INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 87/106

3:00 p.m., July 22, 1987

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

Executive Directors	Alternate Executive Directors
	E. T. El Kogali
	P. E. Archibong, Temporary
	Yang W., Temporary
C. H. Dallara	
	J. Prader
A. Donoso	
M. Finaish	
	B. Goos
J. E. Ismael	
	J. E. Zeas, Temporary
	S. King, Temporary
M. Massé	
Mawakani Samba	
Y. A. Nimatallah	
G. Ortiz	L. Filardo
J. Ovi	
	G. Pineau, Temporary
G. A. Posthumus	
C. R. Rye	
	O. Kabbaj
A. K. Sengupta	L. E. N. Fernando
K. Yamazaki	M. Sugita
S. Zecchini	N. Kyriazidis

L. Van Houtven, Secretary and Counsellor
K. S. Friedman, Assistant

Also Present

African Department: R. S. Bhatia, Deputy Director; M. G. Kuhn. Asian Department: B. B. Aghevli, W. S. Tseng. European Department: H. Russo, Director; M. Guitián, Deputy Director; M. Z. Khan, T. M. Ter-Minassian. Exchange and Trade Relations Department: G. Bélanger. External Relations Department: A. F. Mohammed, Director. IMF Institute: O. B. Makalou. Legal Department: W. E. Holder, Deputy General Counsel; A. O. Liuksila, R. H. Munzberg, J. K. Oh. Middle Eastern Department: M. D. Knight. Research Department: J. A. Frenkel, Economic Counsellor and Director; A. D. Crockett, Deputy Director; M. Goldstein, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. C. Deppler, F. Larsen, P. R. Masson. Secretary's Department: C. Brachet, Deputy Secretary; A. P. Bhagwat. Treasurer's Department: R. A. Feldman. Western Hemisphere Department: S. T. Beza, Director. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. Bertuch-Samuels, M. B. Chatah, L. P. Ebrill, A. R. Ismael, A. Ouanes, I. Puro, A. Vasudevan. Assistants to Executive Directors: N. Adachi, A. R. Al-Abdullatif, F. E. R. Alfiler, M. Arif, O. S.-M. Bethel, F. Di Mauro, W. N. Engert, V. J. Fernandez, M. Hepp, I. Iljas, M. Lundsager, V. K. Malhotra, R. Manfredi Selvaggi, T. Morita, S. Rebecchini, S. Rouai, H. van der Burg, I. Zaidi.

1. SURVEILLANCE - USE OF INDICATORS - ANALYTICAL ISSUES; AND REVIEW OF 1977 DECISION

The Executive Directors continued from the previous meeting (EBM/87/105, 7/22/87) their consideration of staff papers entitled "The Use of Indicators in Surveillance - Analytical Issues" (EBS/87/135, 6/24/87) and "The Use of Indicators in Surveillance - Review of 1977 Decision on Surveillance over Exchange Rate Policies" (EBS/87/136, 6/24/87; and Cor. 1, 6/29/87).

Mr. Posthumus made the following statement:

Surveillance is one of the Fund's central responsibilities, and the staff's continued analysis and clarification of the possible use of indicators in surveillance are greatly welcome. A positive attitude by the Fund in this area can greatly enhance its international role.

The heart of the analysis of policy interactions is the estimation of underlying current account balances and the comparison of those balances with the values that are thought to be sustainable or desirable. Therefore, we should focus on interactions operating through balance of payments flows. A single criterion to determine whether a balance of payments is sustainable or desirable might be misleading. There are more criteria, and they may not all lead to the same conclusion. I agree with the staff's suggestion on page 11 that this problem can be solved. The proposed categorization of indicators into objectives, intermediate indicators, and policy indicators is appropriate.

However, I have considerable hesitation about the next step, described in Section III, especially for indicators of economic objectives. It is clear that the sustainability and desirability of a certain development in the balance of payments implies a certain outcome of output and inflation, and that they need to be balanced. However, we may be going one step too far if a certain growth or inflation path were to be agreed upon as policy objectives in the framework of multilateral or bilateral surveillance. In many instances, the authorities in a member country cannot reach agreement on an objective for economic growth; accordingly, the government's objectives are formulated in terms of, say, an increase in employment, a decline in unemployment, or a redistribution of income. Of course, those objectives imply economic growth, and the rate of implied growth could be calculated, but that does not mean that growth has become an official objective.

Similarly, inflation also presents a problem. If a country wishes to have less inflation, would it be conceivable that the Fund would suggest that, from the international community's viewpoint, a higher rate of inflation would be better? Do countries not always strive for less inflation or a certain degree of stabilization? These points remind me of discussions that have often taken place in the European Economic Policy Committee. The European Commmission staff has suggested that member countries individually should aim their policies at an inflation rate that was the same as the average inflation rate of all the member countries concerned. Accordingly, member countries with below-average inflation rates would have to increase their rates, something that is, of course, unacceptable to those countries.

Another problem is that a strong emphasis on growth and inflation will once again lead us back to so-called fine tuning, and the conditions for sound budgetary and monetary policy could therefore be neglected. Growth is the result of a set of good policies.

There may be a legitimate interest by the international community in considering whether a country's short- and medium-term goals for growth and inflation are sustainable, but I doubt whether such an approach is practicable or manageable. Therefore, the question is whether another approach can be taken, especially as I agree that balance of payments, growth, and inflation remain the three closely related indicators of economic objectives.

Further elaboration of the staff's medium-term scenarios would be helpful in establishing a desirable medium-term evolution of economic variables. It seems more practicable that the Managing Director's summing up after world economic outlook and Article IV consultation discussions should not be very precise or extensive with respect to a desirable or sustainable development of a particular indicator. As to policy indicators, the staff has observed that a change in monetary conditions could in general be measured by movements in short-term interest rates, at least during a particular policy period. On previous occasions, I have stated that when looking at exchange rates one should also look at interest rates. The opposite is also true. Short-term interest rates reflect exchange rate developments and expectations as well as inflation rate developments and expectations. Therefore, the quantitative evolution of the monetary aggregates remains important in judging monetary policy, particularly when the authorities themselves use those aggregates.

As to intermediate indicators, I agree with previous speakers that the exchange rate is an important indicator for surveillance. However, the exchange rate is treated somewhat lightly in the staff paper, and additional work in this area may be needed.

I support the use of indicators in the world economic outlook exercise and in Article IV consultations, whenever it is useful to do so. In addition, the monitoring of policies described on page 23 is the best approach.

The staff raises four issues in its paper on the review of the 1977 decision on surveillance. As to the timetable, some experience should be acquired with the strengthened use of indicators. The present decision does not hamper the use of indicators in surveillance. If the Executive Board would prefer to act sooner, I can indicate now my preference for a supplement to the existing decision that would provide guidelines on indicators of domestic policies.

If we agree to use indicators as a tool of Fund surveillance, we should also agree to expand the guidance provided through the principles for members' guidance. Accordingly, surveillance of the whole policy mix, even when the mix is chosen from an internal point of view only, should be considered. I cannot be more precise at this stage, owing to the lack of experience with the extended use of indicators. It is my understanding that the final sentence on page 6 means that intervention would not be incidental in nature but would instead be more or less permanent, because only the latter would help to foster a pattern of exchange rates that is conducive to adjustment. However, I do not see how such permanent intervention would be possible.

As to the procedural issues, there should be no automaticity in the initiation of special discussions. The Managing Director should take the initiative, and there should be no explicit guidance in this area. However, an Executive Director could raise a specific case in the Executive Board to challenge the Managing Director's lack of action in a certain situation.

Mr. Prader made the following statement:

We should be careful to avoid losing time and momentum by reopening issues that have already been settled; otherwise, there might well be widespread skepticism about the very notion of indicators. Apparently everyone agrees on the usefulness of the indicator approach, although expectations about its potential application vary as widely as the needs and interests of different countries. This chair has stated several times that the indicator exercise will remain of little more than purely analytical use unless it is directed by a commonly accepted reference framework for exchange rates and external payments patterns, which would impose on the participating countries a certain systemic discipline analogous to the discipline produced by a system of target zones or by the European Monetary System.

Other member countries and economists have doubts about the possible gains to be expected from closer international cooperation and supervision and would prefer to limit the role of indicators to a purely analytical one. In this context, it may be useful to consider the topic of indicators in the light of the discussion in the Research Department's working papers on the limits and the possibilities of international economic cooperation.

I will now comment on the analytical issues that are raised in EBS/87/136. I strongly agree with the approach that concentrates on only a few indicators, such as output, inflation, and the balance of payments. It is vital that the indicators chosen be clearly relevant to the proposed analytical framework. As to the analytical framework, the approach of estimating current account balances and comparing them with sustainable and desirable values is sound and appropriate; broad agreement on this matter apparently was reached during earlier discussions.

It is difficult to disagree with the staff that none of the various methods of determining the sustainability and desirability of current account balances can be singled out as being uniquely correct. The appropriate approach for any country will have to be selected and/or adapted in accordance with that country's institutional and economic characteristics.

As to the procedures for monitoring, it seems reasonable to take the medium-term scenarios outlined in the world economic outlook papers as the starting point for evaluating a country's performance and interactions with other countries. However, any attempt to measure divergences and tensions by means of quantified norms and ranges might encounter difficulties similar to the difficulties in monetary targeting. Instead, the Fund should rely on a qualitative summing up of the discussion by the Managing Director. As has been shown by the history of the divergence indicator in the EMS, so-called objective indicators--in the form of quantitative definitions--have a useful role to play as early warning signals but tend to be supplanted when decisions are actually made--for example, decisions on changes in central rates--as the decisions tend to be based on qualitative assessments.

As to the question of how to bridge the gap between medium-term scenarios and the short term, I am inclined, for the purpose of comparability, to prefer an approach that consists of examining the performance variables that are already used in the medium-term scenarios, but at more frequent and regular intervals. However, this approach should be coupled with the use of interim market-sensitive variables; otherwise, crucial indicators, such as the exchange rate, would be in danger of being excluded from the whole indicators' exercise.

I have some difficulty in seeing how the concept of "substantial deviation" could be made operational. Is this concept not vulnerable to the same kinds of controversy, subjective reasoning, and special pleading that plagued the Bretton Woods' concept of fundamental disequilibrium?

Before making any changes in the decisions on surveillance, we should accumulate some experience with the use of indicators. Otherwise, we will become embroiled in debates on a number of legal modifications, since actual experience with indicators would undoubtedly suggest the need to make continuous and frequent modifications of any prematurely adopted decision. As to the legal approach to be adopted, I hesitate to press for a "code of conduct" with respect to domestic policies, since this would entail long and tiresome negotiations over principles of economic policy, thereby further delaying the actual use of indicators; in addition, such a code would be difficult to reconcile with the specific institutions and goals of individual countries. In order to start the exercise, the existing decision could be supplemented with a statement of guidelines for indicators of domestic policies.

On the question of principles for members' guidance, my view of the ultimate purpose of this overall exercise leads me to favor widening the 1977 decision so that it will cover all policies that have a bearing on exchange rates. I also favor placing the policies in a medium-term framework. The criteria of "sustainability" and "desirability" are of the greatest importance for the sensible and successful handling of the indicators' instrument.

I have an open mind on the procedural questions that have been raised. In view of the well-known difficulties encountered by policymakers in meeting their domestic and external objectives, it is perhaps too simple to use divergences between actual and intended developments as the principal criterion that would automatically trigger discussions with a member. This approach could lead to special consultations with almost every member country. Therefore, there should be a pragmatic, judgmental approach.

