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Minutes of Executive Board Seminar 90/7

10:50 a.m., November 21, 1990

M. Camdessus, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
G. K. Arora	L. E. N. Fernando
C. S. Clark	G. C. Noonan
	Shao Z., Temporary
T. C. Dawson	
J. de Groote	J. Prader
	G. H. Spencer
R. Filosa	
M. Finaish	
M. Fogelholm	A. Gronn, Temporary
G. Grosche	B. Goos
J. E. Ismael	T. Sirivedhin
A. Kafka	L. M. Piantini
J.-P. Landau	J.-F. Cirelli
A. Mirakhor	
L. B. Monyake	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	
	N. Toé, Temporary
A. Torres	R. Marino
A. Végh	A. G. Zoccali
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
M. J. Miller, Assistant

Also Present
African Department: S. J. Anjaria, S. E. Cronquist, A. Doizé. Asian Department: P. Gotur, A. Husain, S. M. Schadler. European Department: M. Russo, Director; M. Guitián, Deputy Director; H. O. Schmitt. Exchange and Trade Relations Department: J. T. Boorman, Director; A. Basu, D. Burton, B. de Schaetzen, M. G. Gilman, S. Kanesa-Thasan, M. Precious. External Relations Department: S. W. Kane. Fiscal Affairs Department: H. R. Lorie. IMF Institute: I. Otani. Legal Department: A. O. Liuksila. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; B. B. Aghevli, N. N. Choudry, M. S. Khan, M. S. Kumar, J. S. Lizondo, P. J. Montiel, D. Villanueva. Western Hemisphere Department: S. T. Beza, Counsellor and Director; M. Caiola, Deputy Director; C. M. Loser, P. J. Quirk. Bureau of Statistics: V. Galbis. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, L. F. Breuer, M. B. Chatah, M. J. Mojarrad, A. Napky, Y. Patel, A. Raza, H.-J. Scheid, A. M. Tanase. Assistants to Executive Directors: T. S. Allouba, G. Bindley-Taylor, B. Bossone, Chen M., S. B. Creane, A. Y. El Mahdi, B. R. Fuleihan, M. A. Ghavam, J. Gold, O. A. Himani, K. Ichikawa, M. E. F. Jones, P. Kapetanovic, K. Kpetigo, G. Montiel, F. Moss, M. Mrakovcic, J. K. Orleans-Lindsay, S. Rouai, D. Saha, J.-P. Schoder, N. Sulaiman, Tin Win, S. von Stenglin, Wang J., J. C. Westerweel.

1. EXCHANGE RATE POLICY ASSESSMENTS - ISSUES, AND REVIEW OF EXPERIENCE IN RECENT ARTICLE IV CONSULTATIONS

The Executive Directors considered staff papers on analytical issues relating to Fund advice on exchange rate policy (SM/90/198, 10/16/90) and review of exchange rate policy assessments in recent Article IV consultations (SM/90/200, 10/18/90).

Mr. Posthumus made the following statement:

> The analytical paper on exchange rate policy which we are discussing today is an important contribution to the Board's discussions on this subject. The review of exchange rate policy assessments in recent Article IV consultations provides valuable background; however, a substantially more comprehensive analysis of the Fund's advice in practice is required. It seems to me that there is a gap between the analytical paper, which fundamentally questions the sustainability of active exchange rate policies, and the practice of the Fund's policy advice in the recent past described in the assessment paper.
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> I would like to focus on two issues. The first issue is the question of the relationship between the Fund's policy advice on exchange rate policy and the Fund's role in the functioning of the international monetary system; I will return to this issue at the end of my statement.
>
> The other issue is the relationship between exchange rate policy, monetary policy, and fiscal policy. The analytical paper shows convincingly, in my view, that there is a very close relationship. How important the policy conclusion is which must be drawn from that relationship is shown in the discussions leading up to the negotiations on a European Monetary Union. One of the main conclusions in these discussions is that "...budgetary discipline is a necessary condition for stable prices and a stable currency." The participants in this discussion started out with a belief in the desirability, indeed the necessity, of stable exchange rates. But however simple the relationship between exchange rate policy, monetary policy, and fiscal policy looks--as simple as a triangle--the road to recognize it has been tortuous. To implement the triangle into policy agreements may still be difficult.
>
> The proponents of stable exchange rate regimes have, I think, also learned from experience and from the discussions, in the sense that the importance of all three sides of the triangle has become more clear. But it must be pointed out that the arguments which have been put forward in favor of a stable exchange rate regime hardly receive any attention in the analytical paper.

These are the contribution which a stable exchange rate regime can make to macroeconomic management and to international trade and finance.

The contribution to macroeconomic management can be made through the anchor function which a fixed or stable exchange rate can provide to macroeconomic policy, and, in particular, to monetary policy. It should be clear that the anchor is only an anchor, and therefore it can fail to fulfill its functions, but this of course does not mean that it cannot function at all. It is not necessary to elaborate further, but it is this function which has been the major argument underlying several stable exchange rate regimes.

The other argument is the contribution which stable exchange rates make to expanding international trade, investment and other capital flows. Trade and trade-related investment will profit from stable exchange rates and the associated stable monetary environment. Mr. Al-Jasser made this point clearly during the last Article IV consultation with Saudi Arabia. The increasing liberalization of international capital flows can only profit from the increased certainty which a stable exchange rate offers. The credibility of the currencies in which financial transactions are being made is of some importance. Capital racing around the world to profit from exchange rate fluctuations seems an expensive way to stabilize the markets. In a general sense, confidence in exchange markets strengthens confidence in the other markets.

I question the staff's statement that "it is well established that the type of shock to which the economy is likely to be subjected is a key consideration in determining whether the exchange rate should be fixed or adjusted." As I understand it, the argument is based on the notion that the economy can be insulated from certain external and internal shocks. It seems to me that the only options are different ways to absorb, and later adjust to, shocks. As stated elsewhere, real exchange rate rules, the most systematic flexible exchange rate policy, may have disquieting implications for macroeconomic stability, in particular through inflation. A price increase brought about by depreciation is a way to absorb a shock, but easily leads to inflation. This is even truer in an open economy, because the share of imports is relatively large. I would thus reach a conclusion opposite to that of the staff that "... it is clear that openness, per se, does not affect the choice of exchange rate regimes." In my view, the prima facie observation is more likely to be true, because the more open the economy, the more exchange rate changes work through to internal prices and costs, and therefore erode the price advantage which the devaluation produced.

Against this background, I would like to add that, when exchange rate changes have to be made in order to attain a sustainable level, this can be done through a gradual slide, or in steps. The latter approach makes it easier to prevent price increases developing into inflation. The gradual slide produces a gradual price increase, which may become a floor to the inflation rate. A step devaluation provides a new anchor for an anti-inflation policy package, unless the expectation arises that the step will be followed by another step. In either case, to prevent an inflationary climate, the devaluation should not fully compensate for the loss of competitiveness, but should leave part of the adjustment to internal processes.

Let me now return to my first issue, the question of the relationship between the Fund's policy advice on exchange rate policies of its members, and the functioning of the international monetary system. There are two reasons to look at this relationship. The first is that every exchange rate change affects all trade and finance partners of the country concerned. An improvement of one country's competitiveness is a deterioration of the competitiveness of its partners. It is disconcerting that since the mid-1970s, developing countries, in particular, have moved away from pegging to a single currency to more flexible exchange rate arrangements. Not counting the franc zone countries, two-thirds of Fund-supported programs involved flexible exchange rate regimes. And, as the paper reviewing experience indicates, the real effective exchange rate was targeted as a program variable in most arrangements supported by the use of Fund resources. I wonder if this would have happened if the extreme fluctuations of the major currencies would not have occurred.

The review of experience in the annex shows that in the consultations with countries with single currency pegs, on one hand the authorities agreed with the staff assessments and recommendations in only less than half the cases. On the other hand, the staff's assessments and recommendations to countries with crawling peg, managed floats, and independently floating exchange rate arrangements were favorable in the great majority of cases. The staff has clearly favored active exchange rate policies in most cases, and so has the Board, but in many cases, not unanimously. I did not see any analysis of the Board's comments. Some Directors have cautioned repeatedly that active exchange rate policies might be very inflationary, and also that the staff's advice sometimes bordered on recommending competitive devaluation. This year, for example, our chair devoted attention to exchange rate policies in two-thirds of the statements on countries, almost always questioning the staff's approach.

The objection that active exchange rate policies affect the competitive position of other countries and may even lead to competitive devaluation leads to the conclusion that the Fund's policy advice should be rooted in a framework which takes into account the fact that exchange rate changes always affect other countries. The Fund's responsibility in overseeing the compliance of members with the obligation to promote a stable system of exchange rates must at a certain moment be carried out. This is perhaps not possible at this stage. However, there is renewed interest in the international monetary system as something other than a free-for-all exchange market. In Europe, there is a movement toward changing the stable exchange rate system in the direction of a monetary union. Since 1985 at least, the G-7 countries have professed to be interested in more stable exchange rates between them, and have acted mainly through intervention. Some G-7 members have been outspoken in a desire for more stability of exchange rates. A tripolar international monetary system may develop.

At the same time, the progressive liberalization of capital markets and the hoped for and urgently needed liberalization in the framework of the GATT show the progress that has been made in improving the functioning of the international monetary system. In my view, this requires that the Fund in its policy advice put more emphasis on monetary and fiscal policies, and less on accommodating exchange rate policies. Rather than accepting the resort to inflationary financing by stressing the need for a certain degree of flexibility in the exchange rate, the staff should stress the unsustainability of the "inflation tax." If monetary and fiscal policies are not tackled directly, any exchange rate policy will become unsustainable, even the most active policy; if those policies are tackled directly, a stable exchange rate policy may be very supportive of them.

Mr. de Groote made the following statement:

Let me congratulate the staff for having covered the vast subject of exchange rate policy assessment in theory and in practice in two concise papers which nonetheless deal with all relevant aspects. It is a good thing to be able to stand back and take some perspective in trying to evaluate our almost daily business of reviewing Article IV consultations, which, after all, are intended to exercise surveillance over exchange rate policies of members. It is an even better thing to be able to do this both from a practical side, as is done in the paper reviewing the Fund's experience, and from a theoretical side, as is done in the main paper.

Given the scope of the subject matter, I will of necessity have to exercise restraint, and focus my comments on just parts of the papers. I have thus opted for discussing primarily exchange rate policy matters in developing countries, since we will be addressing exchange rate questions in industrial countries and in centrally planned economies at our next seminar in December.

Taking the structure of the analytical staff paper relating to Fund advice on exchange rate policy as guidance, I intend to raise some comments on exchange rate arrangements in developing countries; exchange rate policy assessments by the Fund; regime choice; exchange rates and external adjustment; and financial discipline.

With respect to exchange rate arrangements in developing countries, and, in particular, their evolution since the advent of floating, I am not totally convinced by the staff's analysis based on the data in Tables 1 and 2 of the main paper. The steep percentage drop in the category of peggers to a single currency in Table 1 is explained wholly in terms of a generalized increase in the use of more flexible exchange rate arrangements. I have the impression that in keeping the Fund membership constant at its 1976 level--that is, excluding members which have joined since, and of which quite a number were U.S. dollar peggers--the decrease in the share of the U.S. dollar peggers as well as that of the pound sterling peggers more than explains the total fall of the single currency peggers category.

This would alter somewhat the conclusions to which the staff paper leads. Indeed, one could then attribute this decrease to two specific factors. First, these two currencies have failed in their role of providing a sound nominal anchor, a fact which in itself has resulted in the demise of the Bretton Woods system, at least as far as the dollar is concerned. Second, the declining overall role of these once exclusive economic superpowers has tended to lessen the attractiveness for other countries to peg to their currencies exclusively, and has led them to opt for some composite type of peg instead.

This is not to deny that a second major explanation for the decreasing attractiveness of fixed pegs in the 1980s relates to the problem of inflation, not in the anchor currency countries, but in the domestic economies. As rightly pointed out in the staff paper, the trend toward more flexible arrangements has enabled some countries to camouflage the effective depreciation of their exchange rate that was needed to avoid a deterioration in their external competitiveness ensuing from a worsening inflation record. In this way, exchange rate flexibility has made it possible to avoid the political repercussions of announced devaluations.

