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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Seminar 90/3

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M. Camdessus, Chairman

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J. W. Lang, Jr., Acting Secretary
D. de Vos, Assistant

Also Present
Asian Department: R. J. Corker. Exchange and Trade Relations Department: P. A. Acquah. External Relations Department: A. F. Mohammed, Director; D. M. Cheney. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: A. O. Liuksila. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; B. B. Aghevli, G. Calvo, N. N. Choudhry, G. Hacche, P. Isard. Secretary's Department: A. Tahari. Treasurer's Department: D. Berthet. Special Advisor to the Managing Director: A. K. Sengupta. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, M. B. Chatah, A. Gronn, K.-H. Kleine, J.-L. Menda, M. J. Mojarrad, P. O. Montórfano, D. Powell, A. Raza, S. P. Shrestha. Assistants to Executive Directors: G. Bindley-Taylor, B. A. Christiansen, S. Gurumurthi, A. Hashim, M. Hepp, O. A. Himani, Hon C.-W., L. Hubloue, K. Ichikawa, M. E. F. Jones, C. Y. Legg, R. Marino, J.-P. Schoder, Wang J., J. C. Westerweel, Yang J.

1. MAJOR ISSUES OF THE EVOLVING INTERNATIONAL MONETARY SYSTEM - CHARACTERISTICS OF A SUCCESSFUL EXCHANGE RATE SYSTEM

The Executive Directors resumed from the previous meeting (Seminar 90/2, 6/6/90), their consideration of a staff paper on major issues in the evolving international monetary system, focusing on the characteristics of a successful exchange rate system (EBS/90/15, 1/29/90).

The Director of the Research Department and Economic Counsellor observed that the relative merits of a formal nominal anchor compared with a well-behaved monetary policy had been a question implicit throughout the Board discussion. Related questions about anchors, the need for a low inflation rate club, and price stability as the primary responsibility of monetary policy had also been posed.

The primary objective of monetary policy was the control of inflation because it was the policy instrument with the comparative advantage in influencing inflation, the Economic Counsellor stated. It was important to recognize that fact, as monetary policy could be used to achieve many other objectives, and thus occasionally be abused or overloaded. He had used the adjective "primary" in describing the role of monetary policy to clarify the discretionary element inherit to all policy, as compared to, for instance, the programming of computers. There was some room to assess and modify chosen policy courses as one observed realities unfolding.

Price and exchange market stability were obviously common policy objectives, the Economic Counsellor continued. One speaker had noted that the achievement of price stability might, in itself, contribute to exchange rate stability more effectively than achieving price stability through the exchange rate. Another speaker had remarked, nonetheless, that exchange rates stability did not stabilize inflation, as inflation could then simply be consistent across borders, or be accelerating. Therefore, a mechanism to anchor the price level was still needed. In assessing alternative monetary mechanisms or anchors, one always had to ask whether they would go beyond stabilizing exchange rates to stabilizing the price level. In that connection, the search for a formal nominal anchor to secure the monetary system might not be necessary if a well-behaved monetary policy was in place. However, a Director's reference to "if" in that regard was crucial, as the rationale for an anchor was precisely to contribute to a better behaved monetary policy. The unwritten peer pressure of adhering to a nominal anchor was useful in that the visibility of the anchor immediately highlighted departures from it. And while the need for an anchor was not new, as exemplified by the anchor in the Bretton Woods system, the Board seemed unanimous in agreeing that the international monetary system could not revert to the earlier arrangements--albeit lessons remained from that experience.

Once a nominal anchor and exchange rate targeting were in place--or commitments to limit monetary policy--the Economic Counsellor commented, policy independence would be constrained, with the paradoxical result, however, that other "goods" were gained in exchange. Loss of independence in policy was beneficial for the countries that lacked discipline, although lack of discipline was a fluid concept, such that rigorous policies under an anchor might lead to the illusion that discipline was inherent, and that the need for an anchor could be disposed of. Without an anchor, there was an incentive to lose policy discipline. Moreover, if independence was used in a manner that was inconsistent with one's policy objectives, it would lead to a net loss in welfare. In any event, it was extremely important that anchors should not be overemphasized in the face of the overriding need to keep policy fundamentals in mind. Indeed, anchors were not a substitute for good policy. In a metaphorical sense, a country or a "boat" could be anchored, but if its "engine" was kept at full power, it was obvious that the engine would either burn out or the "rope" to the anchor would have to be cut. The policy fundamental of turning the engine off--such as adjusting the fiscal position to be consistent with the anchor--had to be in place first.

The notion of losing policy independence obviously raised political considerations, with one speaker having pointed out that credible policy needed to reflect domestic commitments and discipline, not superficial external commitments that were not underpinned by domestic consensus, the Economic Counsellor said. In that connection, while exchange rate commitments had contributed, in many cases, to the credibility of anti-inflationary policies, they had not, in many other cases. In the former, he would note that France's exchange rate commitment within the EMS had contributed significantly to the credibility of its anti-inflationary policies. One speaker had reminded others that nominal anchors were an integral part of stabilization efforts under some Fund-supported adjustment programs in high inflation rate countries, and could contribute to policy credibility if implemented correctly. However, if macroeconomic policy fundamentals were not in place, such anchors had had disastrous consequences in hyperinflationary countries. Anchors were not a substitute for policy fundamentals, or a panacea, but an essential mechanism for validating such fundamentals when in place.

