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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/26

3:00 p.m., February 12, 1986

J. de Larosière, Chairman

Executive Directors	Alternate Executive Directors
	K. Yao, Temporary
C. H. Dallara	
J. de Groote	H. G. Schneider
	S. de Forges
	M. B. Chatah, Temporary
H. Fujino	M. Sugita
G. Grosche	B. Goos
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A. Kafka	
T. P. Lankester	M. Foot
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: H.-J. Huss, K.-W. Riechel. Exchange and Trade Relations Department: G. Bélanger, P. J. Quirk. External Relations Department: M. Goldstein. Legal Department: 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. Western Hemisphere Department: S. T. Beza, Associate Director. 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, J. Hospedales, A. Ouanes, G. W. K. Pickering, I. Puro, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: M. Arif, B. Bogdanovic, J. de la Herrán, F. Di Mauro, J. J. Dreizzen, G. Ercel, S. Geadah, V. Govindarajan, G. D. Hodgson, L. Hubloue, A. R. Ismael, Z. b. Ismail, S. King, M. Lundsager, A. H. Mustafa, W. K. Parmena, J. Reddy, J. E. Rodríguez, L. Tornetta, A. J. Tregilgas, H. van der Burg, Wang X., Yang W.

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

The Executive Directors continued from the previous meeting (EBM/86/25, 2/12/86) their consideration of 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. Rye said that his general remarks would mainly reflect the views of his Australian authorities. There was widespread agreement that the functioning of the present international monetary system had serious weaknesses and should be improved, although the present discussion had underscored the differences in views on possible remedies. He too was concerned about the weaknesses of the system and agreed that they should be seriously examined, but some exchange rate volatility was inevitable, particularly in an environment of deregulated international capital markets. In addition, it was important to bear in mind the advantages for the major currencies of the present system of exchange rate flexibility.

There was a broad range of current exchange rate arrangements, with pegged rates far outnumbering floating rates, Mr. Rye continued. In a sense, the so-called exchange rate system was in effect a nonsystem in comparison with the clear-cut exchange rate arrangements under the Bretton Woods system. The diversity of the present exchange rate arrangements was a reflection of the fact that the optimal degree of exchange rate flexibility varied from country to country, depending upon the structure of the economy and the closeness of the ties between the country's domestic market and world markets. That fact was fully consistent with the arguments in favor of maintaining a floating regime for the major currencies. A country that had a legitimate interest in stabilizing its exchange rate would be more than willing to do so if the country to which its currency was tied had appropriate basic economic policies and objectives, including the maintenance of domestic monetary stability. That conclusion underscored the importance of focusing attention on economic policy choices in the major industrial countries rather than on casting about for radical changes in the present exchange rate system. Indeed, there was a danger that focusing attention on alternative exchange rate systems, rather than on the root causes of exchange rate misalignments--namely, the stance, mix, and divergence of members' policies--might lessen the pressure for corrective action.

A major question at the present stage was the contribution that potential changes in the exchange rate system could make to achieving greater exchange rate stability, Mr. Rye remarked. The same question could be put as follows: could sufficiently improved macroeconomic policy discipline and increased policy coordination be achieved without changes in the exchange rate system? In one sense, the particular exchange rate regime was of secondary importance; what mattered most was whether governments were prepared to maintain monetary and fiscal policies that were consistent with their exchange rate objectives. The effective operation of any exchange rate system would be in doubt until governments marshaled the political will to adopt sound, credible, and stable economic policies.

In Section IV of SM/86/5 the staff presented three broad categories of measures, ranging from comparatively moderate changes in existing institutional arrangements, to fundamental changes, Mr. Rye noted. The various measures were not mutually exclusive. Both the G-10 and G-24 reports had concluded that the most important needed improvement in the exchange rate system was an increase in policy discipline and coordination. He agreed with that conclusion, although governments should of course retain sufficient flexibility to adapt monetary and fiscal policies to current economic and political circumstances. The causation between exchange rate and macroeconomic policy stability was two-way: stable macroeconomic policies should be conducive to exchange rate stability, while greater exchange rate stability reduced the likelihood that domestic policies would be thrown off course by short-term exchange rate fluctuations. The proponents of more far-reaching changes in the international monetary system had overlooked the complexity of international economic linkages, the knowledge about which was limited; it was impossible to predict confidently how all the interrelationships would evolve under a network of target zones or objective indicators. Hence, he was inclined to conclude that it would be most productive to seek improvements within the existing framework of the current system rather than to press for major changes in the framework itself. The success of any new initiatives would obviously depend significantly on the support that they received from major industrial countries.

