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L. Van Houtven, Secretary
J. C. Corr, Assistant

Also Present

Asian Department: I. Otani. European Department: P. B. de Fontenay, P. Dhonte, M. Ishihara, H. Ungerer, H. Vittas. Exchange and Trade Relations Department: W. A. Beveridge, Deputy Director; M. Guitian, G. G. Johnson, S. Kanesa-Thasan, D. Lee, P. J. Quirk. External Relations Department: A. F. Mohammed, Director; N. K. Humphreys. Legal Department: G. P. Nicoletopoulos, Director. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, C. P. Blackwell, J. M. Boughton, K.-Y. Chu, M. P. Dooley, M. Goldstein, R. D. Haas, M. S. Khan, M. D. Knight, D. J. Mathieson, A. K. McGuirk. Secretary's Department: J. W. Lang, Jr., Deputy Secretary. Treasurer's Department: M. A. Lumsden, O. Roncesvalles. Western Hemisphere Department: S. T. Beza, Associate Director. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: H. A. Arias, C. J. Batliwalla, S. El-Khouri, K. A. Hansen, S. M. Hassan, L. Ionescu, H.-S. Lee, W. Moerke, G. E. L. Nguyen, Y. Okubo, I. R. Panday, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: J. R. N. Almeida, I. Angeloni, M. Camara, M. B. Chatah, L. E. J. M. Coene, M. Eran, G. Ercel, V. Govindarajan, D. Hammann, N. U. Haque, C. M. Hull, H. Kobayashi, M. J. Kooymans, G. W. K. Pickering, M. Rasyid, J. Reddy, D. J. Robinson, A. A. Scholten, Zhao Z., Wang C. Y.

1. ISSUES IN THE ASSESSMENT OF EXCHANGE RATES OF INDUSTRIAL COUNTRIES; AND THE EXCHANGE RATE SYSTEM - LESSONS OF THE PAST AND OPTIONS FOR THE FUTURE

The Executive Directors considered a staff paper on issues in the assessment of exchange rates of industrial countries in the context of their economic policies (SM/83/263, 12/28/83), and a paper on the lessons of the past and options for the future of the exchange rate system (SM/84/5, 1/3/84). They also had before them a paper on exchange rate volatility and world trade prepared at the request of the GATT (SM/83/203, Rev. 1, 12/9/83).

Mr. Kafka stated that the three papers before Directors should be published. The focus on the medium-term sustainable exchange rate as defined on page 2 of SM/83/263 had been appropriate; he hoped that the staff would soon produce a paper dealing with the other industrial countries and the developing countries.

On page 8 of SM/83/263, discussing the reasons for deviations of the actual from the medium-term sustainable exchange rate, Mr. Kafka continued, the staff had drawn a clear and welcome distinction between the real interest rate perceived by market participants and what was too often referred to as the real interest rate in staff papers and academic discussions, namely, the difference between the nominal interest rate and the contemporaneous rate of inflation. With regard to price competitiveness and the meaningfulness of various measures of purchasing power parity, it was interesting to compare the performance of normalized unit labor cost indices with that of cost of living indices. The latter performed as well as the former for short periods, but they became much less reliable when the comparisons encompassed several years. He hoped that the staff, in the course of consultations with members, would encourage countries to collect and process the data necessary to prepare unit labor cost comparisons.

The problems that were met in the necessary attempt to go beyond indicators based on measures of competitiveness in goods markets were set out carefully and clearly by the staff, Mr. Kafka said. However, as shown by the examples relating to the United States, Germany, and Japan, the estimates of underlying payments imbalances had led to estimates of deviations of actual from underlying exchange rates, which--except for the yen/dollar relationship in 1980-83--had been a good deal smaller than subsequent exchange rate movements, although they had occurred in the predicted direction. The staff believed that those large movements could not primarily be ascribed to "overshooting."

Other than the suggestion that the staff should continue its efforts to improve its estimates of medium-term sustainable exchange rates, not only on the basis of purchasing power parity, but also on the basis of underlying payments imbalances, four conclusions could be drawn from the paper, Mr. Kafka considered. First, however difficult it might be, and however great the uncertainties, the Fund had to attempt to take a view on exchange rates. Second, if the uncertainties were such that the Fund believed that it could not take a view, it should say so. Moreover, it should indicate those variables for which a lack of information or other reasons prevented it from doing so. Furthermore, if possible, the Fund should indicate the range within which the value of each such variable was likely to fall. It should also, whenever possible, indicate the sensitivity of the outcome with respect to the value of each variable.

Third, in other cases, the staff would often be able to arrive at a reasonably defensible judgment about the direction of the deviation of the actual from the medium-term sustainable exchange rate, even if it were unable to estimate closely the extent of the deviation, Mr. Kafka added. In all such cases, which were likely to be important, the staff should indicate, if possible, the range of uncertainty.

Fourth, and most important, Mr. Kafka went on, the staff clearly spelled out the need for extreme caution in drawing conclusions and, therefore, recommendations from the application of measures of competitiveness and underlying payments imbalances. In that respect, the staff paper contrasted with some of the papers prepared for consultations, in which the staff sometimes drew firm conclusions from a comparison between two unreliable cost of living indices. More exchanges of views among the departments of the Fund were clearly desirable.

Turning to SM/83/203, Revision 1, Mr. Kafka commented that the original request from the GATT had been for a paper on "erratic" fluctuations. He agreed with the staff that such a study would have been uninteresting and that it had been preferable to extend the scope of the paper to deal with any reversible exchange rate movement. He agreed generally with the staff's conclusions. Nobody would dissent from the conclusion that the variability of nominal as well as real rates, short term as well as long term, had increased since the introduction of generalized floating. It was hardly surprising, though not irrelevant, that the increase had been greater for nominal than for real rates. It was important that there had been, apparently, no tendency for variability to decline through a learning process as the period of floating continued. It was interesting that factors other than inflation differentials explained most exchange rate shifts, at least in the short to medium term. The staff had been unable to discover any obvious link between exchange rate variability and trade, perhaps the least surprising conclusion; or between variability and investment and, therefore, growth; or between variability and inflation; or even between variability and the reversal of the earlier liberal trend of trade policy.

The staff carefully qualified those conclusions, Mr. Kafka observed. In Scottish law, the jury had the choice of three, not two, verdicts, the third being "not proven." Such a verdict was uncomfortable for all parties involved, but there was no doubt that it was the appropriate verdict regarding the exchange rate problem under discussion. It underlined the need for additional investigation. For example, with regard to the question of the lack of an observable impact of increased uncertainty on investment, the staff said that the adverse effects of uncertainty might have been outweighed by the need to invest in energy conservation and exploration. Disaggregation of investment data might or might not permit a more definite conclusion. Perhaps such disaggregation, which would have to go well beyond distinguishing the energy-producing sector from other sectors, was not possible; however, the attempt would be worthwhile. The staff concentrated on exchange rate variability among industrial countries, where access to forward exchange markets and, therefore, the cost of hedging, was least expensive. It would be interesting to investigate at an appropriate time the effects of exchange rate variability on trade among developing countries; even when their trade was invoiced in industrial countries' currencies, some surprising conclusions with regard to the cost of variability to those countries might be drawn.

In SM/84/5, which dealt with the present exchange rate system and options for the future, the staff again focused on the major industrial countries, among which floating was prevalent, except for the members of the European Monetary System (EMS), Mr. Kafka went on. The system of floating included currencies of developing countries that were pegged to the currencies of industrial countries, particularly to the U.S. dollar. He had no major problem with the discussion of the detailed evaluation of the present exchange rate system in Part III of SM/84/5. However, a number of points in Part IV of the paper were somewhat puzzling. The average performance of the system with respect to industrial countries was said to have been "good," considering the economic environment. However, later in Part IV, the staff ascribed serious problems to the system and referred in particular to departures, often prolonged, of real exchange rates far beyond the bounds suggested by the best estimates of fundamentals. It was well known that such departures had taken place since the advent of the present so-called system, but was it correct to blame the system for them, particularly since Professor Machlup was quoted to the effect that the adjustable peg--i.e., the Bretton Woods system, as distinct from a system similar to the EMS--had by no means been free of them either? The system might be blamed for such departures, but the point had not been demonstrated in the paper.

A further puzzle was the staff's statement that those departures had created problems in two major areas, Mr. Kafka added, first, in the cost of "seesawing" resource allocation and, second, in the policy reactions to disequilibria, i.e., the resort to administrative mechanisms to offset market movements felt by the authorities to be inappropriate. In SM/83/203, Revision 1, the staff had come to agnostic conclusions on both points. Nevertheless, as he had suggested earlier, a verdict of "not proven" constituted grounds for concern, although perhaps not condemnation. He invited the staff to say whether it had meant to express concern or condemnation.

Commenting on the question of whether a prolonged departure from an ex post perceived equilibrium could be blamed on the system itself, Mr. Kafka suggested that an answer might be found in the recently published Occasional Paper 19, "The European Monetary System: The Experience, 1979-82," and also, in a more recent paper by Mr. Ungerer to be published soon in English. Indeed, it would have been useful to have had those papers on the agenda for the current meeting as background information. The analysis therein indicated that, although the EMS had not been successful in achieving its main goal of convergence among the member countries, it had been successful in reducing exchange rate variability among EMS members and European countries closely associated with them. The reduction in variability had come about because the system restricted fluctuations around the rates established as a parity grid at any time, even though it allowed frequent, albeit relatively small, changes in the parity grid. As a system of the EMS type was associated with reduced variability of exchange rates among participants, as compared to variability among nonlinked, nonmembers of the group, the possibility had to be considered that that outcome was a result of the EMS system, or, inversely, that the greater variability among nonmembers was due to the absence of such a system worldwide. A further possibility that had to be considered, therefore, was that the present so-called international monetary system might be responsible for the prolonged departures of actual from equilibrium rates evident in recent years.

However, such a conclusion could not be drawn with certainty at the moment, Mr. Kafka concluded. An analysis that might be valid for Europe might not be applicable in a wider context. Mr. Ungerer doubted the possibility of the emergence of an EMS-type alternative to the present so-called system on a worldwide basis, or, more precisely, in relation to the three chief industrial economies, although he drew no firm conclusion in that regard. If there were no alternative to the present system, whether on the basis of an EMS-type arrangement or on any other basis, then the present system could not be blamed for anything. The subject should be investigated without delay. Too often in the past, the Fund had shied away from discussing delicate but vital subjects. In 1975, it had published a paper stating that there was no problem of international liquidity and confidence, and the Group of Ten had taken the initiative in attacking the problem; in the late 1960s, the Fund had refused to face up to the problem of the gold pool, and others had dealt with it by themselves. He was, therefore, grateful that issues affecting the exchange rate system had been brought before the Board on the present occasion. Finally, with regard to the questions posed at the end of SM/84/5, some he had answered implicitly; the others required further investigation.

