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INTERNATIONAL MONETARY FUND

SEMINAR 72/11

10:00 a.m., March 27, 1972

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1. THE EXCHANGE RATE REGIME: AN ANALYSIS AND A POSSIBLE SCHEME

The Executive Directors considered a paper by Mr. Hirsch entitled "The Exchange Rate Regime: An Analysis and a Possible Scheme" (DM/72/18, 3/2/72).

Mr. Hirsch referred Executive Directors to the chart on page 14 of his paper and pointed out that the right-hand block of vertical lines running from 105 to 101 should be extended down to 99.

Mr. Gilchrist said that, while he did not believe the scheme outlined in the paper would prove acceptable in any widespread sense at the present time, he considered it to be a most valuable contribution to thought on the subject. The main problem with the scheme was that it called for periodic discussions of parity zones, which would involve political as well as economic judgments, and which would therefore be extremely difficult. No doubt at some stage in the future some such exchange rate regime would prove necessary. For the present, he would be prepared to accept some changes in the existing exchange rate regime as necessary elements in the reform of the international monetary system, although he was not sure what sort of changes would be preferable or how far they should be taken. His authorities would, he believed, look favorably upon any scheme which would bring about smaller, more frequent, and more prompt changes in exchange rates, provided that it left a fair amount of discretion to the governments concerned. Full automaticity simply had no appeal and, in his view, would not be acceptable in the near future.

Mr. Bryce considered DM/72/18 to be a useful and provocative paper. He welcomed, in particular, the assurance on page 10 of the paper that the scheme was proposed as something to be borne in mind in working tentatively and informally toward a new exchange rate regime. He assumed that the Fund could proceed in that direction by adapting its code of conduct and enlarging its consultations with members rather than by radically amending the Articles of Agreement. It would be of interest to know whether Mr. Hirsch would anticipate the parity zones being published. Presumably, a government would find it difficult to withhold such important information from its parliament, with the result that they would become public. In such circumstances, changes in zones would not only have the kind of political implications suggested by Mr. Gilchrist but would also have some impact on the market. That consideration led them to wonder whether the market would take hold of the change in a parity zone and force the authorities' hand in certain situations.

Mr. Brand said that he had not intervened in the discussion of the paper on symmetrical intervention systems (SM/72/58). It was unlikely, he thought, that any of the countries that had elected him would, in the near future at least, wish to change their policy of pegging their currencies within narrow limits based on one or other of the major intervention currencies. It was evident from that paper that several preferences would have to be expressed by the major countries with respect to such matters as whether to intervene in SDRs or in currencies and whether to proceed on the basis of floor intervention, ceiling intervention or abstention from significant net intervention through the variation of currency holdings. He would be content, however, to leave it to the authorities of those countries most closely concerned with intervention to express their considered views on the subject. Executive Directors would then have a better idea of how the various viable alternatives might possibly affect other countries. Executive Directors elected by those other countries would, of course, be most interested if the favored alternative included universal abstention from net intervention through the variation of currency holdings.

Mr. Hirsch's paper was in a different category from SM/72/58, Mr. Brand observed. On page 11 of the paper it was stated that the scheme would be confined to the major countries for which exchange adjustments would have significant effects on the system as a whole. He assumed that that would involve a much wider coverage than was implied in SM/72/58. The countries that had elected him would, therefore, be decidedly interested if anything seemed likely to develop from Mr. Hirsch's paper. He noted that the paper made no mention of symmetrical multicurrency intervention. Indeed, it was assumed that exchange rates would continue to be maintained in relation to parities by intervention against a common intervention currency. That prompted him to ask whether the two papers were mutually inconsistent or whether Mr. Hirsch's scheme could be modified to include arrangements broadly similar to those set out in SM/72/58.

There was the germ of an acceptable idea in equilibrium parity zones as some kind of a development from the national discretion bands that already existed within wide or narrow margins around declared parities, Mr. Brand remarked. However, whereas Mr. Hirsch envisaged the new band being determined every six months by a Fund computer exercise and after appropriate consultations, with the new band not necessarily bearing any relationship to existing parities, he would prefer such a band to allow each country to vary its parity by a small amount, say 5 per cent or less, without having to seek prior Fund approval. He simply could not envisage the countries that had elected him waiting for the results of a six-monthly computer exercise, over the major inputs of which they would have little direct control, to learn whether or not the new equilibrium parity zones still encompassed their existing parities. If, as Mr. Bryce had suggested, the new parity zones would have to be published, the scheme would be a nonstarter. It would be acceptable for the Fund to make comments about or even calculations on appropriate parities or parity bands for individual countries, but not for it to pronounce that countries should stay within an approved equilibrium parity zone.

Continuing, Mr. Brand felt that Mr. Hirsch's scheme went too far in downgrading the existing concept of stable but adjustable par values. A country that was prepared to take technical advantage of the system to the extent that it came to consider its parity of limited significance in the market place and therefore frequently adjustable, could in theory conduct exchange transactions during the six-month period over a full range of 16 per cent--10 per cent for the equilibrium parity zone and 6 per cent for the margins. It would be bad enough if countries without effective exchange markets, such as those which he represented, were able to peg their currencies narrowly in relation to the common intervention currency, but if Mr. Hirsch's proposal were widened to accommodate symmetrical multicurrency intervention so that all currencies, including the present intervention currency, were operating within a 16 per cent band centered on SDRs, for example, the situation of countries without effective exchange markets would become quite intolerable.

