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

Executive Directors	Alternate Executive Directors
M. Al-Jasser	
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	A. Gronn, Temporary
	H.-J. Scheid, Temporary
J. E. Ismael	
A. Kafka	
J.-P. Landau	J.-F. Cirelli
A. Mirakhor	
	L. J. Mwananshiku
	P. Wright
G. A. Posthumus	G. P. J. Hogeweg
	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. E. Cronquist, M. E. Edo, M. Katz. Asian Department: P. Gotur, S. M. Schadler. Exchange and Trade Relations Department: J. T. Boorman, Director; T. Leddy, Deputy Director; A. Basu, D. Burton, B. de Schaetzen, M. G. Gilman, M. Precious. External Relations Department: S. W. Kane. Fiscal Affairs Department: H. R. Lorie. IMF Institute: O. B. Makalou. 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, P. Wickham. Secretary's Department: A. Tahari. Western Hemisphere Department: P. J. Quirk. Bureau of Statistics: J. B. McLenaghan, Director; V. Galbis. Personal Assistant to the Managing Director: B. P. A. Andrews. Advisors to Executive Directors: J. O. Aderibigbe, L. F. Breuer, J.-L. Menda, A. Napky, Y. Patel, A. Raza, H.-J. Scheid. Assistants to Executive Directors: H. S. Binay, G. Bindley-Taylor, N. A. Espenilla, M. A. Ghavam, J. Gold, O. A. Himani, K. Ichikawa, M. E. F. Jones, R. Meron, F. Moss, S. Rouai, N. Sulaiman, Tin Win, Wang J., J. C. Westerweel.

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

The Executive Directors continued from the previous meeting (Seminar 90/7, 11/21/90) their consideration of 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. Spencer made the following statement:

I will direct my comments mainly to the paper on analytical issues, but I have a few comments on the review of Fund advice.

First, the fact that the Fund has been more critical of pegged rather than flexible exchange rate arrangements is perhaps understandable, given the Fund's necessary concern with external adjustment, and the propensity of many countries to maintain fixed exchange rates in the face of lax domestic financial policies. However, it does appear that, in continually stressing the correction of external imbalances, the Fund has neglected to fully articulate the arguments in favor of pegging--or at least a less flexible approach to exchange rate management. Indeed, I would agree with Mr. Posthumus's comment that, even in today's analytical paper, little attention is given to some important arguments in favor of a peg.

Second, I agree with the comments made by many speakers this morning regarding the common Fund practice of recommending real exchange rate targets. There is nothing wrong with trying to estimate an equilibrium real exchange rate to get a feel for the extent of disequilibrium involved. But clearly, these calculations are very rough approximations and, therefore, there is a relatively lower probability that the estimated equilibrium will be near the actual equilibrium, with the result that an unstable situation could be set up--either inflationary, if the estimate is below the actual, or recessionary, if the estimate is above the actual. So this point clearly has very important implications for future Fund-supported programs and policy advice.

Finally, I endorse the call in the paper on the Article IV consultations for greater clarity and consistency in staff recommendations on exchange rate policy. In this regard, I feel that there is a need for a more clearly specified analytic framework that can be applied across a wide range of country cases.

This brings me to the paper on analytical issues. I have comments here both on the general structure of the paper, and on particular aspects of its substance. Overall, I found this a very useful paper. It covers a wide range of relevant issues, and I must say that I agree with most of what it says. However, I feel that the paper does not go far enough to achieve its aim of providing an analytical basis for the formulation of Fund advice on exchange rate policy.

As we heard repeatedly this morning, the optimum exchange rate policy will differ between country cases depending on the mix of economic objectives, shocks, and the market characteristics in each country. But there are many principles touched on throughout the paper which I am sure, with a bit more work, could be brought together to form a useful set of guidelines for Fund policy advice.

One possible approach would be to develop some form of checklist that could be used to recommend a more or less flexible exchange rate regime, depending on the objectives and economic characteristics of individual countries. Relevant items on the checklist would be those discussed throughout the paper, including aspects of capital and labor market flexibility, the concentration of trade, the form of shocks hitting an economy, and the availability of alternative nominal anchors. As brought out in Mr. Yamazaki's comments this morning, these characteristics--such as real wage flexibility--can be assessed at least qualitatively, and potentially also quantitatively across the range of country cases.

This proposal for a checklist approach is similar to that put forward by Mr. de Groote for a categorization of optimal exchange rate policy by broad country grouping.

Both approaches would also be relevant for Fund policy recommendations on broader market liberalization issues as well as exchange rate policy. The policy guidelines would, for example, help to highlight the effects of wage deindexation, or the removal of capital controls, on stabilization and adjustment objectives under alternative exchange rate arrangements.

Turning to the substance of the exchange rate policy discussion, I would like to comment on two important aspects of the paper which gave me some concern. My first concern relates to the tendency in the paper for the exchange rate to be viewed as an additional policy instrument that can be used to achieve relative price adjustments. While it is certainly true that exchange rate flexibility gives an extra degree of freedom to policy in the short term, I feel that the paper should more clearly acknowledge the inability of the nominal exchange rate to achieve permanent relative price movements. In the long run, of course, the exchange rate must be driven by monetary policy, even when domestic capital markets are insulated by exchange controls.

The paper does recognize, however, the potential credibility problems that may arise through overly active use of the short-term nominal exchange rate instrument. As emphasized by other speakers, the potential risks here relate to the discipline of wage setting behavior as well as the discipline of a medium-term approach to monetary policy.

My second concern in the analytical paper was its tendency to draw a dichotomy between financial stability under a fixed regime and external adjustment under a flexible regime. In discussing the achievement of financial discipline, for example, the paper suggests an inverse relationship, or tradeoff, between exchange rate adjustment and a firm financial policy. It neglects the fact that, in many country cases, a flexible exchange rate policy may be the best way of achieving financial stability. This will tend to be the case, for example, when the variance of domestic monetary shocks is relatively small compared with the variance of external terms of trade shocks. This is a situation not uncommon in many small and developing countries.

This result may not appear very relevant in cases in which there is a large initial overvaluation. But it is certainly relevant when considering the most appropriate ongoing exchange rate regime, once any initial overvaluation has been corrected.

On the other side of the coin, in the discussion on external adjustment, I feel that there is a similar gap in the analysis related to real exchange rate adjustment under a fixed nominal regime. In some of the cases of extreme overvaluation confronted by the Fund, I agree with the paper and other speakers that it will often be necessary to implement some nominal depreciation to bring the real exchange rate into the right general area. But in a situation in which domestic financial policies have been brought under control, it needs to be recognized that significant ongoing real exchange rate adjustments can and do take place under fixed nominal regimes.

