the world economy and the exchange rate system, and thus for the assessment of the exchange rate policies of individual members in a multilateral context. A major advance was made with the April 1982

^{1/} "Surveillance over Exchange Rate Policies" SM/76/235, (12/21/76).

^{2/} EBD/78/241 (11/1/78) and EBS/78/657 (12/1/78).

Board discussion of the World Economic Outlook, which gave particular attention, on the basis of the staff's "Main Issues" paper (ID/82/1, 3/29/82), to policies and developments in the major industrial countries and the interactions among them. The approach adopted allowed special focus to be placed on the policy aims or actions of major countries. Since then, this type of analysis has become a key element of each World Economic Outlook exercise. The timing of World Economic Outlook discussions before the spring and fall meetings of the Interim Committee has provided the basic framework for the consideration by the Committee of economic developments and policies. 1/

Another important procedural change in the World Economic Outlook exercise has been the preparation and presentation of medium-term scenarios, providing the basis for a discussion of the global debt problem and, more generally, for a systematic assessment of the medium-term implications of a number of policy strategies in the various groups of Fund members. Successive World Economic Outlook reports have also devoted increasing attention to the sensitivity of the medium-term scenarios to changes in assumptions.

b. Article IV consultations

Several changes have also been introduced, in particular in recent years, in the conduct of Article IV consultations. The formal procedures specify that the consultations should in principle take place annually. In practice, it has not proven possible to meet this target. During the first few years following the adoption of the Second Amendment, a lower target was adopted for operational purposes of completing consultations with approximately 75 percent of members annually, while maintaining annual consultations with major countries and with countries that had Fund-supported programs. However, even this lower target was not achieved as the proportion of members with which consultations were completed fell from 77 percent in 1979 to 60 percent in 1981-82, although, in many cases, discussions for use of Fund resources or informal contacts allowed for continuity of discussions. The number of countries with which no consultation had been held for 24 months or more increased sharply during the same period, from 3 in 1979 to 19 in 1982.

With the emergence of severe debt servicing difficulties in 1982, it was recognized that a determined effort needed to be made to ensure more regular scheduling of Article IV consultations. The criteria for strict adherence to an annual interval between consultations for certain

1/ In addition, following Board discussion on the occasion of the 1980 annual review of surveillance, publication of the World Economic Outlook has contributed to a fuller and more public reporting on the Fund's surveillance activities. Also, a more complete description of the implementation of surveillance and related issues has been included in the Annual Report, since the 1980 issue.

members were reaffirmed, i.e., economies having a substantial impact on other countries, members with Fund-supported programs, and situations where there are substantial doubts about medium-term viability. 1/ For members for which strict adherence to annual consultation cycles was not considered necessary, a permissible outer limit between consultations of two years was agreed. In order to promote stricter adherence to the consultation guidelines, the practice was adopted of specifying at the conclusion of each consultation the final date by which the next consultation with the member was expected to be concluded. The procedure was also adopted of preparing periodic reports for the Board on the status of members with respect to the observance of the consultation schedule and with an indication of any problems that might have been encountered. 2/ Following these modifications, there has been a sharp increase in the number of consultations concluded each year (see below).

The evolving nature of the consultation process has also been reflected both in the focus of Executive Directors' discussions in concluding consultations with individual members and in the content of staff reports. Major elements of this evolution have been the increased attention and sharper focus on exchange rate policies, the coverage of multilateral issues and the greater emphasis on the medium-term impact of members' policies. While it was recognized at the time of the adoption of the formal procedures for surveillance that additional emphasis would have to be given in staff reports to members' exchange rate policies, progress in this area was gradual. Initially, as reported in the 1978 review of the implementation of surveillance, only about one half of the reports referred to changes in effective exchange rates and very few presented information and analysis of changes in real effective rates. 3/ Since then, however, analysis of real effective exchange rates or other indicators of competitiveness has increased sharply. At present, most staff reports include quantified indicators of the evolution of competitiveness.

Another evolving aspect of the focus on exchange rate issues has been the more explicit assessment by staff and Executive Directors of the appropriateness of members' exchange rate policies. Initially, a rather cautious approach was adopted to the presentation of views on exchange rate matters in the consultation reports. In some cases, however, this cautious approach kept the scope and substance of the reports less forthcoming than would have been appropriate. During the course of successive annual reviews, while Directors encouraged continued care in the assessment of the sensitive subject of exchange rate policies, a more forthright treatment of the issue was considered

1/ "Chairman's Summing Up at the Conclusion of the Annual Review of the Implementation of Surveillance," EBM/83/55, 3/28/83, p. 3.

2/ SM/83/210 (10/21/83), SM/84/227 (10/15/84), and SM/85/249 (8/28/85).

3/ "Annual Review of Regular Consultations and Other Issues Related to Article IV," SM/78/287 (12/11/78), p. 15.

desirable, especially in cases of inappropriate exchange rate policies or the existence of an unrealistic value of the exchange rate. ^{1/} Also on occasion, more forthright statements on these issues were included in the Chairman's Summing Up of the Board discussion concluding the consultation with individual members than in the staff appraisal, reflecting the more explicitly stated views of the Board. In recent years, most staff appraisals have included an explicit evaluation of exchange rate policies.

Other improvements in the content of staff reports have related to the expanded coverage of both policy and technical issues. In recent years, structural adjustment, fiscal policy, external indebtedness, and trade matters have increasingly been the focus of attention. The coverage of these issues in staff reports, the analytical basis of staff assessments and the nature of policy recommendations in staff reports for Article IV consultations concluded in 1985 are reviewed in detail in "Surveillance Over Exchange Rate Policies--Annual Review: Background Material".

As called for in the Executive Board's 1983 discussion of the Fund's approach to the problem of external indebtedness (EBM/83/58, 4/6/83), consultation reports for almost all countries where external indebtedness is a significant issue have included a description of the medium-term external debt outlook for the country concerned. More recently, the practice of including medium-term balance of payments scenarios has been extended to countries where external indebtedness is not seen as a major issue, including many industrial countries. Current practices in this regard, including the analysis of underlying policies and of the sensitivity of projections to changes in assumptions, are examined in the background paper.

Several other innovations in the content of staff reports have been introduced in recent years. These include (1) the review of developments and policies more explicitly against the background of the conclusions of the preceding consultation; (2) the inclusion of an appendix on statistical issues; and (3) the inclusion of material describing members' relations with the World Bank, in many cases including a discussion of the Bank's assessment of the investment or development program and other policy issues in the areas of expertise of the Bank.

c. Information notice system

An important procedural innovation introduced in recent years to strengthen surveillance outside the World Economic Outlook and Article IV consultations has been the system of monitoring developments

^{1/} See, for example, "The Chairman's Summing Up at the Conclusion of the Review of the Document "Surveillance over Exchange Rate Policies" and Annual Review of the Implementation of Surveillance," EBD/82/89 (4/13/82), Attachment, p. 4.

in real effective exchange rates. The monitoring system, which covers at present real effective exchange rates for the currencies of 125 members, makes it possible to bring significant changes in real effective rates to the attention of Executive Directors both through quarterly reports and, in cases of changes in real effective rates in excess of 10 percent since the last Board consideration of a member's exchange rate policy, through information notices which analyze and assess recent developments and policies.

More recently, information notices have also been prepared by the staff in order to bring to the attention of Executive Directors major new developments affecting trade. This practice, initiated following the March 1985 Board discussion of trade policies, has since led to the issuance of two information notices. As Directors noted in concluding the 1985 annual review of surveillance, such notifications as well as the exchange rate information notices could provide the basis to initiate supplemental consultations if the Board so requested.

3. Implementation of procedures in 1985 ^{1/}

Article IV consultations and discussions of the World Economic Outlook in 1985 continued to provide the main vehicles for the implementation of Fund surveillance over members' exchange rate policies. Discussions of the World Economic Outlook in April and September provided a comprehensive framework for the Executive Board's review of the world economy and the exchange rate system, and thus for multilateral surveillance over exchange rate policies of individual members. In addition to the usual documentation, and in support of the emphasis on medium-term prospects and the sensitivity of the medium-term outlook to changes in assumptions, supplementary background notes were prepared, inter alia, on developments and prospects in primary commodity prices, trends in capital flows to developing countries, structural policies and the growth potential of industrial countries.

The number of Article IV consultations continued to increase in 1985. A total of 131 consultations were concluded in 1985, involving 85 percent of Fund membership, compared to 120 consultations in each of 1983 and 1984. Consultations were concluded with all of the G-10 countries and with all but two of the non-G-10 industrial countries. Consultations were also concluded with 84 percent of the nonindustrial countries.

For members concluding consultations in 1985, the average period between consultations declined to less than 14 months, from 15 months in 1984 and from more than 19 months in both 1982 and 1983. The number of

^{1/} A detailed review of the implementation of procedures in 1985 is included in "Surveillance Over Exchange Rate Policies - Annual Review: Background Material," op. cit. Only a brief overview is presented in this section.

countries with seriously delayed consultations was also reduced further in 1985; only 4 countries had not had consultations within the past 24 months at the end of each of the last two years compared with 6 at the end of 1983 and 19 at the end of 1982. Twenty-two of the consultations which, on the basis of the interval specified, had been expected to be concluded in 1985 either have exceeded or are likely to exceed the specified interval by more than the three-month grace period. However, in contrast with the longer delays experienced earlier, recent delays have been a matter of a few days or weeks, or at most one or two months; as indicated in the background paper, these have generally been attributable either to continuing discussions on the use of Fund resources or to difficulties in fielding the staff mission (often as a result of staff involvement in missions to other countries).

The period from termination of initial discussions with members' authorities to conclusion of the consultation by the Executive Board which had averaged 104 days in the two preceding years fell to 97 days in 1985. This decline reflected in part shorter delays in cases requiring multiple missions or further discussions at headquarters, generally associated with concurrent discussions on the use of Fund resources. The shorter period required to conclude consultations was also reflected in a reduction in the number of extensions of the three-month period for the conclusion of consultations, from 27 in 1984 to 23 in 1985. ^{1/}

Publication of the World Economic Outlook and of the Annual Report and the public addresses of the Managing Director continued to provide the main vehicles for reporting publicly on the Fund's surveillance activities.

4. Issues related to the frequency of consultations

The guidelines established by the Executive Board at the time of the 1983 Surveillance Review state that Article IV consultations should be conducted annually for members whose economic developments have a substantial impact on other countries, ^{2/} for members with programs involving use of Fund resources, and for members for which there are substantial doubts about medium-term balance of payments viability. For other countries, the interval between consultations may extend up to two years. Directors, however, have also considered that smaller members for which longer intervals between consultations would otherwise be appropriate should be entitled to request annual consultations.

^{1/} Under the Procedures for Surveillance (Procedure II), the Executive Board is required to conclude an Article IV consultation not later than three months after the termination of discussions between the member country and the staff.

^{2/} Interpretation of this criterion was made more specific at the time of the 1985 annual review of surveillance by noting that it should apply to "at least the 25 largest members" (SUR/85/36, 3/28/85).

A standard 12-month interval between consultations had been specified for 127 countries as of the end of 1985, 87 percent of the cases for which the interval until the next consultation had been established. 1/ Standard 12-month intervals had been specified for 85 percent of the industrial countries and for 87 percent of the developing countries. In addition to countries with the largest Fund quotas, 2/ a standard 12-month interval had been specified for one country considered important at the regional level; 51 countries with a Fund stand-by or extended arrangement, or for which such an arrangement has either recently ended or is being considered; 46 countries whose situation indicates a need for close scrutiny; and 5 countries for which an interval of 12 months was specified at the request of the authorities. Of the 19 cases in which longer intervals had been specified, 16- to 19-month intervals had been specified in 17 cases while 24-month intervals had been specified in two cases.

In contrast, the original proposal for implementing a system to specify the interval between consultations had suggested that some 75 to 80 percent of members could be expected to be on a standard annual cycle. The greater incidence of members for which an interval of 12 months has been specified reflects in part the deterioration in the external position of a wide range of members for which it was thought originally that longer intervals between consultations would be appropriate. Many of these countries have a Fund stand-by or extended arrangement. For example, an interval longer than 12 months applies at present for only one country in the African Department, while it had been thought in late 1982-early 1983 that longer intervals would be appropriate for about 20 African members. Also, consistent with the reaffirmation of annual consultations as the norm, longer intervals between consultations have been considered exceptional, used only in circumstances clearly outside the scope of the guidelines for scheduling annual consultations.

While desirable on its own merits, this trend toward more frequent consultations has increased the workload of the Board and staff, prompting a number of Directors to make several recommendations to reduce this workload. 3/ As regards the frequency of consultations, Directors have noted the desirability of focusing efforts on those situations most in need of attention and have suggested that more differentiation in the

1/ Includes Netherlands Antilles for which a separate consultation is specified.

2/ At present, the criterion applies to members with the 24 largest quotas. In the case of Norway, which has the 25th largest quota, a 19-month interval until the next consultation was specified at the conclusion of the most recent Article IV consultation in December 1984.

3/ Most recently, at the time of the annual review of the implementation of surveillance (EBM/85/49, 3/25/85) and during the discussions of the work program (EBM/85/81 and EBM/85/82, 5/29/85; EBM/85/163 and EBM/85/164, 11/12/85).

specification of the interval between consultations would be appropriate. One possibility would be to lengthen the interval between consultations for those countries already on longer cycles. Providing for a 24-month interval for countries for which annual consultations are not currently indicated could sometimes facilitate consultations by scheduling discussions with the authorities at the same time of year and would reduce the total number of consultations by a few each year. Another possibility would be to increase the number of countries for which intervals longer than 12 months are specified. As noted in the background paper, the consultation cycle was lengthened in 1985 in two cases for which 12-month intervals had applied earlier. The rationale for recommending Board approval of standard 12-month intervals for countries not using Fund resources is being examined carefully on a case-by-case basis. It is expected, on present indications, that it may be appropriate to recommend a longer interval in a few cases. As suggested by some Directors in completing the 1985 annual review of surveillance, it may be useful in some of these cases to introduce informal staff visits (without staff report for discussion by the Board) for policy discussions midway between full consultations.

IV. Proposals for Changes in Procedures

Several proposals have been made recently to enhance the implementation of surveillance procedures, most prominently in the reports of the G-10 and G-24 Deputies. These proposals, summarized in Table 1, ^{1/} can be grouped broadly into three categories: proposals to improve the analytical basis of surveillance, proposals to enhance the multilateral setting of surveillance, and proposals to strengthen the influence of the consultation process. Several of these proposals have already received some attention from Executive Directors on the occasion of earlier annual reviews, in particular the 1980 and 1985 annual reviews. Earlier discussions by Executive Directors are summarized briefly below in connection with related proposals of the G-10 and G-24 Deputies.

Some of the proposals examined in this section could increase substantially demands on Board and staff resources. While related costs cannot be estimated precisely at this time, until a clearer picture emerges of the nature and scope of possible changes, the implications for the Fund's workload may need to be considered more carefully at a later stage.

^{1/} Not including enhanced surveillance. Issues related to enhanced surveillance are not reviewed in the present paper since they were discussed extensively at EBM/85/130 (8/30/85) based on "The Role of the Fund in Assisting Members with Commercial Banks and Official Creditors" EBS/85/173 (7/23/85). The Chairman's Summing Up of the discussion noted that a review of the policy of enhanced surveillance would be held in about one year.

Table 1. Summary of G-10/G-24 Proposals to Enhance Surveillance Procedures

	G-10	G-24
<u>Analytical basis of surveillance</u>		
Data	Identify necessary improvements in scope, quality, timeliness.	
Policy coverage	All policies affecting trade, capital movements, external adjustment and the effective functioning of the international monetary system, including microeconomic policies and structural features that could weaken performance and induce exchange rate instability.	Thorough assessment of the national economic policies of major industrial countries.
Time horizon	Analysis and recommendations should be viewed in a medium-term framework. Improve techniques to analyze medium-term external debt and debt service scenarios.	Seek to establish a consistent set of targets, that appear to be sustainable in the medium term.
Policy assessments	Provide more candid assessments, making clear the empirical and analytical basis of policy judgments. Differences of view with the authorities should be spelled out and discussed.	
Policy recommendations	Provide precise suggestions for policy changes.	Identify policies to achieve agreed objectives and appropriate measures when actual outcomes deviate from agreed objectives.
<u>Multilateral setting of surveillance</u>		
	Separate chapter of WEO, for review by G-10 Ministers and Governors, providing a framework to discuss the international repercussions and interaction of the national policies of G-10 countries.	Two stage procedure: - against the background of the WEO, discussion and negotiation of mutually consistent objectives and policies for major industrial countries; - follow-up reports on achievement of policies.
<u>Strengthening the influence of the consultation process</u>		
Follow up to consultations	Review implementation and effects of policy recommendations in subsequent reports. Request members to indicate measures introduced or considered to address problems identified, and respond to specific policy suggestions. Confidential (selective) exchange of views between the Managing Director and the Finance Minister.	References to previous policy recommendations and related measures undertaken. Information notices on deviations in implementing suggested policy changes. Following Board consideration of reasons for noncompliance, discussion between the Managing Director and the member's authorities. Further Board consideration.
Publicity	Basic confidentiality should be preserved. Some Deputies supported certain forms of greater publicity, in particular, public statements by the Managing Director at the end of the consultation process and the release of consultation documents at the member's request.	Confidentiality should be preserved. No statement or document should be released.
Supplemental consultations	Review existing arrangements with a view to making greater use of supplement surveillance.	Greater use of supplemental surveillance.

