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J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
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H. Lundstrom	
M. Massé	L. Leonard
	A. Abdallah
F. L. Nebbia	
Y. A. Nimatallah	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

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

Also Present

Asian Department: A. Ariyoshi. European Department: L. A. Whittome, Counsellor and Director. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; G. Belanger, P. J. Quirk, N. E. Weerasinghe. External Relations Department: M. Goldstein, B. Nowzad. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: F. P. Gianviti, Director; W. E. Holder, Ph. Lachman, A. O. Liuksila. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton, M. P. Dooley. Treasurer's Department: W. O. Habermeier, Counsellor and Treasurer; E. Decarli. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: A. A. Agah, P. E. Archibong, W.-R. Bengs, L. P. Ebrill, S. Ganjarerndee, J. Hospedales, G. Nguyen, G. W. K. Pickering, I. Puro, A Vasudevan. Assistants to Executive Directors: J. R. N. Almeida, B. Bogdanovic, J. de la Herrán, F. Di Mauro, J. J. Dreizzen, G. Ercel, V. Govindarajan, L. Hubloue, Z. b. Ismail, S. King, S. Kolb, M. Lundsager, A. Mustafa, W. K. Parmena, J. Reddy, J. E. Rodríguez, C. A. Salinas, L. Tornetta, A. J. Tregilgas, H. van der Burg, Wang X., B. D. White.

1. FLOATING EXCHANGE RATE SYSTEM - REVIEW AND ASSESSMENT; AND TARGET ZONES

The Executive Directors considered staff papers on the review and assessment of the system of floating exchange rates (SM/86/5, 1/10/86) and on target zones for the exchange rates of the major currencies (SM/86/6, 1/10/86).

Mr. Nimatallah made the following statement:

It is important to maintain a distinction from the outset between the causes of exchange rate variability and misalignments, on the one hand, and the impact of the variability and misalignments on the developing countries and small industrial countries, on the other.

Coming now to the G-10 and G-24 reports, I am heartened to see that both groups agree in principle that the present system of exchange rates needs to be improved. They both are concerned about the short-run variability and the long-run misalignments of exchange rates. Furthermore, they both conclude that the major underlying elements behind the volatility and misalignments of exchange rates of key currencies are the unsound and inconsistent policies, and the related divergencies in economic performances among major industrial countries.

The key questions faced by both groups were how to introduce more stability into the present system, and how to ensure that key-currency countries pursue sound and consistent policies.

In this respect, I am pleased to note that the two groups agree that surveillance is crucial as a basic tool for promoting policy convergence in an environment of sustainable noninflationary growth; that exchange rate intervention cannot be the primary instrument for achieving exchange rate stability, although it can be useful in playing a complementary role; and, most important, that the return to a rigid, fixed exchange rate system is neither desirable nor feasible at present.

However, the two groups differ in degree in their search for the one additional step that is needed, a "missing link" if you will, to improve the functioning of the present exchange rate system. I think that the roots of these differences lie in the two groups' respective assessment of the extent to which exchange rate variability and long-run misalignments affect developing countries and small industrial countries. It is true, as maintained in the G-10 report, that various hedging techniques and forward markets have been developed, improving the ability of large countries and large companies to reduce their exposure to foreign exchange risk. It is also true, however, that the majority of countries, unfortunately, are

still unable to avoid that risk. It is quite clear from the records of the Fund that many countries have suffered a considerable loss of income due to reduced exports, partly as a result of serious misalignments of key currencies. For example, when the U.S. dollar sharply appreciated, many developing countries that had adopted realistic pricing policies, were nonetheless forced to augment their export volumes so as to maintain export receipts. In so doing, not only were their incomes reduced, but, in the process they also had to adopt more difficult adjustment measures.

Therefore, I have no difficulty in answering, in the affirmative, the first staff question on page 6--"Does short-run volatility of major currency exchange rates impact more seriously on the developing countries and on smaller less diversified firms?" Another staff question, also on page 6, raises interesting issues about the effects of exchange rate volatility on international trade: "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?" As far as I can see, it is not so much a question of the volume of international trade as the distribution of that volume. I think that exchange rate volatility leads to a redistribution of income in favor of the larger countries and companies which can influence demand and reduce their exposure to risk.

This leads me to the conclusion that the cost of exchange rate volatility to most countries is sizable and unnecessary. I feel that it would be in the best interests of the large countries if, in the long run, the incomes of the many small and vulnerable countries were not exposed to these arbitrary reductions. A stable environment would enhance their ability to import from the industrial countries, increasing the latter's income and employment through the multiplier effect. One good way of improving the stability and even the growth in the incomes of developing and small industrial countries is by introducing more stability into the present exchange rate system.

Another area where the two groups differ somewhat pertains to their respective assessment of the contribution of the lack of discipline, as well as the level and frequency of macroeconomic policy coordination among large industrial countries, to the volatility and misalignments of key currencies. It is generally argued that the lack of fixity in major exchange rates has greatly reduced discipline on macroeconomic policies. It is further argued that unsound and inconsistent policies have produced historically high real interest rates, low commodity prices, and sluggish economic growth. This has had adverse spillover effects on developing countries' export earnings and growth performance. Moreover, under the present system, efforts

aimed at better discipline and policy coordination have not been initiated on a regular and frequent basis. Rather, they have been, for the most part, triggered by the threat of crises.

The events that followed the September 22, 1985 meeting of the G-5 officials in New York have demonstrated that concerted actions by the key currency countries do work. They also proved the desirability and, indeed, the need for a trigger mechanism other than the threat of crises for enhanced dialogue and policy coordination among the major industrial countries.

It is certainly true that during the par value era domestic macroeconomic policies were fully subordinated to, and constrained by, the maintenance of the exchange rate in a sense that "the tail was wagging the dog." Because of this inflexibility and the lack of control over domestic macroeconomic variables, domestic economies during that era have suffered a great deal. Now that "the dog is wagging the tail," which is a more natural mechanism, the world forgets that the tail has to be connected to the dog for it to be wagged and for the wagging to serve any useful purposes to the dog. The point is that the tail cannot be severed, as some might imagine the floating exchange rate system to be.

There is ample evidence that the major causes of exchange volatility and misalignments are not only the low level of coordination and discipline but also the lack of regularity and automaticity in carrying out even the present level of policy coordination.

Our experience with the present system clearly suggests that the "missing link" in the process of enhancing the level of discipline and policy coordination through more frequent and regular consultations among the major industrial countries is a trigger mechanism. Such a mechanism would have to move the present system in the direction of more automaticity and more centralization in policy adjustment and coordination. The central question is, therefore, what is the most appropriate, practical, and acceptable tool for ensuring that unsoundness and/or inconsistencies are detected early enough to be dealt with in a timely fashion? Put differently, how can the international community ensure that the key currency countries address individually and collectively exchange rate problems before too much damage is inflicted on the world economy?

The answer to this question hinges on finding and incorporating the missing piece in the structure of the present exchange rate system. The missing piece, in our view, is a trigger mechanism that plays the role of an early warning light.

Such a mechanism, we feel, should have the following desirable features:

It should be automatic, in the sense of triggering automatic discussions and consultation at the national and international levels, but not mechanical in the sense of coercing key-currency countries into a course of action. It should be flexible and amendable to frequent revisions. It should be widely acceptable and its implementation should not be cumbersome. It should not aim at fine tuning exchange rate relationships. Our knowledge in this area is far too imperfect.

After reviewing the proposals in the staff paper--namely, hard target zones, soft target zones, objective indicators, and improvements of the existing institutional setting--I came to the conclusion that soft target zones have the most to offer in that they combine some of the desirable features of a trigger mechanism which I mentioned earlier with most of the advantages of the present floating exchange rate system.

Let me explain why. Soft target zones are characterized by wide, frequently revised, confidential zones, and need monetary policies that pay only limited attention to the level of exchange rates. What they introduce is only 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. As these soft target zones have to be negotiated, they can improve the international consistency of macroeconomic policies, thus ending the present practice of letting the exchange rates be determined as residuals of other policy actions. It is true that soft target zones may not be helpful in reducing short-term variability or in identifying small real exchange rate misalignments. However, I think that they would be at least helpful in preventing large and persistent misalignments, thus introducing some discipline. Unfortunately, unannounced soft target zones may not provide the anchor that some might want for greater stability. They will, however, help introduce more frequency and regularity in policy coordination and increase the responsibility of those large countries with the greatest spillover effects on the world economy.

To conclude, the present floating exchange rate system has not failed; it only needs improvement. A return to a rigid par-value system is undesirable and unfeasible at this time. Within the efforts of searching for feasible ways to improve the present system, one should benefit from the experience of the EMS. While soft target zones are not much different from what took place in, and subsequent to, the New York meeting of September 22, they do add the desirable element of regularity, and, therefore, enhanced incentives for more frequent policy coordination among

the large industrial countries. After all, the Summit Conference of the Group of Seven seems to be held on a regular basis; so why not do the same for Finance Ministers and Governors? For all practical purposes, and because the initial discussions for establishing the initial target zones can be difficult and time-consuming, I think that the Board should recommend to the Interim Committee to advise members to initiate such discussions anyway, and as soon as possible, even if there is no full agreement yet on adopting soft target zones.