The target zone proposals covered a wide spectrum of arrangements, ranging from a system of hard zones under which monetary policy would be geared toward maintaining the exchange rate within a narrow, infrequently revised and publicly announced zone, to a system of soft zones under which monetary policy would play only a limited role in meeting external objectives and the zones would be wide, frequently revised, and confidential, Mr. Rye remarked. The target zone proposals also encompassed a wide range of possible mechanisms for encouraging policy discipline and coordination, but he was unconvinced that they offered a reasonable prospect of actually contributing to increased fiscal discipline and policy coordination. The durability and practicability of target zones would depend significantly on the kind of zones that were adopted. He was particularly skeptical about the feasibility of the harder versions of the target zone proposal, even excluding the relatively small likelihood that the major industrial countries would be willing to make the major commitment to exchange rate objectives that such a system would imply. A system of rigid, narrow zones would probably be relatively vulnerable to speculative capital flows and would require complex administration as well as formal negotiations to achieve the policy coordination that would be required under such a system. Those problems would be much less evident under a system of softer zones.

short-run exchange rate volatility could be linked to the dichotomy between exchange rates and the evolution of economies and to the consequent uncertainty about the longer-run sustainability of exchange rate movements that were inconsistent with economic fundamentals. No one could argue that the floating exchange system was responsible for those undesirable developments.

The trend toward integrated national and international capital markets, together with the tendency of financial markets to adjust much more quickly than trade flows to changing economic and financial conditions, had contributed as much as the exchange system itself to the overshooting of exchange rates, Mr. Zecchini noted. The flexibility of the system, although it had not been a cause, had played a fundamental role in facilitating the maintenance by members of inadequate economic and financial policies. The floating exchange rate system had not provided members--especially the major ones--with sufficient incentives either to adopt appropriate policies or to make them coherent in an international context. The obligation to defend a certain parity under the fixed exchange rate system had given members greater incentive to maintain economic policy discipline. However, that system had lacked the appropriate instruments to provide for symmetrical external adjustment between deficit and surplus countries as well as the needed coordination among national economic policies. Stability or flexibility in an exchange rate system were not values that must be pursued for their own sake; but they were best suited to serve for the achievement of the broader economic objectives. That conclusion was important to bear in mind in considering the need to improve the present international monetary system. Among those broader objectives, the mere development of international trade was not the most important one; there was no clear, direct link between the exchange rate regime and the rate of expansion of world trade. The various studies on the impact of exchange variability on trade had been unable to come to firm conclusions. In any event, there were various techniques to hedge exchange rate risks in trade contracts.

The long-advocated improvement in the present exchange rate system was needed mainly to reach two objectives--namely, greater economic discipline, and more effective coordination of the macroeconomic policies of major countries, Mr. Zecchini continued. Those objectives were equally important and inseparable, as sound domestic policies without international coordination would not be sufficient to guarantee the balanced development of the world economy. If that framework for the discussion was shared by the G-10 as well as the G-24 countries, then the issue that confronted the Executive Board was, as the staff had pointed out, what mechanism was most appropriate to attain the goals. He would consider in turn the three options: (1) the target zones for the exchange rate of major curencies; (2) the idea of objective indicators; and (3) adjustments in the surveillance procedures.

The present was not the right time for an abstract discussion on each option, but it was useful to consider in a pragmatic and constructive way the proposed options, Mr. Zecchini said. He had an open mind on the target zone proposals. Target zones could meet the needs seen by many for greater stability in exchange rate relationships, which could be gained only by consistent policies. There were of course a number of gray areas concerning the design and implementation of a target zone mechanism. For example, there was still some uncertainty about which features of a target zone system would represent an improvement over the existing exchange rate system, whether the new system would be acceptable to governments, and whether it would be operationally viable.