Source: "The Functioning of the International Monetary System, A Report to the (G-10) Ministers and Governors by the Group of Deputies," June 1985, circulated as EBD/85/154, Supp. 1 (6/21/85); and "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," 8/21/85, circulated as EBD/85/228, (8/30/85).

1. Proposals related to the analytical basis of surveillance

The proposals related to the analytical basis of surveillance, which are spelled out in some detail in the report of the G-10 Deputies, seek to strengthen the framework for the implementation of surveillance. The first proposal, the identification of necessary improvements in data, has already attracted significant attention on the occasion of earlier annual reviews. At the request of the Executive Board, the staff in early 1984 began to include statements on statistical issues in staff reports. Following the Board meeting on "Review of Fund Statistics" (EBM/85/71, 5/6/85), staff reports for Article IV consultations have included an appendix on statistical issues covering the status of the country's data in IFS. In addition, staff reports have made explicit reference to the quality of statistics used in reports and to major statistical problems affecting the analysis. The timely availability of reliable data clearly is essential to an assessment of developments and policy intentions. Substantial progress is still needed in this area for many members and regular consultations will continue to provide a useful opportunity to assess the adequacy of available data and stress main areas for improvement, and allow the staff to assist the authorities in identifying means to improve statistics, including technical assistance from the Fund.

Other proposals relate to the analytical focus or content of staff reports for Article IV consultations. The reports emphasize the need for a comprehensive policy coverage and for analyses to be presented in a medium-term framework, the provision of more candid assessments of policies (making clear the empirical and analytical basis of judgments and differences of view with the authorities), and the inclusion of specific suggestions for policy changes.

An extensive survey of current practices in these areas is presented in the background paper which reviews in detail the implementation of surveillance in 1985. A conclusion of that survey is that the policy coverage of staff reports for Article IV consultations has typically been quite extensive. In recent years, problems of external debt and protectionism have increasingly been important elements of staff discussions with members. Most consultation reports, in particular reports for almost all countries where external debt is a significant issue, include a description of the medium-term external debt or payments outlook for the country concerned. Problems of fiscal policy and structural adjustment, including in particular the pressing need to increase the efficiency of labor markets, are also being stressed in many consultations. Frequently, however, economy in discussion and reporting requires that the depth of discussions (and related reporting) be tailored to reflect the relative importance or the urgency of corrective actions in various areas of policy.

The reports of both the G-10 and G-24 Deputies stress the importance of presenting analyses and assessments in a medium-term framework. As was discussed in Section II above, the integration of capital markets and the availability of capital from commercial sources may allow inappropriate policies to be pursued for an extended period, leading eventually to the build-up of substantial internal and external imbalances. Thus, the effective implementation of surveillance has increasingly required that the assessment of policies focus on their sustainability and, from this perspective, on their impact on international integration and on the promotion of stable economic and financial conditions, not only in the short term but also in the medium term. Reflecting this concern, the practice of including medium-term balance of payments scenarios in staff reports has been extended in recent years to countries, including industrial countries, where external debt may not immediately be seen as a major issue. In 1985, medium-term scenarios were included in 87 percent of staff reports.

In some cases, however, available medium-term projections have provided only an incomplete basis for assessing the sustainability of members' policies and their consistency with those of other members. Despite the increasing emphasis in many countries on the formulation of policies in a medium-term framework, few countries prepare detailed and quantified medium-term policy plans. This is reflected in the medium-term scenarios presented in staff reports for Article IV consultations, which do not always specify the basic policy stance underlying the assumed rates of growth, inflation and savings/investment balances. In principle, projections are based on the current policy stance of the authorities (including planned changes when these are known). On occasion, however, some change from the set of policies that is in place (or currently being planned) is assumed. The discussion of medium-term prospects in such cases needs to identify clearly the areas in which such modifications or adaptations to the current stance of policies have been assumed. Precision is sometimes also lacking as well, although less frequently and to a lesser extent, in the analysis of shorter-term policy intentions.

Unless key policy instruments are analyzed in a reasonably fully specified and quantified framework, the issues of consistency (internally and with the policies of other members) and sustainability cannot be fully assessed. While neither greater precision nor greater attention to the medium-term sustainability of policies are always necessary to identify major policy inconsistencies internally or with the policies of other members, they may help highlight at an earlier stage the possible emergence of such inconsistencies. Progress in recent years in the analysis of medium-term prospects thus needs to be carried forward, although the balance of emphasis on medium-term issues ought not be shifted so much as to dilute the focus on fundamental short-term policy issues. Further improvements in this area, recommended by both G-10 and G-24 Deputies, will require increased efforts on the part of both members' authorities and the staff. In some cases, there will need to be a greater willingness on the part of members to

enter into a detailed and quantified dialogue with the staff on the basis of staff projections in those cases where such projections may not be prepared by the authorities.

Equally as important, the analytical foundation or structural model underlying short- and medium-term projections on which judgments are based is frequently left implicit. This is sometimes appropriate. However, it would be useful in certain cases to make more explicit the critical parameter assumptions and underlying relations assumed in making these projections. Although judgments as regards the nature and size of policy adjustments are difficult and often leave room for substantial debate, the reasons for differences of view more often than not reflect different assumptions on external conditions or behavioral responses. Clearly spelling out the analytical and empirical basis for such differences would help focus discussions with the authorities and perhaps narrow the range of differences.

The G-10 Deputies also recommend that assessments be more candid, that policy recommendations be specific and that differences of view with the authorities be spelled out and discussed. ^{1/} A conclusion of the survey of current practices in the background paper for the annual review of surveillance is that assessments, while expressed so as to take account of the sensitive nature of the issues involved, were frequently candid. In some cases, however, a more forceful presentation may have helped highlight the importance of the problems identified. Reports also typically indicate whether the authorities agree with staff assessments. To the extent that the analytical and empirical basis of assessments can be made more explicit, the source and nature of differences of view will also be clearer. However, while assessments and the reporting of differences should be sufficiently forthright to be clearly understood, the cooperative nature of the relationship between the Fund and its members would not benefit from the adoption of an overtly confrontational approach. Smooth and productive relations with members will continue to require that differences be handled with discretion and diplomacy.

The survey of current practices in the background paper shows that, while typically clear about the direction of adjustment, assessments of the size of the adjustment needed are often not quantified. Clearly, quantification is neither always possible (in particular, as concerns the various areas of structural policies) nor appropriate (e.g., the size of a required adjustment of the exchange rate; or, unless clearly related to the efficiency of resource use, detailed recommendations on items of expenditure to be reduced or taxes to be raised). However, quantified staff assessments of the size of required adjustments in main

^{1/} Several Executive Directors similarly recommended that differences of view with the authorities should be spelled out when they discussed the content of staff reports to be made available to commercial creditors under enhanced surveillance procedures (EBM/85/130, 8/30/85).

areas of policy (including, as appropriate, trade-offs) could help focus the attention of the authorities on the need for and size of adjustment in specific areas of policy.

2. Proposals related to the multilateral setting of surveillance

A recurrent theme of successive annual reviews of the implementation of surveillance has been the need to make surveillance more effective. Particular attention has been devoted in this context to issues related to the symmetry and multilateral nature of surveillance. The reports of the G-10 and G-24 Deputies both stress the essential nature of the multilateral approach to surveillance, ensuring that the appraisal of members' policies appropriately takes into account the effects of these policies on other members. Most recently, the central role of a multilateral approach to policy formulation and assessment, especially for key currency countries, was stressed in the September 22 announcement of the G-5 Ministers and Governors, and its special focus on the consistency of underlying policies in promoting a more satisfactory and stable configuration of exchange rates.

The specific mechanisms recommended by the G-10 and G-24 Deputies to enhance the multilateral approach to surveillance, however, clearly differ. G-10 Deputies recommend the preparation of a separate chapter in the World Economic Outlook, for the review of G-10 Ministers and Governors, providing a framework to discuss the international repercussions and interaction of the national policies of G-10 countries. G-24 Deputies recommend the establishment of a formal two-stage procedure: the first stage involving discussion and negotiation, against the background of the World Economic Outlook, of mutually consistent objectives and policies for major industrial countries; the implementation of policies and achievement of objectives being reviewed in follow-up reports in a second stage.

In addition to the various improvements in the implementation of surveillance procedures since 1977, several other proposals have been considered by Executive Directors on the occasion of annual reviews. In particular, some proposals discussed during the 1980 annual review are closely related to the proposals of the G-10 and G-24 Deputies to strengthen the multilateral setting of surveillance. ^{1/} These proposals and related discussions are summarized briefly in the next few paragraphs to provide background for the discussion of further proposed changes in procedures.

^{1/} At EBM/80/19 and EBM/80/20 on 2/6/80, and EBM/80/89 on 6/11/80 based on "Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies" SM/79/292 (12/21/79) and Supp. 1 (5/13/80).

A first proposal considered in 1980 envisaged that the authorities of members with large imbalances would be expected in the course of consultations to describe in as precise terms as possible their external and domestic policies, including monetary and fiscal policies, by which the imbalance would be corrected. 1/ These policies were to be described either as part of the staff's reporting or, at the discretion of the authorities, through a written statement appended to the consultation report. A sufficient number of Executive Directors (though not a majority) strongly objected, preventing formal approval of the procedure, 2/ although it was understood that staff discussions with members' authorities for Article IV consultations and staff reports were to pay particular attention to the issues involved.

A second proposal envisaged inviting the seven major industrial countries to submit to the Fund, in preparation for the first major World Economic Outlook of each year, a quantified statement of the economic and financial policies that they intended to pursue in the year ahead. 3/ It was considered, after experience had been gained, to expand the coverage of this innovation beyond the seven major countries initially involved. In their discussion of this proposal, Executive Directors raised a number of doubts, in particular on the possibility of agreeing on a strategy for developments in the world economy. Executive Directors were inclined to the view that any global "strategy" should be conceived in fairly general terms, and that the number of countries whose performance should be assessed in the World Economic Outlook itself should be limited. An agreed change, nevertheless, involved an extension of the World Economic Outlook through inclusion of a more complete description of the policy approach envisaged by major countries, providing a basis for the discussion by Executive Directors of the broad principles of a global "strategy."

These earlier proposals as well as current proposals from the G-10 and G-24 Deputies recognize that, if it is to be effective, surveillance must involve an examination of members' policies in a multilateral framework. This, in turn, requires a common view or understanding among

1/ Specifically, "that any nation with an exceptionally large payments imbalance--deficit or surplus--submit for Fund review an analysis showing how it proposes to deal with that imbalance," (SM/79/292, p. 7).

2/ Although a decision could have been taken by simple majority, the Chairman concluded that "if the feeling is that (the proposal) was to be implemented in a compulsory fashion, to extract commitments and engagements from member countries, we would have made absolutely no progress. On the contrary, we would perhaps have lastingly damaged our relations with a great number of countries." EBM/80/89, p. 32.

3/ Specifically, "that the Fund could assess the performance of individual countries against an agreed global strategy for growth, adjustment and price stability developed in World Economic Outlook reviews," (SM/79/292, p. 8).

members of the effect of various policies on the evolution of the world economy. Analysis in the World Economic Outlook of the international repercussions of the policies of major countries should provide the analytical basis for a consideration of the nature of international interactions. The presentation, in the context of Article IV consultations with major countries, of more detailed and quantified short- and medium-term policy plans would help strengthen the analysis of the consistency and sustainability of policies from a multilateral perspective as well. For major countries for which the timing of consultations differs from the cycle for the preparation of the World Economic Outlook, mini-consultations could again be used to ascertain changes both in the economic outlook and in the stance of the authorities' policies as well as to elicit views on the international interaction of policies and developments. Directors may wish to review in this context whether the proposal considered in 1980 of requesting the authorities of major members (e.g., G-7 or G-10) to prepare a quantified statement of their policies in connection with the World Economic Outlook exercise would help promote this process.

The formal proposal to implement surveillance in a two-stage process, including the specification and monitoring of objective indicators for major industrial countries, is discussed more fully in the companion papers on the review of experience with the system of floating exchange rates and for the biennial review of the surveillance document. ^{1/} Executive Directors also already had an opportunity for a first discussion of objective indicators on the occasion of the 1985 annual review of the implementation of surveillance. Such a proposal had been anticipated to some extent both in the early discussion of the use of real exchange rate indicators to trigger special consultations (under Procedure V) and in a subsequent proposal considered in the context of the 1980 annual review to trigger supplemental consultations if developments or policies differed significantly from those expected at the time of the preceding annual consultation. ^{2/}

It is clear that larger members with key currencies have a special responsibility to adopt policies consistent with the establishment and maintenance of stable economic and financial conditions for those countries closely linked to them through trade and financial relations. For the international economy as a whole, it has become increasingly accepted that this implies a special need for larger members with key currencies to achieve a closer coordination of their policies. The exercise of Fund surveillance, through the World Economic Outlook discussions and Article IV consultations, can provide a primary forum for the assessment of the consistency and sustainability of members'

^{1/} SM/86/5 and SM/86/3, op. cit.

^{2/} "Review of the Implementation of the Fund's Surveillance Over Member's Exchange Rate Policies," SM/79/292 (12/21/79), p. 10. Few Directors addressed this proposal explicitly. Those who did, however, did not favor the implied automaticity.

policies. Whether policies of major industrial countries are negotiated (as envisaged by G-24 Deputies) or not, such an assessment could bring out clearly and forcefully the concerns of the membership with the policies of individual members and the effects of these policies on other members. The follow-up to such an assessment in the form of a review by G-10 Ministers and Governors, as envisaged by G-10 Deputies, would, if adopted, follow a first consideration in the Fund's Executive Board. Directors may wish to consider in this context the form in which they may want the results of their considerations communicated to G-10 Ministers and Governors. Other aspects of the follow-up to the assessment of members' policies in the context of the World Economic Outlook and Article IV consultations are discussed further below.

3. Proposals related to strengthening the influence of the consultation process

Several of the proposals examined in the reports of the G-10 and G-24 Deputies related to the follow-up to consultations, publicity and supplemental surveillance were considered by Executive Directors during the 1985 annual review of the implementation of surveillance. At that time, Directors indicated that there was considerable scope for expanded follow-up to consultations and also encouraged a greater use of supplemental surveillance in selected circumstances. However, on the issue of publicity, most Directors expressed strong reservations similar to those in the reports of the G-10 and G-24 Deputies.

As regards the follow-up to consultations, Executive Directors had already endorsed earlier the strengthening of the continuity of the consultation process through the inclusion of a review of developments against the background of the conclusion of the previous consultation. This has been reflected in the inclusion in staff reports for Article IV consultations of references to the discussion by Executive Directors in concluding an earlier consultation. During the 1985 annual review of surveillance, Directors considered that the review of developments against the background of the previous consultation in Article IV staff reports should be further developed by giving indications of the weight the authorities attached to the views of the Fund. Directors also strongly supported more "internal publicity" among the authorities of member countries for the findings of the Fund and considered it desirable that Management communicate directly with Ministers of Finance regarding the Fund's review in those selected cases where the Executive Board felt high-level consideration to be particularly important because of the urgency of the policy views expressed. Specific reviews of the implementation and effects of policy recommendations by the Fund, as was suggested by both G-10 and G-24 Deputies, could help strengthen further the continuity of the consultation process. Here again, however, smooth and productive relations with members require some degree of discretion and diplomacy.

Several suggestions were considered in last year's review of surveillance with regard to publicity: the release of a public statement by the Managing Director at the conclusion of each Article IV consultation, based on his summing up of the Board discussion, giving a brief assessment of a country's policies and prospects; the release of Article IV staff reports upon the request of the member involved; and wider circulation of Recent Economic Developments papers. Few Directors supported the idea of a major move toward greater publicity in connection with the policy content of Article IV consultations. Directors considered, as had been also stressed in the staff paper, that making discussions between the Fund and its members public could have serious consequences for the candor and frankness of policy discussions with members. Most Directors, however, were open to the wider release, including publication, of REDs with the approval of the member concerned.