What is more important, the paper needs to discuss more fully the circumstances under which external balance may be facilitated under a fixed regime. This brings me back again to my earlier comment regarding the need for a general set of guidelines that can help to identify the exchange rate regime most suited to achieving external balance and financial stability in any given country case.

In conclusion, I would like to encourage the staff to pursue this work further. I am sure that most of the ingredients are already there. The challenge remains, however, to construct a user-friendly framework that can help to maintain consistency in Fund policy advice, while allowing flexibility to meet individual country circumstances.

Mr. Gronn made the following statement:

The Nordic countries appreciate the staff documents that provide the basis for this seminar on the Fund's advice on exchange rate policy. Generally, we share the staff conclusions as summarized on page 35 of the theoretical paper, and I would particularly like to emphasize the merits of using the exchange rate as a nominal anchor. Therefore, in my statement today, I would just like to present some points of view that go somewhat further than the more general support for the staff conclusions.

This chair endorses the view that the role of the Fund's surveillance should be strengthened through more frequent discussions on exchange rate systems--for example, the recent Board discussion on the CFA franc zone. We would also like to see a less restricted analysis of exchange rate policies in the country documents prepared by the staff, including more explicit discussions of the advantages and disadvantages of flexible as opposed to fixed exchange rate regimes in particular situations.

The surveillance task of the Fund provides the staff and the Board with an opportunity to put forward recommendations on member countries' exchange rate policies and on other relevant policies. Advice regarding necessary corrections in economic policies, including exchange rate policies, should be formulated within the context of an assessment of the whole range of economic policy instruments. In forwarding its recommendations, care should be taken by the staff to ensure that the possible policy changes do not generate problems for other countries. This is partly also in concurrence with what others have said about systemic policy changes in larger countries.

Regardless of the regime adopted in an adjustment program, the exchange rate must be set at a realistic level. If the exchange rate remains at an unsustainable or incorrect level for a long period of time, it will create a huge problem not only for the external balance, but also for the economy as a whole. Therefore, it would be helpful if there could be some form of transparency as regards the estimation of the equilibrium exchange rate; by this, I mean that we should have a clear idea of the factors that influence the exchange rate in each specific case.

For those countries with the worst track record for implementing adjustment programs, it is, in practice, difficult to find an alternative to current Fund recommendations. A less flexible exchange rate would, through a rapid real appreciation of the exchange rate, further worsen the external balance, which, in turn, would run counter to the main objective of the Fund, which is, of course, to assist member countries to achieve a sustainable development in their external accounts over the medium term.

We believe that the Fund should increasingly consider recommending that other countries which have been more successful in the adjustment process move to a more stable exchange rate regime, if necessary with certain limits within which the rate can fluctuate. This should be possible, as these countries enjoy a growing confidence in their willingness and ability to implement appropriate adjustment measures. In such cases, a firmer exchange rate could contribute to increased discipline in economic policymaking.

Technically, a move to a more stable foreign exchange regime could be accomplished in many ways. For example, central banks could be given--when institutional arrangements make this possible--a greater role in the decisionmaking process with regard to the setting of exchange rates. Another way, which, from the Fund's point of view, would be preferable, would be to develop a general practice under which the country in question would voluntarily consult with the Fund before implementing an exchange rate adjustment. I hope that such a practice could emerge in the not-too-distant future, even though it may sound unrealistic at this time.

Mr. Torres made the following statement:

I would like to express my appreciation for the staff's excellent job in preparing the two papers we are discussing today. They are very useful for clarifying the rationale and practice of the Fund's advice on exchange rate policies, and I fully subscribe to the main conclusions. In particular, I welcome the new proposals to broaden the coverage of future Fund assessments of exchange rate policies, which I strongly support. In my remarks, I will concentrate on the relationship between exchange rates, external adjustment and financial discipline, and I will include three suggestions for marginal changes in the emphasis of policy advice, and a conclusion.

In its policy advice, the Fund should first avoid doing the right thing but for the wrong reasons. The papers emphasize the role of exchange rates in maintaining and/or improving a sustainable balance of payments position and external competitiveness.

The nominal exchange rate will not affect any of the underlying real variables which are the main determinants of the long-run external constraint, that is, the sustainability of the current account balance. I am also inclined to include external competitiveness under the same statement. It is very unlikely that a country can maintain or achieve lasting improvements in external competitiveness through manipulation of the nominal exchange rate.

However, in our present world--far from a Walrasian world--governments also have good reasons to care about the short-run evolution of the current account and external competitiveness and, for these reasons, to consider the manipulation of the exchange rate.

Nevertheless, notwithstanding all the specific instances which may require a change in the exchange rate--and both papers are full of rich suggestions in this regard--we should not overemphasize the importance of the exchange rate as an instrument of external adjustment. In fact, the staff explicitly shares this view, and says that firm monetary and fiscal policies and appropriate structural reforms are no doubt much more important, although I am not sure at all if the practice in exchange rate policy Fund assessments has been strictly consistent with this view, given the emphasis already mentioned.

Second, in its policy advice, the Fund should not use the wrong reasons to do the wrong thing. A sustainable and credible exchange rate needs appropriate discipline in financial policies, regardless of the nature of the exchange rate regime in place. Policy discipline or policy credibility are not the natural attributes or the natural outcome of any exchange rate regime. Theoretical or empirical work does not allow us to draw conclusions of general applicability in this regard.

Hence, we should avoid introducing a dichotomy between flexible and fixed exchange rates. The exchange rate regime per se is neither a necessary nor a sufficient condition for an endorsement of a country's policies. There are good and bad flexible regimes, just as there are good and bad fixed regimes. I am glad to see that this dichotomy is not introduced in the Fund's assessments of exchange rate policies. However, such assessments have tended to rely on explicit or implicit rules to guide policy, and in particular on those implying potential negative effects on price stability through the accommodation of price disturbances, even if these rules are combined with strict financial policies to contain this potential danger.

I am inclined to think that we should not have rules for exchange rate rules. Otherwise, we should reformulate the rule, in the sense of stressing the need to maintain external competitiveness by adjusting the domestic inflation rate, coupled with a realistic and stable nominal exchange rate. In fact, this means emphasizing the role of the exchange rate as a nominal anchor.

There are good reasons to do the right thing. I would suggest paying relatively less attention to the nominal exchange rate, and concentrating on the important things. Balance of payments sustainability and the relative success of an adjustment program depend on whether or not there exists financial discipline, appropriate structural reforms, and exchange rate stability, regardless of the exchange rate regime.

My view is quite pragmatic: instead of emphasizing greater flexibility in the conduct of exchange rate policies, I emphasize the need for exchange rate stability, coupled with exchange rate action when judged as necessary. That is the only way reasonably to address the challenges of the unbearable lightness of the equilibrium exchange rate.

