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0404

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/28

10:00 a.m., March 6, 1989

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

Executive Directors	Alternate Executive Directors
F. Cassell	
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	J. Prader
	P. E. Archibong, Temporary
	R. J. Lombardo
L. Filardo	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	
M. R. Ghasimi	O. Kabbaj
G. Grosche	
J. E. Ismael	E. Kiriwat
B. Jalan	L. E. N. Fernando
A. Kafka	
	W. N. Engert, Temporary
Mawakani Samba	
Y. A. Nimatallah	I. A. Al-Assaf, Temporary
	M. Fogelholm
H. Ploix	
G. A. Posthumus	G. P. J. Hogeweg
C. R. Rye	
K. Yamazaki	

L. Van Houtven, Secretary and Counsellor
M. J. Primorac, Assistant

<u>Also Present</u>
African Department: R. C. Williams. European Department: P. B. de Fontenay, Deputy Director. Exchange and Trade Relations Department: J. T. Boorman, Deputy Director; P. A. Acquah. External Relations Department: A. F. Mohammed, Director; P. E. Gleason, P. C. Hole. Fiscal Affairs Department: V. Tanzi, Director. IMF Institute: O. B. Makalou. Legal Department: R. H. Munzberg, Deputy General Counsel. Middle Eastern Department: Z. Iqbal, M. Zavadjil. Research Department: J. A. Frenkel, Economic Counsellor and Director; M. Goldstein, Deputy Director; J. M. Boughton, D. Folkerts-Landau, Y. Harada, E. Hernández-Catá, P. Isard, M. S. Khan, D. J. Mathieson, P. R. Masson, P. Wickham. Secretary's Department: C. Brachet, Deputy Secretary; J. G. Marcouyeux. Treasurer's Department: F. G. Laske, Treasurer; T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; P. B. Clark, I.-S. Kim, A. Salehizadeh, T. M. Tran. Personal Assistant to the Managing Director: H. G. O. Simpson. Advisors to Executive Directors: N. Adachi, M. Al-Jasser, M. B. Chatah, S. M. Hassan, P. O. Montórfano, P. D. Péroz, G. Pineau, B. A. Sarr, S. P. Shrestha, M. A. Tareen, A. Vasudevan. Assistants to Executive Directors: B. A. Christiansen, R. Comotto, S. K. Fayyad, B. R. Fuleihan, L. Hubloue, A. Iljas, K.-H. Kleine, C. Y. Legg, N. Morshed, L. M. Piantini, S. Rouai, C. Schioppa, J.-P. Schoder, Shao Z., C. C. A. van den Berg, Yang J.

1. FUNCTIONING OF INTERNATIONAL MONETARY SYSTEM - KEY ISSUES AND ROLE OF SDR

The Executive Directors considered a staff paper on key issues in the functioning of the international monetary system (SM/89/26, 2/2/89) and a paper on the SDR and the international monetary system (SM/89/32, 2/8/89), together with a staff paper on post-allocation adjustment in the distribution of SDRs (SM/89/45, 2/24/89).

Mr. Nimatallah made the following statement:

It is true that one of the reasons that fixed or stable exchange rates are needed is to impose fiscal discipline, which, in itself, is a means for seeking the objectives of sustaining economic growth worldwide and promoting international trade. Unfortunately, exchange rate regimes alone cannot realize the objectives of fiscal discipline, sustained growth, and free capital and goods markets.

The fixed exchange rate regime, for example, was not able to promote fiscal discipline, because exchange markets were not able to influence exchange rates during fiscal deficits. Nor could the floating exchange rate regime promote fiscal discipline, while goods markets were prevented by protectionist measures. Managed floating exchange rate regimes, however, give exchange markets a chance to exert some influence. But, more important, countries also have the opportunity to express their views on the macroeconomic performance of other countries through the process of coordination.

It has now become clearer to me that for an exchange rate regime to succeed in imposing sound macroeconomic performance, it has to be assisted by discipline from market pressure, on the one hand, and peer pressure through multilateral coordination, on the other hand. Furthermore, it would be even more helpful if each country disciplined itself by its own national legislation to aim for balanced budgets within a medium-term context, but allow fiscal deficits only within a small percentage of the size of the budget itself, and not of GNP, in any given year; put a firm ceiling on national debt; and adhere to as low inflation rates as possible. In addition, national recognition should be established so that the problem of unemployment is addressed primarily through structural reforms, and secondarily through macroeconomic policies.

Assuming that the regime is disciplined by national legislation, markets, and partners, the next thing to secure is the appropriate institutional framework to help this regime function well. The staff has considered zones, indicators, intervention, leadership versus symmetry, the anchor, and surveillance for coordination. I am in general agreement with the staff's analyses and conclusions, but I have some further remarks to make for the sake of emphasis.

It is clear that there are zones for exchange rates, and zones for other macroeconomic policy and performance indicators. As far as exchange rate zones are concerned, the present format of "quiet" and reasonably "soft" zones adopted by the Group of Seven is working well, and I see merit in continuing with it. As far as the indicators are concerned, it would be useful to have zones that are generally "silent" and "narrow" for policy indicators, but "loud" and "wide" for performance indicators. That would help authorities within the Group of Seven handle coordination more effectively.

In the meantime, concerted market intervention appears to be very useful on a temporary basis to counteract exaggerated short-term market fluctuations and destabilizing speculation. However, intervention should not be used to counter what appears to be a medium-term development. After all, the basic idea of establishing zones is that they can be adjusted from time to time only in response to developments that do not reflect real changes in economic fundamentals. In addition, interventions have to be sterilized to avoid any potentially undesirable impact on monetary policy.

On the issue of leadership, it seems that in a regime of equal partners, there is not much room for a leader. The system has to be one of symmetry and equals to reduce the chance of a leader destabilizing the system by resorting to undesirable policies and performance.

I consider the anchor to be important for the proper functioning of any regime. The role of anchor is to control inflation, thereby keeping inflation rates low, and to sustain a stable and strong currency. As to the question of who should play this role, the United States was entrusted with the responsibility of providing an anchor under the Bretton Woods regime. However, because of the superior track record of Germany and Japan on inflation and monetary stability in the more recent period, those countries might be in a better position to play that role today, provided that they continue their commitment to such policies.

If Germany or Japan, or both, are not acceptable anchors for the system, an alternative might be to use the SDR, so as to spread the responsibility more broadly among all countries whose currencies are included in the SDR basket. However, if the SDR countries are to be assigned this role, some modifications have to be introduced in light of the dual role of the anchor. The

SDR, itself, is nothing but a basket of currencies that fluctuates with those currencies. It is possible that all countries whose currencies are in the basket would inflate or deflate their economies simultaneously, leaving the basket helpless in playing the full role of anchor. Furthermore, as the staff indicates on page 26 of SM/89/32, "Stabilizing the exchange rates of national currency units against the SDR would stabilize the national currency prices of goods relative to the SDR price of goods. This by itself, however, would still leave the average rate of inflation...undetermined." That leads me to suggest that the SDR as a basket on its own is not enough. An index is also needed, in order to provide a measure of the average rate of inflation and to indicate whether the average stance of policies is appropriate for the countries whose currencies are included in the SDR basket. Incidentally, it would probably be helpful to expand the SDR basket to the G-7 currencies. If these countries acted individually to stabilize the exchange values of their currencies against the SDR, a rise in the price index would imply that the countries should tighten their policies together. Because the Fund is not a country, a price index will have to be constructed from price data for the countries included in the SDR basket.

An SDR goods price index could be constructed by selecting a number of "important" consumer and producer goods, commodities, and services, and by collecting price data for all the countries included in the SDR basket. An SDR price could be constructed for each good using fixed base period exchange rates to convert national prices into SDR prices and using the weights in the SDR basket to average the SDR prices from the different countries. The Fund, therefore, needs the SDR basket and an SDR fixed price index of a group of primary and manufactured basic goods to be adopted once and for all. Furthermore, to strengthen the anchor based on the SDR basket and the SDR fixed price index, I endorse the two additional helpful staff suggestions in SM/89/32: first, that a low-inflation "club" be established to impose on its high-inflation members the obligation to move their inflation rates toward that of low-inflation members; and, second, that all members accept stronger surveillance rules. If the SDR is accepted with these modifications and suggestions, there is a chance that a durable anchor will be established.

Surveillance is essential for the smooth functioning of this exchange rate regime. It is clear that, in addition to periodic meetings held by G-7 representatives to promote economic policy coordination, the Fund can help a great deal through its own surveillance activities. The Fund can also do more research to perfect macroeconomic indicators to improve the quality of coordination. Moreover, the Fund can focus more on structural reform. Structural rigidities are currently hindering the realization of potential output of most of the G-7 countries. These countries can benefit themselves and others if they let the Fund help them develop structural adjustment indicators for gradual application. Potential output is a good starting indicator that can help G-7 members improve their coordination on the scope and speed of structural reform.

Extending his remarks, Mr. Nimatallah commented that if the purpose of the staff paper on the SDR was to look for ways to give the SDR more prominence, he was not sure that the discussion of the supply side of the SDR had helped change the minds of nonbelievers. Therefore, and despite his support for a resumption of an SDR allocation at modest rates, he suggested that discussion on the supply side be delayed, as it had proven to be divisive. Moreover, since there was currently enough international liquidity, it might not be appropriate at present to discuss such an issue. Meanwhile, the proposal in the staff paper to integrate SDR allocations with Fund surveillance in a two-stage process was very interesting and should be examined further. In addition, the Board had already decided to consider the SDR as a safety net, in the event the world economy once again encountered tight liquidity.

However, Mr. Nimatallah continued, the discussion of the demand-side approaches to invigorate the SDR was helpful, and he supported any attempt to enhance demand for the SDR, including the promotion of the use of SDRs by official and private entities. For official use, he encouraged reinstitution of the reconstitution requirement on the use of SDRs. In order to enhance access to additional conditional resources for countries undertaking strong adjustment programs, he found merit in the idea that countries that had SDRs would offer them, with some conditionality, to countries that needed them, on an experimental, case-by-case basis. For the private sector, he encouraged the facilitation of transactions in SDR-denominated instruments.

If the purpose of the staff paper was to find ways and means to strengthen the international monetary system, Mr. Nimatallah remarked, the section on ways to improve the efficiency and stability of the reserve system and on the possibility of using the SDR as an anchor against inflation was very useful. The SDR had the potential to help the international monetary system in two ways--by encouraging central banks and others to hold more reserves in the form of SDRs and SDR-denominated instruments, and by having the SDR play the role of anchor to the system against inflation. The SDR could not play the role of anchor on its own without being supported by an SDR-fixed index of selected goods and commodities.

Mr. Kafka made the following statement:

The two papers before us represent a necessary further step in our ongoing study of the international monetary system. This is a task which the Fund must not eschew. Too many important changes--temporary or longer lasting--in the international monetary system have occurred with or without belated participation of the Fund, beginning with the European Payments Union. This is not a tradition we should follow.

Obviously, in such a delicate undertaking, we ought to be aware of the warning: "surtout pas trop de zêle." But we should proceed, by partial studies, to examine various possible shapes of the international monetary system. The staff might find it useful to prepare for its own orientation in carrying out these studies, a series of sketches of possible international monetary systems. The system we have at present may be the best we can get, but we can hardly be sure of that, although we may harbor the suspicion that the Group of Seven's attempts at policy coordination, even illuminated by statistics called objective indicators, will not provide us with the ideal international monetary system.

In past discussions of the international monetary system, we have distinguished four main themes: adjustment, confidence, liquidity, and the transfer of real resources to the developing countries. The two papers before us deal, by and large, with the adjustment and liquidity problems. I would prefer to regard the confidence problem as an aspect of the problem of liquidity--after all, Mr. Triffin's point, referred to on page 1 of SM/89/32, was simply that lack of confidence in the sufficiency of the gold cover of the U.S. dollar could prevent adequate growth of liquidity. I think that there is a general feeling now that the transfer objective is of such importance and urgency that it has to be treated, at least in the first instance, outside the international monetary system context, although, naturally, the international monetary system problem will have to be studied in the context of its effects on the transfer objective and, indeed, its other effects on various country groups. Finally, it might be useful to conduct future discussions on the international monetary system in the form of seminars.

The first paper--a discussion of six key issues in the functioning of the international monetary system--quite properly does not offer conclusions but poses a series of tantalizing questions. I shall discuss them in turn.

On fiscal discipline and the exchange rate regime, the contribution of the exchange rate regime to fiscal or more generally macroeconomic discipline is often conceived as being the basic question. Contrary to those who neglect capital flows, the staff argues that fixed rates may weaken fiscal discipline. An even greater danger is seen to derive from formal target zones or managed floating, namely, a positive incentive to monetary expansion--in addition to any fiscal expansion which is taking place--rather than mere monetary helplessness. The catch is, of course, the assumption of open capital markets. Hence, for those countries that do not have them, or are aware that they might lose access to capital, fixed rates would not destroy fiscal discipline. It would be interesting to see some econometric analysis on this subject. Another question is not addressed: if there is zero capital mobility, is fiscal discipline then increased by a fixed rate, or is there still no answer to this ancient question?

Fortunately, no country floats "cleanly"--to use Professor Haberler's expression. What about managed floating? The paper insists that in that context, fiscal discipline can be advanced by policy coordination because it can define fiscal commitments. But policy coordination is a doubtful proposition; it may range--as has been noted--as far as concertation, but may also be no more than conversation or even disinformation.

What is the upshot of the discussion? It seems to me that one cannot rely on the exchange rate regime to enforce fiscal discipline as long as there is high capital mobility. For many countries, though not the G-7 countries, that means that exchange rate fixity may still be best. The staff paper seems to suggest that policy coordination will always be helpful. But since one can only coordinate exchange market intervention and, at best, the "fundamentals," will that amount of coordination--provided it is pursued as far as concertation--be enough to obtain reasonable exchange rate stability without fixed rates? And, in any event, how good are stable rates without an anchor--one which assures price stability and not just concerted inflation or deflation?

On monetary policy independence and the exchange rate regime, the burden of the paper's argument seems to be that fixity of exchange rates could be purchased at the cost of greater instability of other prices--especially interest rates--and, in particular, the diminished capacity to use monetary policy for objectives other than exchange rate stability.

According to the paper, if exchange market intervention is sterilized, it could protect monetary policy independence. The paper seems to be bullish on concerted intervention, even concerted sterilized intervention. But it is not clear, though it would be interesting to know, whether the recent concerted intervention to bring and hold down the U.S. dollar was actually sterilized. Or did it, perhaps, have something to do with the rise in inflation?

Other things being equal, it may not be wise to address fiscal policy to internal balance. But I wonder whether the two objections against using fiscal policy--lack of flexibility and the importance of other objectives--really are valid. If one had a "regulator" as the United Kingdom did at one point in the late 1970s, the objections do not look formidable on technical grounds. Perhaps this technique merits a second look.

Overall, however, one would think that the staff paper is right in not attaching too much importance to monetary policy independence, since there is probably not a single country in the world, after the Plaza Agreement, which treats its exchange rate with total indifference.