Mr. Polak said that he shared the widely held view that the behavior of exchange rates in recent years had been far from optimal and that a new critical look at the current exchange rate system was warranted. However, the conclusion that the system needed to be changed could only be drawn after considering the merits and demerits of alternative systems and of means to improve the present system.

It was misleading to describe the present system as "the system of floating exchange rates," Mr. Polak continued. The overwhelming majority of members had exchange rates that were pegged to either a single currency, the SDR, or an alternative basket of currencies. That group included countries that because of high rates of inflation, had to move the peg frequently. Floating accurately described the regime of a small number of major countries, including the United States, Japan, Germany, the United Kingdom, Canada, and Switzerland, as well as a limited number of smaller countries that were wide open to capital movements.

His description of Germany as a member with a floating rate--and, by implication, the other European Monetary System (EMS) countries as members with pegged rates--deviated from the Fund's standard presentation of current exchange rate arrangements, Mr. Polak said. The Fund included all the EMS countries in a special category of members having "limited flexibility under cooperative arrangements." He did not wish to change that categorization formally, but it should be acknowledged that the analytical value of the Fund's way of presenting exchange rate systems was limited, because it described exchange rate arrangements for individual currencies, while the effect of such arrangements could only be properly understood in terms of pairs of currencies. The inherent difficulty in the Fund's categorizations was particularly evident in the description of the EMS currencies, for most of which the floating against other currencies was as important as the fixed relationship within the EMS and the pegging of other currencies to the French franc and the U.K. pound.

He was worried that the staff incorrectly described the nature of the EMS by presenting it as an extreme form of target zones, Mr. Polak went on. The European Monetary System had many unique features--including its objective of policy convergence, its collective mechanism of exchange rate adjustment, and its generous credit mechanism--but as an exchange rate mechanism it was best understood as a form of pegging on the deutsche mark. The EMS was the only legitimate heir of the par value system. The

floating exchange rate system--which consisted of the major currencies--affected all members, as the G-24 report stressed, and all members therefore had a legitimate interest in the way in which it functioned.

In SM/86/5 (1/10/86) the staff had discussed two optional exchange rate systems for the major currencies--namely, target zones and objective indicators, Mr. Polak remarked. The staff had usefully described the advantages and disadvantages of each, and he had concluded from that description that, as an alternative to the present system, both target zones and objective indicators were nonstarters, although elements of those systems might be useful and applicable in some circumstances. Considerable thought had been given to those alternative systems over the previous ten years, and they had been partially or fully endorsed in the G-10 and G-24 reports. However, that endorsement seemed to reflect more the general dissatisfaction with the present world economy--not merely the exchange rate system--than a thorough appraisal of alternative systems.

He had not meant to imply that the system of floating rates was the only possible exchange rate system for the major currencies, Mr. Polak continued. Indeed, the experience of the EMS suggested that a variant of the par value system--which was perhaps more accurately referred to as the adjustable peg system--continued to deserve attention. Such a regime was possible for any country that placed a sufficiently high value on a stable relationship with a low-inflation area as to be willing to sacrifice most of its independence in terms of monetary policy to the maintenance of that relationship. The choices involved depended partly upon a country's economic parameters, such as its degree of openness, and partly on a country's economic policy and political preferences. The most interesting examples of such choices in recent years were France and the United Kingdom. France had joined and then rejected the "snake arrangement" that had existed before the EMS. In persisting in its membership in the EMS, France had clearly chosen stability over policy independence, even though that choice had involved a number of adjustments of the exchange rate peg. The United Kingdom had thus far continued to place a higher value on its privilege to determine its monetary targets in the light mainly of domestic requirements and had accepted the consequences in the form of a widely fluctuating exchange rate.

The main question at present was whether there was a path to a system in which floating would be reduced and would eventually be nonexistent for all but the major currencies, Mr. Polak went on. In his view, such a path existed, although he would not predict the likely progress along that path and he would not preclude the possibility that steps away from the path would be taken. Progress could conceivably be made in two phases. The first phase would involve the countries for which there was a clear potential center to which to attach. That group clearly included Italy, which still maintained a 6 percent margin in the EMS. The second phase would involve Canada, which had a long history of pegging on the U.S. dollar, the only currency on which Canada could logically have pegged. In addition, the United Kingdom could change its relationship to the EMS. The obstacles to Canada, the United Kingdom, or both maintaining a fixed

rate on any stable center should not be minimized; given their energy exports and the openness of their capital markets, both countries might well naturally maintain floating exchange rates whatever the nature of the principal reserve system. However, if those two countries were to fix their exchange rates on their natural centers--namely, Canada on the U.S. dollar and the United Kingdom through membership in the EMS--there would still remain the question of the currencies of the United States, Japan, and Germany--what could be called the North America-Japan-EMS triangle. Two of those countries could peg their exchange rates to the third currency, thereby abolishing all floating among the major currencies. It was conceivable that Japan and Germany--or Western Europe as a whole--would find it worthwhile to restore the peg on the dollar, a policy that had benefited Japan and Germany through much of the 1960s but had become gradually untenable thereafter as the United States had increasingly broke what Professor Richard Cooper had called the bargain of the Bretton Woods system under which the United States maintained domestic economic stability and other countries fixed their currencies to the dollar and accumulated their reserves in gold convertible dollars.

To return to the status quo that had prevailed before 1973, the United States would not have to peg its currency, Mr. Polak went on. Instead, it must embrace the policies of stability that would induce other countries, especially Germany and Japan, to resume their pegging on the dollar. It was not useful to consider whether--or when--such an exchange rate system was likely to be introduced, but it was useful to consider the possible road toward such a system. That road probably would not include target zones or objective indicators, but it must include an increased awareness by the main countries of the external effects of their policies and of the interdependence of each country's policy targets, together with an appreciation of the need for the adoption of sound, credible, and stable policies as recommended in the G-10 report. Recent developments--including the acceptance of a common view on the desirable movement of exchange rates on September 22, 1985 and the subsequent G-5 meeting on that subject--suggested that some progress in those areas was being made.

The United States had come to the view that extreme fluctuations in the exchange rate of the dollar should be prevented in the future, Mr. Polak remarked. The agreement with that view by the other main market participants had moved the exchange rate system from free floating to what could be described as managed floating. At the same time, it was widely agreed that although intervention had a role to play, it could not be the main instrument in achieving certain exchange rate effects. Experience had shown that, in certain circumstances, countries acting together could influence exchange rates without massive intervention. The intervention by the United States and the recognition by that and other countries of the need to conduct their intervention policy in a consistent manner were important recent developments; countries that had needed to prevent a rise in their own currencies within the EMS had done so by buying non-EMS currencies other than the dollar.

Reduced exchange rate flexibility required more than action in the exchange market, Mr. Polak went on. That fact had been recognized during the two most recent G-5 meetings. The United States had taken a significant step toward lowering the dollar through its adoption of strong budget balancing measures, and the exploration among the G-5 countries of possible action in the area of interest rate policy was, at the least, a promising development. He particularly welcomed Secretary Baker's statement at a meeting of the Bretton Woods Committee on January 22, 1986 that "at a minimum, we have to develop a more effective means of assuring that the international implications of domestic policies are taken into account." The various recent developments that he had mentioned were consistent with the policy views that had been expressed by the Fund in various bilateral and multilateral surveillance fora and underscored the importance that the G-10 and G-24 reports correctly attached to the intensification of the Fund's surveillance activities.

Because he did not favor the concept of target zones, he would not comment in detail on the operational questions that the staff had raised concerning the implementation of such zones, Mr. Polak said. However, the staff's discussion in SM/86/6 (1/10/86) on the calculation of target zones--and particularly the middle rate of such zones--was relevant to the Fund's work on the present exchange rate system. For example, that discussion should be taken into account in judging whether the recent depreciation of the dollar was sufficient. He had made some technical points on the calculation of target zones on a bilateral basis.

Mr. Kafka considered that the staff reports contained a balanced presentation of the advantages and disadvantages of various exchange rate systems. A more detailed and systematic discussion of the empirical evidence with respect to the performance of the existing exchange rate system would have been helpful. The paper on target zones was particularly valuable because of its analysis of crucial operational problems, and he would comment on the issue of target zones on another occasion.

The kind of system represented by the EMS was a possible goal for the international community to reach in what would certainly be a long process of moving away from the present unsatisfactory system, Mr. Kafka commented. That goal had been sketched out in the 1972 report of the Executive Directors on the role of exchange rates in the international monetary system and in the final report of the Bureau of the Committee of Twenty. The system that he had in mind would be based on relatively narrow margins and fairly flexible--but meaningful--central rates together with an adequate degree of automatic balance of payments financing in some form. Such a system would not require members to abandon autonomous domestic policy making; it would permit a sufficient number of changes in the grid of central rates but would serve as an anchor for expectations of greater exchange rate stability. The long path to such a system included target zones, beginning with soft zones that could be hardened over time. That approach would be compatible with an expansion of the EMS system or with the introduction of such a system in North America and perhaps Asia. Target zones could be established between the key currencies

on which the various EMS-type systems would be centered. He harbored considerable doubts about the usefulness of a system of objective indicators. The Committee of Twenty had carefully examined that alternative and had concluded that it did not have any significant advantage over a system based on a judgmental approach to the establishment of appropriate exchange rates.

