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October 18, 1990

To: Members of the Executive Board

From: The Secretary

Subject: Review of Exchange Rate Policy Assessments in Recent <u>Article IV Consultations</u>

There is attached for consideration by the Executive Directors a paper reviewing the exchange rate policy assessments in recent Article IV consultations.

This paper, together with the paper on analytical issues relating to Fund advice on exchange rate policy (SM/90/198, 10/16/90), is proposed to be discussed in an Executive Board Seminar on Wednesday, November 21, 1990.

Mr. Basu (ext. 7856) or Mr. Gilman (ext. 8524) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Review of Exchange Rate Policy Assessments in Recent Article IV Consultations

Prepared by the Exchange and Trade Relations Department

(In consultation with the Research and other departments)

Approved by Jack Boorman

October 16, 1990

Contents

I. Introduction

Executive Directors have expressed concern on a number of recent occasions about the coverage and treatment of exchange rate policy in country reports. As background for the further consideration of exchange rate policy issues by Directors, this paper reviews the assessments of exchange rate policy provided by the Fund in the context of Article IV consultations concluded during the period from July 1988 through June 1989. The sample covers consultations with 100 countries that represent a broad cross section of the membership and include 34 members with Fund-supported adjustment programs. 1/ In reviewing the consultations, the paper presents the assessments of the members' exchange rate policies as indicated in the consultation reports, especially the appraisal section. It also reviews the reactions of both the Executive Board and the authorities to the staff's assessments and policy recommendations. 2/

This paper endeavors to identify the main considerations that have guided the staff's policy evaluations and to characterize the circumstances in which the staff has recommended particular policy actions such as step devaluations, moves toward greater exchange rate flexibility, or other changes in the exchange system. In reviewing the consultations, the paper takes a broad view of exchange rate policy, looking at exchange rate arrangements in conjunction with monetary and fiscal policies and also in light of relevant structural policies, such as trade liberalization and price and marketing reforms. It is hoped that this approach will facilitate an understanding of the context in which particular exchange rate policies have been recommended and of the efforts made to integrate recommendations on exchange rate policy with those on other policy areas. However, the paper does not seek to reach judgements about the appropriateness of the staff's assessments of exchange rate policy in individual country cases, and case studies are not presented.

In view of the concerns expressed by Directors about the treatment of exchange rate issues in staff reports, this paper also aims to provide a basis for considering possible improvements in the treatment of such issues. In particular, it provides a perspective for judging how far the general approach and analysis presented in staff reports may have fallen short of directly addressing specific issues such as the

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1/ Appendix I.

2/ This review should be read in conjunction with the accompanying paper "Analytical Issues Relating to Fund Advice on Exchange Rate Policy" (SM/90/198, 10/16/90) which addresses various empirical and theoretical issues related to exchange rate policies. It should also be viewed in the light of the recent discussion of the Fund's surveillance policies "Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision" (SM/90/103, 5/29/90).

potential role of the exchange rate as an anchor for financial stability; and the key importance of sufficiently tight budgetary and monetary policies in supporting a credible exchange rate policy, curbing inflationary expectations, and thereby avoiding a vicious circle of repeated devaluations and accelerating inflation. It also suggests the factors which explain the observed variations in the treatment of exchange rate policies between industrial and developing countries and between countries with differing exchange rate arrangements.

The remainder of the paper is organized as follows. Section II examines the considerations on which staff assessments of exchange rate policy were based. Section III provides an overview of the assessments of exchange rate policy and of the staff's policy advice in the consultations in the sample. The evidence from the consultations, with countries grouped by type of exchange rate arrangement, is reviewed in more detail in the Annex.

II. Considerations Underlying Exchange Rate Policy Assessments in Staff Reports

The review of the consultations in the sample suggests that the staff's assessments of exchange rate policy were framed with particular regard to the magnitude of the recent and prospective financial imbalances and external payments problems of the member concerned. 1/ Accordingly, the assessments were invariably based on an evaluation of the underlying imbalances and on evidence regarding relative cost/price distortions.

Key indicators of imbalances and distortions on which assessments 2/ were based usually included the fiscal and external current

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1/ Although a theoretical analysis of exchange rate policy issues does not feature prominently in staff reports, the general approach adopted is consistent with a range of standard open economy models--see "Theoretical Aspects of the Design of Fund-Supported Adjustment Programs" (SM/86/162, 7/2/86); and SM/90/198 (10/16/90).

2/ Assessments have been classified into three groups: favorable, neutral, and critical (including mildly and severely critical). In individual cases, the classification was based on a review of the staff appraisal in the consultation report, the minutes of the Executive Board in concluding the consultation, and the Chairman's Summing Up. Inevitably, a degree of judgement is involved, especially as exchange rate policy was not always dealt with explicitly. However, severely critical assessments were usually forthright. In a considerable number of cases, mainly when the prevailing institutional arrangements seemed to preclude any change in the nominal parity, the staff did not explicitly express a positive or negative view on the exchange rate policy; the assessments in these cases are classified as "neutral."

account deficits, the growth rates of monetary and credit aggregates, the inflation rate, the real effective exchange rate, the terms of trade, and the rate of economic growth, including sectoral growth patterns. In general, a negative assessment of exchange rate policy was more likely to be made in the case of members where one or more indicators of fiscal and current account deficits, domestic rate of inflation, terms of trade deterioration, and appreciation of the real exchange rate were in the highest range (Chart 1). 1/ The relationship between monetary and price indicators and the assessment of exchange rate policy across sample consultations, however, is less straightforward, with a higher proportion of favorable assessments for countries with intermediate inflation rates and rates of monetary growth than for countries in the lowest categories for those two indicators. 2/ In large part, this outcome is the result of the substantial number of neutral assessments for members (mostly CFA franc countries) where low rates of monetary growth and inflation were combined with fiscal imbalances and weak economic growth (see Annex). But it also reflects favorable assessments for countries with moderate rates of monetary expansion and inflation that achieved a significant reduction in fiscal and external imbalances. In many of these cases (for example, Bolivia, Ghana, and Yugoslavia), a flexible exchange arrangement or flexible management of a pegged arrangement offset the effects of domestic inflation and enabled external competitiveness to be maintained.

The thrust of the staff's policy advice in cases where imbalances were small was that reliance should be placed on appropriiate budgetary and monetary policies to restore or maintain a sustainable balance of payments free of current account restrictions. Explicit discussion of the use of the exchange rate as a nominal anchor, however, was presented in only two staff reports (Iceland and Israel) during the period under review. Where imbalances were large, and especially where downward flexibility in wages and prices was judged to be limited, exchange rate policy was generally regarded as having a role in limiting the cost of the required adjustment in terms of foregone output and social dislocation. At the same time, the staff invariably took the view that any exchange rate action should be supported by tight fiscal and monetary policies and, in many instances, also by structural measures.

From an operational standpoint, the real effective exchange rate was targeted as a program variable in most arrangements supported by the use of Fund resources covered by the sample. 3/ In practice, this has

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1/ See also Annex Tables 1 and 3.

2/ There was a similar relationship between the incidence of favorable assessments and developments in the terms of trade. This reflects, in part, the fact that some countries with large terms of trade gains had not adopted adequately restrictive financial policies (Paraguay, Peru, Zaire, and Zambia).

3/ For example, in the cases of Algeria, Bolivia, Chile, Costa Rica, Ghana, Nepal, Pakistan, Tanzania, and Zaire.

involved adjusting the nominal exchange rate periodically to offset some or all of the real effective appreciation that had occurred from a base date. Also, in some cases (for instance, Bangladesh and Ghana), a rule was applied that involved the adjustment of the official exchange rate to bring it closer to the rate in the parallel exchange market.

It has become increasingly clear that rules based on indicators of the real effective exchange rate and the exchange rate premium in the parallel market carry an inherent risk of inflation when financial policies are expansionary. 1/ To the extent that this exchange rate policy has generally been formulated together with restrictive financial policies, the risk of generating a high rate of inflation is minimized. Also, in some cases (Costa Rica, Pakistan, and Zaire) the real exchange rate target was applied with reference to an official exchange rate that even after the initial adjustment remained overvalued in relation to that in the parallel exchange market, thereby limiting the risk of overdepreciating the real exchange rate and engendering a spiral of rising prices and exchange rate depreciation. 2/ Nevertheless, there are indications that in certain cases the adoption of real exchange rate rules may have contributed to the inflation process and, of course, in those cases in which budgetary and monetary policies were weaker than designed, the real exchange rate rule, while tending to protect the external sector did so at some cost to domestic inflation.