There are nonetheless a number of countries, particularly in Asia, which have been able to combine exchange rate flexibility with a low inflation record, indicating that the exchange rate regime choice can ultimately be made independent of economic performance, but that exchange rate management cannot be disconnected from the whole array of economic management and the ensuing economic performance. I will return to this issue of regime choice later on.

Allow me first to address briefly my second item, the exchange rate policy assessments by the Fund. It is a fact that our understanding of exchange rate policy matters has evolved considerably over the past years. Given the substantial insights we have gained from the already lengthy experience with floating exchange rates, as well as from the EMS experiment in Europe, our approach to assessing exchange rate policies has changed significantly compared to the beginning of the 1980s. I must say I am heartened to read in the paper reviewing the Fund's experience that within the staff's general approach to exchange rate policy assessments, there now appears to be a need to address more directly such specific issues as the merits of using the exchange rate as a nominal anchor for tight financial policies; the rationale for maintaining or reforming the prevailing exchange rate regime; the considerations underlying the steps proposed for correcting an overvalued exchange rate and preventing repeated depreciations; and the implications of the exchange rate policy recommended for the path of inflation. These are indeed elements which should receive increased attention in future staff appraisals of members' exchange rate policies.

Coming to my third item, the choice of exchange rate regimes, I would have preferred the paper to be more specific on this issue rather than summarizing the theoretical literature on the relative merits of fixed and flexible regimes. The brief mention of the criterion of optimality could have provided the ideal starting point for exploring in more detail the issue of the general welfare perspective involved in the exchange rate regime choice. While such a subject would ideally be covered in a separate paper combining theoretical aspects with the vast practical experience the staff has gained in its Article IV discussions with the authorities of so many countries for such a long time, it would have been welcome to have had the basics for such an analysis already spelled out here. Let me explain myself more clearly.

It is evident that the tradeoff between using the exchange rate regime to achieve macroeconomic stability in terms of a certain key variable, and choosing to stabilize other variables in the economy, is of a totally different nature for different categories of countries. Large industrial countries the currencies of which play an important international role are faced with a completely different choice than small industrial countries. The same applies to developing countries which are primarily single commodity exporters, as opposed to exporters of manufactures. Some further useful distinction could be made within the latter categories, depending on whether the external position or inflation constitutes the most pressing problem. Or, perhaps one could isolate a third group where these two are inextricably intertwined, with changes in the external position being immediately reflected in the budgetary situation, which then gives rise to monetary financing.

Certain types of exchange rate regimes, such as soft target zones, might thus provide a preferred choice for certain countries--with exchange rate changes originating from market forces being more or less accepted--whereas other countries might find it more useful to try and constrain market forces within a credible medium-term framework, leaving less room for exchange rate flexibility.

Under this same heading, it would have then been possible to elaborate on the rationale of a system, such as the EMS, intended to lead to permanently fixed exchange rates, without excluding the use of the exchange rate in the meantime, together with other policy instruments, to reinforce overall economic convergence. This diverges substantially from another type of monetary union, such as the CFA franc zone, where the use of the exchange rate has been explicitly discarded from the list of corrective instruments available to the authorities to deal with certain types of shocks. I do not wish to return to this subject today, since we have discussed it amply at our previous seminar.

In touching upon the role of the exchange rate in external adjustment I have announced my fourth subject item. I note that the staff still believes in the possibility of nominal exchange rate changes affecting the real exchange rate level, and thus taking a share in the burden of external adjustment, next to fiscal and monetary policies. I would have liked a different presentation, however, of the various possible types of shocks affecting the equilibrium exchange rate which could substantiate the case for nominal exchange rate corrections. In particular, increased emphasis should have been given to those shocks which affect primarily certain types of countries.

In this regard, the importance of terms of trade shocks in explaining the depreciation of developing countries' equilibrium real exchange rates should have figured more prominently. In the paper, the cases of a tariff reduction and a terms of trade deterioration receive the same kind of attention in both length of treatment and qualitative assessment. It is only in two footnotes on pages 16 and 17 that the difference in the order of magnitude of these two shocks as regards their effect on the equilibrium value of the real exchange rate is revealed. Such quantitative differences are crucial, however, in assessing the appropriate balance between restrictive financial policies and exchange rate adjustment, when trying to close the gap between the real exchange rate and its equilibrium level.

One policy element which in my view receives definitely far too little attention in the paper is that of wage policy. At the bottom of page 12, for example, it is pointed out that the degree of real wage rigidity is crucial in determining the success of a devaluation. In stating that, under the extreme assumption of full indexation, an exchange rate adjustment would be completely ineffective in stabilizing output in the face of domestic shocks, one tends to disregard the reality. As the Belgian example has shown, even in such cases a consensus can be reached to temporarily suspend full indexation in order to have a devaluation meet with success. This will require the existence of a social framework in which the government, the employers, and the unions can agree on such a policy. Or, to phrase it in more theoretical terms, if such a social consensus model can be developed, it becomes possible to affect the degree of wage rigidity in the labor market, and therefore to influence the equilibrium exchange rate of a country in special circumstances, even in the presence of full wage indexation under normal circumstances.

Not only can such a social consensus model be used to correct deviations of the real exchange rate from its equilibrium level, it can also help to prevent such deviations from occurring. Again the staff paper points to this in an indirect way on page 19, but it refrains from developing the reasoning further. It states that under a policy of accommodating price disturbances through monetary and exchange rate adjustments, labor will be less concerned with the employment effects of seeking high nominal wages, as firms are in a position to transmit higher wage costs to higher prices. It does not state that a nonaccommodating monetary and exchange rate policy could be made more credible if labor were to be increasingly concerned with the employment effects of high wage demands. Again, the existence of a wage policy framework based on a social consensus could be highly beneficial in this regard. And again I can refer to the Belgian case, where external competitiveness is closely monitored by comparing, inter alia, domestic wage costs with those prevailing in partner countries, while the so-called social partners recognize that any deterioration due to excessive wage demands will ultimately result in lower output growth and therefore less employment over time.

This has brought me to my final item, the issue of fixed exchange rates and financial discipline. Continuing with my previous reasoning, I remain convinced that in giving up the exchange rate policy instrument, there is a case to be made for an increased attention to wage policy as an additional instrument for small open economies to cope with the constraints imposed by a credibly fixed rate. An article in last Monday's Financial Times (November 19) has touched upon this subject in describing the analogies, on the one hand, between Britain's entry into the Exchange Rate Mechanism of the EMS and Belgium's decision to peg more strictly to the Deutsche mark, while pointing, on the other hand, to the divergences in wage policies between the two countries. I do not intend to develop the argument much further here, reiterating only my previous general remark that, in my opinion, the staff paper attaches not enough attention to wage policy aspects.

A medium-term framework for wage policy agreed upon by all parties concerned will not only make the commitment to a stable exchange rate more credible, it will also neutralize the authorities' incentive to generate inflationary surprises, and facilitate the adjustment in the real exchange rate which otherwise would have to be brought about solely through a restrictive fiscal policy.

Bringing wage policy more into the picture would also change somewhat the analysis of the financial constraints arising from a fixed exchange rate which concludes that a fixed exchange rate requires a country to maintain fiscal discipline. While a sensible wage policy would already affect the fiscal position directly, since it would prevent public wages from escalating in real terms, such a policy would further loosen the intertemporal budget constraint as well, in that it would reinforce the perception of an early reversal of transitory episodes of rapid credit expansion, and thus ease the financing of temporary deficits.

For small industrial countries at least, in an environment of free capital movements and exchange rate fixity established vis à-vis a low inflation country's currency, I believe wage policy aspects to be far more important in assessing the constraints of a fixed exchange rate regime than is the seignorage question on which the staff paper focuses. I can go along with the reasoning that seignorage is not unimportant to certain developing countries, but such a tax on the holders of money can surely be sizable only in cases in which exchange controls are tight and/or other sources of tax receipts are difficult to collect--in other words, not the most optimal situation from a structural point of view. Again, this underscores my earlier remark that the paper could have been improved upon, if the distinction between different types of countries were to have been applied consistently in assessing the exchange rate policies of Fund members.

In concluding, let me repeat, however, what I have stated at the outset, namely, that I found the papers to contain a thorough, well-balanced analysis of a subject which goes to the heart of our institution's purposes. I hope the length of my statement will be regarded as underscoring this view.

Mr. Prader stated that although the choice of an exchange rate regime could be made independently by every country, the consequences of that choice for other countries had not been examined. He agreed with Mr. Posthumus' points in that regard. It was clear that individual choices as to the exchange rate regime would give rise to externalities for other countries, and that those externalities would be larger the larger the country concerned. It was equally clear, therefore, that the Fund should ensure through its bilateral surveillance that those choices did not result in certain countries being far worse off than others after facing such externalities. The Fund should, moreover, see to it through its multilateral surveillance that, on the whole, those individual choices did not result in an inferior international monetary system.

It had become clear in the second half of the 1980s that the free floating of the major currencies was no longer the most optimal outcome for the world as a whole, Mr. Prader continued. That was why the Fund should give careful consideration to the possibilities of a tripolar system leading to a better outcome.

He had noted that the emphasis of the two staff papers had been somewhat different, Mr. Prader concluded. The paper on analytical issues seemed to have a stronger emphasis on long-term questions. The paper on the review of exchange rate policy assessments gave the impression that a nonexpansionary fiscal policy would be a sufficient condition for a well-functioning exchange rate. In his view, a nonexpansionary--or restrictive--fiscal policy was neither a necessary nor a sufficient condition for a good exchange rate policy. In fact, other variables, such as the level of domestic savings and a country's creditworthiness, were important as well. Those variables had been noted in the analytical paper, and rightly so. He could imagine short-term situations in which a stable exchange rate could exist in concert with an expansionary or excessive fiscal policy, because the country's level of domestic savings and its creditworthiness were such that the credibility of the fiscal policy was not impaired.

Mr. Ismael made the following statement:

Before commenting on the papers, I have an observation on the staff's assertion that distinctions between the main categories of the exchange rate arrangements are blurred. Apparently, this has resulted in Singapore being included in two categories in the analysis in the Annex to the paper reviewing the Fund's experience. On page 17 of that paper, Singapore was included in the group of members which peg their exchange rates to a composite, and on page 26, it is included in the group that maintains an exchange rate regime of either a crawling peg or a managed float. I wonder whether this was deliberate. If I am not mistaken, Singapore is usually included in the latter group, as shown in the appendix on page 30.

In the paper on Fund advice on exchange rate policy, the staff has made the finding that the choice of an appropriate exchange rate system depends on criteria including the objective function of the authorities; the nature of exogenous shocks faced by the economy; and the structural characteristics of the economy. In other words, specific country circumstances are important considerations in deciding on exchange rate policies, and uniform policy prescriptions are unrealistic. Nonetheless, the staff has been able to make some general observations in the last page of their paper.

Combining these findings and observations with the review of country practices reinforces the view that the viability of an exchange rate system in providing sustainable macroeconomic performance depends more on the existence of a framework that provides for financial discipline than on the choice of the exchange rate system itself. Firm fiscal and monetary policies are essential in ensuring the credibility of the exchange rate under any system.

With respect to the frequent discussions on exchange rates that have arisen in connection with recent country issues on the agenda, many Directors have advocated the use of a fixed exchange rate as a nominal anchor in order to promote price stability. Some Directors have urged that, where the current exchange rate is overvalued, a "big bang" type of devaluation in order to eliminate overvaluation is called for before using the new rate as an anchor. This may be advisable in some cases, but should not be taken as universally applicable. In some countries, particularly those which are subject to frequent external disturbances, it may be desirable for the authorities to maintain a certain degree of flexibility to adjust rates in response to forthcoming external developments. In other cases, a more gradual approach may be desirable, perhaps even in the form of periodical adjustments, possibly being preannounced. This latter feature will ensure that there are no surprises. It also will enable market operators to cover themselves. It goes without saying that strict financial policies are needed in order to ensure viability whatever system is chosen.