A conclusion by the Chairman at the end of the present discussion that Executive Directors no longer held extremely different views on an appropriate exchange rate system would constitute an important step, Mr. Kafka commented. The next step need not rely on additional staff papers and Executive Board discussions; instead, there should be contacts between the Managing Director and national financial decision makers, including the Interim Committee members, as well as possibly an international conference.

Mr. Goos said that he strongly supported the conclusions of the Group of Ten Deputies on the exchange rate system and surveillance. To some extent the Group of Ten recommendations were already being implemented, as reflected in the September 22, 1985 Plaza Agreement among the major industrial countries. He remained convinced that the existing exchange rate system, including the floating of major currencies, had served the global economy and individual countries well, and that, for the time being, there was no realistic alternative in sight. At the same time, however, there was some room for improvement--and necessary improvements should be sought--within the existing institutional setting of the system. Accordingly, he shared the arguments of the opponents to target zones which were mentioned on pages 11-21 of SM/86/6, including their concern about the technical and operational difficulties and drawbacks of such zones mentioned on pages 21-36. In addition, he remained also critical of the proposal regarding the use of objective indicators or targets for macroeconomic policies and outcomes as recommended in the G-24 report. The proposals to introduce target zones and to use a set of objective indicators in a quantified and multilaterally negotiated framework obviously start from the presumption that the present arrangements for floating rates had systemic flaws that called for systemic changes. By contrast, our basic point of departure was the conviction that concrete exchange rate arrangements mattered much less than the political will and ability to live up to the rules of the game; as long as that latter requirement was not met, no exchange rate system would work properly. He fully agreed with the converse statement on page 37 of SM/86/5 that, when national governments obeyed the rules, proposals for altering the nature of exchange rate arrangements would not be necessary.

No one would disagree that exchange rates had been subject to considerable volatility and misalignment in recent years, Mr. Goos remarked. In any assessment of actual exchange rate developments the main consideration was not whether exchange rate fluctuations had been high or excessive but whether the fluctuations had in the first instance been a reflection of the turbulent environment of the previous 15 years, an environment characterized by two oil price shocks and an insufficient orientation of policies

in several countries toward overall economic equilibrium. In that context, the crucial issue was whether different exchange rate arrangements, such as target zones, would have made the necessary adjustments by individual members in their real economy less costly than had actually been the case, and in particular whether such arrangements would have permitted such adjustments to have been made without severe restrictions on trade and capital flows. He doubted whether alternative systems could have permitted such changes. It was important to note that there was no compelling evidence that exchange rate fluctuations negatively affected international trade.

He disagreed with the view that floating would undermine monetary discipline, Mr. Goos considered. He saw no reason why target zones per se would ensure an increase in policy discipline and in greater policy coordination among the major industrial countries. Even the EMS did not provide such an assurance, as was evident in the first four years of the operation of that system. It had only been after several of the EMS members had found the political resolve to reorient their economic policies toward stable exchange rate relationships that the system had become less volatile; there were still serious shortcomings in the conduct and coordination of national policies of EMS members. In assessing the alleged disciplining force of target zones Executive Directors should bear in mind that the need to compromise and make adjustments to defend given target zones might not necessarily fall upon the countries that were responsible for exchange rate disturbances.

There were substantial technical and political difficulties in determining equilibrium exchange rates, Mr. Goos noted. As the staff had shown in SM/86/6, there was no satisfactory method of calculating equilibrium rate with any degree of precision. Accordingly, such rates would have to be established as the result of what would presumably be very difficult negotiations. Given the competitive nature of exchange rates, he doubted whether such negotiations could be free of political considerations and pressures and, therefore, of the risk of establishing wrong equilibrium rates and an inadequate allocation of the burden of policy adjustment. Under such conditions, efforts to maintain sound and stable policies obviously could easily be frustrated.

Even if it were possible to agree on the "right" equilibrium rates and the appropriate width of target zones, there would be some question whether exchange rates could be kept within the zones, Mr. Goos commented. The staff had clearly noted that the task of maintaining rates within zones would have to be based mainly on monetary policy. He strongly doubted whether the participating countries would be willing to accept the necessary reduction in their ability to gear domestic monetary policy toward the meeting of internal objectives. In that connection, it was incorrect to point to the EMS as evidence that a system of target zones would function properly. After all, the EMS was operating in a rather unique political environment. In addition, the characteristics of the potential members of optimal currency areas suggested that any generalization of the experience of the EMS would be misleading.

It was also important to note that the functioning of the EMS despite the remaining inflation differential could hardly be divorced from the continued existence of capital controls, Mr. Goos went on. A system in which exchange rate developments would be controlled exclusively by monetary policy would be unacceptable. Even the proponents of target zones acknowledged that, as the staff had noted, many of the factors associated with the collapse of the Bretton Woods system had not disappeared, especially the considerable potential for speculative capital flows that could again easily swamp any attempt to stabilize the system. Such an attempt based exclusively or mainly on reliance upon monetary policy would probably have been futile had it been undertaken in the context of the increasing U.S. fiscal deficit in recent years; the immediate result would have been a surge in inflation in the United States together with unacceptable spillover effects in the rest of the world. A possible solution to such difficulties was perhaps the definition of sufficiently wide margins around an adjustable set of exchange rates, something that the supporters of target zones might propose. However, those zones would then probably have to be so wide that they would lose their ability to serve as an anchor for realistic exchange rate expectations.

In current and forseeable circumstances, there was no realistic alternative to the current system based on the floating of key currencies, Mr. Goos considered. The effort to improve the functioning of the present system must be based on a strengthening of the conditions for sustained and noninflationary growth in each country. At the same time, increased attention should be paid to the international repercussions of domestic economic policies with a view to ensuring the international compatibility of those policies. Such an approach should certainly encompass views--that need not be quantified--about the appropriateness of exchange rates, including their relationship to underlying economic and financial developments. His authorities had never considered exchange rate developments to be an unimportant consideration in the framing of their overall economic policy. Instead, they had consistently aimed at securing national and international compatibility of exchange rates without, however, accepting any set of quantitative targets.

While he had some sympathy with the proposal to introduce objective indicators or targets into multilateral surveillance, because their aim was to address the underlying causes of exchange rate misalignments, Mr. Goos said, he felt that the implementation of such a system along the lines of the G-24 proposal would be impracticable and indeed undesirable for the reasons mentioned on pages 33-35 of SM/86/5. During the previous annual review of surveillance his chair had expressed strong reservations about the general introduction of an enhanced surveillance procedure for major industrial countries based on a set of quantified and multilaterally negotiated objective indicators. Such mechanically imposed external constraints--which would be similar to target zones--might well be disregarded by members and might send the wrong signals about the need for adjustment. Moreover, they could not ensure an appropriate allocation of the adjustment burden among the participants. Executive Directors would have another opportunity to discuss objective indicators and similar

approaches during the coming review of surveillance; he would make comments on that matter and on proposed improvements within the existing institutional setting on that occasion. He continued to support fully the relevant G-10 Deputies' proposals.

Mr. Pérez noted that the discussion on the relative merits of floating exchange rates and alternative regimes had continued for a number of years. As the staff papers clearly showed, the list of arguments for and against particular systems was extensive. His comments would focus on some of the particularly relevant aspects of the functioning of the current system, focusing on the effects of exchange rate variability in developing countries and many industrial countries and on the proposals for improving the system.

It was widely acknowledged that the flexible exchange rate system had provided a much smaller degree of autonomous policy making than had been expected, Mr. Pérez continued. Since the breakdown of the Bretton Woods system in the early 1970s, the world economy had experienced much more instability than in the previous two decades: business cycles had been much more pronounced, as bursts of inflation had been followed by deep recessions that had profoundly affected the pattern of world trade, relative prices, and asset accumulation. Moreover, following periods of intense world trade activity and rapidly rising commodity prices, there had been periods of shrinking foreign markets, rapidly falling commodity prices, and rising protectionism. The terms of trade of a large number of countries and key relative prices, such as exchange rates and interest rates, had been unstable.

Financial markets had developed at an impressive pace in response to changing circumstances, Mr. Pérez said. While that development had helped to avoid more pronounced swings in economic activity in the 1970s, the increased capital mobility together with the improved mechanisms for resource transfers through financial markets had led to rapid changes in the pattern of asset accumulation together with erratic movements in exchange rates and interest rates. The rapid pace of debt accumulation of developing countries during the second half of the 1970s had resulted from the continued availability of enormous volumes of liquidity and from the trends in relative prices, which in turn had been due to negative real interest rates and increasing commodity prices.