Two other proposals were put forward in the reports of the G-10 and G-24 Deputies. The first proposal, by the G-10 Deputies, is to request that members indicate measures introduced or considered to address the problems identified through the consultation process and respond to specific policy suggestions. The staff paper for the 1985 annual review of surveillance suggested that it would not be productive to formally require such replies in all cases. ^{1/} In cases when the authorities do not agree with the assessment or recommendations in the staff report, the usual buff statement of the member's Executive Director provides an opportunity for laying out clearly the reasons for such disagreements. A more explicit presentation in staff reports of differences of view with the authorities, and of underlying reasons, would also facilitate this process. As indicated earlier, continued disagreements with a member's authorities at the conclusion of the consultation process, in cases where the Executive Board considered the matter of sufficient importance, could lead to a direct communication between the Managing Director and the Minister of Finance. Alternatively, or in addition, as Executive Directors agreed in concluding the 1985 annual review of surveillance, a supplemental consultation could be appropriate if the conclusion of an Article IV consultation left serious doubts about the appropriateness of a member's policies.

The second proposal, by the G-24 Deputies, envisages the preparation of information notices in the event of deviations in implementing suggested policy changes. Formally, this procedure is envisaged as a follow-up to the negotiation of policies in the first stage of the surveillance process in a multilateral setting, outlined by the G-24 Deputies. Abstracting from the relationship of the proposed procedure to the two-stage negotiation/review process, information notices or interim staff reports on certain aspects of policies could provide an

^{1/} SM/85/65, op. cit., p. 34.

opportunity for closer monitoring of main policy developments. Such a procedure is examined further below as a means to strengthen the supplemental surveillance procedure.

Both the G-10 and G-24 Deputies' reports endorse a greater use of supplemental surveillance. While, when adopted, the supplemental surveillance procedure was intended to provide a more flexible mechanism for closer and more frequent scrutiny of important changes in members' policies, in practice the initiation of formal supplemental consultations has been rare. ^{1/} This rarity has been to a large extent self-reinforcing, as it has implied that supplemental consultations take place only under highly exceptional circumstances. Instead, informal discussions with members' authorities during the period between formal consultations have provided an opportunity on several occasions for the management and staff to keep informed of important ongoing developments, to ascertain the members' reasons for specific policy actions, and to convey Management's views to the authorities. Subsequent regular consultation reports have reflected the information received as well as views formed during such informal contacts.

A wide range of views were expressed by Directors during the 1985 annual review of surveillance in encouraging the use of supplemental consultations in appropriate circumstances. Several Directors suggested that supplemental consultations might be appropriate for members in arrears to the Fund, members without current programs but with large financial obligations to the Fund and members making prolonged use of Fund resources. Several Directors noted that supplemental consultations could be triggered as a result of major policy actions or following Board consideration of information notices on exchange rates or changes in trade policies. Also, as noted above, a supplemental consultation could take place if the conclusion of an Article IV consultation left serious doubts about the appropriateness of a member's policies.

In addition to its acquired exceptional character, two basic reasons underlay the lack of use of the supplemental surveillance procedure. First, its explicit focus on exchange rate policies or the behavior of the exchange rate make it less amenable to use in cases where issues arise that are not explicitly or immediately connected with external policies but rather with domestic economic and financial policies, the effects of which may be reflected only at a later stage in a movement of the exchange rate or may prevent an appropriate realignment of exchange rates. Second, the reliance on judgment that the procedure is needed, at the time it is invoked, tends to focus attention on identifiable actions rather than lack of action.

^{1/} Under the supplemental surveillance procedure; there have been no "supplemental" consultations under paragraph V of the procedures for surveillance.

A first area of improvement would be to recognize explicitly the broader range of policies which could trigger supplemental surveillance. The issues involved are similar to those raised in the companion paper for the biennial review of surveillance in reviewing the appropriateness of the Principles for the Guidance of the Fund and reflect the fact that the key areas of strain in the international financial system have resulted not from external but from domestic policies which, maintained for extended periods, have led to the emergence of large internal and external imbalances.

A second area of improvement would be to make the procedure more automatically usable in relation to developments not necessarily involving specific actions.

First, as indicated earlier, the need for supplemental surveillance may already be apparent at the conclusion of a consultation with a member. Second, a failure to implement within a set period (say, three or six months) policy actions of the kind considered essential and identified as such at the conclusion of a consultation with a member could automatically trigger a supplemental consultation. Third, Directors may consider a matter to be of sufficient importance to warrant more frequent scrutiny than would be provided through the normal consultation process. In those cases, Executive Directors could indicate in concluding the consultation those specific areas of policy on which they would expect an interim report from the staff (say, in three or six months). Following the consideration of such reports, the Executive Board could call for a supplemental consultation.

Interim staff reports could be appropriate, for example, if Executive Directors considered in concluding a consultation that developments or policies were near the threshold beyond which specific follow-up action would be indicated. Another example would be if the assessment at the time the consultation is concluded depended to a significant extent on policy intentions recently announced by the member's authorities but not yet fully articulated or implemented. In considering whether such a procedure would help strengthen the continuity of surveillance, Executive Directors may also wish to consider whether staff appraisals should recommend interim reports in appropriate cases or whether the initiative should be left to the Executive Board.

V. Summary of Main Issues

1. Apart from the several issues arising in connection with the proposals of the G-10 and G-24 Deputies to strengthen the implementation of surveillance procedures, the issue has been raised by several Directors of the need for more differentiation in the frequency of consultations. Specific options examined in the paper are the lengthening of the interval between consultations for members already on longer cycles

and the specification of intervals longer than 12 months (possibly, with interim staff visits) for those members not falling strictly within the guidelines for consultations at annual intervals.

2. Major lessons for the implementation of surveillance procedures highlighted by the experience since 1977 included: (i) the importance of focusing at an early stage not only on a country's overall balance of payments position but also on the sustainability of the structure of the balance of payments; (ii) against this background, the importance of paying particular attention in assessing members' exchange rate policies to the sustainability of a broad range of members' external and domestic economic and financial policies; (iii) the sensitivity of some countries' positions to conditions created in the world economy by other members' policies. In general, these developments all highlight the need to strengthen the exercise and influence of surveillance.

3. Proposals of the G-10 and G-24 Deputies relating to the implementation of surveillance procedures can be grouped broadly in three categories: proposals to improve the analytical basis of surveillance, proposals to enhance the multilateral setting of surveillance, and proposals to strengthen the influence of the consultation process.

4. The central issue highlighted as regards the analytical basis of surveillance concerns the need to focus the assessment of policies on their sustainability and, from this perspective, on their impact on growth, international integration and the promotion of stable economic and financial conditions, both in the short term and over the medium term. Related concerns provide the basis for the several proposals in the reports of the G-10 and G-24 Deputies concerning the focus of surveillance on the full range of policies affecting external developments, on the timeframe of analysis and the need to improve the underlying data base and on the presentation of the empirical and analytical basis of policy judgments. G-10 Deputies also recommend that policy assessments be more candid, that the analytical and empirical basis of assessments be made more evident, that policy recommendations be specific, and that differences of view between the staff and the authorities be spelled out and discussed.

5. Larger members with key currencies have a special responsibility to adopt policies consistent with the establishment and maintenance of stable economic and financial conditions for those countries closely linked to them through trade and financial relations. For the international economy as a whole, it has become increasingly accepted that this implies a special need for larger members with key currencies to achieve a closer coordination of their policies. Specific mechanisms to enhance the multilateral setting of surveillance are suggested by both G-10 and G-24 Deputies: the preparation of a special chapter of the World Economic Outlook, highlighting international interactions and repercussions, for the subsequent review

of G-10 Ministers and Governors (by G-10 Deputies); the discussion and negotiation, against the background of the World Economic Outlook, of mutually consistent objectives and policies (by G-24 Deputies).

6. The reports of G-10 and G-24 Deputies review several proposals related to the follow-up to consultations, publicity and supplemental surveillance: reviewing explicitly the implementation and effects of policy recommendations; requesting members to indicate measures which have been introduced or considered to address problems identified and to respond to specific policy suggestions; confidential (selective) exchange of views between the Managing Director and the Finance Minister; and greater publicity for the consultation process itself. Executive Directors' views on this subject, on the occasion of earlier reviews of the implementation of surveillance, were summarized briefly to provide a basis for further discussion.

7. Both the G-10 and G-24 Deputies encouraged greater use of supplemental surveillance. Related proposals highlighted in this and the companion paper for the biennial review of the surveillance document include: the initiation of a more automatic process of supplemental surveillance; explicit recognition of the broader range of policies which could trigger supplemental surveillance; the initiation of supplemental surveillance in the case of failure by a member to implement (within a set period) policy actions of the kind considered essential and identified as such at the conclusion of a consultation; review by Executive Directors of the need for a supplemental consultation on the basis of interim staff reports on developments in areas of policy identified by Directors (in concluding a consultation) as requiring close and frequent scrutiny.

8. As specified in Decision No. 7939-(85/49) taken March 25, 1985, the annual review of the implementation of Fund surveillance over members' exchange rate policies, including the procedures for the conduct of consultations under Article IV, is to be conducted not later than April 1, 1986. Draft decisions will be proposed for adoption following Board consideration of the reports for the biennial review of the surveillance document and the annual review of the implementation of surveillance. Such decisions are necessary to complete the two concurrent reviews by April 1, 1986. Also, these draft decisions will identify matters for consideration at a later date.

DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR
AGENDA

SM/86/5

January 10, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Review and Assessment of the System of Floating Exchange Rates

Attached for consideration by the Executive Directors is a paper on the review and assessment of the system of floating exchange rates.

This paper, together with the paper on target zones (SM/86/6, 1/10/86) has been scheduled for Executive Board discussion on Wednesday, February 12, 1986.

Mr. Goldstein (ext. 7678) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Review and Assessment of the System of Floating Exchange Rates

Prepared by the Research Department
(In consultation with other departments)

Approved by Wm. C. Hood

January 9, 1986

Contents

	<u>Page</u>
I. Introduction	1
II. Perceived Weaknesses of the Present System	4
A. Short-run volatility	4
B. Large and persistent misalignments of real exchange rates	6
C. Lack of discipline and coordination in macroeconomic policies	10
III. Perceived Strengths of the Present System	14
A. Promotion of external payments adjustment	14
B. Insulation from inflation abroad	17
C. Independence and effectiveness of domestic monetary policy	18
D. The resiliency of the present system	20
IV. Proposals for Improving Exchange Rate Stability	23
A. Target zones for exchange rates of major currencies	24
(1) What is meant by a target-zone approach to exchange rate management?	24

	<u>Page</u>
(2) The rationale for target zones	26
(3) Opposition to target zones	28
B. Objective indicators or targets for macroeconomic outcomes and policies	31
(1) The rationale behind objective indicators or targets	32
(2) Opposition to objective indicators or targets	33
C. Improvements within the existing institutional setting	36
(1) The rationale for seeking improvements within the existing institutional setting	37
(2) Opposition to operating within the existing institutional setting	39
V. Selected Bibliography	42

I. Introduction

At its meeting in Seoul on October 6-7, 1985, the Interim Committee requested the Executive Board "... to study the issues raised in these reports [the reports on the international monetary system presented by the Group of Ten and the Group of Twenty-Four] with a view to facilitating a substantive consideration by the Committee at its next meeting." ^{1/} This paper, and the supplementary paper on target zones (SM/86/6), are among a series of papers prepared in response to that request. The present paper discusses issues directly related to the functioning and improvement of the exchange rate system.

The Reports of the Group of 10 and the Group of 24 (hereafter the G-10 and G-24 Reports) share some important conclusions on the exchange rate system. ^{2/} In brief, both reports conclude that the functioning of the present system of floating exchange rates needs to be improved; that the variability of exchange rates, both in the short run and in the long run, has been a source of concern; that unsound and inconsistent policies, and related divergences in economic performance among major industrial countries, have been central elements in the observed volatility and misalignments of key-currency exchange rates; that surveillance is crucial for an orderly international monetary and financial system and is a basic tool for promoting convergence of economic performances toward sustainable non-inflationary growth; that while exchange market intervention can play a useful supplementary or complementary role, it cannot be the primary instrument for achieving exchange rate stability; and finally, that a return to a rigid par value system is neither desirable nor feasible at the present time.

In some other respects, however, the two reports are quite far apart in their diagnosis of and proposed remedies for the present exchange rate system. The G-10 Report concludes that "...the fundamental approach of the Articles of Agreement remains valid;" ^{3/} that the present system of floating rates has shown "valuable strengths" ^{4/} (as well as weaknesses); and that "... the key elements...require no major institutional

^{1/} "Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund," paragraph 10. International Monetary Fund, Press Release No. 85/33, October 7, 1985.

^{2/} "The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Deputies of the Group of Ten," June 1985, circulated as EBD/85/154, Supplement 1; "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 1985, circulated as EBD/85/228.

^{3/} G-10 Report, paragraph 97.

^{4/} G-10 Report, paragraph 14.

change." 1/ In contrast, the G-24 Report concludes that "the experience with the present exchange rate system has not been satisfactory;" 2/ that "volatility and misalignment of exchange rates have especially hurt the developing countries;" 3/ and that "... a mechanism has to be devised to enforce policy coordination among the major industrial countries." 4/ On the issue of target zones for exchange rates of major currencies, the gulf was also wide. The majority (of Deputies) in the G-10 Report considered the adoption of target zones "...undesirable and in any case impractical in present circumstances" 5/ [some Deputies, however, did think that the proposal could have merits and suggested further exploration of its technical aspects at an appropriate time]. In contrast, the G-24 Report expressed the view that target zones "... could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances;" 6/ it also concluded that the proposal needed to be further studied and pursued to gain general acceptance. Yet another difference is that the G-24 Report envisages a role for a set of "objective indicators or targets" 7/ in the conduct of multilateral surveillance while the G-10 Report emphasizes "... enhanced dialogue and persuasion through peer pressure." 8/

Drawing on the analysis in the G-10 and G-24 Reports, as well as on earlier work done inside and outside the Fund, this paper identifies and discusses issues and proposals for improving the functioning of the exchange rate system. The aim is to identify areas of agreement, to discuss points of contention, and to suggest key issues for further discussion, study, and guidance.

The rest of the paper is organized as follows. Section II discusses several perceived weaknesses of the present exchange rate system, namely: the high short-run volatility of exchange rates; the large and persistent misalignments of real exchange rates, and the lack of discipline and coordination in the conduct of macroeconomic policy in the major industrial countries. Section III turns to the perceived strengths of the present system. Here, the contribution of exchange rate flexibility to external payments adjustment, to insulation from shocks abroad, to the independence and effectiveness of domestic monetary policy, and to the maintenance of an open trade and payments system-- are all considered. These perceived weaknesses and strengths of the present system are those given most attention in the G-10 and G-24 Reports. Finally, Section IV addresses certain proposals for improving the functioning of the existing system. Three types of proposals are examined: (i) the adoption of "target zones" for key-currency exchange

1/ G-10 Report, paragraph 97.
2/ G-24 Report, paragraph 2.
3/ G-24 Report, paragraph 3.
4/ G-24 Report, paragraph 5.
5/ G-10 Report, paragraph 32.
6/ G-24 Report, paragraph 5.
7/ G-24 Report, paragraph 78.
8/ G-10 Report, paragraph 38.

rates; (ii) the introduction of "objective indicators" or quantitative targets for macroeconomic outcomes and policies into multilateral (IMF) surveillance; and (iii) more intensive use of consultative and judgmental mechanisms, within the existing institutional setting, to enhance the appropriateness and mutual compatibility of policies. The proposals analyzed are those specifically presented in the G-10 and G-24 Reports.

The scope of the paper has been conditioned by four considerations. First, although the focus of the paper is on the functioning and improvement of the exchange rate system, it is not appropriate to deny the interconnections between the exchange rate system and other features of the international monetary system. This is especially true with respect to the interrelationship between the exchange rate system and surveillance. ^{1/} For example, any changes in the operation of the exchange rate system, be they changes in exchange arrangements or improvements to the mechanisms for policy coordination, would have to be given content through the implementation of the surveillance. At the same time, proposals for strengthening surveillance, both at the bilateral and multilateral levels, are integral elements of most proposals for improving the functioning of the exchange rate system. As such, the paper discusses on a rather broad level the rationale for, and implications of, changes in surveillance for the operation of the exchange rate system. An in-depth treatment of surveillance issues will appear in the forthcoming paper, "Surveillance over Exchange Rate Policies--Biennial Review." A second consideration concerns the proposal, discussed in both the G-10 and G-24 Reports, to adopt target zones for major-currency exchange rates. In this paper, target zones are examined as one of several concrete proposals for improving the functioning of the exchange rate system. A more thorough treatment of the target-zone proposal, including its more technical and operational aspects, is included in the supplementary paper, "Target Zones" (SM/86/6). Third, in discussing proposals for improving exchange rate stability, the emphasis is on the major industrial countries. This

^{1/} Another potential area of interconnection is that between the exchange rate system and international liquidity. For example, proposals for liberalization of capital markets or for greater use of official intervention in exchange markets cannot be divorced from questions concerning the quantity and composition of international reserves. Still, the present paper makes the assumption that many issues in the evaluation of the exchange rate system can be profitably discussed within the bounds of existing reserve and liquidity arrangements. Several papers dealing with international liquidity and the SDR, as discussed in the G-10 and G-24 Reports, will soon be reaching the Executive Board.

follows the view, given expression in both the G-10 and G-24 Reports, that it is the policies and exchange rates of the major industrial countries that exert the most significant impact on the functioning of the international monetary system as a whole. None of this denies, of course, either the importance of maintaining realistic exchange rates in all countries, or the desirability of an exchange rate system that adequately meets the needs of smaller industrial countries and of developing countries. Finally, although this paper is organized around the issues and proposals raised in the G-10 and G-24 Reports, it also considers views, evidence, and proposals on the exchange rate system from other sources. For these reasons, terms such as "proponents," "supporters," or "opponents" should not necessarily be associated with the G-10 and G-24 Reports unless specifically indicated.

