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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 89/29

3:00 p.m., March 6, 1989

M. Camdessus, Chairman

Executive Directors	Alternate Executive Directors
F. Cassell	
Dai Q.	
	D. C. Templeman, Temporary
J. de Groote	
	P. E. Archibong, Temporary
	R. J. Lombardo
L. Filardo	M. A. Fernández Ordóñez
R. Filosa	
M. Finaish	
M. R. Ghasimi	
	B. Goos
	S. P. Shrestha, Temporary
B. Jalan	L. E. N. Fernando
A. Kafka	
	W. N. Engert, Temporary
Mawakani Samba	
Y. A. Nimatallah	
	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

Also Present
African Department: S. M. Nsouli. External Relations Department: P. E. Gleason. 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, Y. Harada, P. Isard, D. J. Mathieson, P. Wickham. Secretary's Department: C. Brachet, Deputy Secretary; J. W. Lang, Jr., Deputy Secretary; J. G. Marcouyeux. Treasurer's Department: T. Leddy, Deputy Treasurer; D. Williams, Deputy Treasurer; M. N. Bhuiyan, 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, P. O. Montórfano, B. A. Sarr, M. A. Tareen, A. Vasudevan. Assistants to Executive Directors: B. A. Christiansen, R. Comotto, S. K. Fayyad, B. R. Fuleihan, L. Hubloue, K.-H. Kleine, C. Y. Legg, R. Marino, N. Morshed, L. M. Piantini, Shao Z., Yang J.

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

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

Mr. Templeman made the following statement:

We appreciate this opportunity to comment on key issues in the functioning of the international monetary system. My comments today will be made principally against the background of the experience my authorities have gained with the economic policy coordination process.

Like Mr. Cassell, we believe that reform of the international monetary system is not an end in itself. Rather, the key test of a system is whether it can foster trade and payments arrangements that help to create an open, growing, and noninflationary world economy. Our approach to the international monetary system also cannot be divorced from the realities of an evolving global economy and of national political realities. In the past decade, we have witnessed substantial changes that have inevitably had systemic consequences. These changes include the increased interdependence of our economies, the globalization of financial markets, and greater balance in the relative size of major economies, such that external adjustment must be more broadly shared. This latter factor is of particular importance, since no longer can any nation play the "n minus one" country role; policymakers must increasingly take into account the international ramifications of their domestic policies, and greater symmetry is required in our international monetary arrangements. In examining the international monetary system, we must not focus solely on the exchange rate regime, but on the wide range of factors affecting economic performance.

In this context, we welcome the discussion of fiscal policy discipline and the international monetary system. The staff correctly observes that in the past, policymakers have not fully taken into account the relationships between external considerations and fiscal policies. Yet, as the staff points out, greater exchange rate fixity need not exert discipline over fiscal policy. Indeed, it may even exacerbate, rather than reduce, problems associated with fiscal policy management. On the other hand, under the flexible rate system we have also witnessed increased recourse to protectionist pressures, as currency swings have created unacceptable social and economic costs.

In contrast, under the policy coordination process, peer pressure, and in the case of the United States, domestic legislation, have led both surplus and deficit countries to take some fiscal policy actions aimed at sustaining growth and reducing external imbalances. For example, the United States has substantially reduced its budget deficit and must continue to do so, and the major surplus countries have adopted measures to strengthen domestic demand.

A key consideration in the academic literature on alternative international monetary systems has been the effect of the exchange rate regime on monetary policy independence. Traditionally, fixed exchange rates have been equated with a ceding of monetary policy independence, and flexible rates with preserving monetary independence. However, the reality has proved to be much less clear-cut, as monetary policy independence has proven rather illusory under flexible rates and under fixed rates, policymakers were not, in fact, always willing to subordinate their monetary policies to an external discipline.

As the staff observes, exchange rates can be viewed as an intermediate target variable with the characteristics of both a policy instrument and an economic target, since authorities are rarely willing to take a "benign neglect" view of large swings in exchange rates. Furthermore, we agree with the staff that there are trade-offs between exchange rate stability and other economic goals. A reconciliation of these goals is required in national capitals. But the coordination process can also help the reconciliation process at the international level. In fact, the major industrial countries have made progress in strengthening cooperation in the area of monetary policies aimed at assuring the continuation of sound growth with low inflation.

Let me turn now to exchange rate management and equilibrium exchange rates. Over the past decade, we have witnessed wide currency swings at times. Still, the variability in short-term exchange rates seems to have been less than that of prices in other auction markets, such as interest rates, stock prices, and prices of non-oil primary commodities. And exchange rate flexibility was designed, in part, to compensate for the stickiness of nominal wages and prices. Nonetheless, and particularly in hindsight, currency swings have entailed some unacceptable economic and social costs. Markets have at times not responded as might have been expected, in light of trends in underlying fundamentals and policy undertakings. This was an important factor at the time of the Plaza Accord.

In this context, foreign exchange market intervention, as part of broader cooperation on economic policies, can play a useful role. First, it can foster the willingness to engage in economic policy cooperation itself. Second, it can help temper market reactions to isolated releases on data that lie outside expected ranges. Third, coordinated intervention can have a positive impact on expectations, with important spillover effects on securities and money markets.

While officials may have to form a judgment of exchange rate developments, the view of the marketplace must also be heeded. It is virtually impossible for policymakers to identify with certainty an equilibrium exchange rate. The various analytical tools developed to approximate equilibrium rates--purchasing power parity and the underlying balance and sustainability approaches--all suffer from a number of important analytical and technical weaknesses. All of this suggests that, in seeking to promote greater stability, our exchange arrangements must embody an appropriate degree of flexibility.

The growing integration of global capital markets since the 1970s has had clear implications for the functioning of the international monetary system. My authorities view this development positively. Global capital market integration has had a number of distinct benefits in allowing borrowers to diversify, to meet their financing needs with low spreads, to hedge, and to have a broader choice of instruments, as well as allowing savers to obtain higher rates of return. To be sure, destabilizing capital flows have occurred, but these also took place under the Bretton Woods system. Such flows can occur at any time when there are fundamental divergences in economic policies among the major countries. The answer is to work toward more consistent economic policies and performance, not to tax or control capital movements.

The foregoing analysis brings me to the question of "leaders and anchors" and to the economic policy coordination process, because, in our view, coordination represents the most effective, credible, and practical path toward improving the system. It avoids many of the pitfalls and extremes discussed in the staff paper that arise with respect to fixed and flexible rates. It does so by building on the realities in the evolution of the global economy, including the greater balance in the relative size of the large economies, and on the development of integrated global financial markets with freedom of capital flows.

The coordination process recognizes that international monetary reform is not simply a question of exchange rates but must also focus on the broad range of fiscal, monetary, and structural policies that affect global economic performance. In this context, the burden of adjustment is not biased toward or away from domestic policies or exchange rates, as was the case in the fixed and early flexible exchange rate regimes, respectively. The indicator process, coupled with the use of consultations and peer pressure, encourages corrective policy actions. At the same time, coordination is not automatic or rigid. Instead, it preserves the necessary amount of flexibility and judgment to make it effective. Also, it involves no ceding of sovereignty.

In addition, the coordination process provides for greater symmetry by focusing on surplus as well as deficit countries. Efforts to build symmetry into past systems through automatic arrangements have not been particularly successful. Indeed, supporters of exchange rate fixity must be cautious that such arrangements do not foster a deflationary bias, which could impede the achievement of sustained noninflationary growth However, the coordination process can be strengthened.

I will now comment on the staff paper on the SDR and the international monetary system. The growth in private international capital markets has altered the traditional approach to the definition and measurement of international liquidity. Indeed, there is no single measure of the adequacy of international liquidity capable of yielding conclusive results. In this context, we felt that the indicators developed for the September Board discussion provided some useful supplementary information for our traditional reserve to import ratios. At the same time, however, we felt that these indicators suffered from a number of interpretational difficulties, which the staff points out again.

In the paper before us today, the staff proposes that we consider use of a measure of import compression as a proxy for assessing the adequacy of international liquidity and develops calculations to measure this on the basis of import and export volumes in relation to GNP/GDP data. We are willing to consider this measurement, along with others, in assessing the case for an SDR allocation. But the existence of import compression alone does not provide a very convincing or logical basis for concluding that there is a deficiency of international liquidity. Clearly, import compression may be associated with a shortage of liquidity. But this tells us very little about the factors giving rise to the import compression. For example, assume that a country had borrowed unsustainably for many years in order to finance consumption and imports, and then experienced a contraction in liquidity because it was deemed uncreditworthy by international financial markets. Should we view the ensuing statistical evidence of import compression as signaling an inadequacy of liquidity, rather than evidence of a necessary adjustment in the balance of payments? And would increased unconditional financing be the correct response? Furthermore, the staff points to a number of important pitfalls that would emerge with such an indicator--recessions that are not the result of liquidity shortages; contractions in world trade that are not related to liquidity shortages; cyclical patterns in the expansion of world trade that might not be easily identified, in particular the current expansion; and econometric problems with the relationship between import volumes and real GDP.

In sum, there is no single measure for assessing the adequacy of international liquidity, but all of the indicators may contain bits and pieces of useful information. The interpretation of the various bits and pieces is an important subject, which we have reviewed continuously and at length in our discussions on the need for an SDR allocation.

In the context of a longer-term view of the possible evolution of the SDR, the staff discusses four possible approaches to invigorating the SDR. The first possible approach concerns ways to promote growth without discouraging adjustment. In this context, the staff reviews a number of conditional SDR allocation proposals, as well as the old SDR aid-link debate. We have discussed these proposals at length in the past, and my authorities have expressed important reservations with respect to them. We have questioned whether they are consistent with the criteria for an allocation as set out in the Articles. Some proposals could entail use of the SDR in a manner that might detract from the Fund as a quota-based monetary institution and represent a circuitous means of skirting national legislative prerogatives. The SDR is a monetary reserve, in our view, and should not be used as a means of promoting developmental objectives or transferring real resources. Also, questions arise as to what advantage a conditional SDR allocation would have over the ordinary extension of conditional financing from the Fund's quota-based resources.

