March 18, 1997
Approval: 3/25/97

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 95/68

2:30 p.m., July 19, 1995

Contents

Executive Board Attendance

M. Camdessus, Chairman
S. Fischer, First Deputy Managing Director
P. R. Narvekar, Deputy Managing Director

Executive Directors	Alternate Executive Directors
	A. A. Al-Tuwaijri
J. Bergo	
	V. J. Fernández
I. Clark	
	D. Z. Guti
H. Evans	
	R. Kannan, Temporary
J. E. Ismael	L. M. Cheong
	R. F. Cippa, Temporary
	A. Calderón
W. Kiekens	
	H. A. Barro Chambrier
	M. Giulimondi, Temporary
K. Lissakers	
H. Mesaki	
	M. Daïri
C. Saito	A. G. Zoccali
S. Schoenberg	B. Edsar
A. S. Shaalan	Y. Y. Mohammed
D. V. Tulin	
E. L. Waterman	
J. de Beaufort Wijnholds	
	Wei B.

L. Van Houtven, Secretary and Counsellor
D. Rajnes, Assistant

Also Present

Central Asia Department: J. V. Carter. European II Department: J. Odling-Smee, Director; M. A. Horton, A. Knöbl. External Relations Department: D. R. Hawley, P. C. Hole. Fiscal Affairs Department: G. Anulova. IMF Institute: A. Ouanes. Legal Department: W. E. Holder, Deputy General Counsel; R. H. Munzberg, Deputy General Counsel; J. L. Hagan. Monetary and Exchange Affairs Department: P. J. Quirk. Policy Development and Review Department: J. T. Boorman, Director; T. Leddy, Deputy Director; A. Bennett, S. Desai, H. M. Flickenschild, A. Houben, K. J. Langdon, A. K. McGuirk, S. M. Schadler. Research Department: M. S. Kahn, Deputy Director; P. Wickham. Secretary's Department: C. P. Clarke, A. Mountford. Treasurer's Department: D. Gupta, Deputy Treasurer; B. C. Yuen. Office of the Managing Director; S. Sugisaki, Special Advisor; G. R. Saunders, Personal Assistant; D. Burton. Advisors to Executive Directors: J. M. Abbott, B. Andersen, P. Cailleteau, S. S. Farid, S. O'Connor, T. Oya. Assistants to Executive Directors: T. Berrihun, P. I. Botoucharov, J. A. Costa, D. Desruelle, A. Guennewich, J. Hamilius, O. Himani, G. H. Huisman, P. Jilek, W. C. Keller, S. Rouai, D. Saha, Song J., V. Trivedi, V. Verjbitski, Wang Y.

1. CURRENCY STABILIZATION FUNDS - FUND POLICIES - FURTHER CONSIDERATION

The Executive Directors considered a staff paper on Fund policies with regard to currency stabilization funds (EBS/95/109, 6/30/95).

Mr. Clark made the following statement:

As I said in my statement for the December 1994 discussion (EBM/94/109, 12/14/94), I agree in principle that currency stabilization funds can play a useful role in accelerating and strengthening a comprehensive reform effort, provided they are buttressed by strong financial policies.

The importance of the "lender-of-last-resort" function of the Fund has certainly become more topical since the Board's last discussion about a currency stabilization fund in mid-December 1994. Events in Mexico and other emerging financial markets, and the subsequent Board discussions, have sharpened the focus on many of the issues raised in the initial discussion. The current staff paper deals more comprehensively with many of these general issues, incorporating several of the points from earlier discussions in the analysis, and provides more concrete detail about alternative elements in the design of the facility. My comments will begin with a few points on the role of a currency stabilization fund in supporting a nominal exchange rate anchor and end with some remarks on the operational features of a currency stabilization fund.

The function of a currency stabilization fund is to provide support for exchange market intervention against a temporary, speculative attack on a well-defined exchange rate peg, in terms of policy prospects and economic fundamentals. A currency stabilization fund is as much a signaling mechanism to unsure market players about the Fund's confidence in the policy actions and capabilities of the recipient member as it is a financial support mechanism.

Even though the adoption of a fixed exchange rate or an explicit crawling peg defined against the currency of a low inflation country can contribute to disinflation during a period of substantial economic adjustment, it cannot be a substitute for an appropriate macroeconomic stabilization policy. In fact, one of its primary functions is to discipline the adjustment of these policies to preserve the desired disinflation path. Accordingly, the institutional and structural capacity to implement and sustain macroeconomic stabilization policy is, therefore, a prerequisite for an effective exchange rate-based stabilization strategy and for approval of a request for a currency stabilization fund.

Most notable among the staff's comprehensive list of institutional and structural conditions necessary to support an effective exchange rate-based stabilization program are interest rate flexibility, integrated management of international reserves and foreign exchange intervention, and a high degree of current account convertibility with measures that encourage capital mobility, especially resident inflows. Fiscal, monetary, and credit policy settings must also be consistent with the inflation targets and structural rigidities that distort relative price movements, such as full backward wage indexation, should be eliminated. Until such conditions are met, approval of a currency stabilization fund should be withheld and, if such conditions--initially in place--were reversed, the currency stabilization fund should be terminated.

The proposed currency stabilization fund is designed to support the appropriately pegged value of a fixed exchange rate that had been set at the initial stages of a substantial adjustment process. As the adjustment proceeds, the initial pegged value may become inappropriate, and adjustment combined with greater exchange rate flexibility and asymmetry may be required and advisable, particularly if macroeconomic policy credibility has become better established. Workable strategies for the transition from one exchange rate regime to another are critical in this event and should be formulated as a contingent follow-up strategy to a currency stabilization fund. In fact, based on the earlier Board discussion, I had hoped that this issue would have been addressed in this paper.

Furthermore, any emerging market pressures on an exchange rate may be signaling a fundamentally based change in equilibrium value, and not a slippage in optimal policy. Consequently, care must be taken not to engage a currency stabilization fund, or any other regular Fund arrangement that would succeed it, in futile support of a misaligned exchange rate peg. This implies that the exchange rate peg should be evaluated continuously against a variety of indicators of fundamental value.

On the operational features of a currency stabilization fund, the "window" approach is preferred to a separate facility, as it explicitly links the financial assistance to program conditionality and policy adjustment. Early repurchase requirements can still be imposed to limit outstanding credit to, at most, a one-year term. Under the window approach, the currency stabilization fund could also be supported by resources from the General Arrangements to Borrow, if the need arose. The window approach emphasizes the exceptional and transitional nature of the currency stabilization fund, in relation to the regular program to which it is linked.

Although, as the staff suggests, access will be determined on a case-by-case basis in practice, an upper limit of 100 percent of quota is acceptable. This access limit equals the annual limits for stand-by arrangements and extended arrangements. Because of the substantive resource availability that this limit implies, it would provide to markets a strong signal of the Fund's confidence in the recipient's policy program, policy intent, and economic capacity, which should be sufficient to calm uneasy markets. However, such a strong endorsement also requires that the basic conditions for an exchange rate-based stabilization strategy are unambiguously and firmly in place.

While three tranches would seem reasonable, four tranches should be the maximum. Even though flexibility is a valuable feature, six tranches risk diluting the signal of a confidence that the Fund wishes to project. For this reason, the proposal that the first tranche be more heavily loaded, at 35 percent of quota, than subsequent tranches also contributes to the strength of the signal.

The first tranche would be available following approval of the currency stabilization fund request and subsequent tranches would be available upon Board approval. The drawings following the first tranche, which are used to build up reserves for intervention purposes, should be used only to replenish reserves in proportion to the member's use of nonborrowed reserves and interventions should be shared proportionately between borrowed and nonborrowed reserves. As the currency stabilization fund is designed to support a fundamentally sound exchange rate peg in the event of temporary market maladjustment pressures, significant nonborrowed reserves should be available to the currency stabilization fund recipient at the time of the request for assistance. The use of nonborrowed reserves during intervention will help assure the maintenance of monetary and credit policies aimed at inflation reduction and international reserve accumulation.

In addition to the conditions for an effective exchange rate-based stabilization strategy, which must be in place for the activation and maintenance of a currency stabilization fund, a reporting requirement could be imposed. This requirement would facilitate the high-frequency monitoring necessary to ensure that the Fund's resources are used for the intended purposes, that the exchange rate remains pegged at an appropriate value, and that there is rapid response to disbursement requests by the Board--for example, the five working days noted in the staff report. Whether this would require a resident representative of the Fund in the recipient country only to monitor the currency stabilization fund should be considered on a case-by-case basis, with data reporting capacity as a primary determinant.

Contingency measures, beyond direct intervention to address exchange market pressures and provisions to adjust program targets, are appealing as they would permit "market learning" by both the authorities and the Fund, especially as large economic adjustments are anticipated as a result of the stabilization strategy. The initial conditions for flexible interest rates and relative prices are essential requirements for such measures.

All currency stabilization fund purchases should be subject to a maximum one-year repurchase obligation from the date of initial approval of the request for the facility, and subsequent drawings should be subject to a three-month repurchase expectation. Although all drawings on the facility should occur early in the one-year maturity span, if the exchange rate pressures activating the request are fundamentally unsound and the pegged rate remains appropriate, complete payback can be spread over the longer horizon to give the authorities time to build reserves. Indeed, an understanding that no drawings after the first six months would be approved and that upper tranche drawings must be occur within two weeks of approval may be warranted, although it would encourage the drawing on a precautionary basis when an approval is forthcoming. Nevertheless, such precautionary drawings would strengthen the recipient's reserve position, which could help calm uncertain markets even more and further reduce the need for intervention.

Finally, the cost of a currency stabilization fund should be structured similarly to those of other facilities of the General Resources Account, although the level of service charges should be higher to reflect the greater monitoring costs and administrative costs associated with such an information-intensive and fast-disbursing facility. The higher service charge, coupled with intensive reporting requirements and conditionality, will also encourage members to seek next-to-last-resort solutions before requesting a currency stabilization fund.

Mr. Shaalan made the following statement:

We thank the staff for the effort they made in addressing the issues raised on the occasion of the Board's initial consideration of currency stabilization funds. I hope that our discussion today will provide a sufficient basis for the staff to proceed with the preparation of recommendations on Fund policies regarding currency stabilization funds.

I was among those who, at our earlier discussion, expressed support for the rationale for a currency stabilization fund and broad agreement with the main guiding principles for Fund involvement in this area, as outlined in the staff paper on preliminary considerations regarding currency stabilization funds (EBS/94/230). Accordingly, on the issues for discussion grouped under the heading of general considerations, I have only the following brief comments to make.

In the paper before us, the staff notes that the support offered by a currency stabilization fund would likely add little to the overall credibility of the exchange regime in situations in which inflation had already been reduced and a period of relative stability in the exchange rate had been achieved. The staff then point out that a regular Fund arrangement would seem well suited to such situations. I do not disagree with this latter conclusion. But, in those cases in which a regular Fund arrangement is already in place, a currency stabilization fund could still have an important role to play. Specifically, by providing a powerful complement to appropriately tight financial policies, a currency stabilization fund could contribute significantly to bolstering confidence in the prospects of continued exchange rate stability. I would, therefore, consider it only appropriate that the door be left open for the possibility that a currency stabilization fund might be used in support of a managed exchange rate regime or an exchange rate peg in the period after inflation had been reduced.

With regard to the operational issues for discussion, I have the following comments:

Although we previously expressed preference for the special facility approach, we can also go along with the window approach. The potential for a differentiated treatment vis-à-vis the possibility of establishing a repurchase obligation under the window approach is somewhat problematic. However, as the basis for differentiation can be traced to an objective and relevant criterion--exposure to the Fund--we do not view this complication as a strong enough reason to either oppose the window approach or to refrain from establishing a repurchase obligation when feasible.

An access limit of 100 percent of quota seems to be broadly appropriate. I wish, for emphasis, to underscore the staff's observation that the concept of "need" under the currency stabilization fund element would have to relate importantly to the objective of instilling confidence in the exchange rate peg.

The flexibility embodied in the proposed approach to tranching could be desirable from the point of view of enhancing the scope for tailoring the currency stabilization fund element according to individual country circumstances. However, in view of the special nature of the currency stabilization fund and, in particular, the importance of its signaling effect, a differentiated approach to tranching could risk signaling a differentiation, across member countries, in the degree of confidence with which the Fund views the provision of support under the currency stabilization fund element. On balance, I would, therefore, favor a uniform approach to tranching. As to the number of tranches, I think three tranches should be sufficient.

I can go along with the staff's statement on the repurchase expectation and obligation. However, the suggested extension of the repurchase obligation for stand-by arrangements of more than a 12-month duration could be problematic. Providing for such an extension would introduce yet another possibility of a differentiated treatment insofar as the repurchase obligation is concerned; this time, the treatment would vary between multi year stand-by arrangements, on the one hand, and arrangements under the extended Fund facility and enhanced structural adjustment facility (ESAF), on the other. Thus, if we are to have, to the extent possible, a repurchase obligation, it would perhaps be better to have that reflected in a provision that is uniform across arrangements.

I am in favor of levying an arrangement charge only on the net amount of resources committed under the currency stabilization fund element. While this would represent a departure from previous practice, such a departure would seem to be justified by the nature of the currency stabilization fund, specifically by the combination of its revolving and repurchase features. In this connection, I wonder whether the same combination of reconstitution and repurchase features would not represent a sufficiently relevant basis for deciding to levy a reduced service charge on currency stabilization fund purchases.

Mr. Mesaki made the following statement:

This chair's views on currency stabilization funds has not changed since the Board meeting on this matter this past December. I am not convinced by the argument for currency stabilization funds and believe the Fund should be cautious about recommending the establishment of currency stabilization funds for the following reasons: first, it is difficult to judge whether the underlying cause of exchange rate instability is temporary in nature; second, approval of a currency stabilization fund for a member virtually means providing more Fund resources with the same conditionality to that member, and this could undermine the principle of equity vis-à-vis other members with floating exchange rate systems; and third, I have strong doubts about the effectiveness of a nominal exchange rate anchor system, as described below.

In sum, I believe that a currency stabilization fund should be regarded as an extraordinary facility and be established only to deal with exceptional circumstances.

I have argued on previous occasions against the introduction of a nominal anchor exchange rate system, which is a precondition for establishing a currency stabilization fund, at an early stage of economic transformation. My reasons are as follows.

