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Minutes of Executive Board Seminar 84/2 and Corr.1

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	J. L. Feito
J. Tvedt	A. Lindø
	T. A. Clark
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L. Van Houtven, Secretary
K. S. Friedman, Assistant

Also Present

African Department: O. B. Makalou, Deputy Director. Asian Department: U. Baumgartner, I. Otani. European Department: P. Dhonte, M. Ishihara, H. Ungerer, H. Vittas. Exchange and Trade Relations Department: W. O. Beveridge, Deputy Director; G. G. Johnson, D. Lee, P. J. Quirk. External Relations Department: N. K. Humphreys. Legal Department: G. P. Nicoletopoulos, Director. Middle Eastern Department: K. Nashashibi. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. Artus, J. M. Boughton, M. P. Dooley, M. Goldstein, R. D. Haas, M. S. Khan, M. D. Knight, E. C. Meldau-Womack. Secretary's Department: A. P. Bhagwat. Treasurer's Department: M. A. Lumsden, O. Roncesvalles. Personal Assistant to the Managing Director: S. P. Collins. Advisors to Executive Directors: S. R. Abiad, C. J. Batliwalla, S. El-Khouri, K. A. Hansen, S. M. Hassan, H.-S. Lee, W. Moerke, G. E. L. Nguyen, D. I. S. Shaw, D. C. Templeman. Assistants to Executive Directors: H. Alaoui-Abdallaoui, 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, J. Reddy, Shao 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 continued from the previous meeting (Seminar 84/1, 1/30/84), their consideration of 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).

Continuing from the previous meeting, Mr. Erb, commenting on the options discussed in SM/84/5, said that the first three options had a similar thrust, as there was little difference between returning to a fixed-rate system or establishing one based on either presumptive indicators or adjustable par values with narrow margins for the major currencies. His authorities saw no possibility of imposing exchange rate stability by agreeing on an exchange rate regime designed to achieve such stability. In their view, the world economy was still working through a variety of structural adjustments, such as oil price changes and shifts in the location of various industries, and many adjustments would have to be made in the future, as more developing countries established industries of their own. In addition, there were significant differences in the economic performance of countries--including differences in growth rates, stages of economic development, and rates of inflation--which were unlikely to be eliminated soon; their elimination was an important, if not a necessary, condition for greater exchange rate stability. The convergence of conditions in the major countries would probably lead to stable exchange rates. Hence, there would probably be no need for an explicit agreement on a regime of fixed rates or adjustable par values within narrow margins.

The answer to the question whether the solution to excessive exchange rate variability could be found in new taxes or restrictions on international capital flows was clearly no, Mr. Erb stated. While it might be possible for smaller, relatively closed economies to impose restrictions on capital flows, exchange market restrictions by most of the major-currency countries would not be a viable way of seeking exchange rate stability. Indeed, his authorities believed that it was desirable for the authorities responsible for the major currencies--including at least the yen, the deutsche mark, the pound sterling, and the dollar--to examine which controls, regulations, and other institutional rigidities affecting capital markets might be reduced or eliminated. Moreover, his concern extended to regulations, restrictions, and institutional rigidities affecting national money markets, equity markets, and bond markets, as well as foreign exchange markets. Restrictions and regulations that prevented the growth and development of domestic markets would obviously have an effect on the international flow of capital; even if foreign investors were able to obtain foreign exchange, they might not have the investment opportunities in the country concerned unless the markets were well developed and unrestricted. Making both foreign exchange markets and domestic capital markets more efficient would help to make potentially stabilizing capital flows possible.

The staff had asked whether greater exchange rate stability should be sought through increased stability of macroeconomic policies and greater coordination of those policies among countries, Mr. Erb noted. In his view, greater exchange rate stability depended on increased convergence of the underlying economic conditions in countries, including price stability, strong but steady economic growth, and flexibility in relative prices of goods, labor, and financial assets to avoid rigidities that precluded effective adjustment. Exchange rate stability would also be fostered by well-developed money and capital markets in the major-currency countries, and by more open markets for goods, services, and raw materials.

The Fund's multilateral surveillance activities and its bilateral surveillance involving individual countries could be especially helpful in promoting coordination among countries, Mr. Erb continued, although he was not certain of the extent to which coordination of policies among countries would help to achieve greater exchange rate stability. The first matter that obviously required continuous review was the kinds of policies that would foster the conditions that would lead to greater exchange rate stability. There was a general consensus on the importance of maintaining a monetary policy that gave first priority to price stability, but there were differences of opinion on the priorities that should be given in fiscal policy. Some countries had recently focused on the importance of the fiscal deficit, but his authorities attached as much importance to the rate of growth and relative size of the government, and to the tax structure that a government used to finance its expenditures. Some governments clearly believed that reducing fiscal deficits established the basis for economic growth, while others believed that it was important to give priority to restraining expenditure growth and increases in taxes.

In the light of the particular political process in the United States, Mr. Erb went on, his authorities had placed greater emphasis on restraining the growth of expenditures and on achieving a tax structure that did not provide disincentives for investment and growth; in the process, they had attached less importance to the impact of the fiscal deficit, at least in the short run, as they felt that by emphasizing restraint on expenditure growth and tax growth they were more likely to limit the relative size of the Government, thus keeping it from becoming excessively large. Placing primary emphasis on the fiscal deficit at the present stage would be counterproductive in the effort to limit the size of the U.S. Government. There were significant differences among various authorities about the importance that should be attached to the growth of government expenditure, the magnitude and composition of taxes, and the impact of fiscal deficits.

One of the questions on collaboration, Mr. Erb remarked, was which countries should be attempting to increase the extent to which they coordinated their policies. Should the effort at coordination involve a large number of countries, or should it be focused on the key-currency countries? For a variety of reasons, it might be easier to increase collaboration among a smaller group of countries. At the same time, there would obviously be a need to take into account the interests of other countries, and it was in that context that the Fund's multilateral surveillance was important. Surveillance could be a means to improve the degree of collaboration and communication on policy matters.

His authorities did not believe that official exchange rate targets or forecasts would help to reduce exchange rate variability, Mr. Erb said. Presumably the reduction in variability would result from the impact of targets and forecasts on the markets, and, to have a positive impact, the targets would have to be credible. In the light of experience, his authorities did not believe that the markets would be inclined to give authorities the benefit of the doubt. Targets might well be breached, thereby reducing official credibility, rather than enhancing it. The emphasis should be placed on policies that supported conditions conducive to greater exchange rate stability, rather than on trying to impose greater stability.

Mr. Feito stated that, with a minor qualification, he had no objection to publishing the staff papers. The paper on the assessment of exchange rates in industrial countries (SM/83/263) was an important step forward in clarifying the essential aspects of surveillance and some other Fund responsibilities. The issues dealt with in the paper were complex and could not be resolved through the use of simple criteria. That various difficulties and subtleties of exchange rate assessment had been tackled in the staff paper was most welcome. In the past, there had been a tendency to make exaggerated claims for the relevant tools of economic analysis in the delicate field of exchange rate analysis.

In Section 3 of SM/83/263, Mr. Feito noted, the staff had examined the strengths and weaknesses of indicators of international price competitiveness in the assessment of equilibrium exchange rates, and he fully agreed with the staff's conclusions. The soundest indicator of price competitiveness--normalized unit labor costs--related those costs in one industrial country to a certain average of corresponding indices for the other industrial countries; therefore, developments outside the industrial world that might have a bearing on the competitiveness of the industrial country concerned were not captured by the index. Although individual developing countries might not be important competitors of an individual industrial country, the combined effect of a set of developing countries that gained comparative advantage in traditional industries could significantly worsen the competitiveness of all or some industrial countries. Moreover, to the extent that major developments in the international competitiveness of developing countries affected each of the industrial countries concerned differently, their indices of relative normalized unit labor costs would not always provide an accurate indication of the competitiveness of any one of the industrial countries vis-à-vis others.

The supplementary information that the staff had used in studying Belgium, the Netherlands, and France helped in making an adequate assessment of the international competitiveness of industrial countries. It might be useful to extend the experimental system of information notices, based on normalized labor costs, to incorporate the additional sources of evidence on competitiveness provided by the staff, such as export market shares, or trends in manufacturing sector profitability. Even if that information were not available for the same periods as data on normalized labor costs, it should still be taken into account in painting the picture of industrial countries' competitiveness whenever possible.