In the general connection of anchors, the Economic Counsellor observed further that the distinction between fixity and stability was vital. When economic realities were changing, it made no sense to fix a variable in a rigid manner that would prevent validation of the changes in process. When there were occasional changes in real terms of trade and technological progress, for instance, it would be disastrous to peg real exchange rates inconsistently with such changes. There could still be appropriate flexibility that would lend stability to the system, provided the flexibility was consistent with real economic circumstances. In the sense that an anchor was attached to a "rope" with some leeway, an anchor was useful--particularly in stabilizing the "boat" when it moved too far out of line. In the same sense, the design of a bridge had to make allowances for temperature changes, the very flexibility of which was necessary for its stability. Provided that one did not fall into the fallacy of regarding flexibility as an open-ended spectrum, the distinction between fixity and stability was valid. The questions involved were not philosophical, but required a pragmatic recognition of the manner in which the system actually operated.

The underlying rationale for an anchor was to protect economies from the unexpected, the Economic Counsellor continued. As one did not know where the "wind" would come from, one needed an anchor. A further issue was involved, however, namely, that concerning the need for multiple anchors to compensate for varying wind directions. In each instance, only one anchor would be effective, and multiple anchors might therefore indeed be desirable.

The question of international clubs, and the number of members they should have in central positions, had been addressed by several speakers, the Economic Counsellor noted. One Executive Director had considered that the Group of Three should have authority, in view of its primary responsibility in the world economy; another had believed that all countries should participate, as they could each benefit; and a further speaker had observed that if the United States fulfilled effectively the function of a low inflation rate country, having one country alone in the "club" would be fundamentally sufficient for the system. There was not a difference of view in the Board in the sense that the agreed concept of clubs highlighted the common notion of externalties. A small country would obviously benefit from joining the club--hence, the trend for such countries to become members--and the club would not suffer if that country left it, although the country itself would suffer. However, a large country did not necessarily have the luxury of leaving a club, because if it did, the club would no longer exist. A large country in a club was therefore, in effect, the club itself. In view of the partial asymmetry involved, large countries in the system had extra responsibilities for maintaining the club's existence.

As one speaker had noted correctly, collective responsibility for inflation would result in mediocre such performance on average, the Economic Counsellor added. Basically, it was individual responsibility that would maintain the low inflation rate character of a club, the "winners" in which would be the countries that forced their inflation rates progressively lower, making them more attractive to foreign asset holders. The central economy and guardian of the club in the 1960s had been the United States, but it had lost its monopoly to the Group of Three, in consequence of the more loosely disciplined policies that it had pursued in the late 1960s and early 1970s. The role of coordination was precisely to articulate the benefits and costs of clubs.

In regard to the question of domestic policies, there had been some important discussion on the financing of fiscal deficits as a result of GEMSU, whether through taxation or borrowing, the Economic Counsellor observed. That was a general issue, which would preferably be discussed when the specific question of GEMSU was taken up. In that general connection, there seemed to have been various references in the Board to trade-offs between policy variables. One speaker had mentioned that priorities might differ between countries in regard to inflation and growth; another had referred to the need to reduce inflation while also sustaining growth; and a further speaker had cautioned that external imbalances should not be corrected by a low growth policy. It was important to emphasize that the art of policymaking was precisely to avoid such trade-offs, recognizing--as in the past world economic outlook papers--that the countries that had been able to maintain low inflation rates were also the ones that had grown faster, had better export performances, and higher welfare in general than those that had tried to "inflate away" their difficulties, resulting in their becoming weaker members of the system or club, and losing their prospects for growth in particular. One had to ensure, nonetheless, that short-run stabilization would not create extraordinary difficulties for economies and their growth prospects--particularly their standards of living--albeit that trade-off could not be utilized for long.

In describing the characteristics of a good international monetary system, speakers had referred to the need for stable exchange rates, stable and low inflation rates, low real interest rates, and the promotion of growth and an open trading system, the Economic Counsellor noted. In effect, the system had enormous liabilities in having to meet numerous objectives. Two corollaries followed, namely, that systemic questions had to be addressed repeatedly by the Fund in view of the numerous issues involved and the high cost of missed objectives, and that a full range of policy instruments had to be available. In particular, he would note that overburdening of the monetary policy instrument would prevent the achievement of the range of objectives desired.

The Board had had an interesting exchange of views on external imbalances, the Economic Counsellor considered. One speaker had agreed with the staff that external imbalances could be unsustainable in the long run, but not in the short run, and another had posed the inverse question that, since the cost of "bad" deficits would be highly visible and be incurred only in the future, there would be a danger that fiscal imbalances would fail to be addressed soon enough. How could the long and the short runs be reconciled in the light of the above, and given the apparent short-run benefits of external deficits? The solution was to recognize that there was no luxury of separating the present from the future; negative events in future economic policy would be reflected in the present, and conversely. The present/future nexus was not a distinction that could be capitalized upon, for the same reason that trade-offs between policy variables could not be taken advantage of. Indeed, the entire strategy behind the concept of credibility was to ensure that the beneficial results, in the future, of current policy would also condition the existing economic climate. That was the rationale for implementing structural policies that would bear fruit in the future. They would also revitalize an economy in the present through, for instance, reversal of capital flight and increases in foreign investment.