It is not appropriate to advise the introduction of a fixed exchange rate system for transition economies as a whole. It is crucial when recommending an exchange rate regime to take a pragmatic, case-by-case approach, taking account of various factors, including the level of international reserves, administrative capacity, and whether the regime will have a beneficial impact on foreign trade. I believe that a fixed exchange rate could be appropriate for a transition country that has already achieved a substantial degree of macroeconomic and exchange rate stability through the implementation of sound economic reform measures.

It is extremely difficult to determine the most appropriate level of the fixed exchange rate, in light of the highly uncertain economic prospects of countries that are in the process of drastic economic transformation. Experience shows that the wrong choice of fixed rate leads to catastrophic results. In the staff paper the statement is made that, when distortions are very large, "there is no choice but to let the economy adjust to the peg." However, I doubt that is feasible.

The utmost attention should be paid to the degree of confidence in the authorities' commitment to economic reform. I doubt that the introduction of a fixed exchange rate at an early stage of economic reform before confidence has been fully established would have any beneficial impact on economic stability. I am not convinced by the argument that the introduction of a fixed exchange rate system itself would strengthen confidence in the authorities in this regard. Strong commitment by the authorities might not in itself be enough. I believe that confidence can be enhanced only after the successful implementation of sound economic policies.

I do not know which countries the staff envisages when it says that "Fund support for currency stabilization funds could be considered in cases of high inflation countries with good prospects for achieving a rapid and substantial decline in inflation." This description seems to suggest that the scope of currency stabilization funds is very limited. I think, for example, that until several months ago Georgia could have been such a case. However, regarding Georgia's request for a stand-by arrangement, the staff paper says "the managed floating exchange rate policy adopted by the authorities has worked well so far" and that "fixing the exchange rate is not appropriate at this time." Again, I wonder which countries the staff sees as possible candidates for the introduction of a nominal anchor system and use of a currency stabilization fund.

Following the Mexican crisis, Executive Directors generally agreed that the maintenance of a fixed exchange rate regime could be risky and have costly results. I would urge that any discussion on currency stabilization funds should be preceded by a full discussion on when and how members enter into and exit from fixed exchange rate systems.

Recently we observed the Russian authorities adopt an exchange rate band system. I believe that we should continue to monitor the band system's impact on the economy before discussing the advantages and disadvantages of the anchor system and currency stabilization funds.

For the same reason, I am rather reluctant to consider the modality of currency stabilization funds. That said, apart from my difficulty with the substance, on a preliminary basis, I broadly agree with the modality of currency stabilization funds proposed by the staff. Regarding the choice between the window approach and the "new facility" approach, I agree with the staff's conclusion that the same basic operational features of currency stabilization funds could be established under either approach. However, if we attach importance to the use of currency stabilization funds by ESAF-eligible members, I would be inclined to favor the new facility approach because of its simplicity.

I have difficulty, however, with the proposed circulation period of the updated summary prepared by the staff. The staff says that "under exceptional circumstances the circulation period could be abbreviated to allow afternoon Board discussion following morning circulation;" however, this would result in serious inequity among members because the authorities of some countries, especially Asian countries, would have no opportunity to check the staff paper owing to the time difference, while those of other countries would. I urge that there be at least a 24-hour circulation period under any circumstances.

Ms. Lissakers made the following statement:

The international monetary "system" is today composed of a complex array of exchange rate arrangements. No single model fits all members of the Fund. This is particularly true for countries pursuing economic stabilization. Our discussion today focuses on one specific stabilization strategy: exchange rate-anchored disinflation programs backed by a currency stabilization fund.

We believe the currency stabilization fund strategy deserves our continued attention. Virtually all successful stabilizations from high inflation have involved the use of a nominal anchor at some stage. Well-known examples include Germany after World War II and Poland in 1990. There is now considerable evidence that nominal exchange rate anchors, when accompanied by rigorous macroeconomic policies, can be powerful instruments to bring about rapid disinflation. We need to draw on this evidence to develop policies that can most effectively support such cases.

It is an unfortunate fact that hyperinflation has been a hallmark of this decade, particularly in the economies in transition on the periphery of Europe. Some of this inflation is now being reduced, but in many countries inflation remains at high levels, and we should be prepared for possible setbacks and future outbreaks.

The advent of globally integrated financial markets has blurred the distinction between current and capital movements. In this environment, the success of an adjustment effort relies critically on confidence. Any attempt to achieve rapid disinflation will require a strong anchor. And the loss of an anchor can have dramatic effects on countries without a history of strong performance.

The report prepared for last year's conditionality review (Seminar 94/9, 11/9/94), "Staff Studies for the Review of Stand-by and Extended Arrangements," documented that well-structured exchange rate-anchored programs have a high success rate in disinflation. That study also concluded that nominal exchange rate anchors cannot substitute for stringent fiscal and credit policies, and will surely fail in the absence of such policies.

The attraction of a currency stabilization fund to back up an exchange rate-anchored disinflation program is that it adds clarity and transparency to a demanding adjustment program. The involvement of Fund conditionality in a currency stabilization fund provides assurance that neither the anchor nor the stabilization fund will be misused, thereby reinforcing both the policy determination of the authorities and the credibility of the arrangement.

We concur with the staff that any use of a Fund-supported currency stabilization fund should therefore not be undertaken lightly, and should be undertaken only in disinflation cases in conjunction with rigorous macroeconomic programs. Furthermore, it is essential the authorities understand that the currency stabilization fund is not a form of balance of payments or budget support, but rather a credit line to bolster confidence. In such circumstances, we are convinced that an exchange rate anchor can send a strong signal of the government's commitment to disinflationary policies, provide direct discipline on prices of traded goods, and strengthen incentives for the government to stick to its stabilization program.

Announcement of a pegged exchange rate can have an immediate effect on public confidence in the government's disinflation policies. This in turn can set in motion a virtuous cycle where the public becomes more willing to hold domestic money and buy domestic government securities--and disinflation is more likely to be successful because there is increased scope for both noninflationary monetary financing and debt financing of fiscal deficits. Moreover, an enhanced commitment to disinflation could reduce uncertainty about policy and reduce the real cost of stabilization.

Today's staff paper makes the key point that: "an exchange rate peg can provide a much clearer guide for monetary policy than monetary or credit targets during a period of sharply declining inflation, when the behavior of money and credit demand is likely to be changing rapidly and unpredictably."

This same point was made in the staff's 1993 study of exchange rate stabilization experiences, which concluded that the exchange rate is generally preferable to money as an anchor when there is significant scope for disturbances to money demand. A related consideration is that when money demand is subject to disturbances, owing--for example--to disinflation, a money supply anchor will subject the exchange rate to large and potentially destabilizing swings.

In light of this, the staff's treatment of the appropriate response to capital inflows under a peg is somewhat puzzling. The staff seems to imply that such inflows should be sterilized. However, full sterilization would be equivalent to targeting the money supply and would fail to accommodate changing behavior of money demand, such as the remonetization that normally accompanies stabilization episodes. We believe the question of how the authorities should respond to capital inflows in the context of an exchange rate-based stabilization needs to be explored further.

Aside from this point, we are in general agreement with the staff's proposal as it pertains to the circumstances in which a currency stabilization fund would be appropriate and the policy conditions that ought to apply for countries requesting a currency stabilization fund. The weak link in the staff's proposal--and in our understanding of exchange rate-anchored programs more generally--is exit strategies.

Experience shows that the biggest risks to exchange rate-based stabilization programs come from a loss of competitiveness when lagged inflation gains lead to excessive real appreciation of the exchange rate and depletion of reserves, owing to policy slippages and loss of confidence. For the exchange rate anchor to be credible, the authorities must demonstrate a commitment to maintain the peg. But maintaining the peg too long may eventually require more in the way of policy actions or intervention than the authorities judge prudent, or than the market believes sustainable.

Up to a point, these are hazards worth risking. In proceeding to introduce Fund-supported currency stabilization funds we need to develop clearer policies on exit strategies. One way or another, some exit strategy will be unavoidable. Disinflation is, by nature, a transitional process. If inflation were brought down, a revised strategy would be needed to sustain low inflation. More difficult issues would arise if the program were to come under pressure because of policy slippages or unexpected developments. In such circumstances, to avoid unnecessary costs, timely decisions would need to be made as to whether to adjust or exit from the arrangement. Thus, exit strategies are needed to cover both of these circumstances.

Pending further consideration of exit strategies, I am generally satisfied with the proposals made by the staff. I would comment on some specific points.

I believe currency stabilization funds are appropriate for disinflation programs for high inflation countries. I have noted the mention in the staff paper that the Fund has traditionally considered "high" inflation to mean annual rates of inflation of 50 percent or more.

I see the merit of introducing a currency stabilization fund early in a disinflation program. Nevertheless, this may not always be possible, in view of the legislative and political realities of economic policymaking. I would not preclude incorporating the currency stabilization fund at a later stage, after some initial progress has already been made in containing inflation and improved policies are in place.

In general, I would expect a currency stabilization fund to support an exchange rate pegged in a narrow fixed band. There may be a role for crawling pegs or crawling bands as part of the teething process by which the central parity is established. However, I see any initial crawl as being temporary. The currency stabilization fund presupposes a firm commitment to disinflation; if a country's ambitions extend no farther than sustaining a crawling peg, that anti-inflation commitment would be in doubt. Crawling pegs, however, could form an element in an exit strategy.

I support structuring the currency stabilization fund as a window in an upper credit tranche arrangement rather than as a separate facility.

As the currency stabilization fund is not intended for medium-term balance of payments support, a total commitment of up to 100 percent of quota would be reasonable, even if this required occasional use of the exceptional circumstances clause.

I continue to think the original proposal of six tranches was excessive. I can, however, accept the new proposal to allow for between three and six tranches with some front-loading on activation of the program.

I agree with the proposed reconstitution provisions.

Regarding costs, the introduction of a currency stabilization fund might be an opportunity to consider introducing an explicit risk premium over and above normal charges.

Mr. Bergo made the following statement:

I commend the staff for having produced a useful paper responding to many of the issues raised under the first discussion on possible Fund financing for currency stabilization funds.

However, while the possible elements and modalities of currency stabilization funds seem appropriately addressed, I had--like Mr. Clark and Mr. Mesaki--hoped that the issue of transition from one exchange rate regime to another would have been addressed in the document, not least because I received the impression from our discussion in June on the work program (EBM/95/54, 6/2/95) that such useful and needed considerations would be included. In addition, the staff itself provides arguments for such a broadening of the analysis to include discussions on possible exit options from pegged exchange rate systems, as they indicate that something in the order of one to two years of fixity is likely to be sufficient. Moreover, in the paper's brief section on "review of the exchange rate peg," the staff seems to recommend using the exchange rate actively to address competitiveness problems that may arise after some time, and it is emphasized that "a political commitment to a permanently fixed exchange rate should be avoided," inter alia, to avoid one-way bets against the exchange rate. However, such a strategy may indeed give rise to one-way bets and erode the necessary confidence in the anchor. A continuation of strong stability-oriented policies, including timely adjustments, should certainly be preferred to any weakening of the anchor role of the exchange rate policy once introduced.

I would also have appreciated a more extensive treatment in the paper of the comparative benefits of currency stabilization funds, compared with other possibilities of Fund support for using the exchange rate as a nominal anchor in the stabilization process.

Having said that, I share the staff's view that a currency stabilization fund arrangement can provide added confidence to stabilization efforts of high inflation countries. However, I would also like to stress that a comprehensive strategy to achieve and safeguard macroeconomic stabilization is the only effective route for building the confidence needed to limit exchange rate pressures. The choice of exchange rate regime is probably of secondary importance compared with the significance of strong supportive fiscal and monetary policies, but I would agree that there might be additional advantages to the adoption of an exchange rate peg if the necessary support from other policies were in place. Thus, I would believe that the added positive contributions from currency stabilization funds would require that some critical degree of macroeconomic stabilization has already been established, or clearly is at hand, and that the arrangement would be backed by restrained fiscal and credit policies as well as by an adequate level of foreign reserves.

On this background, it might be too risky to introduce currency stabilization funds at an early stage in countries' stabilization efforts. The staff seems to prefer a relatively early pegging; however, while the purpose of ex ante limiting the potential cases for currency stabilization funds seems reasonable, I would appreciate comments on whether the targeted group excludes currency stabilization funds for countries where macroeconomic stabilization has largely been achieved, and that have demonstrated at least some track record in the implementation of sound policies--but where inflation remains fairly high and a signal of "international confidence" could be helpful in their future endeavors in reducing inflation levels. This could be done, for example, in connection with a strengthening of the anchor, through some upward adjustment of the peg, together with a strong stabilization program. Furthermore, a proper phasing could ensure that good policy intentions and commitments are, in fact, followed up by strict implementations, and could allow for the establishment of a sufficiently stable exchange rate.

On the latter, I agree that, in any case, careful consideration would need to be given to establishing the appropriate level at which to fix the exchange rate peg. The staff concludes that it may be wise to err somewhat on the side of initial undervaluation rather than overvaluation. I would prefer to emphasize that the level should be both realistic and sustainable, and that an exchange rate policy that was too unambitious would probably not do much to contain inflation expectations, and, moreover, could have detrimental effects on neighboring countries. I would also caution against activating currency stabilization funds in cases where considerable uncertainty exists regarding the appropriate level at which the exchange rate should be fixed.

A currency stabilization fund arrangement entails considerable risks. These risks need to be balanced against the effectiveness of such an instrument in providing confidence to an appropriate exchange rate anchor. A successful currency stabilization fund would serve its purpose best if it did not need to be used, and this should be the overriding objective in efforts to establish the proper conditions and modalities for the use of such an instrument. I believe that the risks would be appropriately limited if the safeguards laid out in the paper were strictly adhered to in dealing with individual cases. I would, in particular, like to stress the need for a front-loading of measures under the underlying program, such as an ambitious list of prior actions at the outset, as well as agreement on firm contingency measures in the case of drawings, such as pari pasu use of own reserves, the raising of interest rates, and the speedy introduction of fiscal or other policy measures if needed. Moreover, a firm surveillance of policy implementation will be of special importance.

Furthermore, I prefer to establish currency stabilization funds as a window under a stand-by arrangement or an extended arrangement rather than through a separate facility, because--as mentioned by Mr. Clark--this would explicitly link the financial assistance to program conditionality and policy adjustment. Furthermore, it would clearly demonstrate that the currency stabilization fund was an exceptional and temporary arrangement. Having earmarked part of the Fund support solely for intervention purposes, and not for ordinary balance of payments financing, this could indeed send a strong and welcome signal to markets and, together with a strong program, enhance the Fund's catalytical role.