One of the major shortcomings of indices of competitiveness in assessing exchange rate adequacy, Mr. Feito continued, was their reliance on data for the external transactions of a country that were highly responsive to relative price movements. Even if the overall balance of payments position was closely correlated with that subset of transactions, indices of international competitiveness would still not necessarily indicate the sustainable exchange rate, because they neglected domestic equilibrium considerations. Those considerations were taken into account with the underlying balance of payments approach.

Commenting on that approach, Mr. Feito said that, as some of the countries in his constituency were painfully aware, it was possible for a country to keep its overall balance of payments in equilibrium by depressing aggregate domestic nominal income relative to output, thereby reducing the demand for imports. Although the balance of payments might be in equilibrium, it was obviously incorrect to conclude that the exchange rate was a true equilibrium rate if it could only be maintained by means of a depression in the country concerned.

As he had consistently maintained, Mr. Feito went on, many countries that had concluded an agreement with the Fund and attained full or near external balance had, a short time thereafter, again recorded an unsustainable balance of payments position. In most of those countries, external equilibrium had been attained at the expense of an unsustainable domestic imbalance. An equilibrium exchange rate should be defined as one that resulted from, and provided for, both external and internal balance. When that definition was applied to the network of industrial countries' exchange rates, it was clear that a system of equilibrium rates would be one that kept their external accounts in equilibrium but also kept those countries free of excessive inflation and unemployment. There was little doubt that an increase in nominal demand in industrial countries, at least those in Europe, could move unemployment rates closer to their natural levels if conditions in the major world financial center changed. Given the present and prospective world interest rates, European industrial countries had no alternative but to attach priority to the attainment of external balance, with domestic conditions being a by-product. That line of reasoning had implications for the issue of SDR allocations.

One of the arguments against a further allocation of SDRs, Mr. Feito noted, was that, while some developing countries faced a shortage of reserves, the industrial countries did not, and, therefore, no global need for reserves could be conclusively established. In his view, reserve holdings were only one element of a country's equilibrium balance of payments position. There was a subset of industrial countries, including those in Europe, whose balance of payments positions were incompatible with domestic equilibrium. Apparently, their desired reserve holdings had been obtained to some extent at the expense of domestic balance. It would be useful to have a further comment on the relationship between the analysis of international reserve adequacy for the purpose of SDR allocations, and the analysis of the underlying payments balance used to determine equilibrium balance of payments positions and exchange rates. Were they really compatible?

The underlying payments balance approach, Mr. Feito remarked, was undoubtedly the soundest one for assessing the adequacy of exchange rates, and the staff should be encouraged to continue its work on that approach. In particular, it should seek better indicators of domestic balance than the present indicators, which were essentially rough extrapolations of current levels of capacity utilization. The estimates of natural unemployment rates available in some industrial countries were admittedly rough, but they would perhaps be better than the current indicators.

Commenting on the staff paper on the exchange rate system (SM/84/5), Mr. Feito said that the methodology that the staff had used, and most of the conclusions that the staff had drawn, were appropriate. On the other hand, it was difficult to respond to the questions in Part V in the absence of an analysis of the liquidity side of the international monetary system. The staff should examine liquidity and eventually provide an integrated analysis and evaluation of the international monetary system along the lines of the analysis in SM/84/5. Ideally, the present paper on the exchange rate system should be published together with the additional papers that he had suggested, although he was not strongly opposed to publishing SM/84/5 at the present stage.

Reactions to most of the key issues that the staff had mentioned would vary according to the assumptions that were made about the underlying system of international liquidity creation and distribution, Mr. Feito went on. As for the role that the Fund could play in the international monetary system, present codes of conduct for meeting the exchange rate obligations of member countries clearly emphasized the causal relationship between sound domestic policies and global exchange rate stability. As the staff had noted, the fact that appropriate exchange policies had not always been evident during the period of floating rates was not due to the absence of codes of conduct. Why had those codes not been adequately observed? Were there flaws in the Fund's legal armory preventing it from enforcing its code? Were modifications needed in the Fund's legal framework to ensure compliance by members with the codes and the efficient functioning of the international monetary system? Those questions should be examined sometime soon, preferably in the paper on the role of the Fund that was being prepared for the G-10 Deputies. The answers to those questions were particularly important for those who felt that the coordination of macroeconomic policies was the most promising way to attain international exchange rate stability.

As for the relationship between the exchange rate system and economic policy discipline, Mr. Feito remarked, the staff seemed to feel that the differences between countries with respect to the discipline of macroeconomic policies determined the exchange rate regime, rather than vice versa. There was certainly much to be said in support of that view. The staff had mentioned cases of national disequilibrating policies under the Bretton Woods system and strong adjustment policies under the present floating system, but the staff's assessment was not consistent with those examples. That area was a typical one where judgment could not be made without reference to the underlying mechanism of international liquidity creation and distribution.

Those who emphasized the disciplining potential of a system of fixed exchange rates had always had in mind a world monetary standard under which the issuance of international commodity and fiduciary money was kept under control, Mr. Feito continued. However, in the absence of constraint on the excessive issuance of international fiduciary media by the major financial centers, the fixed-rate system had been bound to break down. That was not to say, however, that the fixed-rate system had not provided the discipline; rather, the monetary standard had been changed. The overexpansionary policies of gold-currency countries under the Bretton Woods system had caused a breakdown of the system of fixed exchange rates, because those policies did not respect the only constraint on the issuance of fiduciary money by the countries whose currencies were used as international reserve assets, namely, gold convertibility. Experience showed that a system of relatively fixed exchange rates would become unsustainable if it were not based on stable mechanisms for generating and distributing international liquidity. The breakdown of the Bretton Woods system had been followed by an increase in macroeconomic instability around the world, as the business cycle had become subject to much wider swings than in the past, even when allowance was made for certain shocks, such as the large increases in the prices of oil and raw materials.

The floating exchange rates had had little to do with the renewed cyclical instability of the international economic system, whose behavior over the previous ten years closely resembled that of the interwar period, Mr. Feito remarked. The increased oscillations in the cycle were attributable to the breakdown of the international monetary standard. The evolution of a consensus on the appropriate exchange rate system for the future would depend on whether the political obstacles to coordinating macroeconomic policies were greater than the political difficulties in agreeing on an efficient world monetary standard. The standard should include floors and ceilings on international money growth to avoid recurrences of world monetary overexpansion and excessive indebtedness followed by phases of excessive monetary contraction and depression. Judgments on the crucial aspects of an appropriate exchange rate system could not be made unless due attention were paid to the liquidity side of the question. That the exchange rate system did not matter as much at present as it had been thought to matter in the past was due to the growing importance of international liquidity issues.

Mr. de Maulde considered that the staff papers should be transmitted to the OECD and to the G-10 Deputies and should subsequently be published. The papers' straightforward discussion of the various issues was especially appropriate at a time when exchange rates had become a major problem and in view of the payments disequilibria of the past and the dangers inherent in the present imbalances. It was better to consider the various problems and possible solutions carefully at the present stage rather than to take hasty decisions later, in a crisis. The participants in the Williamsburg summit had agreed to study the exchange rate system, and it was important for the Fund to play an important role in the effort. After all, the exchange rate system was at the core of the Fund's business.

Commenting on the paper on issues in the assessment of exchange rates of industrial countries (SM/83/263), Mr. de Maulde said that he fully agreed with the general approach of determining in a comprehensive and objective fashion the underlying medium-term balance of payments associated with a given exchange rate in order to decide whether or not that exchange rate would be sustainable in the medium term. He agreed with previous speakers who had stressed that it was quite difficult to weigh properly the various elements of a country's underlying current account position. As Mr. Gomel had noted, industrial costs were only one of the elements. The main difficulty was the need to project capital movements by extrapolating past movements over a reference period that had not been typical. As a result, assessments of the underlying position should be approached with caution. They were probably more useful than they had been thought by Mr. Laske, who apparently felt that they merely indicated the direction of a maladjustment. With careful testing of the sensitivity of the various hypotheses involved, assessments of the underlying balance could provide fairly safe estimates of a broad range of the magnitude of the maladjustment, and he looked forward to seeing the method applied during future Article IV consultations. Further experience and analysis would undoubtedly increase the effectiveness of the Fund's surveillance.

As for the staff paper on the exchange rate system, Mr. de Maulde remarked, he agreed with much of what Mr. de Vries had said, although he did not agree with the paramount influence that Mr. de Vries had ascribed to monetary policy. In fact, fiscal policy was as important as monetary policy. The decline of the Bretton Woods system had been a direct consequence of the overextension of the budget of the United States during the period of the Vietnam War and the introduction of a number of social programs. Mr. de Vries had made an important contribution to the discussion by stressing that the volatility and misalignments inherent in a free floating system involved considerable costs in terms of resource allocation, investment, trade, and growth. He strongly agreed with Mr. de Vries that the indications that the market gave were not necessarily the correct ones; Mr. de Vries had usefully noted the shortsightedness of markets on a day-to-day basis. All market economies had felt the need to prescribe rules for the functioning of their free markets in order to prevent uncompetitive conditions and to disseminate information. The same could not be said for foreign exchange markets.