I also have an open mind on the proposals concerning the decision-making process. I can imagine a process under which either the Managing Director or an individual member country could request a special consultation with a member, perhaps even along the lines of supplemental consultations, which in this way could become a more regular feature of Fund policies and over time appear to be less arbitrary than at present.

Mr. Goos made the following statement:

The staff's approach to strengthening the use of indicators is thought provoking and, in many respects, an important and useful contribution toward enhanced and evenhanded multilateral surveillance. As a further contribution to this end, I welcome the Venice Economic Declaration, which reiterates the intention of the G-7 countries to enhance surveillance with the assistance of the Fund and on the basis of economic indicators. While more effective surveillance among the G-7 countries and within the Fund should be mutually reinforcing, this does not imply that the procedures that are to be used for each are necessarily identical; rather, they should be developed according to the particular needs of the different bodies. In assessing the role that indicators can reasonably be expected to play in the surveillance exercise as an analytical and policy instrument, one must bear in mind a number of fundamental limitations--limitations that have an immediate bearing on all the topics for discussion--which call for a pragmatic and flexible approach to the use of indicators.

In this connection, I wish to reiterate my concerns about several aspects of the use of indicators. First, the use of indicators, like surveillance in general, must focus on the medium term and, accordingly, should not give rise to renewed attempts at fine tuning. Second, indicators cannot replace the use of judgment and should not provide automatic triggers for the initiation of discussions or corrective actions. In this connection, it is useful to recall that the Venice Economic Declaration stresses that remedial action should be considered only when there are "significant deviations from an intended course."

Third, while it appears desirable to develop medium-term targets and projections that are consistent on a national and international level, the various conceptual and practical difficulties in using indicators clearly suggest that there is little room for perfectionism. Therefore, attempts to develop a binding multilateral grid of numerical targets for national growth, inflation, and other variables would be unrealistic as an economic exercise and for political reasons. Our theoretical grasp of the complexity of economic interrelationships is still too limited to permit such an ambitious exercise to be undertaken successfully. At the same time, there are clear indications of the existence of a considerable discrepancy between what most members hope to achieve through the strengthened use of indicators and what they are willing or able to contribute to enhance multilateral surveillance, which, in the final analysis, entails a clear limitation on their national economic independence. An unduly specific and refined approach could also give rise to a systemic concern, as it would interfere with the basic market philosophy of decentralized decision making. As Mr. Massé suggested, there is little reason to believe that the collective judgment on the appropriate future course of the world economy even of such distinctive bodies as the Executive Board and the Interim Committee is necessarily superior to the sum of the individual judgments of each member country in terms of prospective welfare gains. Of course, I acknowledge that the weight of this concern depends greatly on the specific design and implementation of the indicator exercise.

Fourth, it should be left in the first instance to member countries themselves to establish their economic objectives, to qualify these objectives as targets or projections, and to decide precisely how they should be achieved. Such decisions have to be taken within the existing institutional and regulatory framework of member countries.

While the staff seems fully aware of these limitations, it nevertheless has striven for a degree of precision and refinement in its analysis and proposals that goes beyond the real potential of indicators. At the same time, much of the staff paper reveals a highly normative perception of the proper role that indicators should play; the same conclusion can be drawn from the surprising change in terminology from what used to be called "performance indicators" to what are now referred to as "indicators of economic objectives." For example, on page 13 the staff suggests formulating as the first step in the analysis "desired and consistent values and objectives of national authorities." It is apparently on the basis of those quantified objectives that the staff would derive the necessary policy adjustments. Moreover, these objectives are supposed to be the central focus of the monitoring procedures in the context of which the objectives would be "incorporated in an as specific and quantified a form as possible in the communiqué of the Interim Committee," as is suggested on page 22.

This approach appears to be so ambitious that it leads to considerable doubt about its feasibility and practical relevance. In any event, I would have difficulty in accepting its strong normative orientation. A more modest approach that, at least for the time being, would perhaps better meet economic and political realities would basically build on the existing world economic outlook exercise; it would therefore focus, in the first instance, on those variables that can reasonably be controlled by national authorities, such as fiscal, monetary, and structural policies. The analysis should then aim primarily at assessing the prevailing economic conditions and at detecting possible tensions in current and prospective developments on the basis of the policies and declared policy intentions of the authorities. Once problem areas are identified, the next step would be the formulation of recommendations indicating the direction of desirable policy changes. The potential impact of alternative sets of economic policies could be examined through alternative scenarios, which would be seen as illustrations of broad trends and not as numerical performance targets. In this connection, I agree with Mr. Dallara that we should not necessarily attempt to identify a particular trend or path of indicators that could be considered "desirable" or "sustainable." Such a policy-oriented and more judgmental approach--as opposed to the precise target approach suggested by the staff--could be developed within the framework presented in the staff paper without posing insurmountable obstacles. In the present experimental phase, the indicator approach should focus on developments within major country groups--as opposed to concentrating on only a few selected countries--in order to ensure evenhanded and effective surveillance.

With these reservations, I can go along with the staff's proposed analytical framework, including the focus on "interactions operating through balance of payments flows," and with the staff's selection of indicators. Flexibility in the selection of indicators and in the adaptation of those indicators in the light of experience would certainly be advisable. However, the proposed analysis to assess the impact of industrial countries' policies on developing countries should be supplemented by indicators that capture economic policies of the developing countries themselves in order to ensure a balanced judgment that is free of any "financing bias." Moreover, I share Mr. Lankester's concern about the calculations on pages 9-10.

As to the setting of standards for variables, in addition to the more general reservations that I have expressed, I wish to associate myself with Mr. Lankester's comments on the use of market-sensitive variables, especially exchange rates. Moreover I share the staff's view on the difficulty in integrating indicators of structural policy into the analysis. Given the importance of such policies for overall economic performance, this shortcoming of the indicator approach clearly underscores the fact that indicators cannot substitute for comprehensive judgmental assessment of economic developments. In this connection, I noted Mr. Dallara's view that there is a need for further work in this area. However, I wonder whether this is not one of the areas where, as Mr. Ortiz put it, further analytical work and refinement would clearly have diminishing returns.

On the trade-off between inflation and growth, noted by Mr. Kafka, I am rather concerned about some of the formulations in the paper that tend to minimize the harmful repercussions of inflation on domestic and external stability.

In the area of procedures for monitoring, I wish to associate myself with the views that were expressed by Mr. Lankester and Mr. Massé on the need for additional discussions, including the initiation and frequency of those discussions. As to the indicators to be used for monitoring, I prefer policy variables. However, in order to gain more experience in the current experimental phase, it might not be advisable to narrow the focus to only one particular group of indicators. I could go along, on a trial basis, with the additional use of the alternative approaches that have been suggested by the staff. Finally, with respect to the existing decision on surveillance, I believe that, for the time being, a revision of that decision would be premature.

Responding to a question, Mr. Goos said that great care should be taken in forecasting exchange rates. However, exchange rates could be one of the variables included in alternative scenarios.

Mr. Yamazaki made the following statement:

Before commenting on specific issues raised by the staff, I will make a few general observations regarding surveillance and the use of indicators. Fund surveillance has an important role to play in ensuring the smooth functioning of the international monetary system. Under the floating exchange rate system, exchange rate stability cannot be achieved unless all member countries endeavor to adopt sound macroeconomic policies that are aimed at sustainable growth without inflation. In the present world of interdependence, mutually consistent policies in this direction are particularly important to promote greater convergence of economic performance, thereby enhancing exchange rate stability. Therefore, my authorities basically support the strengthening of multilateral surveillance in order to improve the convergence of economic performance and to promote policy coordination. Indicators could be a useful instrument in this process. At the same time, my authorities strongly believe that indicators cannot be a substitute for judgmental analysis and should not be used as an automatic trigger device to initiate either policy changes or formal discussions.

The world economy is in a transitional phase of adjustment in response to a disequilibrium that is characterized by a large misalignment of major currencies and an unsustainable flow of funds. This is a dynamic process involving a structural change of industries and a major shift of resources across economic sectors. Policymakers need to be alert to respond flexibly to any unexpected developments or disturbances that might be inherent in such a process. In this connection, the staff's proposed approach to applying indicators is a cause for concern, as it would introduce excessive rigidity into the Fund's surveillance. The proposed procedure amounts almost to an exercise in international fine tuning and fails to recognize the limitations on applied economics in the present context. Questions naturally arise about the effectiveness of such a procedure.

The proper objective of the use of indicators should be to achieve effective coordination of policies among countries. My authorities firmly believe that such policy coordination can be promoted only by enhanced dialogue and persuasion through peer pressure. The significance of the world economic outlook exercise is that it provides the Executive Board with useful and high-quality economic analysis, on the basis of which Executive Directors can discuss developments and interactions in the world economy. I strongly hope that we will continue to receive a thoughtful and articulate staff paper on the world economic outlook and that excessively mechanical approaches or hasty suggestions on policy actions do not result in a reduction of the quality of the papers.

In general, it is my impression that the staff papers on indicators contain an excessive amount of detail on procedural aspects and reflect insufficient examination of the basic concepts of sustainability and desirability.

I will now comment on the specific issues raised by the staff, beginning with the analytical framework. While my authorities accept the importance that the staff attaches to an analysis of the balance of payments, they do not believe that the balance of payments position should be the only focal point. Lasting exchange rate stability cannot be achieved without the convergence of policies and performance among countries toward sustainable, noninflationary growth over the medium term. Therefore, it seems necessary to pay attention to the broad range of indicators relating to domestic economic performance and to analyze the indicators in a balanced way. In addition, it is important to avoid using "trend factors" without reflecting them in balance of payments projections, since adjustment involves a change in such factors.

The concept of "sustainable or desirable balance of payments" is to play a key role in the whole analysis. However, it is highly questionable whether the concept is sufficiently crystallized to warrant assigning it a key role. As the staff has noted, sustainability can be judged on the basis of a set of several guidelines, each of which is open to considerable question. The proposition that a zero combined current account balance of industrial countries--taking into account the statistical discrepancy--would be consistent with an appropriate flow of resources to developing countries seems simplistic. Citing reversible factors that affect saving/investment balances, the staff concludes that the long-run average payments position of most industrial countries would tend to be close to being in balance. In judging the current account position in the medium term, one would have to take into account various factors--for example, whether the country in question is a surplus country or a deficit one, a debtor or a creditor, or a key currency country. The United Kingdom ran balance of payments surpluses for an extended period; after World War II, the United States also ran a surplus for many years. Accordingly, the staff's sweeping approach to the balance of payments cannot be validated and without further detailed analysis would not serve as a useful guide for judging sustainability. As to the proposed guideline of stabilizing the net asset or liability position in relation to GNP, one would have to recognize the susceptibility of such a ratio to exchange rate changes, since the net asset or liability position is normally denominated in U.S. dollars while GNP is expressed in domestic currencies.

The staff also suggests analyzing each component of national savings and investment to decide whether a balance is "sustainable." Despite the apparent simplicity of the national saving/investment identity, the causal relationship is in reality a complicated and dynamic one, and there is no easy way to estimate each component separately. Moreover, the proposed methods could not be made operative, as that step would require an estimation of the "sustainable" fiscal deficit, a concept that is as difficult to define as "sustainable payments position." It should also be noted that, under the present phase of balance of payments adjustment--which involves a large-scale reallocation of resources across economic sectors--the growth potential, on which the estimation of desirable savings and investment relies, cannot be properly estimated. For these reasons, my authorities have strong reservations about the analytical framework presented by the staff.