The staff also discusses the possible use of an SDR allocation in association with securitization and credit enhancement. This discussion reflects proposals presented by President Mitterrand and the Institute of International Finance. We would need to examine a number of questions raised by this proposal. For example, we must ask whether an allocation for such purposes would be consistent with the criteria in the Articles regarding the global long-term need to supplement existing reserve assets. Also, we need to ask ourselves whether such proposals would create an undesirable precedent that might adversely affect the monetary character of the SDR.

The second set of proposals is aimed at facilitating transactions in SDR-denominated instruments. Under this heading, the staff refers to facilitating exchange market intervention in SDRs, through a clearinghouse mechanism or SDR certificates, and to substitution accounts and asset settlement.

These are areas with fundamental implications for the role of the SDR in the international monetary system. This chair supports measures that would improve the usability and liquidity of the SDR within its current framework. At the same time, however, we have observed over past years that changes in the international economy have fundamentally altered the basic rationale for the SDR. In our view, proposals for a greater role for the SDR in the system must offer clearer advantages for an efficient and stable system than have yet been demonstrated.

Over the past decade, we have witnessed the evolution of a multiple currency reserve system in which private markets have supplied the bulk of liquidity needs for creditworthy countries. As part of this development, there has been a significant diversification away from the dollar toward other important currencies, particularly the yen and the deutsche mark, in a fairly orderly manner. As noted earlier, destabilizing portfolio shifts can occur under any system in which there are incompatible and inconsistent policies among the major countries. The key issue affecting systemic stability, in our view, is how to strengthen policy coordination and the adjustment process.

Against this background, my authorities do not see a need for an SDR-based substitution account to foster diversification or to impose added discipline on reserve currency countries--assuming that it would, in fact, do so. To the extent that these are desirable objectives, there are other, more flexible ways to achieve them. We are also mindful of the lengthy and inconclusive discussions that we have had in the past on these subjects.

We are also skeptical about a role for the SDR in exchange market intervention arrangements. The major countries have more than adequate resources and arrangements to conduct intervention operations, consistent with their desire to foster greater stability of exchange rates. Furthermore, the Articles clearly indicate that the SDR cannot be used or held by private entities. We are not persuaded that alternative mechanisms should be created to achieve this purpose. Also, it is noteworthy that private markets have yet to show great interest in SDR-related instruments, in contrast to the experience with the ECU.

The third set of proposals concerns ways that the SDR might be used to provide an anchor against inflation. We believe that, through the economic policy coordination process, substantial progress has been made in promoting early and strong adjustment efforts, including efforts to address inflationary pressures. Moreover, we are skeptical whether the SDR could play a substantial role in regulating nominal demand. Certainly, the notion of the Fund as a global central bank is visionary, given current international economic and political realities. The two-stage approach, involving a link between surveillance of a country's anti-inflation policies and its eligibility to receive its share of an SDR allocation, is an innovative idea. But it would involve a rather basic change in allocation procedures, and it might be rather difficult, in practice, to allow allocations for some members and not others.

The fourth set of proposals concerns ways to improve the efficiency and stability of the reserve system. My authorities recognize that the SDR can play a role as a safety net. However, we have reviewed at length in recent years the arguments concerning the costs and availability of international reserves, and borrowed versus owned reserves. I would simply reiterate our view that creditworthy countries on the whole have been able to tap international financial markets at low spreads, and the periodic need to refinance borrowings may impose a useful discipline on countries' policies. Furthermore, there is still the alternative of providing conditional liquidity through a flexible array of Fund lending facilities.

Mr. Archibong made the following statement:

We welcome the continuing review of the working of the international monetary system. The two staff papers under consideration provide interesting insights into the issues that remain to be resolved.

It is noted that none of the known alternative exchange rate regimes can, by itself, significantly influence fiscal policy behavior. This would not be surprising, since a country's fiscal objectives are intimately related not only to macroeconomic issues, but also to domestic social and political priorities. In this situation, it would appear that fiscal discipline could be better enhanced through an appropriate mix of policies. Among the major industrial countries, a combination of policy coordination and appropriate target zones for exchange rates could be helpful. Policy coordination alone is certainly not enough to achieve greater fiscal responsibility. If it is supported by target zones, then any deviation of the exchange rate from the zone could result in a multilateral review of policies that could enforce fiscal policy discipline.

In addition to its domestic task of influencing real output and employment, monetary policy has recently been assigned the international task of moderating exchange rate movements. The staff observes that, in this connection, greater stability of exchange rates can be achieved only at a high cost--such as instability of interest rates. It seems to us that, under a target zone system with fairly wide bands, the cost could be minimized. This is because the freedom allowed to exchange rates within the wider bands would frequently permit monetary policy to take time off from its exchange rate assignment and become available to assist in the management of domestic demand.

The existing difficulties in identifying equilibrium exchange rates create a problem for exchange rate management and pose a serious challenge to the international monetary system. In a regime of floating rates with greater variability of exchange rates, the situation appears to be even more difficult. While the market cannot be trusted to determine the equilibrium exchange rate, reliance on an exchange rate regime for sound and disciplined macroeconomic management is obviously unrealistic. Mainly for this reason, we would support concerted intervention. However, in order to be effective, such intervention must be guided by changes in real economic conditions.

So much importance is being attached to economic policy coordination. This may be right. But policy coordination as currently practiced is ad hoc, while its effects would be clearer if it had a systematic format. It should also be subject to surveillance. Notwithstanding inherent difficulties, a specific and reliable approach should be devised for evaluating the effects of economic policy coordination among industrial countries and their impact on developing countries.

In the prevailing exchange rate regime, we do not see the need for leadership. Since there are apparently equal partners, a symmetric system should be preferred. In this connection, we endorse the point made by Mr. Nimatallah in his statement to the effect that we should reduce the chance of a leader destabilizing the system by resorting to undesirable policies and performance.

Our position on the need to promote the use of SDRs by official and private entities has been stated in the Board quite often. We would go along with any suggestion aimed at effectively invigorating the SDR. Its wider use should, as a matter of policy, be promoted. One way to do that, of course, is to increase the supply of SDRs through an unconditional and substantial allocation. We believe that the efficiency and stability of the reserve system could be enhanced through this process. Progress should, therefore, be made on devising measures to make the SDR more attractive to hold. We would like to stress that, while more studies on aspects of the SDR may be required, it is necessary that we constantly bear in mind the lessons of history to which Mr. Cassell drew the Board's attention this morning. Specifically, the use of national currencies to represent international reserves has inherent weaknesses that Article VIII, Section 7 of the Fund's Articles of Agreement seeks to address. In the spirit of this Article, we strongly support measures that would move the SDR to the center of the international monetary system.

On the use of the SDR as an anchor against inflation, there is probably a need to review the SDR basket itself. One suggestion by Mr. Nimatallah is that it should be expanded to include the G-7 currencies and the use of a price index. Admittedly, there are potential difficulties in the selection of relevant goods and services and the determination of their prices for the index. But if the intention was to guarantee that the SDR itself was free from inflation, then the real purchasing power of the SDR should be fixed. This could probably be achieved by returning to the old suggestion of a commodity-backed international reserve asset. The SDR would then be valued in terms of a broad bundle of goods rather than a small basket of currencies. Tying the SDR in value to some price index suggests that the SDR would, on average, appreciate in value against each currency by the rate of that country's own price inflation. If the deviation was significant, it should trigger consultations among the policy coordinating members. In this way, the SDR would tend to be the cornerstone of the international monetary system, providing a realistic anchor. We know that there are some technical problems on the choice of goods to be included in the basket, and there would probably be a delay in collecting price information. But given the Fund's technical expertise, these problems could be tackled successfully.

Mr. Jalan made the following statement:

We have had a very long and, I think, extremely instructive discussion on what seems to me to be crucial to the future role of the Fund. Both the topics that we are discussing are vital, but I need not go over all the issues in detail, because most of the points have been made by previous speakers. I will highlight a few points that seem to us to be important.

First, it does seem to me that there is a complete agreement about the need for coordination of economic policies. No one has disagreed with that need. The issue really boils down to what role the Fund or the international community is going to have in whatever surveillance procedure and coordination procedures are going to evolve.

It seems to us that the G-7 mechanism is working effectively today. There is no great problem in the world economy as we see it, and coordination of economic policies is by and large taking place. But when we are thinking about the international monetary system, we should consider not only what is working today, but also what is likely to be sustainable in the very long run. One consideration we must keep in mind is that the G-7 framework represents national negotiating processes among seven countries. It is a political process taking place without, apparently, the independent, professional staff advice that the Fund could provide. If there is consensus, there is no problem. For example, it is easy enough to arrive at an agreement on exchange rates or the kind of international monetary system that best serves the world.

But if there is conflict between different national players or different elements of that Group of Seven, then we may run into a tremendous problem. So, I would urge the developed countries that run the system, as it were, not to ignore the systemic points. The fact that the system is working today is no guarantee that it will work again or that it will work forever. There is something to be gained in nurturing and building an international system of surveillance and an international system of coordination, whereby different viewpoints can be reflected and where conflicts can be resolved outside of a national framework. We place a great deal of importance on building the international surveillance mechanism and strengthening the role of that mechanism. Developing countries are not in a majority strength in the Fund, which is a cooperative institution and represents all views. So I would urge some of the more powerful members to keep in mind that we are dealing with systems.