Hard target zones would certainly be more constraining than the present exchange rate system, as monetary and fiscal policies would have to be aimed at maintaining a particular exchange rate, Mr. Zecchini went on. In addition, hard zones would encourage countries to face the need for internationally consistent policies and would give the market some guidance about the likely future course of members' policies. However, he doubted whether it would be wise to base monetary and fiscal policies solely on the need to meet a particular exchange rate target. It would be difficult to arrive at an appropriate target for the nominal exchange rate, and deviations from the target might not always constitute a signal that economic policies were inadequate and might not give an explicit indication of the direction of appropriate policy adjustments. At the same time, targeting real exchange rates in the short run might discourage members from countering endogenous inflationary pressures, as the targeting would amount to an accommodation of inflation differentials between countries. Moreover, the target zone mechanism would not help to solve the problem of the lack of symmetry in adjustment among members. If the difficulties that he had described were dealt with through frequent changes in the targets, the target zone mechanism would lose the advantages of policy discipline and stabilization of market expectations and could conceivably have adverse effects in both those areas; that outcome was also likely even with a set of soft target zones, which would not by itself constitute a significant improvement over the present exchange rate system.

He did not believe that the experience of the European Monetary System (EMS)--an example of successful targeting of exchange rates--could be extended to other major currencies, Mr. Zecchini said. Two significant ingredients for the successful extension of the EMS were lacking--namely, a design for economic and market integration, and the financial mechanism that would support the new monetary arrangement. An exchange rate contained a sizable amount of information on the appropriateness of a member's economic policies but should not by itself be the sole indicator of that appropriateness or a main constraining factor on policies. Given the present unsettled conditions in the world economy, it was important for members to maintain some flexibility while striving for more stable monetary relationships and a better balance between domestic and international considerations in the management of the larger economies. The target zone proposal contained some useful elements that, together with elements of other options, could contribute to improving the functioning of the international monetary system.

He strongly doubted whether the proposed objective indicators would be practicable and effective, Mr. Zecchini said. The same doubt had been expressed when the proposals had been examined in the 1970s. It could be very difficult to agree on a precise and binding quantification of the relationship between targets and policy instruments, to select an internationally consistent set of targets and instruments, and to ensure that members would correct their economic policies in response to deviations from the agreed targets.

Seeking improvements in the present institutional setting of the Fund's surveillance seemed to be the most promising of the several optional methods mentioned by the staff of improving the exchange rate system, Mr. Zecchini said. The proposal to improve the institutional setting would probably command widespread support among members and be implemented quickly, as it would not involve drastic departures from the present evolution of the floating exchange rate system. The institutional setting approach could incorporate valuable elements of the target zone and objective indicator proposals. For example, exchange rate changes together with changes in some macroeconomic variables related to the external accounts; monetary and fiscal policies could be seen as indicators of impending or emerging policy inconsistencies. A soft version of the target zones could be included as a part of the broader approach based on intensified surveillance. That set of indicators could serve to trigger consultations, policy reviews, and adjustments accompanied, whenever necessary, by exchange market intervention of the kind that had been agreed upon by the G-5 members on September 22, 1985. Under that approach, neither exchange rate targets nor other quantitative targets would replace a comprehensive judgmental assessment of the appropriate course of members' policies. That assessment could provide an incentive for or exert pressure in favor of responsible policy conduct. The relevant issues could be further examined during the coming discussion on surveillance.

Mr. Yao remarked that the international community seemed to be more receptive than ever before to a reform of the floating exchange rate system. The main issues concerning the improvement of the floating system were clearly spelled out in the staff papers but were controversial and complex. The opponents and supporters of the present exchange rate system were polarized, and existing theory explained only partially the behavior of market-determined exchange rates.

The present exchange rate system had hurt the developing countries, Mr. Yao stated. For many of those countries, the system had fallen short of expectations. It had generally been believed that the system's flexibility would enhance its stability, thereby paving the way for expanded trade and more rapid economic growth and development. In fact, however, there seemed to be a consensus that the present system had permitted excessive volatility and that the deviation of market rates from fundamental equilibrium rates had been persistent; they had not been self-correcting, as had been expected. Those developments had adversely affected the terms of trade of developing countries and had made debt management particularly difficult.

Most primary commodities exports of developing countries were quoted in dollars, while a large proportion of those countries' imports of manufactured goods were denominated in the currencies of the exporting industrial countries, Mr. Yao commented. Hence, the fluctuation in the major currencies had affected the terms of trade and current account positions of developing countries irrespective of their underlying economic conditions. The wide fluctuations in the terms of trade had increased the uncertainty about the profitability of investment projects, thereby contributing to the increase in the internal rate of return on projects to be undertaken and a reduction in the level of investment which had undermined the prospects for medium-term economic growth.