He could go along with Mr. de Vries's position on policy coordination, Mr. de Maulde continued. A system revolving around a reserve currency center could only function if the center remained committed to stability; there had been no reason other than the decline in stability for the end of the dollar-based par value system. It had become clear that the system could no longer be based on a single currency, as industrial and financial centers in addition to the United States had emerged. A more stable system than the present one could be based only on a composite of reserve currencies.

Discipline was the key to reducing the costs involved in the present "nonsystem," Mr. de Maulde remarked. The challenge was to make it more costly for all countries, including reserve center countries, not to behave in a financially responsible way. That conclusion raised the old issue of asymmetry with which the Fund had been struggling practically since its beginning. Mr. Erb had suggested that a floating exchange rate system contained a strong element of discipline, as excessively expansionary policies caused a country's exchange rate to decline. That conclusion was not equally applicable to all countries. It was particularly difficult to provide discipline in a multicenter system, and the problems with such a system could be solved only in the Fund.

His own position on the issues mentioned at the end of SM/84/5, Mr. de Maulde said, was close to that of Mr. Tvedt. His authorities had not yet taken a position on all the various issues. However, the time was clearly ripe for examining the issues without any preconceptions, with a view to making gradual progress in rebuilding a viable exchange rate system out of the present "nonsystem."

Mr. Sangare commented that the subject of the exchange rates of the industrial countries, including the key-currency countries, was of paramount importance to all member countries. SM/83/263 contained a useful survey of the techniques that the staff used in assessing the sustainability of the exchange rates of industrial countries. According to the staff, an exchange rate was "viewed as sustainable if it can be maintained over the medium term and is 'appropriate' from the standpoint of the country in question and the international community as a whole." The staff's definition correctly took into account the interests of both the country concerned and other countries. The staff had suggested that there were two basic approaches to assessing the sustainability of the exchange rates of industrial countries, namely, competitiveness--including prices and costs--and the underlying external payments position of a country.

He agreed with the staff's assessment of the various measures of international competitiveness, Mr. Sangare went on, including relative export unit values, wholesale prices, value-added deflators, and unit labor costs. The limitations on those indicators, described on pages 12-14 of SM/83/263, were due to their concentration on relative prices, the irrelevance of the assumptions underlying the purchasing power parity theory, and the technical difficulties involved in choosing an appropriate index and base year. Although those limitations were important, they had not been taken into account in all cases in the past, especially when a particular magnitude of change in the exchange rate was required under a Fund-supported program.

The second approach, which the staff was developing, focused on a country's underlying payments position and seemed to avoid most of the shortcomings of the approach based on competitiveness, Mr. Sangare remarked. It appeared to be less arbitrary, but, as the staff had rightly noted, it had its own shortcomings, arising mainly from the difficulties and uncertainties inherent in projecting payments balances. The limitations suggested the need for caution and flexibility in approaching the issue of exchange rate changes. On the other hand, the approach based on the overall external payments position had the merit of allowing for explicit consideration of a comprehensive set of factors underlying the current and capital accounts of the balance of payments and, in particular, the effects of national policies and cyclical positions. The underlying payments approach also provided a more appropriate framework for consistent assessment of external payments positions and sustainable exchange rates of member countries in a multilateral context.

A more direct evaluation by the staff of the exchange rate performance of the industrial countries--particularly those with floating currencies--with emphasis on the sustainability of exchange rates and the extent to which different national policies had been responsible for each country's performance, would be useful, Mr. Sangare said. Such an analysis should be relatively easy for the industrial countries, whose statistical base was more complete than that of developing countries, and it would make the Fund less vulnerable to criticism than surveillance that focused on developing countries in need of Fund assistance. A staff assessment of the costs of exchange rate volatility and misalignment, and the possible role of the Fund in reducing such costs, would also be useful.

The staff paper on the exchange rate system provided an illuminating analysis of the experience of the major industrial countries, Mr. Sangare continued, but the exclusion of the experience of developing countries made the exercise incomplete. It was the developing countries--not the industrial ones--that had suffered most from the volatility of exchange rates; as a result, they were in the forefront of those advocating a reform of the present arrangements with a view to introducing a more stable and predictable system.

The smooth and efficient operation of the present exchange rate system required a convergence of national policies, Mr. Sangare remarked. The failure to attain convergence was not surprising in a world in which economic and financial giants coexisted with much smaller countries, and different countries had different levels of economic development and varying economic structures. Even among the industrial countries themselves, some preferred a more stable system, while others favored floating.

The establishment of the European Monetary System (EMS) reflected the desire of its members to achieve some order in the exchange rate system, and the value of the stability provided by the EMS was particularly obvious to developing countries.

Experience had shown that a major problem with the present system was the persistent divergence of national interests and the complete disregard of the international consequences of domestic policies, Mr. Sangare said. The divergence was expected to continue unless member countries agreed on objective guidelines for the behavior of national authorities. The staff had hinted at the possible use of objective and presumptive indicators, and that possibility should be further explored. There was an overwhelming need for a reform aimed at achieving a more stable system. The staff's analysis suggested that a fixed-rate regime similar to the Bretton Woods system might not be an attractive alternative at the present stage, but a final conclusion could not be drawn until all the ramifications of the present system were known.

A reform leading to a viable system should include four basic elements, Mr. Sangare considered. First, it should be based on a set of internationally agreed rules providing for the establishment of certain objective guidelines and targets to discipline the behavior of national authorities--including their intervention in the foreign exchange markets--to prevent them from exporting shocks to their partners and to keep them from imposing the costs of their domestic adjustment on other participants. Second, the new system should include specified roles for national currencies, although no single currency should play the central role in the system. That role should be assigned to an asset--such as the SDR--that represented the collective will of the international community. Assigning such a role to the SDR would be consistent with the Articles, under which the Fund was required to promote the SDR as the major reserve asset. Third, the new system should include objective criteria that would enable the Fund to monitor adherence by members to the rules of the game. That step would help to strengthen the Fund's surveillance of exchange rates and of liquidity creation; in the past, surveillance over the latter had been minimal. To ensure the stability of exchange rates, the new system could include target zones, with soft margins within which national authorities would manage their currencies under the guidance of objective targets or presumptive indicators that could be adjusted in response to changes in the fundamental conditions affecting exchange rates.

No reform of the exchange rate system could be made in isolation from the principles governing international liquidity and reserve creation, Mr. Sangare concluded. Finally, any reform should take into account the interests of all groups of member countries; reform that ignored the interest of the majority of countries would undoubtedly be inadequate.

Mr. Qureshi commented that one of the key lessons of the experience with exchange rate systems was that stable, balanced, sound domestic macroeconomic policies, and their compatibility from one major-currency country to the next, were central factors in the stability of exchange rates.

The staff had correctly concluded that "stable and credible policies are a sine qua non for greater stability in exchange rates," and that "effective external adjustments will not be forthcoming unless countries take into account the repercussions of their own macroeconomic policy actions on their trading partners." The staff paper would have been even more useful if it had analyzed more clearly the aspects of domestic macroeconomic policies that had been particularly responsible for the problems with the behavior of exchange rates in recent years.

Noting the diversity of exchange arrangements under the present system, Mr. Qureshi remarked that the staff had said that the diversity was consistent with the proposition that the appropriate degree of exchange rate flexibility differed from one country to the next because of differences in countries' economic structures. However, the staff had not mentioned that, because of the large and frequent fluctuations in the exchange rates of major countries, the smaller countries had effectively not been free to choose the appropriate degree of exchange rate flexibility for themselves. More generally, the assessment of the impact of instability in the exchange rates of major currencies should take into account the resultant constraints on policy choices in other countries--especially smaller, developing countries--as well as the additional difficulties for others' external financial management. While those aspects had not been addressed in the present paper, which focused on the larger industrial countries, several studies had shown that the cost for the developing countries had been significant.

It was easy to agree with the staff conclusion that the capacity of the exchange rate system and of exchange rate movements to do good or ill should not be overestimated, Mr. Qureshi commented. Indeed, it was the Fund that was at times perceived to attribute excessive influence to exchange rates, especially in the context of Fund-supported adjustment programs.