The review of the consultations suggests that in applying the above approach to assess exchange rate policy, consideration was given to the specific economic and institutional environment prevailing in the member country, which has varied between industrialized and developing countries (as well as within each of these groups), and to whether it maintained a fixed exchange rate regime or one with greater flexibility. In general, the staff tended to work within the authorities' preference for a particular type of exchange arrangement, usually the one in place, and this was reflected in the mix of adjustment policies recommended. 3/ For example, in the cases of countries where exchange arrangements were thought to preclude a change in the exchange rate (e.g, members of currency unions), the burden of adjustment had to fall on budgetary and monetary policies and structural measures (including incomes policies)

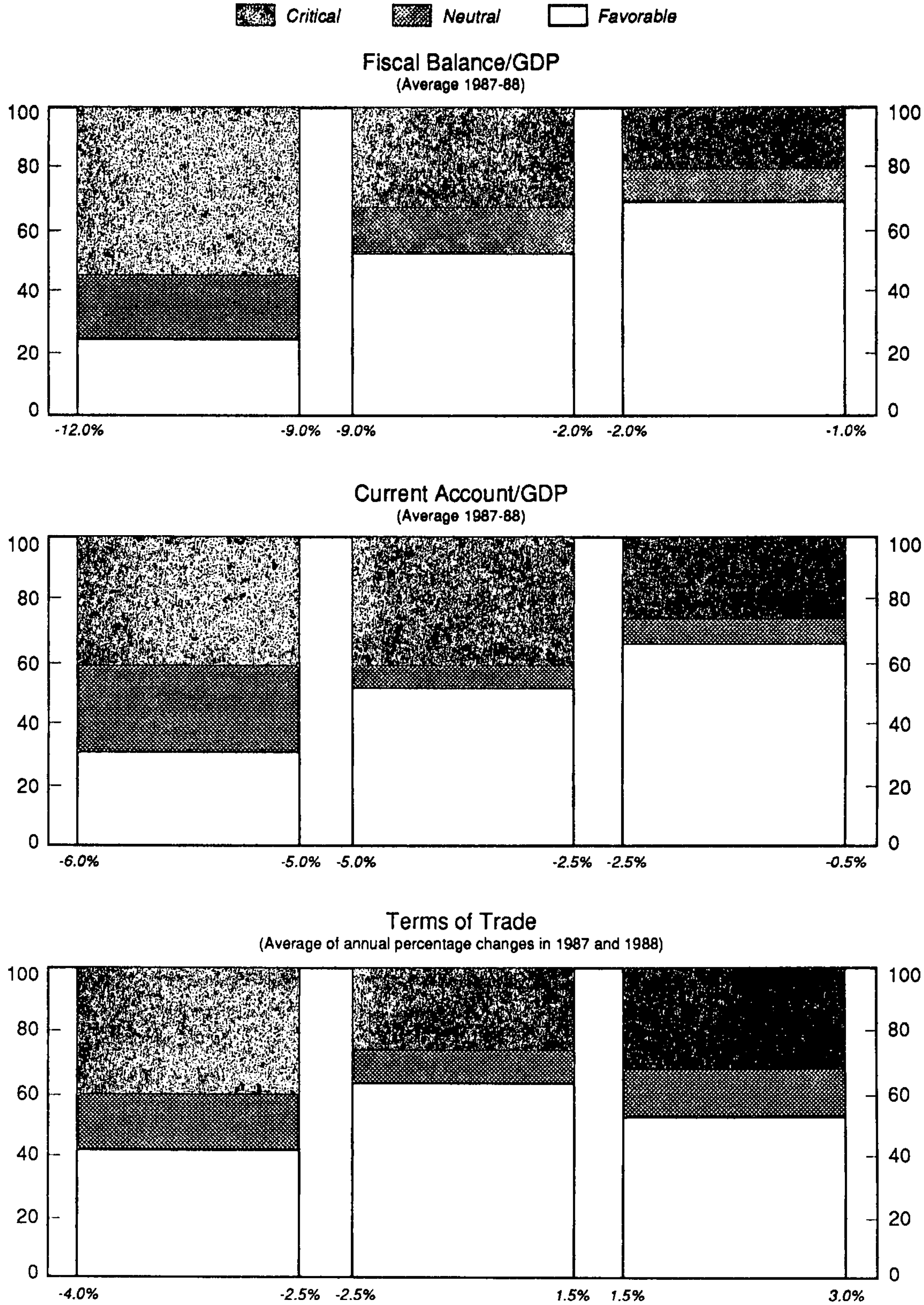
1/ For an analysis of inflationary implications of real exchange rate rules see the accompanying paper "Analytical Issues Relating to Fund Advice on Exchange Rate Policy" (SM/90/198, 10/16/90).

2/ Changes in the official exchange rate in such circumstances may have a limited impact on the price level because the domestic prices of goods imported at the official exchange rate are likely to have already been driven up by shortages. In the case of goods distributed at controlled prices, the underlying demand pressures would be reflected in prices in black or grey markets.

3/ Because the review is based on consultations concluded at a point in time, it is not possible to analyze the experience of specific countries that chose to change their exchange regime over time.

CHART 1A

Assessments of Exchange Rate Policy as Related to Financial Indicators[1]

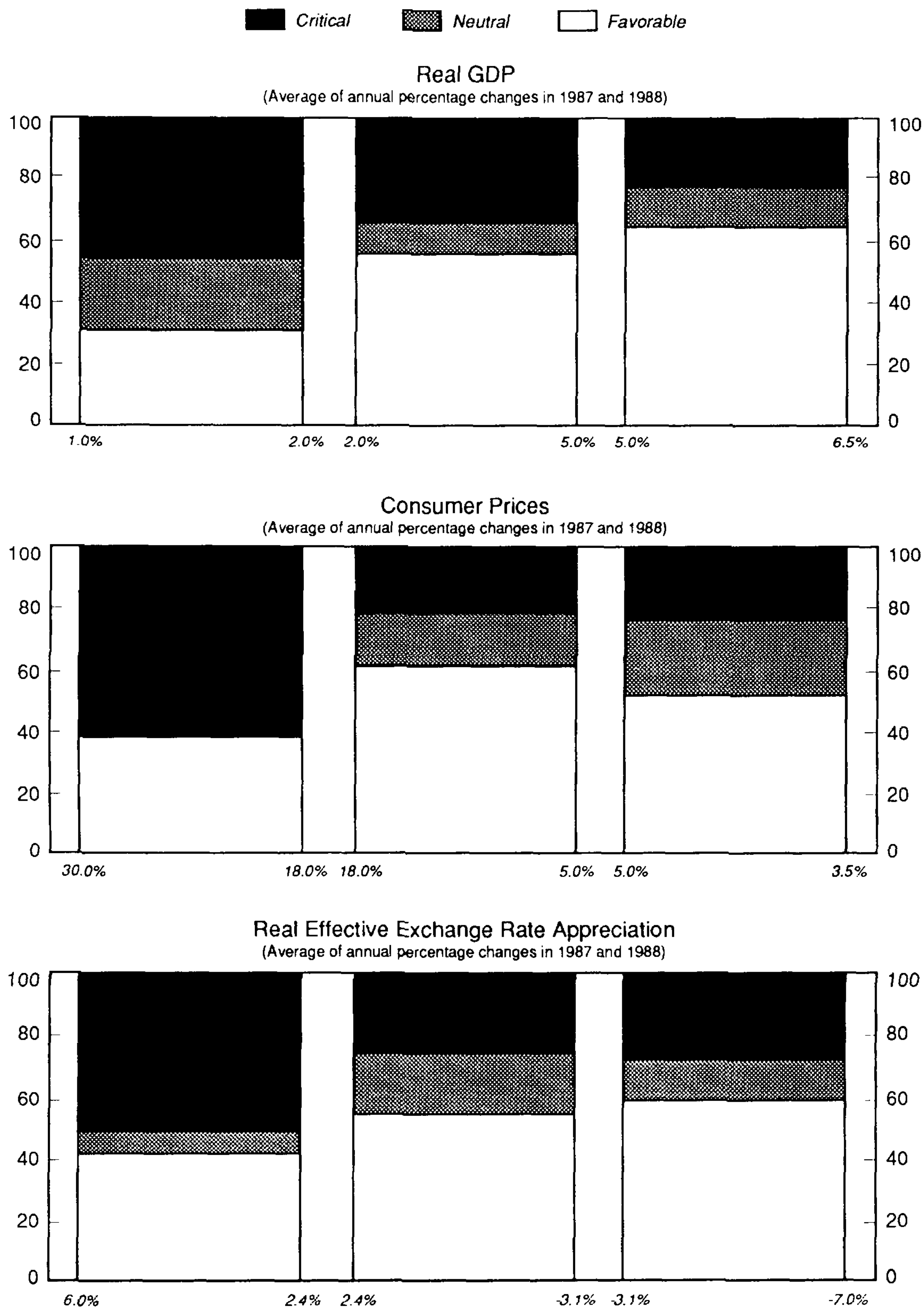


Source: Staff estimates.

[1] Charts display the characterization of staff assessments of members' exchange rate policies as portrayed in the staff reports of 100 consultations concluded between July 1988 and June 1989. Assessments take into account a broad range of variables including cost/price distortions and are not determined by any single aspect of macroeconomic policy.

CHART 1B

Assessments of Exchange Rate Policy as Related to Financial Indicators[1]



Source: Staff estimates.