Distinguishing benign from malign external imbalances in a too rigorously scientific manner would not be successful, the Economic Counsellor went on, although adopting the view that the inability to make the distinction in every case should make one abandon the concept would cause substantial problems. In some cases, it was highly obvious that external deficits were malign, if they were derived from public sector imbalances resulting from excessive expenditure on consumption versus investment or infrastructure, particularly in a distorted environment. In the latter regard, he would agree fully with the general point made by a speaker that external imbalances should not arise as a result of domestic distortions, which hampered, for instance, private savings. Identifying such distortions was important in distinguishing between benign and malign external imbalances, although one should not attempt to draw excessively subtle distinctions in the external area. In any event, external deficits derived from investment booms--or higher rates of return on investment viewed as socially acceptable--should be seen probably as benign imbalances.

The costs of inappropriate responses to external deficits were high indeed, the Economic Counsellor commented. One speaker had referred to the threat of ongoing protectionism and that markets might be unable to distinguish benign from malign external imbalances. It was indeed dangerous to be in a situation in which large external deficits created protectionist lobbies, particularly when capital markets were integrated. In that connection, it would be useful to discuss the forthcoming paper on the systemic implications and determinants of capital flows with the current meeting as background. Both the current and capital accounts were obviously relevant in discussing benign and malign external imbalances, the latter of which had probably been more common, in his view. Other speakers had mentioned that protectionism was not the only cause for concern in the context of large external imbalances, but high real interest rates as well. And while it was a truism that each external surplus had an external deficit as a counterpart, there were situations in which a particular deficit was malign and its counterpart surplus was benign, depending on the existence or not of distortions. In any event, it would definitely not be right to correct external imbalances through a low growth policy. He would emphasize, however, that a successful high growth policy would bear results only within a stable and nondistortionary environment. Policy trade-offs should not be considered.

The whole rationale and basic foundation of the concept of coordination was that all parties had to adjust, especially in view of the fact that there were no shortages of distortions in individual economies, the Economic Counsellor emphasized. One speaker had noted that coordination was useful provided that its limitations were recognized, especially in the fiscal areas and under conditions of high capital mobility. The inevitable difficulties of agreeing to an appropriate model of the world economy, the objectives of authorities, and whether they were consistent, the appropriate rate of inflation and speed of adjustment, and private versus public adjustment responsibilities across borders were not insurmountable. Those difficulties were surmountable precisely because the ongoing process of coordination was not always a reactive one to crises, but one where intellectual resources could be devoted on an ongoing basis to improving the system itself. The preceding informal session on exchange rates indicated the current opportunity for further work on improving the system. In addition to addressing the foregoing limitations, such work would need to consider as well the fact mentioned by a speaker that the coordination problem, in conditions of capital mobility, was not simply an international problem, but also a domestic one.

In commenting specifically on the international monetary system, some speakers had remarked that the EMS was not a model for the world, although that particular system did provide invaluable lessons, the Economic Counsellor said. Another speaker had commented that, in view of the EMS not being replicable on a worldwide scale, there was a significant case for greater fixity of exchange rates in each of the three "poles" of the emerging "tripolar" system, coupled with and made consistent through greater flexibility between poles. The tripolar system was an important question. The concept of a pole itself was not clear, with one speaker noting, for instance, that the prospects for a yen bloc were not good. The important point to appreciate was that there would never be complete symmetry between poles; Europe was likely to be more integrated than a yen bloc or a North American bloc, meaning that one should examine carefully all of the various monetary arrangements--not necessarily only those that would culminate in a single central bank within a monetary union. There were indeed various forms of monetary arrangements, each of them interacting, meaning as well that the system would have to be fluid. The Fund would have to have a view of those varying arrangements because they would all have systemic implications, particularly with respect to fiscal policy.

The distinction drawn by one speaker between rules and law, the former being understood in terms of a framework instead of narrow guidelines, could allow for the appropriate degree of fluidity within the right or desired framework, the Economic Counsellor stated. In that connection, the quote cited from The Economist that the economic historians' verdict of the 1980s would be that flexible exchange rates had failed, represented a fallacy, in that it failed to look beyond a single decade despite more than a century of experience. Indeed, the Bretton Woods system and the EMS--regarded in isolation--could be seen as having failed, the latter in terms of sudden parity realignments. The correct approach was to regard the system in the future as necessarily being fluid, which made the distinction between rules and law highly pertinent. A framework of rules could be expressed through a Bretton Woods-type system in one decade, an EMS-type system in another, and a tripolar system in yet a further decade. The same principles were applicable to each system. To challenge more directly the view that flexible exchange rates had failed in the 1970s, one could ask The Economist's "historians" whether the extraordinary inflation in the early 1980s inherited from the 1970s could have been stabilized with rigidly fixed exchange rates. The answer was obviously no, but not as much because the exchange rate system had failed, but because policymaking or management of the international "club" had clearly failed in the 1970s.

Speakers had provided a long list of suggested topics for work, and more guidance would be needed on how best to prioritize the Research Department's efforts, the Economic Counsellor concluded. Those topics included questions such as: the CMEA; convertibility; a European payments union; EMU; and other regional arrangements in a systemic context; and the SDR, and international liquidity, of which the latter concept--one speaker had reminded others--should be understood subtly. It was encouraging that the question of the international monetary system had been regarded not just with interest for discussion, but as a central responsibility of the institution.

Mr. Newman said that, in view of the seminar format of the discussion, he would pose a theoretical question of how could one ensure that a nominal anchor, in a multiple anchor system, was "in the right place" vis-à-vis the other anchors and members, and that it was disciplined. In the Bretton Woods system there had been the scarce currency clause and gold convertibility. At the time of the Committee of Twenty, there had been attempts to develop a reserve indicator to apportion adjustment responsibilities. Neither of those approaches had been fully successful or accepted.