Turning to the identification of equilibrium exchange rates and exchange rate management, the paper argues persuasively that market exchange rates need not be equilibrium rates. It also argues, however, that the identification of the equilibrium exchange rate is so difficult that accepting market rates may still be the best one can do, although, again since the Plaza Agreement, nobody seems to be prepared to do so any more.

What can one conclude from this? One might think that the exchange regime is irrelevant because the welfare costs of fixed and floating rates may be similar. But such nihilism might be unduly pessimistic. The erosion of union power in some countries may suggest that the costs of fixed rates are receding.

Nobody can be sure that restricting capital flows, even only or mainly short-term capital flows, may not be a costly affair in terms of the efficiency of the world economy. But we have the case of Belgium which has maintained a special market for capital and is certainly a successful economy. This policy will be abandoned after 1992 (unless it is taken over by the European Communities as such vis-à-vis the rest of the world). This yields fascinating prospects in terms of an international monetary system based on the late Professor Williams's key currency proposal, adapted to modern times. The upshot of this section is, perhaps, that we should have another look at the costs and benefits of the Belgian system.

The section on leaders and anchors argues that an international monetary system does not need a leader, and that the position of a responsible leader can be replaced by policy coordination. This seems to me questionable. But the paper also argues persuasively that since present conditions do not favor the appearance of a leader, policy coordination--with all its defects--may be the best there is.

The underlying assumption seems to be that exchange rate fixity also needs a leader or coordination. Is that really true? An ideology of exchange rate fixity--or simple, enduring rules as distinct from no or changing rules or rules that require a good deal of interpretation--might by itself provide all the necessary coordination.

What about the need for an anchor? The SDR will not suffice--all it can produce is concerted inflation or deflation. To use a freely flexible asset price, like the gold price, as an anchor also seems peculiar. Perhaps one could use a product or service price index, which should be kept to zero.

Turning to policy coordination and monitoring zones, there was a great deal of discussion on objective indicators for exchange rate policy during the beginnings of the Committee of Twenty, which did not lead to any results. Certainly statistics can be useful in this context, but they probably increase the need for judgment rather than reduce it. In any event, indicators cannot remove the basic difficulties of the coordination process: the need for agreed objectives and identical models. I would agree that the width of monitoring zones also should be a matter of judgment, but guided by just performance. Finally, the same would seem to be true about whether and when to have loud or quiet monitoring zones.

In the nature of the case, there seems to be no general conclusion to be drawn from the examination of the staff's paper other than the tentative comments made at the very beginning of my statement.

The second staff paper deals with the reserve system and again poses a series of questions. There does not seem to be any objective way of assessing reserve adequacy. This does not imply that one has to wait for an overwhelming inspiration to be found by Fund Governors before the next allocation can take place. Rather, I would think that the approach in the last paragraph of the staff paper, which asks whether the potential usefulness of the SDR in the future might be taken into account in assessing the long-term global need for reserve supplementation, is sensible. Such an approach could justify a modest annual rate of allocation simply to maintain in existence the SDR machinery that was constructed painfully over such a long period until it could be brought into existence in the late 1960s.

It seems to me that the staff's ideas should be seen less as a way of whetting the world's appetite for SDRs than as part of the necessary study of the liquidity aspects of the international monetary system. Can the SDR be helpful in the adoption of growth-oriented adjustment programs? The staff first discusses a group of ideas which would make SDR allocations helpful to enhance the credit of debtor countries. Three proposals are mentioned: the Institute of International Finance proposal, the Mitterrand proposal, and a somewhat nebulous proposal to use the SDR to facilitate hedging and thereby reserve management. They are all based on the idea that SDRs resulting from a new allocation should be set aside to guarantee debt service or better reserve management.

Certainly, all of these ideas merit consideration. They do not, however, take the place of the idea that modest allocations should be maintained annually in order not to destroy the SDR machinery prematurely, as it surely would be destroyed if it is not used. They are, in other words, possible supplements but not alternatives to the basic modest allocation mentioned earlier.

Under proposals by Mr. de Groote and Mr. de Maulde, former Executive Director of France, in 1984, countries not needing SDRs allocated to them could lend them directly to debtor countries or indirectly to the Fund for use by debtor countries subject to an appraisal by the Executive Board. Mr. Sengupta's proposal would make the transfer unconditional but subject to reconstitution. Again, we would think that these proposals are supplements rather than substitutes for a modest, regular allocation.

It is not clear from the paper whether the staff thinks that recent nonuse of the designation mechanism suggests that the SDR is now as good as any reserve asset. The staff does seem to have some doubts about the liquidity or acceptability of the SDR as compared with other reserve assets. I am not sure that all of these defects can be remedied or that they are frightfully important. This merits study, but not debate in this Board, until we are closer to general changes in the international monetary system.

We look forward to discussing the staff paper on the use of the SDR in exchange market intervention, and we recall that during the Committee of Twenty deliberations an imaginative mechanism for this purpose was proposed by Mr. Sangster from the United Kingdom.

To make official SDRs more usable despite the inability of private entities to hold them, the proposal is now being made to use official SDRs as clearing balances for certain transactions in other SDR-denominated instruments. Another idea has been to have "other holders" issue SDR certificates backed by official SDRs; the backing would not have to be one for one. The question asked at the end of the subsection in the staff paper is relevant: "The strength of the case for considering official measures to facilitate the development and use of SDR-denominated instruments depends on how effectively a reserve system based principally on the SDR could promote the broader objective of improving the functioning of the international monetary system."

Another approach goes back to the idea of substituting currency reserves by SDR reserves and in that connection of subjecting all countries, including reserve centers, to an asset settlement system. Major fluctuations in exchange rates always suggest the danger of destabilizing switches between currencies. This, however, does not seem to be a major consideration at the moment. The idea of having a single reserve asset that is internationally controlled remains very attractive, but it is not at all clear whether the SDR would be effective in controlling either overall liquidity or the balance of payments behavior of reserve centers.

One must consider that the connection between international base money and world liquidity is not likely to be stronger than that between national base money and national liquidity. The looseness of that connection has led to grave doubts about base money targeting as an adequate system of liquidity control, not to say of macroeconomic control. From the point of view of balance of payments management, international capital markets are unlikely to prevent reserve centers from running the deficits which they want to run.

A third group of ideas tries to promote the SDR as an anchor against inflation. I have already commented on the idea briefly, in connection with the discussion of the first staff paper. The basic idea of this approach seems to me flawed by the fact that there is nothing inherent in the SDR concept which could prevent a more or less similar expansion of liquidity by all participants. On the other hand, nothing would prevent one measure suggested in the paper, namely, high inflation countries adapting their behavior to the behavior of low inflation countries, from being put into effect without pegging on the SDR. Nor does one need the SDR to justify stronger surveillance rules for a group of countries that wish to accept them: a pledge analogous to the OECD pledge on restrictions could be applied.

More interesting would be a fractional reserve system under which a certain proportion of any expansion of global reserves would be held in the form of SDRs. The paper suggests that the effectiveness of this approach would depend on giving the Fund the mandate to conduct open-market operations in SDRs as a supranational central bank. We should examine this statement. It seems to me that if we are content with a world monetary policy based on expansion of base money according to rule, no open-market operations would be needed.

The idea of making SDR allocations in two stages, with the second stage depending on a finding that each particular country's performance merits an allocation, sounds interesting. However, it would be highly asymmetrical because presumably a country or group of countries with a blocking minority would not consent to any allocation at all unless it were assured of receiving its own allocation.

The idea that the reserve system is heavily dependent on borrowed reserves and would benefit from a higher proportion of owned reserves (SDRs) is an attractive one. Conditional SDRs and reconstitution all would constitute adequate offsets against inflationary dangers.

Again, there can be no general conclusion. But all these ideas merit further study in the context of our ongoing work on the international monetary system.

Mr. de Groote made the following statement:

For several years now, the Board has been challenging the staff's imagination by asking it to provide a methodology, satisfactory to all of us, for demonstrating a quantitative need for reserve supplementation. The latest effort, which proposes a comparison between the degree of countries' import compression and developments in their export performances, has great merit because it produces compelling evidence of serious shortfalls in the availability and distribution of international liquidity since 1982. However, I fear that this time some of us will conclude again, with the same conviction as on previous occasions, that the evidence in Tables 1 and 2 of the paper on the SDR and the international monetary system once more fails to demonstrate either that a global reserve need exists, or that an allocation of SDRs would be the most efficient instrument for offsetting the financing shortfalls in the developing countries.

In any event, the problem of the present system has more to do with the availability of international liquidity in appropriate proportions and at appropriate times than with the existence of a global liquidity shortage; and for this reason, more attention should have been paid from the outset to the role of liquidity in the functioning of the present system. The import compression required of the developing countries as a result of their inadequate access to international reserves is only one of a number of shortcomings in the functioning of the present system; of equal relevance is the excessive absorption of international liquidity by the U.S. economy during the first half of the 1980s, which produced a strong appreciation of the dollar and an immoderate rise in U.S. imports. Now that the correction of this imbalance is under way, the markets have shown a bias either to precipitate an adjustment that can only be extended and structural in nature, or to react to signals of the imbalance's reduction in ways that produce a premature counterappreciation. At the very least, all these developments suggest that the present system fails to provide a systematic availability of international liquidity sufficient for the implementation of sound adjustment policies. The question we should bear in mind during our general discussion of the role of the SDR is therefore whether that instrument can be a useful corrective to the shortcomings of the present system and thereby contribute to the better performance of the world economy. It is also in this general frame of reference, set by the staff on page 12 for our discussion, that we should analyze the different approaches submitted for a reinvigoration of the SDR.

Discussion and further study of those proposals should no longer be shunned on the basis of legalistic arguments concerning the requirement of a long-term global need for reserve supplementation. First, as I mentioned during our SDR discussion of last September, the long-term and global need concepts were originally introduced in response to preoccupations quite different from those implied by today's interpretations: their sole purpose was to preclude the use of allocations for offsetting cyclical movements, which are not supposed to have a durable effect on the world economy.

Second, insistence on a quantitative need assessment seems even less justified today than when the need concept was introduced to avoid a cyclical use of the SDR, because the reserve system has moved since then toward demand-determined liquidity creation, which makes the quantification of need irrelevant. In a system of demand-determined liquidity creation, neither the existence of a global shortage nor that of an excess supply of reserves can be demonstrated by quantitative arguments. Any assessment of reserve need, therefore, has to be based on judgmental elements: at the center of this judgment should be the possible contributions the SDR can make to a better functioning of the system as it operates today. This criterion was generally accepted at the time we decided on the previous allocation, and there have been no changes in the functioning of the system which have lessened its validity since then.

Finally, insistence on a narrow legalistic interpretation of the global need concept has to be measured against the Fund's other legal obligation, which is to make the SDR the principal reserve asset of the system.

The menu of options for revitalizing the SDR proposed by the staff is both extensive and attractive: the objective of promoting debt reduction in cases in which the growing-out-of-debt strategy can no longer be applied, the objective of greater exchange rate and price stability, and the objective of a stable reserve system are now generally accepted. Before drawing a number of general conclusions applicable to most of the avenues outlined by the staff, I will first comment on a few of the operational implications raised by the use of the SDR in debt conversion and exchange rate stabilization schemes. I will not deal in my comments today with the safety net approach, except in the sense that the use of SDRs in debt conversion and exchange rate policies seems to me nothing other than a concrete implementation of the safety net idea adapted to the specific circumstances of this time.

Our recent seminar discussion on the menu approach has underscored once more the fact that implementing either debt reduction or collateralization of converted debts absorbs sizable amounts of resources that could otherwise be used for productive investments or to facilitate the servicing of outstanding debts. A number of proposals have recently been made for using a new SDR allocation or part of a new allocation for the specific purpose of meeting the liquidity requirements of debt reduction or collateralization. This idea deserves the greatest attention at the next Interim Committee meeting because, by providing liquidity which could otherwise only be obtained at the expense of other, productive uses, it would remove one of the basic obstacles that have so far prevented debt reduction from being implemented more systematically.

The French proposal has a number of especially attractive characteristics that would permit the idea's further elaboration and extension. First, by establishing a rechanneling of SDRs from industrial to developing countries, it proposes an effective use of the SDRs allocated to countries that have no immediate need to use their reserve increase. Second, access to this exceptional SDR scheme would be conditioned on the implementation of adjustment programs. And finally, since the scheme would be used for the collateralization of debts, it would have to be mobilized only if a guarantee falls due. Two aspects of this scheme deserve to be discussed in greater detail over the coming months: first, the operational modalities for transferring the SDRs, and second, the cost at which the SDRs would be made available once a guarantee falls due.

The French scheme proposes the establishment of an administered account in the Fund. A similar plan, put forward by Governor Maystadt at the time of the Annual Meetings last September, proposes a transfer to the Fund based on the technique for rechanneling SDRs that was suggested in the original Belgian proposal for a post-allocation adjustment of SDRs. The two schemes utilize transfers of different kinds and involve the Fund in different ways. The Belgian scheme permits a direct transfer of SDRs by the technique explained on page 17 of the staff paper. Because the Fund is not authorized to borrow SDRs, it would in practice borrow currency and sell the currency against SDRs. This technique was described in detail in my statement on the conditional use of SDR allocations of March 26, 1984, and was commented on by the Director of the Legal Department in EBS/84/191 (9/5/84), on the proposal of the Belgian G-10 Deputies. A detailed analysis of the Belgian proposal and similar proposals submitted since then is given in SM/86/154 (6/27/86), on proposals for post-allocation adjustments in the distribution of SDRs.

The French scheme would require the prior conversion of SDRs into currencies, since an administered account cannot hold SDRs. Because the Belgian scheme would utilize a direct transfer to the Fund, it would confer on the transferred SDRs the same degree of liquidity as is enjoyed by other contributions to the General Resources Account; the French scheme would not provide the same assurances to its contributors. My first reaction to the differences between the two schemes is to suggest that our experience with the establishment of the enhanced structural adjustment facility may indicate that contributions will be much easier to obtain from central banks, which are the natural contributors to such operations, if their contributions enjoy the high liquidity standards provided by the Fund's General Account.

The interest cost to debtors of access to the scheme might be an important factor in persuading the banks to participate in debt conversions on a larger scale: the conversion schemes negotiated up to now have shown that their success depends on the availability of exceptional reserves owned by the debtor or obtained on concessional terms that do not add much additional burden to their remaining debt-servicing obligations. Moreover, any resources intended for financing debt conversions would probably have to be made available for an extended period to give the debtors time enough to achieve a structural improvement in their external debt positions. It is doubtful whether an SDR loan by itself would possess all of these desirable qualities. For this reason, our future discussions on the establishment of a collateralization scheme should also consider in due time the desirability of combining resources of various origins to achieve a better blend between their concessionality and the duration of their availability. One possibility would be to make SDRs available with sufficiently long grace and reimbursement periods, while complementing them with concessional contributions from bilateral sources. Another would be to transfer the SDRs at a concessional rate for a relatively short period when a guarantee falls due and complement them with long-term official financing to cover the later stages of the operation.