In appraising the experience with the present exchange rate system, Mr. Qureshi noted, the staff had duly recognized two important caveats: a comparison with the more homogeneous previous exchange rate system was clouded by the existence of many subsystems of the present system. The second distinction appeared to have been more carefully taken into account when a straight comparison of the relevant facts was unfavorable to the period of floating rates than when the reverse was the case. For instance, in Part IV of SM/84/5, the staff had noted that "exchange rate changes (during the period of floating rates) have made a positive contribution to securing effective external payments adjustment." That conclusion was then related only to the finding that "the average size and the average persistence of payments imbalances of the larger industrial countries have been smaller during the last decade than during the last ten years of the adjustable peg system." Any inferences from that comparison would be inherently weak, particularly over a period with many large and persistent exchange rate misalignments and perverse correlations between exchange rate movements and balance of payments developments. In any event, analysis of that sort said nothing about the relative strength of the causal relationship, or about the relative contribution of the exchange rate system per se. Besides, more comprehensive estimates of the equilibrium balance of payments of the major industrial countries did not show a declining trend in the average size of external adjustment imbalances since the mid-1970s.

The main subject of interest was the major problems that had been encountered in operating the present system and ways in which they could be mitigated or solved, Mr. Qureshi continued. In that connection, the most serious problem had clearly been the excessive exchange rate instability. Any evaluation of the implications of the instability should distinguish between short-term volatility and persistent misalignments. While hard, quantitative evidence of the costs of short-term volatility was difficult to collect, the costs for smaller businesses and countries were probably significant.

The problem of persistent misalignments of exchange rates--a prolonged departure of the exchange rate from its long-run equilibrium level--was a cause for more serious concern, Mr. Qureshi continued. Misalignments could adversely affect certain key dimensions of economic performance through their impact on resource allocation and external adjustment. Present misalignments were thought to be large; indeed, they had been so for much of the period of floating rates. The staff had correctly noted that a central objective of any possible restructuring of the present exchange rate system would be to create conditions that would help to limit such misalignments while preserving enough flexibility in exchange rates to facilitate external adjustment. In that connection, the staff had correctly focused on the major-currency countries.

Commenting on possible ways in which the operation of the exchange rate system might be improved, Mr. Qureshi said that there were two practical considerations that greatly narrowed the range of feasible options for the near future. First, there was, at present, not much interest in the major-currency countries in a return to fixed or adjustable par values. They seemed to be interested mainly in seeking greater stability while broadly maintaining the flexibility in exchange rates afforded by the present system. Second, the present international climate did not appear very propitious for the taking of major initiatives, and reform proposals of a formal nature seemed particularly infeasible at the present stage.

For the period immediately ahead, at least, Mr. Qureshi continued, the considerations that he had mentioned served to focus attention on seeking greater stability of floating exchange rates primarily through stable and balanced domestic macroeconomic policies and through better coordination of those policies among countries. Such improvements were in fact needed for the attainment of greater stability under any exchange rate regime, and a more determined and effective effort to achieve those policy goals could obviate the need for any formal changes in the existing exchange rate arrangements for major currencies. A greater and more serious effort in that direction would not require any systemic changes.

The Second Amendment of the Articles, Mr. Qureshi noted, included several relevant obligations concerning exchange rates, including enjoining members to collaborate with the Fund and other members to "assure orderly exchange arrangements and to promote a stable system of exchange rates" and, furthermore, "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions." The Articles also required the Fund to "exercise firm surveillance over the exchange rate policies of members" and to "adopt specific principles for the guidance of all members with respect to those policies." As the staff had noted, if such conduct had not been evident during the floating-rate period, it had not been because of a lack of a code of conduct. The large and persistent misalignments of exchange rates in the recent past underscored the need for more serious efforts toward fulfilling the obligations under the existing Articles.

There were admittedly difficulties in achieving greater macroeconomic policy coordination among countries, Mr. Qureshi remarked, but serious efforts to that end should certainly be made. The concept of policy coordination should be further developed to allow a clearer focus on the aspects of policy compatibility that were thought to be relatively important and feasible. Recent experience suggested that improved policy compatability among the major-currency countries would cover not only monetary policies and exchange market intervention, but also the possible international effects of fiscal policies.

The Fund would have to play a more active role in exchange rate surveillance of the major countries in order to help to promote the needed discipline and compatibility in the conduct of policies, Mr. Qureshi considered. That effort would be in keeping with the Fund's mandate to exercise firm surveillance over exchange rates and would help to achieve the long-standing objective of greater symmetry in surveillance. Given the importance of a strengthened and more symmetrical surveillance effort in improving the operation of the present exchange rate system, the lack of any mention of surveillance in Part V of SM/84/5 was surprising.

Experience in promoting policy coordination by means of closer consultations between the major-currency countries and the Fund, Mr. Qureshi continued, could help to build support for a strengthening of exchange rate management that might involve some alterations in existing exchange rate arrangements, such as an increase in incentives for adjustment. In that connection, several ideas had been mentioned. One relatively promising scheme that had recently attracted support in several different quarters consisted of publicly declared crawling target zones for major currencies with soft--and reasonably wide--margins, to be agreed in consultation with the Fund in order to ensure their consistency with one another, and subject to supervision by the Fund. That idea was of course not a new one, but it merited further serious examination, particularly in the light of the behavior of exchange rates in recent years. In future discussions, attention should also be given to the question of how the promotion of the role of the SDR in the international monetary system could make a contribution to the effort to increase international monetary stability.

Commenting on the paper on the assessment of exchange rates in industrial countries (SM/83/263), Mr. Qureshi said that identifying exchange rate misalignments was a prerequisite for any attempt to eliminate them through a form of exchange rate management or policy coordination. That task entailed the determination of the so-called equilibrium exchange rates for the countries concerned. Given the multilateral character of its surveillance function, the Fund was required to reach judgments, wherever possible, about the appropriateness of members' exchange rates in a manner that was internationally consistent. The determination of the international consistency of the exchange rates of major industrial countries should also take into account, to the extent possible, the implications of those rates for developing countries, even though doing so might introduce a certain inelegance into the quantitative models by adding certain less precise qualitative or judgmental considerations.

SM/83/263 contained a useful description of the alternative methods used to determine an appropriate or sustainable exchange rate in an industrial country, Mr. Qureshi remarked. In countries where the requisite data were available, the more comprehensive underlying balance of payments approach had distinct advantages over conventional indicators of competitiveness, although the two could complement each other. However, both methods were inherently subject to a margin of uncertainty deriving from practical as well as conceptual difficulties, and the staff had correctly noted the need for further research to develop and refine them.

At the same time, Mr. Qureshi continued, the staff had cautioned that the lack of precision inherent in the identification of appropriate, or equilibrium, exchange rates should not be overemphasized. The methods described in the staff paper could generally be expected to yield at least an approximate range for the equilibrium exchange rate. Hence, efforts toward more active and effective surveillance by the Fund over the exchange rates of major currencies should not be weighed down by excessive concern about the lack of precision in present methods, although due care should of course continue to be taken in interpreting the results of the applications of the methods.

The staff's cautious approach toward assessing the appropriateness of the exchange rates of industrial countries, Mr. Qureshi said, and its careful noting of the difficulties and uncertainties involved provided an interesting contrast to the generally much more forthright approach taken by Area Departments, in the context of adjustment programs for developing countries, whereby adjustments of a fairly precise magnitude were frequently recommended with a high degree of confidence. The problems and uncertainties involved in making judgments on exchange rates in developing countries were, however, no less than those encountered in industrial countries, although they might well be different in certain significant ways. The contrast between the staff's approaches to the assessment of exchange rates appeared to be a reflection of the more scholarly approach of the Research Department and the more practical concerns of Area Departments. Some crossfertilization between the departments and their approaches would be useful.

Mr. Kabbaj remarked that the reports raised more issues than could be discussed at a single meeting, and he would concentrate his comments on the main issues concerning developing countries. It was too soon to make a definitive judgment about the relative performances of the gold-exchange standard and managed floating; it was not yet possible to isolate the effects of floating exchange rates on various economic variables. Such judgments could perhaps be made with the development of more sophisticated statistical techniques and with the availability of more reliable data. Table 1 in SM/84/5, however, clearly suggested that the more stable exchange rates in the period before 1972 were preferable. Disturbances had been prevalent during the floating period, but there had been disturbances during the 1960s that, if taken into account, might well paint the fixed-rate system in an even more favorable light. It was important to remember that the Smithsonian Agreement of 1971 and subsequent developments had occurred as a result of the force of economic circumstances; they had not been the choice of the various parties concerned. Table 1 showed that in every major area economic performance under the floating regime had deteriorated. Common sense suggested that, despite exogenous disturbances and other difficulties in making definite judgments, the data in Table 1 were significant.