On the other operational features of a currency stabilization fund, such as access limits, charges, reconstitution, and others, I find the staff's recommendations to be broadly acceptable. The features should, of course, strike an appropriate balance between providing the necessary safeguards to Fund resources and allowing the arrangement to be sufficiently flexible to fulfill its objectives. On tranching, the signaling effect would likely be eroded by excessive tranching, and the first tranche should be made sufficiently large but balanced by the strength of the program. As mentioned by a number of Directors this past December, the three tranche approach of the Polish zloty stabilization fund seems to strike a reasonable balance. I agree that the possibility of cofinancing should not be excluded, and it seems reasonable to be open to such cofinancing, provided that the Executive Board would retain control over all use of Fund resources in support of currency stabilization funds, and that the operations of currency stabilization funds are not unduly complicated.

In sum, it may well be that the needed safeguards and conditionality, together with the circumstances characterizing potential candidates, will exclude any demand for currency stabilization funds in practice. If a currency stabilization fund arrangement would result in higher overall access to the Fund's resources compared with that associated with a normal stand-by arrangement or extended arrangement, I also found it well-taken when Mr. Mesaki in his statement cautioned against providing more Fund resources with the same conditionality to a member, as it would undermine the principle of equity vis-à-vis other members with floating exchange rate systems.

If currency stabilization funds are constructed appropriately, the risks would presumably be limited, but so would the potential benefits. One legitimate question would then be to ask whether it is worthwhile to use the not negligible resources needed, especially regarding staff resources in pursuing this matter further. At this stage I have not been fully convinced and am rather inclined to make further currency stabilization fund considerations a lower priority at this stage, and instead concentrate on the long list of other and possible more important issues related to the future role of the Fund.

Mr. Ismael made the following statement:

At the last discussion on this subject, I had indicated doubts on the necessity of a facility as proposed by staff, but will keep an open mind. Although I can be persuaded on the merits of a CSF, like Mr. Mesaki in his present Gray, I still have reservations on the need for a special facility tied to a particular exchange rate regime, a view also expressed by many Directors at the last meeting. Many, including myself, had preferred that funding to support build-up in reserves should be considered as part of the stand-by arrangement. However, at discussions on lessons from the Mexican crisis, many called for a review of Fund procedures to facilitate quick disbursement. The G-7 had attached importance to this and proposed introduction of an Emergency Financing Mechanism. Amidst all these developments, I had hoped that management would look at the financing issue from a broader perspective, rather than addressing only the needs of countries following a certain type of exchange rate regime. After all, there is little difference between Fund support to bolster reserves arising from capital outflows when the exchange regime is a fixed, flexible or a floating regime. In both cases, as evident in Mexico, Fund assistance is necessary to prevent a total collapse of the exchange rate or to prevent re-introduction of capital controls.

Developments over the last few months, have shown the need for an assessment of the overall procedures in approving application for Fund's financial assistance. Within the existing framework, we should examine the need and modalities for quick disbursements to meet reserves build-up to prevent a balance of payments crisis. An evaluation of the need for quick disbursement of Fund resources should be more thorough, encompassing circumstances of need by all countries, regardless of the exchange rate regimes. Needs of countries with floating rate regimes but facing systemic risks should not be overlooked, to avoid the risk that the Fund is perceived as advocating a general policy of fixed or crawling peg exchange rate-based stabilization. Further work in this area should also assess recent proposals on modalities of an Emergency Financing Mechanism. It is only after we have deliberated on all these issues that the Board should decide on the details of additional funding mechanisms to meet the needs of members in general and the special needs of fixed exchange rate countries in particular.

Mr. Schoenberg made the following statement:

I would start by emphasizing that this chair is in full agreement with staff that there cannot be any doubt that, in certain circumstances, a nominal exchange rate anchor can be a powerful stabilization instrument. Having said that, however, I am disappointed that the new staff paper on currency stabilization funds does not provide satisfactory answers to a number of fundamental questions that we had raised during the Board's previous discussion of the subject last December. The staff paper primarily discusses access conditions and numerous technical details relating to currency stabilization funds, which may be important but do not represent the core issues. I would briefly register some of them again, for the record.

Why should the Fund make additional resources available in favor of an "exchange-rate based stabilization policy," but not, however, for other stabilization approaches? Moreover, as Mr. Mesaki asks, why should the Fund offer more resources with the same conditionality to some of its members? What are the risks that countries will opt for an exchange rate peg because they will obtain additional financing, although their objective circumstances would favor a different stabilization approach? What are the risks that countries following other than exchange rate-based stabilization policies will demand "compensation" for reasons relating to equal treatment?

How would the staff comment on the view that actual experience appears to suggest that countries following solid, credibility-enhancing economic policies do not need a currency stabilization fund, while countries not following credible, convincing policies have generally not succeeded in stabilizing the exchange rate through interventions?

The history of the European Monetary System (EMS), for instance, provides ample illustration that, in many instances, the introduction of what the staff calls a "highly visible anchor" did not master the "clear signals of policy intentions and discipline"--and the exchange rate anchor subsequently failed. So I would be interested in learning what considerations make the staff believe that, in countries with much higher inflation rates, heavy structural distortions, pervasive indexation, and other factors, the policy challenges deriving from the introduction of an exchange rate anchor could be easier and more successfully overcome than in the relatively economically homogenous European countries. This question is crucial because, if currency stabilization funds are to be activated--as proposed by the staff--at an early stage in the disinflation process, and possibly at the very start of a Fund arrangement, satisfactory track records on the pursuit of sound economic policies will hardly be available.

The more the economic fundamentals of a country fixing its exchange rate are out of line with the fundamentals of the country serving as the anchor, the harsher will be the policy requirements for making the exchange rate peg stick and the higher will be the risk that these policy requirements will eventually not be met. We must also avoid falling into the trap of considering a nominal exchange rate anchor as a panacea and a safeguard against all the inevitable uncertainties in transformation countries. To a large extent, the same factors that are responsible for the uncertainties of the money demand function in these countries also make the "right" exchange rate unpredictable. I am, therefore, deeply worried about the logic used in the staff paper, which appears to suggest that a fixed exchange rate is appropriate for high-inflation countries and rather inappropriate for low-inflation countries. If a high-inflation country, namely, a country with an annual inflation rates of 50 percent or more, were to fix its exchange rate to the currency of a country with a an annual inflation rate of 3 percent, then inevitably the exchange must be severely distorted, either at the beginning or at the end of the disinflation process. So, I share Mr. Mesaki's view that a fixed exchange rate is more appropriate for a transition country that has already achieved a substantial degree of macroeconomic and exchange rate stability through the implementation of sound economic policies.

It appears that the staff tends to overestimate the role that exchange market interventions can play, and to underestimate the importance of prompt policy and, in particular, interest rate adjustments. The credibility of an ambitious adjustment and reform program does not primarily derive from the level of reserves, but rather from confidence that the required policy adjustments will be carried out. In this context, I would like to reiterate my earlier question to the staff: in which cases has an exchange rate peg that was considered appropriate by the Fund subsequently failed, owing to a lack of reserves? The staff asserts that currency stabilization funds should not be used for additional balance of payments financing, but rather only to overcome temporary exchange market disturbances. Unfortunately, this theoretically plausible distinction is, in many cases, almost impossible to observe in practice. The staff says that "it is necessary to form a judgment." Apart from the difficulties, with regard to high-inflation countries, in determining the right initial exchange rate, such a judgment rests on the dubious proposition that individual member countries and the Fund can better assess the short-term adequacy of exchange rate movements than can markets. What happens if an exchange rate officially subscribed to by the Fund cannot be upheld in the end? How would the prestige of the Fund be affected, and how would the Fund credit be repaid? It is important to recognize that these problems have reached a new dimension under the conditions of globally integrated financial markets, thus blurring the distinction between current and capital movements, an experience that induced the EMS countries in 1993 to retreat to a 15 percent fluctuation band.

To sum up, we agree with the staff and other Directors that an exchange rate-based stabilization policy can, in many instances, be an appropriate approach to disinflation. We do not see convincing reasons, however, that--as a general rule--such an approach could not successfully be implemented on the basis of the traditional Fund approach and regular access policies.

Nevertheless, if, in a number of extraordinary and very rare cases, a special Fund approach were called for, then such cases should be tackled on an ad hoc basis, and on the basis of only a few preliminarily discussed general policy guidelines and operational features. In this respect, the staff paper presents some valuable groundwork.

Although a special window under Fund arrangements is clearly preferable to the establishment of a separate facility, the creation of a window would invite the impression of a general availability of additional Fund resources. This cannot be in the interest of the Fund, in view of the projected worsening of the Fund's liquidity over the next two years and the potential establishment of additional emergency financing procedures.

I also wonder how the "very infrequent use" of currency stabilization funds, as until recently promoted by staff and management, could be guaranteed by offering this instrument to countries such as those with ESAF arrangements, which in all probability cannot satisfy the corresponding policy requirements listed by staff. Also ESAF-supported programs often do not satisfy the conditionality of other Fund-supported programs in the upper credit tranches, which should be a precondition of Fund support for a currency stabilization fund.

I would welcome information from the chairs favoring Fund financing of currency stabilization funds about how such additional financing obligations should be financed, and as to whether they would cooperate in working toward an early quota increase. In anticipation of potential imaginative thinking, at this stage I would submit that General Arrangements to Borrow resources should not be activated for the purpose of financing currency stabilization funds. In any case, if the Fund's liquidity were to deteriorate drastically, the financing of regular Fund-supported programs would have to enjoy priority; Fund support for currency stabilization funds would then be put on hold.

The staff rightly puts strong emphasis on the need for countries borrowing from the Fund for currency stabilization funds to establish satisfactory track records. This should mean that, as a rule, activation of a currency stabilization fund should be considered after the first program review, at the earliest.

We have doubts about whether permission for as many as three requests for three-month extensions of the repurchase expectation periods of currency stabilization funds would still be in line with the stated objective of offsetting short-term reversible exchange market tensions.

The periods between the circulation of staff papers and Board discussions and the minimum periods required for the Board to act must not be shortened to an extent that would make it impossible for Directors to involve their home authorities.

The staff should be asked to shed some light on the potential connection between a forced liberalization of capital movements--a subject coming before the Board next week--and the demand for currency stabilization funds.

Extending his statement, Mr. Schoenberg said that the focus of the meeting should be on formulating general policy guidelines for access to a currency stabilization fund. It would be extremely difficult to predetermine the operational requirements of all potential users of the proposed new arrangement. For example, tailormaking the fund to ESAF country conditions might lead to excessive use of the new facility, and that had not been the intention of the stabilization fund approach.

Ms. Lissakers queried whether, under an ad hoc approach using existing facilities, the financial resources provided under stand-by arrangements could be used to defend a currency peg without conflicting with the Fund's basic lending principles.

Mr. Schoenberg said that a stand-by arrangement had typically been a precondition for Fund support for an exchange rate peg. A balance of payments need had to be established to qualify for such an arrangement, and the resources obtained from the Fund to meet that need were not generally earmarked.

The Chairman remarked that he was not comfortable with Mr. Schoenberg's apparent preference for an ad hoc approach to the stabilization fund issue.

Mr. Waterman made the following statement:

Policies to reduce high inflation to sustainable levels are of interest to many member countries, including those in transition. We therefore need to keep an open mind on possible approaches toward getting inflation down substantially in a way that moderates the inevitable cost of doing so.

Nevertheless, like others, I remain skeptical about the more general value of currency stabilization funds and whether there is a case for establishing a particular facility for a select group of members to draw on. All strategies for rapidly reducing inflation succeed or fail on the willingness and ability of the authorities to adjust fiscal and monetary policies, and to implement structural and institutional change. In this context, fixing the exchange rate is a less central issue, and the case has not been established for singling it out for special attention. Using a currency stabilization fund seems a rather exotic approach to the problem. It might offer some additional returns when combined with appropriate policy adjustments, but as others have commented, it also poses some very substantial risks--in particular, a risk that is more likely to be called upon when economic policies are not sufficiently strong to maintain the exchange rate at a given level. In such circumstances, a currency stabilization fund would be neither desirable nor effective.

I suspect that most of us accept the fact that reducing inflation is going to involve some significant costs and pain, irrespective of the policy approach, and that the more important issue in some ways is whether the authorities and community are prepared to bear those costs. In saying that, however, I recognize that the perceptions about the determination of the authorities to reduce inflation can have an important bearing on the size of the cost.

Often persistently high rates of inflation are an indication that the government is not prepared to accept the perceived--and actual--cost of reducing inflation by a substantial amount quickly. It would be difficult to judge in the circumstances described in the paper whether the commitment to introduce and sustain a much lower rate of inflation will be adhered to. Moreover, I doubt that either the Board or the staff would be in a position to assess in the early stages of a stabilization process--when no track record of performance under the program has been established--whether the political commitment is there to firmly support a pegged exchange rate with policy action.

Some substantial practical problems and risks would remain even if there were a commitment to adjust policies. The cost in setting a exchange rate peg too low or too high is obvious. And when a country is experiencing very high rates of inflation there are significant, if not insuperable, difficulties in striking an appropriate rate. There can also, of course, be significant problems in exiting a fixed regime or changing exchange rate policy without reducing the credibility of the program and threatening its success. An additional complication is that once there is political commitment for a fixed rate regime, it is often difficult to convince governments to change policy even when circumstances warrant it.

It would certainly be unfortunate if a country were to undertake a commitment to establish an exchange rate anchor largely because of the financial incentive of greater access to Fund resources than would otherwise be the case. That would seem to be the wrong approach.

In sum, I would not rule out a policy approach involving an exchange rate peg for a country with a very high rate of inflation, but I would place the weight on the associated policies--rather than on the peg per se--and treat this as part of a menu of options available to countries under stabilization policies where the Fund is providing financial and technical assistance. That is, I do not see there is a case for establishing a special facility, particularly when there are likely to be very few countries that could reasonably be expected to meet the associated conditions that one would want in place.

If there is a general desire to increase access limits for the countries in transition, especially those making a serious effort to stabilize their economies, I see no reason why it could not be done within the existing framework of Fund assistance.

I will not comment in detail on the operational features of Fund-supported currency stabilization funds as discussed in the paper, because of the more general reservations that I have about how useful such a special facility would be to the membership. There are nevertheless some interesting ideas on how we could move more quickly and flexibly in handling Fund operations in the context of the discussion on currency stabilization funds. Some of these ideas could be usefully picked up in terms of our general approach to the approval of Fund-supported programs, as well as in formulating procedures for the timely response by the staff, management, and the Board to requests for exceptional financing in crisis situations.