I agree that certain issues could be addressed more directly in Board papers. Such issues could include the merits of using the exchange rate as a nominal anchor; the rationale for maintaining or reforming the prevailing exchange rate regime; and the inflationary consequences of the exchange rate policy recommended. I note, for example, that it is reported that out of twelve countries which were recommended to have their overvalued currencies corrected, only two had agreed to do so. There were also instances in which the authorities did not concur with the staff's views. In this regard, I wonder to what extent a shortage of analysis and explicit assessments by the staff had influenced the decision of the authorities not to adopt the staff's recommendations.

The list of key indicators of imbalances and distortions on which exchange rate assessments have been based looks quite exhaustive. The staff's policy prescriptions also appear appropriate. Taking the case of the "severely critical assessment" countries, I see merit in the staff's recommendations of a comprehensive policy package of financial and structural measures and exchange rate action. Sole reliance on exchange rate adjustment or reform to achieve an adequate level of external competitiveness and a sustainable external position is not enough. At the same time, it would be difficult to correct a large overvaluation of the real exchange rate entirely through tight financial policies, without any adjustment of the exchange rate.

Mr. Wright made the following statement:

I very much welcome the attention the Board has recently given to this critical policy issue. I am extremely grateful for the comprehensive and thoughtful papers provided by the staff, which give a strong base for our continuing discussions of this issue. Many of the points which are at issue today were previewed in our recent seminar on the CFA franc zone. Mr. Peretz then indicated very clearly this chair's views on exchange rate policy, and I shall therefore only reiterate some of his general points for purposes of emphasis.

It is clear from both the analytical and survey papers--and Mr. Ismael has already made this point--that the prerequisite for economic stability, irrespective of the formal exchange rate regime, is a responsible fiscal and monetary policy stance, with a minimum of structural distortions. This in itself will tend to provide a degree of stability in the nominal exchange rate, whatever the formal arrangement chosen, which, in turn, will reinforce the benefits to overall economic performance stemming from the domestic policy stance. The clearest examples of this are to be found among successful Asian economies. We must at all times take care not to delude ourselves into thinking that fixing the exchange rate is a panacea for all economic ills--any more than the complete autonomy once thought to be associated with freely floating rates proved to be.

There is no doubt but that a stable exchange rate can serve as a valuable nominal anchor in domestic economic policy. It imposes a simple discipline which is powerful in forcing policymakers to adopt the right mix of policies. The staff papers remind us, however, that theoretical discussions of appropriate exchange rate regimes tend to assume that the starting point is exchange rate equilibrium, whereas in practice, Fund assessments, particularly in program countries, frequently have to address the problem of exchange rates that are clearly out of equilibrium. This may have come about through a variety of external shocks of the type that the staff outlined in the paper, or through the cumulative impact of inappropriate domestic policies.

This raises immediately two questions that Fund assessments must face. Should there be nominal exchange rate adjustment in such circumstances? And if so, how should it be achieved? The answer to the first obviously depends on the circumstances surrounding each case. The paper reviewing Fund policy assessments clearly demonstrates the difficulties of attempting to generalize in this area. The most important economic issue is the feasibility of securing an adjustment of the real rate, which is what ultimately matters, and whether this can best be secured through a change in the nominal exchange rate or through domestic adjustment. This must be decided on a case-by-case basis. But the issues should be fully explored in every case, institutional arrangements and the authorities' preferences notwithstanding, where Fund resources are involved, in particular.

Where there is a case for achieving adjustment through a change in the nominal exchange rate--and this will normally involve a depreciation--the second issue arises, namely, how best to secure this change. This immediately brings into focus the problem of credibility. As a general rule, adjustment through one-step changes will support the authorities' credibility, by demonstrating that the change is in response to a specific shock, and is not a creeping accommodation of lax policies. A credible approach to exchange rate adjustment will, by definition, have the most lasting impact on real wages, achieve a greater shift of export receipts back into the official sector, and induce the return of flight capital. It cannot be emphasized too often, however, that implementation of sound domestic policies plays as great a part in establishing credibility as the form of the exchange rate adjustment itself.

The issue of one-step changes raises the question of identifying the equilibrium exchange rate. This is a problem which we have discussed many times in the past, and which must continue to be the subject of a strong research effort. All too often, it is impossible to gauge with any confidence whether an exchange rate adjustment is warranted and, if so, where it should stop, because of the formidable problems of measurement involved.

In this context, the parallel market, where there is one, may give some guide as to what is an equilibrium rate. But this brings into focus the irrelevance of stability in official exchange rates, if this reflects only the operation of a battery of controls and if the parallel market diverges significantly from it. What really matters is stability of market determined nominal exchange rates which reflects the pursuit of appropriate domestic policies.

Given the general desirability of stability in exchange rates and of adjustment, where this is necessary, in a purposeful and credible way, it should come as no surprise that I strongly endorse the warnings given in the staff papers concerning the dangers of targeting the real exchange rate. This usually involves continuous devaluations which can all too easily accommodate loose domestic policies with disastrous consequences for inflation. The crawling peg is a species of such targeting and this chair has been critical of such arrangements in the past.

One valuable role which I think this discussion can have could be to clarify some of the terms which we commonly use when discussing exchange rate developments. There is a tendency to equate floating exchange rates with volatility and fixed exchange rates with rigid controls and intervention.

In reality, as far as developing countries are concerned, exchange rate flexibility usually refers to the authorities retaining the option to shift the official rate from time to time, so signals of unsustainable policies will come through reserve pressure rather than a declining nominal exchange rate. As a general rule, the response to this should be domestic policy adjustment, unless there is clear evidence of an external shock. This applies equally to might be termed fixed or flexible arrangements. The point is that whatever we call such an arrangement, the desirable features are that the exchange rate is essentially market determined but stable as a result of the authorities' pursuit of the appropriate domestic policies. Indeed, the exchange rate itself will be a valuable guide to the appropriateness of domestic policies.

These are all general prescriptions. But the staff papers remind us that each case is different; there is a wide range of experience across countries with similar exchange rate regimes. Fund assessments of policy, be they in Article IV consultations or for program design, must always explicitly take this diversity into account. I very much endorse the comments in the staff paper on Article IV consultations, which are rather critical of the somewhat oblique approach sometimes taken. Exchange rate issues should be addressed head on, and I fully endorse the guidelines for the general approach that the staff should take.

However, this should not, and I am confident that it will not, be at the expense of domestic policy assessment. Indeed, it should reinforce it. Although the variety of circumstances is as great as the number of countries, a unifying theme is the ultimate importance of domestic policies and we cannot divorce these from external considerations. We cannot consign exchange rate policy to a separate box, to be considered as and when we choose.

Mr. Grosche made the following statement:

The staff has provided us with two excellent papers. They discuss in a comprehensive way the various aspects that have to be considered in analyzing exchange rates and exchange rate policies in Fund-supported programs. I can associate myself with most of the staff's views and can agree with the main conclusions.

This may come as a surprise, since this chair on several occasions in the past had expressed reservations about the staff's views with regard to the conduct of exchange rate policy in specific cases. Today, I fully agree with the staff when it stresses in the papers that there are no easy answers to the choice of the optimal exchange rate regime. Many aspects have to be pondered before reaching a conclusion on the correct policy advice in each individual case. This had been our view all along. In particular, we were not convinced that a uniform policy prescription for a flexible exchange rate management lived up to the difficult circumstances in many cases. I am glad to fully subscribe to one of the main conclusions of the paper on Fund advice on exchange rate policy produced by the Research Department, namely, that in most countries undertaking Fund-supported programs, in adopting measures to maintain and improve external competitiveness, a balance needs to be struck between restrictive financial policies and exchange rate adjustments.

Exchange rate policy is not an end in itself. In my view, the real issue for the Fund is to help establish an economic and financial framework in which stable exchange rates can prevail, and where the defense of stable rates adds to financial discipline. However, in trying to retain a role for the exchange rate as a nominal anchor, countries should not go to the other extreme. In the absence of sufficiently prudent domestic policies, a fixing of the exchange rate or maintaining the rate at an unsustainable level is not a viable option, and only adds to existing problems, on the one hand. On the other hand, in the absence of prudent domestic policies, a freely floating rate is bound to add to instability. As experience shows, it is by no means able to safeguard external competitiveness in a lasting manner. In sum, neither fixed, pegged, nor flexible exchange rates provide a way to circumvent necessary domestic policy corrections.

In reading the papers, I got the impression that the staff might have emphasized a bit too much the capability of flexible exchange rates to stabilize output growth. Even in the short run, I doubt whether there really exists a tradeoff between output and price stability, which appears to be the staff's underlying assumption. I would rather stress the importance of price stability as the major precondition for long-term and sustainable economic growth. It is from that perspective that a stable exchange rate policy can play an important role as an explicit tool in supporting a country's stabilization effort. Once a country's economic policymakers are willing and undertaking comprehensive efforts to put their house in order, I think that a firm commitment to maintain a realistic nominal exchange rate is an excellent tool to gain confidence and to build up credibility. Of course, I would stress that the stabilization has to take place on a realistic level of the exchange rate with a view to safeguarding a viable balance of payments position, and adjustments at the outset of a program might be necessary, preferably in the form of up-front adjustments. On the one hand, I would agree with the staff that in general, it is difficult to envisage a situation in which a substantial overvaluation of the real exchange rate can be corrected entirely by restrictive financial policies, and without any exchange rate adjustment. On the other hand, I continue to believe that a firm exchange rate commitment thereafter, after an adjustment has been made, will send a clear and unambiguous signal to the economic agents that there is no easy way out, that the adverse effects of the wrong policy decisions will not be compensated by simply adjusting the exchange rate again. Always assuming the authorities' willingness to put the necessary domestic policies in place, such an anchoring can work as an effective means to increase responsibility and accountability of the policymakers, be it in the area of fiscal, monetary, incomes, or even structural policies.

I found the review of the theoretical literature for choosing an optimal exchange rate to stabilize the economy in the face of transitory shocks most illuminating, although I did not see references to some quite interesting research by German scholars in this area--published, incidentally, in English. The criteria for choosing the exchange rate have to take into account the specific policy objectives adopted by the authorities. From a theoretical perspective, it is quite appropriate to include among possible objectives the inflation tax, as well. From a political and practical perspective, however, I would urge the Fund to try to persuade the authorities out of such an objective. Resorting to inflationary finance is not only unlawful, in my view, it is harmful to re-establishing the credibility of policymakers and the confidence of investors, and is thus harmful to growth.

I noted with some interest the staff's suggestions for improving credibility, in particular the suggestion to give the central bank independence in pursuing the overriding goal of price stability. In my view, independence in itself is not sufficient; without fiscal discipline, credibility will be difficult to restore. As the discussion on the CFA franc arrangements has shown, a central bank--even if firmly committed to external and internal stability--cannot prevent large fiscal deficits from arising, thus endangering in the long run the exchange rate arrangement. At least, the monetization of fiscal deficits has to be prohibited, preferably by law, and one would also like to see rules being introduced that are conducive to improving fiscal discipline.

I very much agree with what Mr. Wright said about the idea of targeting the exchange rate, and in particular, of fixing a predetermined crawl of the nominal exchange rate in specific cases. Although I can see the advantage, particularly the potential for greater domestic discipline compared with a rigid link between domestic inflation and devaluation, the drawbacks are obvious to me. Domestic interest rates will have to compensate at least for the predetermined rate of devaluation, with adverse consequences for investment, the public debt-service burden, and future growth.

The appropriate balance between restrictive financial policies and exchange rate adjustments has to be found according to the special circumstances of the country case. In searching for the appropriate balance, it is necessary to aim primarily for the medium-term viability of the balance of payments position. Even though the Fund should aim also at higher growth rates, it is in my view not appropriate for a Fund-supported program to go for a short-term maximizing of production and employment levels, at any cost. The Fund must not promote competitive devaluations.

I support the staff's suggestion in the paper reviewing the Fund's experience in country cases to broaden the coverage of exchange rate policy issues in country papers. This will help to dissipate any remaining divergence of views, I hope. I would suggest that such considerations be included also in papers on countries with CFA franc arrangements.

