FOR AGENDA

EBS/84/232
Correction 1

CONFIDENTIAL

December 3, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Formulation of Exchange Rate Policies in Programs Supported by the Fund

The following correction has been made in EBS/84/232 (11/16/84):

Page 3, 2nd full para., line 2: for "as Fund-supported adjustment programs." read "in Fund-supported adjustment programs."

A corrected page is attached.

Att: (1)

be used directly to determine the amount of exchange rate action taken at the outset of the program, as well as the timing and amount of further exchange rate action to be taken during the program.

Where the exchange rate is freely determined by market forces, indicators are not needed to decide on the amount of exchange rate action. They still play an important role, however, being used to assess both the likely future path of the rate and its consistency with the other objectives of the program. Such an assessment might not raise questions about exchange rate policy as such, but could suggest a need to adjust other policies to produce a rate that is more appropriate from a medium-term perspective.

Full market determination of the exchange rate seldom takes place in Fund-supported adjustment programs. Fund resources are provided to ease the process of adjustment, and in that sense are effectively available for intervention in the exchange market. 1/ Such support may, of course, be provided in a form broadly consistent with the principle of market determination, as when quantitative limits are imposed on the amount of intervention during a given period. Most Fund members, however, particularly the developing countries, go further and follow exchange rate arrangements where the rate is determined administratively. 2/ In these cases, a basis needs to be found to determine any initial devaluation and to serve as a guide to further exchange rate action during the program period. The indicators discussed in the paper serve this purpose.

Indicators are necessarily imperfect, and there is always a danger that they give misleading signals as to the appropriate rate. In a restriction-free system, however, deviations from the market-clearing rate will show up in a need for intervention, which provides an automatic check on the signals provided by indicators. Restrictions on external transactions interfere with the operation of this corrective mechanism. The fact that few Fund programs provide for early elimination of restrictions means that exchange rate policy in such programs relies on indicators to a greater extent than would otherwise be the case, reinforcing the emphasis that needs to be given to carefulness in their use.

1/ Market-determined exchange rates are likely to be particularly volatile in the initial stages of adjustment programs, when market participants may not yet fully understand the implications of the new policies or be fully convinced that they will be sustained.

2/ In part this reflects a preference for a more stable exchange rate than is likely to be the case when the rate is basically market determined. This question is discussed in Subsection 3, below.

2. The proper role of exchange rate policies in relation to other policies in adjustment programs 1/

The policy mix chosen to restore a sustainable external position depends on the size and nature of the external imbalance as well as the economic efficiency and sociopolitical implications of the various policy instruments. In some instances, a relative price adjustment may not be needed, and a sustainable external position can be restored through a reduction in aggregate expenditure without unacceptable short-term losses in output and employment. 2/ Similarly, where a moderate improvement in competitiveness is needed, it may be feasible to carry out the necessary correction of relative prices through demand restraint, particularly if supported by incomes and other policies. Where a major improvement in competitiveness is required, however, exclusive reliance on demand restraint and related policies involves large costs in terms of foregone output and unemployment, particularly where costs and prices are relatively unresponsive to such policies. An exchange rate adjustment, on the other hand, produces an immediate correction of the price misalignment and permits adjustment to take place at higher levels of economic activity. The desired change in relative prices generally shows up in an immediate increase in the price level, but the increase will be limited if supporting policies are appropriate. 3/ Although the superiority of exchange rate policy as a means of correcting major price misalignments is likely to be empirically valid for all countries, the optimum policy mix, and the extent of reliance on exchange rate policy, will be considerably influenced by a country's individual characteristics, such as the extent to which it is feasible to use incomes policy to adjust relative prices. If price inflation tends to be passed through to wages, for example, a given improvement in competitiveness will require a larger devaluation than when wages are less intimately linked to prices.

The weights assigned to various policy objectives will also influence the policy mix. For instance, concern over inflation and the distributional effects of a devaluation may lead a country's authorities to choose adjustment policies that rely heavily on demand restraint.

1/ "Exchange Rate Policies in Developing Countries" (SM/82/8, 1/11/82) provides a comprehensive review of the general issues of exchange rate policy that are touched on here.

2/ This would be the case, for instance, if the external imbalance has resulted from a rise in government imports, which can be reversed without significantly compromising other policy objectives, such as growth.

3/ Effective demand management is a necessary aspect of any successful exchange rate action. Note that the exchange rate action and associated price increases, through their effects on the real value of financial assets, themselves contribute to reducing excess demand.