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January 10, 1986

To: Members of the Executive Board
From: The Secretary
Subject: Review and Assessment of the System of Floating Exchange Rates

Attached for consideration by the Executive Directors is a paper on the review and assessment of the system of floating exchange rates.

This paper, together with the paper on target zones (SM/86/6, 1/10/86) has been scheduled for Executive Board discussion on Wednesday, February 12, 1986.

Mr. Goldstein (ext. 7678) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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Department Heads

INTERNATIONAL MONETARY FUND

Review and Assessment of the System of Floating Exchange Rates

Prepared by the Research Department
(In consultation with other departments)

Approved by Wm. C. Hood

January 9, 1986

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I. Introduction

At its meeting in Seoul on October 6-7, 1985, the Interim Committee requested the Executive Board "... to study the issues raised in these reports [the reports on the international monetary system presented by the Group of Ten and the Group of Twenty-Four] with a view to facilitating a substantive consideration by the Committee at its next meeting." ^{1/} This paper, and the supplementary paper on target zones (SM/86/6), are among a series of papers prepared in response to that request. The present paper discusses issues directly related to the functioning and improvement of the exchange rate system.

The Reports of the Group of 10 and the Group of 24 (hereafter the G-10 and G-24 Reports) share some important conclusions on the exchange rate system. ^{2/} In brief, both reports conclude that the functioning of the present system of floating exchange rates needs to be improved; that the variability of exchange rates, both in the short run and in the long run, has been a source of concern; that unsound and inconsistent policies, and related divergences in economic performance among major industrial countries, have been central elements in the observed volatility and misalignments of key-currency exchange rates; that surveillance is crucial for an orderly international monetary and financial system and is a basic tool for promoting convergence of economic performances toward sustainable non-inflationary growth; that while exchange market intervention can play a useful supplementary or complementary role, it cannot be the primary instrument for achieving exchange rate stability; and finally, that a return to a rigid par value system is neither desirable nor feasible at the present time.

In some other respects, however, the two reports are quite far apart in their diagnosis of and proposed remedies for the present exchange rate system. The G-10 Report concludes that "...the fundamental approach of the Articles of Agreement remains valid;" ^{3/} that the present system of floating rates has shown "valuable strengths" ^{4/} (as well as weaknesses); and that "... the key elements...require no major institutional

^{1/} "Communiqué of the Interim Committee of the Board of Governors of the International Monetary Fund," paragraph 10. International Monetary Fund, Press Release No. 85/33, October 7, 1985.

^{2/} "The Functioning of the International Monetary System: A Report to the Ministers and Governors by the Deputies of the Group of Ten," June 1985, circulated as EBD/85/154, Supplement 1; "The Functioning and Improvement of the International Monetary System: Report of the Deputies of the Group of 24," August 1985, circulated as EBD/85/228.

^{3/} G-10 Report, paragraph 97.

^{4/} G-10 Report, paragraph 14.

change." 1/ In contrast, the G-24 Report concludes that "the experience with the present exchange rate system has not been satisfactory;" 2/ that "volatility and misalignment of exchange rates have especially hurt the developing countries;" 3/ and that "... a mechanism has to be devised to enforce policy coordination among the major industrial countries." 4/ On the issue of target zones for exchange rates of major currencies, the gulf was also wide. The majority (of Deputies) in the G-10 Report considered the adoption of target zones "...undesirable and in any case impractical in present circumstances" 5/ [some Deputies, however, did think that the proposal could have merits and suggested further exploration of its technical aspects at an appropriate time]. In contrast, the G-24 Report expressed the view that target zones "... could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances;" 6/ it also concluded that the proposal needed to be further studied and pursued to gain general acceptance. Yet another difference is that the G-24 Report envisages a role for a set of "objective indicators or targets" 7/ in the conduct of multilateral surveillance while the G-10 Report emphasizes "... enhanced dialogue and persuasion through peer pressure." 8/

Drawing on the analysis in the G-10 and G-24 Reports, as well as on earlier work done inside and outside the Fund, this paper identifies and discusses issues and proposals for improving the functioning of the exchange rate system. The aim is to identify areas of agreement, to discuss points of contention, and to suggest key issues for further discussion, study, and guidance.

The rest of the paper is organized as follows. Section II discusses several perceived weaknesses of the present exchange rate system, namely: the high short-run volatility of exchange rates; the large and persistent misalignments of real exchange rates, and the lack of discipline and coordination in the conduct of macroeconomic policy in the major industrial countries. Section III turns to the perceived strengths of the present system. Here, the contribution of exchange rate flexibility to external payments adjustment, to insulation from shocks abroad, to the independence and effectiveness of domestic monetary policy, and to the maintenance of an open trade and payments system-- are all considered. These perceived weaknesses and strengths of the present system are those given most attention in the G-10 and G-24 Reports. Finally, Section IV addresses certain proposals for improving the functioning of the existing system. Three types of proposals are examined: (1) the adoption of "target zones" for key-currency exchange

1/ G-10 Report, paragraph 97.

2/ G-24 Report, paragraph 2.

3/ G-24 Report, paragraph 3.

4/ G-24 Report, paragraph 5.

5/ G-10 Report, paragraph 32.

6/ G-24 Report, paragraph 5.

7/ G-24 Report, paragraph 78.

8/ G-10 Report, paragraph 38.

rates; (ii) the introduction of "objective indicators" or quantitative targets for macroeconomic outcomes and policies into multilateral (IMF) surveillance; and (iii) more intensive use of consultative and judgmental mechanisms, within the existing institutional setting, to enhance the appropriateness and mutual compatibility of policies. The proposals analyzed are those specifically presented in the G-10 and G-24 Reports.

The scope of the paper has been conditioned by four considerations. First, although the focus of the paper is on the functioning and improvement of the exchange rate system, it is not appropriate to deny the interconnections between the exchange rate system and other features of the international monetary system. This is especially true with respect to the interrelationship between the exchange rate system and surveillance. ^{1/} For example, any changes in the operation of the exchange rate system, be they changes in exchange arrangements or improvements to the mechanisms for policy coordination, would have to be given content through the implementation of the surveillance. At the same time, proposals for strengthening surveillance, both at the bilateral and multilateral levels, are integral elements of most proposals for improving the functioning of the exchange rate system. As such, the paper discusses on a rather broad level the rationale for, and implications of, changes in surveillance for the operation of the exchange rate system. An in-depth treatment of surveillance issues will appear in the forthcoming paper, "Surveillance over Exchange Rate Policies--Biennial Review." A second consideration concerns the proposal, discussed in both the G-10 and G-24 Reports, to adopt target zones for major-currency exchange rates. In this paper, target zones are examined as one of several concrete proposals for improving the functioning of the exchange rate system. A more thorough treatment of the target-zone proposal, including its more technical and operational aspects, is included in the supplementary paper, "Target Zones" (SM/86/6). Third, in discussing proposals for improving exchange rate stability, the emphasis is on the major industrial countries. This

^{1/} Another potential area of interconnection is that between the exchange rate system and international liquidity. For example, proposals for liberalization of capital markets or for greater use of official intervention in exchange markets cannot be divorced from questions concerning the quantity and composition of international reserves. Still, the present paper makes the assumption that many issues in the evaluation of the exchange rate system can be profitably discussed within the bounds of existing reserve and liquidity arrangements. Several papers dealing with international liquidity and the SDR, as discussed in the G-10 and G-24 Reports, will soon be reaching the Executive Board.

follows the view, given expression in both the G-10 and G-24 Reports, that it is the policies and exchange rates of the major industrial countries that exert the most significant impact on the functioning of the international monetary system as a whole. None of this denies, of course, either the importance of maintaining realistic exchange rates in all countries, or the desirability of an exchange rate system that adequately meets the needs of smaller industrial countries and of developing countries. Finally, although this paper is organized around the issues and proposals raised in the G-10 and G-24 Reports, it also considers views, evidence, and proposals on the exchange rate system from other sources. For these reasons, terms such as "proponents," "supporters," or "opponents" should not necessarily be associated with the G-10 and G-24 Reports unless specifically indicated.

II. Perceived Weaknesses of the Present System

Although the present system of floating exchange rates has been criticized on many counts, most of these criticisms can be grouped under the following three headings: high short-run volatility of exchange rates; large and persistent misalignments of real exchange rates; and lack of discipline and coordination in the conduct of macroeconomic policy in major industrial countries. In this section each of these criticisms, or perceived weaknesses, is examined in turn.

A. Short-run volatility

Prior to the advent of floating rates, some of its supporters anticipated that stabilizing speculation would act to smooth exchange rate movements, and in so doing, prevent an abrupt increase in the actual variability. Thirteen years of experience have proved otherwise. Whether measured in bilateral or effective terms, nominal or real terms, the short-run variability of exchange rates has been much greater during the period of floating rates than under the Bretton Woods system. A representative calculation (IMF[1984a]) is that the short-term (monthly or quarterly) variability of nominal exchange rates for the seven major currencies was about five times greater under floating rates than during the last decade of adjustable par values. In addition, there has not been a sustained tendency for exchange rate variability to decline over time. Finally, and of interest for linking exchange rate variability to exchange rate uncertainty, most exchange rate changes under floating rates have been unexpected (as revealed by market indicators of expected exchange rates, such as forward rates).

Critics of floating exchange rates contend that one of the main reasons why rates have been so volatile is that market participants lack an anchor for medium-term exchange rate expectations. Without such an anchor, short-term events (be they news, rumors, or shifts in policy) induce large revisions of expectations about future exchange rates,

which in turn, induce large changes in current rates. Also, without an anchor, the risks of self-fulfilling destabilizing speculation (i.e., handwagon effects and speculative bubbles) are increased.

This short-run variability, or volatility, of exchange rates is said to be costly because its associated uncertainty reduces the volume of trade and investment. 1/ These costs are claimed to be especially heavy for developing countries which do not have well-developed financial markets, particularly forward cover arrangements. 2/

The high short-term volatility of exchange rates under floating is not in dispute. What is contentious is the proper yardstick for evaluating that volatility and the costs associated with it. Defenders of the present system make the following points.