Mr. Kyriazidis remarked that he had found the Economic Counsellor's use of nautical analogies in reference to nominal anchors most helpful. An anchor was, in the first place, not for stabilizing a "ship" but for preventing it from drifting when its "engine" was not running. An anchor could help stabilize a ship to a certain extent, if it was thrown astern and not fixed during a storm when the engine was running, which required careful handling. Having an anchor on both the bow and stern of a ship would have disastrous consequences if the "wind" came from the side. In fact, and importantly, the ship would always turn into the wind--wherever it came from--when riding at or with one anchor. A fixed and strong anchor could also have disastrous consequences in a storm; either the anchor or the ship would break up as a result. In such circumstances, a "wise captain would lift the anchor, turn the engine on, and float outside the harbor."

The Economic Counsellor responded that Mr. Kyriazidis had made a vital clarification in referring to the need for careful handling. It was certainly the case that one could not ensure that the anchor was entirely in place; an ongoing examination--along with allowance of some degree of flexibility, without also confusing stability with fixity--was important. One of the difficulties in previous regimes had been that policymakers had "woken up" when the ship had already "drifted" so far away that the slippage became extremely costly to correct. Every devaluation had been traumatic, and the system had had to be changed. With an ongoing mechanism for examining the system, not only would the anchor be adjusted, but also the economic fundamentals to avoid traumatic changes. He would agree with the Chairman that the use of metaphors was risky, in any event.

Mr. Kyriazidis commented that the use of metaphors to refer to precise situations--with definite analogues--could facilitate further thought. He believed that the idea of "floating in a storm" merited serious consideration, for example, in a crisis.

Mr. Cassell remarked that many Directors had regarded the key purpose of an anchor as providing additional credibility to policies. He had some difficulties with the distinction between stability and fixity, although he could accept the view that, in a world prone to shocks, the exchange rate had to be one of the variables that changed. Obviously, a fixed exchange rate regime could not have been sustained through the tremendous shocks of the 1970s. If one was living in a world in which substantial disequilibria were allowed to build up, it was not then of a great help to say that flexibility should not be an open-ended spectrum. More specifically, the difficult judgment had to be made of setting some kind of limits to flexibility to ensure the credibility of underlying policies.

In the United Kingdom, policymakers had come to the view that, while it was correct to let the exchange rate take part of the strain of external pressures such as changes in oil prices, there were great dangers to letting the rate take most or all of the strain, Mr. Cassell remarked. "Letting out more rope" might lead to a system that was ultimately unworkable; it was obviously difficult, however, to judge the appropriate amount of "free play" in the rope. The United Kingdom had lost a Chancellor of the Exchequer in a conflict over exchange rate policy. One had to make either a complete commitment to a currency union--or a similar such system with stability and small margins for exchange rate fluctuation, defending the chosen parities and adjusting policies, as under the gold standard--or accept a type of floating rate system in which exchange rates absorbed a substantial part of the strain of each shock. Devising a mechanism between those alternatives was certainly not easy.

The Chairman considered that, in the debate on the merits of flexibility and stability, there would never be a perfect answer. Judging the appropriate or acceptable amount of flexibility would always be difficult, but it was an area where peer pressure could certainly be helpful. It would benefit a country--and had clearly benefited France--to have other countries telling it that it was "taking too much advantage of the long rope between the anchor and itself," particularly in view of the difficulty in making individual national judgments on such matters. The Fund had a permanent role to play in its surveillance exercise. The purpose of Article IV consultations, in particular, was to inform a country of the international community's assessment of the appropriate mix of adjustment, financing, and flexibility.

The Economic Counsellor said that implicit to Mr. Cassell's view was the notion that defense of an exchange rate would lend credibility to policy. There was a need, even so, to avoid the inverse problem as well, of making unbelievable exchange rate commitments. To obtain the benefits of credibility from a fixed rate while avoiding unbelievable commitments at the same time, policymakers had to allow for and facilitate sufficient flexibility in the rest of the economic system so as to make exchange rate adjustment redundant. If there were sufficient wage flexibility, and prices were allowed to fall in some sectors, exchange rate action would not be needed. The exchange rate and monetary system could therefore not be regarded in isolation from microeconomic structural issues. The credibility of the chosen exchange rate system would depend much on the actions taken in the structural area; if such measures enhanced wage and factor mobility, with firms being allowed to go bankrupt, prices could adjust in response to news instead of the exchange rate doing so.

Mr. Cassell asked why the exchange rate should be unvarying, and not some other variable.

The Economic Counsellor replied that the exchange rate was a unique price. Abba Lerner had remarked once that, with so many goods in the economic system--such as peanuts, tables, shoes, and moneys--why should one speak in terms of a quantity theory of money, as money was not different from all of the other goods in circulation. That was a fallacious view, however, as money was unique in the system and its price was fundamentally different from that of other goods. In effect, it was a "magic" production of something out of nothing, by governments. Obviously, money in itself was worthless, yet it "oiled" the whole system if it worked well, or made the system "squeaky" if it did not. Money linked separate economies and had the potential to contaminate all members of the same monetary system. It, or the exchange rate, was therefore a unique price.

The Chairman observed that the point about the relevance of structural policies to a smoothly functioning international monetary system, and effective management of exchange rates, was vital.