The costs of exchange rate variability for developing countries had been substantial, Mr. Pérez observed. For example, there had been considerable uncertainty about trade and investment flows. As was noted in the G-24 report, developing countries usually did not have the ability to develop forward markets for their currencies and thus could not benefit from that mechanism for risk protection. A genuine float of the currency of a small country was likely to be highly unstable, owing to the inherent instability in the demand for national currencies of countries with open capital markets. The alternative of fixing the exchange rate to a major currency posed the well-known problems of the choice of a peg and required

the authorities of a small country to associate their policy instruments with those of the reserve currency center in the hope that the reserve currency country would maintain sound policies.

The costs of exchange rate variability and misalignment were traceable partly to the insufficient policy coordination among the main industrial countries, Mr. Pérez remarked. The erratic movements of key prices, such as real interest rates and commodity prices, might well have resulted from attempts by individual countries to maintain independent policies in an interdependent world. The system of floating exchange rates had given individual countries the necessary freedom to maintain independent policies.

The variability of exchange rates and other relative prices had caused enormous problems for developing countries, Mr. Pérez commented. The debt problem had emerged and had become a crisis largely as a result of the misalignment and volatility of key relative prices. Many industrial countries had also suffered from the behavior of interest rates, which had involved a major and costly trade-off between efforts to reduce inflation and to maintain adequate levels of economic activity and employment. Many industrial countries had been forced to maintain excessively restrictive monetary policies that had resulted in high real interest rates, intolerable levels of employment, and only a slow and gradual decline in the rate of inflation.

The problems associated with the current exchange rate system should not necessarily be blamed on floating exchange rates, Mr. Pérez remarked. Any analysis of those problems that was based exclusively on exchange rate arrangements must involve the traditional debate about the relative merits of floating and fixed exchange rates. In endeavoring to make a comprehensive presentation the staff had not emphasized the main dissatisfaction of developing countries and many industrial countries with the present international financial system: the absence of an adequate framework for policy coordination and discipline together with symmetrical adjustment. Policy coordination should be regulated and monitored through the Fund's surveillance. Of course, all the issues concerning the functioning of the current exchange rate system warranted careful examination, and much of the criticism of the proposals to limit the flexibility of exchange rates was valid. There were substantial difficulties in measuring directly the costs of exchange rate volatility on trade and in establishing conclusively the magnitude and duration of exchange rate misalignments. Moreover, it was true that a return to more fixed exchange rates would not ensure that countries would maintain more disciplined policies. The main ingredient in an effective exchange rate system was the willingness of the major industrial countries to coordinate policies in order to provide a stable economic environment.

Both the G-10 and G-24 reports agreed that the current exchange rate system should be improved, Mr. Pérez noted. They also agreed that the main ingredient in achieving that improvement was an increase in discipline

and coordination of macroeconomic policies in the major industrial countries. A framework for effective policy coordination should be provided in the context of multilateral surveillance.

Target zones could provide a useful framework within which to conduct multilateral surveillance, Mr. Pérez said. A credible commitment by the principal reserve currency countries to maintain their exchange rates within a specific range would help to stabilize market expectations, thereby considerably reducing the volatility of exchange rates. It might well be difficult to set and revise target zones for exchange rates--the efforts would involve the concept of an equilibrium level of the exchange rate--but, at the least, the clearest cases of exchange rate misalignment could be avoided.

The basic criticism of the target zone proposal was its supposed impracticality, Mr. Pérez noted. Critics of the idea had stressed that negotiating the zones would be so difficult that the resulting frictions that would be created among the main countries might further reduce the chances for policy coordination. They also believed that, even if target zones could be established, there was no guarantee that policy discipline would be increased or that policy coordination among the reserve currency countries would be enhanced. They argued that governments had traditionally been unwilling to adjust domestic policies in order to sustain a particular exchange rate regime and that the current forms of external pressure--such as Executive Board decisions concluding Article IV consultations, and World Economic Outlook reports--had been largely ineffective. They had further argued that if monetary policy were responsible for maintaining exchange rate stability, other instruments would have to be responsible for maintaining internal balance; fiscal policy was not thought to have the flexibility needed to play that role. As a result, the commitments resulting from the introduction of target zones could increase the difficulty in maintaining domestic stability. There was fear that the loss of such a powerful instrument as monetary policy could tempt authorities to impose discriminatory trade practices or other protectionist measures.

There was at least some merit in those arguments, Mr. Pérez continued. However, there were also significant counterarguments. Any workable proposal to improve the functioning of the present exchange rate system must be based on the willingness of the reserve currency countries to cooperate in providing a stable environment. Such an effort would inevitably require a substantial political commitment and the recognition that the international repercussions of the domestic policies of the major countries--which had become increasingly evident with the growing interdependence of countries--must be given priority in the design of domestic policies. An essential part of that commitment must be the acknowledgment that enhanced dialogue or peer pressure would not be sufficient to induce policy cooperation and that a more structured framework of cooperation was required. The subordination of monetary policy to the meeting of exchange rate targets need not undermine the attainment of domestic inflation goals

if exchange rate targets achieved through coordinated actions by the reserve currency countries were aimed at maintaining stability in the world money supply and did not accommodate pressures within the system.

Many of the potential drawbacks of target zones could be dealt with through a prudent and flexible design and implementation of a system of zones, Mr. Pérez considered. It might still be too early to discuss the detailed aspects of a feasible system, but some mix of the characteristics of hard and soft target zones would probably result in an adequate combination of flexibility and commitment.

In examining the proposals for increasing exchange rate stability, the staff had listed among the possible options the establishment of target zones and the use of objective indicators, Mr. Pérez noted. It should be noted that the G-24 report did not consider that objective indicators were an alternative to target zones; rather, they were complementary and were meant to fit together under the umbrella of multilateral surveillance. He agreed with the staff that, in principle, the setting of targets and the use of instruments should take place in a multilateral setting.

The establishment of a mutually consistent set of indicators need not conflict with target zones, Mr. Pérez went on. Indeed, the indicators could focus on policies that would support and lend credibility to the exchange rate commitments and on macroeconomic goals that seemed consistent with stated policies, the agreed exchange rate ranges, and a more stable world economic environment.

In advancing various proposals, Executive Directors should be careful to provide sufficient flexibility: there should be no expectation that external considerations alone would govern the setting of domestic policies in the major countries or that national sovereignty would be surrendered as a part of the increased policy cooperation, Mr. Pérez said. Those who favored objective indicators did not harbor such unrealistic expectations. Much of the criticism of objective indicators was based on their supposed impracticality, including the expected difficulty in reaching an agreement among the principal industrial countries. However, the successful coordination of exchange rates resulting from the September 22, 1985 G-5 meeting and the recent call by President Reagan to study a possible international monetary conference augered well for future policy cooperation and coordination.

Mr. Fujino remarked that possible improvements in the floating exchange rate system were to be a key topic of discussion during the next meeting of the Interim Committee. The staff paper provided useful background information on the perceived strength and weaknesses of the present system, but it did so within a basically theoretical framework. The staff could have usefully paid greater attention to the historical background to the adoption of the present system and to the political and economic factors behind the present inadequate amount of policy coordination among the major industrial countries. Without that broader framework

there was a danger that the discussion could be limited to a theoretical debate on an ideal system rather than encompass realistic ways of improving the present system.

The most important causes of the breakdown of the Bretton Woods system were the change in the structure of the world economy, the development of international capital markets, and the subsequent increased mobility of capital, Mr. Fujino continued. Those factors must be taken into account in any assessment of possible ways of improving the international monetary system. The Bretton Woods--or gold/dollar--system had been built on the premise of the predominance of the United States--or the U.S. dollar--in the world economy. The reconstruction of Europe and the growth of Japan and other countries had changed that premise, as the structure of the world economy had become more diversified. That change had contributed to the breakdown of the Bretton Woods system and was the main reason for the need for increased policy coordination among the major industrial countries. Such coordination was not easy, but considerable progress had been made. The process of improving policy coordination was obviously an evolutionary one. A consensus among major countries on a desirable orientation of policies had evolved, but the implementation of the needed policies could be much improved. The policy coordination among the five major industrial countries since September 1985 should be seen in the context of the evolutionary process that he had described and should not be linked too hurriedly to the idea of target zones.

The development of international capital markets and the increased mobility of capital had added to the difficulty in maintaining the Bretton Woods system, Mr. Fujino continued. It was inappropriate to attribute the short- and medium-term fluctuations of exchange rates solely to the adoption of the floating exchange rate system, but capital mobility had been a significant factor. Moreover, the variability of exchange rates had not exceeded the variability of other asset prices, and there was no convincing emperical evidence linking short-term exchange rate volatility to the volume of trade or capital movements. It was often said that developing countries suffered more than other countries from exchange rate volatility because of their lack of forward exchange markets. However, it was the instability of exchange rates between developing countries and major countries rather than the exchange rates among major currencies that mattered most in the trade of developing countries. Further liberalization of the trade and foreign exchange systems would contribute to the expansion of trade directly or indirectly by encouraging the development of forward markets or other hedging facilities.

Large and persistent exchange rate misalignments were obviously a cause for serious concern, Mr. Fujino said. However, given the present extent of policy coordination and capital movements, it was unrealistic to expect that a structured change in the exchange rate system would correct the misalignments.