Mr. Laske commented that the two papers before Executive Directors were excellent; they analyzed the problems in a cohesive and illustrative fashion, and they were well written. The careful analysis of the factors to be taken into account when judging the sustainability of exchange rates was a timely enterprise, and he appreciated the insights provided in the papers, as did his authorities, who had read both papers with great interest. The papers constituted valuable examples of the Fund's surveillance function, while laying bare the limitations of surveillance.

SM/83/265 had a twofold purpose, Mr. Laske continued. On the one hand, the staff attempted to evaluate the relative importance of such factors as interest rates, current account balances, and cost and price differentials in the determination of exchange rates; on the other hand, the staff assessed the prevailing pattern of exchange rates against prospective developments in the current account and the overall balance of payments. He agreed with the staff's view that each of the criteria used in exchange rate assessments had its shortcomings, and that the results must, therefore, be treated with caution. A firm belief in their correctness would certainly be inappropriate. Because of the problems inherent in such an exercise, all the available criteria should be used in order to avoid excessive reliance on a single criterion. His authorities endorsed the approach pursued by the staff and agreed with the conclusions reached. However, there were marginal differences of emphasis.

He agreed with the staff's view that there was no choice but to proceed in a pragmatic way, Mr. Laske said. The use of a broad range of various methods and approaches promised "to yield an approximate range for the sustainable exchange rate of each member country." His Bundesbank authorities considered such an objective ambitious, and they were content with a more modest goal. They would consider themselves successful if they could determine with a high degree of reliability in which direction exchange rates might, or should, move.

The staff showed that an "overshooting" of the exchange rate could be explained primarily by the emergence of interest rate differentials, Mr. Laske observed, but also, to some extent, by developments in the current account. While the underlying trend for an exchange rate was normally determined by divergences in cost and price developments between countries, deviations from that trend could often be shown by a careful analysis of the prevailing pattern of price movements for internationally traded financial assets, a conclusion based on research done in the Bundesbank. Judged against international developments in prices and costs, the effective rate for the deutsche mark appeared to have been overvalued from the beginning of floating in 1973 until 1981, and undervalued thereafter. That development had been paralleled almost exactly by developments in the German current account over those years. Furthermore, there seemed to exist a close relationship between "overshooting" of the real DM/dollar rate and the differential between short-term real interest rates in Germany and the United States. Such a relationship was understandable, assuming that interest rate differentials had no major impact on exchange rates if they reflected only the differential between inflation rates. Only a marked differential between real interest rates in two countries would make the currency with the higher yield more attractive, thereby influencing exchange rates. He would be happy to make available the charts prepared by the Bundesbank for comparisons of the various parameters.

The staff believed that so-called normalized unit labor costs were the most appropriate indicator for the assessment of real exchange rates, Mr. Laske went on, a view generally shared by his authorities, although they found it difficult to make a meaningful and reliable calculation of that indicator. They were interested, therefore, in learning further details of the method employed by the staff in its exercise. It would be useful if the staff could describe in a technical paper how cyclical variations in productivity were taken into account. His authorities' view differed slightly from that of the staff in that they believed that the time series for consumer prices could have merits beyond the short term. A trade-off appeared to exist: whereas the consumer price index provided more reliable, but perhaps less meaningful, data for the calculations of real exchange rates, "normalized unit labor costs" appeared to be more appealing intellectually, although perhaps less reliable.

His authorities were somewhat less bold than the staff in another area, Mr. Laske noted. The use of the broad balance of payments criterion for the assessment of exchange rates could lead to relatively large inaccuracies. An attempt to use that objection had been made by multilateral working groups in 1980, but it had had to be abandoned in the face of serious difficulties. The broad balance of payments had to take into account capital transactions, which would reflect expectations regarding the future course of economic policy. Thus, an inordinate amount of discretionary evaluation was involved, perhaps permitting the justification of almost any pattern of exchange rates. Extreme caution was, therefore, required when the broad balance of payments concept was applied; it had to be viewed in the context of the results of the other concepts, and tested against those results.

Turning to SM/84/5, Mr. Laske remarked that it contained much valuable information in the course of a comprehensive analysis of the system of floating exchange rates. He was in broad agreement with the approach and the conclusions. The study confirmed his authorities' view that the system of floating exchange rates had worked neither so badly as its opponents had feared nor as well as some commentators had hoped. It also confirmed his authorities' observation that events in the markets for financial assets had become increasingly important for the exchange markets, whereas real transactions had lost part of their former significance. For those reasons and others, a return to the par value system appeared to be highly unlikely at present, if not outright impossible. The staff had concentrated appropriately on possible improvements in the present system, rather than on potential alternative systems.

The staff's general view that a high degree of exchange rate stability could be achieved only on the basis of a high degree of internal stability and with domestic policies conducive to such stability should be stressed, Mr. Laske considered. That conclusion applied to all exchange rate systems, but it was particularly relevant in the present circumstances, in which there was considerable capital mobility. The fact that the conduct of economic policies was of utmost importance for the stability of the international monetary system underscored the importance of the Fund's surveillance function. Exchange rates did not concern only individual countries; they simultaneously affected all other countries. Therefore, the Fund had to direct its attention not only to the exchange rates themselves, but also to the stance of the underlying policies. The staff was fully justified in emphasizing that an assessment of the present system of floating exchange rates had to take due account of the macroeconomic environment in which the system had had to operate so far. It was difficult to conceive of a system that could have coped better with the strong movements of short-term and long-term capital, with growing distortions in relative prices, including real wages and real interest rates, distortions that had been the outstanding characteristic of the 1970s. In the absence of corrective policy measures, any more rigid exchange rate system would have collapsed under the strain.

The staff's discussion of floating rates and monetary policy in Part III, Section 2a(3) of SM/84/5 was not fully convincing, at least in reference to Germany's experience, Mr. Laske suggested. In his authorities' view, the case for floating had been much stronger in 1973 than the staff appeared to believe. Only after the de facto abandonment of fixed rates had the Bundesbank been able to regain control over the money supply. Because German banks had had recourse to the market for dollar funds in almost unlimited quantities, the virtual absence of exchange risks had at times deprived the Bundesbank almost completely of effective control over domestic money creation. Thus, for the Bundesbank, the change from a fixed dollar exchange rate to floating had represented a difference in kind, not simply in degree. Fixed, but adjustable, rates within the EMS did not constitute the same kind of system as a fixed relationship between the deutsche mark and the dollar, because the money market of the other EMS countries represented a much less abundant source of liquidity for commercial banks than the dollar market.

The useful distinction between monetary and real shocks had been discussed at length by the staff, Mr. Laske observed. Flexible exchange rates had provided the German authorities with an additional tool of monetary policy, thereby enabling them once again to shield the German economy from monetary or inflationary shocks originating elsewhere in the world in a smoother and more effective manner than would otherwise have been possible. A careful reading of the literature of the early proponents of flexible exchange rates might reveal that they had considered exactly that kind of possibility. On the other hand, it was now well known that flexible exchange rates did not provide protection against real shocks, such as changes in relative prices, consumer preferences, and the like. Therefore, the conclusion drawn by the staff on page 38 of SM/84/5 should be qualified. The present language was:

> Many of the perceived constraints on monetary policy during the fixed-rate period turned out <u>not</u> to be constraints imposed by the exchange rate regime but rather constraints imposed by the openness of national economies.

He would wish to add that the degree of "openness" of the German economy had not changed with the transition to floating exchange rates, but that the control of the Bundesbank over the monetary aggregates had been dramatically enhanced.

On page 59 of the same paper, the staff stated that "assets denominated in different currencies are close substitutes for one another," Mr. Laske noted. The Working Group on Exchange Market Intervention, made up of experts from seven major industrial countries, had discussed the same subject in its report. Its conclusions had been somewhat more guarded; it had pointed out, for example, that the dollar was not a full substitute for the other currencies in their respective national money markets.

Commenting on the interdependence between floating rates and world trade and investment, Mr. Laske said that he shared the view that flexible exchange rates were more conducive to an open and liberal world trading system than other exchange rate regimes. The main determinant of world trade was real economic growth, a variable dependent on many other factors. In SM/82/203, Revision 1, no evidence was provided that flexible exchange rates exerted a significant trade-deterring effect. The staff's observation that real rates had also shown a high degree of volatility in the medium and long term during the fixed rate period should be noted.

His answers to the six key questions raised by the staff in Part V of SM/84/5 would reflect the intense discussions among his authorities on those issues, Mr. Laske went on. With regard to the first question--whether conditions were likely to recur under which fixity of exchange rates among the major currencies could be restored--the answer would be "no." One important precondition for a more stable world monetary system had been established with the success of the anti-inflationary policies pursued by many countries, primarily the industrial countries and especially the United States. However, that development alone was not sufficient in view of the multitude of structural changes that had taken place during the previous decade. An important and highly relevant development was the tremendous expansion in the volume of international capital transactions and the vastly increased speed with which they could be initiated. The EMS, with its fixed but adjustable rates, was a regional arrangement among relatively homogeneous economies. Its having worked rather well so far did not constitute proof that it could successfully be expanded to cover the whole world.

The answer to the second question would also have to be in the negative, Mr. Laske stated, because the introduction of rules or formulas for determining the right exchange rate encountered the same objections in principle as a return to a fixed exchange rate system. It was by no means certain that the authorities knew better than the markets what the right rate should be. The lack of complete knowledge would sooner or later bring the authorities into a situation of conflict in which they might wish to disregard the previously established formulas. The divergence indicator of the EMS had occasionally given useful signals to authorities about the need to act, but its workings so far had not completely met the expectations of its proponents. The limitations of that indicator in practice had been well described in Occasional Paper 19 by Mr. Ungerer and others. An additional complication would be how to reconcile conflicting rules or formulas among several monetary authorities.

The staff's third and fourth questions should also be answered in the negative, Mr. Laske considered, because free movements of capital were an essential corollary to free trade in goods and services. If countries wished to benefit from the international division of labor, they should also accept freedom of capital movements, which financed the corresponding movements in goods and services. In the German experience, restrictions on capital movements were neither practical nor useful in the long run, one reason being that an increasing volume of trade enlarged the potential for flows of short-term funds that could be redirected on short notice, for example, by variations in the terms of payment. Restrictions on capital flows posed particular problems for countries whose currencies were used on a large scale for invoicing and as vehicles for the holding of working balances and other reserves. Impediments to the free flow of funds also had effects on the existing stocks of financial assets, with undesirable consequences for interest and exchange rates.