First, while the variability of nominal exchange rates has been higher than the variability of the ratio of national price levels, it has been lower than that for other asset prices (e.g., national stock market prices, changes in commodity prices, changes in interest rates, etc.). 3/ The higher variability of exchange rates vis-a-vis national price levels is said to reflect the fact that exchange rates are jumpy, forward-looking auction prices that anticipate future events whereas prices and wages are sticky, backward-looking administered prices that largely reflect past contractual commitments. Hence, some greater degree of variability in exchange rates is to be expected. The fact that all asset prices have been so variable during the floating rate period is often explained by the accompanying turbulence in the global economic and political environment. 4/

Second, and probably more challenging, the defenders argue that there is little evidence that short-run exchange rate volatility has been very costly in either a relative or absolute sense. The question of relative costs hinges on which markets are best able to handle disturbances. The point is that if exchange rates were more rigid, then disturbances would be transferred to goods or labor markets, or would induce limitations on trade and capital movements, both of which might be more costly than the exchange rate movements themselves. As

1/ "It (volatility of exchange rates) has discouraged investment and trade by adding to financial risks for investors and traders." G-24 Report, paragraph 61.

2/ "Exporters and importers in these countries (developing countries) are exposed to high exchange risks in the absence of well-developed financial markets, especially forward cover arrangements. The destabilizing uncertainties of floating rates have increased the reserve and capital needs of developing countries from the levels which would otherwise exist." G-24 Report, paragraph 63.

3/ See Bergstrand [1983].

4/ See Frenkel and Mussa [1980].

to the absolute cost, the defenders of the present system note that a large body of econometric work has produced only sporadic evidence of a link between measures of exchange rate volatility and the volume of international trade (IMF[1984a]). It is also argued that the development of various hedging techniques and future markets has increased the ability of market participants to both reduce their exposure to risk and to purchase relatively low-cost insurance against it. 1/

Issues for discussion: (i) Does short-run volatility of major-currency exchange rates impact more seriously on the developing countries and on smaller, less-diversified firms; if so, what institutional changes or reforms could lessen this problem; (ii) are there kinds of risk or uncertainty that have eluded the existing econometric tests on the links between exchange rate volatility and the volume of international trade; (iii) what is the appropriate "measuring rod" for judging whether short-run variability of exchange rates is excessive; and (iv) would more reliance on exchange market intervention help to reduce short-run volatility of exchange rates; if not, what other policy instruments should be directed at that task?

B. Large and persistent misalignments of real exchange rates

A second indictment of the present system is that real exchange rates of major currencies have been subject to large and persistent misalignments. The term misalignment is commonly interpreted as a deviation of the actual real exchange rate from its "equilibrium" level.

In practice, misalignment has usually been estimated by, or inferred from, three types of calculations. First, misalignment can be calculated as the cumulative departure of the nominal exchange rate from the path implied by purchasing-power-parity. This is equivalent to calculating the deviation of the current real exchange rate from its level in some "equilibrium" base period. Second, misalignment is sometimes inferred from the sheer size of real exchange rate movements themselves. The implicit assumption here is that the equilibrium real exchange rate will change only gradually over time in response to structural changes in competitiveness and comparative advantage. The third method is to compute misalignment as the deviation of the real exchange rate from the (equilibrium) level that would yield an equilibrium in the balance of payments, (given anticipated macroeconomic policies over the next two to three years). The equilibrium balance of payments, in turn,

1/ "... Foreign exchange markets appear to have developed effective hedging techniques available to most operators to reduce the risks associated with exchange rate volatility, generally at comparatively little cost." G-10 Report, paragraph 16.

is defined as an "underlying" current-account balance equal to "normal" net capital flows. In addition, this equality must be achieved without resort to either undesirable levels of unemployment, or "undue" restrictions on trade, or "special" incentives to incoming or outgoing capital. 1/

As representative (albeit dramatic) examples of such calculations, one might offer the following: (i) as of the second quarter of 1985, the real effective exchange rate of the U.S. dollar was over 50 percent above the level implied by purchasing-power-parity (using 1980 as the base); 2/ (ii) between 1975 and 1976, the real effective exchange rate of the pound sterling fell by 20 percent, only to rise by nearly 75 percent between 1976 and 1981; and (iii) using an "underlying balance" approach to calculating the equilibrium real exchange rate, one recent study (Williamson [1985]) estimated that the misalignments of the U.S. dollar and the Japanese yen at end-1984 were 39 and 19 percent, respectively.

Although it was originally thought that real exchange rate movements under floating rates would be dominated by gradual changes in competitiveness needed to restore current account equilibria, it is now recognized that large capital flows, often stimulated by short-term considerations, have usually been the predominant force. 3/ These capital flows, in turn, have been influenced by inter-country differences in interest rates that have reflected different stances and mixes of monetary and fiscal policy--and by changes in expectations about the future course of these policies and their impact on future interest rates and future exchange rates. In addition, rigidities in goods and labor markets have meant that nominal exchange rates have taken the brunt of the adjustment, often "overshooting" their long-term values, to compensate for the stickiness of nominal wages and prices in the short-run.

Such misalignments in major-currency exchange rates have been costly, so it is argued, because: (i) they distort resource allocation and generate "boom and bust" cycles in the tradable goods sector that

1/ This definition is a close relative of those found in Nurkse [1945], IMF [1970], and the G-24 Report, paragraph 69.

2/ The real effective exchange rate used for these calculations is relative normalized unit labor cost in manufacturing.

3/ "... exchange rate determination has been increasingly influenced by conditions in capital markets, including relative interest rates and expectations regarding the impact of national policies and current and future economic performance." G-10 Report, paragraph 18. "Much of the medium-term movement in real exchange rates reflects not the changing pattern of competitiveness but rather the result of differences in fiscal and monetary policies..."
G-24 Report, paragraph 62.

leave unemployment in their wake; and (ii) because they encourage protectionism, as firms and governments attempt to overrule the unjust verdict of the market place by turning to administrative solutions. 1/

By now, there is widespread agreement that the floating rate era has been marked by cases of serious misalignment. Not so clear are the extent of these misalignments, their cost, and perhaps most of all, whether alternative exchange rate systems could eliminate or reduce them. In this connection, defenders of the present system offer the following arguments.

First, not all of the large swings in real exchange rates that have been observed over the past thirteen years represent misalignment. Some of it represents desirable adjustments to changes in real economic conditions, such as continuing inter-country differences in labor productivity, permanent changes in the terms of trade (sometimes associated with discovery of, or large price changes in, natural resources), permanent shifts in savings-investment relationships across countries, safe-haven considerations, etc. For example, a good portion of the appreciation of sterling between 1977 and 1981 could be represented as an equilibrium response to the U.K.'s enhanced oil-exporter status.2/ Even under a system of pegged exchange rates, such changes would call for changes in real equilibrium exchange rates. Under that regime, these changes would occur primarily via changes in national price levels, aided by occasional changes in parities. Under floating rates, the required changes in relative prices occur primarily via changes in nominal exchange rates and they happen more quickly. But, according to defenders of the present system, this need not imply that the latter form of adjustment is inferior to the former.

Second, although misalignment may not be so difficult to define, it can be very difficult to measure when concepts like "normal" capital flows, "undue" restrictions on trade, "special" incentives to incoming or outgoing capital, "cyclically-adjusted" current accounts, and "anticipated" macroeconomic policies have to be estimated. For example, a country that is a "normal" net capital exporter under one set of macroeconomic policies, tax considerations, and political events abroad may become a normal net capital importer under others. For example, if say, one-third of the recent private net capital inflow into the United

1/ "Misalignment inevitably produces either idle resources or wasteful shifts back and forth between tradables and nontradables. It becomes a potent source of pressures for protectionism." G-24 Report, paragraph 62.

2/ See, for example, Bond and Knobl [1982].

States were regarded as "normal" (reflecting attractive perceived investment opportunities and a relatively low domestic savings rate), then one's estimate of the current misalignment of the U.S. dollar would be reduced considerably (vis-a-vis estimates that assume a normal net capital flow of zero for the United States). Yet some would argue that the theory and evidence for preferring the latter assumption to the former are weak. An additional complicating factor is the existence of a large statistical discrepancy in world balance-of-payments-accounts, whose geographical attribution is highly uncertain.

Supporters of the present system acknowledge that misalignments of key currencies carry costs but suggest caution in identifying misalignments as primary factors in explaining both the recent weakness of manufacturing employment in the United States and the resurgence of protectionist pressures in major industrial countries as a group.

While it is true, for example, that the ratio of manufacturing employment to total non-agricultural employment in the United States declined sharply over the 1979-83 period, it also declined in 1969-71 against the background of a depreciating real exchange rate for the dollar; in fact, it has declined in all periods of recession since 1969. Further, this ratio increased in 1984 when the real exchange rate of the dollar was appreciating sharply. Likewise, the same ratio rose in Germany during 1976-79 when the deutsche mark was appreciating, and fell during 1980-83 when the deutsche mark was depreciating. In Japan, the manufacturing employment ratio has been flat since 1978 despite a strong real appreciation of the yen from 1982-84.^{1/} All of this suggests that one has to specify the type of disturbance moving the real exchange rate before one can predict the link between the real exchange rate and the sectoral allocation of resources. As Obstfeld [1985] points out, an increase in foreign demand for domestic manufactures may cause both a currency appreciation and an expansion in manufacturing employment whereas a shift to restrictive monetary policy will induce both currency appreciation and contraction in manufacturing employment.

In explaining the rising tide of protectionism, supporters of the present system argue that exchange rate misalignment is only one of several important factors. They note, for example, that many of the current protectionist measures or proposals have been sector-oriented or country specific and have been influenced by long-lasting shifts in competitiveness arising from factors other than exchange rate shifts. In clothing and textiles, for example, restrictions have been directed against developing countries with a comparative cost advantage and restrictions have become progressively more severe over a quarter of a

^{1/} All of these figures on manufacturing employment are drawn from Obstfeld [1985].

century, almost irrespective of changes in exchange rates. Protection of the agricultural sector and of the steel sector also does not correlate well with exchange rate movements. More generally, it can be argued that pressures for protection will be greater not only when a country's exchange rate is overvalued but also, inter alia: the higher and more rapidly increasing its unemployment rate, the smaller and less generous are its existing trade adjustment programs, the higher is its ratio of imports to consumption, the larger is employment in import-competing industries, and the higher is the level of general government intervention. 1/

Finally, defenders of the present system recall that misalignment and overshooting of major-currency exchange rates were by no means unknown during the Bretton Woods era, especially in its later years. 2/ For example, the effective real exchange rate of the dollar depreciated by 28 percent from 1969-73. Similarly, if a currency had long been overvalued under the Bretton Woods system, and the authorities at last decided on a devaluation, they usually chose a new parity which undervalued the currency at the current level of prices. One common justification for such excessive devaluation was that it was necessary to replenish the level of reserves which had become unduly low during the period of overvaluation. 3/ In short, defenders argue that the current system ought not to be compared to some unobservable textbook ideal but rather to the also flawed real-world alternatives.