His authorities associated themselves with the majority view in the G-10 Deputies' report on the exchange rate system, Mr. Fujino commented. Considerable progress had recently been made in improving the policy coordination among major industrial countries, particularly since the September 22, 1985 agreement on exchange rates. The increased cooperation had already corrected the prolonged misalignment of major currencies. Such efforts at coordination should be further strengthened.

Any proposal to increase exchange rate stability must be based on the present state of cooperation among major countries and would have to be judged on its potential contribution to reinforcing the efforts of such countries to enhance their policy coordination, Mr. Fujino considered. Excessively ambitious schemes ran the risk not only of failing but also of endangering the present degree of cooperation by crystalizing disagreement among the parties concerned. In that connection, his authorities found the proposals to establish target zones or objective indicators went too far and would in any event prove to be impracticable in certain circumstances.

It would be very difficult to reach a consensus on the desirable initial range of exchange rates for a system of target zones, Mr. Fujino went on. The staff had suggested three possible ways of identifying equilibrium exchange rates, had noted the advantages and disadvantages of each method, and had finally proposed to construct a "consensus" forecast on the basis of those methods. That proposal was not convincing, as each of the methods on which it was based had serious drawbacks. For example, under the underlying balance approach, it would be difficult to identify "normal" net capital flows and "underlying" current account positions. Even if such factors could be identified, the determination of the exchange rate would be heavily dependent upon the model used, and it would be difficult to reach an agreement on the appropriate model. In any event, the significance of a consensus exchange rate would be in question if it were based on methods that were not felt to be fully reliable.

Moreover, calculation outcomes might well differ widely, Mr. Fujino said. Indeed, in various recent studies that had been made available to his authorities, estimates of the so-called equilibrium yen/dollar exchange rate had ranged from Y 210 to Y 143; the difference was too large to draw a meaningful "consensus" exchange rate. Even if an agreement on equilibrium exchange rates could be reached, it would be difficult to allocate the burden of policy adjustment among countries. A fundamental criticism of the target zone system was that it would give policy priority to external goals over domestic objectives. In fact, the attainment of external balance should be consistent with the sustainable and balanced growth of the entire domestic economy. That approach was in the best interest of each individual country and of the achievement of sustained growth of the world economy. Constraints imposed by a target zone might undermine countries' efforts to seek sound and stable economic policies within a medium-term framework.

It was difficult in theory to assign policy instruments to individual policy objectives under the target zone approach, Mr. Fujino continued. Given the limited flexibility of fiscal policy, it would be unrealistic to expect to be able to rely on that policy as the sole instrument of achieving internal balance while monetary policy was geared to the achievement of external balance. Moreover, if target zones among major currencies were based upon currency zones or currency areas, the effort to maintain the zones could encourage the development of trade or economic blocks. Caution was required in any generalization of the experience of the EMS; the achievements under that system were the results of specific factors, including the homogeneity of the member countries, their strong political commitment, and the foreign exchange controls maintained by some of them.

A set of objective indicators was even less feasible than target zones, Mr. Fujino considered. It was unrealistic to presume that a consensus could be reached on a variety of mutually consistent policy targets and instruments. Even if the initial consensus were reached, unforeseen developments would eventually cause deviations, raising the need for discussions to identify the causes of the deviations and the allocation of the burden of adjustment among countries. Setting targets for major industrial countries that strongly influenced the course of world economic developments would perhaps be more difficult than setting performance criteria for users of Fund resources.

Improving the functioning of the international monetary system must be based on the present system and should further reinforce the policy coordination among major industrial countries, Mr. Fujino said. He endorsed the majority view in the G-10 Deputies' report, which emphasized, inter alia, the need to adopt sound, credible, and stable policies, consider the international implications and interactions of policies in the design of those policies, and strengthen surveillance through enhanced dialogue and persuasion through peer pressure.

Mr. Massé remarked that whatever exchange rate regime was in use, the coordination of proper macroeconomic policies among the major countries was a prerequisite for achieving exchange rate stability. The recent serious exchange rate misalignments had been due partly to the different stances and mixes of macroeconomic policies, which should not be seen as an inherent weakness of the floating system. His authorities saw no alternative in the present circumstances to an exchange rate system that had considerable flexibility. The system must be able to cope with a variety of unpredictable real shocks in as orderly a manner as possible.

His authorities recognized that there were certain serious weaknesses in the present international monetary system, Mr. Massé continued. Modifications to the system must focus not so much on the exchange rate system, as on the need to improve the mix of national policies and on examining ways of meshing the policies of the major countries. Multilateral surveillance should be strengthened, and the coordination of macroeconomic policies, especially among the larger countries, should be improved. The

focus of any improvement in the exchange rate system should be on the adoption of a framework within which due account would be taken of exchange rate movements in the formulation of macroeconomic policies.

He would not wish to go so far as to select a set of exchange rate objectives or target zones while other macroeconomic policy elements were not similarly programmed, Mr. Massé remarked. The fundamental external constraint on economic policy was the high degree of integration of the world goods and capital markets. That constraint was independent of the exchange rate regime, as macroeconomic policies invariably had international effects. If an exchange rate system were to function well, governments must recognize the need to give due weight to the international repercussions of the whole range of their macroeconomic policies. Hence, there was a clear need for a more effective system of multilateral surveillance and more explicit and active coordination of members' economic policies.

A strengthened system of surveillance should be based on a broad base of important indicators, including exchange rates, Mr. Massé went on. There was no obvious reason why exchange rates should be singled out explicitly for targeting; such an effort would not necessarily trigger a convergence of other policies. Unless governments were prepared to make basic compromises in the interest of improving international policy coordination, a system of target zones would do little good and might even delay needed exchange rate adjustment.

As he understood it, during their September 1985 meeting the G-5 countries had been specifically concerned about the inability of exchange markets to reflect recent shifts in fundamental economic conditions, Mr. Massé commented. His authorities warmly supported the shift in attitudes which was reflected in that meeting. He hoped that the G-5 countries would move quickly to involve the Fund in their deliberations by, at the least, inviting the Managing Director to G-5 meetings.

He had some sympathy for the supporters of the G-24 proposal on objective indicators, as it attempted to reconcile differences in policy stances of the major industrial countries, Mr. Massé remarked. However, there would be considerable difficulties in implementing such a strategy. For example, it would be difficult to maintain consistency in a range of policy targets and instruments that would require agreement not only within individual countries--something that was already difficult to achieve--but also among countries.

His authorities would be particularly concerned by a move to adopt a system of target zones, as the rigidity and uniformity in the application of such a system would likely mean that it could not provide the benefits of exchange rate flexibility, Mr. Massé said. Economies with different output structures reacted differently to real shocks. For example, the difference was evident in the real equilibrium exchange rate--the exchange rate, adjusted for differential price level changes, which was sustainable in the longer run--and it would not be optimal to base adjustment on

inflation or deflation of domestic prices. Changes in nominal exchange rates could help to ease the adjustment to real shocks, and exchange rates must therefore be sufficiently flexible.

The views of his Canadian authorities on target zones were strongly influenced by their own experience with fixed and floating exchange rates, Mr. Massé commented. Given the openness of the Canadian economy, the authorities felt that protection against external shocks, as well as the contribution to the adjustment process, by a floating exchange rate were crucial. Canada had generally benefited from a floating currency, both during the current regime of generalized floating and in the past, when only the Canadian dollar had floated, thereby enabling Canada to adjust when the trend in the balance of payments had become unsustainable.

The implementation of a target zone system among the major currencies might well create difficulties that would prove to be intractable, Mr. Massé remarked. For example, it would be difficult to agree on the initial matrix of exchange rates; the more countries involved, the greater the difficulty. It would also be difficult to define target zones through either the use of econometric techniques or the "underlying balance" approach. As Mr. Polak had mentioned, the exchange rate system could conceivably evolve into a set of EMS-type systems; however, that development would not minimize the difficulties that he had mentioned, especially the need to negotiate an initial matrix of exchange rates.

Target zones were therefore not a practicable, direct means of increasing exchange rate stability, Mr. Massé said. Instead, there should be greater convergence of the policies and conditions that had the primary influence on exchange rate movements. He was prepared to support further examination of the use of "soft" target zones as a means of initiating discussion of policies and conditions when so-called unduly wide divergences of exchange rates occurred. A soft and simply calculated target zone--based on, say, the concept of purchasing power parity--could be helpful in deciding when an "unduly" wide divergence was occurring, leading to a discussion of the influences at work and the possible steps that could be taken to deal with those influences.

Mr. Lankester remarked that there was theoretical and empirical support for a variety of positions on the key issues raised in the staff papers. His position on those issues was based on his authorities' experience over a long period with the U.K. pound as a reserve currency. The experience in the post-war era included nearly all the exchange rate approaches that were discussed in the staff papers. The United Kingdom had started the post-war period with a fixed exchange rate and had briefly maintained in the early 1970s what might be called a narrow target zone regime followed by various forms of floating--with varying degrees of intervention--as the external environment had changed over time. In addition, the United Kingdom, as much as any other major currency country, had experienced the effects of sharp changes in market expectations of domestic inflation and the impact of changing expectations about oil prices. As a result of those experiences, his authorities strongly

preferred the present floating exchange rate system, although they believed that the efforts to improve the system should be continued. While target zones might be appropriate for regional groups characterized by particularly strong economic and political cohesion, such as the EMS group, they probably would not prove to be workable among the major currencies.