The fifth question posed by the staff could be answered with an unqualified "yes," Mr. Laske stated. However, it was much easier to wish for greater stability of macroeconomic policies than to explain how improved international coordination of macroeconomic policies could be brought about. Neither short-term nor long-term experiences provided grounds for much encouragement. Some achievements could certainly be recorded, but the world had also suffered through periods of frustration. When the U.S. Federal Reserve Bank had adopted a basic change in its monetary stance in 1979, the groundwork had been laid for restoring international confidence in the dollar as the most important currency in the system. His authorities believed that that action represented a prime example of the international coordination of macroeconomic policy, even if not all the consequences of the ensuing more determined anti-inflationary policy had been anticipated. Perhaps they could not have been.

The price for restoring the dollar's credibility had turned out to be higher than expected, Mr. Laske added. At present, there were grounds for fearing that some of the positive effects of that achievement might be lost because the financing requirements flowing from the U.S. budget deficit were driving interest rates and the exchange rate of the dollar to levels higher than appeared justified by fundamental factors, such as the rate of inflation, the trade balance, and the current account. The U.S. authorities, responsible for the dominant economy in the world, could be expected to pay adequate attention to the international repercussions of their policies. At the same time, however, the international community had the right to expect that countries that had been less successful to date in restoring domestic and external balances would intensify their efforts. True international cooperation could only mean mutual respect for the legitimate concerns and interests of the partner countries.

Exchange market intervention could at times play a useful role in supporting international agreed macroeconomic policies, Mr. Laske suggested, but its effect was likely to be limited, as experience had shown. The potentially large volume of volatile international funds was now capable of undermining or neutralizing official intervention when the latter's credibility was not demonstrated by consistently applied policies in other areas. To put the argument the other way around, intervention could serve to transmit the authorities' policy intentions of the to the markets, but it would be successful only if the markets were convinced of the authorities' determination and perseverance. If the authorities of several countries were to intervene in a coordinated way, that determination could certainly underpin their credibility. Experience had shown, however, that even large-scale intervention could not necessarily move floating rates in the desired direction.

The answer to the staff's sixth question had, necessarily, to be negative, as to the second question, Mr. Laske remarked. Fixed rates and officially forecast rates or target zones were different not in kind but only in degree. By their very nature, target zones were less firm than fixed rates, but in practice they confronted the authorities with an identical predicament as soon as market participants began to test them. Rate forecasts that were not confirmed by events and target zones that were not defended put the authorities at a disadvantage vis-à-vis the markets. If their defense was pursued primarily or exclusively through intervention, a monetary policy aiming at domestic stability would probably be undermined almost as quickly as under the fixed-rate system. Furthermore, his authorities had serious doubts about the negotiability of target zones on a multilateral basis. Such zones would have to be defined in nominal rates in order for the markets to understand them, but central banks did not necessarily watch only the rate against their major intervention currency; they also aimed at maintaining or moving real rates.

The six key questions raised by the staff deserved more detailed consideration, Mr. Laske said. Thus, although practical alternatives to the present system of managed floating rates among the major currencies were difficult or even impossible to discern, the search for improvements in the system should continue. Discussions about such improvements should be carried on first in the Fund, but also among the various groupings of countries and through contacts with academic circles. In discussing such matters, all participants should commit themselves to preserving the free trading system and to striving for domestic and external goals in accordance with Article I of the Fund's Articles of Agreement. The limited possibilities for fast progress should also be acknowledged, especially with regard to changes in the exchange rate mechanism. No useful purpose would be served by creating expectations that could not be turned into reality because of the naturally slow-moving process of international coordination. Undue haste was more likely to be harmful than beneficial. Any changes in the exchange rate mechanism must avoid putting at risk the opportunities for stabilizing the system. Although floating rates had disadvantages as well as advantages, it was hard to see how the world could cope with a reduced degree of flexibility so long as major countries had difficulty in coordinating and harmonizing their policy objectives and their policies more consistently and effectively.

Mr. Tvedt, taking up SM/83/263, remarked that its tone was objective and that the degree of "self-criticism" of the methods employed by the staff in identifying "sustainable exchange rates and reasons for deviations therefrom" was exemplary. However, the impression conveyed was one of undue pessimism regarding the ability to undertake effective surveillance. He agreed that the interpretation of indices of competitiveness was subject to a great deal of uncertainty and that interpretations should be accepted with caution. However, the explanatory power of those indices was not as limited as suggested by the staff. According to recent studies by the European Communities, a comparison of cost competitiveness (measured by relative unit labor costs) and trade performance (measured by trade in manufactures as a pecentage of GDP) provided evidence that changes in the indicator of competitiveness had been followed by a change in trade performance with a lag of two to three years for the 12 industrial countries concerned, including the United States and Japan. It appeared, therefore, that cost indicators deserved more attention than suggested by the staff.

It was a matter for satisfaction that the staff was currently trying to arrive at criteria for identifying "nonsustainable" exchange rates on the basis of previous studies of underlying payments imbalances, Mr. Tvedt continued. Such calculations could represent useful supplementary indicators of the direction and, to some extent, the magnitude of the payments imbalances. Moreover, they could, in conjunction with traditional calculations of competitiveness, and with data on earnings in industry and capital formation in exposed sectors, become part of an overall assessment. In any case, he hoped that such methods of calculation could render the discussion of countries' exchange rate policies more rational.

However, it had to be borne in mind that the calculations outlined by the staff relied, to a large extent, on judgmental and discretionary methods, Mr. Tvedt suggested. Therefore, they had to be used with great caution, and mainly in the analyses conducted in connection with the World Economic Outlook. The staff itself pointed out that great uncertainty was attached to the calculations, for example, with regard to the adjustment of relative cyclical positions and, in particular, to the capital balance. In the period ahead, the Fund ought to work continuously toward improving the methodology in that field. Another aspect deserving increased attention by the staff was the identification and assessment of the balance of payments and exchange rate effects of alternative fiscal and monetary policies. If adjustment of the underlying payments balance could also reflect alternative policy assumptions, the Fund's surveillance function was likely to improve considerably.

Taking up SM/84/5, Mr. Tvedt remarked that the staff's presentation was interesting and deserved commendation. The problem with many of the studies on the implications of floating exchange rates was that they were based on data from a limited period such as the past ten years, a period that had been marked by exceptional disturbances like the oil price shocks. Taking such developments into account, and bearing in mind that the impact of exchange rate changes was often felt over several years, he found it reasonable to express doubt about how reliable the results of many of those analyses were. His general impression was that the floating rate system had had less favorable effects than the staff apparently suggested.

The staff correctly stated that long-term exchange disequilibria could have far more serious consequences for employment, resource allocation, and economic growth than short-term fluctuations, Mr. Tvedt went on. With regard to exchange rate changes and trade flows, the staff had been unable to demonstrate a connection between exchange rate fluctuations and stagnation in world trade and investments. However, he agreed with Mr. Kafka's comments on the increased cost to enterprises in connection with exchange rate hedging.

The interrelationship between fluctuating exchange rates and protectionist measures was an important aspect of an assessment of the floating rate system, Mr. Tvedt suggested. Expectations that floating rates would lead to smoother adjustment, thereby lessening the risk of protectionism, had not been fulfilled. Experience in recent years showed that fluctuating real exchange rates in conjunction with persistent exchange rate disequilibria over extended periods created pressures for protectionist measures. In a country with an overvalued currency, whether exchange rates were fixed or floating, demands would be raised for protection against undesired imports and for support to export industries in difficulty. Governments often showed little resistance to such pressures. In addition, once protectionist measures had been implemented, they were difficult to repeal. They were often retained even when real exchange rates had moved back to their previous level. Another problem was that protectionist measures themselves might cause a currency to remain overvalued.

Commenting on the first of the issues raised by the staff for discussion in Part V of SM/84/5 Mr. Tvedt remarked that it was hardly realistic to return to a system of fixed but adjustable exchange rates at present. However, the conditions for an approach to a less flexible exchange rate system should be prepared. In view of the convergence of rates of inflation in the major currency countries over recent years, conditions should at present be more favorable for initiating a policy aimed at greater exchange rate stability. An approach toward a more binding exchange rate regime would, however, require closer coordination of economic policies in the major-currency countries, so that the underlying conditions for exchange rate stability could be restored. It was important to point out that, in practice, the system of floating exchange rates had only to a limited extent enabled countries to pursue autonomous economic policies. A political decision by all industrial countries to stabilize their exchange rates might, in itself, contribute to stabilizing expectations and thereby exchange rate relationships, since expectations had played a strong and increasing role in exchange rate formation, not least in the short run, under the floating-rate system.

The second issue raised by the staff dealt with the possibility of introducing indicators, Mr. Tvedt observed. The "basket system" on which exchange rate policy in three of the Nordic countries was based entailed an attempt to keep the effective rate of each country's currency approximately stable; it might form a likely basis for a system of "presumptive indicators." In general, a system based on indicators as part of an overall assessment might represent a reasonable middle ground between the rigidity of administratively set exchange rates and the volatility of market-determined rates. With regard to the third issue, it was unrealistic to establish a par value system for the time being. He agreed with the staff that reasonable coordination of economic policies in the major-currency countries was a precondition for a par value system to function satisfactorily.

Turning to the fourth issue, Mr. Tvedt said that he agreed to some extent with the view that the opportunity to maintain restrictions on very short-term capital movements might, under certain circumstances, make it feasible to limit disequilibrating capital flows, even to and from major-currency countries. Nevertheless, the introduction of restrictions in countries with free capital movements was not an appropriate method of achieving more stable exchange market conditions. He supported the staff's assertion on page 86 of SM/84/5 in relation to the fifth issue, about the need for better macroeconomic policies. A policy aimed at exchange rate stability and balanced growth coupled with low inflation had to encompass a whole set of measures. As he had already mentioned, better coordination of macroeconomic policies, including exchange market intervention, among the major-currency countries would contribute to greater exchange rate stability and to a more stable exchange rate system.

As to the sixth issue, Mr. Tvedt added, he considered the use of "target zones" to be clearly preferable to a floating rate system in spite of doubts about the possibility of establishing tenable target zones. Target zones might help market participants to form an opinion of future rates and the like, so that they could reintroduce some of the discipline on economic policy exerted by the fixed-rate system. The countries would have to explain deviations from the zone, and the system would have to include an obligation, possibly in the form of guidelines, to bring the rate back into the zone if it should depart from it. In that connection, countries would have to announce economic policy measures ensuring that in the longer term the rate would move back into the target zone. Major-currency countries would take a first step in that direction if, when formulating their monetary policies, they considered exchange rates to a greater extent than at present

Finally, the main task before authorities was to bring about more discipline in the exchange rate system, Mr. Tvedt suggested. How that policy should be implemented in present circumstances was a difficult question. He personally believed that an exchange rate system based on "target zones" merited further investigation. He agreed with the staff that initial efforts should be directed primarily at the major currencies. If more stability could be brought about among key currencies, the exchange rate system would on the whole be substantially more stable than had been the case in recent years.