On page 22 of SM/84/5, Mr. Kabbaj noted, the staff had pointed out that experience in industrial countries in 1979-83 showed that anti-inflationary discipline could be restored without fixed exchange rates. In his view, it seemed too soon to make such a judgment. It was important to look at the performance of the overall industrial economy, including growth rates, unemployment, the fiscal balance, and interest rates. It was too early to assess the possible eventual economic and social costs of containing inflation under a system of floating exchange rates.

It had also been noted, Mr. Kabbaj said, that an ex post analysis of floating exchange rates revealed the inadequacy of forward rates as a reflection of the future trend of foreign exchange rate movements. Most exchange rate changes under the floating regime had been unexpected, thereby contributing to the uncertainty in the exchange markets. In fact, various studies had shown that such traditional factors as the current account position, relative inflation rates, and interest rates had by themselves failed to account for the behavior of exchange rates. The period of floating had been characterized by considerable exchange rate fluctuations.

The staff had clearly shown the complexity of the forces at work in exchange rate movements and the interdependence of economic variables that caused disequilibrium to occur in exchange rates, Mr. Kabbaj remarked. It was obviously difficult with the available statistical tools to analyze those forces--some of which were qualitative--in an effort to estimate the optimum exchange rates. Experience had shown that the achievement of optimal rates had remained as elusive as ever under the floating rate system. It was useful to note that exchange market intervention had occasionally taken place not to pave the way for a particular currency to move to its optimal level, but rather to smooth out undesirable daily fluctuations and for other short-term considerations.

Another crucial conclusion, Mr. Kabbaj commented, was that exchange rate changes could be effective only for a certain period and when certain conditions prevailed. Exchange rate adjustments should not be a universal policy prescription. Moreover, while the various aspects of exchange rate policy were controversial, there were several areas of agreement. For instance, exchange rate adjustments in general, and devaluations in particular, often achieved the desired results only in the medium or long run. In the short run, devaluations could actually produce unintended, opposite results. Under the present conditions of general economic and social uncertainty and volatility, countries might not be able to afford to wait for the beneficial results of a devaluation, and the assumptions on which the devaluation had been based might well prove to be inaccurate.

The inflationary effects of exchange rate depreciation were indisputable, Mr. Kabbaj remarked, although the antirecessionary features of monetary policy could be limited under floating rates. Furthermore, unstable rates and the resulting disequilibira in real exchange rates increased structural unemployment. Overshooting of exchange rates could occur when financial markets reacted to short-term adjustments to unanticipated economic developments. Experience had shown that such short-term overshooting could become embedded in the floating system, with profoundly disturbing effects on the real economy. The effect of exchange rate instability on resource allocation and the associated welfare loss had not been fully explored. Moreover, because of the lack of data on capital movements and other associated obstacles, reliable quantitative evidence on the effects of long-term capital flows was lacking.

In assessing the exchange rate policies of industrial countries with floating rates, Mr. Kabbaj remarked, the staff had cautioned that there was a need for a yardstick that would signal when market forces had made rates unsustainable in the medium term. Hitherto, exchange market intervention had apparently taken place without reference to such a yardstick, and it was therefore important to strengthen the Fund's surveillance of the main exchange rates.

Available studies suggested that there was no conclusive causal link between exchange rate volatility and the level of world trade, Mr. Kabbaj observed. However, it was safe to conclude that during the period of floating rates, and especially in the past four years, there had been a tendency to move away from the free trade concepts of the postwar era; that the undesirable trend had occurred only during the period of floating rates suggested the existence of a link between exchange rate volatility and the level of world trade.

The unparalleled uncertainties characteristic of present world economic and social conditions, Mr. Kabbaj concluded, underscored the need for international cooperation and for Fund surveillance of key currencies. Because of the interrelationship among various economies, no single policy measure would prove equally beneficial to all countries. Given the Fund's special role and its multilateral view of the entire financial system, greater Fund surveillance over the key exchange rates would prove invaluable.

Mr. Prowse said that he strongly supported publication of the staff papers, although they could have usefully included a somewhat larger discussion of the theoretical and analytical aspects of the various issues. The staff had raised a number of important questions, and only some of them could be dealt with adequately during a single discussion. The Executive Board should decide which of the various issues it eventually would wish to take a view on; Mr. de Vries had wisely suggested that there should be a series of discussions on key issues with a view to reaching an agreed position on them. A number of the issues were of general importance, and some were particularly relevant for Article IV consultations and negotiations on stand-by arrangements.

Commenting on the paper on issues concerning the assessment of exchange rates, Mr. Prowse said that he agreed with the staff analysis and conclusions, particularly that it was difficult to arrive at judgments about sustainable exchange rates as a part of the Fund's surveillance. He also fully agreed with the conclusion that, although indicators of competitiveness and of underlying payments positions were complementary elements in the assessment of sustainable exchange rates, the underlying payments position, being more comprehensive, had several advantages. That conclusion had important operational consequences and should be reflected both in negotiations on stand-by arrangements and in Article IV consultations. At the same time, he agreed with the staff that there was no real alternative to attempting to improve the existing methods of assessment of exchange rates while increasing the knowledge of the scope and size of particular impediments to exchange rate surveillance.

SM/83/203 confirmed the view of a number of Executive Directors in recent years, namely, that variability of exchange rates was perhaps not as important as some observers had thought, Mr. Prowse said. On page 57, the staff had concluded that "the large majority of empirical studies are unable to establish a systematically significant link between measured exchange rate variability and the volume of international trade, whether on an aggregated or on a bilateral basis." The staff had correctly acknowledged that its inability to establish a statistically significant link did not prove that such a link did not exist.

On the other hand, Mr. Prowse went on, the staff's analysis and conclusions were convincing and significant. The emphasis in the past one or two years on exchange rate variability might have been misplaced. The staff had noted that exchange rate volatility was not believed to have affected investment flows, although the staff had discussed what it had termed the problem of volatility and ways of reducing it, and he wondered whether the discussion on the problem of volatility was consistent with the conclusion that there was no statistically significant link between volatility and world trade. Still, he agreed with the staff conclusion that exchange rates were determined by the interaction of supply and demand schedules. Hence, the factors that caused shifts in those schedules--rather than exchange rate changes themselves--should be seen as the basic cause of uncertainties in exchange markets and should be the object of policy initiatives.

Commenting on SM/84/5, Mr. Prowse said that he agreed with the staff that the optimal degree of exchange rate flexibility might well vary considerably across countries, owing largely to their different economic structure and the different nature of the various shocks facing them. The implications of that important conclusion for stand-by arrangements and exchange rate policy were clear. The staff conclusions on the inapplicability of the purchasing power parity theory to floating exchange rates also had important implications for Fund operations.

As the staff had noted, Mr. Prowse remarked, member countries continued to regard exchange rates at least in part as a policy target, rather than as a predetermined variable. It was important to address the question whether the exchange rate should be a specific policy target or should be seen merely as the outcome of the attempt to achieve certain policy objectives. The answer to the question would have significant implications and was perhaps the most important question raised by the staff.

He found the staff conclusion acceptable that, while the overall performance of the present exchange rate system could best be characterized as remarkably good given the harsh global environment, there was substantial room for improvement, Mr. Prowse said. The staff had usefully concluded on page 77 of SM/84/5 that "the capacity of the exchange rate system per se to do good or evil" should not be overestimated, and that there had been a tendency to underestimate the importance of disciplined and coordinated macroeconomic policies. The latter conclusion was perhaps true generally, but it was not applicable to the Executive Board, which had repeatedly stressed the importance of restoring and maintaining appropriate domestic economic and financial policies. The staff had noted that floating rates had given more autonomy than fixed rates in the use of policy instruments, but that the autonomy was undercut when the exchange rate itself became a policy target. That conclusion brought to mind the key question whether or not the exchange rate should be a target and, if so, on what grounds. The staff apparently was quite skeptical about the practice of adopting the exchange rate as a target, even in cases involving debtor countries.

Another important conclusion, Mr. Prowse said, was that the diversity in the exchange rate system supported the proposition that the optimal degree of exchange rate flexibility differed between countries, largely because of the differences in their economic structures and in the nature of the shocks to their economies. The importance of that conclusion could not be overemphasized.