The volatility and misalignments of exchange rates had weakened the ability of developing countries to service their debt, thereby contributing to the onset of the debt crisis, Mr. Yao remarked. In the 1970s, most developing countries had borrowed heavily, and the currency composition of their debt had reflected largely their long-term assessment of the behavior of their respective currencies. In the 1980s, the misalignments of the major currencies, together with high interest rates, had increased the debt service ratio of developing countries to an unsustainable level. Those problems had resulted in the accumulation of arrears and the restructuring of debt, with developing countries bearing the brunt of the required adjustment.

The evolution of exchange rates had also undermined the economies of developed countries, Mr. Yao noted. For example, the United States had recorded large and growing current account deficits, while Japan and Germany had registered growing current account surpluses, owing largely to the misalignment of exchange rates. Those persistent external disequilibria had intensified protectionist pressures, which had encouraged the G-5 countries to reach the September 1985 Plaza Agreement.

The volatility and misalignment of exchange rates under the floating exchange rate system had obviously adversely affected the world economy, Mr. Yao said. Given the adverse effects of the present system on investment and economic growth in particular, his authorities believed that a reform was required with a view to making the flexible exchange rate system more stable. They did not believe that a return to a fixed exchange rate system was a viable solution. However, experience suggested that government intervention in the exchange rate market was needed to increase the market's efficiency and to reduce or eliminate the destabilizing fluctuations that had characterized the floating exchange rate system. Whether the intervention was carried out as a result of peer pressure, as proposed by the Group of Ten, or a set of rules, as proposed by the Group of Twenty-Four, a set of indicators should be agreed to provide guidance to the major currency countries.

In an internationally integrated financial market, the policies of the major countries profoundly affected the world economy through the exchange rate market, Mr. Yao remarked. Accordingly, a crucial issue was whether the behavior of exchange rates would be based on deliberate policy decisions or would merely be a residual of members' policies. To achieve the desired exchange rate stability, the major countries should take into account the international consequences of their economic policies and should coordinate those policies with a view to reducing the divergence in inflation and payments imbalances.

The determination of a fundamental equilibrium exchange rate would be a thorny issue in the formulation of a set of target zones, Mr. Yao commented. There was no satisfactory method for estimating and forecasting equilibrium exchange rates. That problem could be overcome if the international financial community was willing to act in a coherent manner to develop a stable exchange rate system that would be conducive to an expansion of world trade and to the attainment of payments equilibrium in both developed and developing countries.

Mr. de Groote remarked that the Executive Directors should endeavor to identify the areas of agreement and to chart a possible course of further action by the Interim Committee. The progress report to the Interim Committee could be based on what seemed to be the emerging agreement on the following three propositions. First, the operation of the present exchange rate system should be improved in order to eliminate excessive short-term exchange rate volatility and long-term exchange rate misalignments. The G-10 and G-24 reports and all Executive Directors who had spoken thus far agreed on that point. Second, there should be closer coordination of domestic policies by the major industrial countries, and greater weight should be given in the formulation of domestic policies to the international effects of those policies in order to make further progress toward greater exchange rate stability.

The third proposition was that it was likely that the adoption of a less dogmatic, more eclectic approach to improving the system would be a suitable way to break the stalemate that had arisen from the practice of regarding individual proposals as mutually exclusive absolutes, Mr. de Groote continued. Under the approach advocated at the present meeting by Mr. Polak and Mr. Kafka, the Executive Directors could single out the meritorious features of each of the different proposals and see how elements of those proposals could be combined as circumstances permitted. Such a pragmatic approach had been greatly facilitated by the acceptance--reflected in recent policy decisions--by the major industrial countries of the need to take exchange rates into account. The proposals for major reform did not envisage a system in which domestic policies would be absolutely constrained by exchange rate considerations.

Further research was needed on the consequences of the present exchange rate conditions for the developing and small industrial countries Mr. de Groote considered. The extensive body of available empirical evidence suggested that the damage done by exchange rate volatility to the expansion of international trade might be less severe than had originally been thought, but that conclusion was not applicable to the developing countries, most of which did not possess exchange and money markets that were sufficiently developed to protect them from exchange rate uncertainties. He was not fully convinced by the staff's argument that developing countries' access to the Eurocurrency markets filled that gap, as the markets still did not allow those countries to hedge exchange risks against their own currencies.