Mr. Hirao commented that, while the staff should be commended for producing a well-written set of papers, SM/84/5 was by far the best. It provided a well-balanced appraisal, with which he generally agreed, of the present exchange rate system.

Commenting on the six key issues for discussion, Mr. Hirao remarked that, with respect to the first and third issues, it would be difficult to envisage the return of conditions under which fixed exchange rates among the major currencies could be restored. As the staff noted, structural differences among the major economies remained large, so that the differentials in inflation rates at times diverged greatly, reflecting differences in a multitude of structural rigidities, the kinds of policies pursued, and the like. It would certainly be desirable, under circumstances of uncertainty, to seek a convergence of economic policies. However, a long period might be required to achieve the desired results. If national authorities were to fix exchange rates without paying due attention to the underlying differences, there would be recurrent risks that the system might be endangered by sudden large-scale capital flows and that authorities might be forced to resort to frequent realignments of rates.

In present conditions of high capital mobility, Mr. Hirao continued, even adjustable par values with narrow margins among the major currencies did not appear to be a viable option. Rapid accumulation of financial assets, well-integrated financial markets, and technological advances had contributed significantly to enhancing capital mobility in recent years. The resources of monetary authorities had become proportionately much smaller than previously, and far from sufficient to cope with a sudden large portfolio shift between major currencies. If an adjustable peg scheme were considered desirable--although he did not believe that it was--and if that scheme were to work effectively, the authorities would have to be equipped with an enormous amount of resources that could be readily mobilized at a time of instability.

With regard to the second issue, whether there were rules or formulas that could help to determine the appropriate structure of exchange rates, Mr. Hirao went on, it was not possible to give an easy answer. The issue had been looked at on a more technical level in SM/83/263, in which the staff presented helpful analyses of the usefulness and limitations of various indicators and methods. In using such indicators, the staff should use great caution. As for the various indicators of competitiveness, difficulties in choosing a base period and the appropriate weights had to be kept in mind. The indicators of competitiveness were based on theoretical assumptions that countries continued to produce similar goods, that no major impediments existed to free trade, and so forth. In the real world--in which market imperfections, product differentiation, a variety of trade restrictions, and many other factors worked to influence exchange rate changes--the usefulness of such indicators would be severely limited. Reservations were also in order with regard to any method of assessment based on the underlying payments balance, because of the uncertainty attaching to a number of the assumptions. Some of the assumptions had not been presented explicitly by the staff, and they involved subjective or judgmental elements. In any circumstances, a mechanical application of the various methods of assessing the "appropriate" rate structure involved serious weaknesses.

The question of how to deal with excessive exchange rate variability was the fourth issue raised by the staff, Mr. Hirao observed. As the staff had pointed out, exchange rate variability under the floating system had been much larger than expected, and there had been a number of cases in which "overshooting" had occurred. Ways in which to reduce excessive variability and "overshooting" had to be explored. In the fifth issue, the staff raised the question whether a solution was to be found in new taxes or restrictions on capital flows. Easy recourse to such measures would generally not be effective and perhaps even counterproductive, since they would entail distortions in resource allocation in the medium term. First, they would impede the desired capital flows, particularly in the period after the restrictions were lifted; it would probably be a long time before market confidence was restored. Second, a large amount of resources, which could usefully be employed elsewhere, would have to be used in implementing such measures. As the staff suggested, there was no ex ante method of separating "productive" from "nonproductive" capital flows, and it would be difficult in practice to institute a harmless method of restricting only "nonproductive" flows. However, under truly exceptional circumstances, in which exchange rates were clearly at levels beyond what could be justified by the "fundamentals," there might be instances in which the authorities might need to resort to emergency measures, after all other means of correcting the situation had been exhausted.

Commenting on the sixth issue, namely, whether "official forecasts" or "target zones" would help to reduce the variability of exchange rates, Mr. Hirao said he did not favor those ideas. It would be extremely difficult to determine the appropriate level of a zone. As he had indicated, there were severe limitations on the applicability of indicators for determining the appropriate rate structure. It would also be difficult to decide how wide the target zone should be. If it were too wide, the adoption of the zone would contribute little to increasing exchange rate stability. If the target zone were too narrow, it would have to be adjusted frequently, thereby reducing the stability of the system, or, if the authorities wished to keep the exchange rates within the zone, an enormous amount of resources would have to be available in light of the rapidly growing resources in the private sector.

With regard to the fifth issue, Mr. Hirao stressed the importance of pursuing greater stability in macroeconomic policies at the national level in order to achieve greater stability in exchange rates. Two important observations of developments in the past decade could be made in that regard. First, over long periods, exchange rates tended to move more or less in line with the trend in relative price changes among countries. Second, there was a growing consensus among policymakers that sustainable growth without inflation was the common goal over the medium term. A further important consideration with regard to long-term expectations about exchange rates was that market perceptions critically hinged upon the future course of basic policies. As the staff pointed out, credible policies were the single most important contributor toward stable exchange rate expectations; indeed, exchange rate policy could not be divorced from basic macroeconomic policies. Clearly, the end to which the convergence of basic policies should be directed was sustainable growth without inflation. Sound noninflationary policy was the most effective path to exchange rate stability. In that regard, there were a number of areas in which corrective policies were needed, most notably structural problems, such as the slow response by industry to the changing needs of the times, the slow growth of productivity, rigidities in the labor market, and structural fiscal deficits. Finally, timely and effective joint action by the authorities of several countries could, under certain circumstances, help to restore exchange rate stability.

Mr. Schneider remarked that the staff papers contained a comprehensive and extensive analysis of the systemic issues surrounding exchange rates and that the staff had tried to present a balanced assessment of the various views on the question. It was not possible to comment on each of the many aspects mentioned; he would concentrate his remarks, therefore, on the topics for discussion highlighted in SM/84/5.

He fully agreed with the three working assumptions that the staff had taken as the basis of the issues, Mr. Schneider continued. First, the staff considered that the system had permitted too much flexibility. Furthermore, most participants had wrongly believed that it would permit more freedom for domestic policies; consequently, policies had been pursued that had led to conflicts between internal and external balances and had sometimes resulted in sharp overshooting. Second, the staff also noted that the environment had been extremely unstable during the previous ten years, thereby requiring a system characterized by a large degree of flexibility rather than by excessive stability. Finally, the staff had underlined the basic lack of cooperation or even awareness among the major industrial countries with regard to each other's policies.

Those working assumptions were also the the preconditions for greater stability, Mr. Schneider suggested. While the economic environment might be somewhat more stable during the second half of the 1980s than in recent years, it was realistic to assume that the exchange rate system would have to continue to cope with large disturbances. There were also no signs that the major industrial countries were willing to take account of the consequences of their policies for other countries, when formulating them. Under such conditions, it was not reasonable to envisage a return to a system of stable exchange rates among the major currencies. On the other hand, neither the need for real exchange rate adjustments reflecting comparative advantages, nor the stickiness of prices and wages, was a valid argument for maintaining a system of flexible exchange rates. Under the floating regime, adjustments in nominal exchange rates did not necessarily yield important adjustments in real exchange rates. It was generally accepted that a possible return to a system of stable exchange rates should allow for regular adjustment to avoid the kind of overshooting that had occurred under the Bretton Woods system. However, it was doubtful whether the establishment of a stable-rate system would foster or sufficiently strengthen the discipline necessary for coordination of policies. Although such a system could certainly exert a positive influence on coordination, as the experience with the working of the EMS appeared to suggest, that influence was not strong enough per se to enforce such a discipline.

With regard to the second issue, Mr. Schneider said, it was doubtful whether the use of formulas or rules would be of much use. There were no absolutely reliable indicators on which formulas could be based. Whether a nominal exchange rate was in line with the equilibrium rate remained basically a matter of judgment, except in periods of extreme divergence. Presumptive indicators were not a panacea, as experience within the EMS showed, because they provided insufficient evidence of the action required in a specific country. As the staff correctly stressed, such indicators signaled only the existence of an undesirable trend and a need for adjustment, but they did not specify the combination of adjustment measures to be adopted. That point had also been confirmed by experience within the EMS, in which the passing of the threshold triggered policy responses that were essentially confined to various kinds of intervention or to a tightening of monetary policy. They did not lead to more fundamental policy changes, because the indicators did not necessarily signal the existence of a maladjustment in the economy; they might have been triggered by different policy objectives in different countries. As a result, the degree of publicity given to the divergence indicator had been progressively toned down as the authorities had become fully aware of the broad spectrum of information necessary for a correct assessment of the economic and monetary situation.

If convergent and appropriate policies were pursued by the major currency countries, Mr. Schneider remarked, a system of stable but adjustable exchange rates could probably cope well with the present capital mobility. However, the political commitment to establish such a system did not appear to exist. Moreover, in view of the differing degrees of openness among even the major industrial economies, the exchange rate issue was looked at in different ways, so that divergent policies resulted. Under those circumstances, a system of stable rates could not last for long without major adjustments, unless governments were prepared to adjust policies in line with external requirements and were perceived to follow sound policies. In addition, the solution to the problem could not be found in a system of stable rates coupled with restrictions on capital flows. While a system of dual exchange markets could play a role in a number of specific cases, it could not be applied generally, as the experience in several European countries had shown.

There was probably widespread agreement that greater stability of macroeconomic policies at the national level and better coordination of policies across countries would achieve greater stability of exchange rates, Mr. Schneider observed. However, very little could be done in that area, as success ultimately depended on the willingness of governments to adjust their policies in line with the requirements of external conditions. It was particularly obvious how difficult the issue was when certain policy adjustments were not undertaken, even when they would clearly have positive effects on the domestic economy. No system could impose such discipline. Experience had amply shown that governments did not hesitate to abandon systems when they were perceived as too rigid because they imposed policy adjustments that the governments were unwilling to undertake. Basically, there had been a lack of agreement on appropriate policies across countries, partly as a result of the existence of different economic structures.

It was unclear what incentives could be devised to change countries' unwillingness to adjust policies so that the actual exchange rate would not deviate too much from the equilibrium rate, Mr. Schneider went on. Clearly, the task of devising effective coordination incentives continued to remain open. Refining the techniques that might signal maladjustments, such as the use of target zones, could help by creating incentives to react, but their effectiveness would depend a good deal on a common understanding of the appropriate exchange rate policies.