Issues for discussion: (i) How can the "equilibrium" real exchange rate best be defined in operational terms; (ii) what role have real economic conditions played in the 1979-85 real appreciation of the U.S. dollar; (iii) have inter-country differences in the stance and mix of policies now supplanted inflation differentials as the main determinant of exchange rate misalignments; (iv) in what respect and in what degree have misalignments under floating rates been different than those under the Bretton Woods system; and (v) in what ways have persistent misalignments under floating exchange rates especially hurt the developing countries?

C. Lack of discipline and coordination in macroeconomic policies

The third criticism of the present exchange rate system is that it has not promoted discipline and coordination in the conduct of macroeconomic policy. 4/ Indeed, this is probably the single most damaging charge because

1/ Bergsten and Williamson [1983].

2/ Dunn [1973] and Makin [1974] provide evidence of the trade and investment distortions created by misaligned real exchange rates during the Bretton Woods era.

3/ Machlup [1979].

4/ Coordination is perhaps best thought of as encompassing all international influences on domestic decision-making.

short-term volatility and longer-term misalignments are both widely regarded as manifestations of this failure to get underlying monetary and fiscal policies "right." 1/

Under floating exchange rates, one can expect: (i) the current exchange rate to be heavily influenced by the expected future exchange rate, and (ii) the expected future exchange rate to be heavily influenced by expected future macroeconomic policies. Since instability in current policies generates uncertainty about future policies, it is clear why disciplined and consistent policies are judged to be a sine qua non for greater stability in exchange rates.

Evidence of a lack of discipline and coordination in macroeconomic policy over the past thirteen years is not hard to find. Critics of the present system point to, inter alia, the near-doubling of average industrial-country inflation rates as between 1963-72 and 1973-85 (from 4.2 to 7.6 percent) and to the tripling of the average ratio of industrial-country (central) government fiscal deficits to GNP over the same period (from 1.2 to 3.7 percent). They also note that there have been frequent occurrences where large changes in monetary and fiscal policies have been made in a seemingly independent fashion, with too little thought given to their international repercussions. They point in particular to the 1979-83 period when the stance and mix of policies in the major industrial countries (particularly the heavy reliance on monetary restraint) produced historically high real interest rates, low commodity prices, and sluggish economic activity with adverse "spillover" effects for developing countries' debt service, export earnings, and growth performance. 2/ Finally, critics note that efforts at better coordination during the floating rate period have not produced binding agreements on either monetary and fiscal policies, or on exchange rates.

1/ "It [the present exchange rate system] has not prevented inadequate policies and divergent economic performance which have contributed to a high degree of short-term volatility of nominal exchange rates and to large medium-term movements in real exchange rates." G-10 Report, paragraph 5. "This [improved functioning of the exchange rate system] implies greater effort on the part of the developed countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies." G-24 Report, paragraph 65.

2/ "In the recent past, their [industrial countries] uncoordinated attempts to disinflate led to excessive emphasis being given to monetary restriction relative to other instruments. The result was a halting process of recovery with high real interest rates and low commodity prices having particularly adverse effects on the developing countries." G-24 Report, paragraph 72.

The view that discipline and coordination of macroeconomic policies in industrial countries needs to be improved is now widely accepted. The main point at issue is what contribution the exchange rate system can make toward achieving that objective. Critics of the present system maintain that the obligation to defend the parity in a fixed rate system obliges the more inflationary countries to discipline themselves in order to avoid repeated (and politically costly) realignments. On the other hand, supporters of the present system offer the following arguments.

First, experience suggests to them that greater fixity of exchange rates is neither necessary nor sufficient for enforcing discipline on macroeconomic policy. They note, for example, that the deceleration in growth rates of narrow and broad money that took place in most of the major industrial countries in 1979-82 (in the face of high unemployment) was accomplished without exchange rate targets; hence, greater fixity of exchange rates is not "necessary" for anti-inflationary discipline. Similarly, even during the Bretton Woods era, there were too many cases of exchange rate targets giving way to employment targets when the two came into conflict to believe that greater fixity of exchange rates is "sufficient". In fact, they would say that history is more kind to the proposition that the exchange rate regime is determined by the degree and inter-country dispersion of discipline in macroeconomic policies than to the reverse line of causation.

Second, some observers argue that the exchange rate regime does not necessarily have a comparative advantage over other institutional mechanisms for imposing discipline on national authorities. For example, if greater discipline in monetary policy is sought, then pre-announced money supply rules, or even various types of commodity standards are alternative roads to making a non-accommodation strategy more credible. As regards discipline for fiscal policy, fixed rates may, so the argument goes, be even less effective than flexible rates. This is because (under fixed rates) an expansionary fiscal policy that is not monetized draws in capital from abroad and leads to an increase in foreign exchange reserves; hence, reserve movements impose no discipline. In contrast, expansionary fiscal policy (with tight monetary policy) under flexible rates induces currency appreciation that may in turn lead to political pressure from the traded goods sector for fiscal restraint. ^{1/} And if discipline against inflation is the primary concern, measures that substitute rules for discretion in determining the world money stock, or that put a tax on inflationary wage settlements (e.g., tax-based incomes policy) may represent more direct constraints.

^{1/} An alternative point of view, inspired by the recent experience of the United States, is that strains in the traded goods sector tend to lead to protectionist pressures more than to fiscal restraint.

Third, although trying to describe the "counterfactual" is always a speculative exercise, some have argued that a fixed exchange rate between the United States and the rest of the OECD would not likely have prevented either the recent real appreciation of the U.S. dollar or its international effects. ^{1/} The argument here is that fixed rates cum U.S. fiscal expansion would still have meant relatively high U.S. interest rates and a large net capital inflow. The capital inflow in turn would have lowered foreign money supplies and (unless sterilized) increased the U.S. money supply. The effects of these money supply changes would thus have been to raise U.S. prices relative to those abroad. One would still get a real appreciation of the U.S. dollar, but this time operating mainly via national price levels rather than via the nominal exchange rate. Alternatively, attempts to prevent these money supply changes from taking place under fixed rates (via capital controls or sterilization operations) would only lead to a higher level of interest rates and would remove, so the argument goes, the inflation pressure for a fiscal reversal. The alleged moral of this scenario is that it is fiscal reform rather than exchange rate reform that is the necessary ingredient for preventing misalignment and its effects.

Fourth, supporters of the present system caution that there are "natural" limits to coordination of policies, whatever the exchange rate regime. Exchange rates and interest rates are by their very nature "competitive" in the sense that one country's gain is frequently the other's loss. Also, the compromise of growth and inflation objectives at the national level often leaves little room for further compromise on demand policies at the international level. ^{2/} Given these limits, past efforts at coordination (e.g., the U.S. dollar support package of November 1, 1978, the agreements of the Bonn economic summit of 1978, and the September 1985 G-5 agreement in New York on exchange rates and adjustment policies)--while perhaps still far from optimal--should, in their view, not be seen in too bad a light.

Finally, supporters of the present system are wary of comparisons between the period of floating rates and that of par values. They note that many features of the global economic environment that are important for macroeconomic performance but are not proximately related to the exchange rate regime, were also changing during the

^{1/} See, for example, Obstfeld [1985].

^{2/} See Polak [1981] for an expansion of both these points.

period of floating rates. ^{1/} For example, inflation performance during the floating rate period may have been distorted by the two rounds of large oil price increases (1973-74 and 1979-80) and by the huge expansion (57 percent) in international reserves in 1970-72 associated with the collapse of the Bretton Woods system.

Issues for discussion: (i) Would the adoption of sound, credible, and stable policies in industrial countries be both necessary and sufficient for achieving exchange rate stability; (ii) Could greater fixity of key-currency exchange rates improve the discipline in the conduct of macroeconomic policy, or does the lack of discipline under floating rates have origins outside the exchange rate regime; (iii) Why has coordination of macroeconomic policies been so difficult to achieve over the past two decades; (iv) Is centralized international decision-making inherently more difficult under floating rates than under a par value system; and (v) what "lessons" about the effect of the exchange rate regime on discipline and coordination can be drawn from the experience of the European Monetary System (hereafter EMS)?

III. Perceived Strengths of the Present System

While both the G-10 and G-24 agree that the existing exchange rate regime has shown weaknesses, the G-10 emphasizes that it has also displayed some "valuable strengths." More specifically, they stress that exchange rate flexibility has made positive contributions to "external payments adjustment," to "insulation of domestic price levels from inflation abroad," and to "the pursuit of sound monetary policies geared more directly to domestic conditions." ^{2/} Finally, they doubt whether any less flexible system could have survived the strains of the past decade without increased reliance on restrictions on trade and capital flows. Each of these perceived strengths is discussed in this section.

A. Promotion of external payments adjustment

Although it has perhaps not provided all that was hoped for prior to the advent of floating rates, supporters of the present system maintain that exchange rate flexibility has made a positive contribution to external payments adjustment on at least three counts.

^{1/} "It would be misleading to draw definite conclusions on the merits and demerits of the present system merely by comparing economic performance in the period of floating with that recorded under the par value system. Conditions during the floating rate period have been different in too many respects to allow such a comparison to be meaningful."
G-10 Report, paragraph 13.

^{2/} G-10 Report, paragraph 14.

First, the extent of payments adjustment in the floating rate period (1973-85) has been somewhat better than that during the last decade of adjustable par values (1963-72), at least for the seven largest industrial countries--and this despite the occurrence of some unusually large external shocks during the floating rate period (e.g. two periods of large increases in world oil prices, namely 1973-74 and 1979-80). Simple measures of payments imbalances, such as the ratio of current account balances alone to GNP or the ratio of current accounts plus normal capital flows to GNP, show smaller mean imbalances and less persistence (serial correlation), on average, for 1973-85 than for 1963-72.

Second, the symmetry of adjustment is alleged to have improved. Recall that two well-known charges against the Bretton Woods system were: (i) that surplus countries were subject to a much weaker discipline than deficit countries; and (ii) that reserve centers, particularly the United States, had an unwarranted privilege because they could finance payments deficits by liability as opposed to asset settlement. Both of these asymmetries are said to have been much reduced under floating: there is no evidence (among industrial countries) that mean payments imbalances are larger or more persistent for surplus countries, and the privilege (some would say dangers) of liability settlement has since been extended to many countries, including developing ones.