The staff, Mr. Prowse remarked, had usefully underscored its conclusion of page 79 of SM/84/5 that, even if major changes in the exchange rate system were made, they were not likely by themselves to reduce significantly unemployment, eliminate protectionist pressures, cause a resurgence in investment or productivity, or make economies immune from future disturbances. The exchange rate system was an important mechanism for encouraging economic interdependence among countries, but it was not a panacea for the various problems facing the world economy. Floating exchange rates did not keep the external balance from becoming a problem for member countries. Countries still had to aim their policies at preventing or correcting problems in their external economy.

Again commenting on SM/84/5, Mr. Prowse said that of the issues raised in Part V, only the fifth one could be answered in the affirmative. The various issues had been carefully worded. The first issue could be recast as follows: were the objectives for the exchange rate system appropriate and consistent with the Articles? The objectives that the staff had mentioned were certainly appropriate. The second question could be posed as follows: were those objectives feasible? The answer was that they were, at least in part. The next question was whether or not there was a better system than the present one. In other words, was it desirable to return to the fixed-rate system? The answer to that question was clearly in the negative. The evolution of the present system had not been completed, and the fifth issue raised by the staff had to do with ways of improving the system.

He agreed with the staff, Mr. Prowse continued, that the case against a return to adjustable par values of the Bretton Woods system with narrow margins was that none of the factors that had made that system so vulnerable to hot money flows would be less problematic in the future. Indeed, those factors would probably be more problematic in the future than they had been in the past.

He also agreed with the staff's view on page 85 of SM/84/5, Mr. Prowse said, that "today's situation would be even more tenuous than under Bretton Woods because liberalization measures and technological advances have combined to render capital much more mobile than during the 1950s and 1960s. Hence, if such an adjustable peg scheme could work at all, it would need both wider margins and some mechanism to ensure prompt adjusment of par values." The staff's discussion of capital movements was less comprehensive than its discussion of other important factors. It would be useful to consider further the best approach to capital flows under the present system. The view that the exchange rate should not be a policy objective and that measures affecting it should not be adopted at the cost of the achievement of other economic objectives should be extended to the treatment of capital flows, a conclusion that had important implications for domestic monetary policy objectives. In Australia, large capital inflows had recently disrupted monetary policy, and the authorities had decided that they had no feasible alternative but to float the exchange rate after a long period of managed floating. To the surprise of the authorities, the subsequent exchange rate changes had not been significant, and the capital flows had moderated somewhat. The Australian authorities had been convinced that, on the capital side as well as the transactions side, a floating exchange rate was the most feasible system.

Mr. Nimatallah considered that the papers should be published. He was pleased that the Fund had begun to look actively into the possibility of improving the present exchange rate system. The present discussion should be continued on another occasion, as certain matters should be further explored, such as the relationship between the exchange rate system and Fund operations.

The present floating exchange rate system had clearly led to greater volatility of exchange rates, Mr. Nimatallah continued, and the first question to deal with was whether or not volatility disrupted the world economy. The staff had concluded on page 59 of SM/83/203 that it was difficult to establish clearly that exchange rate volatility adversely affected world trade. However, experience suggested that volatility might in fact have seriously affected the performance of the developing countries. There was some evidence, cited by the staff and other sources, that exchange rate volatility had adversely affected trade and investment among the developing countries as well as their general economic performance. That result was not surprising, as markets to reduce exchange risks were not well developed in the developing countries.

More important, Mr. Nimatallah went on, the fluctuations in the exchange rates of the industrial countries had created considerable uncertainty for economic policymaking and substantial variations in the budgetary receipts and payments of the developing countries. Budgets were planned on an ex ante basis, with assumptions being made about certain economic variables, including the exchange rate. When exchange rates fluctuated widely, the assumptions on which budgetary planning were made were undermined, thereby forcing continuous adjustments in ex post economic policies. The costs of those uncertainties should not be underestimated.

Exchange rate fluctuations could also cause problems for the industrial countries in the medium term, Mr. Nimatallah remarked. Previous speakers had noted the protectionist pressures that could arise from persistent overvaluation of currencies. Currency misalignments--defined as persistent departures of exchange rates from the long-term equilibrium level--also involved costs in the form of resource misallocation. There were also other costs related to the misallocation of resources that would result from persistent disequilibrium in exchange rates. Hence, it was clearly desirable to aim for greater exchange rate stability in the short and medium run and for minimizing short-term volatility.

Under any exchange rate system, Mr. Nimatallah continued, maintaining sound domestic macroeconomic policies would be an important factor in achieving exchange rate stability. However, given the interdependence of countries, another important factor was policy developments in other countries. Hence, it was important for countries both to maintain prudent domestic policies and to achieve a certain degree of coordination among themselves. Such an approach might seem idealistic, but the cost of not coordinating might outweigh the benefits of acting only on the basis of domestic considerations. That conclusion was particularly important for the major-currency countries. A high degree of coordination should be pragmatically based on specific obligations to maintain a certain level or range of exchange rates among countries over reasonable periods. For that reason, the experience of the European Monetary System was impressive. It provided the incentive for its member countries to maintain appropriate policies and a reasonable degree of coordination in the effort to keep exchange rates within specific ranges. The Fund should help member countries to search actively for ways gradually to improve the present exchange rate system, and the main features of the EMS could provide helpful guidance. Achieving greater stability need not involve the introduction of a new exchange rate system. The Fund and member countries should seek to improve the present system over time.

Mr. Malhotra considered that the staff papers should be published. They had deliberately been limited to an examination of the exchange rate regimes in the industrial countries, but as the Executive Board had begun to examine possible ways of improving the international monetary system, the picture that the staff had painted should be completed by an examination of the ways in which the regimes of the major countries had affected developing countries in particular. Exchange rate volatility and misalignments involved costs for industrial countries and, to a considerable extent, developing countries. It was too soon to say precisely what kinds of changes should be made in the present system--what some had indeed referred to as the "nonsystem"--to improve the position of developing countries.

The developing countries did see possibilities for a somewhat more stable system, Mr. Malhotra continued. There seemed to be widespread agreement that it was impossible to return to the Bretton Woods system or a variation of it. He agreed with Mr. de Maulde that the possibility--raised in the sixth issue for discussion in SM/84/5--of a system based on official forecasts and targets zones should be further investigated. Exchange rate stability would be encouraged by greater policy coordination, although previous attempts to achieve it had clearly failed. Any contribution that the Fund could make in that important area would be welcome.

The staff had usefully described the methods used to assess exchange rates of industrial countries, and the limitations and special merits of the methods, Mr. Malhotra remarked. It would be useful to know more about how the methods were evolving. He agreed with speakers who had stressed that the limitations of the various methods should be taken into account in negotiations on stand-by arrangements. The staff had concluded that precise judgments were difficult to make, and that a large set of indicators should be taken into account in making a qualitative judgment about an industrial country's exchange rate. A similar approach should be applied to other countries, including those using the Fund's resources. The staff had suggested that rough and flexible yardsticks should be evolved, and that advocating a specific exchange rate at any particular time should be avoided; exchange rate zones might be more effective.

The Director of the Research Department remarked that the staff had welcomed the opportunity to study the issues dealt with in the papers. The questions were not new ones, and the Executive Board would undoubtedly wish to take them up again on a number of occasions in the future. It was of course incumbent on the Fund to take views on the various issues that had been raised. After all, exchange rates were the daily business of the

Fund, and it should never be reticent about taking views on exchange issues. The views must in fact take the form essentially of judgments, but they were judgments that would have to be made. As Mr. Erb had noted, the surveillance process provided a unique opportunity to gain a further understanding of the various issues concerned.

In commenting on the paper on the assessment of the exchange rates of industrial countries, Executive Directors had expressed considerable interest in the underlying payments approach, while noting its limitations, the Director noted. The staff had no satisfactory alternative to approaching the assessment of exchange rates of industrial countries from the broad perspective of the balance of payments as a whole. The approach had been used in the staff's surveillance work, sometimes formally and explictly, and sometimes less so. It had also been used in the staff's work on the World Economic Outlook, as in the approach to the problems of the major debtor countries. Appraising exchange rates in terms of the underlying balance of payments was fully consistent with the Fund's objective of encouraging members to achieve and maintain sustainable payments positions. Neither the current account nor the capital account could be ignored.

A number of speakers, the Director recalled, had said that they agreed with the staff that it was easier to make a judgment about the direction in which an exchange rate in disequilibrium should move than to judge the appropriate level for an exchange rate. The staff could usefully examine the Bundesbank charts that Mr. Laske had mentioned.

The staff agreed with Mr. Feito, the Director continued, that a balance of payments should not be seen as being sustainable when it was accompanied by domestic disequilibria in general, and excessive unemployment in particular.