With regard to the SDR, Mr. Templeman raised some very basic issues that we would do well not to gloss over. The time has come, perhaps, to face these issues, and to consider them in depth. One issue that he raised, if I understood him correctly, was that in his view the rationale for making the SDR the principal reserve asset no longer existed, that a multi-currency system was now serving what had previously been desired of the SDR, and that perhaps the kind of considerations that went into the amendment leading to the SDR being made the principal reserve asset are no longer valid. We should find a mechanism to consider this issue rather than only going into the quantitative aspects of whether or not there is a need for an allocation. The fundamental question is whether or not the SDR is going to have the role of the principal reserve asset. If the world does not require it, there is no point in wasting a lot of time discussing it or trying to bring quantitative data to bear on this problem. Our reading of the situation is that it was a major advance when the international community decided that there should be a shift away from a multi-currency or a key currency system to an SDR-based system. If the considerations that existed then are no longer valid, the international community perhaps should revise that view rather than argue about technicalities of the matter. Unless we resolve this question, the rest of the debate is futile. Making the SDR attractive is worthwhile only if we feel that it has a role as a reserve asset.

This chair has emphasized, through some of its proposals, that the post-allocation distribution of SDRs is also important in the sense that there should be greater confidence on the part of developing countries not to rush into import compression because of a fear of a reserve decline. SDRs would have to be reconstituted, but you need not compress imports in advance because of the fear that otherwise reserves will fall dramatically. At the time that we made the proposals, there was some lack of reserves; therefore, we had suggested that post-allocation distributional mechanisms are important. However, all this fades into insignificance unless we can reach an internationally accepted view on the future role of the SDR.

Mr. Mawakani made the following statement:

I welcome this opportunity to discuss the two staff papers prepared on key issues in the functioning of the international monetary system and the role of the SDR. These papers adequately highlight the major areas where additional efforts need to be directed to improve the functioning of the present system, namely, the stability of the exchange rate regimes, the management of international liquidity, and the future role of the SDR.

I will address the six broad issues suggested by the staff. In the paper on the key issues in the functioning of the international monetary system. First, on the issue of fiscal discipline and the exchange rate regimes, the experience to date indicates that neither fixed nor floating exchange rate regimes have been adequate to promote fiscal discipline among the major industrial group of countries. Differences in economic fundamentals, and in particular, in the fiscal policies and fiscal conditions of these countries, seem to explain, in part, the short-term volatility of nominal exchange rates and the large medium-term movements in real exchange rates, with their adverse effects on developing countries.

Stable exchange rates are crucial for the proper functioning of the international monetary system. The recent coordinated approach among G-7 countries in managing the floating exchange rates through concerted market interventions combined with increased policy coordination has succeeded in bringing about some stability in the system. However, for this stability to be maintained for a long period, fiscal policies need to be harmonized. To this end, for the coordination process to be credible, it would need to include specific fiscal policy commitments and allow mechanisms for a timely implementation of remedial policies. In this connection, the concept of target zones for the exchange rates of major countries could prove to be a useful approach if the authorities choose credible targets and show a strong political willingness to achieve them. However, as was made clear during our recent discussions on the role of structural policies in industrial countries, structural reforms would need to be accelerated in order to improve the responsiveness of their economies to fiscal policy.

Second, the issue associated with reduced independence of monetary policy and the exchange rate regimes has been addressed bit by bit over the years. The availability of financial support from surplus countries to deficit countries has, to a certain extent, helped in reducing the burden of adjustment and in overcoming the asymmetry problem. However, the real issue for the international monetary system is not the cost associated with reduced independence of monetary policy formulation, but rather how to maintain a reasonable exchange rate stability and what role a nominal anchor and the SDR would play in the system.

Third, on the issue of determining the equilibrium exchange rate and exchange rate management, empirical evidence suggests that the equilibrium rate perceived by the market can be considerably different from the sustainable rate. However, despite problems associated with the determination of the true equilibrium rate, intervention has a role to play in countering disorderly market conditions and smoothening short-term exchange rate movements. But intervention alone cannot be relied upon to achieve lasting stability in the system. Persistent pursuit of sound and coordinated economic and financial policies has a better change to enhance exchange rate stability.

Fourth, on the issue of restrictions or taxes on international capital flows, clearly little will be gained by resorting to restrictions on capital movements in an environment of liberalized capital movements. However, whether exchange rate stability will prove more difficult to maintain under greater worldwide mobility of capital is open to debate. We are of the view that there may be cases in which restrictions on capital movements would have to be resorted to in order to counteract the adverse effects of capital movements.

Fifth, experience, particularly with the EMS countries, shows that leaders and anchors are desirable for an effective functioning of the exchange system. However, in view of the Plaza Accord experience and present economic realities, we share the staff's view that "a hegemonic approach to coordination when economic realities no longer support it could only be counterproductive." The evolving process of coordination of economic policies could provide further insight into the best approach to the issue of leader and the role to be envisaged for the SDR as a nominal anchor.

Sixth, on policy coordination and monitoring zones, possible ways of enhancing the functioning of the international monetary system will involve a stable exchange rate system, which in turn would require better management of national economic policies and a greater degree of international policy coordination. While the coordination process should be given greater scope, its role in improving both global economic performance and the functioning of the international monetary system could be greatly enhanced through effective Fund surveillance. We are of the view that the zones for performance indicators should be loud, while those for indicators of intermediate variables should be quiet in order to avoid market speculation. We can only hope that the concept of monitoring zones will be effective in strengthening the implementation of policy commitments.

With respect to the paper on the SDR and the international monetary system, as the staff acknowledges, it is extremely difficult, and perhaps even impossible, to find an indisputable quantitative indicator of the adequacy of international liquidity that would be sufficient to justify an allocation. I note the staff views that an issue of this importance cannot be determined solely by the quantitative approach, and I welcome the various qualitative elements that they introduced in the analysis.

The lack of access to financial markets by many developing countries and the trends in import compression since 1982, accompanied by other manifestations of liquidity crisis such as external arrears, are all indicative of the liquidity shortage and continue to have adverse consequences for the functioning of the world economy. We agree with the staff that there is a strong case for regular allocations of SDRs that prevents the share of SDRs in reserve holdings from eroding further.

The SDR has not yet assumed a major role in the international monetary system and up to now constitutes only a small portion of total reserves. The actual level of SDRs is incompatible with the objective of making the SDR the principal reserve asset in the international monetary system. I welcome the various proposals to invigorate the SDR and to improve its quality as a reserve asset and as an acceptable unit of account in private transactions. These proposals have their merits and could improve the usefulness of the SDR as well as promote the purposes of the Fund. However, they tend to overemphasize the conditional aspects of the use of SDR allocations. While we recognize that the proposals may help to bring about a consensus on an SDR allocation, we are of the view that they should not divert the Fund from its obligations under the Articles of Agreement to make unconditional allocations of SDRs to supplement existing reserve assets. Thus, we remain opposed to conditional SDR allocations and to rigid rules on the type of activities that could be supported by such allocations. Only unconditional SDR allocations can provide the required reserve strength for the pursuit of growth-oriented adjustment policies.

We welcome the proposals under consideration for post-allocation adjustment of the distribution of SDRs. In our view, those proposals that could improve over time the balance between borrowed and owned reserves would stand the best chance of success. We look forward to the discussion of the paper on the various proposals on the post-allocation adjustment.

If the proposals for debt securitization and collateralization promote creditworthiness of countries, reduce their contractual debt, and improve their access to capital markets, they would certainly contribute positively to the solution of the debt problem. However, it remains to be seen whether these procedures will restore access to capital markets for developing countries and resolve the issue of the adequacy of the balance between borrowed and owned reserves.

On the proposals to promote the use of SDRs by official or private entities, we broadly agree with the staff on the need to promote transactions in SDR-denominated instruments. A promising avenue is the use of SDR-denominated instruments in exchange market intervention. To be effective in promoting private use, the level of SDRs will need to be substantially raised and the quality and attractiveness of the SDR as a reserve asset enhanced.

On the issue of the SDR as an anchor against inflation, experience to date indicates that, for an international monetary system to function efficiently, there is a need to have an anchor against inflation. For the SDR to be an effective anchor, the Fund would have to play a more active role in the conduct of world monetary policy.

The SDR has not been allowed to become the principal reserve asset in the international monetary system. Given the shrinking size of official resources, the withdrawal of private financial markets from lending to developing countries, and the high costs of generating reserves through further adjustment of current account positions, we agree with the staff that only meaningful allocations of SDRs could provide a safety net against the vulnerability of the international monetary system and ensure the efficiency and the stability of that system.

Mr. Finaish made the following statement:

Today's discussion provides us with an opportunity to examine ways to improve the functioning of the international monetary system within a multilateral framework. The staff has usefully highlighted the trade-offs associated with various undertakings in this regard. As is clear from the staff's presentation, the task--being of an ongoing nature--does not lend itself to conclusions of timeless validity. Nevertheless, it is perhaps fair to say with some measure of conviction that the first paper before us today reinforces two general propositions relating to the international monetary system and economic management, namely, that appropriate macroeconomic policies need to be pursued regardless of the exchange rate system followed, and that policymakers have to be aware of how other countries will react to their policy measures and associated feedbacks. This naturally imparts a great deal of importance to the process of economic policy coordination, particularly among the major industrial countries. It is equally important in this regard that the Fund, as the international cooperative institution responsible for the well-being of the international monetary system, be in the forefront of this coordination process and of all efforts aimed at improving the functioning of the system.

With these general remarks, I will now comment on the six questions raised in the paper. First, while it is true that there is no corrective mechanism for fiscal indiscipline that corresponds to that to which monetary policy is subjected under the fixed exchange rate system or the target zone system, the pressures for reversal under the floating rate system with high capital mobility may be delayed and of insufficient magnitudes. These pressures could also entail, as noted by the staff, resorting to the protectionist alternative to fiscal discipline. Timely correction of a lack of fiscal discipline does require administrative measures outside the exchange rate system, as well as effective policy coordination.