Mr. Fernández Ordóñez said that one should regard the difference between fixity and stability as a continuum in time, instead of as a static framework, such that the system adjusted daily, not at discrete intervals of six months or a year, for example. Indeed, there had never been a system of fixed rates but of fixed and adjustable parities. Speculative capital gains could be enormous in such a system that was adjusting daily. In any event, fixity and stability were not different phenomena.

Mr. de Groote remarked that he had found Mr. Newman's earlier question interesting and highly relevant to large industrial countries. A system of more stable exchange rates, if accepted and perceived as a matter of self-interest by countries themselves, would elicit or build in the appropriate policy responses in the fiscal area, wage formation, and in costs in the structural area generally that were, ultimately, the only ones that could correct basic imbalances. In Belgium, for instance, all of the policies introduced since 1982 had been in response to a significant devaluation, with the perception that the new exchange rate would have to be defended by policies stretching over a ten-year horizon. There had thus been important adjustments in wages, competitive position, and the public finances. The great advantage of a system of more stable exchange rates or an anchor was that it elicited semiautomatic adjustment responses once it had been accepted as a guideline that was within a country's interest.

Mr. Posthumus commented that the various points made, and Mr. Newman's question, indicated that the case for stable exchange rates should not rest on the argument for policy discipline alone. He had mentioned the argument about fostering trade flows, which had been highlighted incidentally in a recent article in the financial press about the U.S. company, Caterpillar. One of that company's main problems had been the fluctuating dollar. Mr. Landau seemed to have mentioned the same kind of argument in regard to capital flows.

The Economic Counsellor stated that some work had been done by the Fund in the past on the effect of exchange rate volatility on trade flows and entrepreneurs' decisions. With respect to one speaker's point about the time frame of exchange rate adjustments or the point that the timing of such adjustments was the key, he would note that it was linked with the point made highlighting the cost of those adjustments. The central issue was the predictability and cost of such changes. In analogous terms, there was a yearly switch to daylight savings time and back again, even though clocks could be adjusted incrementally on a daily basis to match the continuous changes in the length of the day, his point being that such small albeit predictable changes would likely be very costly compared with larger, well-known changes at a definite date in the future.

Mr. Newman said that he had raised his point about anchors in view of the different national psyches and economic policy preferences and objectives--of the three anchors of the United States, Germany, and Japan. The experience of the United States in the 1930s had profoundly affected its views on growth and unemployment; Germany's experience in the 1920s had greatly influenced its views on inflation; and the experience of Japan in the interwar years had indeed influenced its view on the role of exports in an economy. It would be difficult to try to establish a mechanism that would make the Group of Three conform its policies to reaching a particular objective that would be consistent with the different national psyches of each country.

Mr. Goos remarked that he wished to reinforce the distinction drawn by the Economic Counsellor between specific commodity prices and exchange rates. If one changed "peanut" prices, for instance, one would simply affect peanut production. But if one changed an exchange rate or let it float freely, one would influence all prices in an economy--and, hence, all production and savings and investment decisions. The exchange rate was a unique price.

Mr. Arora considered that the Economic Counsellor had been able to argue that one could not say that flexible exchange rates had failed in the 1980s by focusing on the benefits of the exchange rate system for a limited group of countries. If one looked at the condition of Latin America and Africa in the 1980s, namely, at the broader global situation, one could not pronounce unqualifiedly the system to have been successful. While the Group of Three or emerging tripolar system was important, and had enormous influence, one should regard it in the context of the broader world economy, particularly in the current era of interdependence. Countries beside the Group of Three were a part of the world economy.

The Deputy Director of the Research Department noted that a number of Directors had appropriately identified the issue of fiscal policy adjustment, discipline, and coordination as a key question facing the system. In that regard, there were at least four mechanisms through which one could seek to ensure fiscal discipline, namely, the exchange rate regime, the markets, peer group pressure, and internal mechanisms that would differ from country to country.

The exchange rate system by itself, whether fixed or floating, would probably not be sufficient to ensure fiscal discipline, the Deputy Director continued. After more than ten years of experience, one could not see in the EMS, for instance, strong evidence of fiscal policy convergence, albeit there had been much monetary policy convergence. Neither, in North America, where exchange rates were much more flexible, was there evidence of consistent fiscal discipline.

As for the markets, if one assumed away, for the sake of analysis, exchange rates in favor of a single world currency, then how would markets exert discipline on fiscal policy, the Deputy Director remarked. For one, a country that consistently ran large fiscal deficits would likely face a widening interest rate spread between its domestic and risk free rates, and the markets would eventually impose the ultimate sanction of cutting off credit. Second, a government with high spending habits would eventually have to match those expenditures with high taxes, resulting in firms and individuals fleeing from its tax jurisdiction to preferable areas with lower rates, thereby creating pressure for tax harmonization and, eventually, expenditure cutting.

If the market was to work as a disciplining device, a number of conditions had to be fulfilled, the Deputy Director added. Comprehensive and accurate information was needed on the full magnitude of debtors' obligations, not just of the central government, but local governments and public enterprises as well. During the debt crisis, the Fund had seen that those reporting mechanisms were not in place in some developing countries. It was indeed hard to obtain a full picture of overall debt obligations. One might say that that was the case only for developing countries, not industrial countries, where developed financial market lenders should have sufficient information. An interesting case was the New York City financial crisis in 1975, in which it was clear that a good deal of "creative accounting" had taken place. Capital budgets had been used for current account purposes and there had been borrowing against future tax revenues that did not materialize. The studies of that crisis indicated, inter alia, that the market had not caught on to the financial crisis until it had developed to quite an extent. One might argue, in that connection, that the credit rating agencies could be relied on to evaluate debtors' risks. Debtors obviously had to be concerned that a change in their credit rating could become a self-fulfilling prophecy. Even so, they were not necessarily obligated to provide bad news before their mandated reporting requirements.