A strengthening of the Fund's surveillance function was another step that would help to foster the pursuit of appropriate policies, Mr. Schneider considered. The kind of exercise that the staff had undertaken to assess the underlying payments position in the major industrial countries was useful and should be treated more explicitly in the World Economic Outlook, in papers on surveillance, and in the relevant reports on Article IV consultations. If the Fund was indeed serious about its intention to improve the functioning of the international monetary system, it should not hesitate to engage such an exercise. It would foster understanding about the fundamental positions of currencies and could thereby help to achieve a greater willingness to adopt appropriate policies. So far, progress had been limited. However, if the Fund were to advance gradually, there might be hope for badly needed improvement.

Mr. Clark remarked that the present discussion was one of several stages in a further round of debate about the financial system and exchange rate arrangements. It was reasonable to hope that consideration of the issues could now take place in a less volatile environment, not subject to the extreme disturbances of the 1970s. He agreed with other Directors on the high quality of the staff papers; in particular, SM/84/5 had been written in a crisp style that could usefully be taken as a model in preparing similar documents.

With regard to the first of the six issues raised for discussion by the staff, Mr. Clark continued, it was easy to see the immediate conjunctural difficulties that would arise with an attempt to return to a system of fixed exchange rates. Inflation differentials remained wide; the major countries were still some way from general policy cohesion; many of the structural rigidities that had developed in economies during the postwar decades were still present. All those immediate considerations, by themselves, would make it difficult to return to a system of fixed rates. However, there were also underlying factors that worked in the same direction. First, there had been a substantial widening and deepening of both domestic and international capital markets; a crude measure of that development had been the increase in the size of the Euromarkets by a factor of about nine between 1971 and 1982, compared with an increase in world trade by a factor of five. Second, the world had moved from a bipolar or monopolar economic system to a much more multipolar one. The greater relative importance of economies outside the United States had, perhaps inevitably, led to greater scope for tensions and inconsistencies. In sum, it was hard to envisage any early return to a system of fixed rates.

Commenting on the second issue, the possibility or utility of devising exchange rate rules, Mr. Clark said that he was skeptical for reasons similar to those that he had just cited. The question was closely linked to the issues considered in SM/83/263, the conclusions of which he generally endorsed. However, with regard to the analytical approach in that paper, it might have been helpful to link the question of the appropriate measures of competitiveness to the character of the market or markets in which a particular country was trading. For example, a judgment on whether a country was primarily a price taker or a price maker would have implications for the form of the competitiveness that might best explain that country's trade performance in its markets. The staff could perhaps have explored that kind of connection further. Second, little mention had been made of "unmeasured" price factors, such as export credit terms, or of nonprice factors, which were apparently mentioned only briefly on page 41. He invited the staff to comment on the value or feasibility of incorporating those factors into the analysis. Third, the staff correctly took a cautious view of the possibility of identifying equilibrium capital flows. The approach normally adopted--an attempt to average actual flows--was suspect for a reason besides the ones mentioned by the staff. Recorded flows were ex post, whereas what was really required was an ex ante measure.

Regarding the implications of the analysis in SM/83/263, two points deserved consideration, Mr. Clark suggested. First, it was necessary to look at the exchange rate in the context of overall macroeconomic objectives. A given exchange rate would not itself, in most circumstances, be an ultimate goal. From that point of view, short-term overshooting might not be unequivocally harmful insofar as it contributed to the speedier achievement of more fundamental goals, such as those with regard to inflation. Second, even when the need for adjustment of the real exchange rate was recognized, account needed to be taken of the difficulties of effecting a change in the real rate, for example, because of the feedback to domestic costs. Such feedback could have implications for other economic objectives, particularly, again, for inflation. The need to take account of the exchange rate in framing macroeconomic policy was clear, and the notion of an equilibrium rate could play a role, although the limitations and imprecision of any quantitative measure should be recognized. The uncertainties and complexities were such that qualitative policy judgments would have to continue to play a major role.

Taking up again the issues raised in SM/84/5, Mr. Clark remarked that the third issue was closely linked to the first. Consequently, the general conditions of policy consistency and stability that would underlie any move back toward fixed rates would also be necessary to secure the viability of an exchange rate system with narrow margins. However, economic policy, while important, was only one possible source of exchange rate instability. The question arose as to how far other sources of instability were susceptible to stabilizing action by the authorities. For example, if portfolio shifts were resilient to such official signals, it could be difficult to maintain narrow margins even with stable and consistent macroeconomic policies.

With regard to the fourth and fifth issues, concerning possible ways of dampening exchange rate volatility, Mr. Clark suggested that the consequences of volatility might be more serious than indicated by most econometric analyses. First, the analysis sought to measure the effects of volatility in variables when even the relationship between the mean values of the variables was not well understood. Second, the effects of volatility might be manifest in some of the variables used to explain trade behavior, rather than in the relationship between those variables and trade flows. As for the specific questions raised by the staff, he could not support the abandonment of the substantial progress in recent years toward liberalizing capital flows, notably in Japan and the United Kingdom. There were, in any case, considerable practical difficulties in policing any system of capital flows, and the efficacy of any such system was doubtful. It had been suggested that there would be advantages in "throwing a certain amount of grit into the machine" on the assumption that the welfare loss from the distortion of capital flows was less severe than that from restrictions on trade flows. However, that view could simply reflect the feeling that capital flow constraints were more insidious than the more obvious, short-term effects of trade control.

Concerning the role of macroeconomic convergence, Mr. Clark agreed that it was the principal practical means through which greater stability of exchange rates might be achieved. He generally endorsed the staff's analysis of the linkage of stable macroeconomic policy to stable exchange rate expectations and, in turn, to greater stability in current exchange rates. With regard to the final issue, the question of forecasts or target zones, he was again skeptical. In the United Kingdom, the authorities had found it more helpful to base macroeconomic policy firmly on medium-term monetary and fiscal objectives.

In addition to the substantive issues raised in the papers, a number of procedural questions deserved consideration, Mr. Clark went on. How did the staff and management propose to carry forward the debate in those papers? Had consideration been given to convening a seminar of interested academics along the lines of the meeting held 18 months previously that had discussed international financial issues? What further discussion was planned in the Executive Board? In principle, the papers before Directors deserved publication; a decision should perhaps be related to the outcome of the study being prepared for the Group of Ten. Finally, while he agreed with much of the staff's analysis, precisely to what conclusion that analysis led seemed less clear at the moment.

Mr. de Vries commented that one of the major innovations brought about by the creation of the Bretton Woods institutions had been to provide the world with a center for world monetary cooperation, a place in which countries could initiate discussions on aspects of the world monetary system that they believed might need their common attention at a particular time. Exchange rates and the evolution of the exchange rate regime fell into that category at the moment. It was, therefore, appropriate that the Executive Board should attempt to take stock of the exchange system and to comment on the lessons from the past and the options for the future. The present discussion was well timed because it was exactly ten years since the attempt to reform the exchange system had been abandoned in light of the energy crisis that had been developing. With the energy crisis receding somewhat, it was useful to resume the discussion and to see whether efforts could be made toward establishing more clearly defined rules and codes of behavior. The excellent staff papers provided a good basis on which to begin the discussion.

The staff's analysis and the remarks already made by Directors indicated clearly that the question of the exchange rate system was complex, Mr. de Vries continued. It was necessary, therefore, to focus on a few issues so as to clarify what objectives were attainable and what action might be possible. Greater stability of exchange rates in the medium term as well as less volatility in the short term were viewed by many Directors as desirable objectives. He did not disagree with those objectives, but it would be wrong to believe that desiring an objective made it attainable; it would also be wrong to believe that because the means of attaining an objective were not readily at hand, the objective was, therefore, undesirable.

Although there was widespread agreement on the desirability of greater stability of exchange rates, Mr. de Vries observed, that view was not unanimous. Some members of the Fund strongly held the view that the outcome of market actions, whatever it might be, was correct. For example, the Governor of the Fund from the United States was reported to have said recently: "The dollar is not overvalued at its current levels, since it is the market which determines its value." Most members held a different view. The time frame in which the market operated was much shorter than was relevant from the point of view of social and economic policy. The market might be cleared at an "equilibrium" rate one day, but the price could be very different a week later. The exchange markets were, therefore, subject to great volatility. An even more costly aspect of the system was that exchange rates were set at present predominantly by money and capital movements. From a purely financial point of view, the cost of shifting large amounts of financial assets and taking account of constant changes in the prices of various assets might be relatively small. However, it could be costly from the point of view of the real economy. In the real economy, particularly in the current account, misalignments in exchange rates that persisted for some time produced signals that led to the creation of large surpluses for one or two years, followed by signals that led to current account deficits for a number of years. Such "seesawing" of resource allocation carried significant costs. There were also high social costs involved in the windfall profits and losses that exporters and importers experienced as a result of unpredictable exchange rate movements.

One possible course of action would be multilateral coordination of policies, Mr. de Vries noted. Realistically, however, such coordination was an illusion rather than a policy prescription. At the global level, there had been attempts to coordinate policies in the 1960s under far more favorable circumstances than existed at present, and they had not gone far. Similarly, the members of the European Communities had been attempting to coordinate policies for a quarter of a century, but they had not made much progress. The fundamental difficulty with coordinating economic policies was that efforts to do so were at odds with the world's political institutions. Governments were responsible to their national electorates and were therefore influenced by the wishes of their national populations. A further difficulty arose when an electorate decided to change governments in certain circumstances, the recent experience of France was a clear example. Without a basic change in the world's political arrangements, it was difficult to place much hope in multilateral coordination in the foreseeable future.

Monetary policy had an overwhelming influence on exchange rate developments, not surprisingly, since exchange rates were determined predominantly by money and capital movements, Mr. de Vries considered. Thus, exchange market intervention in the absence of supportive monetary policies was relatively, perhaps completely, powerless.

There had been examples of exchange rate stability in the past, Mr. de Vries went on, but they had usually relied on the existence of a strong center that pursued a policy of monetary and budgetary stability while being committed to a satisfactory rate of growth. In such circumstances, other countries had been willing to give up their monetary policy and to stabilize their exchange rate in relation to the currency of the center. Often, other factors had influenced their decisions, but those that he had mentioned had played a substantial role in earlier stable exchange rate systems, such as during the period 1870-1914, when currencies had been fixed against the pound sterling. Admittedly, even the actions of the British authorities had been limited by what had been called "the rules of the gold standard."

Similarly, between 1950 and 1969, Mr. de Vries added, although the exchange rate regime had been referred to as the "Bretton Woods system," it had been, in practice, a system in which countries had basically decided to peg their exchange rate to the dollar. Again, the policies of the U.S. authorities had been somewhat circumscribed by the code of behavior embodied in the Bretton Woods system. In the EMS, to take another example, the members had decided to stabilize their exchange rates around the deutsche mark; in that system,there was also a philosophy of monetary union and monetary coordination that made the fundamental operating principle a little less clear.