Mr. Mwananshiku made the following statement:

Let me also join other Directors in thanking the staff for producing these two papers. They give us an opportunity to review this very important matter. Issues on exchange rate policy have assumed increased significance in the adjustment process of most developing countries, particularly those experiencing severe external and domestic financial imbalances, as Fund missions to these countries put ever increasing emphasis on real exchange rate depreciation to correct these imbalances and enhance international competitiveness. Indeed, the real effective exchange rate is usually targeted as a program variable in most arrangements supported by the use of Fund resources. The establishment of an equilibrium rate of exchange for this purpose has, however, been an arduous task. Often, there is the risk of equating the clearing rate with the parallel market rate without giving due regard to the premium built into such rates for various reasons. Thus, the required degree of currency depreciation to restore balance of payments equilibrium and external competitiveness has often been difficult to determine, resulting in bouts of successive depreciation and the misgiving that the Fund is biased toward devaluation without taking into account the implications for inflation, investments, and capital flight.

It is true that the trend of exchange rate policy in developing countries has been toward more flexible arrangements resulting in frequent and substantial nominal devaluations. In the majority of such cases, however, this has been at the insistence of the Fund, particularly where an arrangement is being put in place. It has also reflected the instability of the major currencies. Against this background, we view today's discussion of the papers as a useful framework for assessing the Fund's advice on exchange rate issues in developing countries. The staff's review of exchange rate policy assessment in the background paper on the Fund's experience under Article IV consultations provides a useful backdrop to the theoretical analysis, but it would have been more helpful to evaluate the extent to which past exchange rate devaluation in these countries had succeeded in accomplishing the desired objectives.

In a sound theoretical framework, the staff has succinctly articulated the benefits and drawbacks of a flexible exchange rate system vis-à-vis a fixed exchange rate regime. One important conclusion that has emerged from this analysis is that the type of exchange rate regime appropriate for a country would depend critically on the stage of structural and institutional developments in the economy. There have been persuasive arguments for exchange rate flexibility in the highly diversified industrial economies. However, the weight of such arguments may be considerably weakened for developing countries when viewed against the background of their economic characteristics and institutional rigidities, which render their economies highly vulnerable to external shocks, and less responsive to exchange rate adjustments. Notably, production patterns in these countries concentrate on the primary sector based on a few major commodities, the price elasticity of demand for imports and the supply of exports--at least in the short run--is low, while capital flows are generally influenced by factors other than yield considerations.

Even for industrial economies, frequent exchange rate movements are coming under question. Recently, emphasis is being placed on using the exchange rate more as an anchor for price stability. That argument would be seen to be an attractive consideration for developing countries also. Thus, we would have liked to see a more detailed analysis of this issue in the staff paper.

On balance, it is likely that, given the structure of the developing economies, the real exchange rate rule, which is often suggested by the staff, leaves much to be desired. It is significant to recognize that the effectiveness of flexible exchange rate policy to achieve balance of payments viability at a low inflation rate, observed in the newly industrialized countries of Asia, has been facilitated by the high level of industrial development and the efficiency of institutional facilities in those economies. For most countries in sub-Saharan Africa, the pursuit of an active flexible exchange rate policy has resulted in a significant depreciation of the real exchange rate, with little improvement in the external position. Not only might depreciation not necessarily lead to increased output, but even if this were to occur, the protracted deterioration in the terms of trade could erode the benefits. It would have been useful had the staff paper more fully explored the consequences of the terms of trade shock for developing countries, and the difficulties it creates for economic management in general, and financial adjustment, in particular.

With regard to the choice of appropriate exchange rate regimes for these countries, a fixed exchange rate policy would not automatically guarantee the achievement of the low inflation objective and external sector viability. Experience shows that such a policy would not, in and of itself, impose financial discipline. The important point is that the burden of external adjustment should not be left to exchange rate policy alone. Regardless of the exchange rate regime pursued, maintenance of monetary and fiscal discipline, as well as appropriate structural policies, are critical for the achievement of a sustainable improvement of the external sector position.

Let me turn briefly to the issue of using the parallel market rate as the reference for the degree of devaluation needed. We have seen that theoretically, this carries the potential of creating an inflationary spiral in developing countries. I have already noted that considering the parallel rate as the equilibrium rate could be misleading and should not be encouraged. This is the experience in sub-Saharan countries.

Finally, adjustment efforts are not always likely to bring about the intended result if the external environment remains highly unfavorable, as in the case of most African countries. In this regard, exchange rate stability in the major industrial countries is important, and remains a matter for the Fund's surveillance responsibility, because of its impact on the economies of developing countries.

Mr. Mirakhor made the following statement:

This chair welcomes the opportunity to participate in the discussion of issues related to the Fund's advice to developing countries on exchange rate policies. The two papers before us are important contributions to this discussion. The main theoretical paper contains a number of provocative suggestions, thus addressing--at least partially--one of the concerns of our distinguished Dean about this institution, which demonstrates that intellectual courage is alive in the Fund and, when encouraged, will be thriving.

The excellent interventions by my colleagues this morning and this afternoon allow me to dispense with much of my comments to address some remaining issues which are of vital, and in some cases, of immediate concern to our constituency. If an update of the paper is contemplated, fuller attention to these issues would be very useful.

There is an apparent discordance between the position of the theoretical paper on real exchange rate rules, and the fact that 15 out of 23 flexible exchange rate arrangements in countries with Fund-supported programs in 1988/89 involved explicit real exchange rate rules. If the pursuit of real exchange rate targets could involve a risk of inflation and macroeconomic instability, as the staff correctly points out, then it is important that the current Fund advice to developing countries take due note of this conclusion. In this connection, we do appreciate the staff's assertion regarding the difficulties of applying the results of the theoretical literature to typically high-inflation developing countries with chronic balance of payments problems. But the Fund has the responsibility and the research intellectual capital to address this issue, and we hope that it does so in the near future.

The discussion of various approaches to the determination of equilibrium exchange rates is limited mostly to the discussion of real exchange rates based on either purchasing power parity or relative price of tradeables and nontradeables. The discussion of other approaches, such as the domestic resource costs of tradeables, or developments in parallel exchange markets, would have been very useful. The latter is particularly important since in developing countries, especially those with multiple exchange rates, exchange rate adjustment is considered with an eye toward the parallel market rate as a signal for a possible target.