The proposals for substitution, asset settlement, and an SDR anchor against inflation have in common the fact that they all regard the SDR as an instrument with a role in promoting a system based on more stable exchange rate relationships. The staff paper suggests on page 21 that such a system would probably make it easier to envisage greater use of SDRs in transactions by private and official entities. Although the staff has deferred to a later date the preparation of a paper on the possible use of the SDR in exchange market interventions, I would like to anticipate the outcome of its study: in the present circumstances, the use of the SDR in helping countries mobilize intervention resources seems the most direct way of influencing the stability of the exchange rate system. Moreover, SDR-based interventions would avoid most of the obstacles inherent in more formal schemes such as substitution and asset settlement.

Intervention is now seen as an essential instrument for protecting the adjustment policies of the largest countries against destabilizing market pressures, provided it is coordinated, symmetrical, and backed by the existence of a pool of available reserves adequate to convince the markets that enough reserves can and will be mobilized to support offsetting actions whenever needed. All of these conditions are already met by the U.S./Japanese standing arrangement of January 1988, under which the United States sells SDRs for yen to finance its share of the coordinated interventions undertaken by the two countries. The idea underlying this arrangement is now ripe for extension by the establishment of a pool of SDR holdings to be used for the more systematic financing of interventions needed to stabilize the system.

In practice, an SDR scheme for supporting exchange market interventions could be worked out along the following lines. The surplus countries would agree at the outset on the fraction of their allocation they are prepared to make available for rechanneling purposes. When a need for intervention arises, the Fund would mobilize the SDR resources committed to the scheme and lend them to the country whose currency needs to be supported in the markets. This mobilization would take place via the same technique explained above. That country would then be in a position to obtain the currency needed for intervention by transferring the SDRs to the surplus countries that would thus obtain a new SDR claim. If intervention needs should persist, this SDR claim could be used for a second round of interventions. A scheme for revolving SDR loans on a bilateral basis was proposed by the staff in SM/88/163 (7/27/88) on international liquidity and the role of the SDR. The advantage of such a revolving mechanism for rechanneling SDRs would be substantial. It would allow the financing of large-scale intervention operations without requiring an allocation of politically unacceptable magnitude--an aspect that was already stressed by Governor Maystadt in his intervention at the Interim Committee and 1988 Annual Meetings. Moreover, it would directly improve the composition of official reserve holdings, which is now too exclusively dominated by the currencies used in intervention operations. In sum, the scheme would combine the basic features of the rechanneling mechanism proposed by Belgium for a post-allocation adjustment with those of the proposal submitted by the staff in SM/88/163 for establishing a mechanism of revolving loans in SDRs, and would thereby greatly increase the amount of interventions that could be financed by a given allocation. The liquidity effects of such a revolving scheme might be considerable; however, any assessment of its inflationary potential should also take into account the fact that the scheme would be activated only in order to finance interventions that, according to the coordination principles established by the major countries, should take place anyway. For that reason, the main effect of using the SDR scheme instead of the present intervention practices would be to achieve a greater degree of symmetry between the reserve currency center and other countries.

One of the most attractive aspects of a scheme for rechanneling SDRs for intervention operations is that it would allow the Fund to play an effective role in the exchange rate stabilization efforts of the largest countries without requiring the protracted legal negotiations associated with former substitution schemes that had the purpose of achieving a more stable system by organizing a better balance between countries' exchange rate obligations. The staff reminds us that such negotiations are particularly complex and risk running aground on such issues as the difficulty of ensuring the financial integrity of a substitution account accepting currency against the issuance of SDR liabilities, or the difficulty of imposing a mandatory asset settlement on the United States.

The need for formal deliberation on such issues seems less pressing today. The intensive policy coordination among the largest countries has already firmly established the principle of symmetrical efforts to stabilize the exchange markets, thereby affirming the two basic purposes of any substitution scheme, namely, promoting more balanced exchange rate obligations among countries, and improving the composition of countries' official reserve holdings. Only the modalities of a more symmetrical system now remain to be further reinforced. The proposal for rechanneling SDRs to finance symmetrical exchange market interventions provides a practical solution to this objective, and would generally improve the present system's stability by providing a central asset to support the principal reserve currency's role in that system.

In fact, the mechanism would avoid the disadvantages imposed by the ad hoc nature of intervention means obtained from bilateral or private market sources, and its use would thus in and of itself exert an additional stabilizing effect on the markets. Nor would it exhibit the characteristic rigidity of existing official financing mechanisms like drawings on the Fund or on the General Agreement to Borrow, which makes their use for daily purposes impracticable. Finally, the scheme would be fully consistent with the present approach to the process of policy coordination, because its activation would be decided at least initially on the basis of multilateral consultation and assessment among its participants and not on the basis of any kind of automatic trigger. In that respect, it would deal in a pragmatic way with one of the staff's basic concerns about the prospects for substitution, since its goals would be pursued through consultation rather than by the imposition of formal rules.

The approaches for revitalizing the SDR that the staff has identified all share common characteristics and involve common preoccupations on which our future deliberations could usefully be based. The proposals we are considering today make no claim to solve all the problems with the international adjustment process: they simply identify specific segments of the process to which the SDR could, at certain times, contribute by ensuring a more appropriate availability of international liquidity. Most of these proposals take pragmatic and operational approaches to the SDR that, by inviting more effective uses of the SDR allocations available at any time, are fully consistent with the role the SDR is already fulfilling in connection with the operation of the Fund's General Resources Account. Under the Seventh and Eighth Reviews of Quotas, a total of SDR 11.3 billion, or more than half of all SDRs allocated since the creation of the system, were transferred from member countries to the Fund's General Resources Account, and have been used intensively ever since to finance the Fund's balance of payments loans.

In the Fund's view, the SDR is an asset that can be used to finance loans more freely than any of its members' national currencies, while to the countries accepting SDRs from borrowing members in exchange for currency, the SDR provides a way of contributing to the Fund's financing while obtaining a claim that is more easily transferable than a reserve position in the Fund. These functions should now be consolidated by making regular SDR allocations in connection with the increase in Fund quotas and by extending the role of the SDR to all situations where official reserves may need to be mobilized to meet exceptional adjustment and intervention needs.

A common feature of all SDR proposals submitted in recent years is that they establish a link between the use of SDRs and the implementation of sound policies. This link's most formal expression came as long ago as 1978, when the authors of the Second Amendment to the Fund's Articles decided that 25 percent of future increases in Fund quotas should be paid in SDRs. The same underlying preoccupations motivated the proposal on a conditional use of the SDR first submitted by Belgium in 1984, at a time when no allocation had been made to finance the settlement of the quota increase of 1983. The original purpose of this proposal was to re-establish an operational link between SDR allocations and the role of the Fund in the adjustment. The ongoing SDR debate has ever since been extending the full validity of the principles underlying a post-allocation rechanneling beyond the immediate goals the proposed technique was originally intended to serve. Today's proposals suggest rechanneling SDRs to support such objectives as debt conversion and exchange market interventions. These activities share the common goal of protecting the adjustment against situations of inappropriate reserve availability.

Despite their link with the adjustment process, the proposals for using SDRs more systematically in aid of countries' adjustment policies are not an alternative to regular increases in the Fund's ordinary resources. Their basic raison d'être is to accommodate adjustment needs that cannot be met by loans from the Fund's quota resources. The collateralization of converted debts would address only one of the structural aspects of a country's external debt position, without solving the general balance of payments problems that remain the natural domain of Fund loans under its traditional tranche policies. Similarly, the use of SDRs for financing exchange market interventions would extend the Fund's financial role into an area that is difficult to reconcile with the rigidity of normal balance of payments loans. Most important, the various proposals under consideration can be applied to adjustment needs, which can at certain moments absorb exceptional amounts of reserves. Given the magnitude of the amounts needed, these reserves cannot be obtained from a pool of resources that operates on quota-based principles. The technique of rechanneling SDRs from countries that do not immediately need to use their allocations offers a flexible solution to the problem of exceptional reserve needs, which can arise at any time during the adjustment process.

Although it directly concerns the use of SDRs rather than the conditions to be satisfied for their allocation, the proposal for rechanneling SDRs nonetheless sheds new light on the objections that for over a decade now have stalled the resumption of SDR allocations. The distribution mechanism attached to the allocation process is itself a long-standing obstacle. Because an allocation allots SDRs to surplus and deficit countries alike, in proportion to their relative quota positions in the Fund, most of the newly created reserves would be located in countries that do not need additional reserves, because they have either large surpluses or easy access to external borrowing. The scheme for rechanneling SDRs offers a solution to this imbalance consistent with both the legal requirements of an allocation and the need for adjustment. The scheme would not, however, displace the present allocation principles. Participation would be strictly voluntary; countries needing to replenish the level of their owned reserves would be advised to retain the proceeds of their allocations according to the conventional norm, and the whole scheme could be terminated at any time when the reserve policies it serves have ceased calling for intensive cooperative support. In sum, the rechanneling scheme only proposes a modality that would better clarify the cooperative function of an allocation in the adjustment process. It is hard to see why this function, which is now increasingly accepted as an important property of reserve holdings in general, should not be more intensively assigned to a reserve asset created on the basis of a cooperative decision.

Mr. Yamazaki made the following statement:

Starting with the suspension of the convertibility of the dollar into gold for official holders, which signaled the end of the Bretton Woods system, the international monetary system has undergone sweeping changes in the past two decades. In 1973, the system of fixed exchange rates was abandoned in many countries. The deregulation of exchange transactions, which has taken place in many countries, has had profound implications for the international monetary system.

In our view, the floating exchange rate system has gradually evolved and matured through a number of tests and trials, including major exchange rate changes. Thus, this is an opportune time to step back and look at possible ways to improve the functioning of the international monetary system from the medium- and long-term perspective.

I will take up the six issues raised in the staff paper, in the order presented therein. First, as pointed out by the staff, it is curious enough that the disciplinary effects on fiscal policy have not been much focused upon. However, in the present situation of intensified international economic policy coordination, the coordination process would be promoted by peer pressures based on enhanced dialogue, which equally applies to the monetary and fiscal policies of member countries.

In this context, it should be noted that the symmetry of the coordination process among member countries would be essential for effective coordination. I would particularly stress the need for deficit countries to reduce their fiscal deficit, while recognizing that both surplus and deficit countries have to attach importance to strengthening fiscal discipline in order to improve their economic structure in the medium and long term.

Turning to the second topic, namely, monetary policy independence and exchange rate regimes, we are inclined to the view that the trade-offs associated with greater fixity of exchange rates would not be serious or would not exist. Moreover, while we certainly recognize the lesser degree of flexibility of fiscal policy, we believe that the policy instrument for greater exchange rate stability would be selected on the basis of a particular economic situation of a particular country, and that the policy instrument for attaining the greatest stability of exchange rates would vary from time to time and from country to country. Therefore, in our view, monetary policy might not necessarily be the sole policy instrument for exchange rate stability.

In addition, we would not think it appropriate to determine the ranking of policy objectives pre-emptively. In our view, the choice of the primary policy objective should also be based on a particular economic and political situation in a particular country.

The third issue I would like to address today is the identification of equilibrium exchange rates and exchange rate management. It is our strong view that it would be more realistic to consider ways of diversifying reserve currencies to complement the dollar's key role, thereby facilitating the financing of resources for market intervention and dispersing the exchange risk for reserve currencies, rather than to introduce a system establishing ranges, bands, or other binding means, which would necessarily entail full consideration of asset settlement.

In our view, further diversification of official holdings of reserve currencies could have a positive impact not only on reserve asset management, but also on the promotion of policy coordination, to the extent that the holding of foreign currencies would make the authorities more sensitive to economic performance of other countries and provide them with an incentive to manage their macroeconomic affairs in a more coordinated manner. I might add that Japan has been steadily removing the barriers that would impede the use of the yen as an international currency.

This brings me to the issue of restrictions or taxes on international capital flows. We are quite doubtful as to the adequacy and feasibility of restricting capital flows to stabilize the market. We consider that diversifying reserve currencies, as well as strengthening the role of the SDR, which is at present serving as a "safety net" for future contingencies, would be most instrumental in attaining the stable market.

The issue of leaders and anchors is quite interesting but we are not ready to take a position on it. We would have to consider a variety of approaches that take into account the responsibility of the reserve currency countries as well as the political concept of hegemonic countries. It is worth reiterating the important role that the intensified policy coordination has played in stabilizing the exchange rate market. We would also emphasize that the reserve currency countries have to implement appropriate economic policies if exchange rate stability is to be attained.

On policy coordination and monitoring zones, we welcome the strengthening of Fund surveillance achieved through the strenuous efforts of the Board, management, and the staff. We also feel encouraged by the success of indicators in helping us to gain a better understanding of the problems facing the world economy and the direction of the economic policies of member countries.

However, it is also our strong view that rigid procedures, such as automatic trigger devices, would not be instrumental in improving the effectiveness of Fund surveillance, regardless of whether it would be a policy response or a consultation that would be triggered. We would be seriously concerned about the negative implication that rigid procedures would have on Fund surveillance. In our view, Fund surveillance has been pursued in an appropriate and balanced way, based on candid discussions in the Board. We would be concerned that any triggering mechanism would take away an effective and useful element of Board discussions. Therefore, we would not support the introduction of rigid procedures, which we consider would be counterproductive to the strengthening of Fund surveillance.

I would also like to comment on monitoring zones, which we consider would be extremely difficult to establish, from the technical perspective. Moreover, since the economic conditions of each member country would be influenced by exogenous factors outside the control of authorities, and since a variety of economic movements would occur, we do not think that it would be feasible and realistic to apply mechanical procedures.

Furthermore, even if zones were set up, such predetermined zones could amplify speculation in the market, which could increase unstable market movement.

Given these considerations, it is useful for the Board to explore ways to strengthen its discussions on Fund surveillance, such as world economic outlook discussions and Article IV consultations, rather than focus on procedural issues.

Before concluding, I would like to add some technical comments on the economic analysis presented in the staff paper, but these are clearly less important to us than other comments that I have made and will make today. We certainly recognize the convenience and usefulness of the analytical framework based on the Mundell-Fleming model. However, since the policy response of one country to another country's policy has become important in an interdependent world economy, we would be interested in some analysis based on game theories. As to the analysis of exchange rate variability, we would be interested in further study on this issue. We would also be interested in further analysis of the equilibrium exchange rate, although it is certainly true that the recent literature on "speculation bubbles" points to the possibility of the nonexistence of equilibrium or "going far away from equilibrium." In particular, we are interested in the implication that recent structural changes under way in many countries have for the exchange rate market. Finally, we would also encourage the staff to explore further the issue of "leaders and anchors."

We also welcome this opportunity to discuss the SDR and the international monetary system. The two decades that have passed since the First Amendment of the Articles took effect in 1969 have brought fundamental changes that raise profound questions on the role that the SDR might play in the international monetary system. Although the Managing Director's proposal on the allocation of SDRs for the first basic period predicted that the reserves would not be adequate without allocating the SDR, the conditions on which the planning of the first SDR allocation was based did not materialize. Similarly, there have since been major developments in the international monetary situation, including the shift to floating exchange rates as well as the expansion and integration of the international financial market.