II. Perceived Weaknesses of the Present System

Although the present system of floating exchange rates has been criticized on many counts, most of these criticisms can be grouped under the following three headings: high short-run volatility of exchange rates; large and persistent misalignments of real exchange rates; and lack of discipline and coordination in the conduct of macroeconomic policy in major industrial countries. In this section each of these criticisms, or perceived weaknesses, is examined in turn.

A. Short-run volatility

Prior to the advent of floating rates, some of its supporters anticipated that stabilizing speculation would act to smooth exchange rate movements, and in so doing, prevent an abrupt increase in the actual variability. Thirteen years of experience have proved otherwise. Whether measured in bilateral or effective terms, nominal or real terms, the short-run variability of exchange rates has been much greater during the period of floating rates than under the Bretton Woods system. A representative calculation (IMF[1984a]) is that the short-term (monthly or quarterly) variability of nominal exchange rates for the seven major currencies was about five times greater under floating rates than during the last decade of adjustable par values. In addition, there has not been a sustained tendency for exchange rate variability to decline over time. Finally, and of interest for linking exchange rate variability to exchange rate uncertainty, most exchange rate changes under floating rates have been unexpected (as revealed by market indicators of expected exchange rates, such as forward rates).

Critics of floating exchange rates contend that one of the main reasons why rates have been so volatile is that market participants lack an anchor for medium-term exchange rate expectations. Without such an anchor, short-term events (be they news, rumors, or shifts in policy) induce large revisions of expectations about future exchange rates,

which in turn, induce large changes in current rates. Also, without an anchor, the risks of self-fulfilling destabilizing speculation (i.e., bandwagon effects and speculative bubbles) are increased.

This short-run variability, or volatility, of exchange rates is said to be costly because its associated uncertainty reduces the volume of trade and investment. 1/ These costs are claimed to be especially heavy for developing countries which do not have well-developed financial markets, particularly forward cover arrangements. 2/

The high short-term volatility of exchange rates under floating is not in dispute. What is contentious is the proper yardstick for evaluating that volatility and the costs associated with it. Defenders of the present system make the following points.

First, while the variability of nominal exchange rates has been higher than the variability of the ratio of national price levels, it has been lower than that for other asset prices (e.g., national stock market prices, changes in commodity prices, changes in interest rates, etc.). 3/ The higher variability of exchange rates via-a-vis national price levels is said to reflect the fact that exchange rates are jumpy, forward-looking auction prices that anticipate future events whereas prices and wages are sticky, backward-looking administered prices that largely reflect past contractual commitments. Hence, some greater degree of variability in exchange rates is to be expected. The fact that all asset prices have been so variable during the floating rate period is often explained by the accompanying turbulence in the global economic and political environment. 4/

Second, and probably more challenging, the defenders argue that there is little evidence that short-run exchange rate volatility has been very costly in either a relative or absolute sense. The question of relative costs hinges on which markets are best able to handle disturbances. The point is that if exchange rates were more rigid, then disturbances would be transferred to goods or labor markets, or would induce limitations on trade and capital movements, both of which might be more costly than the exchange rate movements themselves. As

1/ "It (volatility of exchange rates) has discouraged investment and trade by adding to financial risks for investors and traders." G-24 Report, paragraph 61.

2/ "Exporters and importers in these countries (developing countries) are exposed to high exchange risks in the absence of well-developed financial markets, especially forward cover arrangements. The destabilizing uncertainties of floating rates have increased the reserve and capital needs of developing countries from the levels which would otherwise exist." G-24 Report, paragraph 63.

3/ See Bergstrand [1983].

4/ See Frenkel and Mussa [1980].

to the absolute cost, the defenders of the present system note that a large body of econometric work has produced only sporadic evidence of a link between measures of exchange rate volatility and the volume of international trade (IMF[1984a]). It is also argued that the development of various hedging techniques and future markets has increased the ability of market participants to both reduce their exposure to risk and to purchase relatively low-cost insurance against it. ^{1/}

Issues for discussion: (i) Does short-run volatility of major-currency exchange rates impact more seriously on the developing countries and on smaller, less-diversified firms; if so, what institutional changes or reforms could lessen this problem; (ii) are there kinds of risk or uncertainty that have eluded the existing econometric tests on the links between exchange rate volatility and the volume of international trade; (iii) what is the appropriate "measuring rod" for judging whether short-run variability of exchange rates is excessive; and (iv) would more reliance on exchange market intervention help to reduce short-run volatility of exchange rates; if not, what other policy instruments should be directed at that task?

B. Large and persistent misalignments of real exchange rates

A second indictment of the present system is that real exchange rates of major currencies have been subject to large and persistent misalignments. The term misalignment is commonly interpreted as a deviation of the actual real exchange rate from its "equilibrium" level.

In practice, misalignment has usually been estimated by, or inferred from, three types of calculations. First, misalignment can be calculated as the cumulative departure of the nominal exchange rate from the path implied by purchasing-power-parity. This is equivalent to calculating the deviation of the current real exchange rate from its level in some "equilibrium" base period. Second, misalignment is sometimes inferred from the sheer size of real exchange rate movements themselves. The implicit assumption here is that the equilibrium real exchange rate will change only gradually over time in response to structural changes in competitiveness and comparative advantage. The third method is to compute misalignment as the deviation of the real exchange rate from the (equilibrium) level that would yield an equilibrium in the balance of payments, (given anticipated macroeconomic policies over the next two to three years). The equilibrium balance of payments, in turn,

^{1/} "... Foreign exchange markets appear to have developed effective hedging techniques available to most operators to reduce the risks associated with exchange rate volatility, generally at comparatively little cost." G-10 Report, paragraph 16.

is defined as an "underlying" current-account balance equal to "normal" net capital flows. In addition, this equality must be achieved without resort to either undesirable levels of unemployment, or "undue" restrictions on trade, or "special" incentives to incoming or outgoing capital. 1/

As representative (albeit dramatic) examples of such calculations, one might offer the following: (i) as of the second quarter of 1985, the real effective exchange rate of the U.S. dollar was over 50 percent above the level implied by purchasing-power-parity (using 1980 as the base); 2/ (ii) between 1975 and 1976, the real effective exchange rate of the pound sterling fell by 20 percent, only to rise by nearly 75 percent between 1976 and 1981; and (iii) using an "underlying balance" approach to calculating the equilibrium real exchange rate, one recent study (Williamson [1985]) estimated that the misalignments of the U.S. dollar and the Japanese yen at end-1984 were 39 and 19 percent, respectively.

Although it was originally thought that real exchange rate movements under floating rates would be dominated by gradual changes in competitiveness needed to restore current account equilibria, it is now recognized that large capital flows, often stimulated by short-term considerations, have usually been the predominant force. 3/ These capital flows, in turn, have been influenced by inter-country differences in interest rates that have reflected different stances and mixes of monetary and fiscal policy--and by changes in expectations about the future course of these policies and their impact on future interest rates and future exchange rates. In addition, rigidities in goods and labor markets have meant that nominal exchange rates have taken the brunt of the adjustment, often "overshooting" their long-term values, to compensate for the stickiness of nominal wages and prices in the short-run.

Such misalignments in major-currency exchange rates have been costly, so it is argued, because: (i) they distort resource allocation and generate "boom and bust" cycles in the tradable goods sector that

1/ This definition is a close relative of those found in Nurkse [1945], IMF [1970], and the G-24 Report, paragraph 69.

2/ The real effective exchange rate used for these calculations is relative normalized unit labor cost in manufacturing.

3/ "... exchange rate determination has been increasingly influenced by conditions in capital markets, including relative interest rates and expectations regarding the impact of national policies and current and future economic performance." G-10 Report, paragraph 18. "Much of the medium-term movement in real exchange rates reflects not the changing pattern of competitiveness but rather the result of differences in fiscal and monetary policies..."

G-24 Report, paragraph 62.

leave unemployment in their wake; and (ii) because they encourage protectionism, as firms and governments attempt to overrule the unjust verdict of the market place by turning to administrative solutions. 1/

By now, there is widespread agreement that the floating rate era has been marked by cases of serious misalignment. Not so clear are the extent of these misalignments, their cost, and perhaps most of all, whether alternative exchange rate systems could eliminate or reduce them. In this connection, defenders of the present system offer the following arguments.

First, not all of the large swings in real exchange rates that have been observed over the past thirteen years represent misalignment. Some of it represents desirable adjustments to changes in real economic conditions, such as continuing inter-country differences in labor productivity, permanent changes in the terms of trade (sometimes associated with discovery of, or large price changes in, natural resources), permanent shifts in savings-investment relationships across countries, safe-haven considerations, etc. For example, a good portion of the appreciation of sterling between 1977 and 1981 could be represented as an equilibrium response to the U.K.'s enhanced oil-exporter status.2/ Even under a system of pegged exchange rates, such changes would call for changes in real equilibrium exchange rates. Under that regime, these changes would occur primarily via changes in national price levels, aided by occasional changes in parities. Under floating rates, the required changes in relative prices occur primarily via changes in nominal exchange rates and they happen more quickly. But, according to defenders of the present system, this need not imply that the latter form of adjustment is inferior to the former.

Second, although misalignment may not be so difficult to define, it can be very difficult to measure when concepts like "normal" capital flows, "undue" restrictions on trade, "special" incentives to incoming or outgoing capital, "cyclically-adjusted" current accounts, and "anticipated" macroeconomic policies have to be estimated. For example, a country that is a "normal" net capital exporter under one set of macroeconomic policies, tax considerations, and political events abroad may become a normal net capital importer under others. For example, if say, one-third of the recent private net capital inflow into the United

1/ "Misalignment inevitably produces either idle resources or wasteful shifts back and forth between tradables and nontradables. It becomes a potent source of pressures for protectionism." G-24 Report, paragraph 62.

2/ See, for example, Bond and Knobl [1982].

States were regarded as "normal" (reflecting attractive perceived investment opportunities and a relatively low domestic savings rate), then one's estimate of the current misalignment of the U.S. dollar would be reduced considerably (vis-a-vis estimates that assume a normal net capital flow of zero for the United States). Yet some would argue that the theory and evidence for preferring the latter assumption to the former are weak. An additional complicating factor is the existence of a large statistical discrepancy in world balance-of-payments-accounts, whose geographical attribution is highly uncertain.

Supporters of the present system acknowledge that misalignments of key currencies carry costs but suggest caution in identifying misalignments as primary factors in explaining both the recent weakness of manufacturing employment in the United States and the resurgence of protectionist pressures in major industrial countries as a group.

While it is true, for example, that the ratio of manufacturing employment to total non-agricultural employment in the United States declined sharply over the 1979-83 period, it also declined in 1969-71 against the background of a depreciating real exchange rate for the dollar; in fact, it has declined in all periods of recession since 1969. Further, this ratio increased in 1984 when the real exchange rate of the dollar was appreciating sharply. Likewise, the same ratio rose in Germany during 1976-79 when the deutsche mark was appreciating, and fell during 1980-83 when the deutsche mark was depreciating. In Japan, the manufacturing employment ratio has been flat since 1978 despite a strong real appreciation of the yen from 1982-84.^{1/} All of this suggests that one has to specify the type of disturbance moving the real exchange rate before one can predict the link between the real exchange rate and the sectoral allocation of resources. As Obstfeld [1985] points out, an increase in foreign demand for domestic manufactures may cause both a currency appreciation and an expansion in manufacturing employment whereas a shift to restrictive monetary policy will induce both currency appreciation and contraction in manufacturing employment.

In explaining the rising tide of protectionism, supporters of the present system argue that exchange rate misalignment is only one of several important factors. They note, for example, that many of the current protectionist measures or proposals have been sector-oriented or country specific and have been influenced by long-lasting shifts in competitiveness arising from factors other than exchange rate shifts. In clothing and textiles, for example, restrictions have been directed against developing countries with a comparative cost advantage and restrictions have become progressively more severe over a quarter of a

^{1/} All of these figures on manufacturing employment are drawn from Obstfeld [1985].

century, almost irrespective of changes in exchange rates. Protection of the agricultural sector and of the steel sector also does not correlate well with exchange rate movements. More generally, it can be argued that pressures for protection will be greater not only when a country's exchange rate is overvalued but also, inter alia: the higher and more rapidly increasing its unemployment rate, the smaller and less generous are its existing trade adjustment programs, the higher is its ratio of imports to consumption, the larger is employment in import-competing industries, and the higher is the level of general government intervention. ^{1/}

Finally, defenders of the present system recall that misalignment and overshooting of major-currency exchange rates were by no means unknown during the Bretton Woods era, especially in its later years. ^{2/} For example, the effective real exchange rate of the dollar depreciated by 28 percent from 1969-73. Similarly, if a currency had long been overvalued under the Bretton Woods system, and the authorities at last decided on a devaluation, they usually chose a new parity which undervalued the currency at the current level of prices. One common justification for such excessive devaluation was that it was necessary to replenish the level of reserves which had become unduly low during the period of overvaluation. ^{3/} In short, defenders argue that the current system ought not to be compared to some unobservable textbook ideal but rather to the also flawed real-world alternatives.

Issues for discussion: (i) How can the "equilibrium" real exchange rate best be defined in operational terms; (ii) what role have real economic conditions played in the 1979-85 real appreciation of the U.S. dollar; (iii) have inter-country differences in the stance and mix of policies now supplanted inflation differentials as the main determinant of exchange rate misalignments; (iv) in what respect and in what degree have misalignments under floating rates been different than those under the Bretton Woods system; and (v) in what ways have persistent misalignments under floating exchange rates especially hurt the developing countries?

C. Lack of discipline and coordination in macroeconomic policies

The third criticism of the present exchange rate system is that it has not promoted discipline and coordination in the conduct of macroeconomic policy. ^{4/} Indeed, this is probably the single most damaging charge because

^{1/} Bergsten and Williamson [1983].

^{2/} Dunn [1973] and Makin [1974] provide evidence of the trade and investment distortions created by misaligned real exchange rates during the Bretton Woods era.

^{3/} Machlup [1979].

^{4/} Coordination is perhaps best thought of as encompassing all international influences on domestic decision-making.

short-term volatility and longer-term misalignments are both widely regarded as manifestations of this failure to get underlying monetary and fiscal policies "right." 1/

Under floating exchange rates, one can expect: (i) the current exchange rate to be heavily influenced by the expected future exchange rate, and (ii) the expected future exchange rate to be heavily influenced by expected future macroeconomic policies. Since instability in current policies generates uncertainty about future policies, it is clear why disciplined and consistent policies are judged to be a sine qua non for greater stability in exchange rates.

Evidence of a lack of discipline and coordination in macroeconomic policy over the past thirteen years is not hard to find. Critics of the present system point to, inter alia, the near-doubling of average industrial-country inflation rates as between 1963-72 and 1973-85 (from 4.2 to 7.6 percent) and to the tripling of the average ratio of industrial-country (central) government fiscal deficits to GNP over the same period (from 1.2 to 3.7 percent). They also note that there have been frequent occurrences where large changes in monetary and fiscal policies have been made in a seemingly independent fashion, with too little thought given to their international repercussions. They point in particular to the 1979-83 period when the stance and mix of policies in the major industrial countries (particularly the heavy reliance on monetary restraint) produced historically high real interest rates, low commodity prices, and sluggish economic activity with adverse "spillover" effects for developing countries' debt service, export earnings, and growth performance. 2/ Finally, critics note that efforts at better coordination during the floating rate period have not produced binding agreements on either monetary and fiscal policies, or on exchange rates.

1/ "It [the present exchange rate system] has not prevented inadequate policies and divergent economic performance which have contributed to a high degree of short-term volatility of nominal exchange rates and to large medium-term movements in real exchange rates." G-10 Report, paragraph 5. "This [improved functioning of the exchange rate system] implies greater effort on the part of the developed countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies." G-24 Report, paragraph 65.

2/ "In the recent past, their [industrial countries] uncoordinated attempts to disinflate led to excessive emphasis being given to monetary restriction relative to other instruments. The result was a halting process of recovery with high real interest rates and low commodity prices having particularly adverse effects on the developing countries." G-24 Report, paragraph 72.

The view that discipline and coordination of macroeconomic policies in industrial countries needs to be improved is now widely accepted. The main point at issue is what contribution the exchange rate system can make toward achieving that objective. Critics of the present system maintain that the obligation to defend the parity in a fixed rate system obliges the more inflationary countries to discipline themselves in order to avoid repeated (and politically costly) realignments. On the other hand, supporters of the present system offer the following arguments.