Another manifestation of exchange rate instability--large exchange rate misalignments--merited even closer attention, as there was ample evidence that they created distortions in each member's real economy which were difficult and costly to correct and fostered protectionism, Mr. de Groote said. In its further study on exchange rates the staff should focus on the different kinds of harmful spillover effects of persistent misalignments of the major currencies and should assess more systematically the various economic costs that they continued to impose. The study might usefully compare those misalignments with the misalignments of real exchange rates that could occur under a fixed exchange rate system as a result of the divergence of national price levels. Such a study might well lead to the conclusion that no matter what kind of exchange rate system was adopted the implementation of conflicting policies by the major countries created misalignments that spilled over into those countries' own economies, impairing their ability to maintain independent domestic policies. That conclusion certainly seemed appliable to the U.S. authorities who, given the need to avoid the inflationary consequences of a hard landing of the dollar, had found themselves unable to follow the preferred course of easing domestic interest rates in order to consolidate the growth momentum. As disillusionment with the supposed major advantage of the floating exchange rate system--namely, the ability of members to maintain independent domestic policies--became increasingly widespread, policymakers who still hesitated to give more weight than hitherto to the international effects of domestic policies might conclude that a more cooperative approach to the conduct of domestic policies would benefit all the parties concerned, including themselves. An important achievement of the Plaza Agreement was the explicit recognition of the domestic benefits of the so-called concerted approach.

Since that notion was widely accepted, it might be possible to devise a gradual, stepwise approach to increasing international coordination of domestic policies, which would explicitly take into account exchange rate developments, Mr. de Groote continued. That approach could pragmatically combine the meritorious features of each of the proposals for improving the functioning of the present exchange rate system. Accordingly, the three main proposals mentioned by the staff could be seen as elements of a combined approach: Fund surveillance should result in a consensus on compatible economic policies among the major countries and groups of countries; the consensus would have to be based to some extent on an agreement on the desirable direction of the movements of the key currencies; and the consensus on those target directions could usefully be supported by an understanding on some objective indicators, which could gradually be perfected.

The G-10 proposals to improve bilateral and multilateral surveillance were welcome steps toward improving existing procedures and analytical instruments, but they were based on the conviction that sound, stable domestic policies were the key to achieving satisfactory economic growth together with a high degree of exchange rate stability, Mr. de Groote commented. That conviction was not consistent with the experience of recent years, which suggested that domestic policies that were merely sound and stable might not suffice to ensure desirable outcomes if exchange rates were inappropriate. For example, the efforts by the United States to accelerate economic growth--which were fully justified by the country's favorable inflation record--together with the monetary and financial discipline in other major industrial countries, which was equally justified by the persistent rigidities in their domestic markets, had resulted in an excessive absorption of world savings by the U.S. economy and in a consequent steep appreciation of the dollar. The failure of the present exchange rate system to achieve greater convergence among the major countries had consistently prevented a more even distribution of economic growth that would have especially benefited the developing countries and had created the uncomfortable situation in which world economic growth generated by the United States had tended to be counteracted by adjustment pressures from the exchange markets and by persistent high interest rates. The staff should study the possibility that the present exchange rate system was biased toward the use of deflationary policies.

The proposed target zones and set of objective macroeconomic policy indicators could be significant elements of the combined approach that he had described, provided that the notion of target zones were replaced with the idea of target directions and that the so-called objective indicators were regarded as ancillary tools to be used to various degrees and in changing forms to aid in the discussion on the target directions for the exchange rates of the key currency countries, Mr. de Groote said. Discussion in the Executive Board and among the authorities of the key currency countries on the direction of exchange rates would increase exchange rate stability by anchoring medium-term exchange rate expectations in the market and by restoring discipline in and increasing the coordination of the conduct of macroeconomic policies. The ability to effect changes in the policies of large industrial countries would be the most welcome by-product of negotiations on target directions and would reduce the existing asymmetry in the adjustment process. Of course, the results would differ widely depending on whether the directions were "hard" or "soft," or "loud" versus "quiet," but the G-5 agreement of September 1985 suggested that such directions might yield meaningful results. Collective assessments of recent exchange rate behavior together with coordinated market intervention to correct that behavior had proven effective in attacking speculative bubbles and in drawing the market's attention to the underlying fundamentals.