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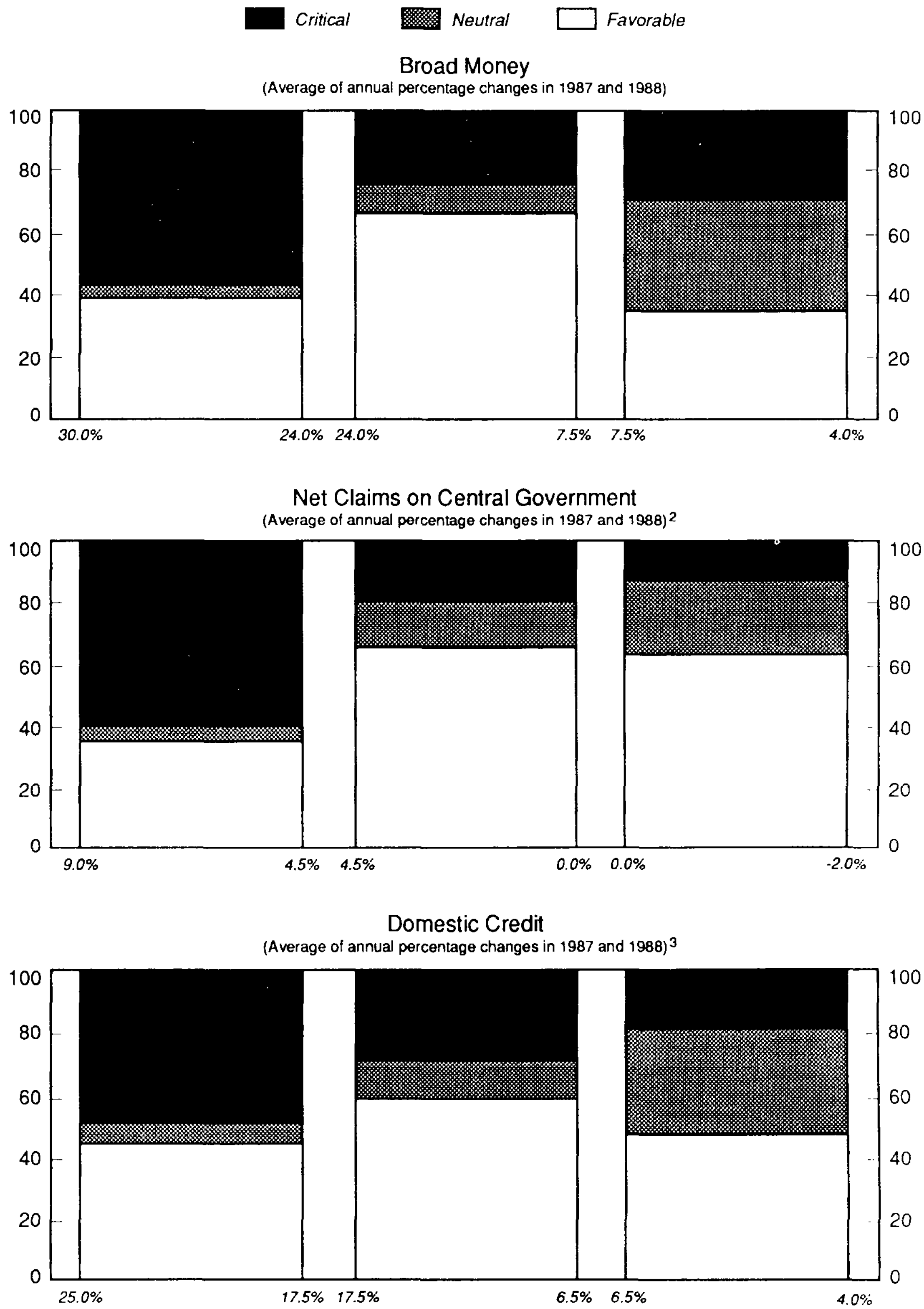
CHART 1C

Assessments of Exchange Rate Policy as Related to Financial Indicators[1]



Source: Staff estimates.

[1] Charts display the characterization of staff assessments of members' exchange rate policies as portrayed in the staff reports of 100 consultations concluded between July 1988 and June 1989. Assessments take into account a broad range of variables including cost/price distortions and are not determined by any single aspect of macroeconomic policy.

[2] Mean of change in ratios of net claims on central government to broad money (end of period, 1987-88).

[3] Mean of change in ratios of domestic credit to broad money (end of period, 1987-88).

that would help to contain costs and improve competitiveness. Only in a few instances in the context of Fund-supported programs, where the extent of the price distortions was large and the credibility of the existing arrangement severely strained, were changes in exchange regimes recommended to facilitate the necessary elimination of distortions and adjustments in the nominal exchange rate. The nature of the staff's policy advice also reflected the administrative capacity, structural features (such as wage indexation practices) and political preferences of the member country, as well as the size of its financial imbalances. Accordingly, the emphasis on structural features varied widely.

The evidence from the consultations reviewed indicates that the criteria applied in making exchange rate policy assessments where the member was using Fund resources were the same as for nonprogram countries. Where a lack of symmetry between program and nonprogram countries does appear to have arisen is in the practical implementation of the Fund's policy advice. For example, the staff recommended an exchange rate adjustment to correct a large overvaluation in the cases of 12 countries with exchange rate regimes classified as fixed, but the authorities agreed to the measure in only 2 instances (Guatemala and Guyana) both in the context of Fund programs. However, for the reasons discussed in the context of the recent review of surveillance over members' exchange rate policies, the Fund's influence is inevitably greater in those countries subject to conditionality on the use of its resources.

III. Overview of Assessments and Policy Recommendations

In about one half of all the consultations, the members' exchange rate policies received an explicit endorsement by the staff and the Board. Such favorable assessments usually involved countries with relatively small financial imbalances and limited distortions in the domestic incentive structure and which had achieved satisfactory economic growth. In these cases, the staff considered that a competitive real exchange rate and a sustainable balance of payments in the medium term could be achieved or maintained on the strength of the prevailing stance of policies.

There were exceptions, however, to this general pattern. Some countries with large imbalances received an endorsement for their policies because there was evidence of a commitment to a strong package of macroeconomic and related structural measures, usually in combination with an exchange rate action or a flexible policy of periodic exchange rate adjustments to correct the underlying overvaluation. 1/ But flexibility per se was not sufficient for an endorsement of policies;

1/ Consultations carried out in the context of Fund-supported programs frequently fell in this category.

there were a few instances in which it was noted that although a market-determined or floating exchange rate system was in place, financial discipline and/or policy credibility were insufficient to stabilize expectations (e.g., Lebanon and Zambia). Also, exchange rate policies in several countries with small recorded imbalances were negatively assessed because of the presence of rigid price controls and extensive trade and exchange restrictions (e.g., El Salvador and Syria).

Critical assessments of the exchange rate policies were usually made against a background of adverse trends in competitiveness, significant financial imbalances, and cost-price distortions. In these cases, the evaluation of the country's medium-term prospects indicated that the present stance of policies was not sustainable. Generally, the authorities of the member concerned were urged to tighten monetary and fiscal policies and, in a number of cases, to consider adjusting the exchange rate to restore competitiveness.

The staff gave severely critical assessments of exchange rate policies (17 out of the 100 consultations reviewed) where there were large financial imbalances and/or major structural problems. Typically, these had resulted in a seriously overvalued currency and a fundamentally weak balance of payments position supported by complex exchange and trade restrictions. The majority of these countries were characterized during 1987-88 by fiscal deficits in excess of 10 percent of GDP, current account deficit to GDP ratios above 8 percent, annual broad money growth rates above 25 percent, and consumer price inflation in many cases above 30 percent at an annual rate.

In most of these cases, the basic cause of the financial difficulties was excessive government expenditure relative to domestic savings. In some countries, this resulted in an excessive external debt build-up with attendant debt servicing problems. Also, in several cases, recourse was made to monetary financing of the fiscal deficit, especially after autonomous foreign borrowing had been exhausted, resulting in high rates of inflation. Moreover, fiscal imbalances and inflationary pressures were in many instances exacerbated by wage policies under which compensation was driven by institutionalized indexation rules (Poland) or ad hoc wage settlements and government decrees (Nicaragua, Peru, Suriname).

Where the exchange rate regime tended toward greater fixity, rapid inflation had yielded appreciation of the real effective exchange rate as the domestic price level rose relative to that in major trading partners, while the nominal value of the currency was administratively maintained by the authorities (Syria, Tanzania). Such a real exchange rate appreciation, in the context of restrictive exchange regimes, fostered activity on parallel exchange markets where market rates depreciated to levels that were sometimes multiples of the fixed official exchange rate (Nicaragua, Peru). 1/ On the other hand, in cases where flexible exchange arrangements were in place, there was a continuing nominal depreciation at a speed depending, inter alia, upon the country's relative price performance and the market assessment of the economic fundamentals. This may have added to inflationary pressures in periods when financial policies have been expansionary (Zambia, Zaire). Official intervention in exchange markets to support the currency in some cases, however, resulted in an increased divergence between official and parallel exchange rates and appreciation of the real effective exchange rate (Dominican Republic, Zaire).

In those countries where exchange rate policies were assessed in a severely critical manner, the staff generally stressed the need for a comprehensive policy package involving financial and structural measures as well as exchange rate action. Major emphasis was often placed on reducing budgetary imbalances and on tightening monetary policy and the maintenance of positive real interest rates. Trade and price liberalization and, in some cases, the deindexation of wages, were structural measures commonly emphasized. In conjunction with these policies, the goal of the proposed exchange rate policy was to eliminate distortionary exchange restrictions and to allow the real exchange rate to move to an equilibrium level in a unified market.

The sample also contained a considerable number of "neutral" assessments in the sense that the staff did not explicitly express a positive or negative view on the exchange rate level because the institutional arrangements were presumed to preclude any change in the nominal parity. However, in a number of these cases the staff emphasized the need to improve export competitiveness by pursuing adequate fiscal and incomes policies and by liberalizing foreign trade and domestic pricing mechanisms. This was usually the case in those consultations (15 percent of the total) where the country concerned was a member of a currency union and a unilateral exchange rate policy decision was thought not to be possible (see below).