On the basis of historical experience, Mr. de Vries suggested, if a center emerged that was strongly dedicated to noninflationary monetary policies and adequate growth, and if those policies were perceived as reasonably permanent, other countries might decide to give up the benefits of having their own monetary policies in exchange for the benefits of pegging to the center country's currency. However, if no such center, or centers, developed that provided sufficient stability and inspired sufficient confidence, there would be no noticeable exchange rate stability. The concept of general multilateral coordination and decision making was too vague to offer much promise. In the past, the center countries had assumed certain limitations on their freedom, and similar limitations on the freedom of the center countries would have to be devised for the successful operation of any new system that might emerge. In that regard, the statement by the Chairman of the U.S. Federal Reserve Board, quoted on pages 64-65 of SM/84/5, was highly relevant.

Turning to the second issue raised by the staff, whether there were formulas or "presumptive indicators" that might help to determine the appropriate structure of rates, Mr. de Vries said that he doubted whether such formulas existed. There was little point to them, nor to the objective indicator developed by the Committee of Twenty, to which the staff had referred. The third issue raised by the staff, dealing with margins, was quite secondary. In a world of high capital mobility, somewhat higher margins might be needed, but the issue was primarily technical; it could be left to a later stage of the discussions.

The fourth issue dealt with capital movements, Mr. de Vries noted. If the only real choice were between a system of freely floating exchange rates in which rates fluctuated unexpectedly and a system in which most countries gave up their monetary freedom in order to follow the policies in the center country, or countries, it was surprising that relatively little attention was being given to the question of how to control capital movements. As a number of Directors had indicated, opinion at present was against capital controls. Some economists might argue that capital movements reduced the volatility of exchange rates, others that exchange rates might fluctuate anyway in the absence of large capital movements. For example, if a country elected a government in whose policies financial market operators had little confidence, the exchange rate in question might move downward in a free market without many capital transactions. Nevertheless, in view of the relatively small amount of attention that had been given to capital controls as a means of reducing the instability of exchange rates, the issue deserved further analysis. Of course, the conclusion might turn out to be that not much could be done in practice.

The fifth issue raised the question whether greater stability of macroeconomic policies would help to bring about exchange rate stability, Mr. de Vries observed. As he had indicated, coordination was too vague a concept; stability in exchange rates would come about to the extent that countries pegged their currencies to one or more center currencies. It was possible that a limited number of center countries might be able to pursue relatively similar policies among themselves rather than attempt a broader coordination of policies. As far as the sixth issue was concerned, there was no benefit in target zones. Either the system should be based on pegging to a stable and reliable center, or the world would have to make do with something akin to the present system.

Commenting on SM/83/263, Mr. de Vries welcomed the efforts to resume the attempt to estimate underlying balance of payments positions. As many Directors had pointed out, it was impossible to achieve great accuracy in that regard, but that reality did not imply that nothing should be done. The Fund had tried to estimate underlying balance of payments positions in the past, and, while the estimates had not always been correct, they had been useful. Finally, the future evolution of the exchange rate regime was a central issue for the Fund. In earlier years, monthly informal seminars on different aspects of that issue had been held so that Directors could come to a comprehensive, although not necessarily unanimous, view on the subject. Perhaps it was time to revive that series of discussions, which might culminate in a report by the Executive Board on the possible evolution of the present exchange rate regime.

Mr. Gomel said that the analysis in SM/83/263 was welcome. As the Chairman had indicated in his opening remarks to the conference on "Exchange Rate Regimes and Policy Independence" held in the Fund in August 1982, it was difficult for the Fund to make pronouncements on the exchange rates of major currencies, but it seemed much easier to do so on the currencies of small countries. However, despite the numerous difficulties involved, the Fund ought to be more concerned about exchange rate gyrations and misalignments in the currencies of the major countries in view of their international repercussions. If SM/83/263 was a manifestation of a renewed interest by the Fund in exchange rate matters, he strongly supported its thrust both with regard to the analysis presented and to the policy implications to be drawn from that analysis. Other longer-range studies should be undertaken by the staff along the lines indicated in the paper so as to strengthen the purposes for which the Fund carried on its surveillance.

The first question was how to devise an internationally consistent set of exchange rate ranges for member countries, Mr. Gomel continued. As the staff had suggested in its concluding sentences in SM/83/263, the Fund was concerned with the issue of whether each member's exchange rate policies were appropriate from a multilateral standpoint. In order words, members' prevailing currency values were to be assessed against a yardstick, however rough it might be, that was related to a world configuration of payments balances considered appropriate from the standpoint of the welfare of the world economy. He agreed with the note of caution sounded by the staff, when it pointed out that there was no unique pattern or distribution of balances that was superior to all others. However, the matter clearly fell within the Fund's responsibilities; the time had come to develop further medium-term analyses and assessments along the lines of those under consideration at the present meeting.

The staff was also correct, Mr. Gomel added, when it stated that it was essential for the effective exercise of Fund surveillance that judgments about the ranges within which the exchange rate for any single country should be maintained should be consistent with the assessment of the set of exchange rates prevailing among other countries, despite the many uncertainties involved. Otherwise, the surveillance function ran the risk of being limited to a series of individual reviews of members' economic policies that resulted in a given exchange rate path, reviews that might be discussed largely in isolation from each other.

With regard to exchange rate determination, Mr. Gomel remarked, the staff's empirical findings of an association between movements in real exchange rates and in real interest rate differentials appeared plausible. For example, the upward trend in the exchange rate for the U.S. dollar since 1980 had been broadly associated with rising real interest rate differentials, while its swings and the resulting disorderly conditions prevailing in world currency markets appeared to have been mainly the result of the variability of U.S. nominal interest rates.

Commenting on the discussion of indicators of competitiveness, Mr. Gomel said that he had no major difficulties with the staff's careful analysis, although he shared the note of caution stressed by previous speakers. However, while unit labor cost indices were important, they needed to be supplemented by price indices, possibly wholesale price indices for manufactured products, because they had fewer drawbacks than other indicators. Labor cost indices captured only one element of costs, on average accounting for about half for industrial countries as a whole and a considerable smaller fraction for countries such as Japan and Italy. In addition, price competitiveness could diverge from cost competitiveness for prolonged periods if profit margins allowed. With regard to cost-based indicators, attempts should also be made to construct total cost indices despite the difficulties involved. More generally, the Fund should not rely on one indicator by which to judge the competitive performance of all countries. A variety of indicators should be looked at; they might well differ among countries. The staff's finding of a low degree of response of trade flows to changes in cost indices should not be surprising; he expected that elasticities with respect to prices would be higher.

The method proposed by the staff to assess a country's underlying balance of payments position and, through comparison with the "normal" position, thereby to estimate a "sustainable" exchange rate was ingenious, Mr. Gomel considered. It could be helpful in conducting medium-term analyses of exchange rates. Although there were shortcomings and sources of uncertainty, as the staff recognized, some of those could be overcome with further work, which the staff should be encouraged to undertake.

Turning to SM/84/5, Mr. Gomel observed that, following the turbulence of the previous decade, the institutional setting of the exchange rate system had become the object of new interest. It was easy to foresee that the future role of the Fund in the world economy would depend to a substantial extent on the type of monetary and exchange rate arrangements that would eventually emerge. Given the importance of active participation by the Fund in the debate on those issues, the present discussion was welcome; he hoped that similar discussions would be held more frequently.

The proposition that greater policy coordination was a prerequisite of stability could not be questioned, Mr. Gomel considered. The question was whether, in practice, such coordination could work in the present world in which governments of independent countries attached different degrees of priority to different economic objectives and frequently appeared unwilling to forsake their control over domestic economic policies. If that type of attitude prevailed, as it appeared to be doing--particularly in the larger, less open economies--there was little scope for a system of fixed nominal parities, although policies to reduce fluctuations in real exchange rates could continue to be attempted.

As the staff had observed, Mr. Gomel went on, the experience of managed floating and the abandonment of nominal exchange rate targets had, in part, failed to meet the expectation of enhanced freedom for national economic policies. In particular, the authorities of relatively small, more open countries had regarded the external value of their currencies as an important policy target under managed floating, in view of the effects on domestic activity and on inflation. The sizable short-run fluctuations in nominal parities during the previous decade appeared to have increased the instability of expectations, which were particularly sensitive at present to new information about the direction of policy and other relevant factors. Unstable and largely unpredictable expectations might have reduced both the scope for exploiting the greater effectiveness of monetary policy under floating rates and, more generally, the possibility of gearing economic policies toward domestic targets.

In view of the persisting demand for independent national economic policies, the high degree of international capital mobility, and the marked instability of expectations, the establishment of a system of fixed rules for exchange parities did not appear to be a viable objective in the near future, Mr. Gomel suggested. In present circumstances, a more limited aim of policy would be to reduce the risks that real exchange rates might diverge substantially and for long periods from equilibrium levels, a tendency that induced unwarranted effects on real output and that strengthened protectionist pressures.

The proposal to establish a system of taxes on international capital transactions had considerable intellectual appeal and should be regarded with interest, Mr. Gomel commented, although it was open to at least two serious criticisms: its distorting effects might be no less serious than those implicit in the floating-rate system, and the administrative difficulties might prove overwhelming. The case for "official forecast" or "target zones" appeared more favorable, first, because they would contribute to the stability of expectations, second, because they would compel national authorities to consider more carefully the external implications of their domestic policy actions, and, finally, because the cost of providing the additional information to the market appeared low, and no unwarranted effects were likely to arise. In view of such considerations, the work recently done by the staff on underlying payments imbalances and equilibrium exchange rates could be important. Further research should be encouraged.

Mr. Leonard stated that the staff had provided a thorough and balanced review of the complexities that arose in grappling with the reform of the international exchange rate system; the papers were particularly valuable because of the detailed knowledge, deep experience, and high intellectual rigor on which they were based. With regard to SM/83/263, he agreed with the staff's observation that the method proposed for calculating longer-term and equilibrium exchange rates was rough and ready.

Two further notes of caution were warranted, Mr. Leonard said. First, the calculated "underlying" capital inflows had been derived from the average ratio of net private flows to GNP for 1975-78 and 1981-82. Little was known about either the sustainability of those flows in the future or their appropriateness. In the periods concerned, the flows had included both short-term movements and large-scale lending to developing countries, which had subsequently become part of the current global debt problem. The flows had also occurred in the context of large movements in exchange rates and interest rates. Second, service payments had been inadequately treated, as the staff recognized. Both points represented intractable conceptual problems. Despite the technical difficulties involved in assessing the sustainability of exchange rates, he agreed that there was no real alternative but to try to improve existing methods so as to narrow the scope and size of current impediments to effective surveillance.