Second, with regard to monetary independence, here again I believe that the issue of reduced monetary policy independence under greater fixity of exchange rates has to be evaluated against what is, not against what in theory can be attained. In other words, in a world with high capital mobility, some loss of monetary policy independence is perhaps in practice unavoidable, even under flexible exchange rate regimes. I would not, however, go so far in this regard as to subscribe to the view that monetary policy has no effect in bringing about desired changes in such key variables as employment and real output. Concerted sterilized exchange market intervention, when appropriate, can help mitigate the costs associated with the loss of independence.

Third, as to the question of equilibrium exchange rates, an official target range for the exchange rate based on a sustainability approach may provide a useful anchor to imperfect markets, or those markets where there is destabilizing speculation. However, the problems inherent in estimating what a sustainable exchange rate is are significant, and the errors associated with such estimates may be large.

Fourth, it may be difficult to argue that restrictions on international capital flows would not be costly. But it should be kept in mind that, while large economies can sustain large flows and the size of their markets limit the destabilizing impact when speculative flows run counter to fundamentals, smaller economies may have more to be legitimately worried about.

Fifth, on leaders and anchors, the increasingly non-hegemonic coordinating process for influencing exchange rates is largely a reflection of an increasingly symmetric distribution of economic power. Hence, the balance of the staff's argument in the section, namely, that hegemony is not a necessary condition for the smooth functioning of the international monetary system, would seem to be warranted on practical grounds, if nothing else. In any event, to the extent that present conditions are not conducive to the emergence of a leader, that should render the need for international policy coordination process that much greater. That process could benefit from reliance on a price index as an early warning signal of future aggregate price developments.

The use of monitoring zones for key economic indicators does have the potential of enhancing the usefulness of indicators and increasing the likelihood of implementation of policy commitments. Such use, however, should not diminish the need for judgmental analysis. On the width of the zones, I would agree that there is a case for narrower zones for policy indicators than for performance indicators.

As to the paper on the SDR, it is true, as is noted by the staff, that the development of large-scale international financial markets has greatly expanded the capacity of national authorities to obtain foreign exchange reserves by borrowing. In practice, however, this has not been the case in recent years for all national authorities, certainly not in debt-burdened developing countries, nor, as a result of contagious effects, in developing countries that are not so debt burdened. This strongly argues in favor of the case for supplementing the reserves of these countries. And it is not necessarily true, as some have argued, that such a need does not constitute a global need and hence does not meet the requirement under the Articles for an SDR allocation. The debt problem is not only the debtors' problem, but one with clear global ramifications.

As to how the concept of adequacy of international liquidity can be made operational in a meaningful and empirically viable manner, it seems that the staff has carried this exercise as far as it could usefully go. I am not sure how reasonable it is to expect that further refinements of the techniques considered will completely rid them of the conceptual and empirical difficulties with which the task of assessing the adequacy of international liquidity seems to be riddled. Nor am I sure that, however perfected, these techniques can eliminate completely the need to use the approach to assessing the need for reserve supplementation that was put forward during the formative stages of the SDR, namely, making judgments "as to whether the functioning of the international monetary system and the performance of the world economy could be improved by expanding the role of the SDR." On this I am in complete agreement with Mr. de Groote, with whom I particularly concur that the legalistic reservations invoked against an SDR allocation have to be weighed against such other legal obligations of the Fund as making the SDR the principal reserve asset of the international monetary system. This would require a strategy of conducting regular allocations of SDRs at rates that prevent the share of SDRs in reserve holdings from eroding further and that progressively bring it back to a level more compatible with the fulfillment of that obligation.

As to the approaches for invigorating the use of SDRs identified by the staff, they merit consideration in their own right, but they should not, in my view, be seen as alternatives to regular allocations of SDRs that are not tied, conditional, or subject to a reconstitution requirement.

I do not have much to add to what has already been said by previous speakers on the last three approaches identified by the staff. In brief, these approaches merit further consideration and at least some of them could realistically be expected to help invigorate the SDR. As to the first approach, we feel that the various proposals under that approach could help if only to allay the concerns that additional SDRs could act as a disincentive to adjustment; the proposals also have a potentially constructive role to play in facilitating debt reduction schemes as well as adjustment with growth.

Mr. Engert made the following statement:

Beginning with fiscal policy discipline and the exchange rate regime, the main message of the staff's analysis is that there are, at best, weak grounds for arguing that a fixed, or target zone, exchange rate regime will effectively discipline fiscal policy. In this regard, I would agree that better fiscal discipline requires a framework of conduct beyond the exchange rate system.

Fiscal shocks generally are seen to affect the real exchange rate that will equate aggregate demand and supply over the short to medium term. Thus, although the time path may differ somewhat under fixed rates--and this could be important--one would also expect a real appreciation to take place under fixed rates given fiscal expansion, and the emergence of protectionist pressures. In this regard, on page 3 it is argued that a fiscal expansion under target zones will produce a loosening of monetary policy to keep the exchange rate from leaving the zone, leading to a real appreciation.

As regards monetary policy independence and the exchange rate regime, I agree with the staff that the central issue is what must be given up for greater exchange rate stability. Moreover, this could be seen as being largely a tactical question, because, as is suggested on page 7 of the paper, the real choice concerns the nature and timing of the constraints on policy given the authorities' objectives. In addition, I agree that, aside from the contribution of price stability, monetary policy should not be expected to have a lasting impact on real variables, nor is there any consistently exploitable relationship in that regard, as suggested on page 7 of the paper. However, my authorities see no reason to question the conclusions of the Jurgenson Report on the effectiveness of sterilized foreign exchange market intervention. This is not to dismiss the apparent success of concerted intervention over the past few years, but rather to re-emphasize that the evidence generally suggests that sterilized intervention is likely to be effective only over very short periods, and then only when it is consistent with actual or expected policies. This implies that attempting to influence trends in exchange rates generally entails some loss of policy independence.

The question of the optimal degree of exchange rate flexibility for a particular economy is rather difficult to assess. It will depend on the typical array of macroeconomic shocks experienced by the economy, whether these shocks are generally shared by the country's main trading partners, the general nature of the trading partners' responses to these shocks, and the degree of policy spillovers from other countries.

While smaller countries seem more likely to adopt a fixed exchange rate with a large trading partner, they are, at the same time, more likely to experience important policy spillovers from that trading partner. Thus, smaller countries would be most likely to adopt a mixed strategy with respect to the exchange rate, keeping it more or less fixed over extended periods of time, but occasionally allowing it to move to a new level to facilitate adjustment in the face of important real--possibly foreign--shocks.

Furthermore, there may be occasions when the optimal response of any two economies to a shock is not to resist movements in the nominal exchange rate, in which event some observers might incorrectly suspect a policy of "benign neglect" with respect to the exchange rate. In this connection, it is noteworthy that the greater the credibility of the monetary authorities, the more readily the nominal exchange rate can perform such adjustments without inciting overreactions on the part of the private sector. In such cases, the private sector will see the exchange rate movement as being consistent with the announced long-term goals of the authorities, rather than as an attempt to renege on them.

Turning to the section on identifying equilibrium exchange rates and exchange rate management, we agree with the staff's analysis, which suggests the great difficulty in identifying equilibrium exchange rates and indicates that this may be the most contentious and difficult issue facing those who advocate exchange rate stability as a policy objective for the international monetary system.

Exchange rate management should be restricted to the very short run, with a view only to reducing exchange rate volatility, and only to the extent that other macro variables do not have to absorb this volatility. This is the realm of sterilized intervention. Beyond this, the goal of exchange rate stability must be considered within the broader macro policy context of the countries in question; as a particular approach to monetary policy, which entails sacrificing the ability to determine independently the domestic rate of inflation; and with reference to, inter alia, the nature of the typical array of prospective shocks facing the country, as I noted earlier.

I have very little to add to the staff's analysis of restrictions or taxes on international capital flows, except to state that my authorities would not favor attempts to impede private international capital flows. While I would acknowledge that it appears at times that financial markets overreact to economic events and add unnecessary volatility to exchange rates, attempts to "throw sand in the wheels" seem unlikely to be effective for a variety of reasons, as noted, for example, in the staff paper. Moreover, market overreactions to perceived macro policies can have some disciplinary benefits. In addition, the perspective of throwing "sand in the wheels" seems to be too episodic, and not sufficiently appreciative of the broader, systemic benefits of uninterrupted capital mobility.

As regards leaders and anchors in the international system, I agree that an acknowledged leader is not necessary and that national macroeconomic policies can tie the system down. In particular, where the benefits of retaining some exchange rate flexibility appear to dominate--and this appears to be the case in the largest countries--there seems to be little point in considering alternative orientations of the international monetary system that do not allow the participants to choose their own nominal anchors. There is no reason why countries cannot meet and exchange views with the aim of "internalizing externalities," and thereby achieve the benefits of cooperation, while at the same time pursuing their own definition of "price stability" at home. Given appropriate domestic policies, with adequate recognition of spillovers, one would observe a reasonable degree of exchange rate stability, other things being equal.

This brings me to policy coordination and monitoring zones. My authorities agree with the points in the staff's summary on page 18 regarding the discussion of September 9, 1988. At the same time, my authorities feel that it may be premature to endorse the policy coordination process so enthusiastically. In this regard, it will be some time before the merits of recent coordination efforts may be confidently and reliably assessed. Also, the empirical support for strong forms of coordination, as suggested by model simulation exercises, is, in general, rather weak. Here, however, I recognize that what we are really working toward, appropriately, is more along the lines of information sharing and more effective multilateral surveillance.

Our views on monitoring zones have not changed materially since last September. In sum, as noted on earlier occasions, my authorities feel that monitoring zones would serve little purpose, particularly if triggers were involved. The surveillance exercise, which is built around a set of indicators, already sets out official projections and then compares them with actual outcomes.