It would be of interest to learn more about the procedures suggested in paragraph (7) on page 12 of the paper, Mr. Brand stated. The first sentence of that paragraph noted that "The zone would be established at periodic intervals, e.g., six months, on the basis of consultations between the Fund and the member and of discussions and calculations undertaken by the Fund in a multilateral framework." What sort of consultations did Mr. Hirsch have in mind and for how many members? The last sentence of the paragraph stated that "The final formulation of the equilibrium parity zones would be the outcome of a high level multilateral review, e.g., in a body such as the Executive Committee of the Board of Governors which has been mooted." That suggestion raised one of the doubts that he had expressed previously in connection with the proposed Committee of the Board of Governors. Was it conceivable, for example, that the Finance Ministers of South Africa or New Zealand would be prepared to leave it to the Finance Minister for Australia to argue their case before a high-level multilateral review board for an equilibrium parity zone different from the one determined by the computer?

Mr. Brand said he could sympathize, however, with the latter part of paragraph 6(b) of Mr. Hirsch's paper which stated that "It would therefore be desirable to introduce an equivalent sanction, designed to be painful rather than shameful, to affect surplus countries. Consideration could be given in this respect to withholding allocations of SDRs, and possibly also to limitation of interest payments on SDRs. These questions would require separate consideration." Separate consideration of those and other similar points could be postponed for a while yet, but he was hopeful that the new version of the Articles of Agreement would provide for the larger countries, whether they were in surplus or deficit, to be penalized financially if they strayed from the rules. At present those countries could do just that without the threat of sanction by the Fund, whereas the smaller countries, particularly if they were in deficit, had to come to terms with the

Fund if they were to avoid real financial difficulties and often political embarrassment.

Mr. Schleiminger agreed with the view expressed by Mr. Hirsch on the first page of his paper that the system of exchange rate adjustment had undergone a major change in the past eighteen months. It was to be hoped that the discussions which had resulted in the 1970 Report of the Executive Directors on the Role of Exchange Rates in the Adjustment of International Payments would not be repeated. On that occasion, arguments in favor of greater flexibility in the system had been counterbalanced by other arguments extolling the virtues of the existing system and emphasizing the disadvantages of making even the most modest changes in the system. Clearly, such an approach would not be appropriate in the present circumstances. In that connection, he had read with great interest a lecture delivered by Mr. Hirsch at Chicago in which he had put recent experience into a wider historical perspective and indicated that the Bretton Woods System, at least of the type that had existed in the 1950s and 1960s, could not be expected to survive in the 70s. The Fund was now faced with the task of devising an appropriate exchange rate regime that would work effectively within the context of a broader reform package. Mr. Hirsch had quite rightly linked the question of such an exchange rate regime with those of the adequacy of the adjustment process and of the practicability of the United States' resuming its convertibility obligations. Some important changes had taken place since the fifties and sixties which would provide the context within which a new exchange rate regime would have to be formulated. One of those was the desire of the United States for a greater diversification of certain responsibilities in the international monetary system and the declared intention of the EEC countries to maintain not only stable but also fixed exchange rates among themselves and to eventually introduce a common currency. The establishment of an economic and monetary union among the members of the EEC would reduce the importance of their external sectors and allow them to place less emphasis on balance of payments and exchange rate problems. In the past, the United States had tended to pay insufficient attention to its external sector, while the European countries, because of the size of their foreign sectors relative to the size of their economies, had sometimes been obliged to build their general economic policies around their external sectors and thus overemphasize balance of payments and exchange rate problems. There was no sign yet of either the United States or Europe changing tack completely, but better balance in the formulation of external policy on both sides of the Atlantic would perhaps reduce the importance attached to some of the problems that currently confronted the international financial community.

Turning to Mr. Hirsch's proposals, Mr. Schleiminger said that, like previous speakers, he could only comment on them in his personal capacity. He had no difficulty in accepting Mr. Hirsch's general views that there should be as much stability as possible and as much flexibility as necessary in the new system, nor with his opinion that exchange rate adjustments should be prompt, smooth, adequate and frequent. He was also gratified to note that Mr. Hirsch viewed the "crawling peg" concept as a second or third best approach and he considered his summary of its disadvantages to be admirable and worth bearing in mind during the course of future discussions. Like previous speakers, however, he had some doubts about the scheme proposed by Mr. Hirsch. He appeared to take the view that wider margins would not only discourage interest-motivated short-term capital movements but also speculative short-term capital movements. That assumption perhaps deserved more extensive discussion, particularly in the light of recent experience. He was also doubtful about the degree of surveillance considered necessary by Mr. Hirsch. Continuing consultations on highly sensitive political issues would be difficult to accept and the sanctions that could be invoked as a result of a computer exercise seemed somewhat harsh. Indeed, the scheme perhaps reflected a vision of the world which went beyond the 20-25 year time dimension mentioned by the Economic Counsellor in his recent sketch. At the same time, like Mr. Gilchrist, he believed that it might be necessary to go in the direction of Mr. Hirsch's scheme at some stage in the future.