Most of the consultation reports in the sample included an explicit staff assessment of the appropriateness of the member's exchange rate policy broadly defined. However, the review found that in a significant number of cases such assessments were oblique or subsumed in the general discussion. Although these reports generally contained useful information bearing on the appropriateness of the exchange rate, they did not draw the various elements together in such a way as to provide an explicit justification for the staff's assessment or to indicate the extent to which alternative adjustment measures had been considered. In particular, within the staff's general approach to assessing the

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1/ It might be noted that in a number of cases exchange losses, derived from official efforts to support the nominal rate often through the use of multiple exchange systems, rose in tandem with widening differentials between controlled and parallel market exchange rates.

exchange rate policies of members, there appears to be a need to address more directly such specific issues as the merits of using the exchange rate as a nominal anchor for tight financial policies; the rationale for maintaining or reforming the prevailing exchange rate regime; the considerations underlying the steps proposed for correcting an overvalued exchange rate and preventing repeated depreciations; and the implications of the exchange rate policy recommended for the path of inflation.

Concerning the views of Directors and the authorities, the Board was generally in agreement with the staff's assessment of exchange rate policy and with its policy recommendations. However, in some cases, the Board felt that the staff could have provided more analysis and been more explicit in its views on the need for exchange rate action or flexibility, or on the need to unify exchange markets. In other instances, the Board advocated the use of the exchange rate as an anchor and to support it by a faster pace of adjustment through fiscal consolidation.

The authorities also concurred with the staff's assessments and policy recommendations in most cases, although their views differed from those of the staff on a significant number of occasions. Where the authorities disagreed with the staff, it was frequently because they preferred a slower pace of adjustment, or because they were not ready to implement the required package of measures. Also, in some cases, despite the proposed tightening of financial policies suggested by the staff, the authorities were reluctant to take the accompanying exchange rate action because of concern about its direct impact on inflation.

The relationship between the assessment of exchange rate policy and the type of exchange rate regime may also be of interest, although it should be borne in mind that in some cases the exchange rate policy actually implemented did not correspond closely with the Fund's categorization of the exchange arrangement (see Annex). The exchange rate policies of countries with fixed regimes received critical assessments in 41 percent of the consultations against 33 percent favorable and 26 percent neutral assessments. As reported in Annex Tables 1 and 3, the group of countries maintaining fixed exchange rate regimes registered higher external and financial imbalances, although lower inflation, in 1987-88 than those countries with more flexible arrangements. For the latter group, favorable assessments of exchange rate policy were made in 74 percent of the consultation reports. 1/ It is worth noting that in all cases, the staff's assessments took account of the need to correct underlying price distortions and/or to reduce reliance on restrictive trade and exchange controls. Where fixed exchange rates were adjusted or flexible regimes were adopted to

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1/ The cross-section analysis of one round of consultations with members presented here does not permit conclusions to be drawn which would require an analysis over time.

facilitate the elimination of such distortions, the staff has generally made a positive assessment of the exchange rate policy in place.

The record of the authorities in maintaining firm monetary and fiscal policies and in following appropriate structural policies is no doubt much more important for the achievement of an adequate level of competitiveness and a sustainable external position than the type of exchange arrangement in place. 1/ Also, other developments, such as large adverse terms of trade changes, increases in international interest rates and natural disasters, have played a significant role in the economic performance of a number of member countries whatever the type of exchange arrangement adopted. But it remains the case that where imbalances and price distortions were large the flexibility of exchange rates widened the range of corrective instruments available to the authorities. At the same time, the costs of a policy of frequent exchange rate depreciation to facilitate external adjustment, namely, its likely consequences for the price level, would have to be taken into account.

1/ The question of the relationship between type of exchange arrangement and financial discipline is not assessed in this paper. See SM/90/198 (10/16/90) for a discussion of the theoretical considerations involved.

Review of Experience

This Annex examines in more detail the consultations in the sample, organized for presentational purposes into groups by type of exchange rate arrangement. For each category, the assessments of exchange rate policy are viewed against the background of the general economic performance of the group.

The main categories of arrangements are: fixed exchange rate regimes, including single currency and composite pegs; and flexible exchange rate systems including managed and independently floating regimes, crawling pegs, and those currencies that are members of the European Monetary System. 1/ However, as mentioned earlier, it should be noted that these categories do not always correspond to distinctions that are clearcut in practice. Some countries whose exchange rates are classified as fixed, manage the rate flexibly over some periods. One could argue that "crawling peg" regimes should be classified under fixed rather than flexible exchange rate arrangements, because the announcement of a single fixed rate is only a special case of a policy of crawling along a predetermined path of fixed exchange rates. 2/ Other countries with arrangements classified as flexible, intervene to keep the nominal exchange rate relatively rigid, or achieve low exchange rate variability through restrained and credible financial policies. In addition, a currency that is pegged to another currency or to a basket, could be effectively floating with respect to third currencies, further blurring the distinction between categories. These considerations notwithstanding, the classification represents a convenient way to group member countries for the purpose of the review.

1. Fixed exchange rate arrangements

During the period under review, Article IV consultations were concluded with 63 countries with relatively fixed exchange regimes where their currencies were pegged either to a single major currency or to a basket of currencies (Tables 1 and 2).

1/ As of December 31, 1989, the Fund membership consisted of 152 countries with the following exchange arrangements: 33 countries were pegged to the U.S. dollar; 14 countries to the French franc; 5 countries to other individual currencies; 12 countries to the SDR; and 32 countries to other currency composites. These 96 countries could be said to have fixed exchange regimes. The remaining 56 countries could be said to have flexible exchange systems: 18 countries independently floating; 24 countries with managed floating; 5 countries with crawling pegs (indicators); and 9 countries in the cooperative arrangement of the exchange rate mechanism of the European Monetary System.

2/ However, when the crawl is not strictly guided by a predetermined path, or determined by inflation differentials or the spread between official and parallel market rates, the "crawling peg" regime is better classified as a flexible regime.

Table 1. Economic Performance in Fixed Exchange Regimes 1/

(Average of 1987-88)

	All Regimes Total 2/	Fixed Exchange Regimes					
		Total	Single Currency Pegs				Composite Pegs
			CFA	ECCB	SACMA	Other	
Developing countries							
a. GDP annual growth	3.8	2.5	0.0	5.7	5.7	1.3	4.0
b. Consumer price change	17.0	12.1	1.9	3.0	11.2	20.5	11.8
c. REER	-4.9	-3.1	-2.5	-4.8	-1.1	-0.6	-6.1
d. Terms of trade change	-0.7	-1.1	-4.0	-2.4	0.9	-0.5	0.1
e. Fiscal deficit/GDP ratio	-6.1	-7.8	-7.1	-4.8	-2.2	-9.1	-8.7
f. Current account/GDP ratio	-3.5	-4.5	-7.7	-11.7	3.0	-3.0	-3.9
g. Broad money growth	20.0	12.2	0.7	15.4	23.9	14.6	14.0
h. Net claims on government 3/	13.0	6.8	-2.3	-7.6	-16.9	-3.0	25.6
i. Domestic credit 3/	16.2	10.8	1.7	5.9	14.9	16.8	11.1
Industrial countries							
a. GDP annual growth	3.3	2.9	--	--	--	--	2.9
b. Consumer price change	6.9	9.8	--	--	--	--	9.8
c. REER	1.8	3.1	--	--	--	--	3.1
d. Terms of trade change	0.0	0.5	--	--	--	--	0.5
e. Fiscal deficit/GDP ratio	-1.6	0.6	--	--	--	--	0.6
f. Current account/GDP ratio	-1.3	-2.9	--	--	--	--	-2.9
g. Broad money growth	13.4	16.5	--	--	--	--	16.5
h. Net claims on government 3/	6.2	14.6	--	--	--	--	14.6
i. Domestic credit 3/	22.3	30.1	--	--	--	--	30.1

Source: Staff estimates.

1/ Based on consultations concluded between July 1988 and June 1989, using unweighted average values for 1987 and 1988. Annual percetnage change unless noted otherwise.

2/ Comprising all countries during the observation period with both fixed and flexible exchange regimes.

3/ Change during last year as a percentage of beginning of period broad money.

Table 2. Assessment by Type of Fixed Exchange Regime 1/

(Average 1987-88)

Assessment of Exchange Rate Policy 2/	Total Number of Countries	Fixed Exchange Regimes: Total (Percentage)	Single Currency Pegs: CFA (Percentage)	Single Currency Pegs: ECCB (Percentage)	Single Currency Pegs: SACMA (Percentage)	Single Currency Pegs: Other (Percentage)	Composite Pegs (Percentage)
Developing countries	59	100.0	100.0	100.0	100.0	100.0	100.0
Favorable	17	28.8	--	25.0	--	22.7	55.0
Neutral	15	25.4	81.8	75.0	100.0	4.5	--
Critical	12	20.3	18.2	--	-	27.3	20.0
Severely critical	15	25.4	--	--	--	45.5	25.0
Industrial countries	4	100.0	--	--	--	--	100.0
Favorable	4	100.0	--	--	--	--	100.0
Neutral	--	--	--	--	--	--	--
Critical	--	--	--	--	--	--	--
Severely critical	--	--	--	--	--	--	--

Source: Staff estimates.