My authorities found the paper on the SDR and the international monetary system to be both comprehensive and ambitious in the range of proposals presented to invigorate the use of the SDR, some of which could be far-reaching in their implications for the global economy. Some of these proposals have been put forward in the past without receiving the required support for implementation. In the view of my Canadian authorities, the arguments in favor of increased use of SDRs remain on the whole unconvincing, and they do not think that it would be useful for earlier discussions to be repeated unless there are reasons for thinking that a stronger case could be made now. Generally speaking, my authorities would desire a more rigorous analysis of the source of the market failure that might be addressed, together with a clear justification as to why the SDR is the appropriate instrument to deal with the problem. At the same time, I should point out that the other members of our constituency have a more favorable view of the SDR and the remainder of my remarks reflect the views of my Canadian authorities.

The historical review of the SDR is useful in that it clearly identifies the original logic and circumstances behind the creation of the SDR. In addition, the results of the staff's assessment of how to measure and project international liquidity suggest that it is extremely difficult, if not impossible, to develop purely quantitative indicators of the level and adequacy of international liquidity.

One suggestion to get around this problem--to infer a liquidity shortage from the simultaneous existence of import compression and export expansion--is ingenious but clearly inadequate. For the reasons presented in the staff paper, my authorities question the validity of this approach.

While it is clear that an assessment of global liquidity is not possible in a purely quantitative sense, it remains an important consideration with respect to the need for an SDR allocation, although it is apparent that judgmental input will be required. The SDR is a unique instrument, representing an internationally agreed approach to supplement existing sources of liquidity. In the current global financial environment, my authorities have difficulty with the idea that this will be necessary in the foreseeable future and in the absence of substantially changed circumstances. Nevertheless, they would retain the SDR as a potentially useful method of increasing global liquidity should the circumstances warrant this.

Some of the proposals outlined in the paper for increasing the use of SDRs are based on the more general criteria of improving the functioning of the international monetary system. Generally, however, my authorities are not convinced that a case has been made to demonstrate the presence of market failure, which requires the use of SDRs.

Recently, proposals have been put forward that link the use of SDRs to schemes intended to ameliorate the consequences of the debt problem, while including provisions to ensure continuing adjustment. Thus, for example, suggestions have been made to use the SDR to effectively guarantee portions of the external debt-servicing payments of indebted developing countries, perhaps by facilitating credit enhancement and securitization. A debt plan, based on a post-allocation redistribution of SDRs to a trust fund, would have many operational difficulties. More important, and of concern to my authorities, the use of SDRs in this way in effect represents a transfer of risk. My authorities are willing to examine any serious debt proposals on their own merits, including those that incorporate the use of SDRs. However, they emphasize that they do not see any inherent advantages in using the SDR in that connection.

A number of issues are raised with respect to promoting the use of SDRs by official and private entities. The paper identifies as a major obstacle to the use of the SDR in official exchange market intervention the limited number of parties that currently hold official SDRs. My authorities question the importance of using the SDR or SDR-denominated assets in exchange market intervention, as countries can already intervene in the currencies that make up the SDR. Perhaps of more relevance to the current discussion, my authorities doubt that efforts to facilitate the use of SDRs or SDR certificates by private sector agents would have any meaningful impact. It is not evident that there is demand for SDRs by private agents--indeed, there is nothing currently preventing the issuance of SDR-denominated assets if this were desired.

Substitution mechanisms have been the subject of substantial past discussion, although the context of the current debate is clearly somewhat different. In this connection, a current objective of these mechanisms would be to impose discipline on countries with large external imbalances. Dealing with exchange risk inherent in the substitution mechanism was a central difficulty in past discussions, and my authorities continue to believe that it would be very difficult to obtain agreement today on how to distribute the exchange risk. In addition, they view the substitution account as a highly questionable method of disciplining countries, and the staff presents, on pages 24 and 25, several reasons why one may doubt that it would actually accomplish this.

Using the SDR as the nominal anchor for the international monetary system is, in the view of my authorities, a very ambitious proposal. Even more ambitious are suggestions that the level of nominal demand in member countries be made responsive to the stock of SDRs. My authorities consider that these proposals are neither feasible nor likely to receive support, and that it is not useful to pursue them.

The final part of the staff paper argues that, with the growth of borrowed resources, disturbances in financial markets can lead to abrupt changes in the cost and availability of reserves. My authorities feel that this argument might be exaggerated, and that the existence of borrowed reserves does not in itself prevent any country from accumulating owned reserves in order to insulate itself from shocks in the financial markets. In my authorities' view, the lack of access to borrowed reserves is primarily a problem of creditworthiness and is best addressed through the use of conditional liquidity in support of adjustment rather than through an increase in global liquidity.

Mr. Fogelholm made the following statement:

The Nordic countries have looked forward to a discussion of the functioning of the international monetary system. As stated on many occasions, we are willing to discuss and consider proposals to improve this system, provided they are set in a realistic framework.

However, the document before us is, in our opinion, not particularly conducive to such a discussion. The staff has presented us with an academic survey covering various issues relating to the international monetary system. The paper, however, stops short of drawing conclusions from these theoretical deliberations. In particular, the paper does not address the question of how the theoretical considerations could be transformed into practical economic policymaking. A more action-oriented paper that analyzed and discussed various proposals for improving the system--for instance, with a view to strengthening policy coordination between groups of countries in general and notably among the G-7 countries--would have been better suited to a Board discussion.

I will concentrate my remarks on the second paper before us, on the SDR and the international monetary system. Over time, the role of the SDR clearly has been reduced, and there is little likelihood, at least in the foreseeable future, that the SDR will become the principal reserve asset as stipulated in the Articles of Agreement. However, as the SDR continues to offer a number of qualitative advantages, the Nordic countries would not like to see further deterioration of its role as a reserve asset. Thus, we continue to support moderate allocations of SDRs. Increased use of SDRs could, in our view, contribute to more stability in exchange rates as well as in reserve holdings. It should be added, however, that we are not ready to support proposals for new allocations linked to the needs of specific groups of member countries.

Regarding the various proposals put forward in the staff paper, as is shown in the paper, shortages in international liquidity are very difficult to define quantitatively. Due to uncertainties, we must therefore be cautious in interpreting such indicators. Although the import compression approach suggested by the staff may be useful in defining the global need for international reserves, it can also be misleading, as has been noted by other Directors. Import compression can be and, indeed, has been, caused by both a lack of creditworthiness and the need to adjust the economy, rather than being merely a symptom of shortages in international reserves. Despite such ambiguities in assessing the quantitative factors, I do not believe that we should stop trying to find alternative methods to define the need for international liquidity.

I will now address possible approaches to invigorating the SDR. As to the proposal for giving the SDR a greater role in the securitization and collateralization of claims on countries with debt-servicing difficulties, this would, to some extent, imply a transfer of risks from private to official creditors. Therefore, we do not support such ideas.

The proposal made by Mr. Sengupta would reduce the liquidity of the SDR and could imply a delayed adjustment process in the developing countries, which, in effect, would run counter to the purpose of the Fund. I am afraid that we are not in a position to support the Belgian or the French proposals either, as they link the allocation of SDRs with the economic situation of particular groups of member countries.

This chair has continuously spoken in favor of enhancing the attractiveness of the SDR as being crucial for increasing the use of SDRs. We believe that measures in this direction should focus on the official SDR, that is, primarily by encouraging member countries to take part in voluntary SDR arrangements. By the same token, suggestions on clearinghouses and SDR certificates may, in a longer-term perspective, deserve further consideration. In contrast, the use of the SDR in private markets should be left entirely to market forces, in our view, as is the case with the private ECU.

It would be desirable to develop a mechanism by which one could control global liquidity, although--for the reasons mentioned by the staff--in practice, it is unlikely that this could be achieved. The substitution account would hardly be a realistic approach, owing mainly to the lack of political will to accept the discipline that this would impose on the authorities of the issuing countries.

Making SDR allocations conditional on the Fund's evaluation of appropriate policies toward inflation, as envisaged in the two-stage allocation suggested on page 27, is not really very realistic either, nor is it acceptable. Such an approach would be beneficial primarily to the industrial countries. Only in a context in which the Fund was, to a certain extent, empowered to function as a world central bank and the SDR played a more central role in the international monetary system, would such an approach have some merit.

We do, however, agree with the staff's view that an SDR allocation could contribute to achieving greater stability in the reserve positions of member countries. Combined with some members' need to increase the share of owned reserves, frequent but moderate SDR allocations would thus seem desirable. Having said this, I would hasten to stress the importance of not allowing new SDR allocations de facto to undermine the ongoing adjustment process.

On the appropriateness of using SDR allocations as a safety net, we would like the staff to elaborate on the ideas put forward in the G-10 report of 1985. It goes without saying that such a safety net would have to be prepared in advance of actual need.

In conclusion, we found the SDR paper to be most useful. We fully agree with the thrust of the paper--that the concept of long-term need has become unoperational, and that instead we have to look at whether and how SDR allocations could serve the purposes of the Fund in a global perspective. The risk involved should be small. Fundamentally, a demand for reserves will always be met. The issue is at what cost. Thus, the SDR may still have a useful role to play in the international monetary system.

Mr. de Groote made the following statement:

On the functioning of the international monetary system, the only objection I could make to an otherwise remarkable staff paper is that it leaves the discussion too open, as if we had made no progress in the establishment of a new system. But as demonstrated clearly by Mr. Templeman, we are now at the preliminary stage of establishing a system of coordination that certainly works better than the floating regime that preceded it. The question, therefore, is how to make such a system more effective, and how to build further on the foundations we have already established.

I submit that the coordination of policies can be strongly assisted by more stable exchange rates, and this for two main reasons: first, because time is required for fiscal decisions to take effect, so that meanwhile a more formalized system of exchange rate mechanisms can help in shaping the expectations on which the success of budgetary decisions will depend; and, second, because exchange rate objectives, when accepted by the markets, can crucially contribute to the definition and implementation of appropriate fundamental policies. I was most impressed with what Mr. Posthumus said on this point in relation to the French experiment of 1983.