Although Mr. Hirsch's scheme was conceptually intriguing and very forward-looking, Mr. Schleiminger went on, it was not as revolutionary in some respects as it might appear. For example, the idea that countries' proposing parity changes within an equilibrium parity zone of 10 percentage points should automatically qualify for Fund authorization was not really very far removed from the suggestion which he himself had made two years ago to the effect that small parity changes within such a range and within a prescribed number of years should not be subject to Fund approval. The great merit of Mr. Hirsch's paper was that it contained certain criteria for Fund policy. While he shared other speakers' doubts about whether those criteria could be made to work automatically, he thought that they might recommend themselves as guidelines for the Fund's new exchange rate regime policy. As both he and Mr. Bustelo had recently pointed out, the Fund would require better criteria if it was to take more initiative in the exchange rate field. Therefore, although Mr. Hirsch's criteria could not be applied on an automatic basis because of the political difficulties involved, some of them could perhaps be used as guidelines for Fund policy. That would, at least, provide members with an opportunity to become acquainted with and accustomed to the application of more objective and arithmetical criteria in the exchange rate field. In that connection, consideration should be given to preparing a two-stage regime; one that would serve for a 20-25 year period, and another that could operate in the interim.

Mr. Lieftinck did not believe that Mr. Hirsch's paper, valuable though it was, really went to the heart of the problem under consideration. Priority should be accorded to remedying the fundamental causes of exchange rate disequilibrium rather than accepting them and changing the exchange rate system.

The most acute imbalances in exchange rate relationships had been associated closely with periods of global deflation, as in the 1930s, and with periods of global inflation, such as had occurred in the 1960s. If such inflationary and deflationary conditions could be eliminated or moderated, the problem of exchange rate adjustments would be rendered much more susceptible to solution. Another phenomenon that had contributed to exchange rate imbalances had been disequilibrating international capital movements. If more attention was paid to such movements, of both a long-term and short-term character, it would become easier to maintain established exchange rate relationships. A third major cause of exchange rate disequilibrium, which tended to operate more gradually than the others, was that of structural changes in the relative competitive positions of countries. The world had recently witnessed a period of rapid structural changes, which had quite clearly contributed to unbalanced exchange rate relationships. Gradual changes in relative competitive positions would continue to take place and would require structural adjustments in the exchange rate system.

Turning to DM/72/18, Mr. Lieftinck agreed with its central thesis; namely, that more flexibility than had been practiced by the major countries in the past would be necessary in the future. Indeed, there was a need to achieve a more symmetrical distribution of the responsibility for undertaking exchange rate adjustments. He was also gratified to note that Mr. Hirsch had rejected the automaticity inherent in most of the crawling peg schemes. He had stated, quite rightly, that countries would continue to wish to relate their exchange rate changes to general prospective developments in their economies. Clearly, such an approach would require analysis rather than simple reactions to external indicators such as reserve movements or market exchange rates. Mr. Hirsch was also correct to point out that, particularly in a symmetrical system, the need for joint adjustment and joint initiatives became more important and perhaps indispensable. Indeed, that observation raised the question of the extent to which the Fund could continue to play a relatively passive role. In that connection, the more open-minded Executive Directors were toward suggestions involving more joint responsibility and more positive initiatives on the part of the Fund, the better. The acceptance of such suggestions, however, would depend in the final analysis upon members' willingness to accept their share of the responsibility for making the appropriate adjustments and to accord the Fund a greater role in the process. If that willingness did not exist, it would be futile to introduce institutional changes in the hope that they, in themselves, would generate the required degree of willingness. On the other hand, however, once members had been pursuaded of the need to take joint action and to permit the Fund to play a more positive role, appropriate institutional arrangements might help in eliciting an even greater willingness to undertake prompt and rapid exchange rate changes when required.

Mr. Hirsch's scheme envisaged the introduction of two margins, Mr. Lieftinck observed. First, exchange margins would be widened from those presently permitted by the Articles to 3 per cent in terms of the intervention currency. Second, the equilibrium parity zone would add up to another 5 per cent on either side of the central point. The assumption appeared to be that the resulting 10 per cent zone would represent a range of equilibrium for a particular member's parity. He, himself, would be inclined to view it as a range of disequilibrium rather than equilibrium. Clearly, the scheme envisaged extremely wide margins which Executive Directors had in the past found fit to reject. He was not yet convinced that such a high degree of flexibility was required at present and was inclined to prefer prompt and frequent exchange rate changes. Existing institutional arrangements in no way prevented such changes taking place, but they required improvement in order to facilitate such changes.

Mr. Hirsch had suggested that, as a general rule, upward changes in the central parity points would be balanced by downward changes, Mr. Lieftinck remarked. Such symmetry would be most acceptable from the point of view of maintaining the value of the numeraire, but to expect it would be unduly optimistic. If a particular country was clearly responsible for an external disequilibrium, it should take the initiative in making the appropriate adjustment. Only in those cases in which a joint responsibility for a disequilibrium clearly existed could one hope for cooperative action and a division of the adjustment burden. Mr. Hirsch's expectation appeared to be based on the questionable assumption that external disequilibria were always attributable to two or more parties. Mr. Hirsch had also suggested that his scheme could perhaps be adopted by a limited group of important countries. It was not beyond the bounds of possibility that certain currency blocs, for example, centered on the United States, the Common Market, and Japan, could emerge in the near future. Clearly, Mr. Hirsch's scheme would not be acceptable within such currency blocs. On the other hand, however, it was possible to conceive of the need to institutionalize the procedures for exchange rate adjustments between such blocs, and a scheme similar to that of Mr. Hirsch's might well be worthwhile considering in that context. Needless to say, it was to be hoped that the emergence of such currency blocs could be avoided.