The discussion of the relationship between openness and the choice of the exchange rate regime, on the one hand, and between openness and the effectiveness of an exchange rate adjustment in stabilizing output, on the other hand, could have received more detailed and unambiguous attention. For example, it is not at all clear that openness does not affect the choice of the exchange rate regime. It does, as the paper points out, but there are conflicting considerations. A discussion of these considerations would have been helpful. Also, there are reasons to believe that openness may not increase the effectiveness of an exchange rate adjustment's impact on output. For instance, the more open the economy, the less likely that there will be money illusion, or that workers will agree to a reduction in their pay in domestic currency terms. When money illusion declines and domestic residents get into the habit of calculating the impact on real variables of changes in the exchange rate, there will also be a decline in the effect on domestic output or other important variables of a given change in the exchange rate.

The paper notes that for countries for which the balance of payments is a binding constraint, their exchange rate policy needs to be aimed at protecting external competitiveness. But it is not clear in what context the balance of payments could become a binding constraint. And is one to assume that in such a context other policy instruments are exogenously fixed, because the balance of payments position of a country is very much dependent on the fiscal, monetary, and other structural policies?

The suggestion is made that in a country with a well-established reputation for financial discipline, it is of small consequence whether a pegged or a flexible exchange rate regime is maintained. This point does not seem to be consistent with earlier remarks that it is not an easy task to determine whether a country is better off with a fixed or a flexible exchange rate system, and that the optimal management of the exchange rate will depend on policymakers' economic objective, the source of shocks to the economy, and the structural characteristics of that economy. In particular, the degree of factor mobility and the openness of the economy are important characteristics that make it more or less desirable for countries to have a flexible exchange rate. For example, the greater the extent to which domestic consumers buy mostly foreign goods, the stronger will be their preferences for holding assets and doing the accounting in terms of foreign goods, unless domestic money is more stable in relation to the consumption basket via fixed exchange rates.

Another provocative suggestion of the paper is that it might be preferable to have a single currency peg rather than a basket peg. A fuller discussion of the issue of the optimal weighting of a currency basket in general, and the circumstances under which it would be optimal to assign a unitary weight to the one currency and zero weight to all others, would have been helpful, especially since a number of developing countries abandoned single currency pegs because of the costs of fixing to a single currency.

The paper suggests that one arrangement for establishing the credibility of the government's commitment to financial discipline is to grant considerable autonomy to a central bank which has a reputation for having a strong bias in favor of price stability and fixed exchange rates. Knowing the reluctance of the finance ministries to be constrained by central banks, it would have been helpful if some use were made of public choice theory to explain how the institutional setup might pose a constraint to the implementation of this very important idea.

In conclusion, we would like to thank the staff for this most provocative paper, which can be of great usefulness to the policymakers in the developing countries.

Mr. Ahmed made the following statement:

It is frequently difficult to make generalizations, and this is particularly true of exchange rate policy. Each exchange rate regime has its own merits as well as its shortcomings. The particular circumstances of countries are an important factor in the choice of an exchange rate regime. But our ability to judge any particular arrangement is also hampered by our limited knowledge of transmission mechanisms, and expectations, to name two of several areas.

Throughout many recent discussions on exchange rate policy, a recurrent theme has been that it is domestic financial policies that determine the success of any exchange rate arrangement. The staff indeed points to this issue, by noting that it is of small consequence whether a pegged or flexible exchange rate regime is maintained in a country with a well-established reputation for financial discipline. We share this view.

I do not intend to engage in an analytical discussion of the merits of each exchange rate system. As I stated earlier, each system has its own merits and shortcomings, and it is difficult to reach conclusive judgments on the issues. I will focus my remarks instead on Fund advice on exchange rate policy, particularly in the context of Fund arrangements.

I would agree with the staff that in most cases of countries undertaking Fund-supported programs, there is a need to strike an appropriate balance between restrictive financial policies and exchange rate adjustment. This, of course, is a question of striking the right balance between external and domestic objectives. *What is crucially important here is that the staff* and the authorities are able to agree on the relative priority to be attached to each of these objectives. Presumably, programs supported by the Fund are the product of a common view between the authorities and the staff about economic targets and policies. But I am not sure that it is always the case that negotiated programs are always based on a clear understanding of the priorities attached to various domestic and external objectives.

In addition to the difficulties in reaching a balance between domestic and external objectives, it is sometimes even more difficult to establish the necessary credibility of the policies that must follow an exchange rate adjustment. Establishment of credibility is a process that requires time. The most appropriate sequence may not always be a substantial exchange rate action from the outset, followed by financial tightening. Sometimes one gets the impression that exchange rate action is required at the outset simply because it is a tangible one-step measure which is perceived as a symbol of the authorities' commitment.

In cases in which domestic financial policies have not been very successful, exchange rate action may in fact prove highly detrimental. Depending, of course, on the structure of the economy, a devaluation could lead to an inflationary cycle that would only compound existing problems. In particular--as many have said this morning--rigid adherence to real exchange rate targets can be seriously destabilizing and lead to hyperinflation.

It is important to recall that one of the principles for the establishment of this institution is that members avoid competitive devaluations. This issue must always be borne in mind when prescribing exchange rate action, so as to avoid the dangers of overdevaluation.

Finally, there would seem to be some scope for improvement in the treatment of such issues in future Article IV consultations. Specifically, we would like to see the staff address the issue of the appropriateness of exchange rate policy with more analysis and more explicit justification for its views. The staff's advice must be supported by a clear justification of the exchange rate policy being proposed, while being careful to integrate it with all the various elements which bear on the issue, and indicating the extent to which alternative adjustment measures have been considered. Within the framework of such an approach, there would appear to be the need for addressing more directly issues such as the potential role and advantages of using the exchange rate as a nominal anchor for financial stability; and, especially for countries with flexible exchange rate arrangements, a more careful analysis of the relationship between exchange rate policy and the path of inflation. Furthermore, it is equally important for the Board to be able to see a more explicit presentation of the point of view of the authorities regarding the policy prescription under Fund arrangements, a view which is sometimes obscured by the agreement.

Mr. Posthumus stated that he would like to support what Mr. Grosche had said about the economic literature to which the staff had referred for their papers. He had been struck by the fact that much research which had been done in Europe--especially in relation to the European Monetary System and its predecessors--had not been consulted by the staff. Many of the issues for discussion had been experienced first-hand in Europe. It might therefore have been appropriate for the staff to investigate more thoroughly the European literature, and perhaps to consult with the European authorities as well on those issues.

There was clearly no agreement in the Board as to what sort of exchange rate regime was most appropriate for either developed or developing countries, Mr. Posthumus observed. Nevertheless, if it were agreed that strict monetary policies and more or less strict fiscal policies were universally applicable, then there could no longer be much of a divergence of opinion as to what would be the most suitable exchange rate policy, in his view--namely, a stable, or at least more stable, exchange rate regime.