1/ Based on consultations between July 1988 and June 1989, using unweighted average values for 1987 and 1988.
2/ Thrust of the assessment of exchange rate policy contained in the staff appraisal of the Article IV consultation staff report.

a. Single currency pegs

Consultations were held with 22 of the 31 members maintaining a single currency peg (excluding members of currency unions) during the observation period. They generally took place against a background of relatively weak economic performance that was characterized by slow growth and sizeable financial imbalances. The average growth rate of real GDP of the group was 1.3 percent in 1987-88, a decrease from 2.1 percent per year during 1984-86, and the lowest of all groups. The slow growth was associated with a decline in terms of trade averaging almost 1 percent annually throughout the 1980s. At the same time, budgetary pressures were reflected in fiscal deficits that averaged 9.1 percent of GDP in 1987-88 and that were largely covered by money creation. Consequently, the average inflation rate of the group rose to an annual average of 21 percent in 1987-88 from 11.5 percent in the previous three years, while the current account deficit to GDP ratio worsened to 3.0 percent per year between 1987-88 from 2.4 percent per year in 1984-86. On average, the currencies of these countries depreciated in real effective terms by less than 1 percent per year during 1987-88.

The circumstances and economic performance of individual countries varied within the group. Some countries had pursued generally prudent macroeconomic policies and implemented structural reforms to reduce their vulnerability to external shocks, improving their prospects for the medium term (Dominica and United Arab Emirates). The majority of countries, however, had large fiscal deficits that were deemed to be at the center of their macroeconomic problems and that were exacerbated in many instances by inappropriate or inadequate incomes policies. In these cases, the expansionary domestic policies manifested themselves in large losses in international reserves (Belize, Lesotho, and Yemen Arab Republic), or the accumulation of external arrears (Grenada, Guatemala, Panama, and Syria), and, in some instances, had led to an appreciation of the real exchange rate (Antigua and Barbuda and Belize). Moreover, in some countries with especially large financial imbalances (Guyana, Mozambique, Nicaragua, Peru, Sao Tome and Principe, Tanzania, Uganda, and Zambia), the monetary financing of their public sector deficits, along with wage/price indexation or accommodative incomes policies, had resulted in high rates of inflation and a sharp real exchange rate appreciation, the emergence of large parallel exchange rate market premia, the tightening of restrictions on international transactions, declining or stagnant output, and severe balance of payments difficulties including accumulation of external arrears.

Staff assessments of exchange rate policy for countries pegged to a single currency were diverse. In about one half of the consultations in the group, including where imbalances were small, price distortions were not severe, and prudent macroeconomic policies were being pursued, the assessment of the level of the exchange rate was either favorable or neutral. In addition, such assessments were also given for some of the members of the Eastern Caribbean Monetary Union (Antigua and Barbuda and

St. Vincent) where the depreciation of the U.S. dollar during 1985-87, combined with prudent wage policies, had fostered an improvement in competitiveness. The assessment was also favorable for some countries that had begun to redress existing imbalances in the context of a program with the Fund by, inter alia, adjusting the nominal parity (Guyana) or unifying the exchange rate markets (Guatemala).

In the other half of the consultations, the staff's assessment of exchange rate policies was mildly or severely critical. In these cases, the nominal parity was typically being sustained by restrictions on the use of official foreign exchange and by accumulation of arrears on external debt. In about half of these latter cases the staff assessment was more critical than it had been in the previous consultation because domestic price and wage increases had hindered export competitiveness (Belize), financial imbalances had deteriorated markedly (El Salvador, Liberia, and Peru), foreign exchange market distortions had increased as a result of the suspension of an auction market (Zambia), or because of the failure to reduce the spread between the official and the parallel market exchange rates as envisaged in the context of a Structural Adjustment Facility program (Mozambique).

The policy recommendations offered to countries maintaining this type of exchange rate regime varied according to the circumstances. In general, however, where the staff assessment of exchange rate policy was favorable or neutral, the authorities were advised to pursue policies of fiscal and wage restraint (Antigua and Barbuda, Grenada, Guatemala, Lesotho, Panama, St. Vincent, and Swaziland) to ensure that the exchange rate remained--or became--competitive. Where the magnitude of the imbalance was substantial and the official peg was judged to have led to distortions in the domestic price and incentive structure, the policy advice was for a tightening of fiscal and monetary policies supplemented by either a step devaluation of the official exchange rate (El Salvador, Ethiopia, Mozambique, Syrian Arab Republic, and Yemen Arab Republic), a unification of exchange markets (Guyana, Liberia, Paraguay, and Peru), or a flexible policy of implementing the required depreciation of the exchange rate through periodic adjustments (Nicaragua, Trinidad and Tobago, Uganda, and Zambia). In those latter countries where a continued depreciation of the exchange rate was proposed, the overriding concern was to reduce a substantial overvaluation of the currency. At the same time, heavy emphasis was placed on the need for restrained financial policies to reduce inflationary pressure. In a large number of cases, the staff also recommended structural reforms designed to deregulate the economy, improve efficiency, and encourage private sector activity.

While the Board generally concurred with the staff assessment of exchange rate policy, the authorities agreed with the staff assessment and recommendations in less than half the cases. The authorities' differences of view mainly concerned the proposed pace of exchange rate action, but in several instances they also disagreed with recommendations on exchange rate and aggregate demand policies (Ethiopia, Liberia, Peru, and Zambia).

b. Monetary unions

For 23 members whose exchange rates are classified as fixed, the rates are pegged in the context of either a monetary union or shared common institutional arrangements thought to preclude a unilateral change in the nominal parity as a policy tool. When a policy correction is deemed necessary in such cases, almost the entire burden of the adjustment falls on fiscal policy instruments and other cost-reducing measures in conjunction with monetary policy. Consultations were concluded with 17 of these members during the period July 1988 through June 1989. In most of the consultations, there was a neutral assessment by the staff in the sense that the appropriateness of the real exchange rate level was not treated explicitly. 1/

i. French franc peg

During the period under consideration, the Board concluded consultations with 11 of the 14 countries whose exchange rates are pegged to the French franc. These countries are grouped together because, aside from geographical location, they share several common characteristics: their nominal parities have been pegged to the French franc at a fixed rate unchanged since 1949; and monetary policy is conducted by two common central banks for all but one of these countries (Comoros).

This group of countries experienced the largest terms of trade deterioration of all categories, declining on average by 6.6 percent per year during 1984-86 and by 4 percent per year during 1987-88. Because of rigidities in prices and wages as well as in exchange rates, the deterioration in the terms of trade had a sizeable adverse impact on employment and output growth: output virtually stagnated. However, for the group as a whole, there was 2 percent annual inflation during 1987-88, the lowest inflation of all country groups. The low inflation enabled the real effective exchange rate to depreciate by 2.5 percent per year during 1987-88.

1/ Lesotho and Swaziland, members of the Common Monetary Area (SACMA) which is an exchange control territory also comprising South Africa, have pegged their currencies to the South African rand at par. Both countries concluded consultations during the observation period. As in the case of other currency areas, exchange rate policy was not treated explicitly in the consultation reports. The staff appraisals underscored the limited scope for independent policy action as a result of the currency arrangement and the heavy burden placed on fiscal policy.

At the same time, government revenues were adversely affected by lower revenues from the foreign trade sector, while public expenditure levels were not sufficiently scaled back. Consequently, the average fiscal deficit widened from 5.8 percent of GDP in 1984-86 to 7.1 percent of GDP during 1987-88. Reflecting the weak fiscal position, the external current account deficit averaged 7.7 percent of GDP during 1987-88, the highest of all groups. Also, external arrears accumulated in a number of cases, and relative price distortions arose as a result of quantitative restrictions on international trade or price controls.

Consultation reports addressed the question of competitiveness in the context of the financial policies pursued and the persistent terms of trade losses experienced by this group of countries. Only in the consultation with Gabon was there a critical reference to the burden placed on other policy instruments by the exchange arrangement. But although exchange rate policy was not specifically discussed in most cases, many reports highlighted the fragility of the external situation and the need to enhance the profitability of exports. In order to improve the competitiveness of export sectors, recommendations were made to liberalize domestic procurement and marketing activities and to reform agricultural marketing boards and public enterprises so as to increase their productivity and cost efficiency. In some cases, trade liberalization was also emphasized.

In all cases, public sector deficits were a major source of concern and the staff recommended the implementation of tighter fiscal policies. The authorities were also urged to complement the fiscal effort by firm incomes policies so as to enhance or protect the competitiveness of the tradeable sector and stimulate export diversification. Such policies were to be supported by reforms to strengthen the performance of public enterprises and thereby make the fiscal adjustment more durable, and to reduce vulnerability to terms of trade shocks. These measures included, inter alia, price decontrol, privatization, enterprise audits, the introduction of new foreign investment legislation, and changes in regulatory frameworks.

In all cases the Board concurred with the staff assessment and, in most cases, the authorities also agreed with the staff's views. When the authorities' views differed from those of the staff (e.g., Comoros and Congo), it was because they preferred to pursue the suggested financial policies in a more gradual fashion.

ii. East Caribbean Central Bank

Seven Fund members in the Caribbean region use a common currency issued by the East Caribbean Central Bank (ECCB), and consultations were held with four of these countries during the observation period. The economic performance of the group was mixed during 1987-88. Economic growth was moderate, inflation relatively low, and the real effective exchange rate depreciated by an annual average of about

5 percent. However, fiscal imbalances were large and the external current account deficit was about 12 percent of GDP for the group.