Mr. Autheman made the following statement:

I continue to welcome the increased interest in nominal anchor strategy and to regret the close link that has been established between such a strategy and the option of creating a stabilization fund. I continue to think, as stated in the Chairman's aide-mémoire of December 15, 1994, that the Fund can adequately support members' exchange rate policies, including policies involving a nominal exchange rate anchor under existing policy, with, if needed, marginal changes to these policies.

On the design of nominal anchors, I would stress three features. First, the nominal anchor must introduce a new constraint. This is why I prefer strict pegs to preannounced crawling pegs, which run the risk of behaving like a targeting of a real exchange rate. Second, it is important to prevent any sclerosis and, from the beginning, to build in an element of adjustability, even if this one is not announced. And, third, to be credible, such policies must be designed in a medium-term framework and not considered as a purely transitory experiment.

On the policy conditions, I am in broad agreement with the conditions mentioned in paragraph E, page 26, of the staff paper. However, I would emphasize that what matters is not so much whether the conditions are met as whether they can be met. What is at stake is not only the political commitment of the authorities, but also their technical ability to react in an orderly and effective way to unforeseeable shocks, their capacity to adhere to the budgetary executions forecast when unexpected events such as a sharp fall in revenues or a sharp increase in arrears develop, their capacity to stabilize capital inflows of an unexpected magnitude, and their capacity to use interest rates freely without creating excessive damages to the banking sector. Therefore, I would insist, of course, on the consistency of the commitment, but I would also insist on the predictability of the main economic variables. I would find it difficult to implement a nominal anchor strategy in a country that is unable to predict how output or inflation may behave. I would also insist, more than is done in the paper, on an assessment of the strength or vulnerability of the banking sector, such as could prevent the authorities from freely implementing the interest rate policy required by the nominal anchor strategy.

Concerning the modalities of our support, for several reasons I am not attracted by the idea of creating a new facility. As a matter of principle, I consider that we should only consider creating a new facility when we deem it impossible to fulfill one of our tasks through the existing mechanisms. Unless we are given clear evidence that we cannot perform the task of helping countries stabilize their currency within the framework of stand-by arrangements, I will be reluctant to support institutional innovations. And I would be concerned if we were to conclude that we are unable to help countries stabilize currencies within the framework of stand-by arrangements.

Second, the creation of a new facility that would be associated with very high access is likely to create a risk of adverse selection, and to bias judgment both in the country and in our institution. It would be unfortunate if the attractive level of access to that facility were to become an excessively important factor in the demand behavior of countries.

Third, I believe that a new facility would lead us to consider operational innovations that are not advisable. Circumstantial law-making is paradoxically conducive to stringent and unworkable practicalities.

I am concerned by the possible emergence of short-term liabilities toward the Fund. There is a risk in the proposed scheme of creating Fund "hot money," and I have doubts about the relevance of the micro management features of the proposed facility. I fear that they could constitute a recipe for failure, whether they triggered a clash between the staff and the authorities in the case of strong turbulences in the market or they made it impossible to implement the scheme.

I am concerned by the need not to undermine the principle of equity, as Mr. Mesaki said in his statement; therefore, I would be reluctant to support the opposite option of an ad hoc approach which would fall under the same criticism. I am therefore ready to consider the design of a window within a stand-by, not above a stand-by, along the following lines.

We have increased our access limits. I personally take them as a binding rule. However, I remain ready to discuss new general limits if it appears that the current limits constitute an excessive constraint of the fulfillment of our mission. But I would be reluctant to breach our agreed rules in a methodical way. If we are to develop above-limit access, we need to set a framework for doing so. Therefore, I envisage a window approach as a window that is within the general architecture and under the roof, and not, like the staff, as a window above the roof.

I see a case for greater financial support to programs relying on nominal anchors, because they are demanding and because countries need to strengthen their reserves. And I would prefer to do it under some enlarged access limit policy. Following some agreed guidelines, and while keeping some measures, I could understand if we increased our access limits by 20, 25, or 30 percent. I would be very reluctant to consider reasonable a doubling of access limits. Within the framework of our existing instruments, we can accommodate several adjustments, such as up-front disbursements and monthly monitoring of reserve targets, and we can also consider a shorter duration for the enlarged tranches. Thus, I would prefer such a gradual approach versus either an ad hoc approach or one that would not be consistent with our principles.

Finally, I would find it helpful if, in the concluding remarks we kept a reference to the General Arrangements to Borrow, as in the Chairman's aide-mèmoire. We may find it useful in the future to follow this course.

Mr. Tulin made the following statement:

I would like to congratulate the staff for an excellent paper, which makes a substantial contribution to the elaboration of both conceptual and technical issues related to the currency stabilization fund project.

I would also like to thank my colleagues for their interesting and sometimes provocative statements, which have set today's discussion on a constructive course. My authorities believe that currency stabilization funds could play a useful role, particularly for those countries that undertake strong Fund-supported adjustment efforts aimed at simultaneously stabilizing macroeconomic situation and achieving greater openness of their economies.

A currency stabilization fund, as a type of currency swap arrangement between a member and the Fund, would provide a considerable underpinning for the conduct of prudent monetary policies by the authorities in the reforming countries where establishment of a nominal exchange rate anchor is considered feasible by the Fund to complement other strong measures aimed at reducing inflationary expectations. The basic idea behind currency stabilization funds is essentially the same as in the case of bilateral swap arrangements; it would be good to have them in place and make them highly visible to the market participants but it would not be expected that they would be frequently activated.

Although many economies in transition and developing countries proceed with the profound liberalization of their external payments regimes, their need for currency swap arrangements of the types that are commonplace among the central banks of industrial countries has become pronounced in cases involving considerable reliance on various types of pegged exchange rates, particularly in the absence of established access to private financial markets. Although countries that closely cooperate with the Fund may be expected to achieve a modest increase in their reserves and an improvement of their medium-term balance of payments prospects soon after initiating their adjustment efforts, for some time they may still lack adequate resources to counter possible speculative attacks against their currencies over the short term. In countries with entrenched inflationary expectations, exchange rate-anchored stabilization programs can become a viable policy option only when they are backed by sufficient reserves. Therefore, to boost the credibility of a currency peg and to achieve a quick reduction in inflationary expectations, currency stabilization funds will need to be meaningful in size. An access limit of about 100 percent of quota, as suggested by the staff, may be regarded as a useful guideline. Nevertheless, the Executive Board will need to determine the appropriate level of access in every case, taking into account possible cofinancing of a particular currency stabilization fund, other swap arrangements available to the member, the size of member's international reserves, and all relevant economic indicators.

Like many other chairs, during preliminary consideration by the Executive Board of this subject in December 1994, we expressed a number of concerns that should be dealt with before the concept of the currency stabilization funds can be successfully implemented. The most important of them are the following: the currency stabilization funds should not be used as a vehicle for financing fiscal deficits or providing traditional balance of payments support; the currency stabilization funds should not discourage or delay members' necessary adjustment efforts; and market signals must be carefully interpreted before the resources are made available for defending a particular exchange rate peg, which might prove to be unsustainable.

The staff paper before us adequately addresses all of these and many other concerns. It appropriately stresses the fact that a case-by-case approach will be necessary to decide whether, in the specific circumstances of a member country, fixing the exchange rate and establishing a currency stabilization fund would be relevant. The precautionary nature of currency stabilization funds implies that they could be established only in the context of a fully financed program with detailed built-in contingency mechanisms. In any event, currency stabilization funds would involve close monitoring of developments by the staff and should be inextricably linked with an upper credit tranche conditionality. Such a close link would allow us to avoid establishing currency stabilization funds as a separate special facility and instead incorporate them as special windows within the framework of extended or stand-by arrangements, upon the expiration of which currency stabilization funds would normally also be terminated. However, bearing in mind Mr. Mesaki's comments about the possible availability of currency stabilization funds in the context of ESAF arrangements, I could also support a separate facility approach, as long as the link to strong conditionality is preserved, and if there was the required 85 percent majority in the Board in favor of this position.

Most operational suggestions made by the staff with regard to currency stabilization funds make sense and are acceptable to me. Therefore, I shall briefly state my views on a selected few of them.

First, I agree, in general, with the proposal to apply to currency stabilization funds the same system of charges that relates to other General Resources Account facilities. However, I do not share the view that higher service charges or risk premia are necessary or desirable for future currency stabilization funds, particularly if a window approach is adopted, under which service charges and commitment fees will be also collected on the amount of regular Fund arrangement. I do not believe that we should unnecessarily overcharge members with weak reserve positions for the provision of additional contingency "credit lines," as Ms. Lissakers described them, that may never be activated. The Fund could, perhaps, levy charges only on the actual use of currency stabilization fund resources, as currency stabilization funds, by definition, will be of a revolving nature and, unlike other forms of the Fund's support, could involve repeated purchases and repurchases during the period of arrangement.

Second, the idea of cofinancing of currency stabilization funds under the Fund's umbrella by individual countries or other multilateral organizations seems promising, as it could pave the way for possible establishment of separate swap arrangements between the program countries and cofinancing participants in the postprogram period.

Third, I am doubtful as to whether excessive tranching of currency stabilization funds will be helpful. A request for a third or fourth tranche should be regarded as a serious warning signal that the exchange rate peg may be unsustainable. Therefore, I would limit the number of tranches to no more than four and support the proposal to establish shorter periods for repurchase expectations for purchases beyond the first tranche.

I would urge the staff to come up with specific proposals on Fund policies regarding currency stabilization funds at an early date on the basis of today's discussion.

Mr. Wijnholds made the following statement:

The notion of a currency stabilization fund financed by the Fund continues to have my support, although strict conditionality would have to be applied and eligibility should be limited. In principle, the Fund's support of an exchange rate peg or crawling peg in the form of a currency stabilization fund has some clear advantages. It could be particularly useful in reinforcing the credibility of appropriately designed and disciplined financial stabilization programs. Such a Fund-supplied confidence-building instrument could be especially appropriate for countries still in the early stages of macroeconomic stabilization and transformation to a market economy, or in cases in which a new currency is introduced, with the aim of consolidating stabilization gains and further improving inflation performance. In this regard, I note Mr. Mesaki's reference to Georgia, and would like to mention that the country is working in the direction of introducing a new currency.

I would also say that however useful a currency stabilization fund can be, its role should not be overestimated. If an exchange rate peg supported by a currency stabilization fund turned out to be unsustainable, the effectiveness of this instrument would be undermined and its confidence-building character would not be available a second time around. Hence, the Board should be cautious when approving the use of a currency stabilization fund, and should insist on strict conditionality. In this regard let me reiterate two of the main conditions advocated by this chair in the previous Board discussion on the currency stabilization fund. It would be desirable to design the eligibility criteria in such a way that, in practice, the availability of the currency stabilization fund was limited to a relatively small number of countries, and the currency stabilization fund should be a window in existing programs rather than a separate facility. Incorporating the currency stabilization fund into a stand-by or extended arrangement would underline its transitional character and strengthen conditionality. Let me emphasize also, as Mr. Clark has done, that the currency stabilization fund would ideally not have to be used; it is there as a confidence-building buffer and should not be viewed as a mechanism for actual financial support. We should therefore also be careful about the size and availability of the first tranche. Indeed, 35 percent of quota would seem to be a reasonable maximum.

As to the further operational modalities of the currency stabilization fund, I feel that the staff has spelled out most of the necessary elements to ensure the level of conditionality and monitoring that the nature of this facility calls for. Strict adherence to these conditions is necessary to ensure that the currency stabilization fund indeed functions as intended, not as an intervention facility. Of these conditions, I attach particular importance to the fulfillment of prior actions to ensure monetary stability, especially firm central bank control of credit growth, the continuous adherence to extensive reporting and monitoring requirements, the readiness to rapidly adjust fiscal and monetary policies in defense of the peg, and a limit on the commitment to the peg of a maximum period of either one or two years. Ms. Lissakers, in her statement, has made some important points on exit strategies. Like her, I would be very interested in the staff's views about the most appropriate ways of "exiting" from an exchange rate peg that is no longer sustainable, also bearing in mind the delicate political dimension that may be involved. As regards other modalities, I agree with a repurchase expectation of three months and an obligation to repurchase after one year.

The staff's frequent references to the exceptional circumstances clause and the use of resources from the General Arrangements to Borrow raises some questions. In my view, a currency stabilization fund of 100 percent of members' quota should be considered a true maximum, with actual availability within this limit to be determined on a case-by-case basis. If regular Fund support for a country using the currency stabilization fund window were to take access beyond 100 percent of quota, the exceptional circumstances clause should be invoked only in order to supersede the annual access limits; I would expect the 300 percent cumulative limit to be adhered to, in view of the early repurchase expectation and the fact that a currency stabilization window is normally designed for programs in the first phase of stabilization. Otherwise, even when all necessary conditions are fulfilled, an enlarged access for intervention purposes would expose the Fund to excessively high risks.

Finally, while I agree with most of what Mr. Clark has said in his statement, I do not think it is reasonable to require countries to have significant nonborrowed reserves already available at the time they request a currency stabilization fund, as he suggests. It seems to me that countries in the early stages of monetary stabilization cannot be expected to have acquired substantial reserves. Were they already to have sizable reserves, the need for a confidence-boosting currency stabilization fund would then not seem all that obvious.

Mr. Cippa made the following statement:

Before focusing on some of the points for discussion raised in the staff paper, I would like to make a general comment.

Since our last discussion in December, significant developments have raised questions about the role of the Fund, especially in dealing with turbulent emerging economies and economies in transition. The debate is ongoing, but it is safe to say that all indications point to important and growing demand on Fund resources for the coming years. In particular, the burden of an emergency financing facility might ultimately also fall on the shoulders of the Fund. Within this context, this chair is somewhat concerned that by opening an excessive number of windows and facilities at this time, yet greater demand for the Fund's resources could be stimulated. We would therefore be cautious about taking any action which could create expectations of additional access to Fund resources. For this reason we do not see as a priority within the present work program the preparation of recommendations on Fund policies regarding CSFs for the consideration of this Board.

After this remark, I can be relatively brief. Also, because we share many of the general reservations about CSF, raised by previous speakers namely Messrs. Mesaki, Schoenberg and Ismael.

A nominal exchange rate anchor can, under certain circumstances, be a useful instrument in breaking inflationary expectations and provide a clearer guide for monetary policy in a context of rapidly declining inflation. However, a nominal exchange rate anchor is by no means a substitute for but rather a complement to strong and credible stabilization policies. Moreover, a CSF should remain an instrument to stabilize expectations and never be employed as a source of balance of payments finance.