He recalled that Mr. Arora had remarked that the social consequences of adjustment could better be taken into account under a flexible exchange rate policy than under a fixed exchange rate policy, Mr. Posthumus continued. However, if it were true that a flexible exchange rate policy very often supported, or even stimulated, inflation, and taking the social consequences of inflation into account, then the social consequences of a flexible policy could not be said to be better than the social consequences of a more stable policy.

Unlike Mr. Dawson, he did not believe that balancing the desire for maintaining external competitiveness against the desire for using the exchange rate as an anchor was the dilemma that faced policymakers, Mr. Posthumus concluded. Rather, using the exchange rate as an anchor was intended to contribute to maintaining competitiveness, but through the use of instruments other than the exchange rate.

Mr. Arora commented that the issue of the Fund's exchange rate advice in Article IV consultations had been a very difficult one in the past. More recently, the staff had managed to remove some of the controversy from it, so that members no longer lived in fear over the Fund's advice. In his view, therefore, it would be a mistake to reactivate the controversy in future reports on Article IV consultations, especially at the current crucial juncture of the external environment. The discussion on exchange rate policy was always a sensitive one between the staff and the authorities, and room for maneuver in those discussions should be retained, without explicitly giving reasons for the advice in the report on the discussions.

He agreed with Mr. Posthumus about the social consequences of inflation, Mr. Arora remarked. A noninflationary environment was essential for social justice. That notwithstanding, from the perspective of social dynamics, a fixed exchange rate left the authorities with no mobility whatsoever to safeguard employment. As the staff paper had pointed out, it was important to maintain the right balance between restrictive financial policy and exchange rate policy, so that part of the adjustment was borne by the exchange rate policy.

Mr. Al-Jasser observed that the staff papers had not analyzed extensively the impact of the exchange rate policies of the major countries on either the choice, or the appropriateness, of exchange rate regime in other countries, and in developing countries, in particular. He believed that the policies of the major countries might have a critical impact on the appropriateness of exchange rate policies in general. It might be interesting to examine those issues, because sometimes the policies of major countries might have a greater impact on one country than another, and varying effects on the domestic policies of developing countries.

The Chairman commented that the Board would have the opportunity to explore those issues during its discussion of a forthcoming staff paper on implications of a tripolar international monetary system. Also, the Board had covered similar issues in its bimonthly discussions, in informal sessions, of recent exchange rate developments. He could not overemphasize the importance he attached to those discussions in providing feedback to industrial countries on the effects of their policies on other countries.

Mr. Al-Jasser said that he realized that the Board examined the exchange rate policies of industrial countries in some detail at bimonthly intervals. He was most concerned about exchange rate policies in the context of some of the smaller economies, however. For example, sometimes either a fixed or flexible exchange rate might appear inappropriate for such an economy because of a recent change in its trade flows, where the traditional trading partners may have changed. The major currency to which the country's currency was linked or pegged may not be the one in which most of the country's trade was actually conducted. There were also cases of some primary commodity exporting countries, for which the exchange rate might almost be considered as an exogenous variable, in that almost all the trade was determined on the basis of another currency. It was important that the staff take such factors into account in its discussions with those countries.

The staff representative from the Research Department stated that many Directors had commented on the application of the various criteria developed in the context of optimal currency theory, and some had asked that these criteria be applied in the formulation of exchange rate policy in specific cases. As had been noted in the paper, the choice of exchange rate regime in specific cases was dictated by three broad criteria: objectives; the nature of shocks; and the characteristics of the economy.

The objectives themselves were not fixed, even for a given country, the staff representative continued. The relative emphasis that would be placed on inflation, on output, or on the balance of payments would depend critically on the initial conditions of the country. To recast some of the debate in that framework, it would be instructive to consider how a country should react to an external terms of trade shock. There would doubtless be differences of view as to the appropriate response, depending on the judgment of how much emphasis should be placed on various objectives, such as price stability, output, the balance of payments, and the complicated relationship between them. Mr. Posthumus did not see much room for the exchange rate as an instrument in that regard, even in the event of a severe external terms of trade shock, and instead he would choose to place a great deal of emphasis on price stability. There could not be much disagreement that in such an event, relative prices in the economy would have to adjust, so that the ratio of the price of traded goods relative to nontraded goods must rise. The question was how to bring that about. Devaluation would raise the ratio by raising the price of traded goods, with inevitable consequences on the rate of inflation, which was undesirable. The alternative would be to operate on the denominator of that ratio, and reduce the price of nontraded goods through restrictive fiscal and credit policy. In a frictionless world, that was quite possible, but in a world of severe wage and price rigidity, there could be a substantial cost in terms of output and employment. As Mr. de Groote had pointed out, it might be possible in certain cases to reach a social consensus in the process of adjustment to reduce such wage rigidities, and in those cases, restrictive fiscal and monetary policies could well be effective in re-establishing equilibrium. However, if there was a concern about the output impact arising from those wage and price rigidities--as Mr. Arora had pointed out--then less emphasis should be placed on maintaining a fixed exchange rate.

The positions of other Directors on those issues fell somewhere in between, the staff representative remarked. Even where it was perceived that the exchange rate played an important role as an anchor, it was also accepted that under certain circumstances, it might be too costly to support the exchange rate and not use that instrument, and to rely instead on fiscal and credit policy to shoulder the total burden of adjustment in a given economy. All of those options would have to be considered in specific cases.

The criteria which he had just discussed had been developed mainly in the context of the industrial countries, where the economy in question was in broad macroeconomic equilibrium to begin with, affected subsequently by a shock, the staff representative pointed out. To complicate the situation--a complication which might be relevant to many developing countries--it might be assumed instead that some disequilibrium was present at the start. The juxtaposition of the configuration of the various objectives, the initial conditions, the various external shocks affecting the economy, the characteristics of the economy, and the nature of the disequilibrium in specific cases then could be seen to be extraordinarily complicated. In that light, it seemed impossible to develop specific guidelines--let alone user friendly ones--to be applied for determining an appropriate exchange rate regime.

There appeared to be no disagreement about the need for an initial adjustment of the exchange rate when there was evidence to support a judgment that it was far out of alignment, notwithstanding the difficulties of estimating what the equilibrium exchange rate might be, the staff representative remarked. It also seemed to have been generally agreed that such an adjustment should be followed by financial discipline. The question then arose as to whether the exchange rate should be used as an anchor, or whether a more flexible arrangement should be adopted, following the initial devaluation. It was in that context that some differences of view between speakers might be seen with respect to the proper course of action in specific cases. Nevertheless, there appeared to be broad agreement on the general issue, namely, that notwithstanding the exchange rate strategy followed, a program lacking financial discipline would clearly be unsuccessful; even if an adjustment of the exchange rate would eliminate the external problems, there would still be severe domestic problems to contend with. Also, it seemed to be agreed that the use of a fixed exchange rate as an anchor for restrictive fiscal and monetary policies by a country with a history of expansionary financial policy could effectively reinforce those restrictive policies.