Third, exchange rate flexibility has, according to its proponents, reduced the cost of adjustment. The argument here is that when exchange rates are less flexible, the burden of adjustment falls more on expenditure-reducing measures and less on expenditure-switching ones, with heavier costs in terms of real output and employment. 1/ They further point out that econometric studies indicate that exchange rate depreciation is likely to be effective in improving the trade balance in the medium to long-term, and that there is no evidence that price elasticities for traded goods have declined since the onset of floating rates. 2/

The contribution of exchange rate flexibility to external payments adjustment is still a matter of some dispute. Critics of the present system offer the following counter-arguments.

On the extent of external adjustment, they note that current account performance of some large industrial countries has been anything but satisfactory over the past three years; that current account performance for the smaller industrial countries has been significantly worse, on

1/ An implicit assumption in this argument is that it is more difficult to alter the relative price of tradables in the presence of a relatively rigid nominal exchange rate.

2/ IMF [1984 C] and Goldstein and Khan [1984].

average, during 1973-84 than during the last ten years of Bretton Woods; and that reversal of current account imbalances, even for the larger industrial countries, has typically taken an extremely long time (on the order of three to seven years). 1/ In addition, they mention that more sophisticated measures of equilibrium payments balances suggest that there have been many instances during the floating rate period of unsustainable or undesirable payments outcomes. 2/ In short, the extent of external payments adjustment under floating rates may have been marginally better on average than during the Bretton Woods period but it was far from satisfactory.

The symmetry of external adjustment as between surplus and deficit countries may have improved under floating rates, but critics contend that some asymmetries have gotten worse. In particular, the burden of external adjustment is alleged to now fall much harder on the developing countries than on industrial ones. 3/ Further, it could be argued that within the industrial-country group, external adjustment has been least effective in the very countries with the most substantial spillover effects on the world economy. Also, whereas the United States is admittedly no longer the only country to enjoy the privilege of liability settlement, some might argue that it now enjoys a new unwarranted privilege--namely, to finance an unusually large part of its fiscal deficit with the rest of the world's savings.

Finally, while exchange rate changes may well improve the current account in the medium to long-term, critics note that there can be substantial "J-curve" effects in the short to medium term. Further, even in the long term, exchange rate changes will not be an equally effective instrument for achieving external balance in all countries; instead, its relative effectiveness depends in good measure on the economy's structural characteristics. Specifically, both theory and empirical evidence suggest that the smaller, more-open, more-highly indexed economies suffer proportionately larger domestic price feedbacks and obtain less lasting relative-price advantage from exchange rate changes than do the larger, less-open, and less-indexed economies. 4/ Therefore, the extent to which exchange rate flexibility reduces the cost of adjustment is not the same for everybody. 5/

1/ See IMF [1984c] and Shafer and Loopesko [1983].

2/ See IMF [1984b], [1984c], and Williamson [1985].

3/ "It [the surveillance function of the IMF] has so far been largely ineffective on major industrial countries, resulting in asymmetry in the international adjustment process, the burden of which has fallen disproportionately on developing countries." G-24 Report, paragraph 9.

4/ See Goldstein and Khan [1984].

5/ "It [exchange rate depreciation] is much less useful in countries that have to rely on export of traditional agricultural and mineral commodities..." "... it could also ... stimulate cost inflation..." G-24 Report, paragraph 87. "... the degree of exchange rate stability deemed appropriate differs from country to country." G-10 Report, paragraph 11.

Issues for discussion: (i) Would less flexibility of exchange rates hinder the extent and speed of external payments adjustment and increase its costs; (ii) has there been an asymmetry in adjustment as between major industrial countries and developing countries, and if so, what factors underlie it; (iii) if external payments adjustment among the major industrial countries has been less than satisfactory of late, is it because the capital-account "tail" is now wagging the current account "dog;" and (iv) if the degree of exchange rate flexibility deemed appropriate differs from country to country, how can such inter-country differences be accommodated if not in a system like the existing one which permits considerable heterogeneity in exchange arrangements?

B. Insulation from inflation abroad

Prior to the actual experience with floating exchange rates, it was thought by many that floating exchange rates would be premier insulators against a whole range of foreign disturbances. The last thirteen years have shattered that illusion. It is now widely accepted that the insulating properties of floating rates are more modest. 1/ Specifically, floating rates can provide good insulation against a rise in the world price level because an appreciation of the domestic currency proportionate to the increase in foreign prices prevents wealth or relative price effects from taking place. But floating rates cannot insulate against relative price changes among different classes of traded goods because they cannot alter relative prices at that level of aggregation. Beyond that, the relative insulating properties of floating rates vis-a-vis fixed rates cannot be generalized without specifying the nature of the disturbance (monetary or real), the origin of the disturbance (home or abroad), what is to be insulated (real output or consumption), and who is to be insulated (the home country alone or the home and foreign country taken jointly). 2/

Having acknowledged this, defenders of the present system still emphasize that the insulation provided by floating rates against inflation abroad should not be underrated. 3/ After all, it was the very inability to protect themselves from imported inflation that induced some

1/ "... the Deputies recognize that no exchange rate system can provide full insulation from the effects of economic policies and performance in other countries." G-10 Report, paragraph 22.

2/ Fiscal disturbances would be described as real disturbances in the classification presented above.

3/ "It [exchange rate flexibility] can help countries, especially the larger ones, to insulate their domestic price levels from inflation abroad...." G-10 Report, paragraph 14.

countries to abandon the Bretton Woods system in the early 1970s. ^{1/} Also, so long as there remains a significant risk for the future that some countries will not follow reasonable monetary and fiscal policies, it would in their view be premature to abandon the protection offered by floating rates against this risk.

Critics of the present system might reply that the dominant shocks of the 1970s and the 1980s have been the very ones (i.e. relative price changes among different classes of traded goods such as oil, and sharp changes in interest rates) against which floating rates have a comparative disadvantage in insulation vis-a-vis fixed rates. In addition, they observe that available empirical evidence suggests that the international synchronization of real and monetary variables has been even higher during the period of floating rates than during the era of par values.^{2/} This evidence would be consistent with a greater incidence of common external shocks and common policy responses to them under floating rates but it could just as well imply greater transmission of disturbances under floating rates. Some critics of the present system would go further and conclude that because floating rates cannot provide good insulation against the representative set of foreign disturbances, the case for policy activism to combat such disturbances, including greater use of exchange market intervention, is strengthened. ^{3/}

C. Independence and effectiveness of domestic monetary policy

One reason why floating rates seemed attractive in the latter years of the par value system was that by then the incompatibility of fixed exchange rates, high international mobility of capital, and independence for domestic monetary policies had become readily apparent. This was particularly the case in Germany and Switzerland where restrictive monetary measures (taken to avoid imported inflation) brought forth capital inflows, official intervention to support the U.S. dollar, more capital inflows, etc. Floating rates offered a way out of that dilemma. Specifically, since there would no longer be an obligation

^{1/} A counter-argument of the supporters of the Bretton Woods system is that the collapse of that system reflected not any intrinsic design flaws but rather faulty implementation. In particular, the system was undermined by "excessive" fixity in nominal exchange rates that produced large misalignments in key-currency real exchange rates.

^{2/} See Swoboda [1983] and IMF [1984c].

^{3/} "Intervention... could be used on a meaningful scale, without confining it to 'leaning against the wind,' towards the end of exchange rate stability, as a complementary measure to other policies, and sometimes in coordination with other countries." G-24 Report, paragraph 66.

to use exchange market intervention to peg the exchange rate, exchange market pressure could take the form of exchange rate changes rather than reserve movements and the foreign component of the monetary base would be stable. In short, floating rates would allow countries to regain control over their own money supplies. A second attraction was that floating rates, at least in theory, were supposed to strengthen the output and employment effects of expansionary monetary policy via the positive effects of the induced exchange rate depreciation on the trade balance.

More than a decade later, even the supporters of the present system would probably acknowledge that the case for the independence and effectiveness of monetary policy under floating rates was exaggerated. Many of the constraints on monetary policy seem in retrospect to be as much related to the openness of national economies as to the exchange rate regime per se. These constraints show up in either a reduced ability to control the instruments of monetary policy (the nominal money supply under fixed rates), or a reduced ability to control some of the targets of monetary policy (the level of real output), or in increased caution in the use of monetary policy because of potentially dangerous effects on expectations.

Still, supporters of the present system maintain that floating rates have been instrumental in facilitating "... the pursuit of sound monetary policies geared more directly to domestic conditions." ^{1/} They are credited with having increased countries' control over their own money supplies without resort to capital controls. It is claimed that floating rates have also allowed countries to choose trend inflation rates and to carry out effective anti-inflationary policies. These extra degrees of freedom would not be so prized in a world in which all countries consistently implemented sound and credible policies on their own accord. But, so the supporters of floating rates argue, they are valuable assets in the real world where one's trading partners can sometimes suffer quite serious lapses of discipline in macroeconomic policy.

Critics of the present system see the contribution of floating rates to monetary policy as more modest, if any. They note that whereas the exchange rate appreciation that goes with a tight monetary policy can aid the home country's anti-inflation efforts, it does so at the expense of handicapping the efforts of partner countries to control their own inflation rates; to them, it is thus a new type of "beggar-thy-neighbor" policy. They argue in addition that, at the margin, floating rates have not increased the independence of monetary policy all that

^{1/} G-10 Report, paragraph 14.

much. After all, the considerable volume of official intervention during the floating rate period suggests that most industrial countries view the exchange rate as a policy target as well as a policy instrument. ^{1/} When the exchange rate moves by a significant amount in a short period, even those countries whose exchange arrangements are classified as "independently floating" develop implicit exchange rate targets and adjust monetary policy accordingly. They also doubt whether floating rates have increased the potency of expansionary monetary policy. In this regard, they mention that: (i) significant feedback effects of exchange rate depreciation on money, wages and prices limit the gain in competitiveness; (ii) J-curve effects in the response of the trade balance to exchange rate depreciation mean that in the short to medium term, the external sector will weaken, not strengthen, the domestic impact of expansionary monetary policy; and (iii) that currency substitution can lead to much larger swings in exchange rates than the authorities may find desirable. Finally, the critics question whether monetary policy ought to be geared toward domestic conditions. They contend that one of the main reasons why exchange rates have been so variable over the floating rate period is because monetary policy has not taken external consideration enough into account. ^{2/}

Issues for discussion: (i) To what extent has exchange rate flexibility allowed countries to regain control over their own money supplies; (ii) should monetary policy be directly primarily at achieving price stability and sustainable growth, or should external targets (like the exchange rate) also play a role; (iii) can floating rates increase the effectiveness of monetary policy without inducing beggar-thy-neighbor effects on trading partners; and (iv) if exchange rate flexibility were constrained, would countries still be able to choose trend inflation rates without resort to capital controls?