I could agree that firm commitment of all large industrial countries to main zones for the objectives and instruments of monetary policy would render less important the strategic usefulness of most stable exchange rates, but I question whether there is at present, or ever will be, the political will in the industrial countries to constantly and completely coordinate policies to such an extent. The only clear instance of explicit coordination of fiscal policies among industrial countries has been observed on the occasion of the Louvre Accord, and the uniqueness of this case seems to indicate that it was inspired not so much by the need to improve the functioning of the international monetary system as such, as by the highly commendable objective to resist the protectionist pressures of the time.

Of course, a new phase of active policy coordination could be expected if the dollar reached an unacceptable level for the international adjustment process. We are, in other words, in an imperfect system of economic coordination, and the purpose of a more stable exchange rate system, as convincingly described by Mrs. Ploix and Mr. Mawakani, is precisely to act as a guideline for policy decisions and market expectations as long as a system of perfect coordination of policies does not exist, which will long be the case.

I was interested in that respect to hear Mr. Cassell's statement on the history of the international monetary system. It is certainly true that the Bretton Woods agreement ceased to be operational when the underlying policies became incompatible with the dollar exchange rate. However, now we have, in effect, a system of coordinated exchange market intervention that is effective because intervention is used not to go against the fundamentals of the market, but to go in the direction of allowing the market to express its basic options. In other words, the system now reflects relationships that are perceived as correct by the market. Mr. Templeman might, therefore, have somewhat underestimated the crucial role played by the implicit exchange rate targets that exist at present, and by the effective intervention mechanism on which the system rests.

It also should not be forgotten that intervention has played a decisive role in stabilizing capital market movements and in allowing speculation to play a stabilizing role. Accordingly, I would not worry too much about this notion of equilibrium exchange rate, to which many speakers have referred. We are now in what the authorities would probably regard as an equilibrium situation, but they have not started from a theoretical or academic vision of the situation. They simply feel that, on the basis of a reaction of a number of variables, the present situation of exchange rates can effectively be defended.

On the SDR, I would just comment on the statement that I made at the previous meeting. The assumption I tried to start from is that 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--a maldistribution, as Mr. Yamazaki called it.

All this suggests that the present system fails to provide systematically for the availability of sufficient international liquidity for the implementation of sound adjustment policies. I therefore strongly recommend that we should not attach too much importance in the future to legalistic arguments concerning the long-term global need. I have already tried to demonstrate that the concept was originally introduced in response to preoccupations that are absolutely different from those implied by the interpretation given today to that notion. While Sir Joseph Gold was quoted this morning, the quotation did not serve the purpose of the demonstration; Sir Joseph simply says that the allocation should be made on the basis of global need. Now we tend to read this, under the influence of the discussion that has taken place since then on quantitative targets in the internal monetary policy, as if the authors of the Second Amendment of the Articles had in mind the establishment of a calculation to determine a shortfall of liquidity. In fact, there is not a trace of that in the text of the Second Amendment. The notion of global need does not necessarily lead to establishing an a priori calculated figure.

Quite to the contrary, if the authors of the original Articles went in the direction of allocating a sufficient amount of SDRs, it was precisely because they recognized that it was impossible to determine quantitatively a precise figure of a shortage, and that the allocation had to be sufficiently wide to be activated and become operational when an effective need arose.

Still on that point, I am surprised that there is now such an insistence on quantitative need. We live in a system of demand-determined liquidity creation, and, under such a system, neither the existence of a global shortage, nor the existence of an excess supply can be demonstrated by quantitative arguments. Therefore, I fail to understand how it can be said that there is no way to determine a quantitative reserve need and at the same time pretend that an allocation would create excess liquidity. One cannot defend those two positions at the same time. If you say that there is no way to determine quantitatively an insufficiency of liquidity, you cannot say that an allocation would create additional or excessive reserve supplies. I always thought that liquidity, internationally or nationally, is determined by demand, and if an allocation takes place, that obviously means that it will not add to overall liquidity but instead substitute for other forms of liquidity.

I was extremely interested by the part of the staff paper on possible ways to reinvigorate the SDR. On the first approach--ways in which the SDR could help to promote growth without discouraging adjustment--I thought that our recent seminar discussion had shown that implementing debt reduction or collateralization of converted debts absorbs sizable amounts of resources and that such operations can take place within the framework of a Fund-supported program. Therefore, the great importance of the French proposal is that it is entirely conditioned on the implementation of adjustment programs. I was therefore surprised to hear so many comments, in the context of that proposal, about the risk that it would pose of slippage in the implementation of sound programs. The aim of the proposal is to make the implementation of sound programs possible. It must also be stressed that the use of those resources would only take place when a guarantee falls due, as was pointed out by Mrs. Ploix herself this morning. In that respect, the staff should examine whether or not an administered account can hold SDRs. I started working on different alternatives because I had been told that an administered account cannot hold SDRs. However, if the staff were to conclude that an administered account can hold SDRs, then of course the modalities of the Mitterand proposal could be implemented very easily.

I had great difficulty in understanding why it is so difficult to get intellectually used to, say, the Mitterand proposal or that family of proposals, as if they were introducing something radically different from what we do now. The great bulk of SDRs are rechanneled by the Fund for precisely the same objective as that of the French proposal. And why would the authors of the Second Amendment have decided that 25 percent of quota increases has to be settled in SDRs if it had not been explicitly for the purpose of making SDRs usable for interventions? The precise purpose of that decision had been to make SDRs more effective in their contribution to the adjustment process. Debt reduction or collateralization should not, therefore, be singled out as if we had introduced any dramatic change from what we do now. The resources in the General Account, which also include the largest portion of SDRs, are used over time in different circumstances and for different objectives, but they always have one characteristic in common--they are used to achieve the Fund's purposes.

I am somewhat surprised by comments that we should not single out a group of countries. The Fund has always singled out a group of countries--the debtor countries. The debtor countries are a privileged group; it is only to them that we lend. Sometimes we lend to debtor countries for pure balance of payments reasons; sometimes we lend to them for reasons related to their debt situation. I do not see any logical difficulty in that approach.

A second objective that is discussed in the staff paper relates to the use of the SDR in helping countries mobilize intervention resources. That seems to me a very important way of influencing the stability of the exchange rate system. I would be very upset if the role of the SDR in that context was completely neglected. Indeed, intervention is now accepted as an essential instrument for protecting the adjustment policies of the largest industrial countries against destabilizing market pressures. And the ideal conditions for coordinated symmetrical intervention are clearly illustrated by the U.S.-Japanese standing agreement of January 1988. In that respect, Mr. Cassell has made a number of interesting remarks on the danger of a system exclusively based in an asymmetrical way on national currencies. Such a scheme could easily be worked out; the surplus countries would agree at the outset on that part of the allocation that they could make available for rechanneling purposes, and when the need for intervention arose, the Fund would then mobilize the resources committed to the scheme and lend them to the country that has a currency that needs to be supported on the markets. That country would then be in a position to obtain the currency needed for intervention. And of course, the SDR claim could be used for a second round of intervention in case of need.

The advantage of such a system is indeed substantial, because it would allow the financing of large-scale operations without requiring an allocation that would otherwise be politically unacceptable. A limited allocation could indeed meet some of those needs. It would also directly improve the composition of official reserve holdings. In sum, such a system would combine the basic features of some rechanneling mechanisms that have already been discussed here many times and some of the suggestions made by the staff in previous documents.

I would stress in that respect that talk about the inflationary potential of such intervention can easily, and indeed should, be dismissed, because such a scheme would only be activated in order to finance interventions that, according to the present coordination principles, should take place in any event. The purpose is not to bring into circulation more intervention means than those that are used at present, but simply to change somewhat their nature by establishing a greater degree of symmetry between reserve currency centers and other countries.

Another interesting feature of this approach, and one on which I disagree slightly with Mr. Filosa, is that not only would such a system allow the Fund to play an effective role in the exchange rate stabilization efforts of the largest countries, but also it would not require the negotiations that are associated with the establishment of a substitution scheme. In fact, the system I advocate would implement the two basic purposes of any substitution scheme, namely, promoting a more balanced exchange rate obligation between countries, and improving the composition of countries' official reserves. In other words, one could avoid most of the difficulties associated with the establishment of a substitution scheme by simply allowing the Fund to play a greater role through the SDR in the intervention mechanisms that are now an essential part of the coordination among large industrial countries.

Incidentally, it could also be stressed that such a mechanism would in itself exert an additional stabilizing effect on the markets, because the markets would perceive the mechanism as an important element of the success of such stabilization mechanism, and, therefore, the credibility of the proposed targets would be enhanced. Hence, the staff has not been too academic, although I do not think that the term "academic" should be considered an insult in present company. I find that the staff has been rather pragmatic, because it showed that one of the main concerns about the prospects for substitutions can be met not by formal rules, but rather by a system of intervention.

Several of the suggestions made by the staff and by a number of speakers, including myself, do not pretend to solve the problems with all aspects of the adjustment process, and, therefore, some of the criticisms of them are somewhat unfair. Nobody has proposed a new monetary system. We are all engaged in patchwork, and the idea is simply to identify specific segments of the process to which the SDR could contribute. Most of these proposals take a pragmatic and operational approach to the SDR and are fully consistent with the role the SDR is already playing in the operation of the Fund's General Resources Account. Accordingly, I approach comments about the loss of the SDR's monetary character with some skepticism. There is no difference between what is proposed and what the General Account is already now doing with half of the SDRs already at its disposal.

Another point that all these proposals have in common is that they establish a link between the use of the SDR and the implementation of sound policies. Proposals to rechannel SDRs to support objectives such as debt conversion and exchange market interventions all have in common the goal of protecting the adjustment against a situation of inappropriate reserve availability. Mr. Lombardo made the point this morning that having enough reserves makes a difference for the developing countries. I suppose that that point is behind some of the proposals that we discussed.