Recourse to the inflation tax could not be ruled out in all cases, the staff representative commented. Although he agreed with Mr. Grosche that the staff should not encourage countries to rely on such a tax, it would not be realistic to insist on absolute price stability in every program, and in some cases some recourse to the inflation tax had had to be incorporated in the program. The best strategy under those circumstances would appear to be some nominal exchange rate crawl--as opposed to a real exchange rate crawl. There had been strong support for the view that it would be problematic to attempt to fix the real exchange rate. If some inflation was expected, a certain rate of depreciation could be anticipated during the period of adjustment, but any inflation above the programmed rate should not be accommodated through exchange rate adjustment; rather, financial policies should be tightened to reduce inflation.

With respect to the question of the relationship between structural policies and the exchange rate, it might be observed that to the extent that the exchange rate was instrumental in effecting the allocation of resources between traded and nontraded goods, it could itself be considered as a structural policy, the staff representative observed. It also played an important role in providing a stable financial environment and establishing appropriate relative prices--important conditions for the success of any other structural reform, such as financial and tax reforms, for example.

In recent programs, the exchange rate had played a role as a nominal anchor in Brazil, Argentina, Mexico, Israel, and, more recently, in the Eastern European countries, especially in Yugoslavia and Poland, the staff representative concluded. In the cases of Israel, Poland, Yugoslavia, and Mexico, there had been broad success in reducing the rate of inflation from very high levels, although in some of those cases there had been a resurgence of inflation subsequently.

Mr. Wright commented that it was true that if the authorities were not committed to policy stability, they would always be liable to circumvent, or ignore, whatever exchange rate regime was imposed on them, including a fixed, or stable, exchange rate regime. However, to the extent that a stable regime would create the expectation that the rate would remain stable notwithstanding the authorities' proclivities, it would, in itself, impose a sort of discipline on them. It would also make their lack of policy discipline more transparent.

It was also true that, from the practical point of view, it was impossible always to strive for a zero inflation rate in Fund-supported programs, Mr. Wright continued. That being said, as the staff representative from the Research Department had pointed out, a depreciation in the nominal exchange rate could be countenanced, provided that any inflation over and above the rate that had been programmed would not be accommodated by further nominal depreciation, but rather by domestic adjustment. However, by countenancing such a creeping depreciation, it would appear that a certain level of inflation would be built into the system. It was then a fine judgment indeed to determine the direction of causation, namely, whether the creeping depreciation and the countenanced amount of inflation were a recognition of reality under the program, or whether they had resulted from the program.

Mr. Posthumus commented that he had not argued for the immediate introduction, world wide, of a fixed exchange rate system. Indeed, it was important to bear in mind that a stable exchange rate system could only evolve over a long period of time. In the case of Europe, for example, stable exchange rates had evolved only after six or seven years. He would also agree that an adjustment of the exchange rate under certain circumstances would be unavoidable; but to say that after a situation of equilibrium had been reached, a flexible system would still be needed, appeared to beg the question of how to achieve equilibrium in the first place, which had been one of his prime concerns.

The Economic Counsellor and Director of the Research Department stated that the staff papers on the Fund's exchange rate advice needed to be considered in the context of broader issues in the international monetary system. Although exchange rate policy needed to be formulated in the context of domestic policymaking, its systemic implications should not be lost sight of. In that connection, Mr. Prader had drawn attention to the fact that the exchange rate policy decisions of one country might impose externalities on other countries. Reconciling the policy issues on the domestic front with those on the international, or systemic, front, was a clear priority, and it was in that area that the Fund could play a key coordinating role.

At the Board seminar on June 6, 1990 (Seminars 90/1 and 90/2, 6/6/90, and Seminar 90/3, 6/8/90) the staff paper on major issues in the evolving international monetary system and the characteristics of a successful exchange rate system had been discussed, and a key focus had been on the exchange rate policies of industrial countries, the Economic Counsellor recalled. A key issue in any future discussion would be the evolution of a tripolar international monetary system, and how exchange rate policies would be implemented in such a system. In particular, the choice of exchange rate arrangements among the major groups of industrial countries would affect the choices of the rest of the world--developing and industrial countries alike--and had first-order relevance to the decisions of the developing countries and general economic well-being. Mr. Yamazaki had emphasized that stability among the major currencies would provide the right environment for the developing countries to make the correct exchange rate and economic policy choices, and that a coordinated approach, not only within countries--between the fiscal and monetary authorities, for example--but also among countries and between the various international coordinating bodies, would be needed.

A number of speakers had noted that the choice of an exchange rate regime would not save the authorities from the effects of bad policies in general, the Economic Counsellor continued. Mr. Filosa had pointed out that no exchange rate regime could survive unless the appropriate supporting policies were also put in place. A general observation might be that there could be no blueprint for the choice and implementation of an exchange rate regime, and that the choice was necessarily to some extent pragmatic.

The tenor of the current discussion was clearly different from what might have been expected a few years previously, the Economic Counsellor remarked. In the past, it would have been said that one could sacrifice a bit more inflation in order to obtain a bit more growth, and that the implications of those tradeoffs needed to be considered. However, it was now clear that there were no such tradeoffs; rather, as Mr. Grosche had stated, there was a complementarity between price stability and good economic performance. The new area for debate was how such price stability could be generated, and the optimum time horizon for it. In that regard, the staff paper had attempted to make the argument that the best policies in the long run also took good care of the short run.

Neither the choice of an exchange rate regime nor the independence of the central bank would, either individually or both together, determine the authorities' credibility, which had been a key point in the discussion, the

Economic Counsellor pointed out. Rather, in the final analysis, credibility and a viable exchange rate regime were affected by political support and the sense that the authorities' policies were leading somewhere in the medium term, as Mr. Arora had indicated.

Another key issue was how to provide a discipline for policymaking, the Economic Counsellor went on. Although in many cases an exchange rate commitment would provide powerful discipline, it would not in all cases; and that reinforced the argument that there were no blueprints for exchange rate policy. Speakers had clearly viewed one policy discipline--real exchange rate targeting--as dangerous, especially for inflation. The concern over real exchange rate targeting did not imply, however, that no attention should be paid to competitiveness.

The real issue was that a broader arsenal of economic policy instruments should probably be employed in striving to generate competitiveness and price stability, the Economic Counsellor remarked. Perhaps Mr. Posthumus had made the point most eloquently in observing that exchange rate stability, in itself, contributed to maintaining competitiveness, by requiring the use of alternative policy instruments. In that connection, although the virtues of exchange rate stability were generally acknowledged, a debate continued to rage around what were the circumstances under which exchange rate stability could be viably and credibly sustained.