It was clear from the staff's analysis, Mr. Leonard continued, that, given the current state of the art, only the broadest assessment of whether exchange rates were evolving in a direction consistent with underlying payments positions was possible. Ultimately, the assessment of the appropriate and sustainable exchange rate for a country would continue to depend on a full qualitative, as well as quantitative, analysis of its economy, in which the plethora of economic indicators would serve as useful, but not conclusive, guides.

Commenting on SM/84/5, Mr. Leonard remarked that, while the benefits of a floating system might have been exaggerated, it had had positive effects by at least partly cushioning national economies against external shocks and by promoting adjustment to changes in economic "fundamentals." Furthermore, the worst fears of the possible longer-term adverse effects of floating rates--such as a general discouragement of trade and investment or weakened responsiveness of trade flows to selected price differentials--had not materialized. Nonetheless, floating rates had not greatly reduced external constraints on policies, nor had they eased the adjustments necessitated by real shocks. The limited degree of independence that they had conferred on monetary policy had also been unexpected, at least from the point of view of economic models developed in the 1960s.

Although it was difficult to disentangle economic developments of the previous decade caused by modifications to the exchange rate system from those that had arisen from other sources of disturbances, Mr. Leonard considered, he agreed with the view that the exchange rate system was not to blame for the more general economic, structural, and policy problems currently facing the global economic community. In general, exchange rates, like other prices, should be seen more as the result of underlying economic factors than as primary economic influences themselves. That view was, of course, an oversimplification; there were conditions under which exchange rates could also be causative factors.

However, exchange rates could have what superficially appeared to be a life of their own, Mr. Leonard added, and they could remain at levels inconsistent with longer-run equilibrium values for as long as two to three years. At such times, recognized fundamental factors such as relative price performance, balance of payments developments, and real interest rates explained only a small proportion of actual movements in exchange rates; less well-understood factors constituted the preponderant influences. The problem was serious because a prolonged divergence of actual from equilibrium exchange rates was likely to have adverse consequences for resource allocation and for domestic macroeconomic goals. Determined efforts to identify and to understand the dominant forces in those instances were a prerequisite for effective policy action; such efforts would be well worthwhile in view of the probability that variable rates would remain for some time to come.

His Canadian authorities had noted the staff's conclusion that trade and capital flows were not adversely affected by shorter-run exchange rate volatility and that the "vicious circle" argument had little empirical substance, Mr. Leonard stated. They urged caution in dismissing the argument, because the econometric results had to be interpreted carefully insofar as they did not allow for policy factors in the matters under examination. In Canada, for example, the central bank had intervened in the foreign exchange market in order to moderate rapid exchange rate movements and to stabilize expectations. Other countries had undoubtedly taken similar actions; different econometric results might be obtained under a policy regime that neglected the exchange rate. Certainly, the risk of destabilizing behavior would be higher. In any event, the Bank of Canada and other central banks had stressed the dangers in regard to inflationary expectations of any appearance that other policy objectives had priority over exchange rate stability.

Turning to the staff's discussion of options for the future, Mr. Leonard suggested that it would be difficult to prescribe a simple global cure for the problems associated with the current system. The present wide range of choices that countries had in designing their own exchange rate policies enabled them to arrive at arrangements that took account of their different economic structures and institutional characteristics. Such diversity of choice was scarcely to be regretted, given the diversity of structures and institutions, but, while it prevailed, it was hard to envisage a return to conditions under which the first option discussed by the staff--a return to fixity of exchange rates among the major currencies--could come about. Even with the convergence of inflation rates and a lessening of current account imbalances, other elements bearing on exchange rate movements that had been accurately identified by the staff would continue to call for flexibility as an essential attribute in the functioning of the international monetary system.

In considering other possibilities, Mr. Leonard went on, it was reasonable to believe that no system would work well without, first, a predictable monetary environment, including reasonable stability in price levels and money growth, and, second, a broad measure of consistency in the policy mix applied in different countries. Both conditions required broad agreement on the main constituents of "sound" economic policies. The Fund had given a good lead in pointing out what those constituents were, and, indeed, some measure of agreement on some of them appeared to prevail among some major trading countries in the Western world. However, the consensus was limited and its duration uncertain because sovereign governments would not quickly or easily give up their rights in a changing environment to pursue policies that they regarded as correct, however misguided they seemed to outside observers. Accordingly, it seemed probable that, as in the past, the international exchange rate system would evolve more in response to the influence of an "invisible hand" than to the good advice and actions of governments or international organizations. Recognition of that reality was not advocacy of the abandonment of rational action, but merely insurance against disappointment at its miniscule impact.

In practice, the wisest course would appear to be gradually to move the present system away from a totally laissez-faire course that, on the basis of experience, would not result in orderly markets for some time, Mr. Leonard commented. To give de Tocqueville's remarks on democratic governments an economic application, it could be said that the market was the best system because it could be depended on to come up with the right solution to a problem only after it had experimented with all the others. To save time, it would be preferable to contain the scope of the market's experimentation through rational action; the authorities in the major countries should be expected to give a lead in that regard. While official exchange rate target zones had attractions, they would be likely to bring along their own set of problems: if set too wide, such zones would be meaningless; if set too narrow, they could be unduly arbitrary and restrictive, leading to the same problems as in a fixed-rate system; if breached or adjusted too frequently, they would undermine government credibility.

A better alternative might be for the major countries, while not adopting target zones, to agree on the broad orders of magnitude for movements of their exchange rates, Mr. Leonard suggested. The basis of that agreement could be a commonly arrived at assessment of the "fundamentals." When a participant began to approach the limiting rate, discussions among the members of the system would be triggered. The value of such an arrangement, as of the use of the divergence indicator in the EMS, was not that it would set in train a mechanical adjustment process but that it would help to ensure regular concerted review of the appropriateness of exchange rates. Perhaps it could build on the embryonic surveillance procedures for the major countries that had been agreed upon at the Williamsburg summit in 1983.

Mr. Zhang said that the staff had produced two excellent papers containing a great deal of useful material and analysis. In SM/83/263, the staff had linked the definition of a sustainable exchange rate to three conditions, namely, no undue restrictions on trade and payments, no severe restraint of aggregate domestic demand, and no massive external borrowing. Could the staff comment further on those conditions? Could the latter two conditions be quantified? Did the staff believe that the exchange rates of the industrial countries at present were sustainable according to those definitions?

The staff recognized the possibility that the various indices of competitiveness could give only limited indications of a misalignment of a country's exchange rate, Mr. Zhang continued. A more interesting point emerged from the results of the statistical calculations presented in Table 2 of SM/83/263, which indicated that the estimated short-term elasticities of imports and exports with respect to normalized unit labor costs of 14 industrial countries were already small and that the longer-term elasticities, though larger, were less than unity in many cases. Indeed, in regard to short-term elasticities, in no case was the sum of the import and export elasticities greater than unity. Those results had wide and important implications. If the calculations were accepted, any devaluation undertaken by those countries would necessarily lead to a worsening, instead of an improvement, in their balance of payments. However, in the Fund's current operations, it appeared that the opposite assumption, i.e., of an elastic demand response, was generally used. Could that assumption be explained?

The underlying payments position approach was useful and rational in a situation in which international capital had become increasingly mobile, Mr. Zhang considered. However, the statistical procedure needed to assess a country's position was hazardous, as it involved, in addition to problems with the data base, the making of broad assumptions and the introduction of statistical adjustments. The projection of private capital flows could be particularly uncertain. Could confidence be placed in the calculated results if they happened to diverge greatly from actual changes? Furthermore, had the staff ever attempted to apply such procedures to the Fund's surveillance operations?

Commenting on SM/84/5, Mr. Zhang noted that the staff stated at the outset that the emphasis in the paper was on the larger countries. However, the subsystems could not and should not be excluded from the present review. As far as Fund members were concerned, the working of the present system included its subsystems. A review of the experience of the previous decade was incomplete unless it covered the countries maintaining more or less firmly pegged rates. In fact, the consequences of more flexible exchange rates among the major currencies were not intelligible without reference to the effects of currencies more or less pegged to them; for example, Germany's effective and real exchange rate movements were strongly influenced by its role within the deutsche mark area. With regard to the experience of developing countries, what was the staff's view of the conclusions in the four non-Fund publications cited in footnote 4 on page 1 of SM/84/5?

Were 1963-72 and 1973-82 the best possible periods for comparison purposes? Mr. Zhang inquired. In the first period, 1970-72 had been years when the Bretton Woods system had not been functioning properly as a result of the failure to correct fundamental disequilibria by adequate exchange rate adjustment; in the second period, the years 1973-76 had been marked by rapid world inflation and by disequilibrium exchange rates after 1972. Were the conclusions not distorted through mechanical comparisons of those two decades, each of which had been strongly affected by the abnormal consequences of the prolonged collapse of the fixed exchange rate system?

The staff recognized that the exchange rate regime was determined by the variety of policy objectives and by the desire for policy independence of the major countries, Mr. Zhang went on. If the major countries were determined to pursue highly independent policies, floating rates were unavoidable. Fixed rates were possible only if national objectives were compatible, or if, for one reason or another, countries were prepared to sacrifice some of their independence. Therefore, it was not useful to focus on the effect of fixed or floating rates on the assumption that they operated in similar circumstances.

It was incorrect to characterize the performance of the present exchange rate system as "remarkably good" considering "the harsh global economic environment," Mr. Zhang said, without carefully examining to what extent the global environment had also been a product of the national policies determining the operation of the exchange rate system. It appeared that the staff blurred the issue by categorizing as "structural factors" developments that had not, in fact, been independent of countries' policies. The staff discussed the "nontrivial adjustment cost" stemming from the persistent movement of real exchange rates. However, there was no certainty that the achievement of a greater degree of price stability in conjunction with an overvalued exchange rate would automatically cause the loss of technical competitiveness to be reversed in the near or medium term. In that context and elsewhere in the paper, the staff appeared to imply that all would be well in the world economy and that all countries would prosper equally only if they all relentlessly pursued "macroeconomic discipline" in the interest of price stability. What assumptions had been used to reach that conclusion, and were they realistic?

He could accept the general thrust of SM/84/5 and the main conclusion reached by the staff, Mr. Zhang stated. He welcomed the staff's observation that "the exchange rate system matters, but not as much as previously thought." That observation represented an important change in the Fund's policy outlook. He also agreed with the conclusion that floating rates had allowed more autonomy than fixed rates in the use or control of policy instruments, but that they had not removed the need for policy coordination across countries. Indeed, greater stability of floating exchange rates had to be sought primarily through less abrupt changes in macroeconomic policy and greater internal consistency of policy at the national level as well as arrangements for insuring compromises between different national policies, including arrangements for exchange market intervention to avoid destabilizing exchange rate movements. In that connection, firm leadership by the Fund was most important and greatly needed. If he had to answer the questions raised by the staff with regard to options for the future, his answer would be in the affirmative to the fifth and sixth issues and in the negative to the remainder. Finally, similar papers by the staff or a summary of the findings of outside studies relating to the experience of the developing countries would be useful for future Executive Board policy deliberations.