Another important point that I would like to stress gives me an opportunity to respond to a point made by Mr. Grosche. The proposals for using SDRs more systematically are not an alternative to a regular increase in the Fund's ordinary resources; that point deserves a little more attention. One could simply say that all the proposals could be done through a quota increase. But first the quota increase would have to be discussed. Even so, and with the doubling of quotas that we need, the basic reason for these proposals is to accommodate needs that cannot easily be met by loans from quota resources.

For instance, the collateralization of converted debts addresses only one of the structural aspects of a country's external position. It does not necessarily solve the general balance of payments problems, which remain of course the natural domain of the Fund's traditional tranche policy. The French proposal had appropriately been presented separately from a quota increase proposal, with a specific aim. For the same reason, the use of SDRs for financing exchange market interventions would extend the role of the Fund into an area where it is difficult to act on the basis of normal balance of payments loans. All the various proposals would or could at a certain moment absorb an exceptional amount of reserves that cannot easily be obtained on the basis of quota resources, but only obtained over and above the pool of resources operating on quota-based principles through an additional window or windows in the Fund's General Account.

The Economic Counsellor and Director of the Research Department remarked that he would highlight a few points that the staff would address in greater detail in coming months. The points that he would not address had been clearly noted and would also be addressed by the staff in its work.

One of the key issues raised was the notion of the constraints on the conduct of macroeconomic policies imposed by the choice of an exchange rate regime, the Economic Counsellor recalled. Mr. Posthumus had noted that the issue was not the number of constraints, but rather where the constraints manifested themselves. The question had also been raised whether countries could impose capital controls in order to overcome the loss of independence of monetary policy, and whether such intervention should take place in order to protect monetary policy independence. Clearly, a country could impose controls, although asset holders in the country would do their best to evade those controls, with costly consequences. The advisability of "throwing sand in the wheels" had been discussed extensively, and the staff's view deserved to be re-emphasized.

The cost of such action was high and seemed to add a distortion rather than eliminate the existing ones. As Mr. Templeman had suggested, a high degree of capital mobility should translate into better policies.

Next was the question of how to assign policy instruments, particularly if there was a conflict between internal and external objectives, the Economic Counsellor continued. In reality, policymakers worked toward domestic objectives, which had both internal and external implications. If appropriate policies were to be imposed, a primary constraint was the availability of international reserves. Some Directors had made the point that there was not so much a liquidity shortage as a liquidity maldistribution. However, the view had also been expressed that the relevant criterion was the general availability of unconditional liquidity. There was indeed a paradox in that one Article referred to long-term global needs while another Article contained a commitment to make SDRs the center of the monetary system. It had to be decided whether those two Articles were in conflict. Perhaps measurement of international liquidity had to be redefined. Once it was decided that a lack of liquidity existed, a decision had to be made as to how to deal with that shortage. That had to be viewed in the context of a segmented world, with some countries having capital controls or constrained access to capital markets; the concept of global liquidity was diluted by the very fact that the world was so segmented.

It could be said that import compression had been experienced, the Economic Counsellor agreed. The issue was how to read the data. Some Directors felt that import compression reflected adjustment, while others felt that it indicated a liquidity shortage. He considered that most instances of import compression should be viewed as a matter of degree, caused partly by adjustment and partly by a shortage of reserves. The questions that then had to be asked were whether the adjustment had been at the optimal speed; whether the reductions had taken place in the appropriate categories of imports; and whether the decline had been in consumption of imports or in investment.

It had been pointed out by Mr. de Groote that the scheme that he proposed for SDR intervention did restore some symmetry, which could be viewed as a bonus for those who preferred a symmetrical system, the Economic Counsellor noted. Mr. Nimatallah had suggested that symmetry ought to prevail because the international economy was currently a regime of equals. However, the reality was that countries were not of equal economic size. Was it possible to design a symmetric system for a world that was basically asymmetrical? One option would be the system proposed by Mrs. Ploix--a tripolar system comprising the United States, Japan, and the EMS. Another system, which had been suggested by Mr. Cassell, was a highly symmetrical system of asset settlement mechanisms and substitution accounts.

Directors had requested a long list of further studies by the staff, and the staff would have to set priorities, with guidance from the Board, the Economic Counsellor indicated. Mr. Nimatallah had requested that the staff examine the link between the SDR and surveillance. Mr. Yamazaki had proposed that the staff examine the issue from the perspective of game theories. Incidentally, game theories viewed the world in a very adversarial way, and in a world in which cooperation and coordination were paramount, approaches based on such theories might not have the most relevant focus. On the question of the equilibrium exchange rate, on the theoretical level, one could be very dogmatic and state that the rate produced by the market was the equilibrium exchange rate. Or, it could be argued that the rate produced by the market was sometimes unsustainable, and that sustainability should be a criterion for the equilibrium exchange rate. If one considered that an exchange rate that was sustainable might nevertheless be undesirable because of certain negative implications, that could further narrow the concept of an equilibrium rate. There was a broad spectrum, therefore, of ways in which to pose such a definition. He was leery of the suggestion that viewing equilibrium exchange rates as bubbles was useful, because that implied that equilibrium exchange rates had a life of their own, which eliminated any sense of policy responsibility.

The notion of concerted intervention had to be reappraised, especially in view of the role of expectations, the Economic Counsellor said. Table 1 in SM/89/26 implied that exchange rates behaved very similarly to other asset markets in that they were forward looking and sensitive to expectations. So one approach would be to assess the extent to which concerted intervention affected expectations. A reappraisal of the notion of concerted intervention was long overdue and would have to be thoroughly dealt with in the upcoming work program. Mr. Posthumus had requested an examination of capital mobility and its significance for monetary policy and exchange rates, and Mr. Kafka had requested that the staff look at the broader question of dual exchange rates, with a specific study of the lessons to be learned from the Belgian experience.

The Deputy Director of the Research Department recalled that a number of questions had been raised on indicators. Mrs. Filardo had asked what practical problems might arise in implementing monitoring zones. If one had a deviation from a target variable, as the staff paper suggested, three reasons were possible; first, policies had not evolved as expected; second, shocks had occurred between the time that the targets were formulated and the time that they were evaluated; or third, the relationship between the policy instruments and the targets had shifted either because of a disturbance, or perhaps because the wrong model had been used. In the real world, forecasts were not based solely on models, but were combined with judgment, so that it became a difficult task to sort out the various influences. Clearly, a judgmental approach had to be taken to make such an assessment. By the same token, group indicators, such as the commodity price indicator, could be helpful if used as a supplement to, rather than a substitute for, judgment.

The staff representative from the Research Department said that a case could be made for promoting private use of the SDR. Mr. Kafka had emphasized that such a case depended on whether doing so would improve the system. Many other Directors had noted that the private market for SDR-denominated instruments had not developed on its own, and wondered why the Fund should then promote it. Mr. Cassell had provided the answer that there were social gains from having a system in which the centerpiece was an asset that was no country's liability. A system based on national currencies had the problem that financing could be too easy for countries that needed to correct problems. Mr. Cassell had then proposed that one solution would be to reconsider asset settlement and substitution mechanisms; in contrast, Mr. de Groote had suggested introducing the SDR more actively in the intervention mechanism. It had been noted at one point that leaders and anchors developed on their own. In contrast, central reserve assets did not develop on their own when private markets had no incentive to develop them, even if there was a social case for their existence. The SDR would not become the central reserve asset unless the Fund or some other international institution promoted the development of the private market for that instrument.

The Deputy General Counsel recalled that Mr. de Groote had raised the question of the Fund's role in the post-allocation distribution mechanism. Several such mechanisms had been presented in the past, and Mr. de Groote had rightly stressed the common elements of those mechanisms. However, with respect to the use of SDRs and the role of the Fund in that process, there were some differences between the three categories of mechanisms, which he would briefly describe. The mechanism proposed by Mr. de Maulde was envisaged to be used under an operational transaction prescribed by the Fund between a participant and another holder. Therefore, there would be no transfer of SDRs through a Fund account. Two other categories existed for the particular purpose that Mr. de Groote had described: channeling the SDRs used for post-allocation distribution through the General Resources Account; and channeling them through an account administered by the Fund.

The first category--channeling resources through the General Resources Account--had been proposed by Mr. de Groote in 1984, the Deputy General Counsel noted. Since the Fund could not borrow SDRs from the General Resources Account, that proposal suggested that a loan be provided in the currency of another member to the General Resources Account, with the Fund then purchasing SDRs from a member country and using those SDRs in the context of the use of its ordinary and borrowed resources in the General Resources Account; that would be a use subject to the normal Fund conditionality. Under that proposal, there might be some difficulties if the Fund wanted to direct the use of resources to a particular group of countries, because of the requirement of uniform access to the Fund's general resources. Under such a scheme, there would be an obligation of the General Resources Account, because it was that Account that would borrow the SDRs. Since the Fund could hold SDRs in the General Resources Account, there would be no question of whether the Fund could use those SDRs in its transactions.

As the staff understood it, the second scheme, as proposed by President Mitterand, was to use an administered account, the Deputy

General Counsel continued. The proposal referred to an account within the Fund, which generally meant an administered account under Article V, Section 2. Article XVII, Section 2 stated that the Fund could hold SDRs only in the General Resources Account and not under any administered account of the Fund. However, that did not introduce an unsurmountable difficulty for effectively using SDRs allocated under a scheme. First, under a guarantee scheme, for instance, it would not be necessary from the outset to transfer SDRs to an account; it could be envisaged that the SDRs could be callable, remaining with the original recipient of the SDRs until a guarantee fell due. Another solution would be to follow the example of the enhanced structural adjustment facility, which used the instrument of an administered account of the Fund. The schemes involved either a conversion of currencies, which would probably be the case under a guarantee scheme, or arrangements that made it possible to have a transfer from a participant to another prescribed holder, such as the Bank of International Settlements, for example. In the latter case, the prescribed holder would hold the SDRs, and the Fund would have an SDR-denominated claim on the other holder, with a direct transfer from the other holder to another participant taking place.