D. The resiliency of the present system

Thus far, the appraisal of the present exchange rate system has been based on implicit comparisons with other exchange rate systems (including both those implemented in the past and those proposed for the future). Supporters of the present system contend, however, that given the strains of the past decade (e.g. two major changes in the price of energy products; a number of important bank failures; sometimes large inter-country differences in inflation rates, monetary policies, and policy mixes, etc.), it is "... questionable whether any less flexible system would have survived" (without increased reliance

^{1/} See Black [1979] and IMF [1984c].

^{2/} "Exchange rate stability should be an important objective of policy instead of being a residual of other policy actions of individual countries, as is the case at present." G-24 Report, paragraph 65.

on restrictions on trade and capital flows). ^{1/} The present system is thus viewed as being particularly resilient to the operating environment--no small advantage if it is assumed that there are significant costs associated with changing exchange rate systems.

To what is this resiliency attributable? Three factors might be identified as contributing.

First, the wide choice of exchange arrangements permitted by the Articles of Agreement means that it is possible to accommodate different country preference with respect to flexibility of exchange rates and to the mix of domestic economic policies. Countries who feel that the benefits of fixed rates outweigh the costs can choose pegged exchange arrangements while those that view exchange rate flexibility as essential can opt for floating. In between these two poles, there is room for adjustable pegs (the European Monetary System) as well for different degrees of exchange market intervention within the group of countries classified as "independently floating". Supporters of the present system recall that the Bretton Woods system operated successfully while there was a consensus about the assignment of responsibilities for exchange rate action and monetary policy as between the reserve-center country and others, but collapsed when this consensus evaporated. To the extent that the degree of exchange rate stability deemed appropriate differs from country to country, the present system can be said to be compatible with these differences.

Second, the present system permits decentralized market-based decisions to act as a "safety valve" when it is not possible to reach centralized decisions about the sharing of the adjustment burden and about the equilibrium pattern of exchange rates. Because the market "takes a view," it is possible to avoid, so say the supporters of floating rates, the centralized management delays of the latter years of the Bretton Woods system.

Third, the present system contains enough "flex" in exchange rates to avoid what defenders of floating rates regard as the crucial flaw of all adjustable peg systems, namely, the incompatibility of high international mobility of capital and fixed exchange rates with narrow margins. They argue that so long as private market participants have greater resources than central banks, market views on exchange rates can change rapidly, and parities have to be changed from time to time to reflect changes in real economic conditions, any system that places tight limits on exchange

^{1/} G-10 Report, paragraph 14.

rate movements will be subject to successful speculative attack; alternatively, attempts to preserve existing parities will force resort to increased restrictions on capital flows.

Critics of the present system acknowledge its resiliency but argue that this is less important than its performance. They point out that the exchange rate system is basically a facilitating mechanism for more fundamental economic objectives, such as high employment, sustainable growth, price stability, and expanding and balanced international trade. As such, whatever its durability, an exchange rate system should be judged in terms of its contribution to those objectives. And on this scale, they find the present system of floating rates wanting. ^{1/} They also maintain that the characteristics that make the present system relatively resilient may have other undesirable implications for its performance while it lasts. For example, the great diversity of exchange arrangements may make it more difficult to define "rules of the game" for macroeconomic policies that are sufficiently specific to be effective. Indeed, it is the very lack of such recognized rules of the game, especially for major industrial countries with floating rates that, according to critics, is responsible for the severe misalignments of the floating rate period. Similarly, while they agree that the present system allows the market "to take a view" when centralized decisions are not feasible, they argue that the present system does not offer a sufficient framework for reaching a satisfactory multilateral decision; in addition, the market's view is too often the "wrong" view. Finally, the same "flex" in exchange rates that provides a defense against "hot money" flows often proves a liability when exchange rates become divorced from fundamentals and get carried along by self-fulfilling destabilizing speculation.

Issues for discussion: (i) Would other exchange rate systems have been able to survive the events of the past thirteen years, without resort to increased use of trade and capital controls; (ii) if excessive variability of floating exchange rates and not fully-credible fixed exchange rates both induce destabilizing speculation, what conclusions can be drawn about the best defense against speculative attack; (iii) is it necessary for successful functioning of the exchange rate system that each of the major industrial countries has a common view about the appropriate degree of exchange rate flexibility; and (iv) is it important for the exchange rate system to be resilient to changes in the international economic environment?

^{1/} "The functioning of the present floating rate system has thus not been able to provide... a framework that facilitates the exchange of goods, services, and capital among countries, which sustains sound economic growth and helps develop orderly underlying conditions necessary for financial and economic stability." G-24 Report, paragraph 64.

IV. Proposals for Improving Exchange Rate Stability

As suggested earlier, both the G-10 and the G-24 Reports conclude that the functioning of the exchange rate system needs to be improved. Also, both reports agree that perhaps the single most important element in achieving such an improvement lies in obtaining better discipline and coordination of macroeconomic policies in the major industrial countries. The key question then is what mechanisms or channels, including Fund surveillance, are available for reaching that latter objective. In this section, three types of proposals identified in the G-10 and/or G-24 Reports as ways of improving exchange rate stability are discussed, namely: (i) adoption of "target zones" for the exchange rates of major currencies; (ii) adoption of a set of "objective indicators" or "targets" for macroeconomic policies in major industrial countries that could be used as a framework for the first stage of multilateral Fund surveillance; and (iii) adoption of policy adjustments and of changes in the procedures for Fund surveillance that could be accomplished within existing exchange rate arrangements and the existing institutional framework for surveillance.

Since most of the specific reform proposals move in the direction of more automaticity in the adjustment and coordination process, it is perhaps useful as a prelude to describe how the present system stands on rules versus discretion in adjustment vis-a-vis alternative exchange rate systems.

If one were to classify alternative exchange rate systems along a spectrum according to either the degree of automaticity of the adjustment process, or the mix between rules and discretion in initiating adjustment, the present system would certainly stand closer to the complete discretion pole than the rules-only pole. In this respect, the pure gold standard with its (alleged) automatic specie-flow mechanism, the adjustable peg system with its clear implication for the subordination of domestic monetary policy to the exchange rate (except during fundamental disequilibrium), the objective indicator system with its automatic trigger for the initiation of adjustment discussions and/or actions, or even a pure floating system with its complete prohibition of all official intervention in the exchange market--all could be considered less discretionary than the present system. By the same token, efforts at coordination of economic policies during the period of floating rates represent at most a middle ground between activist and passive coordination strategies. Efforts have gone beyond exchange of forecasts and policy intentions to encompass occasional common actions but have stopped well short of binding agreements on either exchange rate targets or the stance and mix of monetary and fiscal policies. The present system might therefore be characterized as "... a discretionary and decentralized system, with loose coordination among the main players

but with tighter coordination and disaster relief during crises." 1/ One way of characterizing the first two proposals for improving exchange rate stability (i.e., target zones and objective indicators) is to say that they seek to move the present system somewhat further in the direction of more automatism and more centralisation in adjustment and coordination. In contrast, the third proposal retains the discretionary, decentralized character of the present system but counts on "enhanced dialogue and persuasion through peer pressure" to make the available channels for adjustment and coordination function better than they have in the past.

A. Target zones for exchange rates of major currencies

One proposal for improving exchange rate stability that is specifically addressed in both the G-10 and G-24 Reports is the adoption of target zones for the exchange rates of major currencies. As indicated earlier, the G-24 Deputies felt that the adoption of target zones "could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances." 2/ In contrast, the majority of G-10 Deputies considered that "... the adoption of target zones is undesirable and in any case impractical in current circumstances." 3/

In this sub-section, attention is focused on three questions: (i) what is meant by a target-zone approach to exchange rate management; (ii) what is the rationale for it; and (iii) what is behind the skepticism about and/or the opposition to, that proposal. A more thorough treatment of the target zone proposal, emphasizing particularly the relevant technical and operational issues, is contained in the supplementary paper, "Target Zones" (SM/86/6).

(1) What is meant by a target zone approach to exchange rate management?

In the G-10 Report, target zones are described as follows: "... the authorities concerned would define wide margins around an adjustable set of exchange rates devised to be consistent with a sustainable pattern of balances of payments." 4/

Target zones differ from the present system of floating rates in two respects: (a) the authorities establish a target zone for the exchange rate for some future period; and (ii) the authorities partially

1/ IMF [1984 c].

2/ G-24 Report, paragraph 66.

3/ G-10 Report, paragraph 32.

4/ G-10 Report, paragraph 31.

direct monetary policy to the exchange rate so as to discourage the exchange rate from moving outside its target zone. Target zones differ from "pure" or "clean" floating in that the authorities are permitted to intervene in the exchange market, and indeed, are encouraged "to take a view" on the desirable level of the exchange rate. At the same time, there are no formal or rigid commitments to intervene in exchange markets in all circumstances--a characteristic that differentiates target zones from the adjustable peg system. Finally, in addition to the absence of a formal intervention obligation, target zones differ from a system of rigidly fixed rates in that the zones themselves are to be occasionally reviewed and changed if deemed necessary (e.g. to reflect differential inflation and any need for balance of payments adjustment).

Most target zone proposals envisage the members as being the five largest industrial countries. Other countries could then "fix" or "flex" on the members of the target zones as they saw fit. Target zones would reflect estimates of real equilibrium exchange rates because it is the real exchange rate that is most relevant for resource allocation and balance of payments adjustment; however, for operational purposes, they would be defined in terms of nominal exchange rates. Monetary policy and exchange market intervention are viewed as the two policy instruments to be used for external balance while monetary and fiscal policy are assumed to be adequate to the task of countering "inflationary and deflationary pressures." ^{1/}

As suggested in the accompanying supplementary paper, "Target Zones" (SM/86/6), it is possible to conceive of a whole spectrum of possible approaches to target zones. The various approaches could be distinguished by reference to the following four characteristics: (i) width of the target zones (outside of which the exchange rate is viewed "as out of line"); (ii) the frequency of changes in the target zones; (iii) the degree of publicity given to the zones (e.g., public announcement versus confidential disclosure in official circles, or "loud zones" versus "quiet zones"); and (iv) the degree of commitment to keeping exchange rates within the zone.