It is our firm view that the Fund should clarify the concept and the functions of international liquidity and then, on the basis of that analysis, define what role the SDR can and should play in the international monetary system, and what measures are necessary to enable it to play its proper role most effectively. In our view, it is also imperative to study how to improve the SDR's characteristics and how to make the SDR an easily usable international reserve currency.

In this context, we appreciate the initiative of management and the staff in reviewing the issues relating to the concept and measurement of international liquidity, as well as exploring possible approaches to invigorate the SDR. The staff paper provides us with a useful basis not only for further consideration of SDR allocations, but also for further consideration of the role of the SDR in the international monetary system. I encourage the staff to proceed further with the study on international liquidity and the role of the SDR.

We wish to contribute to the future study of these issues by making several technical comments. First, on the concept, measurement, and distribution of international liquidity, we certainly recognize the difficulty in quantifying the broader concept of international liquidity and commend the staff for providing a useful approach, which will indirectly help in the assessment of the adequacy of international liquidity.

In our view, it is essential to rely on a judgmental analysis in assessing the adequacy of international liquidity. However, it is also essential to develop a quantitative analysis in order to underpin and supplement the judgmental analysis of the adequacy of international liquidity. Therefore, we encourage the staff to explore further approaches to quantifying the broader concept of international liquidity. Work could be done on the aggregate money supply of freely usable or convertible currencies, since the liberalization of exchange transactions has blurred the distinction between freely usable currencies held inside countries and those held outside the countries. We emphasize the need to pay due attention to the assumptions on which the quantitative approach is based, as well as to the limitations that inherently accompany the quantitative approach.

Turning to the approach of focusing on the patterns of adjustment in import volumes relative to both real GDP and export volumes, we found the staff work on this very useful. Since the import and export patterns of developing countries contrast with those of industrial countries, it could be concluded that the issue is the maldistribution of international liquidity rather than the adequacy of international liquidity. Furthermore, it could be argued that compression of imports in indebted countries could be attributable to the policies reflecting the conditionality attached to financing, such as Fund conditionality, rather than to the liquidity shortage. It should also be noted that structural changes stemming from higher energy prices or more advanced technology could have had implications for the import and export patterns in international trade during this decade.

I will now comment on the role of the SDR in the international monetary system and the criteria for SDR allocation. It should be noted that the creation of the SDR was initially intended to supplement international reserves quantitatively. Therefore, the criteria for the SDR allocation in the Articles of Agreement--long-term global need--was based on the idea of allocating the SDR in order to quantitatively supplement reserves.

Since the creation of the SDR, the international monetary situation has experienced major changes, one of which has been the development of regional monetary systems, as illustrated by the evolution of the European Monetary System. These changes necessitate the study of ways to enhance the role of the SDR in order to take advantage of qualitative aspects of SDRs, including high stability of its value and return. However, focusing on the qualitative aspects of the SDR rather than on the quantitative aspect contradicts the concept that the SDR would fill a reserves shortage arising from the gap between the supply and demand for reserves.

In our view, these considerations point to the need to thoroughly review the role of the SDR in the international monetary system and to consider the interpretation of the criteria for SDR allocation based on the review on the role of the SDR. The SDR was given credit as "the principal reserve asset in the international monetary system" in 1978, when the Second Amendment to the Articles became effective. I would stress that in any such review, the purposes of the Fund should be taken into consideration.

Regarding possible ways to invigorate the SDR, we understand that the provision of unconditional liquidity through SDR allocation would discourage adjustment efforts by indebted countries. In reply to the question whether an SDR allocation would discourage adjustment, we first have to establish whether liquidity constraints exist in individual countries, and if so, why. Without these analyses, we could not support the provision of unconditional liquidity through the SDR with the objective of promoting growth.

As to the ways in which the SDR could be used to provide an anchor against inflation, we found the staff's approach to this to be interesting. However, we would be doubtful whether the SDR could play a role as an anchor against inflation, since the SDR currently accounts for only 4 percent of total reserve holdings, excluding gold.

Concerning ways to improve the stability of the reserve system, we would emphasize that the fundamental basis for stability in that system is the creditworthiness of individual countries attained through sound economic management, since many countries have relied upon borrowed resources. It should also be noted that intensified policy coordination and cooperation in the exchange market have contributed to the stability of exchange rates. Therefore, we are not convinced that an increase in the share of SDRs in reserve holdings is necessary to improve the stability of the reserve system. We would encourage the staff to fully study the role of the SDR and the need to increase the share of SDRs in reserve holdings.

In sum, we urge the staff to explore further all the ways to invigorate the SDR that were presented in the paper. In addition, we encourage the staff to proceed with an in-depth study on the merits and demerits of other approaches, such as promoting voluntary transactions in SDRs and prescribing "other official entities" as holders of SDRs.

Mr. Grosche made the following statement:

I will comment first on key issues in the international monetary system. The staff has made a thoughtful and well-balanced presentation of quite intricate and, in part, sensitive issues--sensitive because, if not treated well, they could convey wrong signals to the markets.

We do not believe that the exchange rate regime in itself can do much to discipline fiscal policy. More is needed than exchange rate mechanics. Most important, policymakers need to agree on the "correct" objectives. People tend to have different views of what should be considered to be "correct," but I believe that differences can be narrowed substantially in a multilateral give-and-take exercise encouraged by policy coordination.

We remain convinced that stable exchange rate relationships and a better balanced external situation can be achieved above all through appropriate policies. We believe that it will be easier to arrive at such policies if cooperation among the major industrial countries is improved. The objective of adequate policy coordination has been formulated in declarations of the major industrial countries at recent summit meetings, and in statements of the G-7 finance ministers--for example, the Louvre statement of February 1987, the December 1987 statement, and the statement issued last September in Berlin.

In trying to coordinate policies, one has to aim at a balanced mix of monetary and fiscal policies. Clearly, monetary policy should not be overburdened; in other words, monetary policy should not give up too much in terms of other objectives in order to achieve greater stability of exchange rates. The question arises in this connection whether monetary policy can be shielded from capital flows through the imposition of market restrictions. We think that the answer is no: such restrictions, if at all enforceable, would entail other substantial costs for an economy and are therefore neither realistic nor desirable.

I admit that the present system is not perfect, but I do not know of any solutions better than intensified cooperation. Such cooperation should be "anchored" or centered around the monetary and fiscal policies of participating countries without overburdening either the one or the other. Considering present conditions and those likely to prevail in the foreseeable future, we believe that it is neither necessary nor desirable to search for a nominal anchor. We believe, in particular, that a commodity price index cannot assume a function that goes beyond its present role of a useful analytical tool providing information about price trends.

Cooperation on exchange rates is part of the overall framework of cooperation. But this cannot imply a "fixity" of exchange rates in the sense of target zones, for example. Like the staff, we believe that official estimates of equilibrium rates should be allowed to change over time in response to changes in real economic conditions. But this does not preclude pragmatic cooperation aiming at more stable and more appropriate exchange rates. In certain situations, this may also imply joint statements on the level of exchange rates, which, if required, could be reinforced by market interventions. I should emphasize, however, that market interventions will not offer lasting success if undertaken in opposition to strong underlying market forces.

Economic indicators can provide a useful analytical tool in the process of economic policy coordination. However, they cannot be used for triggering specific actions, nor can they replace the need to make policy decisions.

It is not surprising that we have strong reservations about monitoring zones. In addition to the technical and analytical difficulties, so well explained by the staff, we also see the risk that such an approach could lead toward fine-tuning and automaticity. Also, it could give rise to lopsided expectations of actions by particular countries--expectations that could undermine efforts at closer cooperation.

The staff paper on the SDR illustrates once again the dilemma in which we find ourselves when it comes to the reserve system and the SDR. On the one hand, the Articles of Agreement provide us with an instrument for controlling the quantity of international liquidity in an international monetary system more or less of the Bretton Woods type. On the other hand, however, this system has changed so much that currently the SDR in its present form does not seem to serve a useful purpose, which does not mean, I hasten to add, that the current system functions satisfactorily, or that the SDR has become obsolete. We cannot preclude that conditions similar to those that led to the creation of this instrument and calling for an SDR allocation or cancellation will re-emerge.

The staff is right in elaborating at length on the most controversial part of the concept--long-term global need. I am doubtful, however, whether it is useful to go back to interpretations that have already been discarded, such as the one referred to on page 3 of the staff paper. Instead, we have to base our considerations on the understanding that was generally endorsed, which Joseph Gold defined in his 1970 pamphlet on the SDR as follows: "It is a general shortage of unconditional liquidity which must guide the Fund in reaching a decision on whether or not to generate special drawing rights."

No doubt, the development of large-scale international financial markets has greatly expanded the capacity of national authorities to obtain foreign exchange reserves, and the concept of a quantitative reserve shortage has become more difficult to define. I am grateful to the staff for nevertheless attempting to construct a meaningful quantitative measure of the amount of liquidity that is readily available. Conceptual difficulties and data limitations make this very difficult, however, and even the indirect measure, which draws interferences from the pattern of adjustments in import volumes relative to both real GDP and export volumes, seems to have flaws. But I would suggest further studies on this approach covering a longer period.

Despite those difficulties, we have to continue to search for a measure for determining, in today's context, the long-term global need for supplementing existing reserve assets. I doubt whether the staff's broad approach suggested at the bottom of page 5 is really appropriate and helpful. The staff proposes determining the resources that are "readily available for the purpose of financing balance of payments deficits." In our view, such a broad definition would signal a shortage of international reserves as soon as difficulties arose in financing a balance of payments deficit. Under present conditions, however, I wonder whether such difficulties would not indicate in many cases that a deficit has become "unsustainable," and that a balance of payments needs adjustment. Experience shows that most countries with balance of payments difficulties are in need of long-term financing for economic development, if possible on concessional terms. It does not seem appropriate to monetize such deficits with the reserves of other countries in exchange for SDRs. The staff's broad definition mixes different elements of international liquidity that cannot be substitutes for each other, in our view. I have problems, therefore, with the definition on page 34 that "the overall amount of liquidity has become more relevant than the size of reserve holdings alone in the quantitative assessment of the need for reserve supplementation."

Now, given the conceptual difficulties of determining a reserve shortage, I do not think that we can simply forget about the allocation criterion and look for other possible approaches to "invigorate the SDR." Our attempts to provide the SDR with a new role should not blind us to the very problems that we are facing in today's international monetary system, and we should not allow the creation of additional liquidity to become a panacea for the imperfections of the system. We should avoid solutions that would only cure symptoms and not the illness itself, which would exacerbate future problems.

In passing, I would remark on the "inconsistency" the staff detects between the existing allocation criterion and the interest in making the SDR the principal reserve asset. We have to bear in mind that such an intent had been incorporated in the Articles because, at that time, one wanted to achieve a better control of international liquidity through a reduction of the role of national reserve currencies. The objective was to substitute national currencies against the SDR, which has not yet been achieved. As long as we cannot make strides toward this objective, the provisions in Article VIII, Section 7, and Article XXII cannot be fully translated into reality.

We remain skeptical about the new proposals for linking the reserve creation mechanism to development objectives. I do not want to repeat our arguments. Let me only say that, in our view, the developing countries do not need short-term monetary liquidity, but rather long-term capital. To my surprise, the staff has not made any reference to that crucial distinction.

On previous occasions, I expressed reservations about the various post-allocation redistribution proposals, and this extends also to the Trust Fund idea. If one were to conclude that access to the Fund's resources was insufficient, the best way to remedy such a situation would be to increase the size of the Fund.

As we know from experience, reimposing a reconstitution requirement does not prevent the prolonged net use of SDRs. We remain doubtful, therefore, whether the reconstitution requirement is a useful and practicable approach.

We do not see a need for transactions between private and official entities to be made in SDR-denominated instruments.

An international reserve instrument like the SDR does not have to have more characteristics than those that are required for transactions between monetary authorities and the Fund. And as far as private entities are concerned, there are, to my knowledge, no obstacles to the active use of SDR-denominated instruments in many industrial countries. Despite such opportunities, however, no significant SDR market has developed, which leads me to conclude that there is no genuine demand for an SDR financial market; but I am ready to be convinced otherwise in that area.

On the proposals for substitution and asset settlement mechanism, there are so many complicated legal and political issues involved that we are quite skeptical about the chances for implementation.

The staff's reflections on ways in which the SDR might provide an anchor against inflation are yet another example of trying to cure the symptoms of a problem. As regards the pegging of national currencies to the SDR, I simply can refer to Mr. Nimatallah's statement, which explains the difficulties so well. I would admit that smaller countries feel pegging is useful.

Also, we do not believe it to be very realistic to expect broad support for the Fund to function as a supranational central bank.

The second sentence in the third paragraph of page 26 seems to imply that the SDR was created for the purpose of avoiding worldwide economic deflation or inflation. In our view, these additional qualitative considerations come into play only if and when the long-term global need for an SDR allocation has been established.

The proposal for an allocation in two stages seems at odds with the concept of a global need for unconditional liquidity. If a long-term global need exists, the newly created liquidity should be made available to all members. If, on the other hand, a long-term global need does not exist, there is no case for an allocation.

The staff's reflections on the cost and availability of international reserves seem to be largely irrelevant. I have addressed those arguments on previous occasions. The suggestions put forward by the staff would make more sense to me if we were talking about a closed system of reserve creation in which it was possible to substitute one reserve component for another. This, however, is not the case now, nor will it likely be in the foreseeable future. The staff view implies that a judgment can be made on the appropriate overall amount of global reserves. Otherwise, one would have to assume that any demand for low-cost

SDR reserves had to be satisfied. I am not convinced by the statement that it is "too costly" for countries with limited creditworthiness to obtain additional reserves through improvements in their current account balances.

The fact that liquidity made available from official sources (such as under the General Arrangements to Borrow and the European Monetary Cooperation Fund) has increased less rapidly than the volume of other non-gold reserves does not indicate that the supply of official reserves has been insufficient. Rather, it shows that other reserves have risen, perhaps too strongly.

In many countries--and here again I beg to differ from the staff--import compression is not due primarily to a reserve shortage but rather is required to correct an external position that was not sustainable in the medium run. Necessary and genuine adjustment should not be postponed or even replaced by the creation of liquidity.

We continue to support those who are not in favor of a strategy of conducting regular allocations of SDRs at a moderate rate that prevent the share of SDRs in reserve holdings from going down further. This strategy would very likely have the somewhat paradoxical consequence that the faster other reserves grow, the more SDRs would have to be allocated.

The SDR will have to play a useful role if and when the need arises. The need to provide a safety net for the international monetary system is certainly one of those needs and can arise fairly quickly. I do not believe, however, that preventative allocations serve a useful purpose.

Mrs. Ploix made the following statement:

Everyone is aware of France's traditional position on the functioning of the international monetary system. Since the demise of fixed exchange rates, France has deemed it in the interest of the international community as a whole to do everything possible to return gradually to more stable exchange arrangements and to an orderly international monetary system. While some flexibility is of course necessary, progress in this direction would certainly promote the growth of world trade by making transactions more secure and improving the conditions under which economic agents make their economic and financial decisions.