It was rather regrettable, Mr. Lieftinck said, that little attention had been given in DM/72/18 to the possible effects of the proposed scheme on developing countries. Those countries, to the extent to which they were in a position to maintain the parity system, were strongly disposed in favor of fixed but adjustable exchange rates. It would, therefore, be of interest to know whether such countries would prefer more frequent and gradual exchange rate changes within equilibrium zones to less regular and more substantial exchange rate adjustments, which was one of the alternatives. He was rather doubtful, but he looked forward to hearing the views of Executive Directors elected by the developing countries.

In concluding, Mr. Lieftinck recognized that Mr. Hirsch was not proposing his scheme as an ideal one but as a second or third best solution which might be easier to achieve than better alternatives. Clearly, however, his proposals should not be taken much further without exploring in detail their possible repercussions on the world as a whole and without studying the other improvements that were required in the system. In the latter respect, two problems, which he had already touched upon, were of the utmost importance. First, consideration had to be given to ways of increasing countries' willingness to make use of the existing facilities for exchange rate adjustments. Second, thought had to be given to methods of improving those facilities, particularly with a view to introducing a greater degree of joint responsibility and perhaps a larger role for the Fund.

Mr. Suzuki said that he was in agreement with much that appeared in the first two sections of DM/72/18. It was clear from the second section, however, that many of the objectives of an exchange rate regime were to some extent contradictory and that, as a result, it was difficult to determine what might be the most appropriate exchange rate regime. Mr. Hirsch had defined such a regime as one that would prevent large divergencies of exchange rates from long-term equilibrium rates. He could agree with that view, but particularly in the sense that exchange rates should not be based on the trend in exchange markets, especially if the markets were being distorted by cyclical phenomena or short-term speculative capital flows. Equilibrium parity zones would, therefore, have to take account of many broad economic considerations over and above mere balance of payments indicators.

Another problem, Mr. Suzuki went on, arose from the fact that each country's exchange rate and exchange rate adjustments were closely interrelated with those of other countries. In many circumstances, it was difficult to determine which country or countries should take the initiative, and to what extent, in making exchange rate adjustments. In the later part of 1971 Japan, for example, had been aware of the need to revalue its currency, but had not known precisely by how much because it did not know the intentions of the other countries involved. In such situations, cooperation and international surveillance would seem to be necessary. Mr. Hirsch's scheme, however, seemed to go perhaps too far in that direction, in the sense that it would involve a repetition of Smithsonian-type discussions every six months. Such discussions might well disrupt the exchange market.

Finally, Mr. Suzuki asked Mr. Hirsch what the differences were between his concept of equilibrium parity zones and Mr. Schleiminger's proposal of two years previously.

Mr. Bryce said that he had some additional comments to make in the light of the way in which the discussion had developed. It seemed to him advisable to focus not so much on the particular institutional framework suggested by Mr. Hirsch as on the major question which he had raised about how to achieve prompter small changes in exchange rates. He agreed with Mr. Lieftinck that improvements would also have to be made in other spheres. With respect to the question of inflation, however, he was becoming increasingly pessimistic about the possibility of eliminating it. Most members of the Fund were going to have to contend with some degree of inflation in the future and moderate, reasonably prompt adjustments of exchange rates would appear to be the most appropriate way of reducing the adverse international effects of such a situation.

That approach would, Mr. Bryce went on, clearly require changes in attitudes. One of the attitudes that would have to be changed was that of the market. In that connection, one of the crucial questions that had to be answered with respect to schemes such as that proposed by Mr. Hirsch was whether the exchange rate adjustments it envisaged would be such as to convince the market that a state of equilibrium was being maintained. Another set of attitudes that would need to be changed was that of surplus countries, and greater sanctions than those anticipated in the paper would be required. Loss of SDR allocations or interest payments on SDR holdings would not be sufficient. To be politically effective, sanctions would have to lie in some relaxation of the rules on trade restrictions.

Addressing himself to a point raised by Mr. Lieftinck, Mr. Bryce said that he was not entirely convinced by the argument that wider margins would have a seriously adverse effect on developing countries. He found it difficult to believe that any system that helped the major developed countries to maintain a better balance with one another and to worry less about their balance of payments problems would be adverse to the developing countries generally. It would seem to be in the interest of developing countries for the main developed countries to be confident that their balance of payments problems were being met properly and effectively. Indeed, it was in that sort of atmosphere that the developed countries would be more likely to support international development assistance and be prepared to encourage the free export of capital and import of goods. It would, therefore, be very much to the advantage of developing countries if an effective exchange rate regime could be formulated for the developed countries. Indeed, a system of small prompt exchange rate adjustments would be one in which the developing countries themselves could profitably participate.