His authorities had arrived at those conclusions for four reasons, Mr. Lankester continued. First, even if it were assumed that external and domestic shocks would cease, one could not determine, except within very wide bounds, the appropriate equilibrium exchange rate between the major currencies. That point was made on pages 8-9 of SM/86/5, which stated that "if, say, one third of the recent private net capital inflows into the United States were regarded as 'normal'...then one's estimate of the current misalignment of the U.S. dollar would be reduced considerably...." In addition, there were many exchange rate models, and the assumptions on which they were based could be subject to considerable disagreement.

Second, experience had clearly shown that currencies were subject to major shocks, Mr. Lankester continued. The most obvious example was the sharp changes in commodity prices in recent years. Such shocks affected the sustainable pattern of exchange rates over time, although the extent to which they did so could not be easily agreed. Of course, there had been external shocks in the 1950s and 1960s, and each country had the choice of absorbing the shocks through changes in economic variables other than the exchange rate. However, the number and severity of shocks in the previous 15 years had been such that no form of fixed exchange rates--even target zones with wide bands--would have been any more successful in dealing with the shocks than the exchange rate arrangements that had actually been in place. That conclusion was warranted by the experience of the United Kingdom. In 1977, in the wake of the implementation of a Fund-supported program in 1976 and with growing confidence in the North Sea oil sector, the United Kingdom had experienced a strong inflow of capital. For sometime thereafter the authorities had tried to cap the exchange rate through intervention. The authorities had subsequently concluded that the risks that were entailed by that approach for monetary expansion and inflation were excessively large. Hence, they had decided to take the pressure on the exchange rate instead, and, as a result, the nominal and real exchange rate had risen. The authorities could have conceivably decided to hold the nominal exchange rate through continued intervention, but the real exchange rate would almost certainly have risen in any event because of the faster rise in domestic prices in the United Kingdom than abroad resulting from the acceleration in the rate of monetary expansion in the United Kingdom.

The third lesson to be drawn was that market volatility--especially that resulting from the speculative pressures that were widely noted by many critics of the present exchange arrangements--would not fade away solely because of the adoption of some form of target zone or similar arrangement, Mr. Lankester went on. Since World War I, there had been a growth in the volume of finance which private sector holders and others could shift between currencies. So-called hot money had become a fact

of life, particularly in recent years, and had grown to an enormous size, dwarfing the intervention resources available to even the largest official operators. The adoption of targets would give speculators another factor to take into account in reaching their decisions but would not in themselves inhibit speculation. Indeed, once an exchange rate had reached the upper or lower limit of its band, speculators would feel encouraged to speculate, as they would in effect have a good idea of the likely subsequent movement in the rate.

A fourth lesson to be learned from recent experience was that in looking for improvements in the present exchange rate system, which had obviously been characterized by volatility and misalignments in recent years, Executive Directors should heed the staff's warning to avoid comparing the current system to some unobservable textbook ideal rather than to the flawed real world alternatives, Mr. Lankester commented. Exchange rate performance could be improved through practical changes, such as improved surveillance and greater cohesion of policies and economic performance of the main reserve currency countries. The increase in cohesion would not require a change in exchange rate arrangements. The United Kingdom's ability in recent years to reduce the inflation rate sharply, thereby bringing the rate closer to the rates in its major industrial competitors, while experiencing substantial swings in the effective exchange rate, underscored that point.

The September 1985 Plaza Agreement and its aftermath did not represent a move toward a form of target zone, Mr. Lankester said. It did represent an evolution in the willingness of the G-5 authorities to be active in influencing the path of exchange rates in exceptional circumstances with a view to achieving a needed correction of a major misalignment. That outcome would never have been possible had it required prior agreement on target zones or the setting of mutually consistent objective indicators for a number of countries. The agreement had been successful largely because the markets had been taken by surprise by the announcement on September 22, 1985 and had subsequently been kept guessing on the timing and ultimate extent of the desired adjustment.

Mr. Nimatallah considered that the United Kingdom's exchange rate experience was not typical of that of most members, because of the heavy influence of the oil sector on the United Kingdom's economy in general, and the exchange rate in particular. The U.K. authorities, like the Saudi Arabian authorities, probably had less control over the exchange rate than a number of other members.

He did not agree with Mr. Lankester that target zones would be unable to reduce speculation, Mr. Nimatallah commented. At the least, target zones would reduce the present large swings in exchange rates; speculation would be less substantial than at present. Moreover, while short-run exchange rate variability might not be reduced as a result of the adoption of soft target zones, misalignments could be detected earlier than at present, especially if target zones remained confidential. As a result, misalignments could be reduced before they became substantial. For

example, the recent misalignment involving the U.S. dollar could have been noted before the dollar reached its highest point in an upward trend that had adversely affected the U.S. external current account and European interest rates, which had been unnecessarily high. The misalignment of the U.S. dollar could have been detected at a relatively early stage if the major countries had held regular meetings examining the behavior of exchange rates within the context of soft target zones.

He fully agreed that surveillance should be improved, but effective surveillance required yardsticks against which to measure performance, so that the Fund could judge whether or not a member's performance was out of line, Mr. Nimatallah remarked. Soft target zones, together with the purchasing power parity concept, could provide the needed yardsticks. A recent issue of the Economist had contained a useful list of purchasing power parity rates, which could conceivably be helpful in the Fund's surveillance effort. Everyone agreed that surveillance could be improved, and the question at hand was how to do so. The use of soft target zones seemed to be a good answer.

Mr. Sengupta said that he agreed with Mr. Nimatallah. He wondered why Mr. Lankester felt that the September 1985 Plaza Agreement would not have been possible if the members concerned had had to agree on a set of target zones, equilibrium exchange rates, or desired exchange rates.

Mr. Lankester responded that oil was an important factor in the United Kingdom's position; indeed, the authorities felt that the markets attached excessive importance to oil sector developments. The U.K. authorities had stressed that oil was not the dominating influence in the U.K. economy, as some market participants seemed to think. The oil factor had made the U.K. authorities question the wisdom of joining the EMS.

Given the fiscal, monetary, and other imbalances that the United Kingdom had experienced over the previous several years, it was highly unlikely that the authorities would have been able to maintain the exchange rate within a particular zone, Mr. Lankester remarked. In any event, he doubted whether the G-5 members could have achieved their desired goal if they had negotiated a range of desirable exchange rates and then announced them to the world. The participants in the September 22, 1985 Plaza Agreement probably had assumed that they would be much more successful by fostering a degree of doubt in market participants' minds about the likely exchange rate developments.

Mr. Sengupta commented that Mr. Lankester seemed to be emphasizing the need for avoiding publicity about agreed exchange rate targets. Of course, soft target zones would not have to be made public.

Mr. Lankester noted that the participants in the September 1985 Plaza Agreement had not discussed particular exchange rates or even soft target zones. They had examined the need to achieve a realignment of exchange rates.

Mr. Dallara remarked that the one basic common view among the participants in the Plaza Agreement, as reflected in their communiqué, was that current exchange rates had not fully reflected the underlying fundamentals. Nothing more or less in the way of an agreement on exchange rates had been reached.

Mr. Sengupta commented that there obviously had been no indication of any movement toward concrete policy coordination with respect specifically to exchange rate zones or basic underlying factors during the negotiations on the Plaza Agreement. Indeed, it was precisely the need for such coordination that he and other Executive Directors had stressed. If the major countries had an understanding among themselves on indicative target zones--which need not have been publicized--the significant losses--$20 billion by Japan alone--due merely to changes in exchange rates in January-September 1985 could have been avoided. The objective was to introduce a system that would be based on a more rational mechanism that would avoid a recurrence of the major exchange rate fluctuations of recent years. Presumably the existence of an understanding on target zones would have facilitated the negotiations that had led to the Plaza Agreement.

Mr. Fujino said that it would be difficult for the major countries to hold discussions on hypothetical exchange rate targets. Exchange rates were determined basically by market forces, but it had been evident at the time of the Plaza Agreement that exchange rates were misaligned. The Plaza Agreement was important because of the policy commitment by the countries concerned to greater policy coordination that would be conducive to the needed realignment of exchange rates.

Mr. Lankester commented that the proof of the effectiveness of the Plaza Agreement was its actual result. There was a widespread feeling that the result had been relatively positive.

Mr. Nimatallah said that he attached great importance to enhancing policy coordination among the major countries, and he welcomed the evidence of such coordination since the Plaza Agreement. However, the objective of the present discussion should be to avoid the previous practice of waiting until a crisis occurred before the major countries held discussions examining the fundamentals and in which exchange rate policy was given sufficient prominence; in the past, exchange rate policy had been treated as a residual. There should be a system under which the fundamentals were examined on a regular basis to avoid substantial misalignments that had heavy costs for individual countries and the system as a whole. In sum, members should be able to identify currency misalignments before they reached the crisis stage. To that end, the members concerned should meet regularly and make use of certain yardsticks in measuring their policies. There would be no need to single out the exchange rate in assessing members' performance against established yardsticks. However, members should attach sufficient importance to exchange rate policy within a framework of policy coordination.