I will now comment on the issue of individual indicators. The discussion on this subject in the staff paper seems to assume that from now on the Fund will establish a desirable or sustainable value or range of values for a set of key indicators of major countries. This is an ambitious undertaking that was not envisaged in either the Interim Committee's communiqué or the Venice Economic Declaration. By adopting a procedure in which the Fund suggests domestic economic goals to a member country, the Fund would clearly be exceeding its competence as established by the Articles.

Of course, economic goals set by each member country have to be mutually consistent, and significant inconsistency is a cause for international concern and should be analyzed and discussed, so that the Fund can take a view on a desirable way in which to eliminate the inconsistency. However, this conclusion does not necessarily mean that the Fund should have a system for setting values for key domestic economic targets of member countries. The Fund should respect the economic goals established by each member and should not attempt to take a view on domestic goals unless mutual inconsistencies are such that effective surveillance cannot be undertaken without dealing with the inconsistencies. The Chairman's summing up at the conclusion of a world economic outlook discussion should not aim at identifying a path for key variables that could be considered desirable or sustainable; it should try to summarize various views of Executive Directors, as has been done in the past. Accordingly, my authorities have considerable difficulty in going along with the fundamental assumption of Section III of the staff paper on analytical issues. Therefore, I will limit my comments on individual indicators to a few specific variables.

In the area of intermediate indicators, it would not be appropriate or feasible to predict or set a course for such market-sensitive variables as exchange rates. In addition, with respect to the growth of output, the potential rate of growth has become difficult to estimate because of the structural changes that have been occurring. As a result, I cannot go along with the proposal to use the potential growth rate as a standard against which actual development should be compared. With respect to the fiscal indicator, the emphasis in the staff paper on the fiscal deficit or fiscal stimulus is a reflection of the staff's strong inclination in favor of fine tuning. In many industrial countries, the high level of government debt feeds on itself through increased interest payments, making flexible management of fiscal policy increasingly difficult. In order to incorporate these considerations into indicators, a ratio of government debt to GNP or of interest payments on debt to total government expenditure should be included among the fiscal indicators. As to the budget that is to be looked at, for Japan, the general account of the Central Government should be the most important indicator on which domestic policy discussions are usually based and the authorities' medium-term objectives are framed. In general, the deficit of the public sector, including enterprises, could be a useful supplemental indicator in analyzing the impact of the fiscal position on the economy. Short-term interest rates may not be the only appropriate variable that indicates a change in monetary conditions; they perhaps need to be supplemented by money market conditions or liquidity conditions. With respect to the balance of payments, greater attention needs to be paid to exports and imports in volume terms, which best reflect the progress of ongoing external adjustment.

As to procedures, my authorities do not agree with the staff that the Fund should specify a path for certain key indicators that could be considered "desirable" or "sustainable." This implies that my authorities cannot endorse the procedures presented by the staff. In my authorities' view, monitoring must take all the relative indicators into account and should involve an exercise of judgment by the Executive Board. As the staff correctly notes, the use of objective indicators, policy indicators, or intermediate indicators involves various problems and cannot be fully relied upon. A triggering mechanism is not acceptable in any form. In particular, I cannot support the staff's proposal to initiate a special discussion, as it would introduce excessive automaticity into the surveillance procedures.

I have a number of problems with the proposed analytical framework, the selection of indicators, and the proposed procedure for their application. Therefore, further discussions will be required before a decision is taken on these matters, and it would be premature at this stage to discuss a review of the 1977 decision on surveillance. Still, I wish to indicate my preliminary position on a few selected issues that are raised in the staff paper on procedures.

First, as I understand it, the decision on surveillance procedures should apply to all member countries, regardless of their size, while indicators would apply to larger industrial countries, at least in the initial stage. I wonder how this difference in coverage can be resolved.

Second, in the area of "general principles" there was broad support during the discussion in February 1986 for the extension of the scope of surveillance to include domestic policies affecting exchange rates. However, it would not be appropriate to introduce a limited change at this juncture, when such surveillance in general is still under consideration. Therefore, I cannot endorse the staff's proposal in this area.

Third, as to "principles for the guidance of members' exchange rate policies," I am not prepared to endorse subparagraphs (ii) or (iii). That is because in subparagraph (ii) the concept of "sustainable balance of payments position in the medium term" is not sufficiently clear to be used for operational purposes, and in subparagraph (iii) provision by a member country of projections or targets for discussions with the Fund should be based on voluntary cooperation by the member and should not be a legal obligation at this stage. The staff has raised the question whether guidance concerning intervention should be extended. My authorities are somewhat cautious in giving general encouragement to interventions that would foster a desirable pattern of exchange rates. They have taken such a stance because of the difficulty in reaching agreement on a desirable pattern of exchange rates and because the varying effectiveness of intervention makes it difficult to specify the circumstances in which intervention would help to foster a desirable pattern. In addition, if such intervention were to become the norm, it would probably place an excessive burden on that policy tool.

Fourth, as to the "principles of Fund surveillance over exchange rate policies," I cannot go along with the proposal to drop the term "for balance of payments purposes," and I strongly object to the staff proposal to require a discussion between the Fund and a member country when there is a significant divergence between actual developments and the intended course. Such a procedure would introduce excessive automaticity into Fund surveillance.

Finally, with respect to procedures, I have considerable difficulty in going on with any of the proposed revisions.

Before concluding, I wish to reiterate my authorities' basic support for strengthening surveillance and the use of indicators. My hesitancy in and reservations about supporting the staff proposals are a result of the excessive rigidity involved in those proposals. My authorities fully recognize the importance of policy coordination and the role of surveillance in that process, and they intend to continue to cooperate in a positive manner in surveillance within the framework of the Fund.

Mr. Rye made the following statement:

While the staff papers under discussion represent a further step toward improving the surveillance mechanism, I am inclined to agree with Mr. Ortiz that diminishing returns have set in in these series of discussions, and that we need to move forward in a more practical way, although I have no firm view on whether we should do so through the simulation idea mentioned by Mr. Ortiz or some other approach.

The analytical framework described in EBS/87/135 seems to be appropriately focused. I particularly welcome its emphasis on analyzing current account and exchange rate developments in the context of an assessment of fiscal, monetary, and structural policies and on assessing the consistency and sustainability of policies. However, the paper pays less attention to some of the practical difficulties with the indicator approach. Two areas could be further explored. The first is the tension identified in earlier papers between the convenience of a standardized score sheet and the uniqueness of each country. The need for careful judgment in assessing economic conditions and setting policy in any individual country could have been given greater emphasis. Second, the use of summary statistics as a guide for policy, although appealing in principle, has severe limitations in practice. For example, central banks have found it increasingly difficult to implement objectives such as "a rate of growth of money...consistent with the underlying demand for money at some acceptable rate of inflation," which is mentioned on page 20. In most circumstances, summary statistics cannot adequately replace the need for a qualitative interpretation of policy.

It is not my understanding that the references in recent G-7 communiqués and the April Interim Committee communiqué to the development of the use of indicators imply that these should be applied to every member country. It would be more practical and even, perhaps, more enlightening, to have indicators for the individual major countries and to address the other countries in groups, such as the energy exporting developing countries. It clearly would not be feasible to formulate indicators along the proposed lines for many small developing countries, because of data problems, the large impact of external factors on these economies, and the fact that projections are as likely to be wrong because of the unreliability of their base as because policies have gone off track.

I generally agree with the choice of indicators. I continue to believe that protectionism and trade-distorting policies should be given emphasis, although I acknowledge the difficulties in quantifying such variables.

Setting broad criteria for judging the appropriateness of particular indicators in economic policy and performance allows the concept of surveillance for policy coordination to be made operational. Basically, the general approach proposed by the staff starts with the projection of a medium-term scenario--covering three-five years--deviations from which can then be analyzed or can indicate which policy measures need to be undertaken. One problem with this approach is that present estimation techniques may not produce projections so far ahead that can be accepted as the desired level of competence. Such projections cannot sensibly be purely automatic or arithmetic; they require a substantial exercise of judgment, particularly for periods that are relatively far into the future. In addition, the impact of measures implemented in the short term will alter the relationships of the variables or coefficients on which the projected variables are based. Therefore, there is a problem of maintaining the medium-term perspective while making the necessary short-term adjustments.

As to the procedures for monitoring indicators, in view of the inappropriateness of, and practical difficulties in, implementing indicators for every member country, I would prefer that indicators be restricted to the world economic outlook exercises and to the Article IV consultations with the major countries as well as to the proposed modified exchange rate surveillance exercises.

I will now comment on EBS/87/136. I agree that exchange rate surveillance should be conducted on a country-by-country basis, but that it would be excessive, and probably futile, to inject indicators into this area of the Fund's activity for all member countries, particularly the smaller ones.

As to the general principles, I strongly agree with what is said in the second paragraph on page 4; the distinction between exchange rate policies and other policies is certainly difficult if not impossible to sustain in practice. Indeed, in an era of floating exchange rates, it may be difficult to say what the expression "exchange rate policies" actually means. In any event, it is necessary to ensure that the adjustment burden is not carried solely by exchange rate policy. The impact on other countries' economies of overcompensation through the exchange rate of, say, a fiscal imbalance is well enough known.

However, I am inclined to agree with Mr. Lankester that it is premature to revise the 1977 decision at this stage. Accordingly, I need make only one observation in this area--in relation to the principles for the guidance of members' exchange rate policies, and particularly the discussion in the final paragraph on page 6. My Australian authorities, on the basis of their own experience, see intervention as a useful tool only in the short term and suggest that intervention alone cannot keep exchange rates on any particular path.

In the area of procedures for special discussions, which is dealt with in paragraphs (a) through (d) on page 11, I am skeptical that automaticity can play any great role, as is mentioned in paragraph (a). It would be extremely difficult to specify in advance the deviations that should trigger a consultation. One can only consider each case on its merits. Accordingly, the Managing Director must be given substantial discretion. However, I continue to believe that there should be some kind of role for the Executive Board--perhaps of an advice and consent kind--that, in some urgent or sensitive circumstances, might need to be exercised in informal or restricted sessions. In that event, the case made by management ought to take account of the historical context and not merely of any projections that may be available.

In conclusion, I hope that, in the aftermath of the supplemental consultation with Korea, early opportunities will be taken to hold additional such consultations, and that, in the interest of maintaining a proper balance, the larger member countries will be considered in that regard. It is not sufficient to point to the discussions that will take place between the staff and the authorities in the preparation of the world economic outlook.

Mr. Mawakani made the following statement:

The use of indicators is of fundamental importance to surveillance. The methodology that the staff has proposed is in line with both the suggestions that were made by Executive Directors during previous meetings and the views of this chair.

On the analytical framework and choice of indicators, I agree that, as a beginning, we should use a limited set of indicators. The list that the staff has proposed seems to be appropriate. It can be modified as experience is gained or circumstances change. However, because of different statistical methods, the selected variables may not give the same information in each country; therefore, the assessment of policies will require personal judgments and adjustments. Furthermore, the staff's analysis of the sustainability and desirability of certain variables is very pertinent. It indicates that one will need to exercise great caution in suggesting changes in policies and should not rely on only one specific indicator to determine whether or not a certain position is sustainable.

The issue of setting standards for variables is complex, as it entails considerable personal judgment by the staff. In general, I agree with the criteria that the staff has proposed for the different variables. However, I wish to make one comment on structural policies. While I understand the difficulty that is generally involved in trying to devise indicators of structural policies, I strongly favor some kind of indicators that show the level and/or the direction of protectionism in a particular country. Trade policies of major countries have a direct impact on the economies of other countries, especially developing countries; indeed, in many cases, these policies can be damaging to the smaller economies. An indicator of the level of protectionism, direct and indirect, would greatly help in deciding on the desired path of certain variables.