A second condition for markets to serve a disciplining function was that there had to be no implicit or explicit guarantee that the borrower would be bailed out by another government, because if there was such a guarantee, then the interest rate charged to the borrower would not reflect the borrower's creditworthiness but that of the guarantor, the Deputy Director explained. Indeed, one of the explanations for why interest rate spreads during the debt crisis had risen relatively slowly and with a lag had been the perception that there might be a bail-out, either of the countries or of the banks. Thus, if there were possibilities for bail-outs, the markets would not necessarily "impose" their discipline. Of course, it was always possible for governments to state that there would not be a bail-out, but the question would become how then could the market be assured of that stance. Perhaps the only means of making a nonbail-out entirely credible would be to avoid bailing out one of the borrowers when in difficulty.

A third condition for markets' disciplining function was that financial systems had to be sufficiently strong so that a given borrower was not regarded as too large to fail, the Deputy Director added. If it was too large to fail, then the other financial institutions that were holding that debtor's obligations would also be affected in the process. Moreover, borrowers' debts could not be monetized if market discipline was to be effective, otherwise the market would have difficulty in distinguishing between the nominal and real value of that debt, and therefore in its pricing. Finally, there would not be pressure for tax harmonization if there were compensating differentials in terms of public services. For instance, one might not object to living in Virginia and paying a higher property tax if one thought that Virginia provided better schooling. If there were perceived public services compensating for the differences in tax rates, then tax harmonization would not necessarily exert discipline, or, if the cost of mobility were high, the same would be the case.

In regard to the empirical evidence for the disciplining effect of markets, one speaker had asked whether the market in fact charged higher risk premiums for a more indebted entity, and whether such differentials were effective, the Deputy Director of the Research Department said. There was not much evidence on country interest spreads, as most such evidence dealt with federal fiscal systems, whether, for example, more heavily indebted U.S. state and Canadian provinces were subject to higher borrowing costs. In some cases, those studies had examined Moody's credit ratings and had tried to relate them to various debt variables, such as debt per capita. The evidence was weak that higher debt burdens were related significantly to lower credit ratings. Research had also been done on interest rate spreads between U.S. state obligations, with some evidence that higher debt burdens caused higher borrowing costs. None of the evidence, however, was nonlinear, in which increased debt burdens led to accelerating borrowing costs. Even if one found that increasing debt or irresponsible fiscal policy lead to higher borrowing costs, one still had to consider whether that higher cost would prompt corrective fiscal action, which remained an open question.

The third mechanism for exerting discipline on a fiscal policy was peer pressure or surveillance, the Deputy Director went on. There were different forms of peer pressure, one being, for instance, to have a fiscal policy rule in which there might be a ceiling on deficits. While there were a number of contrary arguments in that area, one difficulty was that a rule had to be found that was equally applicable across a variety of circumstances, when countries had different private saving rates, different outstanding debts stocks, among other variables. There was also a question of whether one could in fact impose sanctions against a country that was in noncompliance. With respect to policy coordination and informal kinds of surveillance that speakers were familiar with, there were some obstacles to effective coordination on the fiscal side, as fiscal policy was probably the most inflexible and disaggregated policy instrument, in necessarily being subject to legislatures among other constraints. Finally, the internal mechanisms for securing discipline, such as the Gramm-Rudman legislation in the United States, the publicly announced borrowing requirements in the United Kingdom, or debt reduction, clearly differed from country to country. All of the foregoing mechanisms should certainly be relied upon to secure fiscal discipline, as the problem involved was difficult and as all of the help that one could obtain from each of the mechanisms would be useful, the Deputy Director considered. If the market could bring some pressure to bear, and the policy coordination process and surveillance could help, and there were internal disciplinary mechanisms that differed from country to country but that could be used, all of those means would indeed be helpful in disciplining fiscal policy. The issue of fiscal adjustment was a difficult and somewhat unresolved one facing the system at present.

Concerning one speaker's inquiry about the prospects for improved analysis of equilibrium exchange rates and of indicator variables of inflation, the Deputy Director of the Research Department concluded that those prospects were moderately promising. The Fund had been doing some work over the past four to five years on equilibrium exchange rates, albeit some of the problems involved were substantial, particularly in terms of the meaning of normal capital flows, the definition of a sustainable debt position, the distinction between temporary and permanent changes in the terms of trade or in investment/savings propensities. The problem of trying to identify large exchange rate misalignments was not as difficult, but more a question of obtaining greater precision in assessing smaller misalignments, where there was clearly a greater margin of uncertainty. A fair amount of work--some of it recently at the Fund--had been done on examining variables such as yield curves, commodity prices, exchange rates, and what they added in understanding beyond the traditional variables such as monetary aggregates. Such indicator variables added somewhat to existing knowledge, but not a great deal in many cases.

Mr. Goos said that he had been intrigued by the reasons given for why the process of adjustment in the fiscal and external current accounts did not work as one would assume from textbooks. An important point emphasized by the Deputy Director of the Exchange and Trade Relations Department had been the role of information, or lack of it, among market participants. It seemed interesting that capital flows--or creditors--exerted greater discipline over external current account and fiscal imbalances some 50 or so years ago, notwithstanding the lesser availability of information at that time. That suggested that the current environment of global communications, where all market participants had instant access to all relevant information, the cause of the loss in the disciplinary impact of capital markets might have to be sought in increased government interference, via either artificial control of credit or explicit or implicit guarantees by governments that borrowers would be bailed out.