Mr. Arora made the following statement:

I would like to compliment the staff for the two excellent papers dealing with analytical issues relating to Fund advice on exchange rate policy and empirical assessment of exchange rate policy as a part of the Article IV consultations. It is important that these papers be considered in conjunction with the paper on the major issues in the evolving international monetary system (EBS/90/15, 1/29/90). The discussion this morning is very important because it will have a bearing on the forthcoming Article IV consultations with member countries, as also on the design of adjustment programs.

I feel indebted to Mr. Posthumus and Mr. de Groote for their valuable contributions to this morning's debate--to Mr. Posthumus for his powerful and elegant plea against what he describes as active exchange rate policies, and to Mr. de Groote, for his more eclectic and insightful treatment of different issues raised in the staff papers. Coming as I do from a developing country, I found Mr. de Groote's argument for social consensus on wage policy appealing and persuasive, although I know as well as Mr. de Groote that short of a major crisis--and periodic episodes of disequilibrium are not perceived as major crises--social consensus in plural societies is difficult to bring about. Sweden is a case in point. In what follows, I try to present a layman's point of view on exchange rate issues.

The first thing to note is that theoretical literature on exchange rate regimes has been developed mainly in the context of industrial countries. By and large, most developing countries today face severe balance of payments constraints. This essential condition is generally not part of the models that are used to clarify issues relating to exchange rate regimes. Empirical evidence may reveal that exchange rate regimes adopted by particular countries in particular circumstances have served such countries well. However, theoretical validation for exchange rate practices is not firm. It is, as Buiter mentioned in one of his papers, like driving a car to work. The driver rarely knows why or how it works. There are, of course, people who know how and why the car works, and one can turn to them for enlightenment. But about exchange rates in developing countries, or perhaps even in developed countries, real knowledge, despite phenomenal mathematical sophistication, is not abundant; it is still evolving. Therefore, I would unhesitatingly support the staff view that it is difficult to prescribe specific guidelines for exchange rate policy which have universal applicability.

Another point to note is that insofar as developing countries are concerned, policy preferences are bound to be different from those adopted in industrial countries. An exchange rate regime has to fit within the framework of an overall strategy. Although from one point of view much the same point has been made in literature that stresses the internal consistency of different policy instruments, such consistency is still oriented to some preeminent objective--for example, price stability. In fact, in the paper on the international monetary system, there was a fairly extensive discussion of the virtues of a "low-inflation club." In this context, exchange rate policy was assigned a supportive role for monetary policy in pursuit of price stability.

This is all very well, but consider how far we have traveled from the starting point of the Bretton Woods Agreement. In the Bretton Woods scheme of things, devaluation was especially recognized as a correct response to situations of fundamental disequilibria, thereby avoiding deflationary domestic policy that would have resulted in high cost unemployment and decline in growth. In other words, the objective was to promote sustained growth. Over 40 years later, growth is no longer a problem for industrial countries. Technologically and organizationally, that particular problem has been solved. To be sure, there are other problems--a liberal open trading system which enhances welfare, for example. But problem number one is price stability and accompanying exchange rate stability. It is in this context that theorizing about exchange rate policies and other policies is taking place today.

The situation in developing countries offers a marked contrast. Here growth and development is, and will remain for quite some time to come, the key issue to which all other questions have to be subordinated. Moreover growth is a key issue in a vastly changed international environment, an environment which in successive annual editions of the world economic outlook appears, to put it mildly, unfriendly to the growth prospects in developing countries. It is not polite to recite a litany of woes when we are discussing a technical subject like exchange rate policy. However, I do not think that any serious student can examine the subject divorced from the overall context of a net and large transfer of resources from developing countries to industrial countries, the adverse terms of trade that have persisted for a long time, the debt overhang, and high international interest rates. Pessimism can be justified on these grounds alone but there is another more fundamental process which is at work and that is the technological and productivity gap between the rich and the poor countries, a gap that is widening all the time. It is in this sense that the takeoff theories have not stood the test of time. Savings rates in the developing countries have increased, and there are a large number of countries which can be considered as having attained a savings rate of 10 percent now. But the millennium has not arrived precisely because, in spite of brave attempts, the technological gap has been, and continues to be, a stubborn roadblock.

The point I am making is a simple one. The exchange rate issue cannot be treated in isolation from the entire gamut of relationships that exist today between the developed and the developing countries. It is, in my view, an error that leads directly to judgments of flexible exchange rate policies as a 'camouflage'--with apologies to Mr. de Groote--or as unwarranted support for the inflation tax, as implied by Mr. Posthumus. Mr. de Groote has himself stressed the importance of terms of trade shocks. Still, it is only one element of the totality of relationship between the industrial and the developing countries.

In this wider framework of interaction between the developed and the developing world, there are problems that the developed world faces from time to time, not problems of growth, but problems of differing speeds of adjustment corresponding to differing cyclical positions, which can often be conveniently transmitted to the developing countries. Such, for example, is the story of the savings shortage in the industrial world, which appears as a high cost of capital. Such is also the story heard not so long ago of extreme exchange rate volatility. And I have great hesitation in mentioning the issue of protectionism because, in the ultimate analysis, what are described as trade issues are nothing but issues of distribution of income within and among nations. The muffled concern over the recent, entirely expected, movement of the dollar shows this more than anything else.

Lest it be thought that my sole intention is to turn the searchlight outward to spot blemishes, I should make an immediate confession. From reading these papers, which as I said earlier, are extremely illuminating, one might, mistakenly perhaps, form a notion that different varieties of fixed or flexible exchange rate regimes found in developing countries have evolved in a rational, objective manner in response to policy objectives, such as the stability of real output. I submit that there is another way of looking at the problem which has perhaps not been touched upon by the staff in view of its political sensitivity; that is the structural characteristics of the economies of developing countries where very often dualistic structures are to be observed--a modern structure approximating in varying degrees market structures in industrial countries, and a traditional structure where market penetration is low, or sometimes nonexistent. The structuralist school may have fallen out of fashion, but I regret to say that the facts that that school dealt with have not. Thus, we can ignore the income distribution issues in developing countries only at our own peril. Whether it was the fixed and very often overvalued exchange rates, or the now managed or flexibly fixed exchange rates, the real question is who gains and who loses. These are questions of social dynamics. Or to put it in another way, these are issues in the historic process of social transformation in developing countries. The exchange rate question is of vital importance to the lives of millions who have never heard of this particular animal. Sometimes, in our anxiety to locate the guilty men, we tend to forget that the guilty men may be both outsiders and insiders. Merely focusing upon the stranger as an enemy will not help in discovering the real source or sources of our predicament.

I referred to the income distribution question in developing countries because the success of stabilization programs depends, at least in part, on the social consensus they can rely on. Mr. de Groote has stressed this aspect. Sebastian Edwards reports in his book, <u>Real Exchange Rates, Devaluation and Adjustment</u>, that successful devaluation requires, in the short run, restraint in the evolution of wages. This matter needs more careful research, as is readily admitted by Edwards. What, however, needs attention is that in many developing countries, organized labor, the wages of which are indexed to the consumer price index in some form or another, constitutes a very small part of the total labor force. Labor in the unorganized sector, or the informal sector, constitutes the overwhelming majority of the labor force. Its wages are not indexed. It is not part of the bargaining process in any manner whatsoever. Since it is unorganized, it is without a voice. It will not figure in any social consensus scenario. There is no safety net for it. The only safety net it knows is growth, which ensures only bare subsistence. Thus, we arrive at the dreaded tradeoff between growth and a tolerable degree of inflation. It is not a satisfactory tradeoff, I admit; but the choice before the policymaker is not some recession now, and better growth later. The choice simply is between the desired degree of fiscal and monetary contraction, versus the sheer physical existence of large numbers of people. The interesting point is that these large numbers of people do not impinge in a major way on the balance of payments situation. Their demand is largely confined to nontraded goods, not defined rigorously, of course, but in a practical sense only to nontraded goods of the exchange rate theory. From this standpoint, flexible exchange rate policy, insofar as it accommodates some threshold of domestic inflation, leaves the door slightly open for men and women at the margin. Need I say how grateful I am to the staff for defending a humane policy, even though it touches only a fringe of the crisis confronting the developing countries.

The question becomes all the more relevant in these times of breathtaking change. Perhaps it is futile to speculate on the end of history. But one thing seems evident. The process, frequently known as the technological revolution in Europe, is now entering a major phase of international integration. National economies, hitherto characterized by large degrees of autonomy, are being carried, sometimes kicking and screaming, but other times willingly and smilingly, into an integrated world economy. This is going to be a long process, but it is difficult to see how isolationist models can work, if at all. Nobody knows whether it will be a tripolar system which will ensure stability, or whether the emergence of a tripolar system will itself be a cause for instability. However, for the developing countries which have lived for much of the post-World War II period with one kind of instability or another, neither the low inflation club nor G-7 coordination have so far produced really good news. Be that as it may, the question before the developing countries is how they will integrate with the world economy with all its benefits and costs. The exchange rate regime in this context is of tremendous significance.

I view the flexible exchange rate regime as more conducive to national objectives of promoting growth and development because it provides policymakers with a degree of freedom that is indispensable in dealing with internal and external shocks. A fixed exchange rate system may ensure price stability, although this cannot be taken for granted. The evidence is not unambiguous, and in any case the causality is far from certain. However, nothing in the evidence we have suggests that it can catalyze growth or export diversification. In our view, only a flexible exchange rate system, combined no doubt with prudent fiscal and monetary policies, can be an important element for an overall strategy of growth. It will also enable developing countries to move gradually and in a predetermined way in the direction of a more open economy. For that to happen, it is of utmost importance that they preserve a viable balance of payments position and maintain international competitiveness. Fortunately, many developing countries have achieved a remarkable degree of export diversification and are therefore now in a position to carry forward the process of liberalization which will inevitably involve significant structural changes. A flexible exchange rate policy has the potential of minimizing some of the costs associated with this transition particularly if, in conjunction with other policies, it helps to stimulate growth of output and employment. Much will of course depend on the global trading environment, but it is clear that in an unfavorable trade environment, nothing will work, least of all a fixed exchange rate regime.

In this context, the Fund has a crucial role. The Fund has an integrated and coherent philosophy of adjustment. This philosophy can find adequate expression only in Fund-supported programs which, among other things, emphasize trade liberalization as a means of efficient resource allocation. I fail to see how, in a large number of situations, trade liberalization will work without a flexible exchange rate policy. Without such a policy, trade liberalization will only worsen the balance of payments. In cricket terminology, the liberal batsman will have been struck by a beamer to be carried out on a stretcher to the hushed moans of spectators who had hoped for a century.

I take the staff's cautionary remarks regarding following real exchange rate rules. Targeting the nominal exchange rate according to a real exchange rate rule in a situation of high imbalances has an inflationary potential if fiscal and monetary policies are permitted to diverge from prudential limits. This proviso is of critical importance. A flexible exchange rate policy provides a degree of freedom to policymakers if, and only if, financial discipline is maintained. Here, I believe I inhabit the same world as Mr. Posthumus. In fact, the effectiveness of a flexible exchange rate policy in safeguarding the balance of payments of developing countries depends on the ability of policymakers to use fiscal and monetary policy for stimulating savings,particularly in the public sector,and for efficient allocation of resources. The lessons that can be drawn from the present stance of policies pursued by major economic powers is that developing countries will be well advised to look extremely carefully at their savings/investment balance and to do all that they can to increase their savings. This is easier said than done, because there are many structural rigidities to be overcome. However, a meaningful use of exchange rate policy in preserving or enhancing external competitiveness is possible only in a noninflationary environment. To my mind, from the income distribution angle, a noninflationary environment is essential for social justice. The issue thus is not of choosing between devaluation and fiscal contraction; it is, squarely, the very structure of fiscal policy and its income distribution implications within the framework of an overall strategy of growth. In this larger sense, interventionism performs the role of a midwife assisting the birth of a new policy paradigm.