The staff lists four procedural steps on page 21 to ensure that indicators will be used in a constructive way. I agree with the approach described by the staff, which is an appropriate first step in the implementation of the exercise. As this chair mentioned during previous discussions on indicators, the world economic outlook exercise and Article IV consultations are appropriate for introducing and assessing the indicators as they apply in the surveillance exercise.

The medium-term scenario in the world economic outlook exercise will take on added importance, as it will be used by the Executive Board to make judgments on the most desirable paths of economic activity. Because of the many uncertainties involved, it might be better if a desired range for each variable were given instead of a specific value. If during Executive Board discussions it is found that the policies being followed will not achieve the desired result, the Managing Director could make that point during the summing up while noting the Executive Board's recommendations of the Executive Board to correct the situation. These conclusions, as suggested by the staff, could then be presented to the Interim Committee for its consideration.

However, since indicators will be monitored continuously, significant departures from the projected values could be brought to the attention of management, which could then decide whether an interim consultation is necessary, as can be done at present under Procedure V of the procedures for surveillance. In this event, however, reference will be made to exchange rate policies as well as to the divergence of indicators from desired and sustainable paths. While I do not see this as an attempt to fine tune the economies of member countries, it will bring to the attention of the authorities the concern of the international community about the potential tensions to which the continuation of certain policies could lead.

In the area of monitoring techniques, I favor the present approach to dealing with Fund-supported programs--namely, to monitor the evolution of policies rather than of outcomes. The other approaches that are suggested would probably require another subset of indicators. Furthermore, sharp short-term variations are common and can send the wrong signal. Similarly, I prefer to avoid the use of short-term leading indicators, at least in the beginning, as they are often subject to revisions. The approach based on monitoring the evolution of policies would seem to be safer and more cautious and is one with which we have some experience.

I will now comment on the issues raised in the staff paper on the review of the 1977 decision on surveillance. It is obvious that, if we wish to give the use of indicators its proper importance and to make it effective, an amendment of the decision is needed. As the staff has mentioned, the established legal interpretation of the present decision has always been that it refers to exchange rate policies. My preference is to incorporate the indicators into the Fund's practice through a separate decision, as described on page 4 of EBS/87/136. To have any effect, the decision should refer to the maintenance of policies that are sustainable and desirable, but it is not necessary to include any list of specific indicators in the decision.

I welcome the progress that is being made in using indicators in the surveillance exercise. I hope that it will help to reduce large imbalances among members and lend a certain degree of stability to the world economy. However, its success will depend on the political will and courage of all the parties concerned. In that connection, the June 1987 Venice Economic Declaration gives some hope, and I look forward to the early implementation of the decision.

Mr. Finaish made the following statement:

Before making specific observations on the points raised in the staff papers, I will make a few general remarks. The changing patterns of international transactions on current and capital accounts have resulted in a great increase in the size and sources of disturbances that may impinge on an industrial country's balance of payments position. On the current account side, the growth in trade and the increasingly fine differentiation of the industrial goods that the industrial countries trade with one another mean that a given change in a country's price level causes a much larger disequilibrium in its current account than if this development had not occurred. On the capital account side, financial innovations and new categories of international financial transactions have given asset holders new possibilities for profitable diversification of their portfolios. These possibilities of increasing interpenetration in financial markets have resulted in much higher elasticities of capital flows in response to differentials among countries in yields on assets. Furthermore, it is not just a matter of increasing sensitivity of capital flows to what might be called ordinary commercial yield considerations; it is also a question of the sensitivity of capital flows to exchange rate expectations and prospective macroeconomic policies. The sources of increased disturbance overwhelm the capacity of income or monetary mechanisms to adjust to them without exchange rate changes, and this was the major reason why the move to floating exchange rates was welcomed, with various degrees of enthusiasm, by most observers. With relatively low international capital mobility, exchange rate adjustments can to some extent be avoided or postponed with only marginal adjustments in macroeconomic policies. But with high international capital mobility, this is no longer true, because exchange rates cannot deviate much from what market participants consider a reasonable price for currencies.

However, the growing influence of capital market conditions as opposed to goods market conditions on exchange rate determination has also caused great short-run volatility in the major exchange rates and wide medium-term swings. These movements have often been very much out of line with inflation differentials, so that real exchange rates have shifted more and faster than what would be considered desirable. The fact that flexible exchange rates in a world of high capital mobility can generate large and sustained shifts in real exchange rates, and that such shifts have costly real economic effects, has led to a growing recognition of the need for greater exchange rate stability and consistency among national macroeconomic policies.

But one thing that has emerged in recent research on international policy coordination is that the so-called supply of cooperation is likely to fall short of what would be mutually beneficial because international cooperation is in essence a public good. The logic of collective action explains that individual members of a group sharing an objective can rationally yet collectively produce a suboptimal outcome. In the case of international policy coordination, a nation's policymakers will decide to coordinate instrument settings with foreign counterparts to the extent that the marginal benefit of the coordination to the home nation exceeds the marginal costs of supplying the coordination. Because each nation ignores the potential benefits of the greater coordination for others, the degree of coordination actually supplied is suboptimal. In this connection, the Fund can play a major role in encouraging member countries to recognize opportunities for beneficial collective action, and I support the use of indicators in multilateral surveillance on the assumption that it will lead to improvements in the international coordination of economic policies. Today's discussion suggests that the Fund will have to provide considerable encouragement to the major players.

I will now comment on some of the specific issues raised in the staff papers. The staff has correctly noted that the analytical framework in which indicators are used should highlight the ways in which domestic economic policies and performance spill over to the economies of trading partners. Furthermore, it is necessary to go behind the proximate determinants of trade and capital flows and ask how they are influenced by the stance of domestic policies. Although the effort to take account of these considerations increases the complexity of the analysis on which assessments of medium-term balance of payments positions are based, this appears to be necessary because trade and capital flows are determined by a wide range of macroeconomic and structural factors.

On the choice of indicators, I agree with the staff that the primary focus should be on a limited number of indicators. Keeping the number small helps to focus attention on those variables that are most important in identifying potential tensions in the medium term and in making the analysis manageable.

The staff has noted that indicators of conditions in developing countries should reflect economic conditions in those countries as a group and changes in the ability of those countries to acquire real resources from the industrial world to support the development effort. The impact of macroeconomic developments in the industrial countries on developing countries is important for understanding the divergent economic performance among developing countries. The policy mixes in the industrial countries and the particular developing countries' trade and debt structure can give rise to a number of different outcomes. This happens because different policy mixes have different interest rate and exchange rate implications and, therefore, the impact depends on the developing country's trade structure and level of debt. The importance of financial markets in the transmission of economic influences from industrial to developing countries has grown considerably as a result of the increased levels of developing countries' external debt and the greater role of private creditors. In this connection, the staff correctly focuses on indicators not only from the real or commodity trade side, such as import volumes and the terms of trade, but also on the financial side, through indicators for real interest rates and capital inflows.

In its discussion on the criteria for judging the appropriateness of particular indicators of economic policy and performance, the staff has noted that broad indications of what constitutes a sustainable balance of payments can be derived from a consideration of domestic investment and saving trends. I agree that it should

should be possible to provide a rough estimate of the implied strengthening of the external position by making estimates of the likely medium-term trends of private saving and investment. The saving/investment approach also provides useful information on the appropriateness of fiscal policy. As the staff has noted, a generalized attempt to reduce fiscal deficits could generate contractionary tendencies in the world economy until enough time had elapsed for investment to rise relative to saving.

Another way in which to examine the appropriateness of a given policy mix is to consider the case of an environment of rapid inflation and a floating exchange rate regime. If policymakers are more concerned about inflation than output growth and wish to export inflation abroad, they will have an incentive to choose a policy mix to strengthen their currency. However, the attempt to force the country's trading partners to import inflation may leave all countries worse off than under alternative policies. The policy inefficiencies arise because the mutual attempts to export inflation cancel out, at least in part, while the mechanisms used to attempt the currency appreciation impose a direct cost. That is to say, this process of noncooperation will result in high interest rates, as countries will be led to pursue excessively restrictive monetary policies and excessively expansionary fiscal policies for exchange rate purposes. In this connection, interest rates serve not only as an intermediate indicator of conditions affecting demand, but also as an indicator of the mix of monetary and fiscal policies.

I will now comment on the paper on the 1977 surveillance decision. Given the nature of the indicators exercise and the manner in which it is evolving, it seems prudent to avoid undue haste in amending this surveillance document. Formal incorporation of indicators in the document can take place after enough experience has been gained from the strengthened use of indicators under the present decision. At the same time, I recognize that there is a cost to such a delay, since the existing surveillance document mandates special discussions in only a narrow set of circumstances. In my view, a waiting period of about one year seems to strike a reasonable balance between the two considerations, since one would need to go through a full round of world economic outlook and Article IV discussions before meaningful experience can be gained. Of course, this applies to changes that pertain to the use of indicators. However, some of the amendments discussed in the staff paper appear to have general implications for members' applications under Article IV. Clearly, the proper time for considering such amendments is during the biannual reviews provided for in the existing decision.

As to the alternative approaches to updating the 1977 decision, I prefer the second one, namely, to leave the existing decision broadly as it stands and to adopt a separate decision under Article IV, Section 3(a) incorporating indicators into the Fund's practice. As the staff has indicated, the problem with redefining the concept of exchange rate policy to include domestic policies that affect exchange rates is that it would be contrary to the well-established legal interpretation of Article IV. I fully agree with the staff that it is difficult to draw a distinction between exchange rate policies and other policies affecting the exchange rate. However, the drafters of the Articles clearly chose to distinguish between obligations that are associated with exchange rate policies and obligations that are associated with domestic policies knowing that the various different economic policies cannot be easily disentangled. Another problem with the first approach is that it introduces a change in members' obligations that seems to go beyond the purpose of the indicator exercise, which is related essentially to members that are large enough to have an impact on the global economy.

In the area of the principles for guidance of members' policies, I broadly agree with the additional principles suggested by the staff on page 6, which cover policies affecting exchange rates to supplement the existing principles on exchange rate policies per se. However, I am not certain that it would be desirable at this stage to extend the guidance on exchange rate intervention beyond its present scope. If a member country adheres to Principles I and II suggested by the staff on page 6, by maintaining appropriate fiscal and monetary policies, I wonder whether it would be useful to include as a principle for guidance that members should be encouraged to engage in exchange rate intervention beyond that which is aimed at countering disruptive short-term movements. With respect to the principles of Fund surveillance, I understand the limitations on, and difficulties associated with, applying the current principles for initiating special discussions with members. Therefore, a simplification of those principles may well be needed. At the same time, it may be useful to maintain a simplified version of the present principles that are of general applicability and to add a principle calling for special discussions when there is a significant divergence between actual developments and the intended course. This principle could be invoked in cases in which indicators are applicable.

One of the issues raised on page 9 is whether the list of indicators should be specified in a decision to be adopted by the Executive Board. I agree with the staff that there is an advantage in avoiding precision and in allowing the list of indicators to evolve without the constraints of a formal decision.

I agree with previous speakers that it is perhaps too early to codify procedures to be followed in the initiation and conduct of special discussions. However, I wish to make some preliminary comments on this subject. Significant departures from the intended course should lead to an internal review by the Managing Director. If after such a review the Managing Director determines that special discussions with the member country concerned are needed, the Executive Directors would be so informed informally. Following the special discussions, the Managing Director would report to the Board on the outcome of those discussions. The report would be presented in a formal Executive Board meeting that would be concluded with a summing up by the Chairman. The staff has asked whether explicit guidance concerning the factors to be taken into account by the Managing Director in reaching that judgment should be provided. I am not certain that such guidance can be provided in advance, given the multiplicity of factors involved. However, it is clear that the departure from the intended course has to be significant enough to have substantial implications for other countries.