Mr. Erb remarked that his authorities had found the staff papers informative and of excellent quality. They believed that, in SM/83/263, the staff had been candid in pointing out the weaknesses and shortcomings of the technical procedures used to assess the appropriateness and sustainability of exchange rates in the industrial countries. Whether exchange rate issues were looked at from a theoretical perspective, or from the perspective of the various empirical analyses that had been undertaken, or even from the perspectives of the practitioners in the commercial and public sectors, the Fund's analytical and empirical understanding of how economies worked and interacted through the markets for money, capital, labor, goods, services, raw materials, and foreign exchange was relatively rudimentary. The situation did not imply that the Fund should avoid judgments, but that it needed to continue to qualify those judgments, as it had done in the past, and to subject them to systemic review. More important, the Fund needed to use surveillance as an important means of developing and enhancing understanding of the economic and financial linkages among countries.

In Part II of SM/83/263, "General Observations on Exchange Rate Determination," the staff began with a reference to the Report of the Working Group on Exchange Market Intervention and to the concept of "overshooting," Mr. Erb noted:

> The authorities in all the Summit countries have intervened at times as part of their response to situations in which exchange rates were judged to have diverged markedly from what appeared to be warranted on the basis of fundamental economic factors. This is often loosely described as "overshooting."

In the context of that Report, the word "overshooting" had indeed been used loosely. While it was an accurate description of one of the motivations that influenced intervention in the exchange market at different times, the circumstances in which that motivation was said to have influenced official behavior often differed during the period covered by the Report. What officials judged to be fundamental economic factors had often not been clearly defined, and sometimes there had been differences of view within and among governments over which fundamental factors were important; for example, at times there had been differences of view regarding the path of the future fundamental factors that would influence the exchange rate. There had been times when officials had believed that the exchange rate had not been out of line with the "fundamentals" but when it had become necessary, nevertheless, following a period of intervention, to change the underlying policies or, in other words, to change the underlying "fundamentals."

Judgments about overshooting or judgments about exchange rates' being out of line had sometimes focused on a particular bilateral exchange rate, Mr. Erb observed. The experience of the dollar in relation to the yen and the deutsche mark in 1978-79 could be used as an example of how the "fundamentals" could be viewed quite differently depending on the exchange rate under consideration. Looking at the yen/dollar experience alone, the turnaround point in the relationship between the yen and the dollar--following the sharp decline in the dollar against the yen during 1977 and most of 1978--had occurred in the autumn of 1978. Thereafter, the yen had begun to fall sharply against the dollar, but it had not been until almost a year later that the dollar had turned around against the deutsche mark. As Mr. Laske had suggested, the change in U.S. monetary policy in late 1979 had caused the turnaround in the dollar after 1979. However, that shift in U.S. policy, which had been greatly influenced by the relationship between the deutsche mark and the dollar, had resulted in an even sharper fall in the yen against the dollar, a fall that had already been taking place for several months. Thus, the problem of identifying overshooting was often complicated by the particular exchange rate being focused on.

The staff explicitly defined the theoretical concept of overshooting in relation to differences in adjustment lags between the financial sector and the real goods sector, Mr. Erb went on. In that context, a degree of overshooting was to be expected. His authorities believed that such overshooting was desirable and part of the adjustment process. To the extent that overshooting reflected market imperfections, policy mistakes, or policy variability, it was undesirable that exchange rates should be out of line with fundamental economic factors; in such circumstances, corrections should be made in those factors. Although the notion that it should be possible to find an objective criterion by which to determine when exchange rate movements had gone too far was appealing, the techniques and calculations discussed by the staff illustrated how difficult it was to make such judgments with much confidence.

The case for the use of calculations based on purchasing power parity theory as a shorthand measure of overshooting, although common in practice, was not compelling, Mr. Erb considered. As the staff acknowledged, purchasing power parity calculations were used because they were easy to obtain and because economists believed that they knew what the direction of the impact of changes in relative prices on exchange rates should be. The choice of purchasing power parity as a model was often the result of ignorance of the relative impacts of other factors, ranging from shifts in current account balances to shifts in real interest rates. Even the best purchasing power parity measure, identified by the staff as relative normalized unit labor costs, was a poor predictor of both future exchange rate movements and shifts in current account balances. It was also technically difficult to construct, it was subject to measurement error, and it was available only after a considerable time lag. In sum, whatever the particular measure of price competitiveness employed, there were well-known, severe problems with purchasing power parity, and the competitive analysis based upon it could therefore sometimes prove to be misleading.

In cases of major structural changes, Mr. Erb suggested, large sustained changes in real exchange rates were a sign of needed economic adjustment rather than unsustainable rates. Conversely, as the staff pointed out, there could often be cases in which a given exchange rate was no longer sustainable, despite the apparent stability of conventional measures of the real effective exchange rate.

Among the major difficulties with measures of price competitiveness, Mr. Erb considered, were their exclusive focus on the goods market and their inability to take into account explicitly the impact of different government policies. One procedure that could possibly correct those shortcomings involved the estimation of underlying payments balances. The staff noted that a general approach along those lines had first been used by the Fund staff in the early 1970s, but that the work had been interrupted in 1980, and that more recently it had been used primarily in specific cases. Illustrative calculations of underlying current account balances for several countries were presented by the staff. They appeared reasonable, and the estimates of the underlying U.S. current account were consistent with some estimates of the cyclically adjusted U.S. current account made recently within the U.S. Government. The estimates of the normal levels of private capital flows, which were extrapolations of past trends, were less reasonable. The situation was unsatisfactory because private capital flows were obviously endogenous. Forecasting their sustainable level by extrapolation of past trends could give misleading information concerning the sustainability of the underlying account balances, as shown by the examples discussed by the staff. Until a less primitive method of estimating sustainable or equilibrium capital flows could be developed, it would be difficult to put much faith in judgments about exchange rate sustainability based on the methods described by the staff.

In the light of the severe acknowledged limitations on the Fund's techniques for assessing exchange rate sustainability, Mr. Erb commented, it was surprising that, in the report for the 1982 special consultation under Article IV with Sweden (EBS/82/222, 12/3/82), the staff had made not only the qualitative judgment that the Swedish devaluation of 16 percent had been too large and therefore presumably unsustainable, but also the quantitative judgment that a devaluation of about 10 percent would have been appropriate. At present, it remained unclear whether the Swedish devaluation had been too large. However, the example was relevant because it touched on the broader question of the types of judgment on the appropriateness of exchange rate levels that could reasonably be made in the course of Executive Board discussions. The analysis in SM/83/263 suggested that only tentative qualitative judgments could be justified, a conclusion with which he agreed.

One criterion by which to judge the sustainability of industrial countries' exchange rates not mentioned by the staff should be stressed, Mr. Erb suggested. If there had been large-scale sustained official foreign borrowing or exchange market intervention in support of the currency in question, there was reason to suppose that the government had been maintaining an overvalued unsustainable exchange rate. The existence of exchange controls would tend to reinforce that presumption. More generally, information on official borrowing and exchange market intervention served as a useful input along with other measures of exchange rate stability discussed by the staff. More attention needed to be focused not only on the institutional arrangements, regulations, and controls that influenced dealings in the exchange market, but also on transactions in domestic money and capital markets. In addition, more attention should be paid to the impact of trade restrictions and trade subsidies on the exchange rate.

The staff clearly recognized the strengths and weaknesses of the particular analytical techniques that it had evaluated, Mr. Erb remarked. The kind of technical analyses that the staff had discussed should continue to be performed. However, caution should be exercised in using them, and the Fund should be seeking other analytical tools for making judgments about the appropriateness of exchange rates in reports for Article IV consultations.

Turning to SM/84/5, Mr. Erb said that he agreed with most of the staff's basic conclusions. First, the present system of flexible exchange rates had functioned well in a difficult global environment, an environment dominated by commodity shocks, differences in economic developments and policies among countries, and widespread structural problems, including rigid exchange rates in some countries. Second, he agreed that exchange rate variability, in both the short and the longer term, had been substantially greater in the first decade of floating rates than in the preceding decade, and that that situation appeared to be a symptom rather than a cause of poor economic performance in the major industrial countries and in the turbulent world economy. Third, because exchange rate behavior and economic performance depended under any regime on soundness of policy and an absence of major shocks to the system, the importance of formal rules or the need for formal rules in the system should not be exaggerated.

On balance, no system radically different from the current flexible rate system could have adapted as well to the events of the previous decade, Mr. Erb went on. Flexible rates had made a significant contribution to the international adjustments that had needed to take place. They had also provided an essentially automatic means of permitting the system to continue functioning, despite international differences over goals and differences of macroeconomic policy, thereby maintaining a relatively smooth flow of international transactions. In that regard, he disagreed with Directors who believed that flexible exchange rates might have exacerbated protectionism. Indeed, the opposite case could be argued: the degree of flexibility in exchange rates had probably reduced the degree of protectionism within the system, given the kinds of shocks that the system had had to face over the previous decade. As the staff appropriately stressed, it was important to the functioning of the system of international consultation and cooperation to reduce differences on fundamental economic issues and, more basically, to establish sounder economic policies.

Some of the conclusions and implications drawn by the staff could be questioned, Mr. Erb suggested. In SM/84/5, as in SM/83/263, too much emphasis had been placed on the concept of overshooting, given the looseness of that concept. On balance, he did not believe that it was a meaningful guide to policy. It was neither feasible nor desirable to suppress the swings in exchange rates resulting from economic differences. On the contrary, it would be better to try to deal with the underlying differences and to bring about greater stability in those differences. Furthermore, the fact that exchange rate variability had increased in the late 1970s and early 1980s after declining in the mid-1970s had been taken as evidence by the staff that the market had not learned how to operate under floating, and in particular that it had not learned how to form correct expectations. However, the increased variability in 1978-82 had reflected an increase in the instability of underlying policies, as well as the second oil shock. It was possible that rates were becoming less variable at present as a result of the convergence toward a narrow band of inflation rates among several countries.

A further argument could be made in favor of the beneficial effects of floating in imparting discipline to policymakers, Mr. Erb added. When a country made a sharp shift in monetary policy, the market anticipated future inflation developments, and the exchange rate moved accordingly, bringing part of those future inflation rate developments into the present. The result was an increase in the inflation cost of an expansionary policy or an increase in the disinflation benefit of a contractionary policy. Thus, a monetary authority pursuing a more expansionary monetary policy that threatened to increase inflation would be subjected quite quickly to the signal effect of a sharply declining exchange rate.

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

LEO VAN HOUTVEN
Secretary