At one end of the spectrum, "hard" target zones would imply narrow margins, infrequently revised zones, public announcement of the zones, and a monetary policy that was directed at keeping the exchange rate within the zone. In this sense, hard target zones might be considered a close relative of the EMS' fixed but adjustable parities with narrow margins and a "divergence indicator". Unlike the EMS, however, there would be no rigid commitment to exchange rate intervention; nor do hard target zones imply any analogue to the credit facilities of the EMS.

^{1/} G-24 Report, paragraph 67.

At the other end of the spectrum, "soft" target zones would be characterized by wide, frequently-revised, confidential zones, and by a monetary policy that pays only limited attention to the level of the exchange rate. Soft target zones differ from existing procedures for Fund surveillance (e.g., the requirement for reporting real exchange rate changes in excess of 10 percent to the Executive Board) in that the former introduces a more explicit and formal framework for defining the appropriate pattern of exchange rates and for specifying the links between exchange rates and macroeconomic policies. 1/

(2) The rationale for target zones

Supporters of target zones make essentially six arguments about why and how target zones will improve the functioning of the exchange rate system.

First, target zones are said to improve the international consistency (i.e. coordination) of macroeconomic policies because target zones have to be negotiated and must display mutual consistency of cross exchange rates. 2/ In this way, so it is argued, the exchange rate implications of alternative stances and mixes of macroeconomic policies will be directly confronted, thereby ending the undesirable current practice whereby exchange rates emerge as a residual of other policy actions of individual countries. 3/ In a related vein, supporters argue that the negotiation and revision of target zones could act as a convenient organizing framework for multilateral surveillance. Even if the zones were wide and frequently revised, they would catch the most flagrant and persistent cases of inappropriate policies. Thus, while soft zones might not be able to identify real exchange rate misalignments of 10 percent or less, they would, so it is claimed,

1/ Existing procedures do not rely on the assessment of appropriate zones but rather use as a starting point the last occasion on which exchange rate developments were brought to the attention of the Executive Board. In addition, this reporting and monitoring procedure has not led to any Board discussions.

2/ "... commitment to [target zones for exchange rates of major countries]... would promote greater international policy consistency." G-24 Report, paragraph 66.

3/ They [target zones] could... trigger consultations that would induce step by step, more direct links between domestic policies and exchange rate considerations." G-10 Report, paragraph 31.

at least prevent the 30 percent or larger misalignments that do so much damage to the system.

Second, target zones may improve the discipline of macroeconomic policies in two ways: (i) if exchange rates are maintained within the zones, then monetary and fiscal policy will be disciplined by the exchange rate constraint, much as in a fixed rate system; and (ii) if the authorities opt to alter the zone rather than their policies, they will still have to explain why a new zone is appropriate and convince other members accordingly. The latter requirement could be said to introduce stronger peer pressure into policy formulation.

Third, target zones are viewed as providing an anchor for medium-term exchange rate expectations, thereby promoting stabilizing speculation and greater stability of exchange rates. 1/ The anchor is said to be established on two counts: (i) the obligation (albeit an informal one) or the intention to keep the exchange rate within the zone gives market participants valuable information about the future course of monetary policy, thereby lessening the danger that short-term deviations of policy will be erroneously extrapolated into the future; and (ii) the publication of target zones gives the market a direct estimate of the equilibrium exchange rate (plus or minus the width of the zone), thereby lessening the risk that the "wrong" model is used to link policies and exchange rates. Target zones can thus also be seen as ensuring that "convergence of economic performance" is "sufficient" rather than just "necessary" for lasting exchange rate stability. 2/

Fourth, because the likely members of a target zone system would be the key-currency industrial countries, it is claimed that target zones would reduce the asymmetry in adjustment that has plagued the present exchange rate system. In particular, it would subject the countries whose policies have the greatest spillover effects on the world economy to the same scrutiny and pressure experienced by smaller countries with external and internal imbalances. And the perception that Fund surveillance was even-handed would, so it is argued, make it more effective on the smaller countries as well.

1/ "They [some Deputies] further believe that credible commitments to target zones would contribute to stabilizing market expectations..." G-10 Report, paragraph 31.

2/ G-10 Report, paragraph 31.

Fifth, while proponents recognize that there are difficulties associated with identifying equilibrium exchange rates, they point out that "arriving at a judgment about the appropriateness of the exchange rate of a currency is part of the current practices of the IMF." 1/ As such, these difficulties should not be exaggerated.

Finally, while it is acknowledged that many of the factors associated with the collapse of the Bretton Woods system have not gone away, supporters maintain that target zones can survive speculative attacks. They reason that so long as target zones are revised frequently to reflect inflation differentials and the need for real exchange rate adjustment, the large and discrete changes in exchange rates that motivate speculative attacks will not occur. Also, they point to the durability and success of the EMS as tangible proof that an adjustable peg system can survive in the 1980s; since target zones share some of the EMS' characteristics, the former too can be considered practical.

(3) Opposition to target zones

Concerns about the desirability and practicality of target zones can be summarized in the following arguments.

First, there are doubts about the extent to which target zones will promote coordination and discipline in macroeconomic policy among the members. It can be argued that by focusing attention on exchange rates rather than on the root cause of misalignment--namely, the stance, mix, and divergence of policies--one may lessen the pressures for corrective action. Also, some would say that evidence from periods during which exchange rates were more rigid does not suggest that there was more complete, faster, or more symmetrical external adjustment. So why then should target zones induce better discipline and coordination when regimes with more formal commitments did not? Further, reaching a consensus on the zones of desirable exchange rates could prove difficult. 2/ This raises two additional dangers: (i) the process of negotiating target zones could produce serious frictions among the members, possibly reducing future coordination in this and other areas; (ii) lack of consensus could reproduce the centralized-management delays of the latter years of the Bretton Woods system, with serious misalignments then stemming from too little nominal exchange rate flexibility.

Second, the claim that target zones would provide an anchor for exchange rate expectations can be challenged. Opponents of target zones argue that because our knowledge about the determinants of exchange

1/ G-10 Report, paragraph 31.

2/ "Most Deputies, however, are of the view that reaching a consensus on the range of desirable exchange rates [for target zones] would prove extremely difficult." G-10 Report, paragraph 32.

rate changes is so imperfect, zones would have to be wide enough to reflect that ignorance. Also, the zones will need to be revised to reflect changes in real economic conditions. But then wide, moving zones will not, so its opponents claim, provide a useful anchor for exchange rate expectations. 1/ What is more, some would add that if the lack of an anchor under the present system reflects uncertainty about future policies, the way to overcome that problem is to announce the future course of policies, not of exchange rates.

A third criticism of target zones is that they do not resolve the problem of how to allocate the burden of adjustment among member countries. When more than one country's (effective) exchange rate leaves the zone, it will be necessary to specify who does what. The target zone proposal does not, so it is argued, solve the "N-1 problem."

Fourth, skeptics of target zones reason that since markets would inevitably test the zones, they could only be defended if monetary policy was diverted rather markedly from its domestic stabilization duties to stabilizing the exchange rate. But this raises the question of which policy instruments would then be in charge of maintaining internal balance (i.e., price stability and sustainable growth). The answer might be fiscal policy but some would say that experience raises serious doubts about whether it would be adequate to, and flexible enough, for that task. In such a case, the constraints imposed on monetary policy by a target zone might, in the view of opponents, handicap efforts to achieve stable prices and high employment over the medium-term. 2/

Yet a fifth concern is that the exchange rate may send false signals about both the need for adjustment and the appropriate corrective action. This is another way of asking whether the exchange rate would be a "sufficient statistic" for guiding macroeconomic policies. Some observers answer that question in the negative. The G-10 Report, for example, concludes that while exchange rate developments "... provide information on private markets' assessments of underlying economic conditions and of current and expected policies," "... a wide range of factors beyond exchange rate developments should also be taken into

1/ "Given our imperfect knowledge of the determinants of exchange rate movements, the target zones would have to be too wide to serve as an anchor for expectations." G-10 Report, paragraph 32.

2/ "Above all, the constraints imposed on domestic policies by target zones might undermine efforts to pursue sound and stable policies in a medium-term framework." G-10 Report, paragraph 32.

account in assessing national policies and the need for consultation and policy discussion." 1/

An example may illustrate the potential pitfalls involved. Suppose an overvalued real exchange rate primarily reflected a structural budget deficit in the home country. Then a (simplistic) application of the target-zone approach would point toward the need for monetary expansion (in the home country) to depreciate the actual exchange rate--and this even though the root cause of the problem lay with fiscal policy. 2/ More generally, target zone systems that rely on monetary policy to keep rates within zones can be criticized as being ill suited to handling disequilibria that derive from inappropriate policy mixes. In short, critics argue that target zones are not a sufficient statistic because money supply changes are not the appropriate response to all types of disturbances. This danger would be reduced if target zones were seen solely as a trigger mechanism for multilateral discussion of policies, with the appropriate policy response determined on a case-by-case basis. But then, opponents of target zones argue, the system will lose its "automatic" character and may not increase the speed of adjustment at all.

Last but not least, opponents of target zones warn that the experience of the EMS cannot necessarily be generalized to a "broader and more heterogeneous context characterized by the presence of a plurality of reserve currencies." 3/ To them, the policy convergence and exchange rate stability associated with the EMS cannot be divorced from the unusual degree of political commitment behind it, the capital controls retained by some members, and the structural characteristics of the member countries. 4/

Issues for discussion: (i) What are the relative merits of "hard" versus "soft" versions of target zones; (ii) could monetary policy in a target zone do the necessary "balancing act" between the dictates of the exchange rate and those of internal balance; (iii) would target zones provide an effective incentive for better discipline and international consistency of macroeconomic policies; (iv) could relatively wide target

1/ G-10 Report, paragraph 30.

2/ Supporters of target zones deny that an intelligent application of target zones would produce such perverse policy prescriptions. In their view, the political pressures that would emanate from repeated breaches of the zones would yield the appropriate corrective policies, both as regards the stance and mix of policies.

3/ G-10 Report, paragraph 24.

4/ Proponents of target zones might reply that successful policy coordination, whatever the exchange rate regime, requires precisely such "unusual" political commitment.

zones (say, 10 percent on either side of the central rate) act as a useful anchor for exchange rate expectations. and (v) are exchange rate movements likely to be a sufficient statistic for charting the course of macroeconomic policies, or would they serve better as a "trigger mechanism" for international discussion of policies?