Mr. Zecchini made the following statement:

This is the third round of Executive Board discussions on this issue, and it is unnecessary to repeat the positions in principle that this chair has already taken on the subject and to which I still adhere. Therefore, my comments will deal directly with the three main parts of the implementation of the plan to use indicators, namely, the framework for their application, the selection of the individual indicators, and the legal decision on the new procedures to strengthen the Fund's surveillance role.

With respect to the framework, it is useful to remember that the objective of using indicators in surveillance is twofold: it is an essential tool for promoting greater consistency of economic and financial policies among countries in a multilateral framework; and it aims at injecting greater discipline into the conduct of policies that affect exchange rate movements in order to achieve, under the current floating exchange rate regime, some of the benefits that were associated with the fixed exchange rate system. Given these objectives, I broadly endorse the staff's presentation of the analytical framework; there is no need to discuss the analytical underpinnings in detail. The proposed framework is sufficiently flexible, as it encompasses alternative explanations of the transmission mechanisms by which domestic policies and developments of one country affect another country's economic performance, especially the external payments position.

The starting point for the indicators exercise is the projection of the macroeconomic consequences of existing policies over the immediate future and in a medium-term perspective. The trends shown in these projections have to be evaluated according to criteria of sustainability and desirability. In so doing, the idea of restricting the focus mainly to the underlying current account balances should be rejected. Instead, the focus should include the major determinants of the national saving/investment balance that are at the origin of both income growth and external positions. In addition, it is essential to stress that "desirability" and "sustainability" are not synonymous and do not coincide. However, our judgment of a country's projections has to comply with both criteria, and we cannot dispose of one of the criteria in order to retain the other. This conclusion has some crucial implications; for example, for some major industrial countries a current account imbalance may be sustainable. Nevertheless, it must be considered appropriate and desirable that, over the long run, the average position of individual industrial countries should be broadly in balance. Achieving this objective would involve over the long term a redistribution of surplus and deficit positions among the major industrial countries unless specific factors make it desirable to maintain the original imbalances for prolonged periods. For countries at a less advanced stage of development, it seems desirable to accept an excess of national investment over savings over the long run to the extent that the counterpart of the excess is a surplus in capital movements that does not imply an excessive accumulation of debt. This principle implies that, for industrial countries as a group, a surplus in the trade or current account over a long period should be acceptable.

In line with the multiple approach proposed by the staff for the definition of criteria of desirability or sustainability, it is not advisable to construct point estimates of alternative, more desirable scenarios with which to compare the projected trends based on existing policies. A more palatable approach would consist of indicating the direction of the needed change in key variables in individual countries and, if possible, specifying ranges that are considered acceptable. In this context, it is important to emphasize that the assessment of desirability should apply not only to economic outcomes, but also to the choice of the mix of policy instruments. This conclusion should lead us to consider the appropriateness of developments affecting short-term interest rates and exchange rates in a multilateral context.

As to the framework for the selection of indicators, I have no objection to the list proposed by the staff, but a shorter definition of some indicators is needed. Among the indicators of economic objectives, the balance of payments pattern has to be broken down into the current account balance and the capital movements balance. Output growth indicators must be assessed over the medium term in the light of the growth of economic potential, which brings both the capacity utilization rate and the unemployment rate into the picture. Therefore, although unemployment is not explicitly included as an indicator, it would be taken into account in determining the desirability of an existing gap between actual and potential output. Over the short term, there might be a trade-off between output and inflation, and it is not clear how a "desirable" trade-off could be established. In this connection, the first paragraph on page 16 of EBS/87/135 is obscure, as it does not spell out the operational criterion for desirability, while the criterion for sustainability is derived from the evolution of economic potential. Since there are differences among countries in the short-term trade-off between output and inflation, an assessment of the appropriateness of an individual country's trade-off has to be based on the analysis of other variables that will accommodate these differences and the implications that these will have on other major economies. Accommodation of these differences may be achieved mainly through changes in relative interest rates, exchange rates, or other structural factors affecting external payments. Consequently, the evaluation of the trade-off should be based on an analysis of its consequences for these variables in a multilateral setting. At the same time, this evaluation has to pay great attention to the objective of reducing inflation to the lowest rate that is compatible with the smooth working of domestic markets. This conclusion implies that, in the absence of significant pressure on the system of relative prices, the desired target for the rate of inflation should be close to zero.

In discussing intermediate indicators, the staff does not deal with the problem of nominal versus real quantities. In addition to nominal values for domestic demand expansion and exchange rates, we should consider their real values because of their informative content, rather than in view of their normative indications. A comparison of real domestic demand expansion with realized real output growth gives a useful indication of the impact of a given policy course for the real foreign balance if the latter is not retained as a target. At the same time, recent developments in real exchange rates could be useful in pointing out their impact on the foreign balance and at the variables to be considered for correction.

With respect to policy instruments, the importance of analyzing the mix of fiscal, monetary, and structural policies apart from the analysis of each individual policy instrument must be emphasized. In addition, I attach considerable importance to the consistency of fiscal policies among major countries, and especially to the estimation and assessment of the fiscal impulse. In the monetary policy area, the staff has referred to indicators of both interest rates and monetary aggregates. In my view, movements in interest rates are most appropriate to indicate the evolution of monetary conditions; changes in monetary aggregates play only a complementary role. Structural policies can best be incorporated in the set of indicators through the use of qualitative statements that cover, in particular, policies affecting external payments.

A particularly delicate part of the indicator exercise is the procedure that has to be established to set up and monitor the indicators, identify deviations from a desired path, and trigger responses. Some experimentation should be undertaken before the procedures are finalized. To begin with, the staff could present in the world economic outlook exercise and in Article IV consultation reports assessments of the desirable direction of change in a few key variables pertaining to the aforementioned three orders of indicators. This assessment should be made against the backdrop of projected ranges for economic trends for the individual country concerned and, whenever possible, it might include a range for the modification of these trends. In this connection, it seems necessary to ensure consistency in the analysis of performance and policy interactions by framing the indicators of the various countries in the same time dimension. The Executive Board should consider all these elements and decide which changes would be desirable. The Interim Committee could be called upon to endorse this decision of the Executive Board.

Short-term monitoring cannot be focused on final policy objectives, as they are not within the control of the authorities. Such monitoring should focus on policy instruments and "early warning" signals of deviations in performance.

The Managing Director should draw to the attention of the Executive Board a departure from an intended desirable path that has persisted for some time. If deviations continue, he should start a supplementary consultation and refer to the Executive Board. The Interim Committee could also be called on to deal with these deviations in a broader perspective during one of the Committee's restricted informal sessions.

I will now comment on the important staff paper on the review of the 1977 decision on surveillance. In order to strengthen the Fund's surveillance, we must upgrade the Fund's rules to express in less soft terms the obligations of all members with respect to the full range of domestic policies that underlie exchange rate developments or which are of legitimate concern to the international community. This range of policies is explicitly described in Article IV, Section 1.

Although I have not yet taken a final position, the approach that I favor consists of adding a new decision to the 1977 decision. The new decision would be based on a reference to both Sections 1 and 3(a) of Article IV. Changing the 1977 decision at this juncture of the evolution of the international monetary system does not seem to be fully appropriate, as the 1977 decision is still valid and effective in view of its primary target. The new decision could be added without waiting to accumulate long experience, as nothing would prevent the Executive Board from reviewing this decision periodically and adjusting it when necessary. Moreover, the new decision would build on what is already done in the world economic outlook exercise and Article IV consultations in dealing with the entire spectrum of domestic policies. The only major innovation would be to formalize the current implementation of surveillance through the introduction of indicators.

As to the principles for guiding members' exchange rate policies, I broadly support the three proposals made by the staff on page 6, with one important addition: the reference to the combination of policies should include not only the notions of appropriateness and stability, but also the notion of consistency with the policy mix of other major countries.

With respect to the principles of Fund surveillance, the proposed reference on page 9 to the notions of "desirable" and "sustainable" should be framed in the context of the provisions of Article IV, Section 1. There is no need at this time to specify the list of chosen indicators, since they can be changed over time and must be country specific. Moreover, flexibility should be used in assessing departures from an intended path of indicators, in the sense that a qualitative judgment on the dimension and duration of the departure is sufficient; there is no need to resort to automatic triggers.

In the area of the surveillance procedure, I favor supplemental consultations as opposed to special consultations, but views on the other issues at hand are still preliminary. Supplemental consultations could be initiated by the Managing Director in the light of a broad set of guidelines. The Executive Board should consider a report on the consultation and reach a conclusion on the consultation. At the end of the consultation, the Board could decide whether it would be appropriate to refer the matter to the Interim Committee for a further discussion in a restricted session.

Mr. Nimatallah made the following statement:

The objective of using indicators in surveillance is to remove tensions, thereby widening the scope for an expansion of economic activity without an acceleration of inflation. In discussing the procedures, the staff may well have raised some alarm when it stated on page 21 that it "would be necessary to define a desirable or acceptable evolution for the international environment at large." Such a task certainly would not be easy. The procedures are better described in the statement on page 4 that "the first step in this process of surveillance and policy coordination is to prepare an analysis of recent economic developments and projection of future trends." Furthermore, I agree with the statement on page 5 that the second step is to identify tensions in actual or prospective developments, and that, as stated on page 5, "it is important to have a framework that is capable of distinguishing situations of undersirable as well as unsustainable trends." It is more realistic to establish a framework designed to identify undesirable or unsustainable trends, than to define in advance an international environment that is sustainable and desirable.

I also agree with the statement on page 5 that "the final step in an indicator-based approach to surveillance is to identify policy changes that would help countries to achieve their objectives and would at the same time strengthen the international financial system." The staff then appropriately concludes that the process should not be excessively ambitious; it states that "less ambitiously, this can be expressed as setting policy directions that will reduce the tensions inherent in prospective developments." It is more feasible, at least at the present stage, to identify policy directions than to establish precise magnitudes for the movement of certain variables.

At the present stage, the list of indicators should be confined to the small number that the staff has proposed. Over time, as the Fund and individual countries gain experience and confidence in the use of indicators, additional ones could be added whenever it is feasible to do so.

The staff has suggested including indicators of output and inflation. The experience of the industrial countries during the 1960s and 1970s clearly shows that establishing targets for real growth can involve a high cost in the form of rapid inflation with accompanying widespread structural rigidities. Accordingly, at present, it is more prudent to concentrate on a target for nominal growth than real growth in judging the appropriateness of growth and inflation policies in the relevant member countries. The staff has concluded that "realistically, governments' policies can be judged primarily on the appropriateness of the sum of inflation and growth objectives." The growth objectives concerned should be the growth of nominal demand. Later, as the number of indicators is increased, the staff could consider both real growth and inflation performance in cases in which relatively greater scrutiny is called for.

I agree that the focus of interactions should be on balance of payments flows, and that particular attention should therefore be paid to current account balances. However, greater attention should be given to exchange rate developments.

I agree with the staff that it is possible to formulate criteria for variables along the lines that the staff has explored in order to judge the appropriateness of particular indicators. The staff has made a good first step in attempting to formulate such criteria, but, at the present stage, it is not clear to me whether greater precision should be sought before more experience is gained.