In concluding, Mr. Bryce agreed with previous speakers that consideration should be given to the question as to how some of the ideas advanced by Mr. Hirsch could be employed without adopting the institutional arrangements which he had suggested. In his view, the staff could conduct regular studies of appropriate parities or zones of parities for individual currencies. The results of those studies should not be reported to the Executive Board, because of their highly confidential nature, but to the management who could then discuss them from time to time with the countries concerned. That would, of course, raise the problem of deciding which country or countries were concerned. Different views on that matter had been expressed by his Canadian authorities. The previous Minister of Finance, for example, had made it quite clear after the Smithsonian settlement that he considered that a country's exchange rate was its own business. On the other hand, however, another Canadian authority had since written a paper on the subject, pointing out that exchange rates inevitably involved relationships between two currencies and were genuinely international. The latter point was perhaps worth bearing in mind because it was inevitable that there would be more discussions and negotiations over exchange rates in the future. Such negotiations and discussions would probably not take place in the Executive Board, but in various groups and on a bilateral basis. However, if the Fund conducted more systematic studies of the kind proposed by Mr. Hirsch, it would be in a much better position to play an effective mediatory role in what could prove to be extremely difficult negotiations.

Mr. Bustelo stated that, like Mr. Schleiminger, he welcomed the fact that the need for greater flexibility in the exchange rate system was receiving greater recognition currently than it had done two years ago. He agreed with him that the 1970 Report on the Role of Exchange Rates in the Adjustment of International Payments had been watered down somewhat and he hoped that Executive Directors would adopt a more positive approach to the present exercise.

Mr. Hirsch's scheme was rather futuristic, Mr. Bustelo said, but represented a worthwhile effort to formulate a system which provided for an appropriate reconciliation of market forces, international surveillance and sanctions and national policies. In that connection, he endorsed Mr. Lieftinck's remarks on the questions of initiative and judgment.

Turning to a point raised by Mr. Lieftinck, Mr. Bustelo expressed the view that developing countries were unlikely to be more adversely affected by greater exchange rate flexibility than developed countries. For example, would a change in the central point for Germany affect Brazil more than it would the Netherlands? Moreover, in recent years developing countries with sliding exchange rates appeared to have benefited more in some respects than those with fixed exchange rates. He was, therefore, doubtful about the validity of the view that developing countries would necessarily be adversely affected by some degree of greater exchange rate flexibility.

Mr. Yaméogo said that there was little doubt in his mind that the interests of developing countries would best be served by a regime of fixed exchange rates. Fluctuating exchange rates had an adverse impact on developing countries' exports, on their costs of investment, and thus on their development plans and projections. It was to be hoped that the present system would be of a temporary character and that a regime of fixed exchange rates would be reintroduced as soon as possible. Turning to the details of DM/72/18, Mr. Yaméogo asked Mr. Hirsch what, in his view, would be the characteristics of an optimum equilibrium parity zone.

Mr. Massad observed that it was rather difficult to evaluate the effects of a particular exchange rate system on developing countries. The question had to be approached through a comparison of the alternatives. The present system of ostensibly fixed exchange rates, with intermittent bouts of rule breaking, involved the use of trade restrictions and limitations on development assistance as an integral part of the adjustment process and was clearly to the disadvantage of developing countries. From their point of view, a preferable alternative would be a system along the lines suggested by Mr. Hirsch of small and prompt exchange rate adjustments. An even better alternative, however, would be a legitimate regime of fixed exchange rates, in which the coordination among developed countries' domestic policies was sufficient to prevent strong divergencies in national inflation rates from disrupting the system, and in which the adjustment process did not rely on trade restrictions and limitations on capital movements. Thus, of the realistic alternatives that were available, developing countries' interests would, in his opinion, best be served by a system, the rules of which were not broken too often by the developed countries, in which the adjustment process did not depend upon trade restrictions and limitations on capital movements, and in which there was a measure of international surveillance and the possibility of applying the type of sanctions referred to by Mr. Brand. Such a system would probably involve smaller rather than larger exchange rate adjustments. Finally, he sincerely hoped that, as had been suggested in the case of Mr. Hirsch's scheme, serious consideration of such a system would not be postponed for 25 years.

Mr. Beaurain wondered whether it was strictly accurate to say, as he understood Mr. Bustelo to have said, that the developing countries which had employed a sliding exchange rate had fared better than those that had used fixed exchange rates. A comparison of the rates of inflation in those two groups of countries might indicate that the use of sliding exchange rates simply reflected a higher rate of inflation. If that was the case, it was a fact of life rather than a proof of sound economic management.

Mr. Omwony agreed with Mr. Yaméogo that fluctuating exchange rates adversely affected developing countries. An UNCTAD study indicated that the recent exchange rate adjustments had increased the debt burden of most developing countries by about $30 million. Moreover, the reserves of most developing countries had been falling in recent months. An exchange rate regime which created uncertainties in the markets for primary products had an adverse effect on development planning and tended to reduce the financial incentives for primary producers. In his view, the stability and development of primary producing countries was best served by a system of fixed exchange rates.

Turning to DM/72/18, Mr. Omwony thought that some of the suggestions advanced by Mr. Hirsch would deserve serious consideration in the forthcoming discussions of the reform of the international monetary system. His suggestions with respect to sanctions, for example, appealed to him up to a point. He would be inclined to give sympathetic consideration to the idea of denying countries a full allocation of SDRs or of introducing different interest rates for SDR holdings--a suggestion which was similar to the one that he had made during the Executive Board's discussion of reserve consolidation. The effect of some of the suggestions in the paper would depend to a large extent on what was adopted as the numeraire of the system. If the SDR, which was a neutral asset, was adopted, some of the fears expressed about some of the suggestions might prove ill-founded.