B. Objective indicators or targets for macroeconomic outcomes and policies

A second specific proposal for improving exchange rate stability and for strengthening the analytical basis of Fund surveillance, is to introduce a set of "objective indicators" or "targets" into the multilateral discussion and negotiation of macroeconomic policies in key-currency countries. This proposal is presented in the G-24 Report as follows.

"Multilateral surveillance and bilateral (Article IV) consultations should form two stages of the surveillance process, rather than two parallel operations. The first stage would involve multilateral discussions and negotiations to be conducted on a regular basis within the framework of the IMF about a mutually consistent set of objectives, and a set of policies to collectively achieve these objectives. The aim might be to search for a set of outcomes or 'objective indicators' or 'targets,' that appear to be sustainable in the medium-term and desirable to all parties. This should be quite feasible when the multilateral surveillance exercise is limited to a few major industrial countries, such as the key currency countries. The second stage would involve a comparison between the actual outcomes and the recommended targets or indicators, and a discussion of what measures would be appropriate when the two differ. This stage might most efficiently be conducted on a bilateral basis as part of Article IV consultations." (Paragraph 78).

Although the G-24 Report is not explicit about what form domestic policy-oriented targets would take, it might be assumed that they would cover the major targets of policy (i.e., rates of inflation and unemployment, the growth of real output, the balance of payments, fiscal positions, and possibly, the exchange rate), as well as some of the major policy instruments (e.g., the money supply, government expenditures, taxes, structural measures, etc.); presumably, they would be framed in a medium-term setting. In principle, the process of setting targets and instruments should be similar to that which explicitly or implicitly takes place in national governments, with of course the important distinction that the process would be done multilaterally. The targets could be specific numbers, or ranges or zones, or if even more flexibility was required, simply obligations to avoid large or sudden changes in the chosen measure. Perhaps the best analogy in a

domestic context is the setting of official targets for the growth rates of monetary aggregates. Such targets provide a presumption that the authorities will conduct policies so that the growth rates of aggregates would evolve within the specified ranges. If the targeted aggregate moves outside its expected range, it is presumed that the authorities will act to counter this movement, or will explain why the earlier target is no longer appropriate. Even when the targets are not always attained, they provide, so their supporters argue, a relatively straightforward way of monitoring and explaining the authorities actions; also, when the targets are announced, they may provide an anchor for expectations.

(1) The rationale behind objective indicators or targets

The case for objective indicators or targets for macroeconomic policies can be said to have five elements.

First, such indicators or targets address directly the perceived main cause of exchange rate misalignment, namely, the lack of soundness and international consistency in macroeconomic policies of major industrial countries. In contrast with target zones, policy targets or objective indicators bypass what some may regard as the uncertain link between exchange rate movements and the setting of monetary and fiscal policies. Here, the desired target values or ranges for all major policy instruments can be specified directly and their implications for exchange rates can be estimated. As such, vague policy intentions, such as "keeping more of an eye" on the exchange rate in the conduct of domestic monetary policy, are replaced with specific and verifiable policy commitments, e.g., the money supplies in countries A and B are targeted to grow by X and Y percent, respectively, over the next six months.

Second, the indicator or target proposal can be used as a "trigger mechanism" to activate coordinated discussions of how recognized departures of actual from desired macroeconomic outcomes can best be remedied. For example, the G-24 proposal envisages such discussion on a bilateral basis as part of Article IV consultations whenever actual outcomes differ from recommended targets or indicators. In this way, the perceived lethargy in adjustment under the present discretion-based system may be overcome. The use of objective indicators to improve the speed of adjustment is of course well-known from the work of the Committee of Twenty. ^{1/}

^{1/} See particularly "The Report of the Technical Group on Indicators," IMF [1974].

A third advantage of the target-indicator proposal is said to be that it pays attention to the level of, as well as to the inter-country differences in, macroeconomic policies. To some observers, this gives it an edge over proposals that use the exchange rate to signal a misalignment of policies. For example, if two countries both inflate at 10 percent, their bilateral exchange rate may be stable but few would agree that their macroeconomic policy stances were right. By focusing on the appropriate setting of policy targets and instruments within as well as across countries, the target-indicator proposal is said to overcome this danger.

Fourth, because the target-indicator proposal would likely encompass a broad set of policy targets and policy instruments, it could be argued that it is less susceptible than is say, a target zone scheme, to sending "wrong signals" about either the need for adjustment or the proper policy remedy for adjustment. Thus, one can monitor directly not only the exchange rate but also growth, inflation, employment, the pattern of payments balances, etc.; similarly, departures of actual from targeted outcomes might be met not merely by altering monetary policy but by other mixes of policies (including structural measures) if deemed appropriate.

Finally, supporters of this proposal might argue that, despite some potential difficulties in negotiating and interpreting the targets and indicators, it is operational. As supporting evidence, they could cite the use of quantitative indicators and targets in domestic monetary policy in many industrial countries. In addition, they might note that the target-indicator proposal is a close relative of the program targets and quantitative "performance criteria" employed by the Fund in its stabilization programs. It might be argued that if these objective indicators and targets have been used to good effect by the Fund for over 35 years in the formulation of stabilization programs for a diverse set of countries, why cannot a similar approach be followed in designing coordinated "shadow programs" for key-currency industrial countries, especially when the systemic consequences of inappropriate domestic policies are so much greater for the latter group of countries? In addition, such an approach would, so its supporters argue, constitute an effective remedy for the current "asymmetry" in the exercise of Fund surveillance.

(2) Opposition to objective indicators or targets

Both the advisability and practicality of objective indicators or targets for coordinated macroeconomic policy formulation remain controversial. At least five counter-arguments might be offered in opposition to this proposal.

To begin with, it might be argued that it would be even harder to reach a consensus on a range of desirable policy targets and policy

instruments than it would on a range of desirable exchange rates. ^{1/} There would simply be too many parameters on which to obtain agreement. And the more specific the desired policy commitments, the more difficult would be the negotiations. Some would say that it is one thing to argue that major industrial countries should "take account" of external repercussions in setting domestic policies, but quite another to argue that they should be dominated by external considerations. Also, if policy responses to target departures too have to be multilaterally negotiated and agreed, then the administrative problems become, according to the critics, even more burdensome. Indeed, some would conclude that if a set of instruments and targets had to be multilaterally negotiated, the constraints on national sovereignty would be even more severe than in a rigid fixed rate system; hence, such a proposal is unlikely to be acceptable to most potential members.

A second criticism of the target-indicator proposal is that if it simply triggers discussions on the appropriate coordination of macro-economic policies, it will not allocate and enforce adjustment among the countries involved. Thus, unlike say, the gold standard, the target-indicator proposal does not offer any "rules" on how to eliminate recognized disequilibria.

Third, although use of a broad set of indicators and targets may send fewer false signals about the need for adjustment than reliance on a single indicator (e.g., the exchange rate), opponents argue that it will still send more false signals than a judgmental appraisal that goes beyond such indicators. With any mechanistic formula, there is always the danger that events and factors unforeseen at the time that policy targets are set will intrude and cause deviations between actual outcomes and targets; hence, the indicators would have to be reviewed judgmentally in any case. As evidence of the importance of such "news," opponents note that past forecasting errors for such outcome variables as current accounts and exchange rates have been very large indeed. ^{2/} Further, when many indicators are used, they may point in different directions.

^{1/} Kenen [1985], for example, in weighing options for reforming the international monetary system concludes: "... it should be much easier, technically and politically, for governments to collaborate in managing exchange rates than to coordinate their monetary and fiscal policies in a timely manner." p. 11

^{2/} See Willett [1977] and Mussa [1983].

Fourth, just as it is difficult to agree on an operational definition of the equilibrium exchange rate, it may also be difficult to agree on internationally-consistent, quantifiable indicators of monetary and fiscal policies (to say nothing of structural policies). Which monetary aggregate should be used as the indicator? Should the fiscal deficit or surplus be measured at the central or general government level, and should it be adjusted for cyclical factors?

Finally, opponents of the target-indicator proposal might doubt whether the use of quantitative indicators in a national setting carries any implications for their feasibility in a multilateral setting. They could argue that at the national level authorities can be confident that if quantitative policy targets prove less helpful than anticipated, their use can be modified or even discarded. In this connection, several major industrial countries have, in fact, ceased establishing monetary targets or indicated that they would place less reliance on them in the future. No such flexibility could be assured for any single member country in a multilateral setting. In addition, they might point to the often lengthy negotiations of quantitative policy targets in Fund programs. ^{1/} What is the outlook then for negotiating a mutually-agreeable set of these targets among five major industrial countries, and what would happen in the meantime if such discussions broke down? In short, opponents might argue that what is feasible with quantitative policy targets on a national level may not be so in a multilateral setting.

Issues for discussion: (i) would a mutually-consistent set of "targets" or "objective indicators" for the key-currency countries represent a better organizing framework for multilateral surveillance than either a set of target zones or the existing procedures; (ii) what types of commitments would be associated with a target-indicator plan-- is it to be viewed mainly as a mechanism for discussion and loose coordination of macroeconomic policies, or as a new set of "rules of the game" for major industrial countries; (iii) if quantitative targets and quantitative performance criteria are necessary and desirable in Fund-supported adjustment programs, why should they not be used for monitoring and appraising policies in key-currency industrial countries; (iv) is there a serious risk that even a broad set of objective indicators would send false signals about the need for adjustment and about the appropriate policy prescriptions; and (v) would attempts to negotiate a set of mutually-consistent "targets" reproduce all the administrative delays and frictions that characterized the latter years of the Bretton Woods system?

^{1/} It might also be argued that industrial countries would not face the same external financing constraint as program countries and as such would be under less pressure to reach agreement on indicators.

C. Improvements within the existing institutional setting

As noted earlier, the G-10 Report concludes that "... the fundamental approach of the Articles [of Agreement of the Fund] remains valid and... the key elements of the current... system require no major institutional change," 1/ and that "... no major changes are required in the present institutional setting for exercising surveillance over national policies." 2/ Instead, the G-10 Report recommends that improvements be sought within the framework of the present system. These improvements would focus on the following four areas.

First, "... the adoption of sound, credible, and stable policies" 3/ at the national level, especially in major countries. This is said to contribute "fundamentally" to exchange rate stability. Also, "... liberalization of capital markets and, more broadly, removal of restrictions and structural rigidities" 4/ so as to reduce the burden placed on foreign exchange markets in absorbing short-term disturbances. This latter action would, so it is argued, reduce the short-run volatility of exchange rates.