In commenting on the staff paper on the exchange rate system, the Director observed, some speakers had asked that more attention be paid to the relationship between the exchange rate system and developing countries. The staff had recently prepared a paper for the Executive Board on exchange rate policies of developing countries, and the staff would look further into the various matters as time permitted. The staff had not had sufficient time to give a developing country dimension to the staff papers under discussion at the present meeting.

It had been suggested by Mr. Feito, the Director of the Research Department recalled, that there was a relationship between the control over international liquidity as a whole and the degree of discipline in a fixed-rate system over macroeconomic policies. That point was a particularly interesting one. The staff agreed in principle with Mr. Feito that a country's balance of payments or exchange rate was not sustainable if the country had an unsatisfied demand for reserves. The fact that a particular country, or even several countries, had an unsatisfied demand for reserves had in itself constituted a case for an allocation of SDRs. The recognition of a more general need for liquidity had been discussed in other staff papers. There were of course important connections between the exchange rate and international liquidity systems, and the staff had deliberately not dealt with them in the papers under discussion. The connections had been addressed in previous papers and would certainly be the subject of further examination.

A staff representative from the Research Department noted that the difficult question had been raised of the responsibility that could be assigned to the exchange rate system for the occasional prolonged departures of actual exchange rates from equilibrium rates during the previous decade. The key factor in exchange rate movements in that period had been the conduct of macroeconomic policies at the national level and the coordination--or lack of it--of those policies across countries. An ideal exchange rate should provide the right incentives for countries to adopt responsible national policies, and it was in that area that improvements should be made.

He agreed that there was little econometric or other evidence of the resource allocation costs of exchange rates that were not in equilibrium, the staff representative commented. However, it was difficult to believe that large movements in the real exchange rate over a short period--say, a 20-30 percent change over a year or 18 months--did not involve some costs, particularly in the light of the importance of the real exchange rate among the various prices in an economy.

He agreed with Mr. Laske, the staff representative said, that, at least in Germany, flexible exchange rates had been a significant aid in the operation of monetary policy; that conclusion was consistent with the analysis in SM/84/5. The effect of the increased autonomy that was gained from flexible exchange rates depended considerably on how responsibly the autonomy was used. In a number of countries, the autonomy had been used to introduce or maintain inflationary monetary policies, and the national authorities concerned had subsequently found that the market disciplined that kind of behavior, thereby reducing the effectiveness of the autonomy.

He agreed with Mr. Tvedt, the staff representative remarked, that it was difficult to evaluate the exchange rate system on the basis of two ten-year periods, the second of which had been characterized by a number of serious disturbances. On the other hand, they were of course the only feasible periods of comparison. If, for instance, periods of disturbance such as 1970-72 or 1973-76 were excluded from the analysis, the range of observations would be particularly narrow. An analysis of the interwar period was of course possible, but the experience was quite remote. Canada's experience with flexible exchange rates could be analyzed, but it was difficult to generalize that experience to the entire exchange rate system. It seemed best to use the periods that the staff had chosen, correct for disturbances to the extent possible, and be cautious in applying the results.

The main difficulty in establishing a system of target zones, the staff representative commented, was to determine precisely how wide the zones should be. The gains in terms of exchange rate stability might not be significant if the zones had to be very wide because of uncertainties about the real equilibrium exchange rates, or if there were a frequent need for changes to reflect new developments.

It was true that some of the environmental changes that had occurred during the floating-rate period had been exogenous, the staff representative said; for instance, there had been the commodity boom of 1973-74, which some observers believed had been fueled by currency speculation. However, he was less convinced that such factors as disturbances in the Eurodollar market, worldwide productivity slowdowns, and oil price shocks had a great deal to do with the exchange rate system. It was fair to say that not all environmental changes were independent of the exchange rate system, but many of them certainly were.

As Mr. Erb had noted, the staff representative commented, there had been instances in the floating-rate period when exchange rate movements had acted as a disciplining force. The main question in that connection was how large and how long the movements had to be before they became a disciplining factor. Ideally, exchange rate changes of only a few percentage points should cause countries immediately to change their policies. If the exchange rate movements had to be large and extended before they caused enough harm to encourage authorities to make adjustments, then floating was a less useful disciplining instrument.

One of the reasons why inappropriate macroeconomic policies were adopted despite the existence of codes of conduct governing exchange rates, the staff representative said, was that governments sometimes permitted internal considerations to prevail over external ones, particularly in responding to pressures by their political constituencies. In addition, responsible codes of conduct had been difficult to maintain over the previous decade because the disturbances in the world economy had been particularly severe.

Responding to Mr. Feito's comment on the demand for reserves and the equilibrium balance of payments, the staff representative noted that some of the important factors in determining the equilibrium balance of payments were a current account balance that equaled normal capital flows without wholesale unemployment and undue trade restrictions, and the absence of capital controls as a means of maintaining an adequate supply of reserves. In the past, the excessive use of exchange restrictions and a high rate of inflation had been seen as indicators of reserve inadequacy. A high rate of unemployment had been another indicator, although a less precise one. Similarly, special incentives for capital inflows could reflect an imbalance between owned and borrowed reserves. The set of factors used to assess the equilibrium balance of payments was related to the set of factors used in determining the adequacy of global reserves.

The staff had noted, the staff representative from the Research Department said, that external adjustment measures appeared to have been more successful in the floating-rate period. Adjustment efforts in that period had been particularly difficult because of the various major shocks and disturbances, such as the oil price increases, but the record of adjustment in the period was somewhat better than the record before widespread floating had begun. Apparently, the fact that exchange rates had been floating had assisted the adjustment effort; most of the other major factors in the period had served to make adjustments more difficult, not easier.

Another staff representative from the Research Department said that, to an important extent, it was true that the treatment of capital flows was one of the main weaknesses of the underlying balance of payments approach to assessing exchange rates in the industrial countries. At the same time, the importance of that weakness should not be overemphasized. When considered over a number of years, the net capital flows among industrial countries had not been very large. Capital account balances tended to change considerably from one year to the next, but normally the moving average was fairly small. That was not surprising, as the various industrial countries were at more or less the same stage of development; it was not true that some of them were capital rich and others capital poor. Moreover, few industrial countries wished to run current account deficits over a long period, and, for that reason, few industrial countries could maintain persistent large current account surpluses.

It was true to some extent that, in a sense, overshooting could be seen as a favorable development, the staff representative continued. However, that conclusion should be approached with caution. In making the point, Mr. Erb had distinguished between good cases of overshooting and undesirable cases; the former resulted from the slow speed of adjustment in the goods and labor markets, and the latter were caused by market imperfections. The problem with that distinction was that slow adjustment in the goods and labor markets was in itself a form of market imperfection. It was true that the goods and labor markets always adjusted more slowly than the financial markets, but when the difference between the two was not particularly large, the overshooting would not be substantial and would not be a cause for concern. Ultimately, overshooting was always to some extent an indication of market imperfections, some of which might be unavoidable. Furthermore, it was also important to acknowledge that the slow speed of adjustment in the goods and labor markets was sometimes due to the existence of inappropriate financial policies. A shift in monetary policy that was isolated, rather than the first step in a determined comprehensive policy stance, could lead to slow adjustment in the goods and labor markets and a large appreciation of the exchange rate. One could hardly view such an appreciation as the reward for a good policy stance.

As Mr. Zhang had noted, the staff representative went on, most of the price elasticities that the staff had estimated were lower than unity, but in an assessment of the balance of payments implications of an exchange rate, what mattered was the sum of the import and export elasticities. Furthermore, it was known that the price elasticity approach to the analysis of a devaluation was a partial equilibrium approach with major weaknesses; a more comprehensive analysis was needed to understand the role of the exchange rate. In any event, there were substantial problems in estimating price elasticity, particularly longer-run elasticities, which tended to have a downward bias as a result of the near impossibility of differentiating between the long-term effects of price changes and other factors, including nonprice competitiveness.

As Mr. Feito had noted, the staff representative remarked, one of the weaknesses of the indicator of normalized unit labor costs was that it did not take into account the competitiveness between industrial and developing countries. It was difficult to correct that weakness, mainly because of the problems involved in measuring unit labor costs in developing countries, whose manufacturing sector tended to have a different composition from that of the manufacturing sector of major industrial countries. Value-added and manpower data in developing countries usually were nonexistent or of poor quality. The staff was attempting to include at least some developing countries in its analysis, but the effort was necessarily on a limited scale.