The notion of CSF is clearly linked to fixed exchange rates. However, we should be careful that the sheer Fund financing for CSFs does not per se create incentives for countries to adopt fixed exchange rates. A comprehensive Board discussion on the appropriateness of a nominal anchor and Fund policy recommendations in this field is still pending.

There are only a few cases where fixed exchange rates and even fewer cases when CSFs are warranted. As the staff points out, a CSF would only be appropriate in cases of high inflation countries with good prospects for achieving a rapid and substantial decline in inflation. This in turn supposes strong macroeconomic policies and clear political will. If prospects for reducing inflation speedily are poor, a fixed exchange rate would rapidly become overvalued, putting pressure on foreign exchange reserves. As a result, the CSF would be used up quickly and the currency would have to be devalued, sooner or later.

The policy conditions necessary to ensure the success of an exchange-rate-based stabilization outlined in point e. at page 26 are extremely important and we broadly share the staff conclusions. Like Mrs. Lissakers, however, we would have preferred the staff to be more explicit also on the possible exit strategies.

In those cases in which an exchange-rate-based stabilization might be appropriate, its chances of success might be greater if the peg were fixed at the beginning, and only allowed to crawl, if at all, later on. A crawling peg could possibly be seen as a less convincing sign of an anti-inflationary stance than a fixed one would be. Therefore, it might be preferable to use CSF to support programs which are designed, at the beginning at least, to sustain a fixed peg.

On the question of potential CSF access, we are a little concerned about the way in which the staff has phrased their point of view in the paper we are discussing today, and we hope it does not reveal the existence of a fundamental tendency on their part toward seeing a CSF as a potential source of finance rather than merely an instrument for stabilizing expectations. On page 16, we read that: "Access under CSFs could vary considerably on a case-by-case basis, depending on the degree to which expected need for reserves is already met..." We do not see this as a question of degree: to us it is clear that any expected need for reserves must be completely met before a CSF could be established. As the staff states elsewhere in the paper, and this we fully support, the program underlying a CSF would have to be fully financed by other funds than those available under a CSF.

Finally, concerning access, we would like to stress that we favor maintaining the present cumulative access limit of 300 percent of quota, and would not support the creation of a special facility which would allow a member to draw more than this amount.

Mr. Kiekens made the following statement:

An exchange rate peg is more than a means of achieving durable policy discipline. Indeed, I agree with the staff that, in certain circumstances, an exchange rate peg can become an effective transitional instrument for quickly bringing down inflation once a stabilization process has acquired a critical mass of credibility.

The fundamental questions are: under what circumstances is an exchange rate-based stabilization policy preferable to a money-based stabilization policy; in case a country chooses an exchange rate-based stabilization policy, what conditions are necessary for it to succeed; and how can the Fund justify discriminating between fixed and floating rates when considering the granting of specific financial support to an exchange rate-based stabilization policy?

Recent experience in several transition countries has led Board members to insist, on several occasions, that we should have a more general discussion on the criteria shaping the guidance the Fund gives to countries as they consider whether to choose a money-based or an exchange rate-based stabilization policy.

I do not believe that the money-based strategy is always a second-best solution that should only be chosen when the policy and other conditions necessary for an effective currency peg are absent. Even in cases in which policymakers are perfectly able to address the root causes of inflation with aggressive fiscal, monetary and structural policies, there is as yet no clear basis for a decision to complement these policies at an early stage by pegging the nominal exchange rate.

The staff states that the fixed exchange rate policy has powerful stabilization effects because: it operates directly to stabilize the prices of traded goods by providing a highly visible price anchor; it builds public confidence and thereby slows the velocity of money circulation; it provides a clear signal of policy intentions and discipline; and it provides clear guidance for monetary policy. All that is true. But the staff also acknowledges that this strategy carries significant risk to the extent that shortcomings in the design or implementation of policies could render the peg unsustainable.

At the same time, the staff seems to say that shortcomings in the design and implementation of policies are the only source of risk, and that this risk is effectively eliminated owing to superior Fund advice and the enhanced monitoring of implementation. I am less sure of this conclusion. Many countries consider a floating exchange rate more appropriate to their circumstances than a pegged rate, and I do not see why the same conclusion would not apply during the transition period of sharply diminishing inflation. I am of the opinion that, even if accompanied by policies capable of sharply reducing inflation, an exchange rate-based stabilization policy would be at risk if a fixed exchange rate regime were unsustainable for the economy in question, even under more stable circumstances. We have to assess whether a fixed exchange rate regime is really the best choice for a given country, in light of inter alia its trade structure and the possibly considerable relative changes in productivity and other factors determining its competitiveness in coming years. Even Canada, whose economy is closely integrated with the U.S. economy, or Italy and the United Kingdom, which are both closely integrated in the European Union, prefer, or have been forced, by the markets to adopt floating exchange rate regimes. Like Mr. Schoenberg, I would also like to recall here that for all participants in the exchange rate mechanism, except Germany and the Netherlands, it was considered a prudent strategy to have a floating band of 15 percent around the ECU, although in fact Belgium and Austria, for instance, have succeeded in maintaining a small range of fluctuation.

Once a country has decided that an exchange rate-based stabilization is the best choice--and it is a difficult decision--I broadly agree with the staff concerning the policy conditions for an effective peg.

The staff admits that in newly transforming economies, or countries verging on hyperinflation, the structure of relative prices may be so distorted that informed judgments on the appropriate level of the real exchange rate are difficult or even impossible. In the latter case, the staff nonetheless considers that a nominal peg can play a useful stabilizing role by forcing the economy to adjust to the peg. But it seems to me that, in such circumstances, it would probably be less costly in the first stage to let the exchange rate adjust to the economy than the other way around, especially in the case of large economies with rather rigid structures. More generally, as I have said in several previous discussions, it is my view that, to succeed, an exchange rate-based stabilization must make it sufficiently visible to the general public that policy measures are in place for achieving a rapid decline in inflation. Such high visibility requires a significant initial reduction in inflation before the exchange rate can be pegged.

On the question of whether the Fund can favor exchange rate-based stabilization over money-based stabilization by providing additional financial support, I am satisfied that a sufficient legal basis for such a policy can be found in the Fund's mandate under Article I (iii) to promote exchange stability. Of course, the Fund's special support should be equally available to all members that fulfill the conditions for a successful exchange rate-based stabilization. However, it is striking that we are discussing introducing such a distinction at a time when few candidates are left, and most of the developing and transition countries have already accomplished a credible reduction in inflation without this type of special assistance.

Another question is whether a member would qualify for such support simply by choosing the exchange rate-based approach, even in cases in which a money-based stabilization is clearly preferable because the higher risks of the exchange rate-based strategy are greater than its advantages. A country might in fact be influenced to choose the more risky strategy precisely in order to receive the additional Fund support. I believe that, in such circumstances, the Fund should be able to refuse its special support.

The staff provides useful information on the compatibility of Fund financing of currency stabilization funds with the prohibition, under Article VI(1)(a), enjoining members from using Fund resources to finance large or sustained outflows of capital.

Just as nominal anchors cannot substitute for stringent fiscal and credit policies, so currency stabilization funds cannot be a form of balance of payments or budget support. They are, in essence, a credit line to finance short-term capital outflows, and are therefore only acceptable in limited amounts. I agree with the staff that the Board's judgment on whether a member is financing large capital flows depends on whether the Fund's involvement in such transactions risks endangering its ability to fulfill its primary task of financing current account transactions, whether in general or for the country concerned. I believe that Fund support for a currency stabilization fund limited to 100 percent of a member's quota is compatible with Article VI.

Further reflections on the Fund's specific support for fixed exchange rate regimes should not be excluded from our future consideration of the broader issues of capital account convertibility, the changing role of the Fund, and emergency financial mechanisms. All these issues stem from the same phenomenon of globally integrated financial markets, which, as Ms. Lissakers stated, have made the distinction between current and capital movements less relevant.

The staff correctly advocates special operational features--including giving currency stabilization funds a revolving character, short maturities for currency stabilization fund drawings, and special conditions for activating and using currency stabilization funds. All these justified special operational features show that currency stabilization fund financing cannot be considered as a window of stand-by arrangements, but rather has an entirely different nature. We cannot circumvent, by an artificial qualification, the requirement of a special majority for introducing a type of arrangement that substantially differs from a stand-by arrangement. The short maturities can only be made legally binding as a condition for granting a waiver of the limitation on a member's use of Fund resources, which is presently 200 percent of its quota. Logically, if that legal basis is chosen, this condition of short maturities for currency stabilization funds should apply to all drawings above 200 percent of quota, regardless of whether they are for current account financing under a genuine stand-by arrangement or for capital account transactions under the so-called currency stabilization fund window. Shortening the maturities for all stand-by drawings above 200 percent of quota would be inappropriate, which argues that Article V, Section 4, is likewise an insufficient legal basis for imposing short maturities on currency stabilization fund financing.

Drawings beyond the first tranche would be subject to Board review and approval. The Board would need to determine inter alia whether the purposes and conditions of the currency stabilization fund would continue to be met and, in particular, whether intervention or policy adjustment was warranted. This feature, which leaves much to the judgment of the Board, differs essentially from the nature of a stand-by arrangement. A stand-by arrangement provides a member with the assurance that a request for purchase will not be subjected to any further review or decision by the Executive Board so long as the member is observing the quantitative performance criteria. Reviews under stand-by arrangements were initially designed to reach additional understandings on quantitative performance criteria for later tranches for which it was not possible, or not desirable, to determine performance criteria at the time of initial approval. The tendency to consider reviews as an opportunity for the management and the Board to assess policy implementation--not on the basis of quantitative performance criteria, but on the basis of judgment--and to refuse to complete the review if this judgment is negative, is probably a welcome evolution in light of the need to adjust policies to rapidly changing circumstances. However, it does not properly belong to the essential nature of a stand-by arrangement.

The right approach is not to create a window under existing stand-by arrangement policies. Nor, probably, is it the right approach to create a new currency stabilization fund facility. I would prefer, to either of these courses, to see us review our stand-by arrangement policies in order to make them more flexible and enable the Fund to design more tailor-made programs. That is why I again wish to call for further examination of this issue in light of the results of our impending discussions on capital account convertibility, the role of the Fund, and emergency financing procedures.

Ms. Lissakers said that a few speakers appeared to have argued that currency stabilization financing might run a high risk of failure because a currency peg would not be sustainable. That would, in turn, put Fund resources at risk. However, substantial resources had already been committed to assist some potentially risky, high inflation cases among the transition economies that had not necessarily adopted currency pegs. Therefore, the policy question that should be addressed was whether or not better results could be achieved with an exchange rate peg, and whether that policy should be supported by the Fund.

There was a growing body of evidence that exchange rate anchors yielded better results, Ms. Lissakers added. A recent study from Princeton University, covering 136 economies over the period 1960-90, revealed that countries using exchange rate pegs had achieved improved inflation performance, increased monetary discipline, declining nominal interest rates, and strengthened confidence in economic policy. High investment ratios and strong growth in international trade were also evident in some countries.

A few Directors were concerned that countries with weak administrative capacity may not be able to maintain an appropriate policy framework to support an exchange rate peg, Ms. Lissakers noted. However, while an exchange rate peg was not a substitute for sound policies, the contrary case could be made that the peg was more useful where there was a lack of capacity to monitor more complex exchange rate arrangements.

Mr. Evans said that it was ironic that many Directors who had favored floating exchange rate regimes had also supported the use of a currency stabilization fund, under which the exchange rate would be pegged. In general, a more pragmatic approach would be needed to deal with those countries that had opted for exchange rate-based stabilization policies.

While there was some merit to the view that opening a new window or facility might bias Fund advice toward a nominal exchange rate anchor, there were many reasons for the Fund to support exchange rate-based stabilization schemes, Mr. Evans added. However, a number of issues needed to be borne in mind, including the avoidance of overvalued exchange rates, the need for an appropriate exit strategy, and the need to discourage too heavy a reliance on the new facility.

It was clear that an exchange rate-based stabilization policy was not a substitute for a program of sound economic policies, Mr. Evans said. To that end, strong conditionality was essential. Moreover, a successful currency stabilization fund should be viewed as a form of financial security, rather than as an additional line of secured financing.

In conclusion, there were essentially four alternative strategies that the Fund could adopt, Mr. Evans remarked. First, there might be no change in current policy. Second, the issue could be addressed in the context of existing stand-by arrangements. Third, enlarged access might be possible under existing arrangements. Finally, a new window or facility might be created. The latter option would be preferred if appropriate terms and conditions could be established.

Mrs. Guti made the following statement:

> We have previously expressed our general support for the use of Fund resources to finance currency stabilization funds. This is a means of broadening the tools available to the Fund, thereby contributing to improved program design in cases where an exchange-rate-based stabilization strategy might be the most suitable approach. The need for Fund support, in this connection, would depend on the individual circumstances of the member country.
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> The scenario that is the focus of attention in the staff paper is the high inflation country that is capable of implementing sound fiscal and monetary policies. Policies aimed at structural reform and the creation of appropriate institutions are also emphasized. In short, a CSF is no escape valve from the orthodoxy of stabilization, and the scheme will not weaken a country's adjustment effort. This is an important principle for Fund involvement in CSFs.
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> With the emphasis on adjustment and reform, it would seem useful also to consider the role that a stable exchange rate might play in preventing inflation from becoming a serious problem. There is evidence, especially in low-income countries, that large and frequent devaluations tend to create an inflation spiral, thereby undermining stabilization and the other goals of adjustment, including the goal of building private sector confidence. By helping to curb inflation, a stable exchange rate will help create an environment conducive to low and positive real interest rates, increased foreign and domestic investment and the return of flight capital. However, it should also be recognized that exchange rate pressures facing low-income countries reflect systemic problems such as the secular decline in these countries' terms of trade which can be corrected only over an extended period of time. Under the circumstances, the short-term nature of the

CSFs would seem to limit its use in low-income countries. I would appreciate staff's comments.

With regard to operational features of CSFs, we can broadly endorse most of the ideas put forward by the staff. The one I find most critical is the need to link the use of CSFs to continuing compliance with a Fund arrangement. It is also important that access limit should be adequate to make the arrangement credible. I could, therefore, go along with the proposal for a limit of 100 percent. Adherence to reporting requirements must also be stressed. However, I do have some concerns. I am not sure that it is necessary to make the use of CSFs conditional on having a Resident Representative in place. It may help in some cases; however, if the aim is to protect the resources of the Fund, then it is difficult to see how a program with a CSF carries a greater risk than one without. Tranching should minimize the risk of Fund exposure; but I think that having up to six tranches might make the system unnecessarily complex. A scheme of two to four tranches seems to be a reasonable balance. Moreover, while I support the need for strong reporting requirements, such requirements must be fashioned to the particular circumstances of each country, and the Fund should be prepared to provide technical assistance where it is needed.