First, experience suggests to them that greater fixity of exchange rates is neither necessary nor sufficient for enforcing discipline on macroeconomic policy. They note, for example, that the deceleration in growth rates of narrow and broad money that took place in most of the major industrial countries in 1979-82 (in the face of high unemployment) was accomplished without exchange rate targets; hence, greater fixity of exchange rates is not "necessary" for anti-inflationary discipline. Similarly, even during the Bretton Woods era, there were too many cases of exchange rate targets giving way to employment targets when the two came into conflict to believe that greater fixity of exchange rates is "sufficient". In fact, they would say that history is more kind to the proposition that the exchange rate regime is determined by the degree and inter-country dispersion of discipline in macroeconomic policies than to the reverse line of causation.

Second, some observers argue that the exchange rate regime does not necessarily have a comparative advantage over other institutional mechanisms for imposing discipline on national authorities. For example, if greater discipline in monetary policy is sought, then pre-announced money supply rules, or even various types of commodity standards are alternative roads to making a non-accommodation strategy more credible. As regards discipline for fiscal policy, fixed rates may, so the argument goes, be even less effective than flexible rates. This is because (under fixed rates) an expansionary fiscal policy that is not monetized draws in capital from abroad and leads to an increase in foreign exchange reserves; hence, reserve movements impose no discipline. In contrast, expansionary fiscal policy (with tight monetary policy) under flexible rates induces currency appreciation that may in turn lead to political pressure from the traded goods sector for fiscal restraint. ^{1/} And if discipline against inflation is the primary concern, measures that substitute rules for discretion in determining the world money stock, or that put a tax on inflationary wage settlements (e.g., tax-based incomes policy) may represent more direct constraints.

^{1/} An alternative point of view, inspired by the recent experience of the United States, is that strains in the traded goods sector tend to lead to protectionist pressures more than to fiscal restraint.

Third, although trying to describe the "counterfactual" is always a speculative exercise, some have argued that a fixed exchange rate between the United States and the rest of the OECD would not likely have prevented either the recent real appreciation of the U.S. dollar or its international effects. 1/ The argument here is that fixed rates cum U.S. fiscal expansion would still have meant relatively high U.S. interest rates and a large net capital inflow. The capital inflow in turn would have lowered foreign money supplies and (unless sterilized) increased the U.S. money supply. The effects of these money supply changes would thus have been to raise U.S. prices relative to those abroad. One would still get a real appreciation of the U.S. dollar, but this time operating mainly via national price levels rather than via the nominal exchange rate. Alternatively, attempts to prevent these money supply changes from taking place under fixed rates (via capital controls or sterilization operations) would only lead to a higher level of interest rates and would remove, so the argument goes, the inflation pressure for a fiscal reversal. The alleged moral of this scenario is that it is fiscal reform rather than exchange rate reform that is the necessary ingredient for preventing misalignment and its effects.

Fourth, supporters of the present system caution that there are "natural" limits to coordination of policies, whatever the exchange rate regime. Exchange rates and interest rates are by their very nature "competitive" in the sense that one country's gain is frequently the other's loss. Also, the compromise of growth and inflation objectives at the national level often leaves little room for further compromise on demand policies at the international level. 2/ Given these limits, past efforts at coordination (e.g., the U.S. dollar support package of November 1, 1978, the agreements of the Bonn economic summit of 1978, and the September 1985 G-5 agreement in New York on exchange rates and adjustment policies)--while perhaps still far from optimal--should, in their view, not be seen in too bad a light.

Finally, supporters of the present system are wary of comparisons between the period of floating rates and that of par values. They note that many features of the global economic environment that are important for macroeconomic performance but are not proximately related to the exchange rate regime, were also changing during the

1/ See, for example, Obstfeld [1985].

2/ See Polak [1981] for an expansion of both these points.

period of floating rates. ^{1/} For example, inflation performance during the floating rate period may have been distorted by the two rounds of large oil price increases (1973-74 and 1979-80) and by the huge expansion (57 percent) in international reserves in 1970-72 associated with the collapse of the Bretton Woods system.

Issues for discussion: (i) Would the adoption of sound, credible, and stable policies in industrial countries be both necessary and sufficient for achieving exchange rate stability; (ii) Could greater fixity of key-currency exchange rates improve the discipline in the conduct of macroeconomic policy, or does the lack of discipline under floating rates have origins outside the exchange rate regime; (iii) Why has coordination of macroeconomic policies been so difficult to achieve over the past two decades; (iv) Is centralized international decision-making inherently more difficult under floating rates than under a par value system; and (v) what "lessons" about the effect of the exchange rate regime on discipline and coordination can be drawn from the experience of the European Monetary System (hereafter EMS)?

III. Perceived Strengths of the Present System

While both the G-10 and G-24 agree that the existing exchange rate regime has shown weaknesses, the G-10 emphasizes that it has also displayed some "valuable strengths." More specifically, they stress that exchange rate flexibility has made positive contributions to "external payments adjustment," to "insulation of domestic price levels from inflation abroad," and to "the pursuit of sound monetary policies geared more directly to domestic conditions." ^{2/} Finally, they doubt whether any less flexible system could have survived the strains of the past decade without increased reliance on restrictions on trade and capital flows. Each of these perceived strengths is discussed in this section.

A. Promotion of external payments adjustment

Although it has perhaps not provided all that was hoped for prior to the advent of floating rates, supporters of the present system maintain that exchange rate flexibility has made a positive contribution to external payments adjustment on at least three counts.

^{1/} "It would be misleading to draw definite conclusions on the merits and demerits of the present system merely by comparing economic performance in the period of floating with that recorded under the par value system. Conditions during the floating rate period have been different in too many respects to allow such a comparison to be meaningful."

G-10 Report, paragraph 13.

^{2/} G-10 Report, paragraph 14.

First, the extent of payments adjustment in the floating rate period (1973-85) has been somewhat better than that during the last decade of adjustable par values (1963-72), at least for the seven largest industrial countries--and this despite the occurrence of some unusually large external shocks during the floating rate period (e.g. two periods of large increases in world oil prices, namely 1973-74 and 1979-80). Simple measures of payments imbalances, such as the ratio of current account balances alone to GNP or the ratio of current accounts plus normal capital flows to GNP, show smaller mean imbalances and less persistence (serial correlation), on average, for 1973-85 than for 1963-72.

Second, the symmetry of adjustment is alleged to have improved. Recall that two well-known charges against the Bretton Woods system were: (i) that surplus countries were subject to a much weaker discipline than deficit countries; and (ii) that reserve centers, particularly the United States, had an unwarranted privilege because they could finance payments deficits by liability as opposed to asset settlement. Both of these asymmetries are said to have been much reduced under floating: there is no evidence (among industrial countries) that mean payments imbalances are larger or more persistent for surplus countries, and the privilege (some would say dangers) of liability settlement has since been extended to many countries, including developing ones.

Third, exchange rate flexibility has, according to its proponents, reduced the cost of adjustment. The argument here is that when exchange rates are less flexible, the burden of adjustment falls more on expenditure-reducing measures and less on expenditure-switching ones, with heavier costs in terms of real output and employment. 1/ They further point out that econometric studies indicate that exchange rate depreciation is likely to be effective in improving the trade balance in the medium to long-term, and that there is no evidence that price elasticities for traded goods have declined since the onset of floating rates. 2/

The contribution of exchange rate flexibility to external payments adjustment is still a matter of some dispute. Critics of the present system offer the following counter-arguments.

On the extent of external adjustment, they note that current account performance of some large industrial countries has been anything but satisfactory over the past three years; that current account performance for the smaller industrial countries has been significantly worse, on

1/ An implicit assumption in this argument is that it is more difficult to alter the relative price of tradables in the presence of a relatively rigid nominal exchange rate.

2/ IMF [1984 C] and Goldstein and Khan [1984].

average, during 1973-84 than during the last ten years of Bretton Woods; and that reversal of current account imbalances, even for the larger industrial countries, has typically taken an extremely long time (on the order of three to seven years). 1/ In addition, they mention that more sophisticated measures of equilibrium payments balances suggest that there have been many instances during the floating rate period of unsustainable or undesirable payments outcomes. 2/ In short, the extent of external payments adjustment under floating rates may have been marginally better on average than during the Bretton Woods period but it was far from satisfactory.

The symmetry of external adjustment as between surplus and deficit countries may have improved under floating rates, but critics contend that some asymmetries have gotten worse. In particular, the burden of external adjustment is alleged to now fall much harder on the developing countries than on industrial ones. 3/ Further, it could be argued that within the industrial-country group, external adjustment has been least effective in the very countries with the most substantial spillover effects on the world economy. Also, whereas the United States is admittedly no longer the only country to enjoy the privilege of liability settlement, some might argue that it now enjoys a new unwarranted privilege--namely, to finance an unusually large part of its fiscal deficit with the rest of the world's savings.

Finally, while exchange rate changes may well improve the current account in the medium to long-term, critics note that there can be substantial "J-curve" effects in the short to medium term. Further, even in the long term, exchange rate changes will not be an equally effective instrument for achieving external balance in all countries; instead, its relative effectiveness depends in good measure on the economy's structural characteristics. Specifically, both theory and empirical evidence suggest that the smaller, more-open, more-highly indexed economies suffer proportionately larger domestic price feedbacks and obtain less lasting relative-price advantage from exchange rate changes than do the larger, less-open, and less-indexed economies. 4/ Therefore, the extent to which exchange rate flexibility reduces the cost of adjustment is not the same for everybody. 5/

1/ See IMF [1984c] and Shafer and Loopesko [1983].

2/ See IMF [1984b], [1984c], and Williamson [1985].

3/ "It [the surveillance function of the IMF] has so far been largely ineffective on major industrial countries, resulting in asymmetry in the international adjustment process, the burden of which has fallen disproportionately on developing countries." G-24 Report, paragraph 9.

4/ See Goldstein and Khan [1984].

5/ "It [exchange rate depreciation] is much less useful in countries that have to rely on export of traditional agricultural and mineral commodities..." "... it could also ... stimulate cost inflation..." G-24 Report, paragraph 87. "... the degree of exchange rate stability deemed appropriate differs from country to country." G-10 Report, paragraph 11.

Issues for discussion: (i) Would less flexibility of exchange rates hinder the extent and speed of external payments adjustment and increase its costs; (ii) has there been an asymmetry in adjustment as between major industrial countries and developing countries, and if so, what factors underlie it; (iii) if external payments adjustment among the major industrial countries has been less than satisfactory of late, is it because the capital-account "tail" is now wagging the current account "dog;" and (iv) if the degree of exchange rate flexibility deemed appropriate differs from country to country, how can such inter-country differences be accommodated if not in a system like the existing one which permits considerable heterogeneity in exchange arrangements?

B. Insulation from inflation abroad

Prior to the actual experience with floating exchange rates, it was thought by many that floating exchange rates would be premier insulators against a whole range of foreign disturbances. The last thirteen years have shattered that illusion. It is now widely accepted that the insulating properties of floating rates are more modest. 1/ Specifically, floating rates can provide good insulation against a rise in the world price level because an appreciation of the domestic currency proportionate to the increase in foreign prices prevents wealth or relative price effects from taking place. But floating rates cannot insulate against relative price changes among different classes of traded goods because they cannot alter relative prices at that level of aggregation. Beyond that, the relative insulating properties of floating rates vis-a-vis fixed rates cannot be generalized without specifying the nature of the disturbance (monetary or real), the origin of the disturbance (home or abroad), what is to be insulated (real output or consumption), and who is to be insulated (the home country alone or the home and foreign country taken jointly). 2/

Having acknowledged this, defenders of the present system still emphasize that the insulation provided by floating rates against inflation abroad should not be underrated. 3/ After all, it was the very inability to protect themselves from imported inflation that induced some

1/ "... the Deputies recognize that no exchange rate system can provide full insulation from the effects of economic policies and performance in other countries." G-10 Report, paragraph 22.

2/ Fiscal disturbances would be described as real disturbances in the classification presented above.

3/ "It [exchange rate flexibility] can help countries, especially the larger ones, to insulate their domestic price levels from inflation abroad...." G-10 Report, paragraph 14.

countries to abandon the Bretton Woods system in the early 1970s. 1/ Also, so long as there remains a significant risk for the future that some countries will not follow reasonable monetary and fiscal policies, it would in their view be premature to abandon the protection offered by floating rates against this risk.

Critics of the present system might reply that the dominant shocks of the 1970s and the 1980s have been the very ones (i.e. relative price changes among different classes of traded goods such as oil, and sharp changes in interest rates) against which floating rates have a comparative disadvantage in insulation vis-a-vis fixed rates. In addition, they observe that available empirical evidence suggests that the international synchronization of real and monetary variables has been even higher during the period of floating rates than during the era of par values. 2/ This evidence would be consistent with a greater incidence of common external shocks and common policy responses to them under floating rates but it could just as well imply greater transmission of disturbances under floating rates. Some critics of the present system would go further and conclude that because floating rates cannot provide good insulation against the representative set of foreign disturbances, the case for policy activism to combat such disturbances, including greater use of exchange market intervention, is strengthened. 3/

C. Independence and effectiveness of domestic monetary policy

One reason why floating rates seemed attractive in the latter years of the par value system was that by then the incompatibility of fixed exchange rates, high international mobility of capital, and independence for domestic monetary policies had become readily apparent. This was particularly the case in Germany and Switzerland where restrictive monetary measures (taken to avoid imported inflation) brought forth capital inflows, official intervention to support the U.S. dollar, more capital inflows, etc. Floating rates offered a way out of that dilemma. Specifically, since there would no longer be an obligation

1/ A counter-argument of the supporters of the Bretton Woods system is that the collapse of that system reflected not any intrinsic design flaws but rather faulty implementation. In particular, the system was undermined by "excessive" fixity in nominal exchange rates that produced large misalignments in key-currency real exchange rates.

2/ See Swoboda [1983] and IMF [1984c].

3/ "Intervention... could be used on a meaningful scale, without confining it to 'leaning against the wind,' towards the end of exchange rate stability, as a complementary measure to other policies, and sometimes in coordination with other countries." G-24 Report, paragraph 66.

to use exchange market intervention to peg the exchange rate, exchange market pressure could take the form of exchange rate changes rather than reserve movements and the foreign component of the monetary base would be stable. In short, floating rates would allow countries to regain control over their own money supplies. A second attraction was that floating rates, at least in theory, were supposed to strengthen the output and employment effects of expansionary monetary policy via the positive effects of the induced exchange rate depreciation on the trade balance.

More than a decade later, even the supporters of the present system would probably acknowledge that the case for the independence and effectiveness of monetary policy under floating rates was exaggerated. Many of the constraints on monetary policy seem in retrospect to be as much related to the openness of national economies as to the exchange rate regime per se. These constraints show up in either a reduced ability to control the instruments of monetary policy (the nominal money supply under fixed rates), or a reduced ability to control some of the targets of monetary policy (the level of real output), or in increased caution in the use of monetary policy because of potentially dangerous effects on expectations.

Still, supporters of the present system maintain that floating rates have been instrumental in facilitating "... the pursuit of sound monetary policies geared more directly to domestic conditions." ^{1/} They are credited with having increased countries' control over their own money supplies without resort to capital controls. It is claimed that floating rates have also allowed countries to choose trend inflation rates and to carry out effective anti-inflationary policies. These extra degrees of freedom would not be so prized in a world in which all countries consistently implemented sound and credible policies on their own accord. But, so the supporters of floating rates argue, they are valuable assets in the real world where one's trading partners can sometimes suffer quite serious lapses of discipline in macroeconomic policy.

Critics of the present system see the contribution of floating rates to monetary policy as more modest, if any. They note that whereas the exchange rate appreciation that goes with a tight monetary policy can aid the home country's anti-inflation efforts, it does so at the expense of handicapping the efforts of partner countries to control their own inflation rates; to them, it is thus a new type of "beggar-thy-neighbor" policy. They argue in addition that, at the margin, floating rates have not increased the independence of monetary policy all that

^{1/} G-10 Report, paragraph 14.

much. After all, the considerable volume of official intervention during the floating rate period suggests that most industrial countries view the exchange rate as a policy target as well as a policy instrument. ^{1/} When the exchange rate moves by a significant amount in a short period, even those countries whose exchange arrangements are classified as "independently floating" develop implicit exchange rate targets and adjust monetary policy accordingly. They also doubt whether floating rates have increased the potency of expansionary monetary policy. In this regard, they mention that: (i) significant feedback effects of exchange rate depreciation on money, wages and prices limit the gain in competitiveness; (ii) J-curve effects in the response of the trade balance to exchange rate depreciation mean that in the short to medium term, the external sector will weaken, not strengthen, the domestic impact of expansionary monetary policy; and (iii) that currency substitution can lead to much larger swings in exchange rates than the authorities may find desirable. Finally, the critics question whether monetary policy ought to be geared toward domestic conditions. They contend that one of the main reasons why exchange rates have been so variable over the floating rate period is because monetary policy has not taken external consideration enough into account. ^{2/}

Issues for discussion: (i) To what extent has exchange rate flexibility allowed countries to regain control over their own money supplies; (ii) should monetary policy be directly primarily at achieving price stability and sustainable growth, or should external targets (like the exchange rate) also play a role; (iii) can floating rates increase the effectiveness of monetary policy without inducing beggar-thy-neighbor effects on trading partners; and (iv) if exchange rate flexibility were constrained, would countries still be able to choose trend inflation rates without resort to capital controls?