No discussion of the exchange rate policy in developing countries can be complete without a glance, however brief, at the process which lends itself to instability in the present international monetary "system"--or lack of it. I have not much to add to the well argued section on the role of the Fund in the paper on the international monetary system. Suffice it to say that the present trends in international liquidity, which have serious and adverse implications for developing countries, have to be rectified if even a semblance of a symmetric and well functioning international monetary system is to take shape. The analysis of the Managing Director presented on page 22 of the paper on the international monetary system can hardly be improved upon. A compelling case has been made by the Managing Director for a larger role for the SDR in the international monetary system. It is not from the narrow point of view of developing countries that I request that serious thought be given to this question. I am not sure whether the systemic threats have been fully comprehended and whether it is not time to give multilateral surveillance its wherewithal. Without the SDR, multilateral surveillance is a pale shadowy thing, meaning all things to all men. In any event, the Fund must continue to deliberate upon the systemic role of the SDR. This issue should not be put on the back burner.

Mr. Dawson made the following statement:

The Fund's advice on exchange rate policy--and at times its silence on exchange rate questions--has prompted some heated discussions around this table on the pros and cons of fixed versus flexible exchange rate regimes. I doubt that today's discussion will settle those thorny questions about how best to balance competitiveness considerations with the desire for an anchor for domestic prices. However, I welcome the opportunity to revisit these questions.

The main paper, in particular, provides an excellent, and I thought reasonably well-balanced, discussion of the complicated theoretical issues related to exchange rate policy. In fact, its main contribution to our discussion may be to remind us of the complexity of the issues involved and the futility of looking to an exchange rate regime, be it fixed or flexible, as a cure-all for financial mismanagement.

The usual goals of economic policy are to promote sustained growth, low inflation, a viable external position, and financial market stability. Exchange rates are an important economic policy tool in achieving these goals, but they are only one tool, and they can only play an appropriate role as a complement to sound fiscal, monetary, and structural policies.

The type of exchange arrangement chosen may help policymakers to attain some of the objectives of economic policy better than others. Certainly, exchange rate fixity can create important incentives and pressures for financial discipline, particularly as the exchange rate is a transparent nominal anchor. Often, however, calls for fixity have arisen against a background of turmoil in markets and an inflationary environment. These are generally not the most favorable circumstances to introduce a fixed exchange rate regime, particularly where there are foreign exchange constraints. Indeed, as the paper reviewing exchange rate policy assessments notes, the record of authorities in maintaining firm monetary and fiscal policies and in following appropriate structural policies is no doubt much more important for the achievement of an adequate level of competitiveness and a sustainable external position than the type of exchange arrangement in place.

Fixing exchange rates and thereby placing the entire burden of adjustment on domestic policies can also result in suboptimal results. In these circumstances, exchange rate fixity, while reducing inflation, might only transfer volatility to other economic policy variables. For example, maintaining parities could simply ratchet upwards interest rates and unemployment, while complicating financing problems. This could result in countries slashing investment, damaging the prospects for growth-oriented adjustment, and creating a larger disruption for the world economy. We have also seen numerous examples of countries trying to maintain rigid exchange rate arrangements through the use of inefficient controls and dual exchange rates. Empirical evidence is an important barometer in this regard. It is noteworthy in this respect that the staff's analysis suggests that countries maintaining fixed exchange rates, while registering lower inflation than countries with flexible regimes, have had larger external and financial imbalances. The discussion of the CFA franc zone highlighted some of these problems. Countries sometimes also experience enormous difficulties in sustaining fixed exchange rates, causing a succession of crises and the very instability fixed exchange rates seek to avoid, while in the end weakening the credibility of the authorities.

It should also be clear that fixed exchange rate regimes do not, in and of themselves, produce discipline. As noted in the

Board's discussion of the CFA franc zone, policy discipline comes from within--it cannot be imposed from the outside. As the staff has noted, it is by no means obvious whether pegged exchange rates have induced greater price stability, or whether greater price stability has permitted the maintenance of a fixed rate.

At the other extreme, however, exchange rate flexibility is not a panacea, either. Excess flexibility could give rise to a vicious circle of repeated devaluations and accelerating inflation. This is illustrated in the paper's discussion of real exchange rate rules. Exchange rate flexibility also has never provided authorities with the degree of independence or insulation theorized in textbooks. Excessive exchange rate flexibility can also disrupt trade and investment, depressing employment and growth. Moreover, it can inject substantial uncertainties into financial markets, placing upward pressures on interest rates. In short, exchange rate flexibility should not be used as a vehicle to shield the authorities from the responsibility of implementing sound policies. Without a commitment on the part of the authorities to implement sound policies and to contain inflation, sustained growth cannot be achieved, and policy credibility will be lost.

Ultimately, the challenge the Fund faces in its policy advice to developing countries is to help countries put in place sound policies by striking an appropriate balance between expenditure-reducing and expenditure-switching policies. Both types of policies are generally needed. Countries have often borrowed excessively to finance consumption, and find themselves living beyond their means. This inevitably requires fiscal and monetary policy remedies. But impediments to price flexibility are also frequently present, introducing distortions into the relative prices of tradeable versus nontradeable goods. Many developing countries are usually bound by their external constraints, and must maintain real competitiveness to address their financing problems. Even when external competitiveness has been achieved, over time divergences in policies, relative inflation performance, and structural factors will re-emerge, leading to relative changes in underlying competitiveness.

In this regard, in countries where the Fund advises on exchange rate policy, it has generally done a good job in striking an appropriate balance. This is not an easy task. The Fund has worked well with many countries, putting in place sounder fiscal and monetary policies, directed at providing the necessary basis for financial stability. At the same time, it has generally avoided excessive rigidity, and taken the social consequences of its adjustment policies into consideration. It has adopted a case-by-case approach, recognizing that each country's situation is different. Meeting these objectives has required a considerable degree of judgment.

We would hope that all countries would be able to put in place the sound policies that would allow us to put the exchange rate debate aside. This, however, seems unlikely to occur any time soon, and in the meantime, neither economic theory nor practical experience offers us any hard and fast rules. Thus, I see no alternative but to evaluate country exchange rate policies on a case-by-case basis, and to give all countries the benefit of the Fund's careful scrutiny of their exchange rate policies.

Mr. Landau made the following statement:

Much has already been said by my colleagues, and the main arguments have been set forth. I fully agree with the thrust of the statements of Mr. Posthumus and Mr. de Groote. I had the occasion to express myself very thoroughly during the previous discussion on an issue close to the one we are debating today, namely, the CFA franc arrangements. That being said, I will be brief.

I would like to commend the staff for the great quality and thoroughness of the analyses which have been presented in the two papers. What I found especially interesting is the classification of exchange rate regimes according to the characteristics of the economies and the nature of the shocks they are facing. It seems to me it can be summarized along the following lines. The more open an economy, the less flexible are its prices and wages, and the more it is exposed to monetary--in contrast to real--shocks, then the more this country should adopt a fixed nominal exchange rate, commit itself to maintaining it, and look for maximum credibility. Like Mr. Grosche, however, I would have appreciated more specific references to the research on these issues in Europe, following our experience regarding the EMS; some of this research is even published in French. But the staff paper gives us a very clear guidance as to what should be the choices for achieving the maximum efficiency in the exchange rate regime and internal economic policies.

In this regard, the last decade has been marked by generally floating exchange rates. While the countries have been able to retain some of the benefits of this system--namely, a greater internal monetary autonomy--some drawbacks have been equally evident, such as greater volatility and persistent misalignment in real exchange rates. There is thus a general inclination today toward greater exchange rate stability, which has formed the basis for international economic cooperation between industrialized countries in the last five years. It has also found its way into the design of Fund-supported programs. In this regard, a simple static view of the present situation of such programs might be misleading. If we look at the more recent data and the more recent trends, we find very significant features; in particular, it is striking that many of the programs for Eastern European countries are based on very strong nominal exchange rate commitments; the examples of Poland and Yugoslavia are very significant in this regard.

To a large extent, however, the conventional wisdom on which many programs are built is very much in favor of targeting not the nominal, but rather the real, exchange rate. With the benefit of experience, we can see some of the important drawbacks of this approach. For example, the precise determination of equilibrium real exchange rates proves to be rather difficult. The papers give us much relevant information and analyses on what, in general terms, influences those equilibrium exchange rates--namely, terms of trade, the rate of technological progress, and the general thrust of fiscal policies. The impact of the interest rate is more ambiguous, since it would depend, on the external side, on whether the country is not a creditor or a debtor, and, on the internal side, on the elasticity of national savings to changes in the rate of interest.

But of course, when designing a program, some quantification is necessary. Therefore, the target itself might be somewhat blurred: we can certainly detect ample misalignments, but the necessity of preventing an overall 10 percent or 20 percent real appreciation or depreciation might be difficult to justify on firm scientific grounds. Furthermore, targeting the real exchange rate might introduce a very important inflationary bias to economic policy. If price and wage formation are affected by rigidities, this would lead to a permanent process of depreciation and spiraling inflation, which would be even more pronounced if international capital mobility allows inflationary expectations to be transmitted instantly into nominal depreciation. It is now well established that such a process, leading to higher and higher inflation, is detrimental to the formation of saving, investment and, finally, growth in developing countries.

There might therefore be great merit in basing exchange rate policy on the targeting of the nominal exchange rate. Countries would win in financial discipline what they lose in monetary autonomy; overall, the tradeoff might be worthwhile. It seems to me that, in recent years, we have come to appreciate more and more the contribution of financial discipline and financial stability to the process of development. To the same extent, there is a general recognition that the absence of financial discipline or of a properly functioning financial system could very much impede or derail the process of transition from centrally planned to market economies. The nominal anchor is all the more necessary when a country goes through a difficult process of structural change. I would welcome any comments by the staff in this regard.

Nominal targeting is not incompatible with real exchange rate adjustment, either through internal price and wage formation, or through discrete nominal adjustment. We must be aware, however, that the efficiency of the latter is closely linked to the degree of flexibility of internal wages and prices and the existence of a supply response to price signals.

Targeting nominal exchange rates ensures predictability and leads to credibility of the overall fiscal and monetary policy mix. Especially interesting, in this regard, is the experience of the Mexican peso in the last few years, where an increasing degree of stability could be combined with the avoidance of real appreciation through periodic but decreasing rates of nominal adjustment. I would appreciate any comment the staff could make in this regard, especially to the extent that this might have contributed to a change in internal wage and price formation policies.

But it seems to me that our mission goes beyond that analysis, and that the Fund should not limit itself to advising countries on their exchange rate policy on an individual basis. The Fund is, by its very nature, a multilateral institution, which has to discharge systemic responsibilities. By their very nature, also, exchange rate policies have important effects on other countries. Such externalities provide the rationale for strong international cooperation. This could best be achieved by having the Fund assume a leading role, by defining, so to speak, the general rules of the game. In this regard, the very substance of its mission is to avoid disorders in exchange rate regimes which would lead, as has been the case in the pre-World War II period, to restrictions in the trade of goods and the erection of protectionist barriers. The fact that we are addressing today exchange rate policies of developing countries, the weight in world trade of which is increasing rapidly, makes the case even more strongly. We can see many instances in which the absence of an appropriate exchange rate policy has led to the persistence or the introduction of trade restrictions; and finally, to the reduction of growth. The prospect for competitive devaluations is indeed a very real one, and I fully agree with Mr. Posthumus's remarks in that connection. That is, in my view, the very reason why the Fund cannot limit itself to dispensing ad hoc advice, and should have an overall view and approach as to what exchange rate systems should be for developing, as well as developed, countries.

We definitely need a doctrine, and it seems to me that the balance should be tilted, today, in favor of more stable nominal exchange rate commitments.

Mr. Clark made the following statement:

Let me express my appreciation to the staff for the quality of the paper. It obviously covered a wide range of very complex issues, and what I particularly appreciated was the ability of the staff to write at a level that we could all understand, which made it even more enjoyable reading. I hope we can continue to have this degree of clarity in the future. I know I benefited; I am assuming the Board benefited; and I am sure the new French, German and Italian schools of thought will benefit as well.

Most of my comments will deal with some operations which I believe in reality probably limit the scope that developing countries may have in implementing exchange rate regimes as they embark on a program.