On the question of whether to have a "window" or a separate facility, I prefer the former. This would show clearly that our emphasis is on adjustment and the supporting policies, and not merely support for a fixed exchange rate. In this connection, I take note of the staff's view that a fixed exchange rate should not be a permanent policy.

Regarding the repurchase period, we should emphasize the temporary nature of Fund financing. In this connection, I could go along with a one-year repurchase obligation. There is one question: would the same rule apply for co-financing operations? Perhaps for low-income countries, which are likely to have relatively small financing requirements, the Fund might wish to work more closely with the donor community to mobilize concessional financing, minimizing purchases from the General Resources Account.

Mr. Fernández made the following statement:

Mr. Chairman, we support Mr. Mesaki and Mr. Schoenberg on their difficulties with the substance of the staff's reasoning in making the case for the creation of a currency stabilization fund.

We are not convinced that the new paper on the currency stabilization fund has made much progress to support the establishment of a new window or facility.

Questions to be more carefully studied are related to the following issues:

In the case of consistency between targets and instruments, it is well known that when you fix the exchange rate, price and quantitative nominal variables become endogenous. There is no way to target successfully upper or lower limit levels for variables such as prices of goods and services, interest rates, wages, etc, or international reserves, monetary base, net domestic assets, etc. Central Banks loose their capacity to achieve a specific inflation rate through other intermediate monetary variables.

We are not sure all parts of the staff's paper take, appropriately, these general rules into account. For instance, in paragraph 1.e., section IV of the paper, it is suggested to target simultaneously a specific rate of inflation together with the fixing of the exchange rate. In the same paragraph it is suggested to establish credit creation targets.

With regard to the purpose of the currency stabilization fund, in our view, we should be more precise about purposes and circumstances for activation of the currency stabilization fund. Proposed present terms of the currency stabilization fund facility are poorly defined. For instance, at the top of page 2 of the staff's paper it is said that the facility would be used typically in cases of high and rising inflation and entrenched inflation expectations; however, in page 26, paragraph 1.b., it states that the currency stabilization fund could be considered in cases of high inflation with good prospects for achieving a rapid and substantial decline in inflation. At the same time it is said that the activation of the currency stabilization fund could take place at the outset of an arrangement or during the course of a review.

Turning now to the issue of the choice between pegged versus exchange rate crawls, these two exchange rate systems end-up being very similar in practice, in many instances. This is the case when the targeted exchange rate level has been calculated wrongly or when the economic agents behaved inconsistently with that target. In these circumstances the exchange rate quickly moves toward one of the limits of the crawl. Nevertheless, it is confusing and inconsistent with the key purpose of breaking inflationary expectations to leave open the possibility of choosing between fixing, crawling, corridors, target zones, etc. If the facility tries to make a u-turn on a hyper inflationary situation, fixing the exchange rate at the beginning of the program would be, conceptually, the most appropriate thing to do.

Preannounced crawls, corridors, target zones, etc., incorporated during the course of a program's review, will serve different purposes than that of suddenly breaking rising inflationary expectations.

Concerning exit strategies, we also, as Mr. Clark and others, had hoped to find a section on this important issue in the paper.

With regard to the burden of adjustment, the staff talks about contingency plans for dealing with large capital outflows or inflows associated with the exchange rate targeting, but it lacks to explain how the economy should typically adjust to one situation or the other. It seems to suggest that full flexibility of interest rates is an essential part of the program, and we agree with that. But we shouldn't expect the authorities to accept the contractionary effects on the real economy, on the banking system, and on the fiscal position of prolonged high interest rates, as the only variable in the economy available in the short-term to sustain the exchange rate fixing. How much financing would then be required to support the parity? Involving the IMF into the business of going counter market forces is very risky for the institution.

In conclusion, we don't think that the currency stabilization fund facility, as proposed, would be useful, neither as a crisis prevention facility, nor as a crisis management one. We consider, as in December, the crawling peg or corridor version as an instrument for providing added stability and certainty to a strategy of stabilizing and reducing the rate of inflation when the program is already on track, that is to say, when key macroeconomic and structural policy decisions have been taken and are in the process of being implemented. But we are not sure we need a specific facility or a window for these purposes.

Mr. Wijnholds sought clarification of the difference between the proposed currency stabilization fund and the type of financing package that the Group-of-Ten had established for Mexico in the period 1993-94.

Mr. Fernández said that, in the case of Mexico, both interest rates and the exchange rate were permitted to adjust to absorb external shocks. The current proposal involved fixing the exchange rate, which would limit the capacity of exchange rate policy to compensate for movements in monetary variables.

The Chairman said that the current proposal would be very similar to the scheme previously adopted for Mexico, providing the proposed conditions could be met.

Mr. Schoenberg noted that the Fund's provision of financial support for an intervention facility in Mexico confirmed that regular Fund resources could be used for exchange rate stabilization.

Mr. Autheman remarked that a fixed-exchange-rate approach had worked in Argentina, and that too much focus on the exchange rate issue might risk losing sight of the fundamental objectives of the proposed intervention facility.

Mr. Giulimondi made the following statement:

The basic question of the theoretical preferability of money-based versus exchange-rate-based stabilization is still far from answered. Also from today's discussion, it is easy to come out with the feeling that a general rule cannot be determined and that the choice of a nominal anchor must be made on a case-by-case basis.

In theory, the establishment of a Fund facility to support exchange rate based stabilization policies is fairly appealing, as it would complement existing policies and increase the array of instruments available to the Fund. Its actual utilization would prudently depend upon verification of the specific circumstances regarding each individual country. However, in the concrete, CSFs might become either a normal or a rather exceptional instrument according to the implied theoretical framework which would prevail in the actual implementation.

To be successful, a CSF would be expected to enhance the credibility of the underlying policy framework, in a strong conditionality context. Under a fixed exchange rate regime, it may be hard to say whether exchange rate pressures are driven by market misperception and short-term speculative attacks or, rather, if they are expression of real market forces owing to a lack of supportive policies or to an initial level of the exchange rate set inappropriately. Since the markets, by definition, are normally assumed to be right, a heavy recourse to CSF arrangements in the course of program implementation could signal the malfunctioning and potential failure of the peg. Therefore, and somehow paradoxically, the CSF would serve its purpose best when it would not need to be used, at least not in an important way. This, in all probability, would, in turn, indicate that an acceptable policy track record is already in place and confidence has been rebuilt to some extent.

Early currency pegs in transition economies are likely to run into additional difficulties. Since credibility is the key word in managing the exchange rate, an early currency peg would easily entail a two-fold uncertainty and, hence, credibility problem. First, the policy targets are inherently uncertain in an environment of wandering monetary aggregates, distorted international relative prices, structural changes, and inadequate economic statistics. Second, the link between instruments and targets may turn out to be even more uncertain because of the inefficiencies of the financial system, even if in the presence of a serious commitment by the authorities.

Therefore, CSFs at early stages of the stabilization process would be risky businesses, both for the Fund and for the countries concerned. An ancillary, later role for them in the sequencing of the adjustment measures would be prudent. Indeed, the appraisal of which is the right moment for establishing an exchange rate anchor is highly judgmental and considerable risks are implied by the failure of an exchange-rate-based stabilization. Furthermore, the unsettled status of the economic debate on the pros and cons of fixed versus floating exchange rate adjustment would not recommend that the Fund be perceived as advocating a general policy of fixed-exchange-rate-based stabilization.

An additional argument in favor of a cautious approach might be found on legal grounds in the provisions on capital account convertibility contained in Article VI, Section 1 of the Articles of Agreement. The question of the interpretation that is to be given to "large and sustained" capital outflows is still pending. The staff correctly holds that it is not possible to determine numerical values which can define what "large" and "sustained" eventually is, and provides two interpretative criteria, namely the ability of capital flows financing to affect Fund's liquidity and the fact that large or sustained outflows will often be a consequence of inappropriate monetary or fiscal policies. While I have no problems with the first criterion, the correlation between policies and outflows may signal a potential conflict with the role assigned to the currency stabilization funds by the staff itself. Fund financing of early-stage currency pegs might conflict with Article VI, precisely because it might be aimed at stemming sizable capital outflows fueled by policies which are still largely unsettled. In this light, one of the criteria to assess the compliance of Fund's financing with Article VI provisions could be, indeed, the previous establishment of an appropriate policy track record and the build-up of a certain degree of market confidence.

Finally, I will touch briefly upon two fundamental technicalities of the hypothetical new facility. First, as concerns the choice between the window approach and a separate facility, the window approach would be preferable as it would better emphasize the close linkages between the additional financing and the conditionality imbedded in the "parent" credit-tranche arrangement, as well as it would allow to construct the new policy as an exceptional, transitional, and limited form of support. Second, the calculations made by the staff of the adequate reserve coverage, both in terms of months of imports and relative to domestic base money, point roughly to the adequacy of the proposed level of access at 100 percent of quota. However, a repositioning of the new policy from a vanguard to a later, more auxiliary role could entail a reduction of the level of reserves deemed as necessary to manage the exchange rate and, therefore, a lower level of access.

Mr. Barro Chambrier made the following statement:

Like previous speakers, we commend the staff for providing us with more specific proposals on the issues and procedures pertaining to possible Fund policies on currency stabilization funds. At this juncture, this chair intends to be brief and will address some of the issues for discussion proposed by the staff as follows

First, on general considerations, we continue to see merit in the role that the Fund could play through the currency stabilization fund in assisting member countries implement a strong anti-inflationary program. In this connection, it is also our view that, to be effective, the currency stabilization fund would need to meet two preconditions. It should be applied in cases where firm indications are that the policy measures adopted will contribute to a rapid deceleration of inflation, and where close monitoring is possible so as to ensure that the exchange rate peg and supporting policies are appropriate.

Furthermore, in addressing the root causes of inflation, the staff has provided convincing arguments that the exchange rate-based stabilization policy, the exchange rate peg, would be preferable to the money-based stabilization policy, as it could better enhance the public's confidence while providing clearer guidance for monetary policy.

However, we concur with the viewpoint that the currency stabilization fund should be supported by restrictive fiscal and credit policies, and by measures aimed at encouraging the return of flight capital and securing foreign exchange reserves through the use of appropriate monetary tools, including a flexible interest rate mechanism.

We also support the view that the period of fixity of the exchange rate should be a matter of judgment, and that continued assessment of the variable relevant to the sustainability of the peg would need to be made. In particular, emphasis should be put on such variables as balance of payments financing, and international cost and price competitiveness.

Above all, the currency stabilization fund could provide the necessary confidence to markets about the firm commitment of the authorities to the disinflation objective and, as Ms. Lissakers mentioned, can set in motion a virtuous cycle which will improve significantly the chance of success of the program.

Regarding the issue of cofinancing of the currency stabilization fund, we note that, as envisaged, the facility will only be extended in limited circumstances, and on a temporary basis. Therefore, we see here a case for considering cofinancing operations with other sources, particularly when the financing needs are significant. However, as pointed out by the staff, cofinancing for Fund-supported currency stabilization funds could become more complex and entail potential risks, such as the reluctance of other sources to participate in a timely fashion to the financing package. This would, therefore, limit its usefulness and credibility.

Second, turning to the operational features of the currency stabilization fund, given the fact that the facility is conceived to serve primarily as a confidence-building mechanism, we believe, therefore, that it could operate under a window within stand-by or extended arrangements and not as a separate facility. It is reassuring to note that ESAF-eligible member countries would be able to use currency stabilization funds through operations parallel to an ESAF arrangement, although such assistance would carry the risk of being too costly for this category of members.

We have no difficulty with the proposed access limit of 100 percent of quota, as well as with four tranches at a maximum for access. We, however, would recommend flexibility in access to Fund's resources, as suggested by the staff, and like Mr. Clark and others, we agree that the first tranche be front-loaded. The respective circumstances of eligible countries would need to be taken into account.

On the early repurchase issue, this Chair can go along with the proposed reconstitution provisions. On the cost of the currency stabilization fund transactions, we agree with the proposal that charges under the currency stabilization fund be similar to those pertaining to arrangements in the GRA.

Finally, on the procedures for handling Fund operations under the currency stabilization fund, the facility being both an emergency and an exceptional type of assistance, we have no difficulty with the procedures described in Section 3.7 of the staff paper.

Mr. Al-Tuwaijri made the following statement:

At the outset, let me say that I feel it would have been more efficient to have discussed the issue of currency stabilization funds after our forthcoming discussion on the role of the Fund.

During our discussion of last December, this chair, like Mr. Mesaki and others, expressed some reservations regarding currency stabilization funds. I will not repeat these reservations again today, but will nevertheless make three general remarks.

One important conclusion of our discussion in March 1994 of the policy experience in the Baltic countries, Russia and the other countries of the former Soviet Union, was that stabilization can be successfully undertaken in an environment of a flexible exchange rate regime. I am not suggesting that a pegged rate is of little value. However, it is important to recall that, in view of the difficulties of various issues related to a pegged rate regime in a turbulent macroeconomic environment, especially the determination of the "right" exchange rate level, the costs and benefits of pursuing a pegged exchange rate strategy need to be carefully considered. The lessons of those countries that have been successful in stabilizing their economy in the absence of an exchange rate anchor is instructive. Clearly, the need for a pegged exchange rate is an area requiring considerable judgment. Furthermore, in discussing the issue of currency stabilization funds it is important that the Fund not be seen as advocating a particular exchange rate system.

It is clear that currency stabilization funds can only play a useful role when domestic policies are sufficiently strong. In those circumstances, and given the increase in access limits, it remains an open question whether the need to supplement reserves by those countries that wish to pursue a pegged exchange rate regime could not be adequately addressed under our existing procedures. Here, the example of Lithuania, which made use of its access under a Fund arrangement to establish a currency board, is relevant.

Setting the exchange rate at an appropriate level is key to the success of the stabilization process. The staff rightly points out the difficulties in determining this level in certain circumstances. However, the staff argument that, when distortions are very large, the precise level of the nominal peg may not be critical to the success of the effort to sharply reduce inflation, and that "there is no choice but to let the economy adjust to the peg," raises some serious concerns. Specifically, allowing the economy to adjust to the exchange rate level, as opposed to the opposite, requires a highly flexible economic structure. We have seen the difficulties in relying solely on domestic adjustment in the CFA franc countries prior to last year's devaluation. I am not sure that a sufficiently flexible economic structure exists in economies that are still in the process of a substantial and lengthy stabilization and reform process. Presumably, if the economic structure was flexible enough to allow such an adjustment, would the large distortions not exist in the first place?