Mr. Bustelo said, in response to Mr. Beaurain's comment, that he had meant to imply that developing countries with sliding exchange rates tended to fare better in terms of real economic growth. Turning to a point made by Mr. Omwony, he would be inclined to consider the Smithsonian Agreement as a manifestation of a fixed exchange rate system rather than of a flexible exchange rate system. Any adverse effects of the Smithsonian Agreement on developing countries should be attributed to insufficient flexibility rather than to too much flexibility.

Mr. Schleiminger said that he wished to comment on several points which had been made during the course of the discussion. Mr. Bryce had raised the valid question of whether small exchange rate changes would prove convincing to the market. A related question, which had been touched upon by Mr. Hirsch, was whether small exchange rate changes would generate the required resource shifts. As the German experience had demonstrated, a small exchange rate adjustment need not bring about a price adjustment, which could be avoided by the acceptance of a change in profit margins, and even if price changes did take place, they might not trigger the resource shift required to ensure the success of the rate adjustment. Clearly, much would depend upon the background against which a small exchange rate adjustment was made. In a situation, like that which had followed the Smithsonian Agreement, in which exchange rates were more or less in an equilibrium state, small exchange rate changes might be successful, because the market might consider them sufficient and importers and exporters might permit the necessary price adjustments to take place. In the sort of situation that had existed in Germany, however, in which the economy had been overexport oriented, one small exchange rate adjustment would not be successful because it would not bring about the necessary resource shift. Like Mr. Bustelo, he saw no reason to believe that small exchange rate adjustments would adversely affect developing countries. On the contrary, they were likely to be more adversely affected by occasional large adjustments than more frequent small ones.

Mr. Lieftinck had suggested that Mr. Hirsch's system might be appropriate for adjusting exchange rate relationships between currency blocs, Mr. Schleiminger remarked. He, himself, was far from convinced on that score because he would have thought that adjustments between currency blocs would take the form of oligopolistic bargaining and, as such, be far from automatic. Like Mr. Lieftinck, he hoped that the world would not see fit to divide itself into such currency blocs.

Turning to the question of sanctions, Mr. Schleiminger recalled that the Economic Counsellor had recently observed that the existing system already exerted at least as much pressure on creditor countries as upon debtor countries. He had referred to the Bonn Agreement, to delayed exchange rate adjustments on the part of major debtor countries such as the United Kingdom and the United States, and he had noted that capital movements exerted particular pressure on creditor countries. During the same discussion, Mr. Beaurain had expressed the view, with which he fully agreed, that no revaluation should ever again be brought about by capital movements. At the same time, he could support Mr. Ugueto's view that any device which exerted pressure on creditor countries was worth considering--provided, of course, that the distribution of responsibility between debtor and creditor countries was inequitable. In that connection, however, he was in no doubt that the creditor countries had been bearing their share of the responsibility for exchange rate adjustments. Indeed, it should not be forgotten that revaluations by creditor countries had played a major role in the adjustment process during the past five years. Mr. Bryce's support for sanctions against surplus countries should perhaps be examined in the light of his country's adoption of a floating exchange rate, which permitted it to avoid either a surplus or a deficit position. His own view was that if stability was desired, deficit and surplus positions would have to be accepted and the responsibility for adjustment, together with sanctions, if any, distributed equitably between creditor and debtor countries.

Mr. Dale considered the suggestions in DM/72/18 to go in the right direction, to the extent that they were concerned with a redistribution of authority between national governments and the international community. Those suggestions could, in his view, make a contribution to overcoming three of the four main problems that had plagued the major countries in the exchange rate field in the past. The first problem was that of the "recognition lag" which had been unduly long in some cases. He, himself, had concluded well before 1971--possibly even as early as 1968--that a realignment of major exchange rates would become necessary, but it had taken a long time for that view to become generally accepted by the officials concerned. The second problem was that of the "decision lag" which, of course, was a political problem. Even after a wide variety of U.S. officials had reached the conclusion that an exchange rate adjustment was necessary, it had taken at least six months for the U.S. Government to make the appropriate decision. The third problem was that of deciding how much of a change in the exchange rate was required in order to produce a given shift in the balance of payments. The fourth problem, which was the one about which the Fund or Mr. Hirsch's scheme could do little if anything, was that of the "effectiveness lag" or the period of time that elapsed between the decision and the desired results. There was something which the Fund had been doing and would undoubtedly continue to do, irrespective of whether or not the exchange rate system was changed, about the third problem. It seemed to him, however, that the Fund could, on the basis of Mr. Hirsch's suggestions, make a greater contribution to resolving the first two problems:

the recognition and decision lags. That would involve a basic change, insofar as the Fund would have to take some initiative in suggesting the need for exchange rate adjustments on the part of individual countries. Like Mr. Gilchrist and Mr. Schleiminger, he believed that that would prove necessary at some stage in the future and he hoped that it would come about sooner rather than later. At the same time, a wide latitude would have to continue to be permitted the national authorities. The need for the Fund, or the international community more generally, to play a greater role would have to be reconciled with the existing situation under the Articles in which all the initiative for exchange rate adjustments rested with national authorities. The redistribution of authority would raise difficult problems of law, politics and analysis and Mr. Hirsch had made a commendable start in clarifying them and in suggesting solutions.