It is always useful in a discussion of this type to set out those areas where there is agreement. I detect so far three areas where I think we can all agree. The first is perhaps somewhat obvious--that stable exchange rates are preferred over volatile exchange rates. If we can agree on that, we have gone at least one step further. Second, and I think this is the most important, regardless of the exchange rate regime, appropriate financial policies are of critical importance to increasing the welfare in the economy. Almost every speaker has said that appropriate financial policies are a sine qua non of stable exchange rate regimes, whether a fixed exchange rate or flexible floating exchange rate. Third, I am hoping that there is a consensus that price stability should be given a very strong priority in the welfare function a country is implicitly following.

The question around which there are considerable differences of view is whether the choice of an exchange rate regime affects the conduct of financial policies; in other words, do fixed exchange rate regimes help establish credibility and lead to appropriate financial policies, whereas flexible rate regimes take the pressure off the authorities to introduce appropriate financial policies.

The staff paper sets out fairly clearly the fact that there is neither a theoretical nor an empirical basis for resolving that particular question. I am sure that is no surprise. In a real sense, research can only take us so far when making policy decisions, and in looking at the Fund's advice I note that it is not usually a question of either one or the other; it is usually a question of degree, and in terms of a policy package which includes exchange rate recommendations. One is probably looking at a combination of policies which in real terms is going to provide the best chance of succeeding in achieving the objectives. That will involve varying degrees of flexibility, or in other cases may call for a movement more in the direction of a greater degree of fixity. There is no simple prescription.

My own constituency in some ways represents a microcosm of this Board. Two countries follow a floating exchange rate regime, a number of countries form a currency union with a pegged exchange rate; one country pegs the rate on its own; and one country is a member of the ERM. It is not surprising that in my own constituency I do not have a consensus on the question of the relationship between exchange rate regime and financial policies at the theoretical level; it would be fair to say I do have a consensus on a practical level.

There is agreement that to achieve price stability--and I assume here that price stability is a key variable in all welfare functions--there are advantages for small open economies in using the nominal exchange rate as an anchor for price stability. There is also agreement, however, that this strategy will cnly be effective in countries where the authorities are also following appropriate financial policies that do not give rise to an inappropriate appreciation of the real exchange rate. Where both conditions are met, what comes first--the stable exchange rate or price stability--is somewhat immaterial. These are not countries that generally require Fund assistance, and rarely is there a question regarding the appropriateness of their exchange rate regimes.

Mr. Dawson and Mr. Wright pointed out that the Fund usually deals with countries that have not followed adequate policies in the past, and therefore suffer from a general lack of credibility, a balance of payments problem, and often accelerating inflation. The disagreements that we may be hearing in the Board have very practical implications. Some Directors hold strong views that such countries must start with the stabilization of exchange rates as a means of earning credibility. Other Directors--and I would include myself in this group--believe that the stabilization of the exchange rate should be the outcome of a successful adjustment program aimed at reducing domestic and external imbalances and achieving price stability.

Let me examine a situation in which a country embarking on an adjustment program has some difficulties in achieving exchange rate stability quickly. To stabilize the exchange rate, countries suffering from domestic and external imbalances must rapidly adopt appropriate financial policies to contain these imbalances, suppress inflationary pressures, and preserve competitiveness. Moreover, countries need an adequate level of foreign exchange reserves, and/or access to external borrowing at least sufficient to permit the authorities to sustain temporary imbalances as well as to defend the exchange rate against speculation. Most countries embarking on an adjustment program lack the required reserves.

Clearly, there is a tradeoff between the degree of financial discipline and the level of reserves or access to external borrowing. In cases in which there has been a long period of economic mismanagement and a consequent erosion of credibility, irrespective of the authorities' resolve to impose financial discipline, it is likely to be very difficult to command confidence in the currency, particularly when the country's low level of reserves and lack of access to foreign credit are well known.

In these circumstances, the degree of tightening of policies required, as well as the length of time during which tight financial restraint would have to be maintained, may not be feasible and may not be desirable. The economic and social and political costs implied by such restraint are not likely to be acceptable to many developing countries, especially as adjustment programs usually follow long periods of economic stagnation and, often, decline. Moreover, the possible rapid loss of political and social support could fuel speculation that the exchange rate must be moved.

The staff suggests that one way to strengthen the credibility of the authorities' commitment to maintain a fixed exchange rate is for the country to forge institutional arrangements which make it costly to alter the exchange rate. We see examples of such arrangements as the European Community's ERM, West Africa's French Franc Zone, and the East Caribbean Currency Union. The credibility in such cases is attributable not only to the explicit cost of changing the arrangement, but also to the fact that part of any such arrangement is a pooling of reserves. This substantially increases the resources available to defend a rate, and therefore reduces most of the incentives to speculate against it.

Such an arrangement would enable the authorities to avoid the initial risks associated with fixing an exchange rate. At the same time--and this is well described in the staff paper--these arrangements can have quite a high cost, as they preclude the use of a devaluation as a policy instrument to promote adjustment to regain competitiveness.

Unfortunately, most developing countries do not have the luxury of choosing which cost they are willing to bear, as there are no such institutional arrangements available to them. The ERM is not even an option for all European countries; the French Franc Zone may be willing to accommodate a few more West African nations, but it is not an arrangement which could accommodate wide participation from the rest of Africa. There is no arrangement for the countries that perhaps require most the increased credibility associated with entering into such arrangement--the countries in Latin America.

Another path to increasing the credibility of the authorities' commitment to a stable exchange rate is to increase the independence of central banks in determining monetary policies. This will increase the public's confidence that appropriate financial policies will be sustained, and, therefore, that the exchange rate will be stabilized.

I fully support any move that would increase the independence and credibility of central banks, and would urge all countries to move rapidly in this direction. Increased credibility can only be earned over time as a central bank develops a track record and manifests its independence in practice as well as in name.

These practical considerations lead me to conclude that even if it could be established on theoretical grounds--whatever that term means--that fixing the exchange rate at the onset of an adjustment program is a superior strategy to permitting the market to determine an appropriate rate, it may not be an option open to most developing countries that require the assistance of the Fund.

In light of the low level of reserves of most countries seeking Fund support, the adoption of such a strategy can be seen as an invitation to speculation. In my view, given the difficulties of regaining credibility and confidence, once it is lost, there may be little initial choice but to allow the exchange rate to float. This has its own risks, particularly the risk of accommodating inadequate financial policies. It is therefore just as important, if not more so, that a floating exchange rate be supported by tight financial policies. The exchange rate will stabilize when the authorities' goal is reached, or, in other words, when a successful policy track record is established. However, a stable exchange rate would be the end result of the adjustment effort rather than one of the foregoing conditions.

Mr. Yamazaki made the following statement:

This is a most opportune time to review the Fund's advice on exchange rate policy, as Board discussion on individual country cases has increasingly focused on exchange rate policy in recent years. In particular, concern is sometimes expressed about the inflationary implications of frequent devaluations under a flexible or pegged adjustable exchange rate arrangement, on the one hand. On the other hand, the adequacy of the nominal exchange rate has also been questioned, frequently when a country with a fixed rate system faces large external imbalances.

The two staff reports before us complement each other. One provides an overview of exchange rate recommendations and their background, and the other deepens the analysis of the considerations underlying those recommendations. Nevertheless, the two reports share some important theses, with which I fully agree.

First, the role of exchange rate policy should be considered in conjunction with policy objectives and the financial policies that are already in place. The exchange rate arrangement does not determine the course of economic development by itself. However, it is critical for a developing country to pursue an exchange rate policy that is consistent with its own macroeconomic fundamentals, if it is to achieve sustainable growth by maintaining financial stability and external viability over the long run. At the same time, the conduct of exchange rate policy should be supported by consistent financial policies in order to strike a balance between the two objectives.

Needless to say, stability of the exchange rate is indeed desirable. Finance Minister Hashimoto expressed his long-term desire at the last Annual Meetings that a more stable international monetary system should be explored that would firmly substantiate the spirit of cooperation thus far. In my view, this will require the efforts of all the members in pursuing stable and coordinated fiscal, monetary, and exchange rate policies.

This being said, the optimal precondition for a stable monetary system should be sought through addressing the compounded structural problems of the developing countries. Thus, when a country embarks on a Fund program, particularly when it enters a structural adjustment program, the adequacy of the exchange rate policy should be reviewed fundamentally, as one of the important structural elements of the program design.

As the staff report suggests, a straightforward application of optimal exchange rate theories is difficult, as there are conflicts in policy objectives and as the causes of external shocks are difficult to identify. This being said, to the extent that the balance of payments is an immediate concern for many developing countries, it seems that exchange rate action cannot be precluded from the policy options for certain countries, as I will elaborate on later. In this respect, I believe that staff consultations with member countries on exchange rate policy are generally successful, in seeking a balance between financial stability and external adjustment in a medium-term macroeconomic framework.

Second, exchange rate policy should not be regarded as a substitute for macroeconomic policies. Empirical evidence, as well as theoretical analysis, strongly suggests that devaluation without appropriate tightening of fiscal and monetary policies could easily lead to a vicious devaluation-inflation cycle. Furthermore, depreciation of the real exchange rate would be smaller than expected, compared with the degree of nominal devaluation, if a compensatory nominal wage adjustment is fully allowed. However, the second thesis implies that a fixed exchange rate does not, by itself, impose financial discipline. When we reviewed the performance of the CFA franc zone countries, there was evidence that even under a restrictive monetary policy, the authorities could sometimes resort to unsustainable external financing or accumulation of domestic arrears.

This empirical evidence leads to a critical assessment of the external and financial implications of real exchange rate rules. The papers demonstrate the double-edged risk of the authorities' adherence to real exchange rate stability. On the one hand, a depreciation of the real equilibrium rate due to nonmonetary exogenous shocks would bring about a change in the optimal relative price between tradeables and nontradeables, thereby creating a need for real depreciation beyond the difference in the inflation rates. On the other hand, if the real appreciation due to domestic inflation is to be thoroughly corrected through nominal devaluation under the real exchange rate rule, it could lead in the long run to inflationary financial policies. This is a serious concern for the conduct of, and staff consultation on, flexible exchange rate policy. Automatic nominal depreciation under the rule would not only distort price developments, but also prolong external imbalances.

However, it should be clear that the institutional problem associated with the real exchange rate rule is a different matter from the choice of exchange rate regime. This is a less explicitly stated, but important, third thesis. In this regard, like Mr. de Groote, I think that more attention should be paid to flexibility in wages and prices. Empirical evidence from newly developing Asian countries suggests on the one hand that modest growth of real wages allowed the authorities to maintain a stable real exchange rate at a fairly competitive level, while keeping inflation under control under a flexible and adjustable regime. On the other hand, the experience of wage indexation and the crawling peg in Latin American countries suggests that the authorities were left with limited policy options, and have generally failed to check inflationary developments. In this regard, real downward wage adjustment is generally more difficult in the absence of exchange rate action, as can be seen in the difficulties in recent adjustment programs of the middle-income countries of the CFA franc zone.

Thus, the overall view suggests that a country with greater flexibility in wages and prices can rely to a great degree on the flexible use of exchange rate policy. Otherwise, as the staff report suggests, exchange rate policy is expected to play an important role in providing a nominal anchor for financial stability.

This being said, while I appreciate the staff's theoretical analysis of the importance of the anchor role of exchange rate policy, it seems that there are some operational constraints for the straight application of the last thesis. First, an optimal equilibrium exchange rate is hard to determine ex ante, particularly when the nominal rate had been extremely overvalued before the initiation of the structural adjustment program. In such a case, the rate has to be floated until the structural rigidities are eliminated from the price and wage structure. The lessons of Bolivia and Peru suggest that a floating exchange rate can serve as an anchor in such an extreme circumstance. By contrast, Poland is an example of a country that successfully reduced inflation with a fixed exchange rate policy.

However, that Poland was an exceptional case, in that it was provided with sufficient contingent reserves by donor countries to counterattack any speculative action against the fixed rate, needs to be borne in mind. Usually, the authorities have to operate with a less adequate reserve position. They are often forced to devalue the exchange rate against unexpected increases in the demand for foreign currency, rather than to spend their central reserves to defend the rate. The longer the actual balance of payments adjustment takes, the more the pressure will fall on the exchange rate.