In three of the consultations, as in most of the currency union countries described above, there was no explicit staff assessment of exchange rate policy (Antigua and Barbuda, Dominica, and Grenada). However, there was an endorsement of the exchange policy of St. Vincent, where economic performance had been somewhat better than the average of the group. Moreover, the appraisal was more favorable than at the time of the previous consultation when it had been felt that there was a need to review the appropriateness of the exchange rate level. However, in all cases the staff's views, endorsed by the Board, emphasized the importance of containing wage and fiscal pressures to maintain internal and external balance.

c. Exchange rates pegged to a composite

Fund members accounting for 26 percent of the membership (the largest group), peg their currency to a basket. Some of these countries peg to the SDR, but in most cases they have chosen to peg to a basket comprising the currencies of major trading partners.

The Board concluded consultations with 24 of these members--62 percent of the total with this type of exchange arrangement--during the period under consideration. For this group, the average growth rate increased marginally during 1987-88 to 4 percent per year from 3.9 percent per year in the previous three years. However, fiscal deficits widened from 6.9 percent of GDP per year in 1984-86 to 8.7 percent in 1987-88, one of the highest ratios among country groupings. The lax fiscal policy was accompanied by accommodative monetary policies that resulted in rising inflation. Excluding Israel, whose within-year inflation rate was 445 percent in 1984 and 185 percent in 1985, the average inflation rate for this group increased from 8 percent per year in 1984-86 to almost 12 percent per year in 1987-88. However, despite the increase in inflation, the real effective exchange rate depreciated by an annual average of 6.1 percent during 1987-88 (also excluding Israel). This was facilitated by several factors, including the U.S. dollar depreciation during the period and exchange rate adjustments in some countries to offset inflation differentials.

Even though the group as a whole was characterized by rising inflation, some countries had both maintained a stable macroeconomic environment and achieved rapid growth (Botswana, Malaysia, Singapore, and Thailand). Consultation discussions in such cases focused on structural problems that could undermine competitiveness over the medium term. For the majority of countries though, fiscal consolidation was a major policy concern. Moreover, most of these countries were particularly vulnerable to negative external shocks because of their limited export diversification. In fact, in about half of the cases where fiscal policy was already a source of concern, recent terms of trade deteriorations or natural disasters had also occurred (Bangladesh, Kenya, and Solomon Islands). In a few other cases, the macroeconomic situation was under strain from severe balance of payments problems Poland, Sao Tome & Principe and Rwanda), the accumulation of external arrears, parallel market premia, and high rates of inflation.

The staff assessment of exchange rate policy for this group was favorable or neutral in 16 out of the 24 countries. In most cases this represented no change with respect to the previous consultation. In four cases, however, the current consultation's assessment was more favorable on account of: the easing of restrictions in the foreign exchange market and the authorities' commitment to eliminate the exchange rate differential in the context of a program supported by the Fund (Algeria); the strengthening of fiscal policy to improve competitiveness (Seychelles); the judgement that external competitiveness had improved (the Solomon Islands and Malaysia). When the staff assessment was unfavorable, the reasons included: the use of export subsidies in lieu of exchange rate adjustment (Malta); the maintenance of high real wages that hindered the economy's competitiveness (Papua New Guinea), and the prevalence of macroeconomic imbalances and cost/price distortions together with restrictions on access to the exchange market and a substantial overvaluation of the real exchange rate (Myanmar, Poland, Rwanda, Sao Tome & Principe, and Tanzania).

The nature of the staff's policy recommendations depended on the size of the financial and external imbalances. When imbalances were large and the assessment of exchange rate policy had been strongly critical, the staff recommended a step devaluation of the nominal exchange rate in conjunction with restrictive fiscal and monetary policies and, in some cases, wage restraint (Malta, Myanmar, Rwanda, Sao Tome & Principe, and Tanzania). In other cases, it was recommended that a flexible exchange rate policy be continued (Poland), or that it be implemented if imbalances could not be redressed with wage restraint and cost containment (Papua New Guinea).

In the majority of cases, the staff recommended a continuation of the exchange rate policy being followed by the authorities. Depending upon the circumstances, this implied that: (i) in conjunction with a noninflationary stance of financial policies, the exchange rate continue to be managed flexibly to safeguard the gains in competitiveness that had already been achieved (Bangladesh, Botswana, Fiji, Kenya, Nepal, Papua New Guinea, Seychelles, and Vanuatu), while promoting trade liberalization and structural adjustment in some cases; (ii) the exchange rate remain pegged to the basket (Finland, Iceland, Israel, Norway, Sweden, and Thailand); 1/ or (iii) the exchange rate be allowed to appreciate if necessary to strengthen the credibility of efforts to lower inflation (Malaysia). In all cases, however, the staff emphasized

1/ In the cases of Iceland and Israel, the staff mentioned explicitly the need to use the exchange rate as a nominal anchor.

that the steady pursuit of cautious fiscal and monetary policies was essential for price stability.

The Board and authorities generally concurred with the staff's assessment and recommendations. However, the Board did express somewhat different views to those of the staff in a few cases. Directors felt that excessive weight was placed on monetary policy and that some exchange rate flexibility could be useful in the case of Norway. In other instances, they encouraged the authorities to move faster than planned in narrowing the gap between the official and parallel exchange rates (Algeria and Pakistan). Directors expressed the hope in the case of Israel that the devaluations in 1989 did not represent a move away from the stated policy of nominal exchange rate stability. Also, many Directors indicated that the proposed adjustment and exchange rate policy in the SAF program for Tanzania would need to be strengthened considerably. When the authorities disagreed with the staff views, it was because they preferred smaller exchange rate movements to avoid inflationary consequences (Malta and Papua New Guinea), they were not yet ready to move the exchange rate (Myanmar, Rwanda, and Tanzania), or they were still in the process of formulating an economic program to deal with existing imbalances (Sao Tome & Principe and Poland).

2. Flexible exchange rate arrangements

During the period under review, 37 members maintaining relatively flexible exchange regimes (66 percent of the countries with this exchange arrangement) were considered by the Executive Board in the context of Article IV consultations (Tables 3 and 4). For the developing countries in this group, the average external current account and fiscal deficits in 1987-88 were almost half the size of those of developing countries with fixed regimes, while economic growth and inflation were both substantially greater. The higher rate of inflation, however, was more than offset by the depreciation in nominal exchange rates and, as a result, the REER for the developing countries depreciated by over twice as much as that for those operating with fixed regimes. However, even in cases where a market-determined exchange rate arrangement was considered to be appropriate in providing support to growth and the external payments position, high inflation and accommodating monetary policy were criticized by the staff. However, in these cases, a more explicit analysis of the relationship between high inflation and the flexible exchange rate system would have been appropriate in the assessment.

a. Cooperative arrangements maintained under the European Monetary System

The review covers six of the nine industrial countries participating in the exchange rate mechanism (ERM) of the European Monetary System. Under this mechanism, each member's currency is pegged within margins to the currencies of other members while the foreign exchange markets determine the value of each ERM currency against third currencies.

Table 3. Economic Performance in Flexible Exchange Regimes 1/

(Average of 1987-88)

	All Regimes Total 2/	Flexible Exchange Regimes				
		Total	Cooperative Arrangements	Crawling Peg	Managed Floating	Indendently Floating
Developing countries						
a. GDP annual growth	3.8	5.1	—	4.4	5.4	5.0
b. Consumer price change	17.0	21.7	—	21.4	15.5	35.5
c. REER	-4.9	-6.6	—	-12.2	-6.7	-3.8
d. Terms of trade change	-0.7	-0.3	—	-2.9	-0.5	1.4
e. Fiscal deficit/GDP ratio	-6.1	-4.3	—	-1.3	-4.4	-5.4
f. Current account/GDP ratio	-3.5	-2.4	—	-3.1	-2.1	-2.6
g. Broad money growth	20.0	27.9	—	28.9	20.4	43.6
h. Net claims on government 3/	13.0	19.1	—	7.9	24.6	11.7
i. Domestic credit 3/	16.2	21.6	—	21.1	24.0	16.7
Industrial countries						
a. GDP annual growth	3.3	3.6	3.1	4.2	2.2	4.6
b. Consumer price change	6.9	4.0	1.8	9.6	15.0	3.2
c. REER	1.8	0.5	0.1	-0.5	2.4	1.1
d. Terms of trade change	0.0	-0.4	-1.2	-4.5	3.9	0.8
e. Fiscal deficit/GDP ratio	-1.6	-3.7	-2.6	-10.8	-12.7	-1.3
f. Current account/GDP ratio	-1.3	0.3	1.3	-0.6	-0.5	-0.8
g. Broad money growth	13.4	10.4	7.4	12.4	22.3	11.5
h. Net claims on government 3/	6.2	-2.3	4.2	14.6	9.8	-17.5
i. Domestic credit 3/	22.3	14.6	14.0	8.8	18.1	15.8

Source: Staff estimates.

1/ Based on consultations concluded between July 1988 and June 1989, using unweighted average values for 1987 and 1988. Annual percetnage change unless noted otherwise.

2/ Comprising all countries during the observation period with both fixed and flexible exchange regimes.

3/ Change during the year as a percentage of beginning of period broad money.