While recognizing that it would take a considerable period of time for the sort of scheme envisaged by Mr. Hirsch to become generally acceptable, Mr. Dale believed that serious consideration should be given to moving in that direction. Article XII, Section 8, would seem to offer some possibilities on that score. It referred to the Fund publishing "a report made to a member regarding its monetary or economic conditions and developments which directly tend to produce a serious disequilibrium in the international balance of payments of members." It did, therefore, seem to offer the possibility of according special treatment to a small group of economically large countries, rather than the entire Fund membership, because only the economically large countries could produce a serious disequilibrium in the international balance of payments of members. Article XII, Section 8 also provided a solution to the problem raised by Mr. Brand about the possibility of New Zealand's or South Africa's equilibrium parity zone being determined by a special committee of the Board of Governors, upon which they were represented by the Australian Minister of Finance. Article XII, Section 8 stated that "if the member is not entitled to appoint an Executive Director, it shall be entitled to representation in accordance with Section 3(j) of this Article." There would seem to be, therefore, a fair amount of authority within the existing Articles of Agreement for moving in the direction suggested by Mr. Hirsch.

There were two features of DM/72/18 that were rather disappointing, Mr. Dale stated. First, the suggestion in paragraph 4 on page 11 that a narrower parity zone might be appropriate for exceptionally large economies such as that of the United States constituted, in his view, a regrettable lapse into asymmetry which would not be acceptable. Second, like Mr. Brand, he welcomed the suggestions made in the last few lines of paragraph 6(b) on page 12, but wished Mr. Hirsch had given them the separate consideration which he had said they deserved. With respect to Mr. Schleiminger's remarks on the subject of an equitable distribution of responsibilities and sanctions between deficit and surplus countries, he could agree that under the present system certain deficit countries had had an easier time of it than certain surplus countries. However, in a tight symmetrical system, the situation would be reversed and it was for that reason that he would continue to have a considerable interest in Mr. Hirsch's suggestions.

In concluding, Mr. Dale said that he was inclined to agree with what Mr. Bryce and Mr. Massad had said about the likely effects of various alternatives on developing countries. All his comments had been personal ones and he had nothing of an official nature to add to them.

Mr. Hirsch said that he would first attempt to respond to the individual points of detail made by Executive Directors and then address himself to the more general issues that had been raised during the course of the discussion. In answer to a question by Mr. Brand, he said that the scheme which he had outlined was certainly consistent with a symmetrical intervention system. He had not referred to symmetrical intervention systems in DM/72/18 because he had wanted to avoid an unnecessarily complicated exposition. It could, however, perhaps be argued that his scheme would prove less complicated to operate with a symmetrical intervention system. As to the number of countries that might be involved, he had not attempted to establish that with any precision, but had assumed that the countries that would be involved would be those for which a change in competitiveness would have a significant effect on the world as a whole. Indeed, that criterion was similar to the one that Mr. Dale had quoted from Article XII, Section 8.

Addressing himself to Mr. Yaméogo's question, Mr. Hirsch said that he had not proposed a zone of 10 per cent as the optimum zone, but as an illustration. As to whether a zone of 10 per cent plus a band of 6 per cent constituted a rather large range of variation, it should be remembered that the scope for movement within the equilibrium parity zone was not equivalent to the existing scope for movement within the margins. A country could not be sure of maintaining its freedom to change within its parity zone, because that zone would be reviewed within six months. If a country adjusted its rate from the top of its zone to the bottom against the likely trend of its competitiveness, it would run a high risk of being forced to change its parity at the next six-monthly review. He agreed that there was a certain kinship between Mr. Schleiminger's suggestion of two years ago and his own scheme of equilibrium parity zones. Indeed, both were related to the initial 10 per cent change in exchange rates permitted by the Articles, which until quite recently had been available to a large number of relatively important countries. The increased scope for exchange rate adjustments envisaged by his scheme was not, therefore, as great as might appear.

The reason for proposing a parity zone within which there would be freedom of movement, Mr. Hirsch went on, was twofold. First, it reflected an attempt to maintain the existing balance between national discretion and international validation. It did not involve an attempt to shift the balance away from national authorities and it would not, in his view, necessarily make the system operate more automatically by bringing more automatic international pressure to bear on the national authorities. Second, the idea of a parity zone was designed to allow for the area of uncertainty that existed in the calculations, particularly with respect to assessing the effect of policy measures undertaken by national authorities. Indeed, it could be argued that, from that standpoint, the system was less rather than more precise than the calculations made, for example, on August 16.