D. The resiliency of the present system

Thus far, the appraisal of the present exchange rate system has been based on implicit comparisons with other exchange rate systems (including both those implemented in the past and those proposed for the future). Supporters of the present system contend, however, that given the strains of the past decade (e.g. two major changes in the price of energy products; a number of important bank failures; sometimes large inter-country differences in inflation rates, monetary policies, and policy mixes, etc.), it is "... questionable whether any less flexible system would have survived" (without increased reliance

^{1/} See Black [1979] and IMF [1984c].

^{2/} "Exchange rate stability should be an important objective of policy instead of being a residual of other policy actions of individual countries, as is the case at present." G-24 Report, paragraph 65.

on restrictions on trade and capital flows). ^{1/} The present system is thus viewed as being particularly resilient to the operating environment--no small advantage if it is assumed that there are significant costs associated with changing exchange rate systems.

To what is this resiliency attributable? Three factors might be identified as contributing.

First, the wide choice of exchange arrangements permitted by the Articles of Agreement means that it is possible to accommodate different country preference with respect to flexibility of exchange rates and to the mix of domestic economic policies. Countries who feel that the benefits of fixed rates outweigh the costs can choose pegged exchange arrangements while those that view exchange rate flexibility as essential can opt for floating. In between these two poles, there is room for adjustable pegs (the European Monetary System) as well for different degrees of exchange market intervention within the group of countries classified as "independently floating". Supporters of the present system recall that the Bretton Woods system operated successfully while there was a consensus about the assignment of responsibilities for exchange rate action and monetary policy as between the reserve-center country and others, but collapsed when this consensus evaporated. To the extent that the degree of exchange rate stability deemed appropriate differs from country to country, the present system can be said to be compatible with these differences.

Second, the present system permits decentralized market-based decisions to act as a "safety valve" when it is not possible to reach centralized decisions about the sharing of the adjustment burden and about the equilibrium pattern of exchange rates. Because the market "takes a view," it is possible to avoid, so say the supporters of floating rates, the centralized management delays of the latter years of the Bretton Woods system.

Third, the present system contains enough "flex" in exchange rates to avoid what defenders of floating rates regard as the crucial flaw of all adjustable peg systems, namely, the incompatibility of high international mobility of capital and fixed exchange rates with narrow margins. They argue that so long as private market participants have greater resources than central banks, market views on exchange rates can change rapidly, and parities have to be changed from time to time to reflect changes in real economic conditions, any system that places tight limits on exchange

^{1/} G-10 Report, paragraph 14.

rate movements will be subject to successful speculative attack; alternatively, attempts to preserve existing parities will force resort to increased restrictions on capital flows.

Critics of the present system acknowledge its resiliency but argue that this is less important than its performance. They point out that the exchange rate system is basically a facilitating mechanism for more fundamental economic objectives, such as high employment, sustainable growth, price stability, and expanding and balanced international trade. As such, whatever its durability, an exchange rate system should be judged in terms of its contribution to those objectives. And on this scale, they find the present system of floating rates wanting. ^{1/} They also maintain that the characteristics that make the present system relatively resilient may have other undesirable implications for its performance while it lasts. For example, the great diversity of exchange arrangements may make it more difficult to define "rules of the game" for macroeconomic policies that are sufficiently specific to be effective. Indeed, it is the very lack of such recognized rules of the game, especially for major industrial countries with floating rates that, according to critics, is responsible for the severe misalignments of the floating rate period. Similarly, while they agree that the present system allows the market "to take a view" when centralized decisions are not feasible, they argue that the present system does not offer a sufficient framework for reaching a satisfactory multilateral decision; in addition, the market's view is too often the "wrong" view. Finally, the same "flex" in exchange rates that provides a defense against "hot money" flows often proves a liability when exchange rates become divorced from fundamentals and get carried along by self-fulfilling destabilizing speculation.

Issues for discussion: (i) Would other exchange rate systems have been able to survive the events of the past thirteen years, without resort to increased use of trade and capital controls; (ii) if excessive variability of floating exchange rates and not fully-credible fixed exchange rates both induce destabilizing speculation, what conclusions can be drawn about the best defense against speculative attack; (iii) is it necessary for successful functioning of the exchange rate system that each of the major industrial countries has a common view about the appropriate degree of exchange rate flexibility; and (iv) is it important for the exchange rate system to be resilient to changes in the international economic environment?

^{1/} "The functioning of the present floating rate system has thus not been able to provide... a framework that facilitates the exchange of goods, services, and capital among countries, which sustains sound economic growth and helps develop orderly underlying conditions necessary for financial and economic stability." G-24 Report, paragraph 64.

IV. Proposals for Improving Exchange Rate Stability

As suggested earlier, both the G-10 and the G-24 Reports conclude that the functioning of the exchange rate system needs to be improved. Also, both reports agree that perhaps the single most important element in achieving such an improvement lies in obtaining better discipline and coordination of macroeconomic policies in the major industrial countries. The key question then is what mechanisms or channels, including Fund surveillance, are available for reaching that latter objective. In this section, three types of proposals identified in the G-10 and/or G-24 Reports as ways of improving exchange rate stability are discussed, namely: (i) adoption of "target zones" for the exchange rates of major currencies; (ii) adoption of a set of "objective indicators" or "targets" for macroeconomic policies in major industrial countries that could be used as a framework for the first stage of multilateral Fund surveillance; and (iii) adoption of policy adjustments and of changes in the procedures for Fund surveillance that could be accomplished within existing exchange rate arrangements and the existing institutional framework for surveillance.

Since most of the specific reform proposals move in the direction of more automaticity in the adjustment and coordination process, it is perhaps useful as a prelude to describe how the present system stands on rules versus discretion in adjustment vis-a-vis alternative exchange rate systems.

If one were to classify alternative exchange rate systems along a spectrum according to either the degree of automaticity of the adjustment process, or the mix between rules and discretion in initiating adjustment, the present system would certainly stand closer to the complete discretion pole than the rules-only pole. In this respect, the pure gold standard with its (alleged) automatic specie-flow mechanism, the adjustable peg system with its clear implication for the subordination of domestic monetary policy to the exchange rate (except during fundamental disequilibrium), the objective indicator system with its automatic trigger for the initiation of adjustment discussions and/or actions, or even a pure floating system with its complete prohibition of all official intervention in the exchange market--all could be considered less discretionary than the present system. By the same token, efforts at coordination of economic policies during the period of floating rates represent at most a middle ground between activist and passive coordination strategies. Efforts have gone beyond exchange of forecasts and policy intentions to encompass occasional common actions but have stopped well short of binding agreements on either exchange rate targets or the stance and mix of monetary and fiscal policies. The present system might therefore be characterized as "... a discretionary and decentralized system, with loose coordination among the main players.

but with tighter coordination and disaster relief during crises." 1/ One way of characterizing the first two proposals for improving exchange rate stability (i.e., target zones and objective indicators) is to say that they seek to move the present system somewhat further in the direction of more automatism and more centralisation in adjustment and coordination. In contrast, the third proposal retains the discretionary, decentralized character of the present system but counts on "enhanced dialogue and persuasion through peer pressure" to make the available channels for adjustment and coordination function better than they have in the past.

A. Target zones for exchange rates of major currencies

One proposal for improving exchange rate stability that is specifically addressed in both the G-10 and G-24 Reports is the adoption of target zones for the exchange rates of major currencies. As indicated earlier, the G-24 Deputies felt that the adoption of target zones "could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances." 2/ In contrast, the majority of G-10 Deputies considered that "... the adoption of target zones is undesirable and in any case impractical in current circumstances." 3/

In this sub-section, attention is focused on three questions: (i) what is meant by a target-zone approach to exchange rate management; (ii) what is the rationale for it; and (iii) what is behind the skepticism about and/or the opposition to, that proposal. A more thorough treatment of the target zone proposal, emphasizing particularly the relevant technical and operational issues, is contained in the supplementary paper, "Target Zones" (SM/86/6).

(1) What is meant by a target zone approach to exchange rate management?

In the G-10 Report, target zones are described as follows: "... the authorities concerned would define wide margins around an adjustable set of exchange rates devised to be consistent with a sustainable pattern of balances of payments." 4/

Target zones differ from the present system of floating rates in two respects: (a) the authorities establish a target zone for the exchange rate for some future period; and (ii) the authorities partially

1/ IMF [1984 c].
2/ G-24 Report, paragraph 66.
3/ G-10 Report, paragraph 32.
4/ G-10 Report, paragraph 31.

direct monetary policy to the exchange rate so as to discourage the exchange rate from moving outside its target zone. Target zones differ from "pure" or "clean" floating in that the authorities are permitted to intervene in the exchange market, and indeed, are encouraged "to take a view" on the desirable level of the exchange rate. At the same time, there are no formal or rigid commitments to intervene in exchange markets in all circumstances--a characteristic that differentiates target zones from the adjustable peg system. Finally, in addition to the absence of a formal intervention obligation, target zones differ from a system of rigidly fixed rates in that the zones themselves are to be occasionally reviewed and changed if deemed necessary (e.g. to reflect differential inflation and any need for balance of payments adjustment).

Most target zone proposals envisage the members as being the five largest industrial countries. Other countries could then "fix" or "flex" on the members of the target zones as they saw fit. Target zones would reflect estimates of real equilibrium exchange rates because it is the real exchange rate that is most relevant for resource allocation and balance of payments adjustment; however, for operational purposes, they would be defined in terms of nominal exchange rates. Monetary policy and exchange market intervention are viewed as the two policy instruments to be used for external balance while monetary and fiscal policy are assumed to be adequate to the task of countering "inflationary and deflationary pressures." 1/

As suggested in the accompanying supplementary paper, "Target Zones" (SM/86/6), it is possible to conceive of a whole spectrum of possible approaches to target zones. The various approaches could be distinguished by reference to the following four characteristics: (i) width of the target zones (outside of which the exchange rate is viewed "as out of line"); (ii) the frequency of changes in the target zones; (iii) the degree of publicity given to the zones (e.g., public announcement versus confidential disclosure in official circles, or "loud zones" versus "quiet zones"); and (iv) the degree of commitment to keeping exchange rates within the zone.

At one end of the spectrum, "hard" target zones would imply narrow margins, infrequently revised zones, public announcement of the zones, and a monetary policy that was directed at keeping the exchange rate within the zone. In this sense, hard target zones might be considered a close relative of the EMS' fixed but adjustable parities with narrow margins and a "divergence indicator". Unlike the EMS, however, there would be no rigid commitment to exchange rate intervention; nor do hard target zones imply any analogue to the credit facilities of the EMS.

1/ G-24 Report, paragraph 67.

At the other end of the spectrum, "soft" target zones would be characterized by wide, frequently-revised, confidential zones, and by a monetary policy that pays only limited attention to the level of the exchange rate. Soft target zones differ from existing procedures for Fund surveillance (e.g., the requirement for reporting real exchange rate changes in excess of 10 percent to the Executive Board) in that the former introduces a more explicit and formal framework for defining the appropriate pattern of exchange rates and for specifying the links between exchange rates and macroeconomic policies. 1/

(2) The rationale for target zones

Supporters of target zones make essentially six arguments about why and how target zones will improve the functioning of the exchange rate system.

First, target zones are said to improve the international consistency (i.e. coordination) of macroeconomic policies because target zones have to be negotiated and must display mutual consistency of cross exchange rates. 2/ In this way, so it is argued, the exchange rate implications of alternative stances and mixes of macroeconomic policies will be directly confronted, thereby ending the undesirable current practice whereby exchange rates emerge as a residual of other policy actions of individual countries. 3/ In a related vein, supporters argue that the negotiation and revision of target zones could act as a convenient organizing framework for multilateral surveillance. Even if the zones were wide and frequently revised, they would catch the most flagrant and persistent cases of inappropriate policies. Thus, while soft zones might not be able to identify real exchange rate misalignments of 10 percent or less, they would, so it is claimed,

1/ Existing procedures do not rely on the assessment of appropriate zones but rather use as a starting point the last occasion on which exchange rate developments were brought to the attention of the Executive Board. In addition, this reporting and monitoring procedure has not led to any Board discussions.

2/ "... commitment to [target zones for exchange rates of major countries]... would promote greater international policy consistency." G-24 Report, paragraph 66.

3/ They [target zones] could... trigger consultations that would induce step by step, more direct links between domestic policies and exchange rate considerations." G-10 Report, paragraph 31.

at least prevent the 30 percent or larger misalignments that do so much damage to the system.

Second, target zones may improve the discipline of macroeconomic policies in two ways: (i) if exchange rates are maintained within the zones, then monetary and fiscal policy will be disciplined by the exchange rate constraint, much as in a fixed rate system; and (ii) if the authorities opt to alter the zone rather than their policies, they will still have to explain why a new zone is appropriate and convince other members accordingly. The latter requirement could be said to introduce stronger peer pressure into policy formulation.

Third, target zones are viewed as providing an anchor for medium-term exchange rate expectations, thereby promoting stabilizing speculation and greater stability of exchange rates. 1/ The anchor is said to be established on two counts: (i) the obligation (albeit an informal one) or the intention to keep the exchange rate within the zone gives market participants valuable information about the future course of monetary policy, thereby lessening the danger that short-term deviations of policy will be erroneously extrapolated into the future; and (ii) the publication of target zones gives the market a direct estimate of the equilibrium exchange rate (plus or minus the width of the zone), thereby lessening the risk that the "wrong" model is used to link policies and exchange rates. Target zones can thus also be seen as ensuring that "convergence of economic performance" is "sufficient" rather than just "necessary" for lasting exchange rate stability. 2/

Fourth, because the likely members of a target zone system would be the key-currency industrial countries, it is claimed that target zones would reduce the asymmetry in adjustment that has plagued the present exchange rate system. In particular, it would subject the countries whose policies have the greatest spillover effects on the world economy to the same scrutiny and pressure experienced by smaller countries with external and internal imbalances. And the perception that Fund surveillance was even-handed would, so it is argued, make it more effective on the smaller countries as well.

1/ "They [some Deputies] further believe that credible commitments to target zones would contribute to stabilizing market expectations..." G-10 Report, paragraph 31.

2/ G-10 Report, paragraph 31.

Fifth, while proponents recognize that there are difficulties associated with identifying equilibrium exchange rates, they point out that "arriving at a judgment about the appropriateness of the exchange rate of a currency is part of the current practices of the IMF." ^{1/} As such, these difficulties should not be exaggerated.

Finally, while it is acknowledged that many of the factors associated with the collapse of the Bretton Woods system have not gone away, supporters maintain that target zones can survive speculative attacks. They reason that so long as target zones are revised frequently to reflect inflation differentials and the need for real exchange rate adjustment, the large and discrete changes in exchange rates that motivate speculative attacks will not occur. Also, they point to the durability and success of the EMS as tangible proof that an adjustable peg system can survive in the 1980s; since target zones share some of the EMS' characteristics, the former too can be considered practical.

(3) Opposition to target zones

Concerns about the desirability and practicality of target zones can be summarized in the following arguments.

First, there are doubts about the extent to which target zones will promote coordination and discipline in macroeconomic policy among the members. It can be argued that by focusing attention on exchange rates rather than on the root cause of misalignment--namely, the stance, mix, and divergence of policies--one may lessen the pressures for corrective action. Also, some would say that evidence from periods during which exchange rates were more rigid does not suggest that there was more complete, faster, or more symmetrical external adjustment. So why then should target zones induce better discipline and coordination when regimes with more formal commitments did not? Further, reaching a consensus on the zones of desirable exchange rates could prove difficult. ^{2/} This raises two additional dangers: (i) the process of negotiating target zones could produce serious frictions among the members, possibly reducing future coordination in this and other areas; (ii) lack of consensus could reproduce the centralized-management delays of the latter years of the Bretton Woods system, with serious misalignments then stemming from too little nominal exchange rate flexibility.

Second, the claim that target zones would provide an anchor for exchange rate expectations can be challenged. Opponents of target zones argue that because our knowledge about the determinants of exchange

^{1/} G-10 Report, paragraph 31.

^{2/} "Most Deputies, however, are of the view that reaching a consensus on the range of desirable exchange rates [for target zones] would prove extremely difficult." G-10 Report, paragraph 32.

rate changes is so imperfect, zones would have to be wide enough to reflect that ignorance. Also, the zones will need to be revised to reflect changes in real economic conditions. But then wide, moving zones will not, so its opponents claim, provide a useful anchor for exchange rate expectations. 1/ What is more, some would add that if the lack of an anchor under the present system reflects uncertainty about future policies, the way to overcome that problem is to announce the future course of policies, not of exchange rates.