Table 4. Assessment by Type of Flexible Exchange Regime 1/

(Average 1987-88)

Assessment of Exchange Rate Policy 2/	Total Number of Countries	Total (Percentage)	Cooperative Arrangement (Percentage)	Crawling Peg (Percentage)	Managed Floating (Percentage)	Independently Floating (Percentage)
Developing countries	25	100.0	--	100.0	100.0	100.0
Favorable	15	76.0	--	100.0	71.4	75.0
Neutral	--	--	--	--	--	--
Critical	4	16.0	--	--	21.4	12.5
Severely critical	2	8.0	--	--	7.1	12.5
Industrial countries	12	100.0	100.0	100.0	100.0	100.0
Favorable	10	83.3	100.0	100.0	--	75.0
Neutral	--	--	--	--	--	--
Critical	2	16.7	--	--	100.0	25.0
Severely critical	--	--	--	--	--	--

Source: Staff estimates.

1/ Based on consultations between July 1988 and June 1989, using unweighted average values for 1987 and 1988.

2/ Thrust of the assessment of exchange rate policy contained in the staff appraisal of the Article IV consultation staff report.

A theme of the consultation discussions was that the commitment to stable exchange rates limited the autonomy of monetary policy and increased the urgency of fiscal consolidation. In the consultations with Belgium, Italy, and the Netherlands the threat posed by high domestic debt ratios, which were projected to rise over the medium term, was a central issue. Structural rigidities were also extensively discussed during consultations with all EMS countries. In this connection, particular emphasis was placed on labor market reforms because of the existence of high unemployment and high capacity utilization rates (e.g., France, Belgium, Germany, and Italy). Trade and capital market liberalization was also a common theme in the Article IV consultations because of the financial market integration within the EMS expected for 1992 and the impact of these countries' trade policies on world markets.

As in the previous consultations with all the countries in this group, the staff endorsed the exchange rate policies being pursued. The endorsements were based on the commitments by those members to macroeconomic policies consistent with exchange rate stability and to the success of the system in safeguarding competitiveness and promoting price stability. In its policy recommendations, the staff emphasized the need for fiscal consolidation and cautious incomes policies. With regard to the former, it was recommended not only that fiscal deficits be reduced to stabilize domestic debt ratios, but also that changes in the tax system give due consideration to the need to reduce rigidities in labor markets and to foster prospective economic integration. Wage restraint in the public sector was regarded as an essential signal to labor markets to contain costs so as to promote employment prospects while maintaining external competitiveness. Finally, in the cases of Belgium and Luxembourg, the staff strongly encouraged the authorities to abolish the dual exchange rate markets before the planned date of 1992. 1/

The authorities generally agreed with the staff's recommendations. In most instances, the Board was also in agreement, but in the cases of Belgium and Italy Directors recommended a faster pace of fiscal adjustment than proposed by the staff.

b. Industrial countries with flexible arrangements

Most of the remaining industrial countries falling in the flexible arrangement category maintain floating exchange rate regimes. For the G-7 countries in particular, including those participating in the ERM of the EMS, the evolution of their economic variables and their impact on the world economy has been the subject of regular Board consideration in the context of the WEO exercise and of periodic informal seminars on exchange rate developments. The views of the staff and Directors in those exercises reinforce their views as expressed in individual Article IV consultations.

1/ The dual market was eliminated in March 1990.

The focus of the bilateral consultations was on the need to strengthen the prospects for noninflationary growth and for financial market stability and thus an orderly exchange rate system. Emphasis was also placed on structural policies that could contribute to efficiency in the working of markets and, in the long run, also to external adjustment. Japan's overall macroeconomic stance was viewed favorably and no major policy shifts were recommended. For Canada and the United States the staff reports concentrated on their fiscal deficits, their medium-term prospects under present policies, and, in the case of the United States, the burden its deficit imposed on world financial markets. A major issue in the staff report for the United Kingdom was the inflationary impact of the monetary policy pursued in the period prior to the consultation under which interest rates had been held low because of exchange rate concerns. With respect to structural issues, labor market rigidities (Canada and the United Kingdom) and latent protectionism (Japan, the United States, and various European Community members) were seen as obstacles to the efficient functioning of domestic economies and international trade.

In its policy recommendations, the staff concentrated on medium-term savings and investment issues. Although it was acknowledged that there could be a limited role for intervention policies to smooth out fluctuations in exchange rates, it was stressed that there was no alternative to fundamental policy adjustments as a means to secure stability in exchange markets. Accordingly, a tighter fiscal policy was strongly recommended for the United States and Canada as a way to reduce current account deficits while sustaining growth and making progress toward price stability. An appropriate mix of fiscal and monetary policy tightening together with measures to provide more flexibility in labor markets were recommended for the United Kingdom and Canada. This recommendation sought to arrest inflationary pressures and to offset persistent imbalances in the private sector savings-investment behavior. Finally, for Japan, policy recommendations focused on further efforts to liberalize domestic markets and trade.

c. Crawling peg and managed floats

During the period under consideration, the Board concluded consultations with 19 countries that maintain an exchange rate regime classified either as a crawling peg or a managed float. 1/ Countries with these types of exchange rate regime are grouped together because under both systems there is a limited degree of flexibility in the pricing of foreign exchange. 2/ The monetary authority manages the exchange rate directly by fixing the price according to a set of

1/ The countries covered represent 66 percent of the 29 countries falling into these two categories.

2/ As noted earlier (in page 14), under the crawling peg regimes, the exchange rate has not moved strictly in accordance with a predetermined path.

indicators--crawling peg--or by intervening in the foreign exchange market on the basis of less rigid criteria--managed float.

Countries in this group grew faster than any other group during the 1980s and had inflation rates below the average for all groups. While growth accelerated in 1987-88 to an annual average of 5 percent, which was again the highest of all groups, inflation also increased. Excluding Mexico, where inflation average over 100 percent during 1986-88, the average annual inflation rates for the group increased by 2 percentage points to 16.6 percent between 1984-86 and 1987-88. Part of the explanation for the rise in inflation may be that monetary policies accommodated relatively stable fiscal deficits in the face of reduced external financing. The fiscal deficits of the group, excluding Mexico, fluctuated around 3.8 percent of GDP per year in 1984-88 (the lowest figure for all groups), while the current account deficit was cut in half between 1984-86 and 1987-88 to 2.3 percent of GDP, adjustment that was prompted by restricted access to foreign financing from international capital markets in several cases (Chile, Colombia, Madagascar, Mexico, and Morocco). At the same time, with the relatively active exchange rate policies being pursued by the countries in the group, real effective exchange rates depreciated on average by 8.2 percent per year during 1987-88.

Consultation reports analyzed the stance of financial policies both in terms of the progress achieved in the short run toward stabilization goals and in the context of medium-term prospects. Several of the countries in this category had pursued restrictive financial policies for several years in an effort to reduce macroeconomic imbalances. But for some countries, rapid monetary growth had produced high and persistent inflation (Chile and Colombia) and adjustment to achieve price stability was the focus of policy discussions. In these cases, the dominant problem was the fiscal deficit, often exacerbated by a high level of external debt. Moreover, the fiscal deficits in many instances were accommodated by monetary expansion (Turkey) or financed by compulsory subscription by banks to government debt instruments at below market interest rates (Portugal). 1/ Frequently, the result was the accumulation of external arrears as well as inflation (Costa Rica, Madagascar, and Mauritania). In other cases, the central issue was how to frame macroeconomic policies against a background of an external debt overhang (Costa Rica and Mexico) or of distortions arising from extensive quantitative controls on economic activity (China). Structural policies, including trade reforms and measures to streamline the operations of public enterprises, also featured in the consultations with about two thirds of the countries in this category.

1/ At the time of the Article IV consultation in August 1988 Portugal was still classified as a developing country.

The exchange rate policies of the great majority of countries in this group were favorably assessed by the staff. Exchange rate flexibility, trade liberalization, and responsible demand management were stressed as the central inter-related tools to achieve external balance and to enhance export competitiveness. Similar assessments had also been made by the staff for most of the countries concerned in the previous consultations, with two exceptions (Madagascar and Morocco), where the current assessments were more favorable because, inter alia, nominal exchange rate adjustments had helped bring about needed real exchange rate depreciations and had improved competitiveness.

Critical assessments for countries in this group were the result of a variety of circumstances. In some cases the problems were deteriorating trends in domestic and external balances together with inappropriate--although flexible--exchange rate policy (Dominican Republic). The latter was characterized by frequent changes in the exchange rate arrangement aimed at stabilizing the rate but without adequate support from financial policies. In other cases, heavy intervention in foreign exchange markets (China, Greece, 1/ Guinea, and Mexico) had kept the official exchange rate at an appreciated level that was not compatible with sustainable external balances.

In cases where the assessment of exchange rate policy was favorable, the staff recommendations focused on the need to pursue prudent financial policies. The consultation reports generally underlined the need for fiscal consolidation and restrictive monetary policies to lay the basis for sustained growth, convergence toward world inflation rates, and the maintenance of stability in exchange rate markets. In one case (Portugal) the staff advised that a more active exchange rate policy be pursued in view of the authorities' intention to slow down the pace of nominal depreciations while no substantial change in financial policies was envisaged. In another case (Turkey) the staff endorsed the authorities' intention to depreciate the exchange rate in conjunction with restrictive financial policies, in order to allow a real depreciation during the year. In cases where the assessment of exchange rate policy was critical, policy recommendations focused on tightening financial policies and on incomes policy (China, the Dominican Republic, and Mexico), but also stressed the need for more flexible application of exchange rate policy (Dominican Republic and Guinea) or the unification of exchange rate markets (China and Mexico).