Mr. de Groote remarked that the Deputy General Counsel's explanation showed that both the French and Belgian proposals were possible and could work in practice, since there were no legal obstacles. He took issue with the point that the Fund would not be able to direct use of resources, since the loans would not be made specifically to groups of countries, but rather to support certain balance of payments policies. It was in that context that the Fund had been able to use general resources, for example, to finance the compensatory financing facility and, more recently, the compensatory and contingency financing facility. Clearly, only a specific group of countries benefited from those facilities, but the policies were not aimed at helping that particular group, but rather at supporting specific balance of payments policies.

The Chairman made the following summing up:

Directors welcomed the opportunity to discuss the functioning of the international monetary system and the role of the SDR in that system. While a wide range of views was presented, three broad themes surfaced repeatedly. One was that the working of the international monetary system was the business of the Fund and that the Fund's responsibilities in that area were no less demanding today than in the past. A second theme was that disciplined and coordinated policies were a necessary element in the successful operation of all exchange rate systems, encompassing the entire spectrum from fixed to freely floating exchange rates. The third theme was that, despite the growth and breadth of private capital markets, efforts to improve the functioning of the international monetary system should pay adequate attention to provisions for the supply and management of international liquidity and, in particular, to the contribution that the SDR could make to that task, as well as to other objectives.

Directors addressed the question of whether the exchange rate regime could do much to discipline fiscal policies, especially in the major industrial countries. Some Directors felt that, although the disciplinary effects of a fixed exchange rate were less direct for fiscal than for monetary policies, an explicit exchange rate commitment put more pressure on fiscal authorities to rein in undisciplined policies than did other, more flexible exchange rate arrangements. Those Directors also cautioned against generalizing from selected experiences in the first half of the 1980s, when fiscal expansion was sometimes associated with large capital inflows and an appreciating exchange rate. They regarded as more typical the cases in which either growing fiscal deficits were associated with capital outflows and a depreciating exchange rate--thereby setting up forces and incentives for policy correction, or in which, as in much of the developing world, capital mobility itself was less extensive. Some other Directors saw the ability of the exchange rate regime, be it fixed or floating, to discipline fiscal policy as more limited, and argued that the problem would have to be addressed by other means, including the policy coordination process and the exercise of Fund surveillance.

Most Directors accepted the view that, with open capital markets, a commitment to greater fixity of exchange rates implied a reduced independence for monetary policy. To many Directors, such reduced independence should not be equated with any reduction in the effectiveness of monetary policy, since the prospect of truly independent monetary policy under greater exchange rate flexibility was, in their view, largely an illusion. They felt that the real choice was between different kinds of constraints, not between freedom and constraints. A few speakers also noted that since assets denominated in different currencies were not perfect substitutes, countries retained some room for maneuver even with high capital mobility.

A number of Directors stressed that exchange rate commitments should not deflect monetary policy from its prime objective of pursuing price stability. Directors were generally opposed to reversing the progress that had been made in liberalizing international capital flows as a strategy for easing the internal-external demands on monetary policy, although several speakers felt that temporary use of "sand-in-the-wheels" measures should not be dismissed out of hand. A more sympathetic view was espoused by Directors toward the potential for using concerted exchange market intervention both to lend greater stability to exchange rates and to ease the burdens placed on monetary policy, although many emphasized that intervention had both to support resolute action on policy fundamentals and to avoid countering medium-term trends.

While acknowledging that official estimates of equilibrium exchange rates could be subject to margins of error and that such estimates in any case should be allowed to change over time in response to changes in real economic conditions, most Directors were wary of relying exclusively on the market for determining the right pattern of major currency exchange rates. It was noted that there had been several periods when market forces seemed to have pushed exchange rates far away from fundamentals, and/or when the short-run volatility of exchange rates appeared excessive. Most Directors felt, therefore, that the greater emphasis placed on currency stability in recent years was a positive development. Some went further and argued that the system ought to evolve toward more formal arrangements for greater fixity of exchange rates, perhaps along the model suggested by the European Monetary System. Others, however, saw less justification for either greater fixity or even "loud" target zones and cautioned against asking the exchange rate regime to do more than it could realistically deliver.

On the subject of anchors and leaders for the system, several speakers argued that an effective anchor depended on holding together and expanding a "low-inflation club" and on inducing high-inflation countries to adjust their policies and performances toward those of the low-inflation countries. Many Directors emphasized in that context the importance of the policy coordination process and of the Fund's own surveillance activities. A few Directors considered a formal mechanism to be desirable for ensuring better inflation performance. One suggestion was that currency stability and control of inflation could be pursued together by stabilizing the exchange rates of the major countries vis-à-vis the SDR and by relying on an SDR price index to assess the appropriateness of the average stance of policies among the major countries. Some Directors noted that anchors had traditionally focused on the best, rather than average, inflation performance. In a related vein, several speakers observed that leaders for the system had "evolved" rather than having been created for that purpose. In that connection, a few Directors noted that economic realities pointed toward a more symmetric monetary system among the major industrial countries than had been the case in the Bretton Woods era, and that the coordination process already reflected that development. A few Directors also argued that a more symmetric monetary system would be enhanced by greater diversification of reserve currencies.

In reaffirming the need to build upon the progress already made in implementing stronger international coordination of economic policies, Directors also commented upon the role that monitoring zones for key economic indicators might play in that ongoing process. As in earlier Board discussions, most Directors considered that monitoring zones were best seen as a tool for judgmental analysis rather than as triggers for automatic policy responses. Directors generally felt that more work on quantitative indicators, in concert with world economic outlook discussions and Article IV consultations, was desirable to carry forward the use of indicators in the coordination process.

Let me turn next to the concept and measurement of international liquidity and to a number of possible approaches for invigorating the role of the SDR. While some Directors thought that the staff's attempt to draw inferences from patterns of adjustment in import volumes relative to both real GDP and export volumes was useful, most Directors argued that quantitative approaches by themselves were not reliable for assessing the adequacy of international liquidity. Those Directors who did emphasize the importance of a quantitative approach to assessing the long-term global need for reserve supplementation argued that the staff ought to continue its search for indicators that would be meaningful in the current context. More generally, a few Directors emphasized that the concept and measurement of international liquidity was worthy of thorough examination.

Possible approaches for invigorating the SDR were discussed under four broad headings: (1) ways for the SDR to help promote growth without discouraging adjustment; (2) ways in which wider use of SDRs might contribute to greater exchange rate stability and more effective adjustment; (3) ways that the SDR might help provide an anchor against inflation; and (4) ways for the SDR to improve the efficiency and stability of the reserve system.

A number of Directors who advocated using the SDR to promote growth and adjustment were broadly in favor of allocating SDRs in support of market-based approaches to debt reduction, and some Directors reiterated their interest in proposals for post-allocation adjustment in the distribution of SDRs. Other Directors, however, stressed the monetary character of the SDR and remained strongly opposed to linking the SDR with either development efforts or the debt problem.

Some Directors expressed interest in mechanisms, such as a clearinghouse or the issuance of SDR certificates, that would allow wider use of SDRs. A few Directors also felt that it might be worthwhile to reconsider substitution and asset-settlement mechanisms, and that in the long run, it was desirable to consider a system in which the central reserve asset was no individual country's liability. Some other Directors argued, however, that reserve diversification and better discipline over policies of reserve center countries could be better pursued by other means. There was also interest in the establishment of a pool of SDR holdings for use in intervention as another approach to stabilizing exchange rates and moving toward a more symmetric system. Some Directors, however, regarded such proposals as neither desirable nor practical and also stressed the need to avoid exaggerating the role that the SDR could play in contributing to exchange market stability and adjustment.

In addressing ways that the SDR might help to provide an anchor against inflation, a number of Directors addressed the idea of a two-stage allocation process in which an individual country's receipt of its allocation would be subject to Executive Board surveillance while the use of SDRs, once received, would remain unconditional. Other Directors, however, regarded this approach as inconsistent with the unconditional and "owned" character of the SDR.

In considering the potential of the SDR to improve the efficiency and stability of the reserve system, several Directors took the view that the sharp differences in the terms under which reserves and liquidity had been made available to different countries, and even to the same countries over time, offered a good reason for moving away from a system that relied heavily on borrowed reserves. Other Directors cautioned, however, on the need to distinguish an overall reserve shortage from a reserve shortage for individual or groups of countries, and also noted that any prolonged net use of SDRs would be counterproductive to the objective of having the SDR play the role of a safety net.

In closing, let me say that I was particularly gratified to have heard Directors reaffirm the Fund's important responsibility to oversee the functioning of the international monetary system and to study ways of improving that functioning. We have heard a host of interesting suggestions that we will need to reflect on, including ideas for possible "sketches" of alternative monetary systems, for a reappraisal of concerted intervention, for new quantitative approaches to identifying both the adequacy and appropriate distribution of international liquidity, and for various mechanisms for reinvigorating the SDR.

Equally important, a number of thought-provoking ideas have been put forward, on which it could be useful to reflect in seminar form some time shortly after the April Interim and Development Committee meetings. Any suggestions you may have on how to organize such a seminar would be welcome. The staff could prepare a two- or three-page statement focusing on topics around which to organize the debate.

Of course, today's meeting was not an occasion to consider a decision on allocation, but because of my strong concern about the dwindling share of SDRs as a component of reserves, I have been listening carefully in hopes that there may be some way to reconcile the views of Directors. As agreed, I will hold informal consultations with Directors and then share my conclusions with you as a basis for reporting to the Interim Committee in April.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/89/28 (3/6/89) and EBM/89/29 (3/6/89).

2. EXECUTIVE BOARD TRAVEL

Travel by an Assistant to Executive Director as set forth in EBAP/89/57 (3/1/89) is approved.

APPROVED: September 12, 1989

LEO VAN HOUTVEN
Secretary