Great pragmatism is required in this matter, however, and I must admit that while I find both staff documents extremely well done and interesting, they are somewhat academic in tone. I also note that efforts to improve the functioning of the international monetary system began in 1985, with the Plaza Agreement and the Louvre Accord. These accords, which constitute a fundamental achievement, reflect a recognition of the limits of freely floating exchange rates. They are based on the concept of intensified coordination at three levels--central bank interventions in the foreign exchange markets, monetary policy, and fiscal and structural policies--to create the conditions for lasting stability of exchange rates. They have worked so well in part because of the high quality of the technical support provided by the Fund. Therefore, we should be thinking, with all necessary prudence, of ways to reinforce the Fund's role in this informal coordination process. On the other hand, it does not seem at all realistic in the short term, if only for reasons of practical effectiveness, to contemplate extending this process, or a system derived from it, to the entire Fund membership.

In the medium term, it is clear to my authorities that further ways to improve present international monetary mechanisms will have to be found. My country, for its part, would look favorably upon taking a further step toward the improved functioning of the international monetary system by formalizing, to some extent, the current process of concerted management of exchange rates.

In this framework, which would have to be designed and implemented very pragmatically, the exchange mechanism would be based on a grid of bilateral exchange rates with agreed fluctuation margins around central rates. Using an approach similar to that of the Louvre Accord, each central bank would be required to intervene at those limits, whether its currency is at the ceiling or floor in relation to the other currency concerned. Realignments would be permitted, but would be subject to mutual agreement after examination of the economic policies of all participants, to make sure that economic adjustment and monetary realignment are implemented in a consistent manner. A monetary benchmark could be introduced, perhaps in the form of a basket of international currencies. Ways to maintain the value of that benchmark in the context of world inflation should be carefully considered.

These arrangements, which would differ fundamentally from those of Bretton Woods in order to reflect the changes that have taken place in the world economy in the postwar period, would be founded on clear principles and procedures. We think that they would provide better protection against speculative flows than would a tax on capital movements, the feasibility of which has yet to be proven and which would conflict with the pursuit of liberalization of capital markets.

The international monetary pillars would be the currencies of the United States, Japan, and the EMS. Still, we should consider whether it would be expedient for central banks, in settling their mutual exchange obligations, to have recourse to the monetary benchmark, into which these currencies would be convertible and which could play the role of a world reserve asset.

I would point out to the Board that the experience of the European Monetary System demonstrates the operational nature and fundamental merits of this kind of exchange arrangement, in which economic policy coordination plays a major role and true symmetry in the burden sharing among all participants is the basic rule.

On the subject of the SDR's role in the international monetary system, I can only stress how paradoxical it is that today, a full 20 years after it was created, the SDR makes up only 4 percent of the world's total non-gold reserves while, according to the Fund's Articles of Agreement, it was supposed to become the principal reserve asset of the international monetary system.

Therefore, I believe that the Board should go beyond academic debate and ask itself what can be done to promote the role and use of SDRs. Of course, my authorities continue to favor making the SDR, perhaps after some improvements, a major reserve instrument in the international monetary system, pursuant to the Fund's Articles.

Several proposals to this end should be carefully examined. The World Bank and other official institutions authorized to hold SDRs could be encouraged to denominate their loans in SDRs. The list of prescribed holders of SDRs could be broadened to include financial institutions responsible for development assistance. The proposal to establish a clearing house mechanism could be studied. Similarly, a more detailed study of measures to enlarge the use of the SDR could be submitted to the Board for an in-depth examination. On the other hand, the proposal put forward by Mr. Polak in 1979 of a Fund based entirely on the SDR still looks rather unrealistic in the short or medium term, although it is interesting in principle.

I suggest that the staff take another look at the idea of a substitution account, whose mechanism could be derived from the one described in 1974 by the Committee of Twenty. The modalities of such an account should lead to greater discipline on the part of reserve currency countries whose external payments are significantly out of balance.

As for the role the SDR could play to offset the inflationary drift of all currencies, I would suggest studying the feasibility of a "constant SDR," revised annually on the basis of world inflation.

My authorities attach great importance to increasing the monetary nature of the SDR and to halting the decline in the SDR's share in world reserves. Adoption by the Fund of a strategy of regular SDR allocations could help reverse this trend. The fact that the last SDR allocation was as long ago as 1981 is, in our view, quite unfortunate.

I am aware that certain of my colleagues remain wary of the potential risks of regular SDR allocations for the level of international liquidity; I will only stress how difficult it is to come to a firm view on the concept of international liquidity, particularly in view of the expansion of international capital markets. Given the major uncertainties regarding the quantitative approach suggested by the staff, it appears virtually impossible today to make any overall assessment of the adequacy of world liquidity for the needs of the economy.

At the most, it may be said that, for the group of countries having access to the international capital markets, the supply of liquidity readily adjusts to needs. One might even argue that for reserve currency countries, as well as for other creditworthy countries, liquidity constraints today are insufficient, with the result that those countries borrow massively rather than make appropriate adjustments in economic policy.

It would be incorrect, however, to conclude that there is no liquidity problem today. On the contrary, some developing countries do not have access to the capital markets on their own because of their relatively high indebtedness. The liquidity constraints they face are severe, if not insuperable, judging from the scope of the adjustment measures they have had to take and the significant efforts their creditors have had to make.

Turning to my authorities' proposal for an SDR allocation specifically designed to assist with middle-income countries' debts, I would like to clarify certain points raised in the staff paper. First, the Guarantee Fund could be more easily administered by using the provisions of Article XVI, Section 2 of the Fund's Articles, which have already been used twice, in connection with the Trust Fund and the enhanced structural adjustment facility, than by applying Article V, Section 2(b). Similarly, since an SDR allocation is not meant to entail the automatic creation of liquidity, these SDRs could not be converted into currency as soon as the Guarantee Fund is created; conversion would take place only if and when a guarantee is activated. Of course, this recent initiative has superseded our previous proposal, formulated by Mr. de Maulde in 1984 and referred to by the staff.

Mrs. Filardo made the following statement:

The two papers for today's discussion contain very important issues for the enhancement of the functioning of the international monetary system in the framework of the Fund. I view this meeting as the beginning of a set of discussions eventually culminating in an appropriate set of rules that could be faithfully observed by the members of this institution. The papers would seem to indicate that at present we are operating under a "nonsystem": each country or block of countries has chosen the exchange and trade regimes that best serve its purposes.

The Fund is not having much success with its task of surveillance. Outside of the Fund's domain, policy coordination among the G-7 countries would appear to be the key to keep the system on track. By the same token, the SDR was created to supplement reserve assets when necessary, but now that the concept of international liquidity has broadened to include more than just international reserves, it has become difficult to decide on the appropriate formula for further SDR allocations. In order to eliminate these problems and facilitate an improvement in the functioning of the world economy, we must reach a consensus on the international monetary system.

I will now address some of the questions raised by the staff in the two papers. It has been demonstrated, both by the Bretton Woods period up to 1971 and by the EMS, that one can have exchange rate discipline as long as the major industrial countries are politically committed to implementing sound macroeconomic policies aimed at achieving sustainable economic growth, price stability, and external viability, and are willing to abide by the agreed rules and regulations. When these conditions are not met or when an exchange or financial crisis has emerged, the second-best solution of policy coordination is necessary. However, as Mr. Kafka has rightly indicated in his statement, the coordination of exchange market intervention has only been used in the context of lasting imbalances in the three major industrial countries. Thus, I wonder how one could possibly envision the transformation or evolution of the exchange rate regime if even the United States, as the traditional leader of the system, does not discipline its fiscal and external imbalances.

In a world of high capital mobility and protracted imbalances, in which the major industrial countries want their exchange rates to fluctuate within a defined unknown range, monetary policy loses its independence. The question then is whether the costs that this implies could be moderated by the implementation of concerted intervention. The staff paper indicates that, while intervention has been helpful in smoothing short-term volatility and providing the market with signals on the appropriate course of policies, monetary policy cannot serve two masters. Nevertheless, the staff seems to suggest that concerted intervention can be a second-best solution if it is sterilized, and that, in the end, its success has a lot to do with the structure of any modification in the exchange rate system. I would add that such success also depends on disciplined economic policies in the major industrial nations.

The arguments expressed by the staff favoring the market rate as the equilibrium rate are convincing. If fundamentals are not properly addressed, the market rate should reflect the disequilibrium and the ability to correct it. Nevertheless, experience with concerted market intervention since 1985 would seem to indicate that the G-7 countries tend to maintain their exchange rates at neither the equilibrium rate nor the market rate.

With respect to restricting international capital flows, the question the staff should ask is not what the implications would be, but rather whether, in today's world of high capital mobility and integration of financial markets, it would even be possible to implement capital restriction and, if so, whether that could work properly.

Regarding leaders and anchors, the staff paper indicates that in a world of more symmetric economic influence, policy coordination could shape a new implicit contract for the international monetary system. While this is a very convincing argument as a second best alternative, such a contract would require the commitment by each country to the adoption of sound and stable macroeconomic policies at the national level, as was envisaged under the Bretton Woods system or as was implicit under the floating exchange rate system. In addition, it requires the compromise of accepting the Fund as the appropriate institution to promote economic policy coordination and surveillance.

On policy coordination, I reiterate our support for the main conclusions contained in the summing up of the previous discussion on this subject. I would emphasize the importance of the role of the Fund in this function and the commitment of major industrial countries to appropriate discipline of its macroeconomic policies. Just as in the case of performance criteria in Fund programs, the establishment of a monitoring zone for key economic indicators could reinforce the role of indicators. If we really want to give an operational meaning to the surveillance exercise for industrial countries, we should carry out special consultations on this subject. The Fund staff has developed a particular expertise in selecting the indicators and the width of the zone from its Article IV consultations with industrial countries, the world economic outlook exercise, and program design for countries that use Fund resources. In our view, policy and performance indicators are complementary.

The identification of why deviations from monitoring zones take place is crucial. Nevertheless, the staff seems to suggest that the amount of work that is required depends on how extensively one wants to study indicators to determine why economic performance has gone off track and what to do about it. Perhaps the staff could elaborate on this, pointing out the difficulties that it has encountered in enhancing the use of indicators and monitoring zones.

Regarding the choice between loud or quiet monitoring zones, again the important issue is whether the zones are realistically defined and deviations properly explained and addressed in response to the authorities' commitment.

In the paper on the SDR and the international monetary system, the staff indicates that the definition of international liquidity has broadened to include all the resources that a country has readily available for the purpose of financing balance of payment deficits or intervening in foreign exchange markets to stabilize the value of its currency. International reserves and external resources that are readily available from private sources are now included in this classification, among others. After assessing various quantitative methods to determine the adequacy of international liquidity, the staff comes to the conclusion that it is a hopeless task.

Nevertheless, I would say that the problem the current system faces is not so much a shortage of liquidity as how liquidity is distributed and how readily available financial resources are for developing countries with debt problems. While the staff mentioned the difficulties in quantifying these elements, if the numbers in Tables 1 and 2 were properly classified according to groups of developing countries--especially those with debt problems--they could serve as useful indicators of the serious shortfall in the availability of liquidity to those countries since 1982.

Given the current uneven distribution of liquidity, it is possible that the allocation criterion has lost its operational usefulness in the sense that any new SDR allocation would be distributed primarily among those countries that have either significant amounts of international reserves or ready access to capital markets. Given this apparent constraint, the question is how to make the SDR an instrument that could enhance the functioning of the present system.

In addition to suggesting four approaches to invigorate the SDR, the staff raises the possibility of a strategy for conducting regular and moderate allocations of the SDR, in order to preserve the SDR's share in total reserves as well as to fulfill the criterion in the Articles that the SDR should become the main asset of the international monetary system. We fully endorse this proposal.

In considering the different approaches, each one in itself is very important and deserves further evaluation. At this time, I will concentrate my comments on ways to promote growth without discouraging adjustment. As the paper rightly recognizes, "the success of growth-oriented adjustment programs requires not only effective and appropriate policy implementation in the indebted countries, but also an adequate supply of international liquidity for these countries and a supportive world economic environment."

The present circumstances of the financial markets clearly indicate that there is no new money available for the highly indebted countries unless they can provide a guarantee for the new debt, and that sizable amounts of resources are required for implementing debt reduction schemes, which otherwise could be used either for more productive uses or to service the existing debt. In this regard, the present debt strategy could be enhanced, with the Fund continuing to play an active role, through the use of SDRs for collateralization of principal and interest or for facilitating the use of hedging instruments, on the conditions that the member country will enter into an arrangement with the Fund and that the country will be able to capture the discount in the secondary market. The question remains whether it would be more appropriate to recycle the SDRs that are currently held by major industrial countries in their official reserves (the French and Belgian proposal), or either make some portion of SDR allocations subject to conditionality or reimpose a reconstitution requirement on the use of SDRs. The first option seems more attractive and deserves careful consideration along the lines expressed by Mr. de Groote in his statement.

Mr. Dai made the following statement:

I welcome today's discussion on the two issues of the international monetary system. The first staff paper presents a comprehensive analysis of some key issues concerning the functioning of the international monetary system, including alternative proposals in recent years for improving the functioning of the system in the context of fixed and floating exchange rate regimes. Clearly, the underlying concern over the functioning of the international monetary system is the international transmission of disturbances through terms of trade and exchange rate mechanisms.

A well-functioning international monetary system should be able to smooth out instability induced by spillovers of domestic policy actions, particularly those of major industrial countries, thereby fostering an environment for sustainable growth in world economic activities and trade.

The staff has analyzed the effects of fiscal and monetary policies on a country's internal and external balances under different exchange rate regimes. However, it should also be pointed out that the national objectives of the two balances must be well coordinated with the overall objectives of the international monetary system if the authorities want either of the balances to be relatively sustainable. This is especially true of the major industrial countries. Their policy actions can affect the stability of the international monetary system which, in turn, provides favorable conditions for the achievement of national objectives.

I will now comment on the issues raised by the staff. The issues of fiscal policy discipline and monetary policy independence under different exchange rate regimes are closely related. Strictly speaking, fiscal policy decisions are not constrained by exchange rate regimes, given that national output and employment are usually the primary objectives of government policies. In particular, political considerations generally determine a government's policy orientation. In addition, since fiscal policy has a direct impact on the real sector, where, in the short run, adjustment is usually slow because of the prevailing rigidity in this sector, fiscal policy flexibility in terms of adjustment is further limited. Consequently, if monetary policy independence is defined as ensuring price stability, that policy would lose its independence under a fixed regime as well as a floating regime, depending on whether the monetary authority is willing to "wear two hats." In other words, in the absence of fiscal policy discipline, certain monetary policy sacrifices have to be made in order to maintain both internal and external balance.

Under a fixed regime, the monetary authorities may find it impossible to sustain target exchange rates while keeping the money supply on track in order to avoid inflation. Under a floating regime, the monetary authorities are relatively independent, in the sense that their monetary policy is not restricted by the goal of a stable exchange rate. However, when national economic objectives other than inflation are threatened, monetary policy cannot escape the pressure to change its policy orientation. In the circumstances of high capital mobility and close interdependence in the world economy, transmission of disturbances between countries would only worsen the situation, because the pressures are international as well as domestic.