The staff report is right to point out that the public's belief in the credibility of the authorities' anti-inflationary policy is a more important variable than the tightness of the financial policies themselves. However, in my view, the workability of the precommitment to a nominal fixed rate also depends on the availability of intervention resources, as the authorities' capacity to defend the rate also affects their credibility. In formulating the Fund-supported program, while requiring sufficiently tight financial policies, the staff has to take that reality into account in their exchange rate policy recommendations.

Third, the inflationary effect of devaluation depends on the tightness of the incomes policy and the degree of the wealth effect of the devaluation. If current inflation reflects mainly past price adjustments, and if the authorities are generally committed to a disinflationary policy, it is still feasible to assume a steady decline in inflation in the program under a flexible exchange rate policy. The case of Sri Lanka may fall into this category. I hasten to add, however, that the staff needs to pay great attention in such a judgment to a country's past wage and price structure.

The history of the Fund's exchange rate advice and its assistance to member countries with balance of payments difficulties seems to have been a generally successful one. In particular, the emphasis attached to structural adjustment policies reinforces the effectiveness of the flexible exchange rate policy. While arguing for retaining some flexibility in the exchange rate regime, however, I am not advocating an active exchange rate policy or an automatic nominal adjustment. The staff should pay particular attention to the stability of the exchange rate, and hence, to the stabilization of the domestic financial situation, thereby protecting the adjustment momentum. I could not agree more with Mr. Posthumus when he says that fiscal and monetary policy thus becomes more important.

In this respect, I agree with the staff that exchange rate policy can play the role of an important nominal anchor in certain cases. This being said, the balance between exchange rate action and financial adjustment should be struck in the context of the viable medium-term framework of macroeconomic adjustment. It seems that it is a bit too early to assume the universal applicability of any single exchange rate regime. All in all, I can endorse most of the main conclusions of the two excellent staff reports.

Finally, in reviewing the Fund's important role in assisting members to solve their balance of payments problems, I share my Minister's desire for a more stable monetary system in the future, and for stability among major currencies in particular, in order to provide an environment of stability in which developing countries may pursue sustainable growth.

Mr. Filosa made the following statement:

I welcome this opportunity to discuss a topic of such crucial importance. The rapidly changing world economic and policy environment makes it necessary for this institution to constantly and critically rethink its policy advice function. I believe that the need was felt for the Board and the staff to give some thought to the optimal use of the exchange rate as a policy instrument.

Indeed, the staff has dealt successfully with the difficult task of condensing into two concise and fine documents the essential analytical and practical issues. I laud the efforts made and the pragmatic approach taken in the analysis.

Both the theory and the empirical evidence reveal that there is no such thing as an "ideal" exchange rate policy which best fits each and every possible circumstance. On the one hand, neither fixed nominal nor fixed real exchange rate rules can be preferred one over the other for coping better with all possible kinds of disturbances. On the other hand, adapting the exchange rate policy setting with the aim of neutralizing external shocks encounters the great difficulty of identifying unequivocally the nature of the shocks, and the impossibility of determining ex ante either their duration or their impact on the equilibrium value of the exchange rate. Moreover, while it seems clear that a regime of purely flexible rates may be destabilizing, a system of irrevocably fixed rates may impose unbearable costs on the economy.

Indeed, the great variety of exchange rate regimes which Fund members have adopted is clear proof of the difficulties that the international community has encountered, and is encountering, in establishing a uniform approach to exchange rate policy. Also, the fact that in reviewing country cases the Fund's assessment of the members' exchange rate policy has been critical, and sometimes severely so, even under quite different exchange rate regimes, is proof that no exchange rate regime can survive under inappropriate policies. Should we then give up the idea of establishing a more uniform approach to exchange rate policy, that is, should we set the stage for a reform of the international monetary system? My answer is that what we know about theory, along with the practical experience we have accumulated over the past several years, could help us a great deal in providing the policy advice needed to achieve greater nominal exchange rate stability. Applying Professor Laidler's comment on the current state of the art of monetary policy to that of exchange rate policy, I would say that perhaps we do not know enough about it to use it to do good, but we do know enough to prevent us from doing harm.

The basic medium-term objective of our policy advice should be the achievement of greater nominal exchange rate stability. This by no means amounts to predicating the adoption of a fixed nominal exchange rate rule in the short term. In a number of countries, the overvaluation of the exchange rate requires corrections, sometimes substantial corrections. High domestic inflation is also incompatible with a fixed nominal exchange rate. External shocks might require the adjustment of the exchange rate. At the same time, however, I very much agree with the staff that the adoption of a real exchange rate rule is likely to leave the country without a nominal anchor for the price level. This leads me to think that while at the beginning of an adjustment program, exchange rate flexibility might be advisable or necessary, greater emphasis should be put on the important role that the exchange rate can play as a nominal anchor. Like Mr. de Groote, I believe that some form of target zone might be used as an interim system to proceed further toward nominal exchange rate stability.

Attempts to preserve competitiveness through nominal adjustments of the exchange rate do not have lasting effects, and cannot substitute for structural policies. Certainly, exchange rate corrections can create temporary differentials in international price trends and redress external imbalances, but they do not affect the real causes of insufficient competitiveness. In the final analysis, they might delay the elimination of uncompetitiveness, while compounding the difficulties of the task in the future. Also, experience shows the high likelihood of rising inflation as a result of periodic devaluations, as well as the illusory, short-term, and ultimately neutralizing effects of a change in the exchange rate on external imbalances, due to inflation.

One should nevertheless not be deceived by the seeming thaumaturgic power of fixed nominal rate rules as a price anchor. In fact, the nature of the exchange rate as an indicator suggests that the nominal exchange rate cannot of itself be the anchor for anything. The staff is right in emphasizing that ultimately, only financial discipline can provide an anchor for domestic prices. Thus, a fixed rule is insufficient to anchor prices in a country which lacks such discipline.

A fixed nominal rule, however, presents unique advantages. Thanks to its transparency, a market determined exchange rate is not only an effective indicator for policy, but it is also an immediately visible signal to the public. Therefore, once financial discipline is put in place by the authorities, the announcement to peg the rate at a given parity signals the authorities' commitment to stick to a disciplined conduct of policy, setting a standard against which their credibility can be publicly judged. However, one should be aware that fixed nominal rules may be unsustainable in the absence of consistent financial policies.

I wish to put forth the following policy propositions. First, fixed real exchange rate rules should be discouraged because of their inherent destabilizing characteristics. Second, given the policymaker's ignorance as to the nature and duration of future shocks, exchange rate policy should not be used to fine-tune the economy. Third, fixed but revocable exchange rate rules are desirable for countries undertaking adjustment programs, and their adoption should be encouraged--a point which I support more strongly than does the staff. Their adoption should be encouraged provided that they are established only after major adjustments have been made to the economy, especially in cases of high inflation; that appropriate financial policies are set in place to prevent imbalances that would feed back into the exchange rate; and that any given parity target would be defended as long as possible, but would be modified once permanent shocks or persistent imbalances had proved it to be unsustainable.

The fourth proposition is that policy packages intended to restore a country's external competitiveness should contemplate a combination of nominal exchange rate adjustment and restrictive financial policies consistent with external equilibrium. As part of the adjustment package, wage indexing mechanisms--or, at least, an import price indexation component for wage contracts--should be suppressed, in order to preserve the effectiveness of the exchange rate realignment.

With respect to the Fund's exchange rate policy advice, in the case of countries participating in monetary unions, unilateral changes in nominal parities are precluded by the monetary arrangements. Thus, the burden of adjustment, where necessary, falls entirely on financial policy, sometimes at the risk of formidable social costs. Moreover, the high cost involved may even prevent the adjustment from being carried out fully. I thus believe that the Fund should find ways to discuss exchange rate issues with members of monetary unions where adjustments need to be undertaken and when the use of Fund resources is required.

In advising members on exchange rate policy, the Fund should always evaluate the potential repercussions of suggested policy changes on competitor countries and/or trading partner countries. The Fund should adopt a systemic approach and deal with a single country's problems in the context of a general equilibrium framework, which is fully in line with its mandate. This of course requires a close and continuous coordination among all the Area Departments of the institution.

In cases of countries undertaking structural adjustment programs, exchange rate settings which may be appropriate in the initial period of the program may need to be revised during the adjustment process, particularly if the program has succeeded in changing, as was desired, certain economic parameters. In such cases, the Fund should be ready to adapt its policy advice to the new circumstances. This is of particular importance for high inflation countries where Fund-supported programs initially envision the maintenance of a stable real exchange rate. In these countries, once inflation has been brought down considerably, the adoption of more stringent exchange rate policies would become instrumental in reinforcing deflationary expectations and lowering inflation further.

Mr. Végh made the following statement:

Let me congratulate the staff for the two illuminating papers submitted to the Board. I would like to reflect on the desirability and the feasibility of targeting the real exchange rate in the context of a floating mechanism. I think differently about that today than I did 15 years ago, and I will try to explain how the circumstances have changed. With regard to the desirability of targeting the real exchange rate, I strongly question whether the government is ever able to determine the level of the equilibrium exchange rate, or how that level changes as a consequence of external shocks.

With respect to the issue of the feasibility of targeting the exchange rate, intervention by the monetary authority in the foreign exchange market may be ineffective, or, even worse, may lead to a result that is the opposite of what is being sought. Consider, for example, the case in which the central bank purchases dollars in order to raise the nominal exchange rate and, hopefully, the real exchange rate, in order to improve the competitive position of exports. In the absence of an increase in the demand for money or of offsetting monetary actions that are frequently expensive on the fiscal side, this action would result in an increase in the price level. Since the real exchange rate is the ratio between the exchange rate and the price level, both the numerator and the denominator increase, and the end result is uncertain. It may happen that the ratio remains unchanged, and we are left with the same real exchange rate and higher inflation.

It may even happen that the denominator increases more than the numerator, and we are left with more inflation and a lower real exchange rate than before. The likelihood of this self-defeating result is enhanced by the recent tendency, in some of the Latin American countries, to build up a large stock of private cash holdings in foreign currency and a small monetary base in domestic currency. Under these conditions, the action of the central bank may contribute very little to the rise in the nominal exchange rate, but may lead to a significant expansion of the price level.

Why was it different in the mid-1970s? Then we were successful in following real exchange rate targets and improved significantly the level of exports and the balance of payments situation. Some of these experiences in the Latin American region have been analyzed recently in an interesting working paper prepared by Mr. Max Corden for a World Bank Seminar in April 1990. What has changed? I think the answer lies in the intensity of inflation and in the structure of supply in the foreign exchange market.

As for the first, we were dealing with more stable and predictable inflation levels and larger monetary aggregates in domestic currency. As for the second, the proportion of foreign exchange transactions related to exports and imports of goods and services has declined dramatically, and so has the impact of exchange rate policies on the correction of balance of payments disequilibria. In this respect, developing countries are very similar to the more developed ones. The proportion in Buenos Aires is not very different from the proportion in New York, Tokyo, or Frankfurt; the order of magnitude is less than 10 percent.

Even when it is successful, as it was in our case in the mid-1970s, it is clear that the targeting of the real exchange rate has an inflationary bias, as Mr. Posthumus rightly argues in his statement, and as other speakers have emphasized today. There is a clear-cut policy choice. Recent analytical work in the Research Department indicates that any stabilization policy, whether with a fixed or a flexible exchange rate, results in an appreciation of the domestic currency and a fall in the real exchange rate.

Mr. Kafka made the following statement:

I have only a few comments on this paper, which I enjoyed very much. The staff's central question is whether or not the staff is too much inclined to recommend exchange rate flexibility to developing countries, even at the expense of monetary stability, which would require, or at least suggest, the use of an exchange rate anchor.

To answer this question, the paper discusses the effects of the exchange rate regime in different circumstances. I would agree on the whole with the staff's answers to that question. In other words, if inflation cannot be beaten, then the exchange rate must be allowed to join it, up to a point--but only up to a point. A pure real exchange rate rule must lead to disaster, but so must a fixed rate or an excessively limping peg. One could also ask why should one single out the exchange rate, among all prices, since it is not the single most important price. The wage rate would seem to be the more important price in that regard. However, we all know that exporters are more malleable than workers, are less unionized and less inclined to strike.