Many Fund-supported programs started out with very large disequilibria in the exchange rate, the Economic Counsellor noted. Once the decision was taken to address that problem, the two policy objectives were, first, to restore equilibrium, and second, to maintain it. In most cases, if the rate of exchange was seriously out of line, a devaluation would be called for. In devaluing, however, the authorities needed to be clear as to what their goals were, and to be assured of adequate political support for them. It was important that the authorities' intentions be transparent, and that the political consensus to support the devaluation existed, so as to ensure that the price increase caused by the one-time devaluation did not lead to an indexation-induced upward wage-price spiral. To sustain the equilibrium rate of exchange, perhaps a commitment should be made to use the exchange rate as an anchor, if the other supporting policies could be put in place. If the level of reserves was inadequate, another method would be needed to maintain equilibrium. Adequate financing at the beginning of a program was a prerequisite for the success of the exchange rate policy. If such financing was available, and if the program was sufficiently strong, that financing would be used in the optimum way--that is, it would not be used at all.

There were divergent views as to the extent of the required devaluation, the Economic Counsellor concluded. Mr. Posthumus, on one side, had said that the devaluation should be a bit less than what was on first sight warranted, in order to provide incentives to other policy instruments to bear the rest of the adjustment burden. But another view was that the devaluation should be more than what was warranted, so that the price increase that would inevitably follow the devaluation would not erode competitiveness completely, and the rate of exchange might be sustained a bit longer. The key determinant in that debate should be judgment as to what part of the economy was its Achilles' heel. For example, if competitiveness was weak, it would be wise not to erode it by underdevaluation; if inflation was high, it should not be exacerbated by overdevaluation. The desirability of a social safety net might have to be taken into account in the determination of the extent of the devaluation. The economy's Achilles' heel should also determine the choice of anchor for the economy, and the conditions under which it should be lifted. The Achilles' heel of the economy differed from country to country, and had to be examined on a case-by-case basis.

The *staff representative from the Exchange and Trade Relations* Department stated that Mr. Posthumus had noted that an improvement in one country's competitiveness was a deterioration in the competitiveness of its partners. However, in countries with domestic distortions in relative prices and rigidities--those generally in disequilibrium, not only in the sense that actual output was below potential, but also in that the structure of production itself was inward-oriented--potential traded goods were, in effect, nontradable, because of the distorted trade and exchange regimes. In such an environment, a comprehensive structural reform process with trade liberalization and supporting exchange rate adjustments could actually push out the production frontier, enlarging global supply and improving global welfare. In that process, devaluation would generally not cause inflation, given the higher cost efficiency of production that would result, and in fact an enlarged output would result from more exchange rate flexibility and trade liberalization. Such a process of reform could be started in a disequilibrium economy, with greater weight being put on output growth and efficiency to begin with.

In the transition from an economy with an overvalued currency and an unsustainable financial policy stance, to one with a competitive exchange rate and a sustainable financial policy stance, the necessary real exchange rate correction would not be achieved under certain circumstances, namely, when the recommended fiscal and monetary policy restraints had not been put in place, the staff representative went on. Thus, at the time of the review of a program, the real correction that was desired at the start of the program might be found not to have taken place because of a slippage in financial policies. The mix of policies would have to be reconsidered at that stage, including another adjustment in the exchange rate.

The exchange rate of the currency of Singapore was managed with reference to a trade weighted basket on the basis of a general assessment of the economic situation, and he wished to thank Mr. Ismael for noting the inconsistency that had appeared in that respect in the staff paper, the staff representative concluded.

Mr. Al-Jasser commented that the discussion had served to emphasize the need to take care in applying real effective exchange rate targeting because of its inflationary bias, a point which had been an important concern of his chair. The Fund would be much more careful about the use of exchange rate targeting in recommending exchange rate policies to members, and in the context of Fund arrangements.

Mr. Wright said that he agreed with Mr. Al-Jasser. The discussion of the real effective exchange rate and the equilibrium rate of exchange had, of necessity, been a highly conceptual one. With respect to the latter, advice about how to reach the equilibrium exchange rate and to maintain it presupposed that there was a way to identify the equilibrium rate. The staff had shown that identifying that rate was extremely difficult, if not impossible. That notwithstanding, the staff should continue its research, because of the operational importance of clarifying and identifying the equilibrium exchange rate in general, and in the context of Fund-supported programs in particular. In many recent discussions, for example, the Board had had no idea of what the real exchange rate was, much less the equilibrium rate, and therefore what the real competitive position of the economy was. Often that had been attributable to the presence of distortions in the form of price controls. The staff needed to do some research into how to derive the real exchange rate under those, and similar, circumstances.

The discussion had also served to highlight the importance which the Board attached to exchange rate issues, vis-à-vis all the Fund's members in general, and vis-à-vis countries with Fund-supported programs, in particular, Mr. Wright remarked. He would be disturbed to find that the Fund was not exploring the issue of exchange rates with its members for reasons of political sensitivity. Exchange rate issues were a central area of concern, and should not be overlooked in discussions between the Fund and its members, especially in the context of Fund-supported programs.

Mr. Arora said that he had not intended to convey the impression that exchange rate issues should not be examined in country discussions. Indeed, such issues needed to be examined at great length in the discussions between the staff and the authorities. The key was that such issues not become a stumbling block for the effective implementation of programs, and their effective presentation to the public. The consideration of exchange rate issues should be structured in a way that ensured that the negotiations did not become hostage to the political process.

Mr. Posthumus commented that a number of speakers had noted that the debate over exchange rate policy would continue, and that policy decisions would not be changed by the outcome of a few seminars in the Executive Board. It was indeed true that changes in that respect were occurring only very gradually, perhaps too gradually, seen in light of the fact that changes were also taking place in the international monetary system, and given that that system was probably unsustainable as it was currently constituted. The exchange rate policies of industrial countries were of course key; but the Fund's exchange rate policy advice to developing countries should not be overlooked, nor should the importance of that advice in the context of the entire system be underestimated.

The Chairman remarked that he agreed that the focus on the link between the exchange rate policies of individual countries and the operation of the international monetary system as a whole should be made clearer in future Fund policy advice on exchange rates.