Second, "... in setting national policies, the international implications and interactions of those policies should receive an appropriately high priority." 5/ This, it is argued, would improve the compatibility of policies among countries and the convergence of economic performance around sustainable non-inflationary growth. As such, it would lead to greater exchange market stability. To achieve better international coordination of policies, "... close and continuing cooperation among countries and a strengthening of international surveillance" 6/ are identified as central elements.

Third, strengthened surveillance should be built on "... enhanced dialogue and persuasion through peer pressure rather than mechanically imposed external constraints." 7/ Specific measures to strengthen surveillance cover both bilateral and multilateral surveillance.

Among the proposals for improving bilateral surveillance that appear in the G-10 Report are those that address the policy-making level at which governments are represented in the consultation process; the possibility of a confidential exchange of views between the Managing Director and the Finance Minister at the end of the consultation process for important countries; the degree of candor in the assessment of

1/ G-10 Report, paragraph 97.

2/ G-10 Report, paragraph 36.

3/ G-10 Report, paragraph 28.

4/ G-10 Report, paragraph 28.

5/ G-10 Report, paragraph 29.

6/ G-10 Report, paragraph 33.

7/ G-10 Report, paragraph 38.

national policies and of their international impact; identification of necessary improvements in the scope, quality, and timeliness of data; improvements in analytical techniques; the use of supplemental surveillance techniques; and the continued development of enhanced surveillance procedures. In addition, mention was made of the publicity to be given to the outcome of the consultation process and to other Fund reports and summings-up.

Turning to multilateral surveillance, the G-10 Report proposes that there be "... a separate chapter" of the World Economic Outlook devoted to "... analyzing the repercussions of national policies of G-10 countries and of their interaction in the determination of exchange rate developments and international adjustment." 1/ In addition, the G-10 Report proposes that the G-10 should review the conclusions of this chapter, when appropriate, at Ministerial level.

Finally, the G-10 Report argues that "... neither capital controls nor intervention can be relied upon to attain lasting stability of exchange rates." 2/ On official intervention, the G-10 Report endorses the conclusions reached in the Report of the Working Group on Exchange Market Intervention [1983]. With respect to controls on international capital flows, the G-10 Report concludes that such controls would carry "substantial" economic costs and that free capital movements are beneficial to "... the expansion of trade and to efficient resource allocation." 3/

(1) The rationale for seeking improvements within the present institutional setting

Although the G-10 conclusion for seeking improvements in exchange rate stability within present institutional arrangements encompasses a wide and diverse set of proposals, it is possible to describe (as was done with the two proposals analyzed earlier) the underlying rationale. This rationale might be said to rest on the following five arguments.

First, supporters argue that the observed weaknesses in the functioning of the present system of floating rates reflect not design flaws in the exchange rate system per se but rather flaws of implementation in the underlying macroeconomic and structural policies. Until national governments themselves muster the requisite political will to adopt sound, credible, and stable policies, no exchange rate system--be it one of very low or very high flexibility of nominal exchange rates--will work properly. Conversely, when national governments do so act, proposals for altering the nature of exchange arrangements would not be necessary.

1/ G-10 Report, paragraph 51.

2/ G-10 Report, paragraph 27.

3/ G-10 Report, paragraph 25.

As such, supporters argue that energy ought to be concentrated on ways of bringing this improved policy implementation into being. "Enhanced dialogue" and "peer pressure" represent in their view the most hopeful routes to that end. The existing channels of surveillance could be used more effectively and coordinated better to support these efforts.

Second, after over a decade of experience with floating rates, it is clear that it is neither realistic nor helpful to believe that each country can decide independently its own policy stance and mix and allow the exchange rate to settle all conflicts in the market place. It is not realistic because floating rates are not capable in any case of providing enough insulation to make independent targeting work. It is not helpful because failure to take other countries policies and objectives into account will only induce in the long run retaliatory actions which, in turn, will make the path to internal and external balance slower and less satisfactory than if some coordination of policies was carried out. Improved coordination of policies would do much to reduce the large swings in real exchange rates that have characterized the last thirteen years. Again, supporters of the existing framework argue that the way to get such better coordination is through close and continuing cooperation not via "mechanically-imposed external constraints."

Third, no exchange rate system can provide full insulation from the effects of policies and disturbances abroad. Nevertheless, exchange rate volatility and overshooting could be much reduced if restrictions and structural rigidities in goods, labor, and capital markets were dismantled. In this way, asset prices, particularly exchange rates, would not have to compensate so much for the stickiness of wages and prices. Exchange rates would still of course show variability but, so it is argued, this variability would not necessarily be "excessive."

Fourth, exchange rate developments can provide some useful information on the market's appraisal of macroeconomic policies. In some cases, the market's appraisal may not be consistent with fundamentals and authorities will want to make known their own view (e.g., the September 1985 Group of Five Agreement in New York). This however, will be more the exception than the rule. Similarly, (pre-announced) quantitative targets for macro-economic policies, especially monetary policy, may be useful in certain circumstances in providing an anchor for expectations. But, so the argument goes, neither exchange rates nor quantitative targets can substitute for judgmental assessments about the appropriate course of policies over the medium-term. To replace the latter with the former would endanger the achievement of price stability and sustainable growth. Also, experience suggests to defenders of the existing framework that automatic adjustment rules usually turn out to be less automatic in practice than in theory, and that very specific adjustment or policy rules can become liabilities when the global environment changes in unexpected ways.

Fifth, they find no presumption that the resource allocation costs from impeding the international flow of capital would be any less serious than those associated with restrictions on trade flows. Also, they note that even aggressive capital control programs (such as those of the early 1970s) often failed to stem private capital flows, and the subsequent development of offshore banking could be seen as making their efficacy today even less likely. As regards official intervention, they could point to a large body of empirical evidence that strongly suggests that non-sterilized intervention is unlikely to have a lasting impact on the level of the exchange rate. ^{1/} Nevertheless, intervention can in their view be useful in: (i) countering disorderly market conditions; (ii) reducing short-term volatility; (iii) complementing and supporting other policies; and (iv) expressing an attitude toward exchange markets.

(2) Opposition to operating within the existing institutional setting

The arguments in favor of improving exchange rate stability via the existing institutional setting have not gone unchallenged. The case against that position might be said to rest on the following arguments.

First, while acknowledging the fundamental role played by sound, credible, and stable policies in achieving a stable system of exchange rates under all types of exchange arrangements, it could be argued that a good exchange rate system offers the right incentives and pressures for responsible policy conduct. On the basis of experience with floating rates, it might be concluded that floating rates have been wanting on that score, i.e., they have not promoted the right policies. Further, while "enhanced dialogue and peer pressure" may be necessary elements for improving policy behavior, they are unlikely under this view to be sufficient. In short, some would say that the choice is not policy reform or exchange rate reform but rather how best to design the exchange rate system to achieve policy reform. For this reason, the "incentive," "pressure," and "trigger" features of target zones, or at least of some concerted "views" on exchange rates (as seem to be developing since September 22, 1985), should--so the argument goes--not be dismissed.

Second, while it could easily be accepted that better coordination of policies would reduce the large and persistent misalignments of real exchange rates observed in the past, and that such coordination requires "close and continuing cooperation," it might again be maintained that some

^{1/} Report of the Working Group on Exchange Market Intervention [1983], Rogoff [1984], Obstfeld [1985].

type of external constraint is essential to get that cooperation. 1/ Modes of coordination that do not send clear, regular, and strong signals about when, what, and how to coordinate can be viewed as ineffective. This in turn leads opponents of the existing framework to the conclusion that substantive strengthening of both the principles and procedures of Fund surveillance is probably necessary.

Third, it might be conceded that target zones (or concerted views on exchange rates) and objective indicators would occasionally make the wrong diagnosis and occasionally prescribe the wrong remedy for external adjustment. Nevertheless, these adjustment mechanisms might still be regarded as performing better on average than a judgmental mechanism that sometimes doesn't initiate adjustment at all, and sometimes, by its inaction, encourages other more costly forms of adjustment (e.g., protectionism). It might also be argued that the constraints placed on domestic monetary policy in the EMS have not unduly handicapped efforts to achieve price stability and sustainable growth. Furthermore, critics of the existing framework might argue that while the recent G-5 initiative was welcome, it would have been even more welcome if it had taken place in 1982 or 1983 and if authorities had on a more regular basis spoken out against market-determined misalignments of key-currency exchange rates.

Fourth, while liberalization of capital and trade flows might be regarded as an effective means of dampening exchange rate overshooting in countries with "... diversified economies and high mobility of factors of production," 2/ its applicability to developing countries might be questioned. Here, the arguments (as presented in the G-24 Report) are that protection of infant industries, judiciously applied, may be indispensable to diversification and development, and that controls to limit capital flows may become "... necessary for the stability of exchange and interest rates." 3/

Finally, some have argued that even in industrial countries, impediments to capital flows (e.g., round-tripping taxes) need to be seriously evaluated. 4/ It is not that such impediments would be

1/ "In the meantime, a mechanism has to be devised to enforce policy coordination among the major industrial countries." G-24 Report, paragraph 5.

2/ G-24 Report, paragraph 70.

3/ G-24 Report, paragraph 87.

4/ See Tobin, [1980].

costless. They would not. But these costs are viewed by supporters of such proposals as smaller than the macroeconomic costs associated with larger exchange rate fluctuations under free mobility of capital. Under this view, the answer to excessive volatility of exchange rates is to "throw some sand" into the wheels of the efficient world capital market, not to apply more grease to those wheels. On intervention, a case might be made that the potential for increasing its effectiveness by combining it with other policy measures has not yet been fully realized. As an example, it might be argued that developments since the G-5 agreement in September 1985 are consistent with the position that official views on deviations of exchange rates from fundamentals, in combination with intervention and with some prospects of an improvement in fundamentals, can be effective in "pricking" a speculative bubble in the exchange markets.

Issues for discussion: (i) Do the incentives for implementing sound, stable, and credible policies come primarily from "within," or can the exchange rate regime condition and reinforce those incentives; (ii) how much scope is there for improving the international consistency of policies by using the existing channels of Fund surveillance more effectively and in a more coordinated manner; (iii) in what circumstances and in what types of economies would liberalization of capital flows--and more generally, a reduction of structural rigidities--pay the largest dividends in terms of exchange stability and of other objectives; (iv) what are the relative merits of "judgmental" versus "objective indicator" approaches to initiating adjustment and to guiding macroeconomic policies over the medium term; and (v) what are the main implications for exchange rate management of the G-5 meeting in New York on September 22, 1985?

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