In an assessment of the cost for developing countries of persistent exchange rate misalignment in industrial countries, the staff representative said, an important factor was the implication for the real value of the developing countries' external debt and the cost of servicing the debt. After all, most developing countries' debt was denominated in U.S. dollars, and a large unanticipated change in the exchange rate after a loan had been contracted could suddenly increase the real value of the debt greatly.

Responding to questions by Mr. Ramtoolah, the staff representative explained that there was no agreement on the meaning of "fundamental factors" beyond such factors as prices and comparative advantage. There was some question whether fundamental factors would include a sudden change in monetary policy followed by a lag in adjustment in the goods and labor markets, an increase in real interest rates, and an appreciation of the exchange rate. That series of events certainly constituted a fundamental aspect of the determination of the exchange rate. If there had been no reasonable way of avoiding the overshooting of the exchange rate in those circumstances, the series of events should be seen as "a fundamental factor" in the determination of the exchange rate; they would not be seen as such a factor if the overshooting could have reasonably been avoided.

Responding to a second question, the staff representative from the Research Department concluded that it was difficult to say whether stable relative prices among countries with more or less the same rate of inflation would be sufficient to ensure exchange rate stability. The process of returning to a previous rate of inflation could in itself cause exchange rate instability, as countries tended to use different approaches to reducing inflation, some relying more on monetary policy, others emphasizing policies other than monetary ones. Exchange rates could be expected to tend to stabilize when countries maintained basically the same rate of inflation over a long period; in those circumstances, there would be little doubt about the likely course of inflation in the major countries, and the distinction between purchasing power parity in the short run and the long run would tend to disappear, as prices would be expected to remain roughly unchanged. However, purchasing power parity could not be expected to remain completely stable. For instance, if a country discovered a large reserve of oil, its exchange rate would likely change even if the inflation rate did not.

Mr. Feito said that he agreed with the staff that all the factors taken into account in assessing an equilibrium balance of payments should also be used in assessing the adequacy of a country's reserve holdings. Recent data provided by the staff suggested that reserve stringency was not a problem in most major industrial countries. One of the most important arguments that some Executive Directors had made against resuming SDR allocations was the supposed absence of a global need for reserves. They had noted that the need for reserves was concentrated in a particular group of developing countries, while the reserve holdings of most, if not all, industrial countries were at equilibrium. The reserve indicators in the staff paper on SDRs showed no need for reserves by industrial countries, but the indicators of equilibrium balance of payments positions in the papers under discussion at the present meeting suggested that the opposite was true. There seemed to be a contradiction in the analysis underlying the two papers. The matter of a further allocation of SDRs would probably be one of the most important items on the agenda of the coming meeting of the Interim Committee, and some of the relevant theoretical discussion in the present staff papers should be available for the participants, who would be interested in analyzing the relationship between reserve adequacy and a further allocation of SDRs.

The staff representative from the Research Department responded that the factors in the assessment of the underlying balance of payments position of industrial countries were possible indicators of reserve adequacy. They were not the only, or necessarily the best, indicators of reserve adequacy; nor would they necessarily make the case either for or against further allocations of SDRs.

Mr. Feito inquired whether it was possible for a member country to have simultaneously an unsustainable balance of payments position and an equilibrium level of reserve holdings.

The Director of the Research Department remarked that the staff recognized that, in assessing the sustainability of a country's balance of payments, it had to take into account whether or not the authorities concerned felt that the country's reserve position was adequate. If the authorities believed that the level of reserves was inadequate, they would probably feel encouraged to adopt policy measures that were inconsistent with the retention of the existing reserve position or, perhaps, even of the current exchange rate. In a closed system, the unsustainability of one country's position must be mirrored in the positions of other countries. Hence, it had not seemed particularly useful to judge the global need for reserves by the sustainability of countries' reserve positions.

At the same time, for the analysis of a particular country's balance of payments, the view of the authorities concerned about the adequacy of their reserves was certainly important.

Mr. Erb said that he was skeptical about the recommendation that "a more promising avenue would be to try to achieve a better anchor for longer-run exchange rate actions by inducing countries to produce credible macroeconomic policies and framing these policies to take more explicit account of their repercussions on other countries." As a general proposition, it was certainly acceptable. But it was not clear to him precisely what the proposition would involve in practice. It seemed to imply that, if authorities established appropriate policies from the medium-term perspective, the exchange rate would more or less take care of itself. Apparently the assumption was that a rate of growth of money that was consistent with relative price stability and a budget deficit that was approximately "balanced" on a full-employment basis, would as a matter of course be consistent with stable exchange rates. An alternative to setting policies in the context of the longer-run prospective, without emphasizing demand management, was to base policies on the needs of the moment. Accordingly, policy management would be activist and oriented toward the short run. In the present circumstances of the United States, for instance, that kind of approach would result in policies designed to decrease excess capacity and increase employment, thereby driving economic growth in the United States as well as abroad, with little concern being paid to the consequences for the budget deficit in the immediate future.

There were variations of the two basic approaches that he had described, Mr. Erb continued. For instance, national authorities could establish the exchange rate as an explicit policy target. While that approach might be appropriate for smaller countries that wished to tie their monetary policy to the policy of a larger country, it was a questionable approach for larger economies. Another option was to use the exchange rate as an indicator of the appropriateness of policies in the short run.

Different countries had a variety of perspectives on the various options that he had mentioned, Mr. Erb went on, and successful policy coordination would require countries to agree on the feasible steps that they could take to manage their economies in a way that would encourage stability in the longer run. Two years previously, there had been a movement in the United States away from activist demand management--so-called fine tuning--and toward an emphasis on the need to set policies that were appropriate in the medium-term perspective. Circumstances had subsequently led the authorities to worry less about the large fiscal deficits, although they were clearly undesirable in the long run. He himself tended to share the view that it was best to set general policies and let the exchange rate and other prices take care of themselves, and to maintain those policies on a fairly stable basis, rather than try to manipulate them.

The U.S. Treasury did not believe that "the markets are always right," Mr. Erb said. His authorities did believe that, at any given moment, the markets reflected given supply and demand positions, but also that market judgments about future prices could be proven incorrect. The main question in that area was whether or not government officials could forecast developments better than the markets and effectively modify existing prices to reflect likely future developments. His authorities certainly doubted whether government officials could make such judgments accurately. In any event, although the U.S. dollar was strong at present, it would not necessarily remain so indefinitely; a weakening of the dollar might be an appropriate change in the exchange rate, but the authorities would let it happen as a matter of course.

After a brief discussion, the Executive Board agreed that the three staff papers under discussion should be published.

Mr. Zhang said that he hoped that the text on elasticities could be extended somewhat. There seemed to be some inconsistency between the elasticity estimates and the conclusions about the possibility of improving members' balance of payments positions through a devaluation.

The staff representative from the Research Department replied that the text could be extended. As the staff had implied, there was certainly some doubt about the long-term price elasticity calculations.

The Chairman noted that the Director of the Research Department was to participate in the coming G-10 meeting. Executive Directors would be informed of the outcome of the meeting; they could consider the possibility of taking up on future occasions certain matters that had been discussed at the present meeting.

Mr. Erb noted that the staff had underscored the need to coordinate fiscal policies as well as monetary policies. It had been remarked that, in the past, the emphasis on coordination had been placed on monetary policies. It would be useful to have the staff and the Executive Directors examine that issue in particular. During a number of Article IV consultations, Executive Directors had raised the issue of the advice that should be given to the major-currency countries on fiscal policy consistent with their relative economic positions. In the case of the United States, for instance, what was the appropriate size of the fiscal deficit thought to be? What degree of adjustment of the external current account deficit was thought to be required to make it fit the fiscal policies of other countries? Some of his authorities felt that the Fund's advice to governments other than the U.S. Government should have placed more emphasis on the fiscal deficit. What set of fiscal positions among the major-currency countries would be conducive to exchange rate stability?

The staff representative from the Research Department remarked that the question raised by Mr. Erb was a large one and should perhaps be dealt with in a separate paper.

Mr. de Maulde said that he supported Mr. Erb's proposal. It might be better to start with a small number of countries, concentrating on the Fund's view of their fiscal policy, including the appropriate budget balance and overall public sector growth.

The Chairman remarked that it would be useful to have the staff prepare a paper on the world economic situation based on the mix of monetary and fiscal policies in the industrial countries that would encourage monetary and exchange rate stability together with a growth pattern that was consistent with price stability. The paper could underscore the rigidities in various markets--particularly in financial, goods, and labor markets--which had a bearing on the stability issues. Work on such a paper would make a useful contribution to the surveillance effort.

The Executive Board concluded its discussion of the exchange rate system.

LEO VAN HOUTVEN
Secretary