Having said this, I am not suggesting that the establishment of currency stabilization funds through the Fund would be entirely undesirable or inappropriate. However, in order to clarify some of the issues, we will need to revisit this question following our discussion on the role of the Fund next month.

Although the desirability of establishing currency stabilization funds is not clear, I will, nevertheless, make three remarks regarding some of the operational issues raised by the staff. First, there are some considerable practical difficulties in administering a currency stabilization fund through this institution. In particular, the Board's approval for purchases beyond the first tranche may be required at very short notice. The need for Directors to consult with their capitals prior to Board discussion on many issues highlights some of these difficulties.

Second, currency stabilization funds would require close and careful monitoring by the Fund staff, and the costs of such monitoring are clearly higher than those for Fund arrangements. However, it seems that charges associated with the operation of currency stabilization funds would have to be the same as those pertaining to arrangements in the General Resources Account. The presence of a resident representative would be critical. In such circumstances, cost-sharing arrangements with the authorities concerned, to help defray the costs of the resident representative post, would be only logical.

Third, cofinancing of currency stabilization funds is an option that should be pursued.

Mr. Calderón made the following statement:

Dellas and Stockman, in their paper "Self-Fulfilling Expectations, Speculative Attacks, and Capital Controls," concluded that "if a third party"--such as the Fund--stood willing to supply foreign reserves to a domestic policy maker at "favorable" terms in the case of a speculative run, on the condition that "responsible" monetary policy be maintained, no runs would occur and a fixed regime without capital controls would be viable, and no foreign reserves would ever actually be supplied by the third party.

The two necessary conditions for a successful exchange rate-based stabilization program are adequate macroeconomic policies and the willingness of the Fund to supply the necessary foreign reserves. Furthermore, the credibility of the program implies that no reserves are actually used. An obvious corollary of the model is what would happen if one of the conditions were not fulfilled; for example, if there was an inadequate supply of foreign resources by the Fund. The outcome would be the worst possible: the stabilization effort would fail and the country would have with a higher debt level.

The idea behind the currency stabilization fund is similar. As the staff tells us, the currency stabilization fund would be meant to support stabilization strategies involving a relatively early pegging of the exchange rate--once there were adequate assurances of the ability and willingness of a government to implement the program. A supplement of reserves is needed, during a transitional period, for instilling confidence and for possible intervention.

In an ideal program, the additional foreign reserves would only be used to instill confidence. When would intervention with Fund resources be needed? When the program lacked credibility or the Fund's supply of resources was considered insufficient. We will consider these two reasons in what follows.

The paper enumerates some of the basic prerequisites of a credible exchange rate-based stabilization program: first, the appropriate level of the currency peg is crucial; second, all monetary and fiscal policies should be in place; and third, any automatic indexation practices must be abolished. Such actions generally require legal reforms and therefore must be adopted before access to the currency stabilization fund is granted.

One issue that is unclear is the review of the exchange rate peg. The staff tells us that a political commitment to a permanently fixed exchange rate should be avoided. However, a temporary commitment would be useless, because the anchor would have no credibility. For the most part, recent exchange rate-based stabilization programs try to persist with their fixed exchange rate or fixed crawl, and only when their currency has appreciated excessively do they adjust their exchange rate regime. The point is that, only if it is perceived that the authorities are doing all they can to meet their exchange rate target, will the peg have any credibility.

A second way in which a currency stabilization fund-type program could run into trouble would be if the market sensed that the Fund's supply of resources was insufficient. What would be sufficient is a difficult question. The staff believes that an access limit for currency stabilization funds of 100 percent of quota would be adequate. We believe that such an important limit warrants further analysis. Studies should be extended to other countries besides those of the former Soviet Union.

The staff also thinks that four tranches, with a first tranche of a maximum of 35 percent, would be acceptable. My intuition is that, at a minimum, a bigger first tranche would be needed. As I mentioned earlier, in a perfect program the currency stabilization fund's resources would only instill confidence. Any interventions could be interpreted as a lack of credibility of the program. Hence, one of the crucial aspects is the size of the first tranche. In our previous discussion, this chair stated that it was in favor of two tranches. If the decision is to have four tranches, then the first one should be of at least 50 percent. In other words, a relatively modest first tranche would not instill confidence, and perhaps would lead to the interventions that a successful program wants to avoid.

Finally, it is not clear that access to the currency stabilization fund should always be conditioned to a stand-by or extended arrangement. If not, a facility would be preferable to a window.

To conclude, the success of the currency stabilization fund option depends not only on a good stabilization program--adequate monetary and fiscal policies, an appropriate level of the currency peg, elimination of indexation practices--but also on the knowledge that the total amount of foreign reserves, including those provided by the currency stabilization fund, is enough to instill confidence. If this were not the case, countries and the Fund would be better off with a monetary-based stabilization program.

Mr. Daïri made the following statement:

During our preliminary discussion last December, we saw merit in the establishment of currency stabilization funds, as they could constitute an important vehicle for reinforcing confidence in member's exchange rate policy in the context of a strong stabilization and anti-inflationary program. The paper prepared by the staff is helpful in clarifying the issues raised by Directors during the previous Board meeting. However, we still need to assess whether the initial configuration of currency stabilization funds remains valid when drawing lessons from the Mexican crisis. We therefore consider today's discussion as an element in advancing the debate on adapting the Fund's role and policies to changed circumstances. Other important and related topics will soon be discussed by the Board. They include the General Arrangements to Borrow, the role of the Fund, the issue of capital account convertibility, and the emergency financing mechanism. While it is important to discuss each issue on its own merit, our preference is for a comprehensive strategy to deal with the new international environment. In a period of budget consolidation, this approach will also help to avoid unnecessary proliferation of Fund's financial facilities.

As to the general considerations with regard to currency stabilization funds in support of exchange rate-based stabilization programs, it should be emphasized that a nominal exchange rate anchor is not a substitute for strong macroeconomic stabilization policies. Such policies should, in the first place, address the monetization of large fiscal imbalances that generally constitute the root cause of high and rising inflation. In addition, it is important that the program be fully financed in the context of an upper credit tranche arrangement, and that the currency stabilization fund be considered as a precautionary element to supplement reserves in case of need. We agree with the staff on the importance of fixing the exchange rate peg at an appropriate level. Most important, however, the experience with exchange rate-anchored programs shows the difficulties of exiting from these arrangements, and we see here a need for further work by the staff. Also the Chairman mentioned in his aide-mémoire the possibility referred to by some Directors of using a currency stabilization fund in support of the unification of the exchange rate, or of moving to a nominal peg, for countries that have already reached some measure of stability. I would like the staff to indicate whether such a role for the currency stabilization fund is still being considered. More generally, we are of the view that the issue of exchange rate policies and regimes should be further discussed before any final decision on currency stabilization funds.

With regard to the operational features of currency stabilization funds, we would like to offer the following preliminary comments. Although we are attracted by the idea of a separate facility, we have an open mind. However, in the case of a separate facility, it will be necessary to see on what basis the need for a traditional use of Fund resources will be assessed. In other words, could a combination of a Fund-supported program and a currency stabilization fund be justified by the need to strengthen credibility with regard to the exchange peg, even if by usual standards there was no balance of payments need?

With regard to access, the proposed limit of 100 percent seems appropriate. With regard to tranching, our preference is for a limited number of tranches--two or three, for example--with some sort of front-loading.

Finally, we can support the staff proposals with regard to the conditions for activation, reconstitution, costs, and procedures for handling Fund operations under currency stabilization funds.

Mr. Saito made the following statement:

I welcome today's discussion as an opportunity to make progress in the formulation of policies regarding currency stabilization funds. The benefits that can be derived from such arrangements are well described in the paper and I believe the Board should proceed with the consideration of specific proposals in order to arrive to their early approval.

Having said this, I will limit myself to a few comments regarding both the policy and operational sections of the paper. Beginning with the policy issues, I would say that given that the main purpose of a CSF is instill confidence on the sustainability of an exchange-rate-based stabilization strategy, I share the view that its early activation in the context of an upper credit tranche program is recommendable.

On the types of exchange rate arrangements that could be supported by a CSF, I consider that, once an appropriate level of the exchange rate is chosen, the pegging gives the most unambiguous signal to the market. Preannounced crawling pegs or preannounced floors of the exchange rate introduce an element of uncertainty that does not bode well with the stabilization objective.

Regarding the conclusion that CSFs are not suitable in cases with currency board arrangements, it should be kept in mind that one of the main features of a currency board arrangement is the enhanced credibility that it provides to macro-economic policies aimed at price stability. In that context, the stabilizing effect of a given peg could very well be enhanced by the presence of CSF, particularly at the moment of introducing such a foreign exchange arrangement. The issue is not the availability of a CSF to cover base money as it is stated in the paper, but to help instill greater confidence. In this regard, currency boards may also represent an appropriate setting for CSFs to show their full potential benefits.

A comment is also in order regarding the staff's advice concerning the desirability of introducing greater flexibility to the exchange rate peg once inflation has been reduced. There is a clear contradiction here between the need to impart confidence to the stabilization effort based on a fixed exchange rate and the expectation that the peg will have only a limited life span according to the staff's suggestion that one to two years would be sufficient. It is surprising that the case of Poland has been presented as an example, in footnote 3 of page 8 of the paper, when inflation in that country is still running at a 30 percent a year after more than five years since the first stabilization program was adopted. The question of exit from a fixed exchange rate should not only be approached in terms of greater flexibility. What should matter is the strengthening of the domestic currency on a permanent basis which comes about primarily through the perseverant pursuit of strong macroeconomic policies and full-fledged structural reforms. The latter makes possible an increase in productivity allowing for a real appreciation of the currency.

The section on Fund financing of CSFs and Article VI offers a reassuring view that there are no unsurmountable legal obstacles for providing financing even to cover capital account deficits, to the extent that the use of Fund resources is consistent with the purposes of the Fund. Moreover, CSFs are not supposed to address balance of payments needs but only to serve as a confidence catalyzer in the very short run.

On policy issues, I share the staff's views on the possibility of implementing co-financing schemes for CSFs.

With respect to the operational features of Fund-supported CSFs, I should note that despite having favored the window option in our previous meeting on grounds that it would give the right signal regarding the mix between policy performance and financial support, I am inclined to conclude that a special facility would not hinder that balance. It might even provide other benefits in terms of greater operational simplicity, for example by avoiding the need to resort to Article V, Section 4 to establish an early repurchase obligation or to the exceptional circumstance clause when access limits become a constraint.

On the question of access there is clearly no way of indicating "a priori" if the availability of a given percentage of quota will be enough to counteract speculative attacks on a currency. It will all depend on the particular circumstances impinging on each case. I could say, however, that if the potential availability of a 100 percent of quota is not enough to meet the objective of instilling confidence in the exchange rate peg, the activation and use of a CSF is probably not justified. Regarding tranching, I agree with the distinctions made in the paper between the first tranche and the rest both in terms of availability and repurchase obligation but I would prefer a more flexible scheme by which both the number and size of tranches would be defined on a case by case basis.

The conditions listed in the paper for activation and use of CSFs are clear and well defined and should ensure that improper use of a CSF will not occur. My only question is related to the requirement that monitoring and reporting procedures as well as an integrated operational management of foreign exchange reserves and intervention policy be already in place and functioning properly.

Since CSFs are aimed to countries in transition in which institution building is a major challenge, I wonder if this condition, particularly the latter, may not end up being too restrictive for some countries.

It seems appropriate that CSF purchases should be subject to an early repurchase obligation in order to remain consistent with the short-term nature of the facility. I am not so sure, however, that we should establish repurchase expectations of such a short time-span and subject to so severe penalties in the case of a failure to comply, particularly if mitigating circumstances lead to recommendations to approve recurrent extensions.

Finally, regarding the costs of CSF transactions, I have been persuaded by staff considerations that it would be inappropriate to introduce any changes to the current rules. In the same vein, I consider the procedures for handling Fund operations under CSFs described in the paper as appropriate.

Mr. Wei made the following statement:

We welcome the further discussion today of Fund policies with regard to the establishment of currency stabilization funds. The staff efforts in deliberating the policy conditions of currency stabilization funds and elaborating on their operational procedures are appreciated. As I broadly agree with the staff on the analysis of the many aspects of the policies in relation to the establishment of currency stabilization funds, I will make only a few brief remarks.

On the issue of the necessity of establishing currency stabilization funds, we understand that the authorities of countries in transition are making great efforts to transform their economies toward those based on a market mechanism. In order for them to bring down inflation, which is unfortunately high, pegging the exchange rate is one of the effective approaches.

However, as emphasized by the Directors, the key to the authorities' victory over inflation through a nominal exchange rate anchor is to persevere with stabilizing the macro economy, in particular, reducing fiscal deficits and accelerating the pace of structural reforms.

In this context, I agree with the staff that an exchange rate-based stabilization policy would help build the public's confidence by providing a highly visible anchor, and would send a clear signal of policy intentions to the public.

However, there are obvious risks involved when authorities adopt such a policy, and these have been clearly stated by the staff in its paper. Such risks have been evidenced in the Mexican case. I believe we all agree that, without the substantial financial assistance provided by the Fund, the Mexican authorities probably would not have been able to control the situation as quickly as desired. In other words, the damage caused by the crisis would have been more extensive--more serious for Mexico as well as for the stability of the international monetary system.

Therefore, I join the other Directors in supporting the establishment of currency stabilization funds, through which the Fund will provide timely financial assistance to any member country when it confronts a speculative attack on its currency.

I share the concerns that have been expressed by some other Directors, in particular, the concern expressed by Mr. Mesaki that the staff should be cautious in recommending such an exchange rate peg system to member countries. In this respect, Mr. Mesaki rightly pointed out that the level of international reserves and the institutional capacity for the member country must be taken into account. I also agree with the staff that such a pegging system should not be maintained indefinitely, but rather should be terminated when circumstances warrant it.

Our other concern is the eligibility of member countries to have access to currency stabilization funds. As this chair indicated in the previous discussion, we believe that access to this facility should also be given to those countries, irrespective of their exchange rate regime, who might face similar difficulties when they adopt Article VIII obligations or deepen their reforms in the financial sector.