Mr. de Groote remarked that in the EC, it was generally agreed that some convergence in fiscal positions had taken place, although it had taken some time. While that process was still under way and would probably accelerate in some countries in the period up to 1993, he certainly agreed with the Deputy Director of the Research Department that the recognition of the need for such convergence had taken a long time. The size of government expenditures and deficits, and also rates of personal or enterprise taxation or turnover taxes, showed definite convergence.

The Deputy Director had discussed the interesting question of whether such convergence was due to exchange rate anchorage or to other factors, Mr. de Groote continued. He would agree that convergence was due to a combination of factors; in Belgium's case, he would point out that increased servicing of public debt--requiring increased use of public resources--had lessened the scope for modernizing infrastructure and had, thereby, put that country at a competitive disadvantage. The fiscal convergence under way in the EC had important effects on the manner in which many countries perceived their welfare and subsidy systems. He was optimistic that within a few years, basic fiscal deficits--excluding the servicing of pre-existing debt, which could only be eliminated gradually through growth of national income--and other variables would converge relatively significantly within the EC.

Mr. Posthumus said that he found the discussion on the international monetary system to have been a satisfying one, precisely because it had not been solely theoretical. The discussion on more than simply alternative systems, but on low inflation rate clubs, GEMSU, and even Japanese monetary policy had been most fruitful, although the references to discussing some of those questions in the context of Article IV consultations had illustrated that the Board was perhaps overly cautious in considering those questions. Discussion of "clubs," for instance, should not remain at a theoretical level only.

Mr. Cassell commented that the whole question of fiscal policy in different monetary regimes merited discussion in a future staff paper. In a system in which more stable exchange rates were achieved--with the associated greater credibility--it would presumably not be possible to sustain the current interest rate differentials with the objective of limiting exchange rate swings. Credibility, indeed, was not only a relevant concern to exchange markets, but also to money markets. A system of more stable exchange rates and enhanced credibility would impose a fair degree of indirect pressures for harmonization of fiscal policies, a question that was worth examining.

Mr. de Groote stated that he agreed with Mr. Posthumus that the discussion had been extremely fruitful and, in fact, successful. The discussion had met its purpose of facilitating a dialogue between G-7 and non-G-7 members. The productive exchange of views had covered, inter alia, the effect of German reunification on world interest rates, and the necessity, perhaps, of alternative policy responses. The intent of such dialogue was to build a common stock of ideas on the system which Directors could then consider for their merit in due course.

There had also been substantial discussion on longer periods in the history of the international monetary system, prompted by Mr. Cassell, Mr. de Groote observed. The extent of the discussion on anchors and the seeming general desire to move in the direction of greater stability, in terms of both prices and monetary "regulators," had been remarkable. That desire had been a most positive outcome of the discussion and should not go unnoticed in subsequent discussions, including on the world economic outlook.

The Chairman then made the following concluding remarks:

This has been an enlightening discussion of major issues, concentrating both on the characteristics of a successful exchange rate system for the world economy and on related issues raised by recent systemic developments in Europe. The discussion focused on industrial countries, but Directors will soon have an opportunity to discuss exchange rate policies for developing countries.

I was impressed by the number of Directors who stressed that the rapid evolution of the system underscored the responsibility of the Fund to evaluate continuously the functioning of the international monetary system and to identify improvements that could be implemented. As one Director put it, "The Fund has a unique vantage point from which to take a synoptic view of our interdependent world." Consistent with this theme, many Directors made specific requests for studies that would assist the Board in evaluating the broad systemic implications of recent developments. I noted particular interest in all forms of emerging economic and monetary unions in different regions of the world, including, but not limited to, German Economic, Monetary, and Social Union (GEMSU) and wider European economic and monetary union (EMU); in currency convertibility and potential payments systems in Eastern Europe; and in the changing conditions surrounding the provision, measurement, and management of international liquidity. These requests will be given careful consideration in the weeks ahead.

A major issue addressed in the staff paper was how the exchange rate system can provide a nominal anchor. Directors noted that exchange rates alone cannot anchor the system, and generally agreed that the task of delivering price stability falls mainly to the monetary authorities of each country. It was felt that the growing importance of Japan and Europe makes it unrealistic and undesirable to consider returning to a Bretton Woods-type system, in which global price stability depended almost entirely on price stability in the United States. A few Directors regarded the three largest industrial countries as forming the nucleus of a low inflation club, whereas others felt that this responsibility should be shared more widely. Views were exchanged about the prospects for implementing a more rule based approach to monetary policy. Most Directors argued that rigid rules can prevent adequate responses to unforeseen circumstances. There was broad agreement that monetary policy had too often in the past been overburdened, and that well-disciplined fiscal policy had to be an important ally of monetary policy in promoting sustained noninflationary growth. The question remains open, in the view of many Directors, if there is a need to supplement the existing forms of international surveillance by some form of arrangements that would reduce the risks of emergence and worldwide propagation of inflation. This issue, being central to multilateral financial cooperation, will indeed continue to be explored carefully.