Experience under the floating exchange rate regime has shown that some of the major advantages to such a regime have not been as fully realized as originally expected. The frequent dollar crises in the 1970s and the unsustainable dollar surge in the period before the Plaza Agreement was signed in 1985 indicate the limited role that the floating regime can play in external adjustment. Under this regime, the freedom of monetary independence should not be overstated. Similarly, the costs of reduced monetary independence under greater fixity of exchange rates should not be exaggerated if the overall effects on the economy are to be taken into account.

The central problem before us today is how to ensure an international monetary system that is relatively stable and that can facilitate the expansion of world trade and international investment and transfer resources to the developing countries. Such a system undoubtedly requires the support and concerted efforts of the major industrial countries, since it would lead to more disciplined macroeconomic policies, particularly fiscal and monetary policies, in these countries. In other words, with what policy mix in these major industrial countries can internal policies and international objectives be better balanced, and what kind of an exchange rate system can best ease the implementation of such a policy mix?

I will now comment on policy coordination and monitoring zones, together with the issue of leaders and anchors. First, what can we expect from international coordination of economic policies? Generally, we hope that better policy coordination among the major industrial countries will have a stabilizing effect on the international monetary system. The key to successful policy coordination is the willingness of a country's authorities to consider their national policy objectives together with the overall objectives of the international community. The problem seems to lie in the dilemma that the authorities may face during the process of coordinating their international policies. However, no policy coordination at all probably poses just as much of a dilemma to a country's authorities.

In my view, appropriate policy coordination will reduce this dilemma if the cross-effects of the national policies of each country are examined. For example, if a deficit country with a huge budget deficit reduces its deficit, the surplus countries would not have to make much of a monetary policy sacrifice in order to increase domestic demand. On the other hand, if the surplus countries strengthen their domestic demand, the deficit country then has less difficulty in adjusting its fiscal policy and external imbalance because its exports to surplus countries increase.

Before I turn to the question of whether we need a mechanism to bring policy coordination into action, I will examine the structure of the present exchange rate system, which has certainly diversified since the breakdown of the Bretton Woods system. The systems fall roughly into three categories: some currencies (most of which are those of small developing countries) are pegged to a single currency or currency composite; some currencies float independently; and some currencies are in between the two extremes.

In terms of capital mobility, some economies--most of which are developing countries--are less integrated with world capital markets, while others are highly, although not perfectly, capital mobile. In this framework, three currencies--namely, the U.S. dollar, the deutsche mark, and the Japanese yen--play a dominant role, as other currencies are either pegged to one of them, or give them heavy weight. Therefore, movements of these three currencies induced by their countries' policy actions easily affect the stability of other economies, even though the channels of transmission may differ depending on the degree of capital mobility and the degree of flexibility of exchange rates.

In the present circumstances, it is not unreasonable to suggest that these three major currencies be more or less fixed or stabilized through a mechanism such as the suggested monitoring zone. Such a zone would strengthen the process of international economic policy coordination by firming up the implementation of policy commitments. In addition, it would oblige a country's authorities to be aware of the effects that their policies have on the world economy and might allow the macroeconomic policies of the three major countries to serve as anchors in the coordinated process. This would not trigger automatic policy responses as in the case of a fixed exchange rate regime, but it could serve as a policy coordination guide and perhaps initiate some form of concerted intervention.

Of course, such an exchange arrangement--which is not intended to be a recreation of the Tripartite Agreement in the 1930s--should be completely under the multilateral surveillance of the Fund in the context of a continued reform process of the international monetary system. Again, the effectiveness of such an arrangement depends on the political will of the major currency countries to assume their responsibilities in international monetary affairs. However, there is no guarantee that exchange stability will not give way to the national policy objectives of the major currency countries. Therefore, while such a system may be the best choice, I doubt whether it is an ideal one.

I support the view that reform of the international monetary system is not a crisis management instrument but rather a means by which to build a mechanism to ensure the long-term stabilization of the international monetary system from which all countries may benefit equally.

I will now comment on the SDR and the international monetary system. I appreciate the staff's efforts in coming up with several different scenarios to show how the role of the SDR in the international monetary system can be strengthened.

On the issue of assessing the adequacy of international liquidity, although the expansion of private international capital markets makes a strictly quantitative measurement more difficult, this does not imply that there is no way to make an assessment by certain quantitative approaches, supplemented by judgmental analyses. The approach suggested in the staff paper can be useful and rational.

In order for the SDR to become the principal reserve asset in the international monetary system, the first and second approaches proposed by the staff for invigorating the SDR are more attractive and of more practical significance in the short term, while the third and fourth approaches merit careful study in the context of international monetary reform in the longer run.

However, to invigorate the SDR, several characteristics have to come into play. First, there must be much wider use of the SDR in the international monetary system. Based on the present limited use of the SDR, it is hard to believe that it could actually be seen as a potential principal reserve asset, especially as the present involvement of the SDR in the monetary system is so limited in amount and coverage. I note that the share of SDRs has dwindled to less than 4 percent of global non-gold reserves, a situation that is hardly consistent with the objective of making the SDR the principal reserve asset.

First, in conjunction with wider use of the SDR, participation should be open to private as well as official entities. Since present coverage from the Fund's legal point of view is restricted to the usage defined in the Articles of Agreement, perhaps issuance of SDR certificates--backed by official SDRs--could be promoted in the context of exchange market intervention and other transactions denominated in SDRs, as suggested by Mr. Polak. In short, SDRs must be used much more widely and in larger volume, and greatly increased exposure needs to be given to the merits of the SDR's role in order for it to play a more important and acceptable role in the world's markets.

Second, to ensure worldwide recognition of the SDR as the principal reserve asset, attention has to be devoted to making it as easy to use as other reserve assets. This in turn would gain the confidence of the holders in its ready availability and would also tend to act as a form of guarantee for trading partners.

Third, one of the most positive factors in using the SDR on a worldwide basis is its low operating cost and relative stability of value. There are almost no net costs, and this is particularly advantageous for the developing countries, since it would allow them to participate to a greater extent in world trade.

I agree with the staff that a new SDR allocation is also desirable in the context of the present debt problem. Access of debtor countries to the international capital markets could be ensured through some means of security and credit enhancement, and, against this background, debtors would be able to strengthen their economic growth and thereby their ability to repay their debts.

It is appropriate to take into account the potential usefulness of the SDR in the future in assessing the long-term global need for reserve supplementation. From a long-term point of view, since there is no firm assurance in relying on a national currency as an international reserve asset, the possibility of making the SDR the principal reserve asset has to be explored in our efforts to reform the international monetary system.

Mr. Cassell made the following statement:

I greatly welcome the paper and discussion on key issues in the international monetary system. While the paper does not say so specifically, it should not be forgotten that the international monetary system is not an end in itself, but a means to an end. The relative merits of different possible systems must be judged in relation to how well they contribute to the achievement of those wider ends. It has been accepted that one defines international monetary systems in terms of exchange rate regimes. I recall that Fred Hirsch produced a chart that showed the swing of a pendulum swinging through history between fixed and floating rates. It is helpful to remember this historical perspective in the context of this discussion. First, it shows that, whatever the theoretical merits of freely floating rates, governments have always in fact sought before long to return to a system that imposed more stability on exchange rates. Secondly, it is often illuminating to ask at what point in the spectrum a particular observer is standing.

The standpoint of the authors of the staff paper seems to me to be well toward the floating end of the spectrum. They believe, if I read them correctly, that more weight should be put on policy coordination, especially fiscal coordination, and less on exchange rate management. Broadly speaking, exchange rates can be left to look after themselves. This is a well-known view, but others would argue that it takes insufficient account of the realities of exchange markets, where exchange rates can be seriously affected by misperceptions of market operations (e.g., the dollar in 1984-85), or of the nature and limitations of international cooperation. International influence on fiscal policy is necessarily indirect and, as was clearly said by some Directors when we discussed the general issue of coordination last September, it is vital to concentrate first on getting the right policies rather than on coordination. We do not want to sail into a concerted inflation even if we do so in convoy.

It is clear that the breakdown of the Bretton Woods system was due partly to the fact that exchange markets were becoming dominated by capital flows rather than trade flows. This process has gone much further since then, and the staff paper needs to be interpreted against that background.

I will structure the rest of my remarks in terms of the six key issues identified by the staff. On fiscal policy discipline and the exchange rate regime, I think that the distinctions made in this section may be rather exaggerated if applied to the real world. The staff seems at one point to imply that protectionism is particularly associated with floating rates. Surely, the fear of monetization applies its discipline to fiscal policy under all exchange rate regimes. I question the assertion that in real life fixed exchange rates will inherently facilitate irresponsible fiscal policy. What evidence for this is there in actual experience? In the United Kingdom's own experience, the most obvious fiscal irresponsibility I can think of was decided in the full knowledge that the exchange rate would be floating.

The staff seems to assume that the discipline exerted by the risk of monetization or a breach of target zones comes from outside the system. But the credibility of an exchange rate system cannot be divorced from the credibility of the underlying policies. As is argued later in the paper, when discussing the role of common objectives with particular reference to the EMS, underlying commitment is the source of price stability, while exchange rate mechanisms are essentially secondary devices to help reinforce the agreed rules. This point was also made in our recent discussion of the EMS and has been highlighted by Mr. Nimatallah in his statement.

These doubts lead me to say that I am not convinced that exchange rate regimes can or should be judged mainly in terms of their effect on fiscal discipline. In most countries, the constraint on irresponsible fiscal policies is provided by the financeability or sustainability of fiscal deficits.

As to monetary policy independence and the exchange rate regime, I wholly agree with the staff that the exchange rate regime cannot take away what is no longer there in any case, namely, the ability of monetary policy to influence real output and employment in the long run under conditions of high capital mobility. Price stability must be the correct long-term goal of monetary policy. The loss of monetary independence to pursue real economic objectives in high-inflation countries is therefore no loss at all.

The problem is that capital flows can put the objective of greater stability in exchange rates into conflict with the anti-inflationary objectives of monetary policy, as we have seen in several countries. Sterilized exchange market intervention can provide some relief, and I agree with those who think a reappraisal is warranted, particularly of concerted intervention. However, at the end of the day, it is safest not to risk an inflationary episode.

I very much sympathize with the staff's caution about the concept and measurement of equilibrium exchange rates. These problems are reflected in the pragmatic and judgmental approach adopted by the Group of Seven, and the longer-term flexibility of their exchange rate objectives over time. The aim of the G-7 countries since 1985 has been more modest than to identify equilibrium exchange rates; it has been to avoid the excesses of freely floating rates. The main case against serious misalignments is that they can send misleading signals and lead to pressures for protectionism.

It is not entirely clear to me what messages are intended to be drawn from Table 1 in the staff paper. It seems to show that exchange rates have been less volatile than other financial prices, the implication being that we do not need to worry much about exchange rate volatility. But the central importance of exchange rates means that exchange rate volatility is more harmful than volatility of share prices. I also really question whether the use of standard deviations in this table is quite the right way to approach it. If you take a stock market index over the past seven or eight years, you get a rise, which then accelerates, and then you get a fall in the second half of 1987 and then a flat rising trend thereafter. Now that is a totally different pattern from what we have observed in the major exchange rates, say, between the dollar and the deutsche mark and the dollar and the yen. I also believe that the average bear market since the war has experienced something on the order of a 23 percent decline in equity prices. We have seen movements in these key exchange rates over a period of two years or so of 40 percent or more. Whereas I could persuade myself at any time that the equity index was at more or less a "right" level, there have been many periods in the past five or six years when it has been quite incredible to believe that the exchange markets have put the exchange rates of these key currencies "at or near right levels."

The figures in Table 1 relate only to short-run volatility and not to longer-run misalignments, which represent the major cost of free floating. Figures at a lower frequency (quarterly or annual) would seem to me more appropriate. The concept of relying solely on the market to determine the "right" exchange rate (mentioned at the end of Section IV) is almost meaningless, given the crucial dependence of exchange rates on fiscal and monetary policies.

Arguments for throwing "sand in the wheels" of the international capital market are unrealistic. They amount to an attempt to relieve symptoms rather than tackle tensions that are directly responsible for capital volatility. Throwing "sand in the wheels" surrenders the important gains to be derived from financial liberalization in order to accommodate other inefficiencies; in effect, it seems to be advocating acceptance of two problems rather than one, in the hope that they will cancel each other out.

I also think that the sort of schemes that have been proposed in this area are not realistic. The experience of the United Kingdom and other countries has shown that restrictions become increasingly ineffective as the market adapts to them; they thus require continuous tightening to maintain the same effect. Thus, liberalization, once initiated, tends to be a self-reinforcing process. Partial retreat is probably not feasible. And the serious practical problems of implementing selective restrictions seem to rule the idea out anyway.

On leaders and anchors, I agree with the staff that fixed rate regimes have in practice involved some degree of hegemony. This implies, I think, that the more limited objectives of G-7 policy cooperation are appropriate in a more symmetric world. I agree also with the conclusion on page 17 that reinstatement of a hegemonic approach to coordination would be counterproductive.

None of this, however, avoids the need for an anchor. But a broadly symmetric group makes the choice of an anchor less obvious and encourages convergence toward the average. This may not provide an adequate safeguard against inflation or deflation in the system as a whole. I missed a discussion in the paper of the merits of indicators for G-7 countries as a whole. Commodity price indices and group indicators are now an important part of the surveillance process within the Group of Seven. As Mr. Kafka neatly put it in his statement, we need an anchor that ensures price stability and not just concerted inflation or deflation.

The success of the Group of Seven to date has reflected the care taken not to be overambitious, particularly in what are still early days in a novel experiment, and not to overreach our modest knowledge about the functioning of the international economy. We should not make the mistake of thinking that technical devices like zones and indicators can create of themselves the political commitment that underlies policy coordination. The case against monitoring zones made on page 19 of the paper is quite impressive, but it excludes one important objection, namely, that interdependence of economic variables presents a serious problem in interpreting a deviation for any one variable. The seriousness of one variable falling outside its monitoring zone will depend on the behavior of the interrelated variables. So, in the end, there is no substitute for judgment.

With respect to the paper on the SDR and the international monetary system (SM/89/32), I have much sympathy with what is said there, but its suggestions are not practical propositions at the moment. The staff tries, in a sense, to link the creation of SDRs with other objectives and in the process runs into serious problems. There is no evidence of a general reserve or liquidity shortage. And with high capacity utilization rates in many countries, there is a risk that any creation of SDRs, however distributed initially, would have inflationary consequences. Nonetheless, we should explore whatever means we can to enhance the role of the SDR in the long run.

There are enormous difficulties in adopting an international monetary system that uses national currencies as international reserves. We have seen this in a limited way with the working of the sterling area at an earlier phase in history. The problem was not so much that there was a great crisis when the reserves ran out, but that in the earlier period, when the country was moving into imbalance, financing was automatic and was too easy. The use of a national currency as an international reserve enables delay of the necessary corrective action until a crisis emerges. One can see the same sort of patterns re-emerging now in the case of the dollar.