In response to Mr. Brand's question about the nature of the consultations envisaged in paragraph 7 on page 12 of the paper, Mr. Hirsch stressed that he had deliberately tried to avoid being too precise, but added that he had had a four-stage procedure in mind. First, an assessment would be made by the staff on the basis of all the information available on a country, particularly that elicited from the regular country consultations. That would provide the input for the computer exercise, which would be the second stage. The third stage would involve an internal staff review of the computer output in order to eliminate any manifestly unreasonable results. In the final stage, the staff recommendations would be submitted to a high-level review body. The recommendations would only have the status of the input from which they had been derived and would, of course, be open to adjustment by the review body. He had not, in reply to Mr. Bryce's query, envisaged that the final results would be published--at least not by the Fund. Naturally, however, an administration's relationship with its parliament was its own business. Whether or not the publication of results would make the scheme impossible to operate would depend upon the spirit in which countries entered the scheme. If, inconceivable though it was, countries adopted the scheme reluctantly, without being prepared to adjust their parities in a flexible way, their rates would often be close to the zone margins and they would be obliged to make frequent parity changes. In those circumstances, leakages of information would cause great disquiet and great pressures in the market and the system would probably break down. If, on the other hand, countries operated the scheme in the intended way, it would be exceptional for parities to be outside the zone or up against the limits of the zone, and leakages of information would then not have any clear inference for market rates, so that they need not have the usual disruptive effects. Moreover, it should be remembered that the final stage of the review would be political in character and would, therefore, provide for a degree of flexibility. If a country brought great political pressure to bear in the multilateral review, it would perhaps succeed in preventing a shift in the zone in a way that indicated a change in parity; but that would create its own pressure for parity adjustment, as such a country could not expect to receive similar treatment at the next review.

Turning to the likely effects of the scheme on developing countries, Mr. Hirsch associated himself with the views expressed by Mr. Bryce and Mr. Massad. He had always felt that the effects of greater exchange rate flexibility on developing countries would be of second or third order importance. If greater exchange rate flexibility was the price required to permit the developed countries to adopt expansionary and nonrestrictive policies, such flexibility constituted a better alternative for developing countries than a rigid and restrictive system. It was for that reason that he had suggested that any adverse effects of more flexible parities on developing countries, compared with effective adjustment by developed countries not involving exchange rate flexibility, should be offset in the general reform package rather than in the exchange rate system itself.

Addressing himself to the question of sanctions, Mr. Hirsch agreed with Mr. Bryce that those suggested in the paper were really rather mild. Some schemes, particularly that of Professor Cooper, provided for surplus countries to be subjected to exchange equalization duties. In such schemes, countries would be permitted to levy import charges against the exports of surplus countries that failed to revalue. He had not, however, considered it appropriate to examine the question in detail in his paper. Under the existing system, even if tight convertibility was introduced, the constant injection of liquidity into the system through SDR allocations certainly removed one of the asymmetries which had previously existed between deficit and surplus countries. It had seemed to him, therefore, that all that was required was a sanction on surplus countries that would be equivalent to the sanction that could be applied to deficit countries by withholding additional conditional liquidity.

Turning to the more general comments that he wished to make, Mr. Hirsch observed that Executive Directors had interpreted his paper in a way that conformed with its intentions. Its intent was not to propose a scheme for immediate, or perhaps even for eventual, implementation. Rather, it constituted an attempt to indicate the sort of comprehensive scheme that might prove necessary to permit the parity system to operate smoothly in conditions in which parities would be adjusted fairly frequently by all major countries, including the United States. The paper as a whole, and not just the scheme, suggested that that would be rather difficult to accomplish. An underlying intention of the scheme was to offer an alternative type of flexibility to temporary floats. A system of temporary floats might be administratively easier to operate, but it would be rather far removed from a parity system. His scheme attempted to suggest how the parity system might be retained, but made to work more effectively.

In response to the question of whether the scheme could be approached gradually and informally by a greater exercise of Fund initiative, Mr. Hirsch said that it might be possible to achieve some of the advantages of the scheme by that method. He would be inclined to suggest, however, that an informal approach incorporating no new institutional mechanisms would have to find ways of dealing with two problems entailed by a gradualist approach. First, if an unwritten and informal approach was adopted and the Fund simply extended its initiative gradually, countries might feel that they had surrendered initiative without receiving any additional leeway in return.

Second, without clearly defined parity zones, the system could become more precise and perhaps even over precise. Thus if a more informal approach were to be adopted, serious consideration would have to be given to the problem of the distribution of initiative between the Fund and national authorities and to that of dealing with the area of uncertainty in the exchange rate field.

A scheme of the type he had suggested, or indeed any method of operating the parity system more flexibly, would only have a chance of success if the participating countries were convinced of the need to make it a success, Mr. Hirsch observed. It was difficult to judge, on the basis of past evidence drawn from quite different conditions, whether countries would be prepared to make the appropriate small exchange rate changes or whether the markets would be convinced by such changes. Clearly, as Mr. Schleiminger had pointed out, small exchange rate changes from a position of disequilibrium would be unlikely to prove convincing to the market. On the other hand, if the market believed in the possibility of reversibility, in the sense that it could conceive of small changes taking place in reverse directions within six months, small changes would be much less likely to encounter destabilizing speculation. One of the difficulties of achieving more prompt parity changes was that they would oblige national authorities to take decisions before they were completely certain that the exchange adjustment would be seen to be justified in retrospect. If national authorities took action before they were sure that it would continue to be appropriate, they had to be prepared to reverse such action and, in those circumstances, the international community required safeguards against countries changing their parities whenever they liked. That consideration provided part of the rationale behind the idea of equilibrium parity zones. Finally, he recalled that Executive Directors had expressed the understandable desire to avoid half-yearly Smithsonian agreements. The intention of his scheme was to avoid biennial Smithsonian agreements before the television cameras by conducting half-yearly reviews in the Fund.

The Executive Directors concluded their discussion of DM/72/18.

ROGER V. ANDERSON
Acting Secretary