A second issue discussed by Directors was how to distinguish "good" from "bad" external imbalances. A number of Directors expressed support for the view that this distinction requires careful analysis of at least three factors: first, whether the fiscal position is appropriate; second, whether, on the whole, the increased investment associated with the external imbalance can be expected to provide a rate of return that exceeds the cost of borrowing, after taking into account the relevant externalities; and third, whether any increased consumption associated with the imbalance can be regarded as temporary and desirable for purposes of intertemporal consumption smoothing. An implication of this approach was that, in prescribing policy action to correct an undesirable imbalance, a judgment had to be reached on the source of the imbalance. Several Directors, however, questioned whether it was operationally feasible or useful to attempt to identify desirable and undesirable external imbalances, since the multilateral nature of the external adjustment process would, in any event, inevitably involve adjustment of both types of imbalances. A number of Directors emphasized that current account imbalances could not be assessed in isolation of global saving and investment needs. At the current juncture, they felt that there was a global shortage of savings and that policies aimed at reducing existing external imbalances should take into account the need for increased global saving. Some other Directors, while not challenging the need for increased global saving, argued that there was no less compelling need to ensure that the process of external adjustment did not operate with a global deflationary bias.

In addressing the diversity of exchange rate arrangements that currently exist, Directors focused on three explanatory factors: the structural characteristics of economics; the need to reinforce monetary policy credibility; and commitments to regional integration. With regard to structural characteristics, some Directors endorsed the view that fixed exchange rates are likely to be more desirable, ceteris paribus, the more open an economy is and the more integrated it is with its neighbors, the greater the flexibility of internal wages and prices, and the less subject the economy is to country-specific real economic shocks. In this connection, it was argued that, where nominal wages and prices are downwardly inflexible, and where labor mobility is low, an aversion to nominal exchange rate adjustment could be costly. In the same vein, it was noted that economies that depend heavily on primary products are often highly exposed to relative price shocks, and that exchange rate flexibility can be an important means of cushioning these economies when there is low correlation of terms-of-trade shocks across countries. A number of Directors, however, saw the advantages of greater exchange rate stability in terms of providing a supportive, more stable, environment for trade and investment, as extending more broadly across different economic structures. Some of them also regarded nominal exchange rate adjustment as an imperfect substitute for internal price adjustment, noting that the existing degree of downward wage rigidity was, in some cases, itself the outcome of validating, too readily in the past, wage increases with currency depreciation.

On the credibility issue, it was widely agreed that a fixed exchange can provide the means for a low-credibility country to achieve price stability. Such a "hard currency" policy requires a commitment to tighten monetary policy as much as might be required to resist currency depreciation, with such a course of action being supported appropriately by the fiscal stance. Over time, currency and price stability can reinforce each other. On regional integration, Directors expressed broadly positive views of the progress toward monetary and economic union in Europe and toward free trade in North America, and some Directors saw the system evolving in a "tri-polar" direction. Many Directors cautioned, however, that greater regional integration should be seen as a step toward, instead of a substitute for, greater global integration.

If the exchange rate system were to evolve in a tri-polar direction, there would still remain the key question of how to limit more effectively the extent to which major currencies were subject to serious misalignments and/or excess volatility. Some Directors interpreted the experience to date with managed floating as suggesting that exchange rate determination could not be left exclusively--or even predominantly--in the hands of markets, as those markets had often demonstrated an undue sensitivity to transitory economic and political developments that, in turn, had pushed exchange rates away from fundamentals. Several of these Directors viewed the experience of the European Monetary System (EMS) with progressively greater stability of exchange rates as having positive lessons for the management of the international monetary system as a whole. Other Directors, however, emphasized that exchange market stability was not synonymous with exchange rate fixity, and that exchange market stability had to follow from--instead of lead--internal stability. Whether exchange rates among the largest industrial countries, or across the poles of the exchange rate system, should be subject to loose and quiet guidelines, but not to publicly announced targets or to narrow ranges, was still a matter of debate. While recognizing the difficulties that still exist for future progress, Directors reaffirmed the important role that the policy coordination process had played in sustaining the long-running, noninflationary expansion in the industrial world, and in promoting greater exchange market stability.

Several Directors pointed out that an improved functioning of the international monetary system required a better mechanism for the creation and distribution of international liquidity. While some Directors saw no need at present to enhance the role of the SDR in the management of international liquidity, some Directors noted with regret the continuing impasse on the SDR, arguing that the SDR could, and should, play a larger role in the system, including as a means of increasing the amount of potential liquidity available to members directly or through retransfer to the Fund, as suggested by Mr. de Groote. We will continue, as suggested by Mr. Arora, to think and work seriously about the SDR.

Directors were of the view that the Fund was effectively discharging its mandate for overseeing the functioning of the international monetary system--through its bilateral and multilateral surveillance activities, its technical assistance, its support for the policy coordination process, and its readiness to alleviate global liquidity shortages should they arise. It was also agreed that enhancing the Fund's role in the system depended primarily on the quality of Fund surveillance, a topic that the Board will be taking up in full in July 1990.

Executive Directors took note of the information provided by the German chair on German unification (GEMSU), and, as an Article IV consultation is currently being completed, they decided to discuss soon this issue in depth, with special emphasis on its systemic implications.

In the following weeks and months, we will have further discussions on all of these important issues, including consideration on the kinds of papers to be published following the discussions.

Mr. Yamazaki said that the discussion had indeed been productive, partly because of its seminar format. It was important to continue to develop the ideas expressed through a free exchange of views in an informal setting. He therefore hoped that the Chairman's remarks would indeed be designated informally as "concluding remarks."

LEO VAN HOUTVEN
Secretary