The Chairman remarked that some Executive Directors apparently felt that the effort to increase policy coordination would be facilitated by the existence among members of a "view" on the pattern of exchange rates that would be consistent with a set of coordinated and coherent economic policies designed to yield optimal growth and minimal inflation. Other Executive Directors apparently believed that it would be difficult to reach an agreement on such a view. Some Executive Directors thought that the Plaza Agreement was an overdue start in the direction of taking such a view, while others considered that it was merely an opportunity that had been taken by the G-5 countries to indicate to the markets that exchange rate trends had gone too far; it was not an indication of an agreement on a set of target zones but rather of the direction in which rates should be moving. The G-5 communiqué of September 22, 1985 had mentioned that the major currencies should appreciate against the dollar. The members concerned had also committed themselves to maintaining economic policies that would convince the markets that the direction of movement of exchange rates advocated by the G-5 countries was correct. It thus seemed incorrect to conclude that the Plaza Agreement was the first step toward the introduction of a set of target zones.

Mr. Sengupta remarked that if there had been some kind of trigger mechanism--based on soft target zones or some other indicators--for consultations among the major countries, an understanding like the Plaza Agreement might have been possible well before September 1985.

The Chairman recalled that an effort had been made in early 1985 to break the strong upward movement of the dollar. The September 1985 Plaza Agreement had taken advantage of the recent downward movement of the dollar and had given the dollar a push in the direction in which the market had already moved. The Plaza Agreement was skillful in terms of its timing; it had apparently accelerated the downward trend of the dollar in the market and had not attempted to counter a strong market trend.

Mr. Sengupta said that he fully agreed that an accord like the Plaza Agreement worked best when the relevant authorities were attempting to accelerate a trend that was already evident in the market. However, it would have been useful to encourage the major countries to hold discussions on the whole range of their macroeconomic policies.

The Chairman remarked that it was true that if the major countries had maintained a more favorable mix of policies in recent years, the overshooting of exchange rates evident in 1985 might well have been avoided. However, that conclusion had more to do with the whole range of policies and surveillance than with the issue of target zones.

Mr. Nimatallah recalled that immediately following the Plaza meetings Secretary Baker had mentioned that the economic fundamentals showed that the U.S. dollar was misaligned. It was worth asking what might have happened if the relevant authorities had recognized earlier that the economic fundamentals suggested that exchange rates were misaligned and

had agreed then to take appropriate steps to correct the misalignment. The proponents of soft target zones were in favor merely of the kind of mechanism that apparently had been used to reach the Plaza Agreement: the members concerned should reach a view, based on the economic fundamentals, and agree to take steps to correct obvious misalignments. It was incumbent upon the major currency countries to find a means of regularly communicating to the market their conclusion that the economic fundamentals suggested that there were serious exchange rate misalignments and that steps should be taken to correct them. Greater firmness was needed in running the international monetary system. There should be a regular means of assessing and taking a view on the economic fundamentals and their relationship to exchange rate zones and current exchange rates. That possibility should be further examined. Appropriate policies, policy coordination, and target zones were all required. Exchange rates should no longer be treated as a residual of other policies. Major countries should follow up an announcement about the appropriate trend in exchange rates based on the fundamentals with the adoption of policies that would ensure that the desired trend would be maintained.

Mr. Grosche remarked that the Plaza Agreement reflected a new awareness by major countries of certain problems. Those countries had concluded that a greater effort was needed to give some guidance to the markets. He would not be surprised to see additional similar meetings in the future, as necessary. Indeed, the need for such meetings in certain circumstances had been explicitly expressed in the G-10 report. Some of the proposals in that report concerning surveillance would provide better opportunities to draw members' attention to exchange rate misalignments owing to external or domestic policies. The G-10 report stressed the important role of the Fund and its Executive Board, whose comments would be taken into account by his authorities in the design of their policies. However, an approach under which definite steps would have to be taken whenever certain indicators suggested would not be workable.

Mr. Dallara recalled that in his statement after the Plaza meetings Secretary Baker had referred to the underlying economic performance and policies of the major countries. There had been significant changes in those conditions in the months leading up to September 1985 which had enabled the G-5 members to issue a statement that a convergence of economic performance was occurring and that they were committed to maintaining policies that would encourage that trend. Conditions had been much different eight or nine months prior to the Plaza Agreement than they had been at the time of that Agreement: U.S. economic growth had slowed in late 1984 and early 1985; the United States had managed to contain the fiscal deficit which, as a proportion of GNP, had begun to show signs of improving; and there had been positive signs in the performance of the U.K. and French economies. Moveover, all those countries had supported their positive trends with appropriate policy actions. For example, Germany had introduced significant tax reform measures and had continued its sound monetary policy. In Japan, further steps toward liberalization had been taken and additional positive statements by the Government on the economy had been made. As a result, the Plaza Agreement, including

its statement of policy intentions, seemed fully plausible to the markets. A similar agreement and statements well before September 1985 might well have not been as credible.

The success of the Plaza Agreement was not due to the increased awareness by the U.S. authorities alone of the need to act, Mr. Dallara went on. In fact, all the countries at the Plaza meetings had arrived prepared to cooperate and to make broad and fundamental policy commitments. The ultimate success of the Plaza Agreement depended upon the determination and ability of all the countries concerned to follow through on their policy commitments. The effort to strengthen the monetary system must rely upon the willingness of all major countries to take into account to a greater extent than hitherto the international implications of their policies. At the same time, the countries concerned must appreciate the ultimate domestic consequences of the international effects of all their policies.

Mr. Fujino remarked that the timing of the Plaza Agreement was crucial. Careful account had been taken of world market conditions, the economic conditions in the various countries concerned, and the recognition by those countries of the need for cooperation. The actions that the G-5 countries were taking to follow up their commitment under the Plaza Agreement were also crucial. For example, Japan's commitment was reflected in an increase in short-term Japanese interest rates and in the formulation of the Government's new budget.

The Chairman said that he fully agreed that the follow-up measures would lend credibility to the message conveyed by the Plaza Agreement.

Mr. Lankester commented that, as he understood it, economists had great difficulty in reaching a consensus on what exchange rates were appropriate at any given time. In that connection, he doubted whether economic models could be relied upon to produce appropriate results.

The staff representative from the Research Department responded that the degree of consensus on appropriate exchange rates varied from one period to another. In some periods, all the various methods for calculating equilibrium rates pointed in the same direction, thereby facilitating the reaching of a consensus. In other periods, the various methods might point in different directions, thereby making it particularly difficult to reach a consensus. The existing methodology could not be relied upon to identify equilibrium exchange rates within, say, 3-4 percent of the actual rate; there were too many variables involved and too many assumptions that had to be made to permit such accurate calculations. However, the calculations probably could be relied on in many instances to come within 10 percent of the actual rate and were therefore often helpful in identifying misalignments. In a sense, the Fund had to make such calculations one way or another whenever it was asked to take a view on the appropriateness of a member's exchange rate. A regular system of, say, a form of target zones, would differ from the present system in that it would enable the Fund to share its calculations more explicitly with the

market; the Fund's methods would be subject to scrutiny by the market and there would be a formal mechanism for making the calculations and revealing them to the market.

Mr. Zecchini considered that a major issue was whether the commitment to introduce appropriate policy measures reflected in the Plaza Agreement should have been made through a mechanism that would share the responsibilities concerned among a larger group of countries than the G-5 members.

Mr. de Groote remarked that it was helpful to distinguish between target zones and target directions. The staff representative had mentioned that it might be possible to establish target zones within a range of certainty of about 10 percent. He doubted whether even that range of certainty was possible. However, it might well be possible to determine whether certain exchange rates should move up or down; that kind of judgment apparently had been exercised by the participants in the Plaza meeting in September 1985. The participants in that meeting apparently had not had an exchange rate target in mind and would not wish to work with such targets in the future. However, they had obviously had a notion of the desirable direction of certain exchange rate relationships.

The timing of the Plaza meeting apparently had been dictated by circumstances, rather than by careful advance analysis and planning, Mr. de Groote continued. All the major countries had broadly perceived in September 1985 that the high value of the U.S. dollar had hurt U.S. exports and was causing a considerable intensification of protectionist pressures in the United States. There had been in effect a sudden realization that exchange rates mattered and that steps were needed to correct the current misalignments.

Mr. de Forges remarked that the staff papers were interesting and useful as reference material. They could have usefully included more empirical information on the evolution of the floating exchange rate system. In recent years, there had been a widely shared apprehension about the current exchange rate system, although there were different opinions about the most appropriate means of solving the problems with the system. The Bretton Woods system obviously had not been sufficiently flexible to absorb the significant changes in members' economies in the 1960s and 1970s. That rigid system had not been compatible with the opening of members' economies and developments in international commercial and financial transactions.

At the same time, there was a general agreement that the floating exchange rate system had not functioned as well as had been expected, Mr. de Forges went on. The system's main weaknesses were the excessive volatility of exchange rates in the short run and the substantial and persistent misalignment of exchange rates of the major currencies. Those trends had led to undesirable developments in international trade, investment, and financial relations.