It is important for the Fund to help to identify the extent of the spillover of the economic policies of the industrial countries onto developing countries. It is not clear to me which indicator should be used to identify the extent of those spillovers. I welcome the staff's attempt to create a list of magnitudes that could help to identify the impact of spillovers, but I am not certain that the list is adequate or will help in judging the full extent of the impact and what could be done about any possible harmful repercussions. For example, it is true that primary commodity prices are decided mainly in markets that clearly are not characterized by perfect competition, and, therefore, that prices fluctuate widely. Producers react to consumers, who in turn are influenced by cycles and changes in the economic environment. In this connection, the indicator exercise can make a meaningful contribution to identifying areas of harmful spillovers, so that over time the Fund can reduce such problems for developing countries, especially primary commodity exporters.

As to the 1977 decision on surveillance, I favor an approach that would provide guidelines on indicators as a separate supplement to the existing decision. That supplement should be introduced at a later stage, in the light of experience.

Mr. Yang made the following statement:

I basically agree that the sustainability of the balance of payments position should be the focus of the analytical framework. I have no difficulty in accepting the proposed list of indicators and their criteria; the four general procedural steps needed to carry out the indicators exercise are also acceptable. It is premature at present to amend the 1977 decision on surveillance over exchange rate policies. It would be advisable to wait until more experience has been gained in the use of indicators, so that any amendments can be made with confidence.

However, a fundamental issue is the role of the exchange rate in the indicator exercise. The staff correctly notes that a key role in the monitoring process could be played by interim market-sensitive variables. This recommendation is consistent with my view that the exchange rate is an essential indicator of incompatibilities in economic policies among countries, since the exchange rate links domestic policies with the external sector. Disturbing movements in exchange rates triggered policy discussions among the major industrial countries that led to the Plaza Agreement in 1985 and the Louvre Accord in 1987.

One problem with incorporating exchange rates into the analytical framework is the difficulty in and complexity of assessing appropriate exchange rate levels. However, I doubt whether the task of defining the sustainability of the balance of payments position is any less difficult and complex. If we have a good notion of standards of broad ranges for particular indicators, we may well be in a position to assess their appropriateness. I have great confidence in the staff's expertise in this area.

Another problem with incorporating exchange rates into the analytical framework is the market sensitivity of those rates. Incorporating exchange rates into the analytical framework does not mean that the indicator exercise needs to include daily projections of exchange rates. What is required is an analysis of the trends in and direction of medium-term exchange rate movements on the basis of economic fundamentals. Therefore, I continue to believe that misgivings about market reactions to the use of the exchange rate as an indicator are unwarranted. Presumably, if the markets do react more strongly to such analysis than to short-term developments, this analysis could become an ideal anchor for assessing medium-term exchange rate expectations; in any event, we do not yet know how strongly the markets will react to the analysis.

In an analytical framework of indicators the balance of payments and exchange rates are complements, not substitutes. Their complementarity is particularly noticeable when the delays in and inaccuracy of balance of payments data are taken into account.

I am pleased that the application of indicators has gained the increasing support of the international community. That support essentially reflects the crucial need to improve the present international monetary system through greater discipline and increased coordination. In the present circumstances, it seems impossible to resume the pure gold standard or to maintain a clean floating system. Therefore, there is a need for a middle ground between the use of complete discretion and a "rules only" type of system. Given the growing interdependence among national economies, the authorities of all countries have to sacrifice some degree of discretion in exchange for an increase in coordination. The essential question is how much discretion a country may be willing to give up in exchange for the increase in coordination; I suspect that the answer may well depend on how each country evaluates the benefits and costs of policy coordination, and I was impressed by Mr. Massé's comments on such an evaluation.

Against the background of different evaluations of the benefits and costs, two approaches may well exist--one characterized by peer pressure, and the other based on discipline or a code of conduct. These approaches have been apparent during the discussions of the indicator exercise--for example, during the discussions particularly on the degree of automaticity and on the binding force of indicators. These basic differences may well persist as the indicator exercise advances. The staff has suggested in its paper that "in designing a strategy to alleviate payments imbalances, reaching agreement on the broad distribution of domestic demand growth across countries will typically be a key element in the coordination process." If this international distribution of domestic demand growth is to materialize, the discretion shown by each country in its economic policies will certainly be restricted even further. I doubt whether such an agreement can be reached merely through peer pressure even though the idea of an agreement is a good one.

Another issue is the proposed special consultation that would be triggered by a serious departure of indicators from the normal path. Will such a consultation lead to the necessary policy action, or stop short of an agreement on such action? Reaching an agreement could be a crucial test for the effectiveness of the two approaches that I have described. Some form of discipline may eventually be needed if the indicator exercise is to be effective.

The staff has suggested several plausible methods of assessing the sustainability of current account balances. A better understanding of the applicability of each of these methods would of course be desirable. As Mr. Lankester has correctly noted, there is a need to specify which benchmarks would be most appropriate. Presumably the methods are to be used in combination, which means that the kinds of various combinations will have to be clarified.

I can go along with the list of indicators reflecting the impact of industrial countries' policies on developing countries. However, greater emphasis on the analysis of those variables in the world economic outlook exercise is clearly needed.

With respect to the criteria for assessing individual indicators, I do not favor a mechanically quantified and rigidly uniform approach to establishing standards. A feasible approach may involve the determination of ranges that are judged to be appropriate. Moreover, some judgment may well be needed; the particular situation of the individual country concerned should be taken into account.

In the final analysis, whether or not the indicator exercise can be effective will depend crucially on how great a part, and the degree to which, political will is involved. If the will is lacking, the indicator exercise may well be ineffective. I hope that, as further discussions take place and a greater understanding of the subject is gained, the political will emerges. The Fund should play a central role in the indicator exercise, so that multilateral surveillance can be strengthened, thereby improving the functioning of the international monetary system.

Mr. Sengupta made the following statement:

The main task today is to reach an agreement on or understanding of the analytical framework for indicators, the number and types of indicators to be used, and procedures that would highlight economic interactions. In addition, we should establish appropriate mechanisms for discussions leading to adaptations of policies wherever circumstances warrant. It may not be possible to complete those tasks today, but the Interim Committee may have had that possibility in mind in noting in its latest communiqué that the Executive Board should submit a "progress report" on the strengthened use of indicators for the September 1987 meeting.

I agree that the analytical framework should focus mainly on the underlying external current account balances and the channels of transmission that link domestic policies and developments with spillover effects on other countries. However, the present state of our knowledge is not as specific or quantified as we would wish. Therefore, we have to proceed on the basis of accepted theories, and the ranges of values of the key economic variables that have to be achieved by different policy mixes over the medium term will have to evolve over time.

I have no serious difficulty in accepting the suggestion to have a range of values for medium-term variables as key indicators, and I agree with Mr. Dallara that exchange rates should be given a special place in the indicator scheme. However, two problems have to be squarely faced. First, the estimated values of key variables will have to be "desired" and "sustainable." The staff has stated that such variables might be thought of, depending on the circumstances, as "equilibria," "objectives," or "projections." The staff then defines desirability and sustainability as conditions that are consistent with the growth potential of the economy concerned and that are judged to be appropriate from the viewpoints of both the country and the international community. But sustainability is not the same as desirability, and sustainability can be evaluated on a number of bases, such as historical experience, debt-servicing capacity, and factors that generate changes in saving/investment balances.

The way in which the financial flows to developing countries has been considered by the staff is a cause for concern. The staff suggests that an approximate balance in the combined current account positions among the industrial countries would be consistent with a broadly appropriate flow of resources to developing countries. If this is true, the developing countries can hope to meet their financial requirements only by in effect relying on the so-called statistical discrepancy. Developing countries as a group have payments deficits, and these deficits should be covered by surpluses of industrial countries, so that there can be a real resource transfer and smoother international adjustment. If the sustainability of current balances among the major industrial countries is approached in terms of either stabilization of ratios of net external assets to and liabilities to GNP, or compensating changes in the components of the national saving/investment identity, there can be consistency in the calculations but not the desired international pattern of current account balances.

Clearly there should be a full understanding of what is desirable, as distinct from sustainable, in the international context. As the staff suggests, we could start with the formulation of medium-term objectives for some variables, such as growth and inflation, the balance of payments, or even exchange rates. However, as Mr. Dallara noted, it is not clear how to coordinate these country preferences in an international context. I agree with Mr. Dallara that the medium-term objectives of the member countries concerned should be tested first for their internal consistency with reference to the countries' other objectives, and then for external consistency and compatibility among the different countries. Mr. Dallara's comments on exchange rates as variables to be employed in medium-term scenarios to test for internal and external consistency should be applicable to other variables, such as the rate of inflation, output growth, interest rates, and, of course, fiscal deficits.

The second major problem that must be faced, which Mr. Lankester highlighted in his opening statement, is the frailty of medium-term analysis, as reflected in the margin of error in forecasts of variables. This problem cannot be solved by having more than one medium-term scenario with different sets of medium-term goals and objectives. Depending upon the resources available, we should have a number of scenarios to facilitate the choice of a set of objectives and policies. That choice must be made so that a system of surveillance can be built on possible deviations from the chosen path. However, the problem that Mr. Lankester noted is related to errors owing not to the method of estimation but rather to unforeseen shocks or developments that are not captured in the model. In this situation, there is a need for contingency planning, namely, a set of policies that would be implemented if the actual path of variables deviates from the projected path owing to unforeseen developments.

The staff should consider the matter of contingency planning systematically. In that connection, the methodology developed would have broad applicability, including the design of programs of balance of payments adjustment in developing countries. This aspect of the issue will be further discussed during the review of the design of Fund-supported programs. At this stage, I wish merely to stress that a proper system of multilateral surveillance must incorporate such contingency policy planning.

With respect to the procedures, I am pleased that the starting point will be the global economic projections in the world economic outlook, complemented by detailed discussions of individual country situations in the context of Article IV consultations, and that desirable medium-term scenarios will be established to explore the possible consequences of alternative policy settings. While this approach has considerable merit, assessment should also be made of the current year's developments and policies, and short-run considerations should not be wholly excluded. I am not suggesting that there should be fine tuning of policies in the short run, but the Chairman's summing up of such discussions would have to attempt to identify for key indicators a path that is considered to be sustainable and preferable and the way in which current policies are contributing to the achievement of that path.

With respect to the 1977 decision on surveillance, I agree with Mr. Lankester that it is premature at the present stage to revise or modify that decision or to adopt a new decision; some experience with the use of indicators should be gained first. As to the decision to initiate a special discussion in the event of a large divergence between the actual and intended paths, it should be noted that, at present, the Managing Director has sufficient discretion to initiate such discussions and there is adequate scope for Executive Board involvement in the process. What is perhaps still needed is an agreement that, once the indicators are well developed, there will be grounds for having some automaticity in the initiation of special discussions. I doubt whether Mr. Yamazaki would object to this automaticity, without which the analysis of indicators would be meaningless.

Mr. Archibong made the following statement:

I am pleased that we are now moving to the stage of discussing more specific aspects of operational procedures for the use of indicators in multilateral surveillance. In exploring a suitable analytical framework for indicators and acceptable criteria for assessing economic policies and performance we should not lose sight of an important objective of surveillance, namely, to reduce both the asymmetry that has characterized the international monetary and financial system, and the imbalances and irregularities in international adjustment that have imposed a disproportionate burden on the weaker economic partners.

I agree with the thrust of the analysis in the staff papers. With respect to the analytical framework that the staff has proposed for the use of indicators in multilateral surveillance, the focus on the international repercussions of domestic economic policies and performance of major industrial countries is appropriate, provided that adequate attention is paid to implications for the international adjustment process and the promotion of growth in developing countries. Trade and capital flows provide a proper linkage or transmission mechanism through which domestic policies may influence economies of other partners. I agree that effective multilateral surveillance would require assessment of not only relative rates of demand, growth, and competitiveness, but also how such variables are influenced by domestic macroeconomic and structural policies and their impact on interest rates, exchange rates, relative costs and prices, and the level of output.