I greatly hope that we could move to an international monetary system, the centerpiece of which is an asset that is no country's liability. So while I see no scope at the moment for increasing the allocation of SDRs because there is too much liquidity, I do think that we need to keep working on the other side, to open the door to use of the SDR in asset settlements and substitution accounts. This will be a long process, but I do see that as the most likely role to achieve the end that was intended by our predecessors to establish the SDR at the center of the system. In the meantime, one could certainly look at proposals for promoting the use of SDRs by official or private entities, and I would support further work by the staff in these areas. The past decade has provided further evidence that there are great risks in using national currencies as international reserves.

Mr. Filosa made the following statement:

In organizing my comments, I will follow the sequence of questions raised in the introduction of the staff paper. I will start by considering the problem of whether the exchange rate regime can discipline fiscal policy when high international capital mobility prevails. The answer to this question is clear and well recognized in the paper. Exchange rate regimes do not possess automatic stabilizers capable of substantially offsetting the domestic and international effects of fiscal policy measures. I want to add that the existence of a mechanical, built-in stabilizer is not even desirable, because fiscal policy must serve a wide range of domestic objectives. However, excessive fiscal stimuli, as well as an overly restrictive fiscal stance, impair the proper functioning of both the international monetary system and the country's economy itself. Therefore, corrective fiscal measures should be external to the exchange rate regime and aimed at avoiding strains in the international monetary system.

I will elaborate on this, focusing on the case of fixed but adjustable exchange rates and on freely floating exchange rates. Under both regimes, theory and facts reveal that, in the short term, fiscal expansion tends to produce positive effects on growth, on inflation, and on balance of payments financing--that is, on strictly short-term national objectives. In these circumstances, the exchange rate regime offers an incentive to the expansionary use of fiscal tools, rather than a compelling inducement to prudence.

But at the same time, excessive fiscal stimuli could be a direct cause of large swings in nominal and real exchange rates that are not conducive to the smooth functioning of the international monetary system. Appreciation resulting from excessive fiscal stimuli offers opportunities for destabilizing speculative attacks. Net capital inflows in excess of normal levels can easily be reversed. However, initial overshooting of the equilibrium exchange rate level may require substantial undershooting later on. Countries that export inflation through excessive appreciation of their currency will subsequently produce a deflationary bias at the international level when fiscal adjustment becomes necessary.

Therefore, in order to avoid strains in the international monetary system, fiscal discipline should be based on the proper recognition of the international consequences of domestic policies. I would also add that the positive effects of excessive fiscal expansion on domestic targets, such as growth, balance of payments financing, and inflation, are not lasting, or, worse, could be counterproductive in the medium term.

It is my firm belief that the fiscal discipline needed to avoid strains in the international monetary system should be found in the framework of a coordinated process aimed at identifying common economic policy goals and consistent policy mixes. Policy coordination is also in the interest of national long-term objectives.

I come now to the second issue, namely, the question of the reduced independence of monetary policy when exchange rates tend to fixity and when high international capital mobility prevails. It seems to me that despite the progressive removal of capital controls and the recent trend toward tax harmonization, the real world is far from a situation of perfect capital mobility. Different currencies are not perfect substitutes for a variety of historical, political, and economic reasons. As a consequence, some, and, I would say, a substantial, degree of autonomy in monetary policy will remain in the years ahead.

In the recent discussion of the staff paper on the EMS, we saw that a number of possible solutions are available to solve the problem of the degree of centralization of monetary policy in a region that is much more economically interlinked than the international monetary system at large. In the past, increased monetary policy coordination among EMS countries has ensured greater fixity of exchange rates, without drastically reducing the room for an autonomous setting of national monetary aggregates. Capital controls certainly helped to maintain autonomy in the monetary field, but there is no demonstration that the successful implementation of the exchange rate stability in the area without capital controls would have implied a complete loss of monetary sovereignty. Recent measures undertaken to ensure freer financial markets have not produced any major drawback.

Therefore, I believe that in the present economic conditions, as well as those that will prevail in the near future, there is no need to have monetary and credit aggregates growing at the same rate in all the major industrial countries in order to regain stability in the exchange rate system. It seems to me that the argument of the loss of monetary policy independence has been overemphasized in the staff paper. In addition, in any developed monetary and financial system, there is a variety of technical measures that can successfully counteract shocks, thus preventing changes in the very short-term interest rates from being transmitted to the whole term structure of interest rates.

Furthermore, exchange market intervention will continue to be a powerful additional instrument of monetary policy to counteract short-term exchange rate fluctuations. This instrument has proven to be extremely effective on a number of occasions, particularly when the interventions have been internationally coordinated.

In addition, temporary changes in the taxation of income from financial instruments could ease monetary management and reduce the costs of its implementation. Tax harmonization is an objective to be forcefully pursued. However, it should not be viewed as a target in itself. In exceptional circumstances, short-term changes in the tax rates of particular financial instruments should be permitted. At times, some "sand in the wheels" can help to pursue the medium-term target of financial liberalization and to increase its allocative function, while avoiding the negative effects of temporary short-term financial shocks.

While recognizing that monetary policy and exchange market intervention can control exchange rates, I would not jump to any conclusions about their omnipotence. When fiscal policies are uncoordinated and divergent, the effectiveness of both monetary policy and exchange market intervention is greatly reduced.

As to the question of leaders and anchors, the position of my authorities is that the move toward increased fixity of exchange rates cannot be divorced from a common identification of economic policy goals: these must obviously include the stability of prices, but also growth. Again, the experience of the EMS is illuminating. The EMS countries have specific rules about the intervention obligation of the member countries. These obligations place a greater burden on the adjustment process of those countries whose currency is less demanded on the international markets, even when the cause of the imbalances is in part to be attributed to a less growth-oriented policy of the leader country. In such a situation, the system is under a deflationary bias and cumulative trade imbalances emerge. These effects should be carefully considered in the context of the international monetary system at large.

The success reached so far in the fight against inflation suggests a reconsideration of the weight to be given in the coordination process to different objectives, with more importance than in the recent past being attached to the objective of growth, thereby increasing the symmetry of obligations. In light of this consideration, the move toward greater coordination should also be a step in the direction of a more balanced distribution of responsibility and economic influence.

The line of reasoning followed so far gives an implicit answer to the question of whether the determination of the exchange rate levels should be left to market forces alone or whether, on the contrary, it should be guided or corrected by policy actions. Market forces alone do not necessarily generate an equilibrium exchange rate level for the reasons clearly and extensively analyzed in the staff paper. Therefore, governments should use their ability to influence an orderly path of exchange rates through appropriate policy mixes and, when necessary, through exchange market intervention. Market forces can clear the market even when policy mixes are divergent. In such cases, exchange rates can diverge from desirable and sustainable levels. More fundamentally, it is well established that governments have the ability to influence, at least in the short run, nominal and real exchange rates. It is also recognized that an independent policy setting does not necessarily lead to an optimal exchange rate structure and that, therefore, coordination of policies could correct substantial misalignments in the exchange rate system. Given the aim of enhancing the coordination process, the monitoring zones approach could prove to be an appropriate and helpful analytical instrument.

It seems quite natural to establish a narrower zone for policy indicators than for performance indicators, not only because they are under the direct control of the authorities, but also because of the link between the two types of indicators. Corrective actions are therefore called for not only in the event of failure of an earlier policy commitment to be fully implemented, but also when, on a judgmental basis, a presumption of inconsistency between policies and sustainable and desirable economic results could be established.

Despite the difficulties in making such an assessment, the collective judgmental recognition of this cause and effect relationship remains the unavoidable rationale of the multilateral surveillance exercise. The proposed approach based on the monitoring of economic policy indicators combined with intermediate indicator variables provides the minimum information that should be carefully analyzed to assess whether an economy's performance is significantly deviating from the appropriate path. In addition, the possible international effects of these policies on exchange rates, inflation, and growth should be explored.

Building on the gains in information that are possible to achieve with the proposed approach, further steps could lead to developing criteria for triggering consultations and could offer a broad range of tentative conclusions about appropriate policies to address the present imbalances.

With this aim in mind, it would be particularly helpful to relate the past track of the monitored indicators to a range of sustainable and desirable future paths, with a view to making tentative conclusions about past and prospective effects of alternative policy choices.

Furthermore, such an exercise could be accompanied by some sort of routine use by the Fund of the global macro-model MULTIMOD. Such an approach could enhance the coordination process in at least four ways: it would improve the collective evaluation and judgment of the relative importance of different policy indicators; it would make more explicit the trade-off among different policy objectives like growth, inflation, and exchange rate stability; it would offer more chances to discuss the structure of behavioral models, which is one crucial step in the coordination process; and it would offer persuasive estimates of the effects of different policies on exchange rates while avoiding endless and inconclusive discussion on the equilibrium exchange rate levels.

Mr. Rye made the following statement:

The paper on key issues in the functioning of the international monetary system provides an excellent starting point for what I hope will be a series of Board discussions on international monetary reform in which the Fund will assume its rightful place at the center of this debate.

The paper's conclusion that the type of exchange rate regime in operation does not in itself ensure fiscal discipline is one to which we can doubtless all subscribe. But fiscal policy should not be examined in isolation. Adjustment of fiscal policy often comes to the forefront only when the implications of using other policies for adjustment become increasingly unacceptable, and when the costs of an inadequate fiscal policy become too high to bear.

It seems to me, however, that the whole question of policy assignment is often treated simplistically. While the efficacy of directing monetary policy toward external balance is certainly questionable, it does not follow that fiscal policy should be assigned to external balance. Experience in a number of countries--including the United Kingdom and Australia--certainly does not suggest an inevitable close linkage between the "twin" deficits. Perhaps the problem is partly a semantic one, the distinction between domestic and external balance being essentially artificial; in an underlying sense, they are two sides of the same coin.

I agree with the staff that, over the long run, monetary policy is best directed toward ensuring price stability, and that the choice confronting policymakers is largely one of either accepting reasonable constraints beforehand or having them imposed at higher cost later by the markets. It would be much more difficult to accept any implication that monetary policy has little or no impact on the real sector. That might be the logical long-run outcome in a world in which all prices were flexible, but in practice monetary policy does seem to have a very real impact on investment, housing, and consumer durables, not only through higher interest rates, but also through the effects of announcements and consumer confidence.

We agree with the staff that the identification of an equilibrium exchange rate would be an exercise of questionable value. There is no clear and precise relationship between the exchange rate and other economic variables such as nominal or real income, inflation, employment, or external balance. An appropriate "underlying" exchange rate today is not necessarily consistent with that of the past or future. All this would lead one to agree with the staff's tentative conclusion that exchange rate determination is an ongoing exercise best left to the market--except that, as Mr. Cassell observed, given the effects on exchange rates of all sorts of policies--and not even just economic policies--this is a particularly cloudy position.

While significant and persistent exchange rate misalignments between major currencies have occurred in recent years, it is not clear that they are a function of the floating rate system, or that they would have been avoided by appropriate adjustments in a fixed rate system. The periods of high volatility and misalignments over the 1970s and 1980s have of course occurred against a background of world financial shocks, unusual economic uncertainty, and an increase in the size and volatility of capital flows.

I am not optimistic about more elaborate efforts by governments to fix and manage exchange rates. Essentially, these are likely to be successful only if the underlying conditions are conducive to greater stability--that is, low inflation with narrow differentials, stable financial conditions, and sustainable patterns of investment and savings across countries--in which event, of course, the need for such management would evaporate. The best that policymakers can do is try to manage the inevitable adjustments and minimize their costs.

Restrictions on capital flows are at best for temporary emergency use. They carry high costs in inefficient use of resources, and tend to become less and less effective over time.

On the subject of leaders and anchors, I endorse the views expressed by the U.S. and U.K. chairs when the Board discussed the EMS: leaders and anchors evolve, they cannot be created, and a nominal anchor should tie performance to the best inflation outcome, and not to some average measure of performance.

International economic policy coordination obviously has the potential to be beneficial. However, its success will primarily reflect the ability of the major economies to ensure that each undertakes a disciplined approach to its own economic policymaking. In this regard, the process of international coordination is in essence about buying time for appropriate domestic policies to be put in place.

The SDR paper is a very interesting "think piece." It is, however, difficult to come to grips with, not least because it raises issues--such as the role of the Fund as a supranational central bank--that extend beyond the priorities of the current agenda, and which would require much more extensive and considered analysis if they were to be pursued.

Despite the problems associated with definitions, my authorities are not convinced that broader concepts should be discarded when assessing the adequacy of international liquidity. While the question of the adequacy of liquidity has become more subjective, in our view the present reserve system is functioning adequately, and the global need for reserve supplementation through further SDR allocations has not been demonstrated.

While the staff appears to favor the use of indirect measures of liquidity adequacy, we would caution against the suggestion that inferences can be drawn from the adjustment of import volumes relative to real GDP or export values. As noted by the staff, there are major difficulties of interpretation with this approach, and it is doubtful that they can be resolved econometrically or otherwise. In our view, the decline in import volumes of developing countries since 1982 has in most cases reflected adjustments arising from the unsustainable balance of payments positions built up in preceding years.

Each of the various proposals to reinvigorate the SDR would require careful consideration. Those that would involve shifting the risk of developing country indebtedness to the industrial country public are not likely to be acceptable at this stage. I have no objections in principle to proposals to encourage use of the SDR in private sector transactions, although, as Mr. Cassell recently said with regard to ECUs, one has to be wary of the dangers of artificially promoting something for which there is no real demand. I also agree with Mr. Cassell's statement today that proposals to establish a substitution account or asset settlement mechanism based on the SDR are worth further consideration.

A safety net remains one of the more attractive potential future roles for the SDR. However, it is difficult--and I should think unnecessary or even counterproductive--to be precise. The nature of the contingency that might activate such a safety net cannot, by definition, be foreseen. In any event, I am not aware of any obstacles to rapid action, should agreement be reached that the need has arisen.

Mr. Lombardo made the following statement:

Although staff papers are comprehensive, I would like to refer to one point that is of major concern to my constituency. The staff has stated that one of the possible approaches to invigorating the SDR is the way in which the SDR could help promote growth without discouraging adjustment. In dealing with this subject, the staff recalls the pros and cons of the proposals made during past discussions in the Executive Board. I would like to comment on this point.

When a possible increase in international liquidity is considered, it is important that the risk of an indiscriminate development and the potential damage to several countries facing adjustment be taken into account. This concern is in contrast to the indiscriminate encouragement given ten years ago to those same countries to adopt internal policies to attract international liquidity. Nevertheless, this cautious attitude cannot be ignored. I can understand that in 1986, when the Executive Board examined this subject, there were doubts about the convenience of proceeding with the proposed post-allocation adjustment in the distribution of SDRs; the debt strategy had been launched only a few months previously, and a long path remained to be traveled in the adjustment process.

The staff paper states that "the success of growth-oriented adjustment programs requires not only effective and appropriate policies in the indebted countries, but also an adequate supply of international liquidity for these countries and a supportive world economic environment." Today, seven years after the debt crisis, only one of these three requirements has been really achieved: strong adjustment has been made by most of the debtor countries. The second requirement, of an "adequate supply of international liquidity," is far from having been accomplished, not only because of the banks' reluctance to increase their exposure in our countries, but also because the United States has been absorbing most of the world's liquidity to sustain its deficits. The third requirement--"a supportive world economic environment"--has also been delayed, mainly because of trade restrictions applied by most of the developed countries, and particularly by the EC countries and Japan on agricultural matters. In addition, interest rates have been rising, reflecting the distortions of the major economies and increasing the burden on the debtor countries.