A third criticism of target zones is that they do not resolve the problem of how to allocate the burden of adjustment among member countries. When more than one country's (effective) exchange rate leaves the zone, it will be necessary to specify who does what. The target zone proposal does not, so it is argued, solve the "N-1 problem."

Fourth, skeptics of target zones reason that since markets would inevitably test the zones, they could only be defended if monetary policy was diverted rather markedly from its domestic stabilization duties to stabilizing the exchange rate. But this raises the question of which policy instruments would then be in charge of maintaining internal balance (i.e., price stability and sustainable growth). The answer might be fiscal policy but some would say that experience raises serious doubts about whether it would be adequate to, and flexible enough, for that task. In such a case, the constraints imposed on monetary policy by a target zone might, in the view of opponents, handicap efforts to achieve stable prices and high employment over the medium-term. 2/

Yet a fifth concern is that the exchange rate may send false signals about both the need for adjustment and the appropriate corrective action. This is another way of asking whether the exchange rate would be a "sufficient statistic" for guiding macroeconomic policies. Some observers answer that question in the negative. The G-10 Report, for example, concludes that while exchange rate developments "... provide information on private markets' assessments of underlying economic conditions and of current and expected policies," "... a wide range of factors beyond exchange rate developments should also be taken into

1/ "Given our imperfect knowledge of the determinants of exchange rate movements, the target zones would have to be too wide to serve as an anchor for expectations." G-10 Report, paragraph 32.

2/ "Above all, the constraints imposed on domestic policies by target zones might undermine efforts to pursue sound and stable policies in a medium-term framework." G-10 Report, paragraph 32.

account in assessing national policies and the need for consultation and policy discussion." 1/

An example may illustrate the potential pitfalls involved. Suppose an overvalued real exchange rate primarily reflected a structural budget deficit in the home country. Then a (simplistic) application of the target-zone approach would point toward the need for monetary expansion (in the home country) to depreciate the actual exchange rate--and this even though the root cause of the problem lay with fiscal policy. 2/ More generally, target zone systems that rely on monetary policy to keep rates within zones can be criticized as being ill suited to handling disequilibria that derive from inappropriate policy mixes. In short, critics argue that target zones are not a sufficient statistic because money supply changes are not the appropriate response to all types of disturbances. This danger would be reduced if target zones were seen solely as a trigger mechanism for multilateral discussion of policies, with the appropriate policy response determined on a case-by-case basis. But then, opponents of target zones argue, the system will lose its "automatic" character and may not increase the speed of adjustment at all.

Last but not least, opponents of target zones warn that the experience of the EMS cannot necessarily be generalized to a "broader and more heterogeneous context characterized by the presence of a plurality of reserve currencies." 3/ To them, the policy convergence and exchange rate stability associated with the EMS cannot be divorced from the unusual degree of political commitment behind it, the capital controls retained by some members, and the structural characteristics of the member countries. 4/

Issues for discussion: (i) What are the relative merits of "hard" versus "soft" versions of target zones; (ii) could monetary policy in a target zone do the necessary "balancing act" between the dictates of the exchange rate and those of internal balance; (iii) would target zones provide an effective incentive for better discipline and international consistency of macroeconomic policies; (iv) could relatively wide target

1/ G-10 Report, paragraph 30.

2/ Supporters of target zones deny that an intelligent application of target zones would produce such perverse policy prescriptions. In their view, the political pressures that would emanate from repeated breaches of the zones would yield the appropriate corrective policies, both as regards the stance and mix of policies.

3/ G-10 Report, paragraph 24.

4/ Proponents of target zones might reply that successful policy coordination, whatever the exchange rate regime, requires precisely such "unusual" political commitment.

zones (say, 10 percent on either side of the central rate) act as a useful anchor for exchange rate expectations. and (v) are exchange rate movements likely to be a sufficient statistic for charting the course of macroeconomic policies, or would they serve better as a "trigger mechanism" for international discussion of policies?

B. Objective indicators or targets for macroeconomic outcomes and policies

A second specific proposal for improving exchange rate stability and for strengthening the analytical basis of Fund surveillance, is to introduce a set of "objective indicators" or "targets" into the multilateral discussion and negotiation of macroeconomic policies in key-currency countries. This proposal is presented in the G-24 Report as follows:

"Multilateral surveillance and bilateral (Article IV) consultations should form two stages of the surveillance process, rather than two parallel operations. The first stage would involve multilateral discussions and negotiations to be conducted on a regular basis within the framework of the IMF about a mutually consistent set of objectives, and a set of policies to collectively achieve these objectives. The aim might be to search for a set of outcomes or 'objective indicators' or 'targets,' that appear to be sustainable in the medium-term and desirable to all parties. This should be quite feasible when the multilateral surveillance exercise is limited to a few major industrial countries, such as the key currency countries. The second stage would involve a comparison between the actual outcomes and the recommended targets or indicators, and a discussion of what measures would be appropriate when the two differ. This stage might most efficiently be conducted on a bilateral basis as part of Article IV consultations." (Paragraph 78).

Although the G-24 Report is not explicit about what form domestic policy-oriented targets would take, it might be assumed that they would cover the major targets of policy (i.e., rates of inflation and unemployment, the growth of real output, the balance of payments, fiscal positions, and possibly, the exchange rate), as well as some of the major policy instruments (e.g., the money supply, government expenditures, taxes, structural measures, etc.); presumably, they would be framed in a medium-term setting. In principle, the process of setting targets and instruments should be similar to that which explicitly or implicitly takes place in national governments, with of course the important distinction that the process would be done multilaterally. The targets could be specific numbers, or ranges or zones, or if even more flexibility was required, simply obligations to avoid large or sudden changes in the chosen measure. Perhaps the best analogy in a

domestic context is the setting of official targets for the growth rates of monetary aggregates. Such targets provide a presumption that the authorities will conduct policies so that the growth rates of aggregates would evolve within the specified ranges. If the targeted aggregate moves outside its expected range, it is presumed that the authorities will act to counter this movement, or will explain why the earlier target is no longer appropriate. Even when the targets are not always attained, they provide, so their supporters argue, a relatively straightforward way of monitoring and explaining the authorities actions; also, when the targets are announced, they may provide an anchor for expectations.

(1) The rationale behind objective indicators or targets

The case for objective indicators or targets for macroeconomic policies can be said to have five elements.

First, such indicators or targets address directly the perceived main cause of exchange rate misalignment, namely, the lack of soundness and international consistency in macroeconomic policies of major industrial countries. In contrast with target zones, policy targets or objective indicators bypass what some may regard as the uncertain link between exchange rate movements and the setting of monetary and fiscal policies. Here, the desired target values or ranges for all major policy instruments can be specified directly and their implications for exchange rates can be estimated. As such, vague policy intentions, such as "keeping more of an eye" on the exchange rate in the conduct of domestic monetary policy, are replaced with specific and verifiable policy commitments, e.g., the money supplies in countries A and B are targeted to grow by X and Y percent, respectively, over the next six months.

Second, the indicator or target proposal can be used as a "trigger mechanism" to activate coordinated discussions of how recognized departures of actual from desired macroeconomic outcomes can best be remedied. For example, the G-24 proposal envisages such discussion on a bilateral basis as part of Article IV consultations whenever actual outcomes differ from recommended targets or indicators. In this way, the perceived lethargy in adjustment under the present discretion-based system may be overcome. The use of objective indicators to improve the speed of adjustment is of course well-known from the work of the Committee of Twenty. 1/

1/ See particularly "The Report of the Technical Group on Indicators," IMF [1974].

A third advantage of the target-indicator proposal is said to be that it pays attention to the level of, as well as to the inter-country differences in, macroeconomic policies. To some observers, this gives it an edge over proposals that use the exchange rate to signal a misalignment of policies. For example, if two countries both inflate at 10 percent, their bilateral exchange rate may be stable but few would agree that their macroeconomic policy stances were right. By focusing on the appropriate setting of policy targets and instruments within as well as across countries, the target-indicator proposal is said to overcome this danger.

Fourth, because the target-indicator proposal would likely encompass a broad set of policy targets and policy instruments, it could be argued that it is less susceptible than is say, a target zone scheme, to sending "wrong signals" about either the need for adjustment or the proper policy remedy for adjustment. Thus, one can monitor directly not only the exchange rate but also growth, inflation, employment, the pattern of payments balances, etc.; similarly, departures of actual from targeted outcomes might be met not merely by altering monetary policy but by other mixes of policies (including structural measures) if deemed appropriate.

Finally, supporters of this proposal might argue that, despite some potential difficulties in negotiating and interpreting the targets and indicators, it is operational. As supporting evidence, they could cite the use of quantitative indicators and targets in domestic monetary policy in many industrial countries. In addition, they might note that the target-indicator proposal is a close relative of the program targets and quantitative "performance criteria" employed by the Fund in its stabilization programs. It might be argued that if these objective indicators and targets have been used to good effect by the Fund for over 35 years in the formulation of stabilization programs for a diverse set of countries, why cannot a similar approach be followed in designing coordinated "shadow programs" for key-currency industrial countries, especially when the systemic consequences of inappropriate domestic policies are so much greater for the latter group of countries? In addition, such an approach would, so its supporters argue, constitute an effective remedy for the current "asymmetry" in the exercise of Fund surveillance.

(2) Opposition to objective indicators or targets

Both the advisability and practicality of objective indicators or targets for coordinated macroeconomic policy formulation remain controversial. At least five counter-arguments might be offered in opposition to this proposal.

To begin with, it might be argued that it would be even harder to reach a consensus on a range of desirable policy targets and policy

instruments than it would on a range of desirable exchange rates. ^{1/} There would simply be too many parameters on which to obtain agreement. And the more specific the desired policy commitments, the more difficult would be the negotiations. Some would say that it is one thing to argue that major industrial countries should "take account" of external repercussions in setting domestic policies, but quite another to argue that they should be dominated by external considerations. Also, if policy responses to target departures too have to be multilaterally negotiated and agreed, then the administrative problems become, according to the critics, even more burdensome. Indeed, some would conclude that if a set of instruments and targets had to be multilaterally negotiated, the constraints on national sovereignty would be even more severe than in a rigid fixed rate system; hence, such a proposal is unlikely to be acceptable to most potential members.

A second criticism of the target-indicator proposal is that if it simply triggers discussions on the appropriate coordination of macro-economic policies, it will not allocate and enforce adjustment among the countries involved. Thus, unlike say, the gold standard, the target-indicator proposal does not offer any "rules" on how to eliminate recognized disequilibria.

Third, although use of a broad set of indicators and targets may send fewer false signals about the need for adjustment than reliance on a single indicator (e.g., the exchange rate), opponents argue that it will still send more false signals than a judgmental appraisal that goes beyond such indicators. With any mechanistic formula, there is always the danger that events and factors unforeseen at the time that policy targets are set will intrude and cause deviations between actual outcomes and targets; hence, the indicators would have to be reviewed judgmentally in any case. As evidence of the importance of such "news," opponents note that past forecasting errors for such outcome variables as current accounts and exchange rates have been very large indeed. ^{2/} Further, when many indicators are used, they may point in different directions.

^{1/} Kenen [1985], for example, in weighing options for reforming the international monetary system concludes: "... it should be much easier, technically and politically, for governments to collaborate in managing exchange rates than to coordinate their monetary and fiscal policies in a timely manner." p. 11

^{2/} See Willett [1977] and Mussa [1983].

Fourth, just as it is difficult to agree on an operational definition of the equilibrium exchange rate, it may also be difficult to agree on internationally-consistent, quantifiable indicators of monetary and fiscal policies (to say nothing of structural policies). Which monetary aggregate should be used as the indicator? Should the fiscal deficit or surplus be measured at the central or general government level, and should it be adjusted for cyclical factors?

Finally, opponents of the target-indicator proposal might doubt whether the use of quantitative indicators in a national setting carries any implications for their feasibility in a multilateral setting. They could argue that at the national level authorities can be confident that if quantitative policy targets prove less helpful than anticipated, their use can be modified or even discarded. In this connection, several major industrial countries have, in fact, ceased establishing monetary targets or indicated that they would place less reliance on them in the future. No such flexibility could be assured for any single member country in a multilateral setting. In addition, they might point to the often lengthy negotiations of quantitative policy targets in Fund programs. ^{1/} What is the outlook then for negotiating a mutually-agreeable set of these targets among five major industrial countries, and what would happen in the meantime if such discussions broke down? In short, opponents might argue that what is feasible with quantitative policy targets on a national level may not be so in a multilateral setting.

Issues for discussion: (i) would a mutually-consistent set of "targets" or "objective indicators" for the key-currency countries represent a better organizing framework for multilateral surveillance than either a set of target zones or the existing procedures; (ii) what types of commitments would be associated with a target-indicator plan-- is it to be viewed mainly as a mechanism for discussion and loose coordination of macroeconomic policies, or as a new set of "rules of the game" for major industrial countries; (iii) if quantitative targets and quantitative performance criteria are necessary and desirable in Fund-supported adjustment programs, why should they not be used for monitoring and appraising policies in key-currency industrial countries; (iv) is there a serious risk that even a broad set of objective indicators would send false signals about the need for adjustment and about the appropriate policy prescriptions; and (v) would attempts to negotiate a set of mutually-consistent "targets" reproduce all the administrative delays and frictions that characterized the latter years of the Bretton Woods system?

^{1/} It might also be argued that industrial countries would not face the same external financing constraint as program countries and as such would be under less pressure to reach agreement on indicators.

C. Improvements within the existing institutional setting

As noted earlier, the G-10 Report concludes that "... the fundamental approach of the Articles [of Agreement of the Fund] remains valid and... the key elements of the current... system require no major institutional change," 1/ and that "... no major changes are required in the present institutional setting for exercising surveillance over national policies." 2/ Instead, the G-10 Report recommends that improvements be sought within the framework of the present system. These improvements would focus on the following four areas.

First, "... the adoption of sound, credible, and stable policies" 3/ at the national level, especially in major countries. This is said to contribute "fundamentally" to exchange rate stability. Also, "... liberalization of capital markets and, more broadly, removal of restrictions and structural rigidities" 4/ so as to reduce the burden placed on foreign exchange markets in absorbing short-term disturbances. This latter action would, so it is argued, reduce the short-run volatility of exchange rates.

Second, "... in setting national policies, the international implications and interactions of those policies should receive an appropriately high priority." 5/ This, it is argued, would improve the compatibility of policies among countries and the convergence of economic performance around sustainable non-inflationary growth. As such, it would lead to greater exchange market stability. To achieve better international coordination of policies, "... close and continuing cooperation among countries and a strengthening of international surveillance" 6/ are identified as central elements.

Third, strengthened surveillance should be built on "... enhanced dialogue and persuasion through peer pressure rather than mechanically imposed external constraints." 7/ Specific measures to strengthen surveillance cover both bilateral and multilateral surveillance.

Among the proposals for improving bilateral surveillance that appear in the G-10 Report are those that address the policy-making level at which governments are represented in the consultation process; the possibility of a confidential exchange of views between the Managing Director and the Finance Minister at the end of the consultation process for important countries; the degree of candor in the assessment of

1/ G-10 Report, paragraph 97.

2/ G-10 Report, paragraph 36.

3/ G-10 Report, paragraph 28.

4/ G-10 Report, paragraph 28.

5/ G-10 Report, paragraph 29.

6/ G-10 Report, paragraph 33.

7/ G-10 Report, paragraph 38.

national policies and of their international impact; identification of necessary improvements in the scope, quality, and timeliness of data; improvements in analytical techniques; the use of supplemental surveillance techniques; and the continued development of enhanced surveillance procedures. In addition, mention was made of the publicity to be given to the outcome of the consultation process and to other Fund reports and summings-up.

Turning to multilateral surveillance, the G-10 Report proposes that there be "... a separate chapter" of the World Economic Outlook devoted to "... analyzing the repercussions of national policies of G-10 countries and of their interaction in the determination of exchange rate developments and international adjustment." 1/ In addition, the G-10 Report proposes that the G-10 should review the conclusions of this chapter, when appropriate, at Ministerial level.

Finally, the G-10 Report argues that "... neither capital controls nor intervention can be relied upon to attain lasting stability of exchange rates." 2/ On official intervention, the G-10 Report endorses the conclusions reached in the Report of the Working Group on Exchange Market Intervention [1983]. With respect to controls on international capital flows, the G-10 Report concludes that such controls would carry "substantial" economic costs and that free capital movements are beneficial to "... the expansion of trade and to efficient resource allocation." 3/

(1) The rationale for seeking improvements within the present institutional setting

Although the G-10 conclusion for seeking improvements in exchange rate stability within present institutional arrangements encompasses a wide and diverse set of proposals, it is possible to describe (as was done with the two proposals analyzed earlier) the underlying rationale. This rationale might be said to rest on the following five arguments.