I see some merit in focusing on a small number of indicators, provided that they capture the impact of industrial countries' policies on the growth and adjustment efforts of the developing countries and the implications of the distribution of costs of global adjustment among different participants. These considerations are of major importance to developing countries and should therefore be important elements of the assessment of the desirability and sustainability of a particular outcome. However, it is not clear to me how the suggested indicators reflect these considerations, and a further staff comment on the matter would be helpful, as it is a crucial factor in judging whether or not the proposed indicators are appropriate.

If the assessment of individual economic indicators shows that there is a divergence between actual as well as prospective developments from the intended course, this should at least trigger consultations between the Fund and the authorities concerned as part of a prompt re-examination of the situation, including the consideration of possible policy actions warranted by the changed circumstances. I have no difficulty with the proposed classification of indicators into economic objective indicators, intermediate variables for monitoring purposes, and policy instruments under the full control of the authorities. In addition, I can go along with the outlined analysis of the elements that give operational content to the use of indicators. In this connection, my only concern is that the indicators should be able to capture and reflect the implications for developing countries and the distribution of the adjustment burden.

The proposed procedures are appropriate as a general approach to using indicators to identify potential tensions; the approach correctly focuses on the international interaction of domestic policies and involves a triggering of intergovernmental discussions to adapt existing policies. At this initial stage, the world economic outlook exercise and Article IV consultations could provide a satisfactory source of information for deriving the needed indicators and for defining a desirable and sustainable evolution for the global economy as well as for defining the appropriate role of individual major industrial countries. It is important to develop a political consensus among the major economic factors so that a significant divergence of actual and prospective performance from the desirable and sustainable developments will trigger discussions that could lead to a supplementary consultation to determine what kind of policy adaptation may be required.

As to the review of the 1977 decision on surveillance over exchange rate policies, it is unnecessary for the staff to proceed now to prepare a decision for the Executive Board; there is not yet sufficient experience. Such experience can be gained only from a strengthened use of indicators under existing decisions. In other words, I favor an approach under which the existing decision would be left broadly as it stands. The indicators could be incorporated into the Fund's practice through a separate decision adopted under Article IV, Section 3(a).

Meanwhile, with respect to the purely procedural issues, it seems sufficient for the Fund to use a departure of actual from intended developments as the principal criteria for initiating discussions with a member. However, the problem of reaching decisions on whether a departure is significant enough to warrant discussions could be a difficult one to solve; it could probably be solved with the use of quantified ranges or "target zones."

My authorities look forward to the Fund making rapid progress in the use of indicators in multilateral surveillance in the hope that it will contribute substantially to effective policy coordination.

Mr. Ovi made the following statement:

The Nordic countries support an increased use of indicators in the surveillance process. This might not only be a way of making more specific the responsibility of individual countries for better coordination of economic policies internationally, but could also result in a greater degree of symmetry in the adjustment process.

However, political will is clearly needed. A more effective surveillance process can be achieved only if member countries--particularly the major ones--are willing to undertake formally more binding commitments and to live up to these commitments. The aim must be to develop a system committing countries to initiate discussions with the Fund in the event of marked deviations from some sort of preferred path.

Having these considerations in mind my authorities will be flexible with respect to the analytical framework and to possible changes in the existing rules for surveillance. Before dealing with the specific matters raised in the staff papers I wish to take up two issues.

First, without being very precise with respect to country coverage, the staff paper on the analytical framework deals mainly with "the analysis and appraisal undertaken in the context of the world economic outlook exercise." I take that statement to mean that, as has already been agreed in earlier discussions, in an initial phase the use of indicators should be limited to the largest countries. At the same time, the G-7 countries agreed in Venice to strengthened arrangements for multilateral surveillance among themselves. In order to achieve consistency and to ensure that the interests of the remaining member countries will be represented, I continue to advocate strongly that the Fund staff should provide the input for the G-7 deliberations, the monitoring process should be integrated, and the Managing Director should be present in the policy discussions among these countries.

Second, during the Executive Board discussions in January 1987, a number of staff papers were requested--for example, a paper on the forecasting record of the world economic outlook exercises--so that a more definitive judgment could be reached on the modalities of an indicator system. In addition, the staff said that it wished to gain experience from another round of world economic outlook preparations and discussions. What can be expected of these projects and what is the time schedule?

Basically I agree with the discussion in the staff paper on the analytical framework. The outlined surveillance process, including the various steps in it, appear to be logical. I agree that, at least in the beginning, only a fairly limited number of indicators should be used. Given the focus on international repercussions--as well as the traditional role of the Fund--the current account and the exchange rate come to mind first. Some flexibility seems to be desirable with respect to the addition of other indicators that could trigger discussions. There is an obvious need for continuity and comparability among countries. Still, at the present stage, this need should not prevent us from using supplementary indicators if the structure and particular circumstances of the country so require. In addition, the choice of indicators, or at least the attention paid to individual indicators, may well have to change over time. We should normally select a combination of final objectives, intermediate targets, and policy indicators.

The staff paper contains an interesting section on the concept of sustainability and its application to the current account. Although the difference may appear to be merely one of semantics, in the beginning we may have to concentrate our efforts on unsustainability rather than sustainability. For example, with respect to the stabilization of ratios of external assets or liabilities to GDP, it is fairly easy to determine what might constitute a potentially unsustainable situation. However, as was clearly demonstrated during our recent discussion on Korea, this criterion does not provide much guidance when we wish to move away from such a position. Judgment will still be needed. We will be able to specify only fairly broad--and not necessarily consistent--ranges of sustainable current account positions. This does not mean that we should delay the implementation of an indicator system, but rather that we need to gain some experience.

While I basically agree with the proposed criteria for assessing individual indicators, we are still at the stage of defining areas for the selection of indicators rather than specifying concrete indicators. Are we close to the point at which the staff will start to formulate indicators on the basis of relevant criteria in individual cases? Following this process it will be up to the Executive Board and, in particular, to the country concerned, to determine which indicators will be the most important during a given period. Similarly, the Executive Board will have to determine the kind of precision--for example, the use of ranges versus specific quantities--in which such indicator values will have to be specified. To the extent that the aim of promoting desirable and sustainable international developments makes it possible to do so, the point of departure should be the economic priorities of each individual country, and the Fund should avoid interfering with more narrowly defined economic policies.

The stages of the monitoring procedures presented by the staff seem to be logical. However, the difficulty in this area is how the procedures can realistically be implemented. I agree that the biannual world economic outlook exercises should be the point of departure. Monitoring is clearly the crucial aim of the indicators exercise. The staff should monitor all indicators, including policy variables. The possibility of using leading indicators, such as exchange rates or interest rates, has to be further examined.

In the staff paper, leading indicators seem to deal only with each individual country. As was suggested by the participant from the Nordic countries in the April Interim Committee meeting--and he was supported by a number of other speakers--my constituency continues to believe that there is a need to develop an exchange rate indicator that would trigger multilateral deliberations on the need for overall policy adjustments.

In addition, as was mentioned during the recent discussion on Korea, this chair supports a more active surveillance role for the

Fund to give the Executive Board an opportunity, if necessary, to discuss member countries' policies between ordinary Article IV consultations. One means of doing so--and in this area my views are close to those of Mr. Sengupta--would be to introduce a presumption that in the event of a significant deviation from one or more of the indicators, ad hoc consultations would normally be expected to take place. The final decision whether to use such a procedure should rest with the Managing Director, and in making that decision he should take into account all available information.

The staff should begin the preparatory work to bring the 1977 decision on surveillance up to date. However, the revised decision should remain valid for a number of years. Therefore, the references to the use of indicators should not be very specific; more experience is still needed. Even though domestic economic policies would become more directly part of the surveillance rules, the main emphasis should continue to be on the current account and the exchange rate. Softer language will be needed on domestic policies. My preference is to accomplish this through a supplement to the existing decision, although I remain open to considering other suggestions.

With respect to procedures, these should be kept in general terms only. As the staff has noted, the procedures on special discussions have not been invoked. To provide an opportunity for ad hoc discussions, the Executive Board adopted in 1979 the so-called supplemental surveillance procedures. Even these procedures have been used only rarely; furthermore, they are based only on the policies on or behavior of exchange rates. Therefore, to the extent that we wish to include other policies, there may be a case for revising the text on special discussions and, perhaps, for discontinuing the rules on supplemental consultations.

Mr. Donoso made the following statement:

The indicator exercise should be designed to facilitate the implementation of policies that are conducive to growth and stability, foster an environment in which member countries can prosper, and avoid actions that would result in a world economic system that would limit countries' development. Accordingly, we must be careful to avoid any attempt to develop a system of coordination of economic policies that might inhibit the operation of the markets. The system should coordinate the implementation of policies that enhance the role of the markets and the international mobility of goods and resources. In addition, it should facilitate the detection of restrictions or limitations on competition and should exert pressure in favor of the elimination of those restrictions. For these reasons, we should avoid attempts to formulate strong views on appropriate current account balances per se and independently of the underlying factors determining those balances. As the staff has indicated, a large current account surplus might reflect high savings ratios at a particular period in the evolution of a country, namely, when that country does not have attractive opportunities for investing domestically all its savings and a current account surplus is a reasonable outcome. Alternatively, a current account deficit might reflect merely a surge in demand for resources required to undertake profitable investments. Large swings in current account balances might reflect market conditions and events.

At the same time, an attempt should be made to detect movements in current account balances that reflect monetary, exchange rate, or fiscal policies that do not help to foster an economic environment that is conducive to world economic growth. An attempt should be made to formulate views on appropriate monetary, exchange rate, and fiscal policies and to monitor events relating to those policies, rather than place excessive emphasis on current account balances.

Moreover, we should try to develop a system of indicators that facilitates the task of generating pressure on individual countries to bring current monetary and fiscal policies in line with the policies that should be maintained in the longer run. The system should not be designed to coordinate in the short run the use of monetary and fiscal policies to achieve other objectives. Rather than aim at multilateral fine tuning of the world economy, we should make an effort to reach agreement on long-term, mutually compatible and sustainable rules for monetary and fiscal policies in the countries concerned. For example, like Mr. Kafka, I find it difficult to define a priori the current account deficit of developing countries. However, using a system of indicators it should be possible to say something about the existing level of transfers--for example, whether it makes sense. The purpose would be to detect restrictions on or structural impediments to more appropriate levels of transfers and to remove those restrictions, rather than to coordinate policies to offset the consequences of the restrictions without removing them.

Coordination should be aimed at fostering an appropriate environment, rather than at obtaining specific results or a specific evolution of a variable. Contrary to what is indicated in the staff paper, the indicator system should not lead to constraint on a current account surplus in order to avoid the establishment of trade restrictions in the countries experiencing current account deficits. If there are no fiscal or monetary policy problems connected with a surplus, the indicator system should be a good protection against trade restrictions and should make it more likely that the existence of imbalances will be a reflection of market realities.

I fully agree with the staff that, although there are difficulties in doing so, efforts should be made to detect and address structural problems. Structural policies in one country may have effects on the performance of other countries, and the Fund should try to detect and discourage structural policies that adversely affect the economic environment. The staff proposes to split the analysis of nominal income growth between inflation and output, which, in the staff's view, would provide information on the efficiency of an economy. Indicators would highlight problems owing to inefficiencies, and once the origin of a problem is detected, work would be undertaken to bring about structural reform. I support this approach and favor orienting the indicators exercise in this direction, so that problems in the area of public policies can be detected.