Of course this is not the time to discuss the debt problem. However, it seems to me that the reluctance to accept a way in which the SDR could help promote growth does not take into account the huge adjustment already made and the fatigue that the debt problem is causing in most countries together with unforeseeable political and social consequences. Most of the developing countries need further adjustment and structural reforms, and I do not think that providing liquidity will discourage adjustment efforts. On the contrary, more liquidity would help.

The staff has examined various ways to promote growth without discouraging adjustment. All of these proposals are worthwhile and it is not possible to set any of them aside. Nevertheless, at the current stage of the debt problem, we need to emphasize debt reduction techniques.

The securitization of existing and new bank claims could have different advantages. In particular, such securitization could be a natural evolution of the present debt reduction menu, without representing a big change.

Fund involvement could also be a helpful debt reduction technique, and I could go along with the French proposal to create a fund, but new methods of conditionality might have to be explored in that connection. As the staff points out, the proposals seeking to limit a country's exposure to interest rate risks by setting caps on a particular level of the interest rate are very worthwhile.

Mr. Posthumus made the following statement:

Stable exchange rates are gradually being considered desirable again. The Fund has a stake in this development and a responsibility to promote international monetary cooperation. The Fund is not neutral in a scientific sense. In my view, it must actively advocate greater exchange rate stability, identify the policies required to maintain stability, and exercise surveillance over such policies as soon as efforts to stabilize major exchange rates get under way. The paper that we are discussing today identifies a number of key issues, but the role of the Fund itself has not been addressed.

Many of the key issues identified were already addressed by the Board when we discussed the European Monetary System. Therefore, I will make just a few remarks. First, on the issue of discipline, the commitment to defend a stable exchange rate does not provide discipline; rather, it translates and supports the intention to follow stable and sustainable financial policies. Indeed, fiscal policy discipline is difficult to achieve, but I agree with Mr. Cassell that this is not a key test of the viability of an international monetary system. The turnaround in France's fiscal policies in 1983 showed that the commitment to exchange rate stability in the framework of the EMS was strong and therefore instrumental in the change of course.

More generally, it is questionable whether more than a very few countries can follow irresponsible fiscal policies in an era of high capital mobility and a commitment to stable exchange rates, and be rewarded for that by a capital inflow and a balance of payments surplus, and therefore with funds to continue the irresponsible fiscal policy. Why should lenders trust the commitment to parity if they see fiscal irresponsibility paying off?

Another issue is the question of monetary policy independence. We are being taught that in a world of high capital mobility, monetary policy is completely ineffective for a small country with a fixed exchange rate. The important question is what the exact meaning of "completely ineffective" is. The most important task of monetary policy is to provide price stability, to keep inflation as low as possible, which is a very asymmetric task. This task is substantially taken care of if the authorities choose an exchange rate anchor as part of their monetary policy--assuming that that anchor itself is stable. Of course, once you chose a certain policy direction, your freedom to choose any other direction is limited. And, as is indeed being pointed out by the staff, the question is whether, in a world of high capital mobility, countries without foreign exchange rate targets have many policy options anyway. Our position on this issue is given on pages 6 and 7 of the staff paper. The same point is rather clearly formulated in Occasional Paper No. 61: "...the choice is not one of constraints versus freedom, but one between different constraints."

This leads me to the question of how to proceed from here. I realize that the Fund can only be what its major shareholders allow it to be. The paper, while trying to be neutral, seems to advocate the present regime of managed floating with international economic policy coordination as the best there is, in the sense that other alternatives either do not work or will not work. That may well be the case.

However, the emphasis on symmetric adjustment--even from a base of imbalance which was and is asymmetric--and on intervention makes me worry about the consequences for worldwide inflation. On the other hand, the potential for worldwide inflation may well be exaggerated. This is also a subject for the world economic outlook discussion.

Further work must be done. We should not design a new international monetary system. But elements of any system, and certainly the issues of leaders, anchors, and symmetry should be studied. Another important issue is that of capital mobility and its significance for monetary policy and exchange rates. In this regard, the U.K. Article IV consultations offered some valuable insights. Also, the significance of fiscal policy, which is after all one of the major sources of financial and monetary instability in the world, should be examined. Integration of the work in the paper before us with the work on the EMS in the Research and European Departments and with the experience of the Exchange and Trade Relations Department regarding members' exchange rate policies can be invaluable, because there is no other single institution in the world that has access to as much data and expertise.

This brings me to the SDR paper, on which I will make a few remarks. As is well known, this chair supports, in principle, annual allocations of SDRs of a moderate magnitude as a contribution to the maintenance of the allocation mechanism with a view to possible future problems in reserve supply.

I recognize that today, perhaps more than in the past, access to liquidity, be it to hold as reserves or to spend on imports, is virtually unlimited for creditworthy countries. By contrast, for those countries that have used liquidity provided by the markets in such a way that their creditworthiness is now impaired, the markets in a way exist only in the form of a debt overhang and debt service obligations. For these countries, a shortage of liquidity can be very acute without, however, pointing to a global need. The indirect quantitative measurement approach provided by the staff relates to this phenomenon and is therefore of little help.

I believe that it is of fundamental importance to adhere to the character of the SDR as laid down in our Articles of Agreement. While this is not legalistic, it is the only way to let the SDR survive. SDRs were created to serve as reserves to hold, and not as a means of financing balance of payments deficits. It should be realized that for the schemes mentioned in the paper to help debtor nations, SDR allocations are not at all necessary. SDRs so created and used only provide a monetary, seemingly costless way to finance such schemes. Such a process will not enhance the standing of the SDR.

The staff admits that private market participants have not found it sufficiently attractive to develop a large market for SDR-denominated instruments on their own. The real pressure to solve technical obstacles to wider use of SDRs should come from the markets and not be pushed upon them. I note, however, that if the SDR is to assume a central role in a future international monetary system, it will be necessary for the SDR to be available for foreign exchange market interventions.

Techniques, however, cannot impose discipline on countries. It is the other way around. The willingness to accept discipline will lead to agreement on an international monetary system; techniques to implement that discipline will then be found. In the context of such an evolving monetary system, consideration of the use of the SDR as the nominal anchor is appropriate.

We must indeed recognize that the supply of international liquidity cannot be taken for granted in all circumstances. The SDR as envisaged in our Articles can provide a safety net, apart from possible substitution of other reserves. It is this consideration that lies behind our support for moderate annual allocations that would keep the allocation mechanism alive. Costs, as we have said on earlier occasions, should not be a consideration in their own right. I note that our position comes very close to that proposed by the staff under the final issue for discussion.

Mr. Ghasimi made the following statement:

We welcome the technical papers prepared by the staff for today's discussion and, in particular, the analysis aimed at assessing the adequacy of international liquidity and enhancing the role of SDRs in the international monetary system. Last September, the Board had the occasion to discuss the issue of measurement of international liquidity and the difficulties associated with the establishment of a broader quantitative concept. The analysis and suggestions presented by the staff are indeed very helpful, since they have the merit of including various quantitative approaches and, more important, of stressing the need to rely also on qualitative assessments in determining the role of SDRs and the adequacy of international liquidity.

This chair has stated on previous occasions that, despite the evident need for reserve accumulation, no progress has yet been accomplished in establishing the SDR as the principal reserve asset of the international monetary system. Indeed, many developing countries continue to be compelled to resort to current account adjustments by means of import compression and economic growth restraint so as to compensate for the lack of owned reserves. In this regard, we are certainly attracted by the third approach indicated by the staff, which identifies and underscores symptoms of inadequate liquidity through widespread increase in import restrictions. We note with particular concern that the volume of imports by developing countries declined by nearly 5 percent per year on average relative to real GDP between 1982 and 1986. Indeed, this is not surprising given the enormous financial difficulties associated with the escalation of the debt crisis during that period, which is also reflected in the net outflows of resources from developing countries as well as in the reduction in access to international capital markets. While we have no difficulties with the idea of further staff work on the development of indicators for assessing the adequacy of international liquidity, we continue to believe that the issue of sufficiency of international liquidity could perhaps be better evaluated in relation to the potential role for the SDR to enhance the functioning of the international monetary system.

The staff paper on the SDR offers various interesting approaches to invigorate the SDR. The first approach deals with ways of promoting growth without discouraging adjustment. In this respect, we must indicate at the outset that the concerns being expressed about SDR allocation as a disincentive to adjustment are greatly exaggerated, particularly in the current international environment, which is characterized by lower availability and high cost of external financing. These concerns should also be alleviated by all the possible safeguards and other elements of conditionality associated with the use of Fund resources.

To further alleviate these concerns while expanding the role of the SDR and the stock of SDRs, measures aimed at creating a fund with the Fund guaranteeing certain payments from middle-income, heavily indebted countries would be quite useful. The resources of this fund would be comprised of the industrial countries' share in a new allocation of SDRs. This proposal could be combined with other arrangements for a post-allocation adjustment in the redistribution of SDRs. The objective is to reorient SDR allocations to countries with a relatively weak reserve position. We see great merit in this proposal, since it would support the implementation of strong adjustment programs and would secure additional guarantees to external financing. In this regard, we encourage the Board to consider this proposal positively and we request that the staff pursue its work on the modalities and characteristics of this mechanism.

Regarding the second approach, aimed at advancing the use of SDRs by official or private entities, the proposals presented by the staff are worth further consideration. However, we must point out that measures to promote the use of SDR-denominated instruments can benefit only those countries with substantial stock of reserves including SDRs. Unfortunately, this is not the case for most developing countries.

The third approach, aimed at using the SDR as an anchor against inflation, is well intentioned and we support it. However, we fear that its effective implementation depends on the existence of a strong political will on the part of all member countries to increase the Fund's role or to make the surveillance exercise more symmetric. Furthermore, such an approach based on a two-stage SDR allocation will definitely affect the unconditional nature of SDR allocation.

The fourth and final approach deals with the SDR as an instrument to enhance the efficiency and stability of the reserve system. In this respect, we concur with the staff analysis that an increase in the supply of SDRs will help member countries to diminish the cost of reserve accumulation as well as to reduce countries' vulnerability to reliance on borrowed financing.

While we encourage the staff to continue its work on measures to invigorate the SDR role in the international monetary system, without immediate actions to augment the stock of SDRs, the share of SDRs in total international reserves will inevitably continue its relative erosion. In this regard, we reiterate this chair's strong support for a resumption of new SDR allocations and measures designed to making the SDR the principal reserve asset in the international monetary system.

The Interim Committee's communiqué issued in Berlin wisely reminded us that we have "a continuing responsibility to keep the working of the international monetary system under review, and to identify ways for its improved functioning within a multilateral framework." Since then, the staff has provided us with very high quality papers on the functioning of the European Monetary System and the two subjects for discussion today.

The Executive Board has indeed tried for many years to study these issues, but no decisive conclusions have been reached, not because of a lack of technical appraisals, but mainly because political consensus was unattainable.

Indeed, the developing countries have addressed most aspects of the international monetary system in their August 1985 report of the Group of Twenty-Four on the functioning and improvement of the international monetary system. While the paper before us clarifies in a footnote that a number of the issues raised in this paper were also discussed in the 1985 report of the Deputies of the Group of Twenty-Four, we fail to see an elaboration of the issues of paramount importance to developing countries, such as problems of debt, trade, and the transfer of resources, except in the separate paper on SDRs.

We believe that examination of exchange rates in major industrial countries and surveillance and coordination of their policies are not sufficient to arrive at a consensus for generating a viable reform of the international monetary system. In this regard, the experience of developing countries, which have certainly suffered considerably under the present system of floating exchange rates, is of paramount importance. The G-24 report emphasized that: "Exchange rate stability should be an important objective of policy, instead of being a residual of other policy actions of individual countries, as is the case at present. It is necessary to devise an exchange rate system to overcome the recognized rigidities of the par value system and the destabilizing uncertainties of floating rates."

Turning now to the issues for discussion, I wish to address them very briefly in the order suggested by the staff. First, the part of the paper on fiscal policy discipline and the exchange rate regime clearly refers to the case of major industrial countries and does not elaborate on or consider the relevant issues in other countries. We fail to see how a widening fiscal deficit in a smaller or developing country can attract sufficient flows of external capital to finance a fiscal deficit. This being said, it seems clear that there is no broad agreement on the impact of exchange rates on fiscal policy behavior in all types of exchange rate regimes. As to the industrial countries, it is unfortunate that even in the area of economic policy coordination, serious doubts remain about the willingness or ability of the participants to forcefully address fiscal problems.

Second, on monetary policy independence and the exchange rate regime, the reasoning here is also obviously based on the experience of large industrial countries. We have the feeling that many developing countries, or for that matter smaller industrial countries, do not have these options available to them. Indeed, given the assumption of high capital mobility, we are not certain about the long-run influence of monetary policy on real macroeconomic valuables, such as real output and employment. In this regard, it can hardly be denied that even advocates of the present floating rates admit that the case for the independence and effectiveness of monetary policy under floating rates may have been somewhat exaggerated.

Third, on identifying equilibrium exchange rate and exchange rate management, in many cases the floating exchange rates have been detrimental to developing countries and have compounded their problems, particularly the debt problem. We are therefore in favor of a managed system that would not give the markets the sole responsibility for determining the exchange rates. In this regard, we agree with the staff that, subject to an affirmative reply to the three questions listed on page 12, the recent evolution of the system toward more "management" and more "fixity" of exchange rates is to be applauded. It is, however, doubtful that all participants would agree at the same time with the answers to all three questions--particularly the third one: can officials identify and agree on the policy adjustments necessary to achieve their exchange rate targets in concert with other policy objectives? Indeed, any effective reform would require a strong and collective political will on the part of all the participants.

Fourth, on restrictions, or taxes, on international capital flows, here again a distinction is to be made between groups of countries. The major industrial countries have the ability and the necessary instruments and conditions to attract international capital flows. For developing countries, and particularly the most highly indebted countries, a call for a free flow of international capital is certainly unrealistic and unattainable.

Fifth, systems based on leaders and anchors obviously have some pitfalls, the most important being a breakdown of discipline by the leader such that satellites come to see it as exporting inflation rather than stability. Our recent discussion of the EMS and the paper before us today both clearly indicate that the success of the EMS is due mainly to the discipline observed by its acknowledged leader and to the maintenance of capital controls by some members. This experience does not seem to be easily transposable. We would not, therefore, favor any system that puts the rest of the world under the hegemony of one or a very small group of countries. Our preference is for a system anchored by the SDR and supplemented by other quantitative indicators.

Sixth, on policy coordination and monitoring zones, we cannot help but reiterate that the issue is not really whether

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 88/133 and 88/134 are approved. (EBD/89/64, 2/27/89)

Adopted March 3, 1989

APPROVED: September 12, 1989

LEO VAN HOUTVEN
Secretary