First, supporters argue that the observed weaknesses in the functioning of the present system of floating rates reflect not design flaws in the exchange rate system per se but rather flaws of implementation in the underlying macroeconomic and structural policies. Until national governments themselves muster the requisite political will to adopt sound, credible, and stable policies, no exchange rate system--be it one of very low or very high flexibility of nominal exchange rates--will work properly. Conversely, when national governments do so act, proposals for altering the nature of exchange arrangements would not be necessary.

1/ G-10 Report, paragraph 51.

2/ G-10 Report, paragraph 27.

3/ G-10 Report, paragraph 25.

As such, supporters argue that energy ought to be concentrated on ways of bringing this improved policy implementation into being. "Enhanced dialogue" and "peer pressure" represent in their view the most hopeful routes to that end. The existing channels of surveillance could be used more effectively and coordinated better to support these efforts.

Second, after over a decade of experience with floating rates, it is clear that it is neither realistic nor helpful to believe that each country can decide independently its own policy stance and mix and allow the exchange rate to settle all conflicts in the market place. It is not realistic because floating rates are not capable in any case of providing enough insulation to make independent targeting work. It is not helpful because failure to take other countries policies and objectives into account will only induce in the long run retaliatory actions which, in turn, will make the path to internal and external balance slower and less satisfactory than if some coordination of policies was carried out. Improved coordination of policies would do much to reduce the large swings in real exchange rates that have characterized the last thirteen years. Again, supporters of the existing framework argue that the way to get such better coordination is through close and continuing cooperation not via "mechanically-imposed external constraints."

Third, no exchange rate system can provide full insulation from the effects of policies and disturbances abroad. Nevertheless, exchange rate volatility and overshooting could be much reduced if restrictions and structural rigidities in goods, labor, and capital markets were dismantled. In this way, asset prices, particularly exchange rates, would not have to compensate so much for the stickiness of wages and prices. Exchange rates would still of course show variability but, so it is argued, this variability would not necessarily be "excessive."

Fourth, exchange rate developments can provide some useful information on the market's appraisal of macroeconomic policies. In some cases, the market's appraisal may not be consistent with fundamentals and authorities will want to make known their own view (e.g., the September 1985 Group of Five Agreement in New York). This however, will be more the exception than the rule. Similarly, (pre-announced) quantitative targets for macro-economic policies, especially monetary policy, may be useful in certain circumstances in providing an anchor for expectations. But, so the argument goes, neither exchange rates nor quantitative targets can substitute for judgmental assessments about the appropriate course of policies over the medium-term. To replace the latter with the former would endanger the achievement of price stability and sustainable growth. Also, experience suggests to defenders of the existing framework that automatic adjustment rules usually turn out to be less automatic in practice than in theory, and that very specific adjustment or policy rules can become liabilities when the global environment changes in unexpected ways.

Fifth, they find no presumption that the resource allocation costs from impeding the international flow of capital would be any less serious than those associated with restrictions on trade flows. Also, they note that even aggressive capital control programs (such as those of the early 1970s) often failed to stem private capital flows, and the subsequent development of offshore banking could be seen as making their efficacy today even less likely. As regards official intervention, they could point to a large body of empirical evidence that strongly suggests that non-sterilized intervention is unlikely to have a lasting impact on the level of the exchange rate. ^{1/} Nevertheless, intervention can in their view be useful in: (i) countering disorderly market conditions; (ii) reducing short-term volatility; (iii) complementing and supporting other policies; and (iv) expressing an attitude toward exchange markets.

(2) Opposition to operating within the existing institutional setting

The arguments in favor of improving exchange rate stability via the existing institutional setting have not gone unchallenged. The case against that position might be said to rest on the following arguments.

First, while acknowledging the fundamental role played by sound, credible, and stable policies in achieving a stable system of exchange rates under all types of exchange arrangements, it could be argued that a good exchange rate system offers the right incentives and pressures for responsible policy conduct. On the basis of experience with floating rates, it might be concluded that floating rates have been wanting on that score, i.e., they have not promoted the right policies. Further, while "enhanced dialogue and peer pressure" may be necessary elements for improving policy behavior, they are unlikely under this view to be sufficient. In short, some would say that the choice is not policy reform or exchange rate reform but rather how best to design the exchange rate system to achieve policy reform. For this reason, the "incentive," "pressure," and "trigger" features of target zones, or at least of some concerted "views" on exchange rates (as seem to be developing since September 22, 1985), should--so the argument goes--not be dismissed.

Second, while it could easily be accepted that better coordination of policies would reduce the large and persistent misalignments of real exchange rates observed in the past, and that such coordination requires "close and continuing cooperation," it might again be maintained that some

^{1/} Report of the Working Group on Exchange Market Intervention [1983], Rogoff [1984], Obstfeld [1985].

type of external constraint is essential to get that cooperation. 1/ Modes of coordination that do not send clear, regular, and strong signals about when, what, and how to coordinate can be viewed as ineffective. This in turn leads opponents of the existing framework to the conclusion that substantive strengthening of both the principles and procedures of Fund surveillance is probably necessary.

Third, it might be conceded that target zones (or concerted views on exchange rates) and objective indicators would occasionally make the wrong diagnosis and occasionally prescribe the wrong remedy for external adjustment. Nevertheless, these adjustment mechanisms might still be regarded as performing better on average than a judgmental mechanism that sometimes doesn't initiate adjustment at all, and sometimes, by its inaction, encourages other more costly forms of adjustment (e.g., protectionism). It might also be argued that the constraints placed on domestic monetary policy in the EMS have not unduly handicapped efforts to achieve price stability and sustainable growth. Furthermore, critics of the existing framework might argue that while the recent G-5 initiative was welcome, it would have been even more welcome if it had taken place in 1982 or 1983 and if authorities had on a more regular basis spoken out against market-determined misalignments of key-currency exchange rates.

Fourth, while liberalization of capital and trade flows might be regarded as an effective means of dampening exchange rate overshooting in countries with "... diversified economies and high mobility of factors of production," 2/ its applicability to developing countries might be questioned. Here, the arguments (as presented in the G-24 Report) are that protection of infant industries, judiciously applied, may be indispensable to diversification and development, and that controls to limit capital flows may become "... necessary for the stability of exchange and interest rates." 3/

Finally, some have argued that even in industrial countries, impediments to capital flows (e.g., round-tripping taxes) need to be seriously evaluated. 4/ It is not that such impediments would be

1/ "In the meantime, a mechanism has to be devised to enforce policy coordination among the major industrial countries." G-24 Report, paragraph 5.

2/ G-24 Report, paragraph 70.

3/ G-24 Report, paragraph 87.

4/ See Tobin, [1980].

costless. They would not. But these costs are viewed by supporters of such proposals as smaller than the macroeconomic costs associated with larger exchange rate fluctuations under free mobility of capital. Under this view, the answer to excessive volatility of exchange rates is to "throw some sand" into the wheels of the efficient world capital market, not to apply more grease to those wheels. On intervention, a case might be made that the potential for increasing its effectiveness by combining it with other policy measures has not yet been fully realized. As an example, it might be argued that developments since the G-5 agreement in September 1985 are consistent with the position that official views on deviations of exchange rates from fundamentals, in combination with intervention and with some prospects of an improvement in fundamentals, can be effective in "pricking" a speculative bubble in the exchange markets.

Issues for discussion: (i) Do the incentives for implementing sound, stable, and credible policies come primarily from "within," or can the exchange rate regime condition and reinforce those incentives; (ii) how much scope is there for improving the international consistency of policies by using the existing channels of Fund surveillance more effectively and in a more coordinated manner; (iii) in what circumstances and in what types of economies would liberalization of capital flows--and more generally, a reduction of structural rigidities--pay the largest dividends in terms of exchange stability and of other objectives; (iv) what are the relative merits of "judgmental" versus "objective indicator" approaches to initiating adjustment and to guiding macroeconomic policies over the medium term; and (v) what are the main implications for exchange rate management of the G-5 meeting in New York on September 22, 1985?

V. Selected Bibliography

- Bergsten, C. Fred, and John Williamson, "Exchange Rates and Trade Policy," in Trade Policy in the 1980s, ed. William R. Cline, (ed.), Washington: Institute for International Economics, 1983.
- Bergstrand, Jeffrey, "Is Exchange Rate Volatility 'Excessive'?" New England Economic Review, (September/October 1983), pp. 5-14.
- Black, Stanley W., "Central Bank Intervention and the Stability of Exchange Rates," Paper presented at the Conference on Currency Risk and Exposure, Graduate School of Business, New York University, New York, 1979 (processed).
- Bond, Marian E. and Adalbert Knobl, "Some Implications of North Sea Oil for the U.K. Economy," Staff Papers, International Monetary Fund (Washington), Vol. 29 (September 1982), pp. 363-97.
- Deppler, Michael, and Duncan M. Ripley, "The World Trade Model: Merchandise Trade," IMF Staff Papers (March 1978), pp. 147-206.
- Deputies of the Group of Ten, "The Functioning of the International Monetary System: A Report to the Ministers and Governors of the Group of Ten," June 1985, circulated as EBD/85/154, Supplement 1.
- Deputies of the Group of Twenty-Four, "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 1985, circulated as EBD/85/228.
- Dunn, Robert, "Exchange Rate Rigidity, Investment Distortions, and the Failure of Bretton Woods," Essays in International Finance, No. 97, Princeton University (Princeton, New Jersey: Princeton University Press, 1973).
- Frenkel, Jacob A., and Michael L. Mussa, "The Efficiency of Foreign Exchange Markets and Measures of Turbulence," American Economic Review (May 1970), pp. 374-81.
- Genberg, Hans, "On Choosing the Right Rules for Exchange-Rate Management," The World Economy, Vol. 7, No. 4 (December 1984), pp. 391-406.
- Goldstein, Morris and M. Khan, "Income and Price Effects in Foreign Trade," in R. Jones and P. Kenen (eds), Handbook of International Economics, Vol. II, North-Holland Publishing Co., 1985, pp. 1041-1105.
- International Monetary Fund, The Role of Exchange Rates in the Adjustment of International Payments: A Report by the Executive Directors (Washington: IMF, 1970).

- _____, International Monetary Reform: Documents of the Committee of Twenty (Washington: IMF, 1974).
- _____, (1984a), Exchange Volatility and World Trade, a study by the Research Department of the International Monetary Fund, Occasional Paper No. 28 (Washington: IMF, July 1984).
- _____, (1984b), Issues in the Assessment of the Exchange Rates of Industrial Countries, a study by the Research Department of the International Monetary Fund, Occasional Paper No. 29 (Washington: IMF, July 1984).
- _____, (1984c), The Exchange Rate System: Lessons of the Past and Options for the Future, a study by the Research Department of the International Monetary Fund, Occasional paper No. 30 (Washington: IMF, July 1984).
- Kenen, Peter, "Reforming the International Monetary System," paper prepared for presentation to New York Academy of Sciences, September 1985.
- Machlup, Fritz, "Comments on 'The Failure of Global Fixity' and 'The Failure of Global Flexibility'," in EMS: The Emerging European Monetary System, ed. by Robert Triffin (Brussels: National Bank of Belgium, 1979), pp. 65-78.
- Makin, John H., Capital Flows and Exchange-Rate Flexibility in the Post-Bretton Woods Era, Essays in International Finance, No. 103, Princeton University (Princeton, New Jersey: Princeton University Press, 1974).
- Mussa, Michael, "Empirical Regularities in the Behavior of Exchange Rates and Theories of the Foreign Exchange Market," in Theory, Policy, Institutions: Papers from the Carnegie-Rochester Conferences on Public Policy, ed. by Karl Brunner and Allan H. Meltzer (Amsterdam: North-Holland; U.S. and Canada: Elsevier Science Publishers, 1983), pp. 165-312.
- Nurske, Ragnar, Conditions of International Monetary Equilibrium, Essays in International Finance, No. 4, Princeton University (Princeton, New Jersey: Princeton University Press, Spring 1945).
- Obstfeld, Maurice, "Floating Exchange Rates: Performance and Prospects," Brookings Papers on Economic Activity, forthcoming, 1985.
- Polak, Jacques J., Coordination of National Economic Policies, Occasional Paper No. 7 (New York: Group of Thirty, 1981).

Rogoff, Kenneth, "On the Effects of Sterilized Intervention," Journal of Monetary Economics, Vol. 14 (September 1984), pp. 133-150.

Shafer, Jeffrey R., and Bonnie E. Loopesko, "Floating Exchange Rates After Ten Years," Brookings Papers on Economic Activity: 1 (1983), The Brookings Institution (Washington), pp. 1-70.

Swoboda, Alexander K., "Exchange Rate Regimes and European-U.S. Policy Interdependence," Staff Papers, International Monetary Fund (Washington), Vol. 30 (March 1983), pp. 75-102

Tobin, James, A Proposal for International Monetary Reform, Cowles Foundation Paper No. 495, Cowles Foundation for Research in Economics (New Haven, Connecticut: Yale University Press, 1980).

Ungerer, Horst, Owen Evans, and Peter Nyberg, The European Monetary System: The Experience 1979-82, Occasional Paper No. 19 (Washington: International Monetary Fund, May 1983).

Willett, Thomas D., Floating Exchange Rates and International Monetary Reform, American Enterprise Institute Studies in Economic Policy (Washington: American Enterprise Institute for Public Policy Research, 1977).

Williamson, John, The Exchange Rate System, (Washington, Institute for International Economics, 2nd edition, 1985).

Working Group on Exchange Market Intervention, Report of the Working Group on Exchange Market Intervention (processed, March 1983).



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

1985 JAN 10 PM 5:24

FW
STR
IO
F

TO: Mr. C. David Finch

January 10, 1986

FROM: L.A. Whittome *LAW*

SUBJECT: Surveillance Over Exchange Rate Policies--
Annual Review: Background Material

I am not certain that the paper serves a useful purpose in its present encyclopedic form. But if in your judgment it does then I worry that it seems to encourage some inter-related misconceptions, namely that surveillance and the Fund's internal procedures for surveillance are one and the same thing, and that the quality and value of surveillance depend on the frequency of consultations, the number of missions, and so on. We need to move in a different direction. In some of the smaller and medium-size countries in this Department, the task of adjustment involves among other things complex fiscal reforms, major institutional changes in financial markets and structural shifts of investment and production patterns. In these circumstances we should seek to make a serious contribution by means of solid preparation, comprehensive discussions and analytically significant staff reports. It is a fundamental error to suppose that the attainment of any particular consultation cycle will by itself force the pace of adjustment.

Mr. Hauvonen has sent Mr. Belanger some detailed comments on the paper but I would myself like to pick up one point. Tables 19 and 20 should I think be dropped completely. We try to ensure that the policy sections of staff reports and the corresponding parts of the staff appraisal contain most carefully weighed, nuanced, polite but also candid, analytical prose. The essence of this simply cannot be captured by the sort of simplistic device represented by Tables 19 and 20. If staff appraisals could really be reduced to the level of multiple choice questions, then life would be a great deal simpler for all of us. All this is quite apart from the fact that some of the assessments made are somewhat puzzling to those who produced the original appraisal.

cc: Heads of Departments: ADM, AFR, ASD, EXR, FAD, LEG, MED,
RES, SEC, STAT, TRE, WHD



Office Memorandum

INTERNATIONAL MONETARY FUND
WESTERN HEMISPHERE DEPT.

Mr. Wilensky
EW
STB
TO
FI

1985 JAN 10 PM 5: 27

January 10, 1986

To: Mr. Belanger

From: A. S. Shaalan *AS*

Subject: Surveillance Over Exchange Rate Policies--Annual Review: Background Material

This is a very good draft: it provides useful, well-organized, background material for the discussion of the issues and procedures regarding the implementation of surveillance covered in the two papers on which we have commented earlier.

As regards the references to the Middle Eastern countries in the text, we have no difficulties. Also, we find Tables 19 and 20 to be a rather useful and telling representation of the pointedness of staff policy recommendations in selected countries, and of divergencies between the views of the staff and the authorities where they exist. The categorization, however, is, of necessity, somewhat simplified and some additional qualifications in the remarks column may be desirable. In the case of Pakistan, the staff's assessment of its monetary/credit policies is said to be "in accord with policies". This is true only in a narrow sense of the rates of growth of certain monetary aggregates. In fact, the staff was critical of the general stance of credit policies in Pakistan. Thus, we would prefer to see Pakistan in the 'mildly critical' category.

As far as the selection of countries for inclusion in Tables 19 and 20 is concerned, we would prefer to leave out Libya and, instead, include Egypt, indicating strongly critical assessments of its fiscal and monetary policies.

Finally, one general point: we believe that in discussing the increasingly long list of topics, e.g., trade policies, structural policies, etc., expected to be covered in the staff reports for the Article IV consultations, it would be pertinent to refer to the question of a trade-off between quantity and quality of analysis as well as to considerations relating to the demands on staff time and resources. On the latter, we would fully support the comments made by Mr. Whittome.

cc: Heads of Departments:

ADM	LEG
AFR	RES
ASD	SEC
EUR	STAT
EXR	TRE
FAD	✓WHD