The Plaza Agreement of September 22, 1985 had apparently started an era of concerted management of the parities of the main currencies, Mr. de Forges remarked. The agreement obviously represented a favorable trend that should be continued; that trend should gradually be formalized and institutionalized. In that connection, two conclusions were significant. First, the management of the exchange system and the strengthening of multilateral surveillance would work together toward the achievement of the same objectives--namely, the stabilization of the international monetary system and the creation of an international economic environment that was more favorable to growth. Second, members had to give the markets the assurance that they would do their best to avoid monetary disturbances and that should such disturbances appear and persist, the authorities would do their best to correct them. The Plaza Agreement had been operating on the basis of those two assumptions and had not led to undesirable reactions by the markets. His authorities did not attribute the absence of those unfavorable reactions solely to the surprise effect of the Plaza Agreement.

At the present stage, Executive Directors should avoid the persistent and not always useful debate on the usefulness of exchange rates as indicators of macroeconomic maladjustment and the compatibility of national policies, Mr. de Forges said. Exchange rates should perhaps not be singled out as indicators, but their behavior was an indicator of the relative evolution of members' economies; hence, it would be suitable to use the exchange rate as a trigger of multilateral consultations, which should also cover other aspects of a member's economic situation, including the external accounts, growth, and fundamental domestic factors.

The stabilization of the international monetary system implied that the autonomy of one country's policies ended where those policies directly and seriously affected the economies of other countries, Mr. de Forges remarked. The Plaza Agreement was based on the political will of the members concerned to cooperate. The persistence of that will should permit a progressive improvement in the international exchange rate system. That process should involve the adoption of reference zones for exchange rates which should be fully integrated into the effort to strengthen multilateral surveillance; those two elements were inseparable in the effort to stabilize the international monetary system and to create a more favorable international economic environment. The effort to strengthen surveillance would be ensured only if it included the Fund.

His authorities saw no need to engage in theoretical discussions on the specific modalities of reference zones, Mr. de Forges said. Such a debate would not be fruitful. There was obviously a consensus in favor of controlling the evolution of exchange rates, not in absolute terms but in terms of current exchange rate levels; that idea was consistent with Mr. de Groote's notion of a target direction.

The present discussion was a welcome opportunity to discuss exchange rates in light of the more favorable circumstances created by recent developments, especially the September 22, 1985 Plaza Agreement, Mr. de Forges

commented. As soon as an agreement on the basic principles was reached, his authorities were prepared to consider an appropriately pragmatic and gradual process of improving the exchange rate system.

Mr. Ismael remarked that the staff papers clearly identified the relevant issues and raised pertinent questions. While it was useful to compare the floating rate and par value systems, it was irrelevant to consider whether the par value system was a viable alternative to the present system. The G-10 and G-24 reports clearly showed that the par value system was no longer a feasible alternative. The staff could have usefully evaluated other possible approaches, such as the EMS. The absence of a staff appraisal in SM/86/5 was disappointing.

The staff papers had noted the main perceived weaknesses of the present floating exchange rate system, Mr. Ismael continued. Short-run exchange rate volatility and the misalignments of exchange rates were the most serious and damaging problems. To some extent, exchange rate volatility was to be expected in a freely floating system. However, the inherent instability of the present system was disappointing, as it made the system unpredictable and did not promote external equilibrium; those problems had become particularly acute in the wake of developments in capital transactions and improvements in communications. The weaknesses of the current system were reflected in the fact that, even in the longer run, trade flows and inflationary differentials had not promoted a desirable alignment of currencies.

There had been some progress in handling the exchange rate system, Mr. Ismael remarked. For example, members had realized that market forces could not always be depended upon to produce the correct currency values in a freely floating exchange rate system. That realization had paved the way for the industrial countries to undertake significant, concerted intervention in the market to realign the value of their currencies. He fully supported the G-5 actions in that direction. In the short run, they would serve as an entirely appropriate means of moderating currency fluctuations and of reinforcing underlying trends. The G-5 actions should not be a substitute for fundamental policy changes to correct deep-seated underlying misalignments.

The recognition that authorities should take a "view" on what an exchange rate should be--or at least on what the rate should not be--led to two significant conclusions, Mr. Ismael said. First, if an exchange rate were thought to be seriously inconsistent with economic fundamentals, it would be incumbent upon authorities to act. In the very short term, concerted intervention could be useful, but in the longer run, policy coordination to promote convergence would be required. Second, it should be possible to calculate so-called equilibrium exchange rates. The Fund had been judging the appropriateness of members' exchange rates for several years, and it should be able to do so in the future.

It was common knowledge that persistent misalignments of exchange rates were due to divergent monetary and fiscal policies, Mr. Ismael remarked. That conclusion had been mentioned in both the G-10 and G-24 reports. To promote exchange rate stability macroeconomic policies must be directed at achieving the convergence of economic performance of the major industrial countries. He did not agree with the G-10 report that small changes in present procedures would promote discipline in the conduct of domestic policies of the large industrial countries, particularly the key currency members. More significant safeguards were required.

Industrial and developing countries were worried about the risks posed by protectionist pressures in the major countries whose currencies were substantially and persistently overvalued, Mr. Ismael said. Although the present exchange rate system had certain merits in theory, it was constantly subject to the danger of protectionist pressure.

The floating exchange rate system had certain strengths, Mr. Ismael went on. To some extent, it had promoted economic adjustment, especially in smaller members. However, he doubted whether it had promoted adjustment in the key currency countries.

In their search for a consensus on means of increasing exchange rate stability Executive Directors should bear in mind the common views expressed in the G-10 and G-24 reports, Mr. Ismael remarked. The G-10 report could be fairly described as a reaffirmation of faith in the existing institutional framework. It was less critical of the existing system's performance than the G-24 report and had concluded that no fundamental changes in the exchange rate system were necessary and that only modest changes in the Fund's multilateral surveillance were required. The G-24 report emphasized that peer pressure through "enhanced" dialogue would be sufficient to address the weaknesses of the present exchange rate system. The G-24 Deputies had concluded that neither target zones nor a set of economic indicators were necessary.

The G-24 report was based on the perception that the present exchange rate system and institutional procedures could not ensure exchange rate stability, Mr. Ismael continued. The institutional arrangements had failed to promote policy coordination and economic convergence. The enhanced dialogue recommended by the Group of Ten probably would not yield the required results.

A return to the par value system was out of the question, Mr. Ismael commented. The main issue at hand was whether the floating exchange rate system could be improved through the adoption of target zones that would ensure exchange rate stability and whether that system could be supplemented by more demanding multilateral surveillance. A good case on theoretical and practical grounds could be made for establishing target zones for key currencies. The rationale for maintaining the EMS was the same as that for introducing a workable set of target zones.

He doubted whether much would be gained by improving the present surveillance framework on the basis of the G-10 proposals, Mr. Ismael remarked. Enhanced dialogue and peer pressure were worth examining, but they would probably prove to be inadequate.

The staff's presentation of the issues was illuminating and interesting, although in some parts the emphasis was misplaced, Mr. Ismael said. The choices to be made by the Interim Committee had not been greatly facilitated by the papers and the Executive Board's discussion on them, as many convincing points had been made on both sides of the arguments on the various issues. On balance, he favored retaining the present flexible exchange rate system because of its inherent strength from its flexibility. However, the system could sometimes become distorted because of the ability of many countries to ignore market pressures and the implications of economic fundamentals.

The causes of the problems facing the current exchange rate system were inappropriate and inconsistent policies, and a more determined policy effort could solve those problems, Mr. Ismael considered. However, he doubted whether the major countries were ready to eliminate their differences of opinion and national objectives to cooperate voluntarily; more demanding multilateral surveillance procedures were required. The recent moves by the G-5 countries were in the right direction but must be followed by the implementation of the kinds of policies that Executive Directors had mentioned during the present discussion. The increased mobility of capital in recent years among industrial and developing countries had profoundly affected exchange rates. That subject had been barely touched upon during the present discussion.

In the circumstances, the proposal to adopt target zones should be further examined, Mr. Ismael stated. He had an open mind on the proposal to set targets for established indicators within the context of multilateral Fund surveillance. However, surveillance needed more modifications than the Group of Ten had proposed if it were to be made more effective. He doubted whether, as some had claimed, that exchange rate targets would be impossible to establish. The strength of the G-24 proposal concerning multilateral surveillance was the potential improvement in the framework for procedures for consultations, rather than the setting of targets or indicators; the potential improvement merited further detailed exploration.

The Executive Directors agreed to continue their discussion in the afternoon.

DECISION TAKEN SINCE PREVIOUS BOARD MEETING

The following decision was adopted by the Executive Board without meeting in the period between EBM/86/24 (2/11/86) and EBM/86/25 (2/12/86).

2. EXECUTIVE BOARD TRAVEL

Travel by Executive Directors and by Advisors to Executive Directors as set forth in EBAP/86/33 (2/10/86) is approved.

APPROVED: September 29, 1986

LEO VAN HOUTVEN
Secretary