The Board was in broad agreement with the staff's recommendations and, in most cases, the authorities' views were also in line with those of the staff. However, in some instances (Dominican Republic and Guinea), the authorities felt that as there was little room to change fiscal and monetary policies substantially, a more flexible exchange rate policy could initiate a devaluation/inflation spiral. In another

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1/ At the time of the Article IV consultation in April 1989 Greece was still classified as a developing country.

case (China), although the authorities agreed with the goal of unifying the exchange markets, they were not prepared to commit themselves to a timetable for unification. Their approach was rather to try to stabilize the market-determined exchange rate by tightening financial policies. Finally, in the case of Singapore, the authorities concurred with the staff on exchange rate policy, but disagreed with the staff's recommendation of reducing tax rates so as to lower public savings and the external current account surplus; in their view, growth in productivity and in foreign demand would slow down in the medium term acting to reduce the current account surpluses.

d. Independently floating exchange arrangements in developing countries

During the period under consideration, the Board concluded consultations with 8 countries with independently floating exchange rate arrangements. 1/ The countries in this category share ability to pursue independent monetary policies, but differ in a variety of other characteristics and in overall economic performance.

The performance of economic growth and inflation for the group as a whole was similar to that for the group of countries with crawling peg and managed float regimes. Excluding Bolivia and Lebanon, the inflation rate for the group increased by 15 percentage points to 36 percent per year (the highest of all groups) during 1987-88 in relation to 1984-86. 2/ Over the same period, economic growth increased by over 1 percentage point to 5 percent per year. The sharp increase in inflation was probably related to a widening of fiscal deficits during a period when the availability of foreign financing was reduced. The improvement in the group's growth performance may have been due to a number of factors including: (i) the beneficial effects of trade liberalization and other structural policies pursued in a number of countries in the group; (ii) terms of trade improvements of almost 1 1/2 percent per year during 1987-88; and (iii) average real effective exchange rate depreciations of 4.6 percent per year.

The consultation discussions with developing countries with floating exchange rates focused on problems arising from expansionary fiscal and accommodative monetary policies. Although significant macroeconomic adjustment policies had been initiated in several countries, adverse external developments, exacerbated by an undiversified export structure, had retarded progress toward viability in several cases (Bolivia, The Gambia, Ghana, Lebanon, and Venezuela). The difficult economic situation faced by many of these countries was reflected in domestic inflation (Ghana, Lebanon, South Africa, and Venezuela), the accumulation of external arrears during the period preceding the consultation (Bolivia,

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1/ 67 percent of members in this category.

2/ Inflation in Bolivia and Lebanon exceeded 100 percent in at least three years during the period 1980-88.

The Gambia, and Ghana), and very heavy debt burdens (Bolivia and Venezuela). As part of their adjustment efforts, several countries in this group had an arrangement with the Fund at the time the consultation was held (Bolivia, The Gambia, Ghana, and Zaire) or entered into an arrangement shortly thereafter (Venezuela).

The staff's assessment of exchange rate policy remained favorable in those cases where it had been so assessed in the previous consultation. The only exception was Venezuela, where the assessment was more favorable because a highly restrictive system of foreign exchange allocation had been replaced by a market for foreign exchange that had facilitated a substantial real effective exchange rate depreciation. For the majority of developing countries in this category, the staff did not recommend changes in exchange rate policy, but encouraged the authorities to conduct macroeconomic policies in a manner consistent with the overriding objective of reducing inflation. The reduction of the borrowing requirements of the nonfinancial public sector was regarded in all cases as a centerpiece of the adjustment effort.

In some cases, however, where restrictions on access to the official market for foreign exchange had led to the emergence of parallel exchange markets (Ghana and Venezuela), the staff called for changes in exchange rate policy that involved the unification of exchange markets. In the case of Bolivia, Central Bank intervention in the auction market allowed the authorities to commit themselves to a path of gradual real exchange rate depreciation as part of a SAF program. These exchange rate policies were to be supplemented by fiscal and monetary policies that would help to achieve economic growth with financial stability.

The staff's recommendations were generally shared by the countries' authorities and in several cases were included in an economic program that was being supported by the use of Fund resources. The Board was in general agreement with the thrust of the staff's recommendations except for two cases (Bolivia and Pakistan) where some Directors encouraged greater flexibility in exchange rate management.

Exchange Rate Arrangements--Countries with Article IV Consultations During July 1, 1988 to June 30, 1989

Country	Article IV Consultation Date	Program in Place
Currency Pegged to the U.S. dollar		
Antigua & Barbuda	01/27/89	
Belize	06/16/89	
Dominica	09/14/88	SAF 6/
Ethiopia	11/09/88	
Grenada	10/14/88	
Guatemala	10/26/88	SBA 6/
Guyana	04/28/89	
Haiti	06/26/89	SAF
Liberia	08/03/88	
Mozambique	11/23/88	SAF
Nicaragua	10/24/88	
Oman	12/21/88	
Panama	11/23/88	
Peru	02/24/89	
St. Vincent	03/01/89	
Suriname	10/17/88	
Syrian Arab Rep.	04/17/89	
Trinidad and Tobago	11/18/88	
Uganda	09/14/88	SAF 6/
Yemen Arab Rep.	05/15/89	
Zambia	07/08/88	
Currency Pegged to French Franc		
Benin	06/16/89	SAF 6/
Cameroon	09/19/88	SBA 6/
Central African Rep.	12/12/88	SAF 6/
Chad	06/21/89	SAF 6/
Comoros	06/02/89	
Congo	10/12/88	
Gabon	09/16/88	SBA
Mali	08/05/88	SBA, SAF 6/
Niger	12/12/88	ESAF 6/
Senegal	11/21/88	ESAF 6/
Togo	05/31/89	ESAF 6/
Currency Pegged to Other Currency		
Kiribati (Australian dollar)	06/21/89	
Lesotho (South African rand)	02/08/89	SAF
Swaziland (South African rand)	01/09/89	
Currency Pegged to the SDR		
Myanmar	07/08/88	
Rwanda	10/17/88	
Seychelles	02/27/89	

Exchange Rate Arrangements--Countries with Article IV Consultations During July 1, 1988 to June 30, 1989 (continued)

Country	Article IV Consultation Date	Program in Place
Currency Pegged to Other Composite 1/		
Algeria	05/31/89	SBA 6/
Bangladesh	05/31/89	SAF
Botswana	11/18/88	
Fiji	01/27/89	
Finland	07/25/88	
Iceland 2/	02/17/89	
Israel	06/23/89	
Kenya	05/15/89	ESAF 6/
Malaysia	07/27/88	
Malta	10/26/88	
Nepal	12/14/88	SAF 6/
Norway	12/21/88	
Papua New Guinea	10/14/88	
Poland	09/14/88	
Sao Tome & Principe	02/24/89	
Solomon Islands	09/16/88	
Sweden	08/03/88	
Tanzania	11/30/88	SAF 6/
Thailand	03/01/89	
Vanuatu	12/16/88	
Zimbabwe	10/12/88	
Flexibility in Terms of a Single Currency 3/		
Bahrain	10/12/88	
United Arab Emirates	06/21/89	
Flexibility Limited in Terms of a Cooperative Arrangement 4/		
Belgium	05/17/89	
France	09/12/88	
Germany	07/22/88	
Italy	04/26/89	
Luxembourg	06/21/89	
Netherlands	02/13/89	
Adjusted According to a Set of Indicators 5/		
Chile	08/05/88	EA 7/
Colombia	10/24/88	
Madagascar	09/02/88	SBA, SAF 8/
Portugal	08/03/88	

Exchange Rate Arrangements--Countries with Article IV Consultations During July 1, 1988 to June 30, 1989 (continued)

Country	Article IV Consultation Date	Program in Place
Other Managed Floating		
China	02/15/89	
Costa Rica	05/23/89	SBA 6/
Dominican Republic	10/26/88	
El Salvador	04/28/89	
Greece	04/12/89	
Guinea	10/14/88	
India	08/31/88	
Indonesia	05/03/89	
Mauritania	05/24/89	ESAF 6/
Mexico	05/26/89	EA 6/
Morocco	06/28/89	SBA
Pakistan	12/28/88	SBA, SAF 6/
Singapore	09/16/88	
Sri Lanka	09/02/88	SAF
Tunisia	05/24/89	EA
Turkey	07/29/88	
Independently Floating		
Bolivia	07/27/88	ESAF 6/
Canada	02/22/89	
Gambia, The	11/23/88	ESAF 6/
Ghana	11/09/88	ESAF 6/
Japan	06/07/89	
Lebanon	11/02/88	
Maldives	01/27/89	
South Africa	09/14/88	
United Kingdom	03/03/89	
United States	08/29/88	
Venezuela	03/29/89	
Zaire	10/12/88	SAF

1/ Comprises currencies which are pegged to various "baskets" of currencies of the members' own choice, as distinct from the SDR basket.

2/ Interim report was placed on the Board's agenda for consideration.

3/ Exchange rates of all currencies have shown limited flexibility in terms of the U.S. dollar.

4/ Refers to the cooperative arrangements maintained under the European Monetary System.

5/ Includes exchange arrangements under which the exchange rate is adjusted at relatively frequent intervals on the basis of indicators determined by the respective member countries.

6/ Use of Fund resources approved on the same date as the Article IV consultation.

7/ An extension was approved on the same date as the Article IV consultation.

8/ The stand-by arrangement was approved on the same date as the Article IV consultation.