As regards operational features, while I can generally go along with the staff proposals, we are open-minded as to whether currency stabilization funds should be established as a window under the existing arrangements, or as a separate facility. As regards tranching, we are in favor of three tranches, with the first tranche being up to a maximum of 35 percent of the total size of the 100 percent quota for a member country. Finally, on the issue of the circulation period of the updated summary, we share Mr. Mesaki's concern and support his proposal that a minimum of a 24-hour circulation period is needed before the Board discussion.

Mr. Kannan made the following statement:

We had at the last meeting extended a cautious support for this proposal. I say cautious, as at that stage the criteria for ensuring success of such intervention and safeguarding the integrity of the Fund were vague and not crystallized. However, the present paper goes a long way in clarifying things and we are now hopeful that a stage has been reached for giving a final shape to this proposal.

We had also recommended earlier that this facility should be in the form of a separate facility rather than a window in an existing facility. We have not come across any strong arguments to change our mind on this point.

Furthermore, we stressed the need for this to be a quick response strategy, if it is to succeed at all. We can, therefore, agree with the staff suggestion that this facility should be front loaded with three tranches to be approved in 2 to 5 working days of the receipt of the proposal.

As far as access is concerned, the present 100 percent level appears to be sufficient. Cofinancing could be messy but worthwhile pursuing in the interest of securing larger resources, provided the preferred creditor status of the Fund is maintained. As regards interest rates , in the absence of any arrangements for subsidy, it has to be the SDR rate. We also welcome the suggestion for the 3 months early repurchase expectation concept within the one year repurchase obligation.

I now come to the substantive point, which this chair had raised in the last meeting and would now like to reiterate. At the last meeting we stressed the need for making available this facility to program countries only. the rationale was that the intimate association which the Fund would have had with the country concerned could secure the success of the stabilization program and also protect the integrity of the Fund. Equally importantly the prior association with the Fund would also have given an opportunity to the Fund a role in fixing the exchange rate at a level, which is worth defending. This is very important, as it is one of the primary objectives of this organization to ensure proper alignment of exchange rates. We , therefore, should not convey that we are prepared to defend any exchange rate that a country may have when it seeks our support.

This is perhaps what the staff have in their mind when they mentioned that the CSF activation could take place at the outset of an arrangement or during the course of the review. We will feel happy if it is made abundantly clear that it is important to have up front not only the members' policy package for stabilization but more importantly to be associated in the initial determination of the exchange rate at a level which is not heavily misaligned .

As far as the staff's suggestion for extending the facility even to those members who have a crawling peg system, we can in the circumstance explained in the staff paper, can go along with the staff, provided, the crawling peg system is a purely temporary and transitional arrangement, as rightly observed by Ms. Lissakers.

The Deputy Director of the Policy Development and Review Department said that the development of an appropriate exit strategy was critical in any Fund program whether or not it was based on a nominal exchange rate anchor, an exchange rate peg, or a crawling peg, and whether or not there would be a currency stabilization fund. Modifications to an exchange rate peg would be needed periodically to adjust for prevailing economic conditions. In addition, there were a number of basic ground rules. First, the authorities should avoid a political commitment to a permanently fixed rate that could prevent them from reacting to circumstances that require a change in the exchange rate. Second, the Fund and the authorities should stand ready to closely review exchange rate and other economic developments. As it would be imperative to abandon the operation if it were not working, the staff had favored relatively tight tranching and had structured reporting requirements to facilitate early identification of an operation's failure. Contingency plans were also needed in the event that disinflation was successful but the exchange rate anchor was no longer sustainable.

In developing its proposals, the staff had examined a number of exchange-rate-based stabilization experiences over the previous 15 years, the Deputy Director added. In four cases, the stabilization program had to be abandoned under difficult or crisis circumstances. A departure from the nominal anchor was required because supporting policies were not in place or had not been sustained. In the initial stabilization phases, the Mexican case was clearly a success. However, things began to go wrong, and the program ultimately had to be dropped.

In about half of the cases, measures to promote disinflation had been successful, and the countries had either adjusted the exchange rate or implemented a different exchange rate regime, the Deputy Director noted. In the remaining cases, reasonable success had been achieved in curtailing inflation, and the countries concerned had kept their initial exchange rate anchors.

The staff had not been advising fixed rates across-the-board for the transition economies, the Deputy Director emphasized. In fact, most of the transition economies were using pegged or anchored systems, and many of those were achieving substantial success in reducing inflation. Others were pursuing that option.

The possibility of introducing a currency stabilization fund would not induce the Fund to favor fixed-exchange-rate regimes, the Deputy Director concluded. Nor would it induce more financing for the same level of conditionality. An additional layer of conditionality would be needed together with stricter reporting requirements. Moreover, the new fund would represent a source of short-term financing and would only be constituted if a program were otherwise fully financed. Therefore, the fund was viewed by the staff as a confidence-building tool that would be subject to annual access limits. Under exceptional circumstances, however, combined access to the stabilization fund and a stand-by arrangement might exceed 100 percent.

Further consideration would need to be given to dealing with increased capital inflows, the Deputy Director said. Moreover, at least initially, a reasonable allowance would have to be made for reductions in velocity, and increases in money demand.

There would be no more risk to the Fund of a failure of a currency stabilization fund than of a failure of any other program of financial assistance, the Deputy Director said. In either situation, the importance of a strong underlying policy framework could not be overemphasized.

The Deputy General Counsel made the following statement:

> With regard to general scope and purpose of reviews, they were not limited to the monitoring of performance criteria. They had a broader purpose, specifically to monitor the continued adequacy of a member's policies. For instance, the continued adequacy of safeguards provided by a member was within the scope of a review. Executive Directors had agreed, during previous discussions of the guidelines for conditionality, not to expand the scope of reviews too broadly; however, reviews were not limited to monitoring prespecified, objective, quantified criteria, or to setting new performance criteria for the remaining period.
>
> Comparing the scope and relative advantages of a "window" under an existing facility with the proposed special policy, the adoption of the special policy would provide the basis for a number of special features. There would be special repurchase period obligations that would apply in all cases. Access could be floating above the reserve tranche and against other facilities. Moreover, the Board could adopt a special schedule of charges for the holdings acquired under the special policy. The adoption of wider characteristics would require an 85 percent majority for the decision on the repurchase period and the exclusion from the reserve tranche. Setting a different charge would require a 70 percent majority.
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> The second question was the extent to which one could give a currency stabilization fund, which was not established under a special facility, the same characteristics as described for the currency stabilization fund under a special facility. The answer is that the characteristics could not be the same, that not all could be duplicated, but that some of those characteristics could

be provided under a "window." The main difference, however, and one which could not be overcome, was that under a "window" no special repurchase obligation, that would apply in all cases, could be established. Existing rules, including on the repurchase periods of an existing policy would be used--for instance, in the present case, the credit tranches on the extended facility. Therefore, the normal repurchase periods of three to five years, or four to ten years, would apply to the use of resources under the currency stabilization fund. This was not a new approach. Special problems had already been addressed for the credit tranches under the guidelines for debt-reduction operations, and without establishing a facility. Those guidelines also contained the possibility of early repurchase expectations. If the early repurchase was not made, future purchases could be interrupted. Some of those features were also built into the CSF "window."

I would now like to explain the meaning of "repurchase obligation, to the extent possible". Pursuant to Article V, Section 4, if holdings of a member's currency are above 200 percent of quota, the Fund may, in an individual case, impose a repurchase obligation in order to provide additional assurances for the repurchase of its resources. This power would not be derived from the "window", but from the application of Article V, Section 4 in an individual case. Therefore, it is not applicable in all cases, and, the general provisions on repurchase periods are not circumvented.

A special feature could be adopted under the "window" using another provision of the Articles. The Articles require that charges be uniform; not that uniformity should be linked to the establishment of a special facility. Even in the absence of a special facility, a higher charge could be imposed based on the level of holdings, for instance, above 200 percent.

Mr. Kiekens said that most Directors appeared to agree on the need for special features concerning short maturities, the revolving character of drawings, and a larger than normal role for the Executive Board in determining subsequent tranche releases. The Deputy General Counsel had confirmed that such special provisions would, in general, be possible. However, there would be difficulties in using Article V, Section 4, to provide adequate safeguards, as the provision would not be available unless the limit of 200 percent of fund resources had been reached.

The Chairman made the following concluding remarks:

This has been a useful further stage in our consideration of Fund policies with respect to currency stabilization funds. Directors agreed that, under certain circumstances, a nominal exchange rate anchor could be a powerful instrument, when employed in the context of strong financial policies, to help bring about a rapid decline in inflation. All Directors stressed--and that was clearly the starting point for the staff and for management--that an exchange rate anchor was not a substitute for, but a complement to, strong macroeconomic stabilization policies.

Many Directors considered that Fund financial support for the specific purpose of establishing a currency stabilization fund within the context of a Fund arrangement could provide an important element of additional confidence to a member adopting a strong stabilization program. Indeed, in cases of high inflation countries with good prospects for achieving a substantial decline in inflation, potential access to a precautionary pool of reserves could provide an important confidence-building complement to a nominal exchange rate anchor to assist in achieving such a decline. Several Directors would prefer further exploration of general issues concerning the choice of exchange rate regime and the conditions for achieving exchange rate stability before dealing with policies on possible establishment of currency stabilization funds. As a great deal of work had been done in that area, however, I doubt that further general papers at this stage would shed much additional light. A number of Directors continued to have doubts about the need for Fund policies for currency stabilization funds, as they considered the Fund's existing policies sufficient to address cases in which an exchange rate anchor was adopted. That was, of course, the central issue for the Board. The idea of Fund-supported currency stabilization funds is not new, and we need to be in a position to advise members on whether the Fund is, or is not, prepared to contemplate a currency stabilization fund-type mechanism in individual cases; and, if so, to give them an indication of the conditions and modalities that the Board would expect to apply.

Among those speakers who expressed support for currency stabilization funds, a few suggested that they could be useful not only in cases in which rapid disinflation from high levels was being pursued, but also in cases in which substantial progress in reducing inflation had already been achieved. Most Directors, however, considered that the latter cases could be dealt with adequately under the Fund's traditional arrangements. They stressed that Fund support of currency stabilization funds should be limited to a narrowly defined set of circumstances, and that use would be expected to be limited and temporary.

With regard to exchange rate regimes to be supported by currency stabilization funds, most Directors generally considered that an exchange rate peg--or perhaps a preannounced crawl--that would limit the discretionary use of the exchange rate would be most appropriate for the purpose of the member. While it should not be expected that a peg would be maintained indefinitely, it was emphasized that it would be difficult to instill confidence in an exchange rate peg if it were expected to be adjusted, or possibly abandoned, within a short time. It was recognized, however, that decisions on whether and when to change the peg or move to a different regime would have to be made based on available quantitative indicators combined with judgment. Furthermore, the appropriateness of the nominal exchange rate anchor supported by a currency stabilization fund would need to be kept under continuous review by the authorities, the staff, and the Board. In that context, reference was made of the need to have a resident representative involved closely in monitoring the working of such arrangements.

Apart from the above-mentioned group of Directors who continued to have doubts about the need for Fund policies with respect to currency stabilization funds, I have noted that the Board in its majority generally supported the main operational aspects outlined in the staff paper. Directors generally favored the integration of currency stabilization funds directly into Fund arrangements through a window, while noting that a relatively short repurchase obligation for currency stabilization fund purchases could be ensured in all cases only if a separate facility were established; this is an important consideration. Nevertheless, Directors agreed that the differences between the two approaches were not major. Moreover, in either case, ESAF-eligible countries would be able to use currency stabilization funds through operations parallel to an ESAF arrangement. However, the conditions for use of the General Arrangements to Borrow for nonparticipants would also be a relevant aspect in favor of the window approach.

With respect to access, those Directors who supported the need for Fund assistance through currency stabilization funds considered that maximum access of 100 percent of quota for a currency stabilization fund should provide sufficient scope for the Fund to support such operations effectively. In any event, it was likely that access under currency stabilization funds would vary considerably from case to case, depending on members' specific circumstances and factors such as their own holding of reserves and access to other sources of precautionary financing.

Directors noted that--as conceived by the staff--currency stabilization funds would involve a degree of complexity and demanding reporting requirements. Nevertheless, Directors believed that would be unavoidable in order to ensure that adequate safeguards were attached to the use of Fund resources in the circumstances envisaged for currency stabilization funds. Most Directors supported the staff's suggested approach to tranching, noting that consideration on a case-by-case basis should allow for sufficient flexibility.

The design of repurchase terms should be guided by the need to ensure that currency stabilization fund resources would be used, as intended, only for short-term intervention operations. There was general support for the suggestion that all currency stabilization fund purchases would be subject to a one-year repurchase obligation, to the extent possible, and that purchases beyond the first tranche would be subject to a three-month repurchase expectation. Directors generally supported the staff proposals with respect to charges, although various ideas were put forward that will require further consideration.

In light of the discussion today, Directors might wish to reflect further on the following basic question: is there a role for currency stabilization funds, supported by the Fund, where the conditions are appropriate; that is, where the authorities wish to adopt an exchange rate anchor and there is a firm commitment to the policies needed to sustain the anchor? I would suggest that we come back to this issue soon, because we need to know how to respond to members that express interest in receiving Fund assistance in establishing a currency stabilization fund. For our next--and, it is to be hoped, final--meeting on this issue, the staff will prepare a short note recapitulating the general conditions and specific modalities that could apply to a currency stabilization fund, bearing in mind the views Directors expressed today, as well as last December. On that basis, we would seek to come to an early decision on conditions under which the Fund could support such mechanisms and, if so, how.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/95/67 (7/14/95) and EBM/95/68 (7/19/95).

2. INCOME POSITION FOR FY 1995 - REVIEW

Pursuant to Rule I-64(4)(c), the Fund has reviewed the income position for FY 1995. (EBS/95/114, 7/12/95)

Decision No. 11034-(95/68), adopted
July 14, 1995

3. STAFF PAPERS ON STATISTICAL POLICY AND ACTIVITIES OF THE FUND - RELEASE OF INFORMATION TO OTHER INTERNATIONAL ORGANIZATIONS

The Executive Board approves the proposal set forth in EBD/95/94 (7/7/95).

Adopted July 14, 1995

4. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors as set forth in EBAM/95/105, Supplement 3 (7/17/95), EBAM/95/119 (7/14/95), and EBAM/95/120 (7/17/95), by Advisors to Executive Directors as set forth in EBAM/95/119 (7/14/95) and EBAM/95/120 (7/17/95), and by an Assistant to Executive Director as set forth in EBAM/95/117 (7/11/95) is approved.

APPROVAL: March 25, 1997

REINHARD H. MUNZBERG
Secretary