I wish to associate myself with Mr. Massé's comments on the analytical framework, the specific set of indicators, the use of the analytical framework, surveillance procedures, and the 1977 decision on surveillance.

I am pleased that management has been able to ensure the Executive Board that the Venice Summit Declaration should be interpreted as endorsing an agreement on the need for the Fund to exercise surveillance over the G-7 economies.

Mr. Ismael made the following statement:

The subject of using indicators in multilateral surveillance is both interesting and difficult because it is as much an economic subject as a political one. In today's discussion, as well as in future discussions, we will consider an analytical framework for indicators, the choice of indicators, the criteria for assessing individual economic indicators, and procedures that are best suited for the implementation of indicators in the bilateral and multilateral surveillance process. Therefore, it is important to make a modest start, by taking a flexible but pragmatic approach that will take into account the characteristics of individual economies, and to make progress with the use of indicators without expecting perfection in the initial stages of implementation. The choice of indicators, the setting of standards for variables, and the procedures for implementation can be reviewed and adapted as we gain experience over the coming years.

I fully agree with the staff that the analytical framework must be general enough to accommodate differences in emphasis among countries' views on the precise ways in which economic developments in different countries interact. The framework should nevertheless highlight the ways in which domestic policies affect the economies of trading partners. In this connection, a careful examination of the relative rates of demand growth and competitiveness should be examined. The techniques available for measuring and evaluating domestic demand growth and competitiveness are not perfect, but they are adequate to help make broad judgments on the desired direction of changes in the economy and in economic policies, even though there may be differences about the precise magnitudes.

Since the focal point of interest in the indicators exercise will be balance of payments, I support the staff proposal that, for practical purposes, the underlying current account balances should be estimated first and then compared with values that are considered sustainable or desirable. Since there is no single criterion for determining whether or not a particular payments position is sustainable or desirable, a combination of methods, together with a considerable element of judgment, will be necessary in the use of indicators.

I confirm my support for the use of a limited set of indicators in assessing the medium-term sustainability of payments positions; the primary focus should be on no more than six indicators. The indicators suggested by the staff are appropriate; they meet the objectives of the indicator exercise. In addition, I attach particular importance to the need to appraise the international interactions of domestic policies and performance in the light of alternative medium-term scenarios. While the focus of the indicator exercise will be the interactions of policies and developments among industrial countries, it will be important for the Executive Board as well as national authorities to have a clear understanding of how the existing policies of industrial countries are affecting the performance in developing countries and how better policies in industrial countries would lead to improved prospects for the developing countries.

It is possible to develop criteria along the lines suggested by the staff for assessing the appropriateness of indicators of economic policies and performance. Since the focus of multilateral surveillance will be on policy interactions and the spillover effects of policies, special attention needs to be given to indicators of the sustainability of the balance of payments. I agree that precise estimates of a sustainable balance are difficult to make, and that in individual cases a considerable element of judgment will be necessary with respect to the desired direction of change, even though it may be difficult to arrive at precise magnitudes. I also agree with the staff suggestion that broad indications of sustainability of the balance of payments position can be derived from a consideration of the trends in domestic saving and investment.

Another important proposed indicator is economic growth. Techniques are available to estimate the underlying rate of growth in productive potential and the degree of economic slack in an economy. Similarly, it is not particularly difficult to measure the underlying rate of inflation. The important point is that, while the techniques for estimating the indicators are not perfect, they are nonetheless important and should be applied judgmentally. Therefore, I can go along with the criteria suggested by the staff for assessing the appropriateness of particular indicators.

With respect to the procedures for monitoring, the staff seems to suggest a procedure under which a comprehensive and consistent set of forecasts for key variables would be developed. After Executive Boad discussions, the staff would modify these forecasts to reflect a more desirable outcome, and if subsequent actual developments deviate from the projections, there could be supplementary consultations. While I support this approach, I have some difficulty in understanding the timing of the proposal for special consultations, which, in my view, should take place soon after the Executive Board or the Interim Committee arrives at a judgment that a better outcome is possible with a change in policies; we should not wait until after the subsequent actual developments have deviated from the desired outcome. The objective of a special consultation should be to convince the authorities of the need for a change in policies. If subsequent actual developments continue to deviate from the desired path, further consultations may become necessary, and the Fund may then consider ways in which to exert greater national pressure on the authorities to bring about the desired policy changes.

In the area of monitoring, I support the suggestion that interim market-sensitive variables can play a key role in the monitoring process; they would ensure that subsequent actual developments are consistent with a more desirable outcome. In addition, I support the staff's suggestion that initial estimates for chosen indicators should be derived from Article IV consultations and world economic outlook exercises.

I will not comment on the possible changes in the surveillance document to provide explicitly for the inclusion of indicators. The Fund should adopt a flexible but pragmatic approach. It already has been using various indicators to monitor and analyze members' economies. We should strengthen the use of indicators in a flexible and pragmatic approach, accumulating experience as we move along. At a later date, the experience gained could be crystallized as supplementary decisions on the use of indicators in surveillance. Adopting supplementary decisions is more desirable than a straightforward amendment of the existing surveillance decision. The more flexible approach to adopting a supplementary decision would allow us to make more frequent changes to fine tune the surveillance system over time.

As to the principles for members' guidance, I agree that there should be a widening of the extent of guidance to include exchange rate and balance of payments objectives. The guidance should also be extended to include domestic policies that by agreement are considered to be "sustainable and desirable."

I agree that the Managing Director should have the discretion to determine the existence of a substantial deviation of indicators from their intended path and to initiate special discussions with a member country. However, the Executive Board has to provide explicit guidance concerning the factors that should be taken into account in reaching such a judgment. Other member countries should not have a role in initiating special discussions. The Fund should not be used to settle bilateral differences. The Managing Director, while using his discretionary power, should keep the Executive Board informed on a timely basis and treat all member countries equally.

The Director of the Research Department said that in its future work on indicators and surveillance the staff would take into account the wide variety of comments and suggestions that had been made during the present discussion. A number of questions had been raised that could be answered on a bilateral basis.

One of the general issues that had been raised was the appropriate list of indicators, the Director continued. In the staff's view, the list should evolve over time. If additional variables proved to be useful, they could be added to the list as necessary. It was important to distinguish between the many variables that were merely of interest, and variables that should be formal indicators. Any discussion of the formal indicators should take into account other variables that were of interest. Further thought would have to be given to the question of whether unemployment should be a formal indicator or an indicator of interest. Executive Directors had mentioned a number of indicators in addition to those that the staff had proposed, including protectionism and monetary aggregates.

A number of speakers had suggested that the staff's studies on indicators were yielding diminishing returns, the Director recalled. In moving to areas of increasing returns, the staff assumed that Executive Directors would wish to see the staff undertake more concrete, numerical analysis, perhaps in the form of a simulation analysis in the context of the world economic outlook exercise. Alternatively, Mr. Sengupta had suggested that the staff could prepare contingency policy plans. The references to diminishing returns apparently did not mean that the staff should put aside its work on the use of indicators in surveillance. Rather, Executive Directors apparently wished the staff to increase the present limited knowledge of the various factors involved. For example, further work was required on the definition of "sustainability" and on the possible use of benchmarks. Given the present limited knowledge of the factors concerned, Executive Directors had stressed that point estimates and concrete scenarios would be inappropriate. The staff would have those conclusions in mind in preparing for the coming world economic outlook exercise, particularly in presenting alternative medium-term scenarios. A basic conclusion is that mechanistic analysis alone is insufficient; it cannot substitute for judgmental analysis.

As some speakers correctly stressed, the concept of sustainability was not the same as the concept of desirability, the Director said. The differences between the two would be reflected in the staff's future work.

The staff had considered the various studies showing the supposed limits to the scope and usefulness of coordination, the Director remarked. The staff's understanding of the conclusions suggested by those studies was less negative than the conclusions that had been drawn by Mr. Massé and Mr. Prader. The staff agreed that blindly and mechanically following the guidance of technical models would yield inappropriate results. After all, the models did not capture member countries' commitment to credible policies. However, the exercise of policy coordination was based on peer pressure. It was important to recognize that the very process of coordination altered the economic and financial environment and the credibility of commitments. There was clearly a need to study in greater detail the fruits of policy coordination.

Apparently Executive Directors felt that there was no need at the present stage to make formal changes in the present decisions on and procedures for surveillance, the Director of the Research Department said. However, as Mr. Dallara had stressed, exchange rate surveillance could not be undertaken in a vacuum--in isolation of other, domestic policies. In addition, as a purely economic matter, exchange rate policies were very broad; they did not involve merely buying and selling of foreign exchange. Moreover, most macroeconomic policies affected exchange rates. It was for that reason that many Executive Directors were interested in making the exchange rate a key indicator: the exchange rate was a reflection of the entire spectrum of macroeconomic policies. Executive Directors apparently had concluded that there was no need to change the formal decision on surveillance over exchange rates because the revised decision would merely validate what was actually done in that area of surveillance.

The Deputy Director of the Research Department remarked that the staff had not meant to give the impression that it advocated, as a kind of long-term rule, a zero current account balance for the industrial countries as an optimal outcome. The relevant point that the staff had meant to make was that the aggregate surplus of the industrial countries must, as a matter of accounting, equal the flow of resources to developing countries; the counterpart of the desired flow of resources to developing countries would be the industrial countries' surplus, excluding the statistical discrepancy. If the industrial countries aimed collectively to have a different surplus--either larger or smaller than the surplus needed to finance a desirable flow of resources to the developing countries--there would be an ex ante inconsistency that might cause problems. The staff had not meant to suggest that there was any fixed number of the appropriate balance at any given time, or that it was easy to calculate such a number. The figures that had been given in the staff paper were meant to be merely illustrative of the present situation.

The staff's discussion on intervention on page 6 of the paper on the 1977 decision was meant to suggest that intervention was perhaps viewed in a somewhat different light at present than when the 1977 decision was drafted; in 1977, intervention had been expected to be limited to circumstances characterized by disorderly markets, the Deputy Director remarked. However, over the previous six months or so, intervention might have been used occasionally to guide the market or to send a signal to the market of the intentions of the authorities concerned. Hence, the staff had felt it appropriate to pose the question it had about the use of intervention; it was not intended to suggest a conclusion on the possible need to revise the decision in a particular way.

The next world economic outlook paper would include, as Executive Directors had requested on previous occasions, not only a medium-term projection based on the assumption of unchanged exchange rates and unchanged interest rates, but alternative scenarios based on different possible evolutions of policies and market conditions, the Deputy Director of the Research Department commented. During the present discussion, Mr. Dallara had asked the staff to include a series of alternative acceptable or sustainable evolutions of pof policies. It would be difficult to provide a series of medium-term scenarios without Executive Directors finding one more attractive in terms of outcome than the others. The staff understood Executive Directors' wish to have alternative medium-term scenarios, and the staff would certainly provide them, but the staff would not wish the Executive Directors to assume that the staff would be able to provide a large number of equally desirable evolutions from which member countries could then select; there were obvious practical limitations on such an exercise. In any event, even if it were possible to have several equally attractive evolutions, that alone would not be sufficient for effective policy coordination; one would have to ensure that the decisions of each country concerned were from the same set of possible decisions, and not from alternative sets of policies that would be mutually inconsistent.

The Executive Directors agreed to continue their discussion on the use of indicators in surveillance on July 23, 1987.

APPROVED: February 5, 1988

LEO VAN HOUTVEN
Secretary