The Chairman then made the following concluding remarks:

> This has been a seminar of major importance, as the subject of exchange rates is at the core of the Fund's responsibilities. It is important to step back from time to time to see if the Fund is helping its member countries in an appropriate way to deal with the problems confronting them, in light of changing circumstances. In that regard, it is important that the staff, management and Executive Board not lose sight of the institution's key purposes. The seminar has forced us to confront more directly and more precisely the Fund's recommendations on exchange rate policy, and to think about how further progress in that respect might be made.
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> Directors focused on several major issues, including the effectiveness of a greater commitment to a nominal exchange rate target in promoting financial discipline and price stability, the criteria determining the choice of exchange rate regimes, the systemic considerations of exchange rate policy and the role of the Fund, and the coverage of exchange rate matters in staff reports. Certain aspects of those issues were also touched upon in the Board's recent discussion of the CFA franc arrangement, to which several speakers referred.
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> Directors unanimously insisted on the central role played by financial discipline in the adjustment effort, noting that adherence to some medium-term fiscal and monetary policies could simultaneously promote price stability and maintain external competitiveness. Directors observed that when countries had established a reputation for financial discipline based on past performance, the choice of exchange rate regime was not of critical importance; there were, however not many countries in that situation.
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> Several Directors noted that the role of the exchange rate became most problematic in the case of countries that were seeking to stabilize after a protracted history of inflation and financial imbalances. Some Directors felt that in such cases, a fixed nominal exchange rate could serve as a useful role as an anchor for price stability, both by providing a benchmark for price level expectations and by serving as a highly visible signal of the authorities' commitment to financial discipline, provided they

were serious. Clearly, a sine qua non of that strategy would be a firm resolve to maintain sound financial policies. Furthermore, such a policy would require that significant prior actions be undertaken, and that the means for defending the exchange rate be at hand in the form of exchange reserves or access to external funds. A difficult issue, however, was how some flexibility could be reintroduced into the exchange rate without sending an improper signal to private agents. On balance, Directors felt that exchange rate policy, although clearly playing a secondary role to that of sound fiscal and monetary policies in determining the success of a stabilization program, was essential to support the latter policies.

Directors agreed with the staff's view that analytical arguments--at least in the existing literature--did not support uniform policy advice on the choice of exchange rate regimes or exchange rate management. In the context of the choice of exchange rate regimes, Directors noted that the choice of regime by one country might impose externalities on others, raising systemic issues which needed to be considered. In the case of countries that required some exchange rate action, Directors felt that there should be an appropriate balance between restrictive financial policies and exchange rate adjustment, taking into account their relative short term costs. In the short run, restrictive fiscal and monetary policies were likely to have adverse effects on real output. Consequently, there was some difference of opinion among Directors about the relative weights to be attached to exchange rate action and restrictive fiscal policy. Directors noted that where imbalances were large, a role was often seen for exchange rate policy in correcting the underlying cost-price distortions and limiting the cost of adjustment in terms of forgone output. Directors agreed with the staff that when exchange rate action was called for in such cases, it had to be supported by restrictive monetary and fiscal policy and by appropriate structural measures.

Several Directors voiced their concern about the use of rules that guided the nominal exchange rate with reference to a real effective exchange rate target. Rigid adherence to a real exchange rate target could prove destabilizing, not only because of the usual problems associated with indexation, but also because of the difficulties inherent in identifying the equilibrium real exchange rate, and the fact that the equilibrium real exchange rate would move over time in response to domestic and external shocks.

Going further into the analytical arguments for the choice of an exchange rate regime, there remained wide differences of views among Directors. The distance between those who favored a fixed or stable exchange rate as an anchor for macroeconomic policy, and those who believed that a flexible exchange rate regime cum policy discipline provided a better basis for the achievement of economic policy objectives, had not narrowed significantly; but those differing views had been clarified, and had sharpened the Board's appreciation of the importance of the policy objectives of the authorities and the individual country's specific circumstances in the choice of an exchange rate regime and how to make it work.

Directors were concerned about the indications in the paper reviewing experience that some developing countries with flexible exchange rate regimes had tended to have higher inflation rates than those with fixed exchange rate systems. Moreover, they also noted that countries with fixed systems that had followed lax financial policies had experienced high inflation accompanied by successive devaluations and problems with reducing exchange and trade restrictions. In those cases, they stressed the importance of an early move of the exchange rate to a competitive level, supported by noninflationary fiscal and credit policies. The point was also made that it would be preferable to have a steep one-step exchange rate adjustment than a creeping adjustment.

Directors considered the issue of adapting the staff's exchange rate policy advice in the light of the differing circumstances and the adjustment needs of developing and industrial countries, and also of countries with different exchange rate regimes. They agreed that, in making recommendations on the mix of exchange rate and other adjustment policies, the staff should take into account the specific economic and institutional environment prevailing in the member country, including the type of exchange rate arrangement preferred by the authorities. For example, where countries were members of currency unions which effectively precluded exchange rate action and also limited the scope of monetary policy, the burden of adjustment in Fund-supported programs was then to be borne by fiscal policy, together with appropriate structural policy measures and wage restraint. However, irrespective of the chosen exchange regime, Directors emphasized the need to ensure that the policy mix aimed at an early correction of overvalued exchange rates when that was necessary, and at gearing domestic financial and structural policies to achieving price stability and maintaining competitiveness. Moreover, they agreed that changes in the exchange arrangement could be recommended in cases in which they would be indispensable to facilitate the move to a market-based exchange rate, and to establish a more credible and efficient exchange system. The case was also made as to the desirability of central bank independence in dealing with exchange rate issues, even though it was acknowledged that an instance of pure independence did not exist.

Concerning the coverage of exchange rate issues in staff reports, Directors felt that although most reports included an assessment of exchange rate policy, in many instances the discussion of the issues involved was limited, and frequently, the relevant information was not drawn together sufficiently to provide an adequate justification of the staff's assessment, or to indicate the extent to which alternative strategies had been considered. They indicated that the presentation of exchange rate issues in staff reports should be comprehensive in covering the analysis of issues that would help the Board to evaluate the appropriateness of exchange rate policy in individual country cases. In particular, the reports should address more directly such specific issues as the use of the exchange rate as a nominal anchor, the rationale for maintaining or reforming the prevailing exchange rate regime, the considerations underlying any proposed correction of the exchange rate, and the implications of the exchange rate policy recommended for the path of inflation. I would like to assure Directors that that message has been well received.

I have been greatly impressed by the link which has been emphasized by so many speakers between the Fund's decisions on individual exchange rate problems and the Fund's systemic responsibilities. The desire of several Directors that the Fund develop more consistent advice on exchange rate policy, while avoiding dogmatism, has also been noted. I would call attention in particular to the view of Minister Hashimoto, as conveyed by Mr. Yamazaki, that by working in a longer-term context toward more stable exchange rates among the major countries, the Fund would better serve the evolution of a more stable international monetary system. Those thoughts will assist the Board in defining more precisely the scope of future discussions on exchange rate issues.

LEO VAN HOUTVEN
Secretary