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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. <u>The biennial review of the 1977 document on surveillance</u>

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

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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.