Is it not true that a nominal exchange rate anchor can be made to dominate policy which would otherwise be inflationary? Conceivably, in a revolutionary situation, such as in Eastern Europe today, the new governments may be able to convince the public of a new policy, and, thereby, help to make it effective, even if that policy has no precedent. One might also find an uncle prepared to supply assistance on a very large scale. Yet another possibility might be formation of a currency union, where the preservation of the nominal anchor can also be made to dominate policy.

These considerations suggest that to give good advice, we may have to go beyond the field of economics, into sociology and political science. This is a rather disconcerting prospect for economists, but we may have to think about it a little more than we are wont to do. Or can we perhaps rely on common sense to guide our missions?

The papers correctly insist that to surrender power to fix the exchange rate has its costs, but they suggest that these costs will be large only if the exchange rate is to remain fixed even in the face of major and enduring exogenous shocks. Unfortunately, the exact meaning of the terms "major" and "enduring" is not clear.

There is one point where I find it hard to follow the staff. The staff suggests that granting considerable autonomy to a central bank with a reputation for fiscal conservatism can be helpful for a country in which the credibility of policies aiming at monetary stability is not firmly established. How is one to find a central bank with a reputation for financial conservatism under these conditions?

The exchange rate regime is clearly something that has to concern the Fund; but where should we draw the line regarding policies which we should--or should not--attempt to influence? Is it too simple to say that we should be concerned with all policies that--in whatever way--affect the purposes listed in Article I? Or would it be more sensible to say that we should be concerned only with those policies which affect these purposes immediately, directly and powerfully? There is no simple answer to this question, which includes--inter alia--matters such as the environment and income distribution.

Mr. Al-Jasser made the following statement:

After reading the staff papers, one is reminded of the vitality of this institution despite its being a large bureaucracy, albeit an efficient one. As the paper on the review of exchange rate policy assessments in recent Article IV consultations indicates, a real effective exchange rate peg has been instituted in most Fund-supported programs. Notwithstanding the repeated concerns of several Directors regarding the potential inflationary consequences of such an approach, it is refreshing to see that the staff has itself cautiously come around to this view in the papers. Clearly, the fact that an institution stops to take stock of and evaluate critically its policy advice from time to time is a sign of health and vigor.

From an operational standpoint, the most crucial point in dealing with exchange rate issues is to avoid a dogmatic approach. I firmly believe that the appropriateness of an exchange rate regime depends primarily on the nature of the domestic policies that support it. Therefore, the staff should work in the light of the authorities' preference for a particular type of exchange arrangement, provided that it can be supported adequately and credibly by domestic financial policies. The wide array of individual country experiences highlights the limited applicability of general rules on exchange rates, and the lack of an obvious optimal policy regime.

The main attributes of a real exchange rate target are well stated in the staff papers. Given the susceptibility of an open economy to a variety of external and domestic shocks, a real exchange rate peg may help avoid unsustainably large external imbalances. Thus, with small and regular nominal exchange rate movements, the real exchange rate can remain stable while preventing undue adjustment costs to the economy.

However, as the staff paper points out, in practice it is very difficult to determine an equilibrium real exchange rate. Therefore, a real exchange rate peg can be very costly. In addition, with the adoption of a real exchange rate peg, one is advocating an externalization of adjustment, when, in reality, domestic adjustment is required. More significantly, this approach could prove highly inflationary given its tendency to unleash a wage-price spiral that is continuously aggravated through automatic nominal devaluation. Therefore, in my view, the jury is no longer out on this issue, as the staff papers have clearly put this debate to rest. The uncertainty regarding the equilibrium level of the real exchange rate provides considerable grounds for rejecting this approach. Moreover, if domestic policies were sufficiently supportive of financial stability, there would be, a priori, little reason for instituting a real exchange rate objective.

In the same vein, the staff paper also highlights the positive attributes of immutably fixed nominal exchange rates. The views of this chair on the benefits of the exchange rate as a nominal anchor in the context of an anti-inflationary policy mix are well known. Nonetheless, it is worth emphasizing that a nominal exchange rate anchor can provide the authorities with the needed credibility to implement their anti-inflationary policy stance. This positive externality should not be underestimated, since the credibility of policy announcements is of pivotal importance in most developing, and in many developed, economies. Here, I fully agree with Mr. Posthumus when he agreed with me that stable rates minimize uncertainty and therefore promote investment, international trade, and capital flows.

However, this approach is dependent on the government's ability to consolidate public finances. If it is perceived by economic agents that fiscal policy will not satisfy the government's intertemporal budget constraints, then agents would expect the government to undertake currency devaluations. This would lead to speculative attacks on the currency, hence establishing self-fulfilling expectations. Consequently, it is imperative that a government support its exchange rate policy through adequate fiscal retrenchment. Indeed, it is even argued that the adoption of a fixed nominal rate would be conducive to prudent policies.

However, the adoption of a fixed exchange rate at an unrealistic level imposes a heavy burden on fiscal and wage policies to preserve external competitiveness. In the absence of downward flexibility in wages and prices, the necessary fiscal overcorrection may be drastic and extremely painful. This is particularly true given that such expenditure-reducing policies would not be coupled with the dampening effects of expenditure switching that result from an exchange rate adjustment. Moreover, the ability of an economy to withstand prolonged draconian fiscal corrections, even if they are coupled with comprehensive structural adjustments, is doubtful.

One is confronted with the policy choice of either gaining an additional adjustment tool through the adoption of flexible exchange rates, or increasing the effectiveness and credibility of fewer tools through the implementation of a fixed exchange rate. In either case, there are benefits and costs. Nonetheless, I would submit that the enhanced credibility of other policies should be awarded somewhat greater weight. Thus, I would opt for greater stability in exchange rates, while allowing for rare adjustments in response to changes in economic fundamentals--that is, fixed but adjustable rates. Again, I agree with Mr. Posthumus that a stepped adjustment will have a smaller inflationary bias than a creeping adjustment. Operationally, this would imply that the rate could be adjusted at the outset of a Fund program if, and only if, it is deemed necessary. Subsequently, however, domestic financial policies should bear the greater burden in maintaining competitiveness.

Finally, the main contribution of the paper on the review of exchange rate policy assessments in recent Article IV consultations is its recognition that, in some cases, the adoption of real exchange rate rules may have contributed to the inflation process. I was disappointed that the paper did not develop this theme further by fleshing out these cases and providing a critical assessment of our advice, including any impetus to competitive devaluations. The fact that the paper does not seek to reach judgments about the appropriateness of the staff's assessments of exchange rate policy in individual country cases defeats the whole purpose of undertaking a review of such policy assessments. I hasten to add, however, that I am mindful of the constraints and limitations imposed on the staff in undertaking such assessments. This highlights the urgent need of establishing an independent evaluation unit to undertake such studies. I hope management will at some stage recognize the urgency of this issue.

Mr. Toé made the following statement:

I would like to join previous speakers in congratulating the staff for the excellent papers, and in welcoming this opportunity to discuss, in a seminar format, Fund advice on exchange rate policy to member countries, especially those undertaking Fund-supported adjustment programs. This discussion is all the more timely in view of the fact that the general pattern in the staff's policy recommendations has been to advocate frequent use of the exchange rate instrument to effect external adjustment and achieve balance of payments viability in the medium term. The emergence of such a pattern, and the lack of tangible results by many countries that use this instrument, have prompted some Executive

Directors to question the appropriateness of a continued use of the exchange rate in these cases. I should hasten to add that the authorities of many developing countries have in the past voiced such a concern, and the outcome of this seminar will be of interest to them.

As pointed out in the main paper, in a small open economy, the exchange rate performs a dual role--it helps to achieve and maintain international competitiveness, and serves as an anchor for the domestic price level, thereby ensuring overall macro-economic stability. The question is, which one of these two roles should have precedence given the specific circumstances of the economy undergoing an adjustment process. I would agree that the answer to this question is not straightforward, and that one needs to take into account various factors and to strike an appropriate balance between the two objectives. Nevertheless, it should be noted that from recent experience, Fund policy advice on exchange rate management has tilted toward too much flexibility, entailing repeated and frequent adjustments to the exchange rate, thus calling into question the importance accorded in these programs to the achievement of macroeconomic stability. In this respect, it would have been revealing had the excellent and well-documented background paper attempted to assess the rationale and the appropriateness of staff recommendations on exchange rate management in individual country cases--in particular, the actual costs in terms of a higher inflation rate and macroeconomic instability which these frequent adjustments to the exchange rate may have entailed.

One conclusion to be drawn from the paper is that it is not an easy task to determine an optimal exchange rate regime, be it fixed or flexible, for a small open economy. I cannot but agree with the staff that the analytical arguments presented in the paper do not support uniform policy prescriptions for exchange rate management. Indeed, as was made clear during our last seminar on the CFA franc arrangements, what matters most is not the exchange rate regime adopted by a country, but ultimately the quality of the financial policies that the country concerned commits itself to implement in order to firmly support the chosen exchange rate regime. This view is reinforced by the many case experiences of countries which adopted an active exchange rate policy, yet did not make much progress toward external adjustment, and in which medium-term balance of payments viability seems to be even further away. Instead, these countries experienced hyperinflation and macroeconomic instability because of the poor quality of the supporting financial policies implemented. Conversely, there are countries that have pegged their exchange rates, but failed to maintain the financial discipline that a fixed exchange rate regime is supposed to impose. These examples underscore the critical importance of economic fundamentals to the credibility and viability of a chosen exchange rate regime.

Another conclusion that emerges from the paper is that while a commitment to manage the exchange rate flexibly may provide helpful assurances to producers of tradeables (thereby supporting external adjustment) it may undermine the credibility of the government in adopting restrictive demand policies and, thus, make it more difficult to lower inflation without imposing an output cost. In the same vein, it is further stated in the paper that the pursuit of real exchange rate rules could involve a risk of inflation and macroeconomic instability. From this conclusion, one should expect that at the operational level, the staff would put more emphasis on the role of the exchange rate as an anchor for the domestic price level and macroeconomic stability in its policy recommendations to member countries. Macroeconomic stability is all the more important as developing countries strive to attract much needed nondebt creating capital inflows to finance their economic development. In this connection, I was encouraged to read from the conclusions of the staff paper that it seems desirable to retain a role for the exchange rate as a nominal anchor for the domestic price level, by requiring that at least some of the burden of adjustment in the real exchange rate be borne by changes in the domestic price level brought about through restrictive financial policies, rather than by automatic adjustments in the nominal exchange rate. I would urge the staff to translate this fine concluding statement into practical advice at the operational level in their policy recommendations to member countries. It is, therefore, encouraging to note from Mr. Landau's statement that there has been some move in that direction as evidenced in the programs for some Eastern European countries.

Turning to the issue of exchange rate management after the level of external competitiveness has been corrected at the outset of the program, I am of the view that the staff's preceding observation fits well with such a situation. Once external competitiveness has been corrected at the inception of the program, it is of paramount importance that the authorities commit themselves to implementing credible financial policies supplemented by structural reforms to remove rigidities in order to maintain the exchange rate as a nominal anchor, hence avoiding further exchange rate adjustments. It can be argued that maintaining a fixed exchange rate in the face of adverse external shocks would lead to a loss of output in the short term. But I submit that the financial stability resulting from such a policy stance, and the removal of rigidities brought about by the implementation of the structural reforms, would lessen the impact of output loss in the short term, and lead to higher output growth in the long run.

We should keep in mind that the exchange rate is a unique instrument which, if not properly used, can have destabilizing effects on the economy. Therefore, Fund advice in this area should put greater emphasis on the implementation of prudent fiscal and monetary policies and structural reforms, and promote more the role of the exchange rate as a nominal anchor for price stability. Here, I would like to associate myself with Mr. Posthumus's conclusion in his statement.

The Executive Directors agreed to continue their discussion in the afternoon.

LEO VAN HOUTVEN
Secretary