It would be useful to promote a better perception of those fundamentals by devising some indicators that would be used--without any coercion--merely to signal the appropriate direction of the major exchange rate relationships, Mr. de Groote remarked. For example, it would be interesting to compute what the target directions might be for the five major currencies, or for the U.S. dollar, the yen, and the European Currency Unit, with some correction for the hypothetical inclusion of the U.K. pound. It would be helpful to compare the results of using the three methods proposed by the staff, adjusted for the use of target directions rather than target zones. It seemed to be widely accepted that consultations on economic policy were needed in the Fund and among the key currency countries, and that the direction of exchange rate movements was of common concern to members.

The adoption of a target direction system would have implications for the functioning of the reserve system, as it might require the reserve currency countries, or at least some of them, to intervene periodically in the exchange markets either to reduce the level of their exchange rates or to keep the rates from falling below an acceptable level, Mr. de Groote commented. Meeting the latter objective would of course require either the use of swap arrangements among the major currency centers or, preferably, the availability of SDRs on a sufficient scale to be used in exchange market intervention. Several speakers had mentioned the EMS, but it was important to remember that that system had proved workable not only because it allowed for adjustment in the exchange rates when needed but also because its members had made substantial amounts of additional financing available to each other, thereby permitting them to intervene in their exchange markets. Some EMS members already used their SDR position in the Fund to settle their balances resulting from such financing. An important role for the SDR--which could require new allocations--might be to assist in the implementation of a more generalized system of intervention.

Commenting further on target zones--as distinct from target directions--Mr. de Groote said that the exchange rate itself admittedly did not provide a sufficient means of detecting incorrect macroeconomic policies, and target zones were therefore not a sufficient technical indicator for monitoring those policies. Moreover, target zones would give no guidance in the choice of policy instruments to use in response to departures of exchange rates from the zones, and they would not help to allocate the burden of adjustment properly among members. The use of target zones could therefore lead to frequent conflicts of views among participating members and to an overreliance on monetary policy adjustments instead of adjustments in other, less flexible policies.

For those reasons, any agreement on the desirable pattern of exchange rates for the major currencies should be expressed only in terms of target directions and should be supported from the outset by understandings on a set of desirable macroeconomic objectives and policies to achieve those objectives, Mr. de Groote continued. Such an approach would have to be developed slowly, on the basis of experience with bilateral and multilateral surveillance and with the emerging policy coordination among the G-5 members, leaving room for further strengthening of the approach as circumstances might permit. The staff should study possible schemes under which such an approach could gradually be set in place and should identify the policy areas where firm understandings would be essential to attaining the desired degree of exchange rate stability.

In that connection, the EMS could provide important lessons, as it had become clear that the viability and credibility of that system depended to a large extent on the periodic adjustment of central rates in response to the diverging policy stances of the EMS members, Mr. de Groote remarked. A more stable and credible exchange rate system among the major industrial countries would not require excessive rigidity or an excessive loss of independence in the formulation of domestic policies. A few prudent steps in the direction of such exchange rate stability should be taken, especially as that objective seemed to be supported by the highest authorities in several of the major members.

Mr. Abdallah said that he would comment on the issues raised in the staff papers that were of particular interest to the countries in his constituency. There seemed to be a broad consensus that the existing exchange rate system was not working well. That conclusion had been reached in the G-10 and G-24 reports as well as in a number of independent studies. The major problem with the floating exchange rate regime was the excessive exchange rate fluctuations, which had significant economic costs. On page 41 of the Annual Report, 1982 the Fund had argued that "the desirability of reductions in the variability of exchange rates is not in doubt." On page 43 of the 1983 Brandt Commission Report strong support was expressed for "action to provide a greater stability to relationships among exchange rates."

The uncertainty caused by floating exchange rates had induced capital flight and had intensified inflationary pressures, Mr. Abdallah continued. Floating exchange rates had asymmetrical effects: they intensified inflation in countries with depreciating exchange rates more than they suppressed inflation in countries with appreciating exchange rates. Floating rates discouraged trade, especially in countries with rudimentary or nonexistent forward cover facilities. While the cost of exchange rate fluctuations might be modest in global terms, they were significant for developing countries.

Many observers believed that the floating exchange rate system had coped much better with the turbulent environment of the previous 15 years than the par value system could have, Mr. Abdallah remarked. Indeed, some observers felt that there was no practical alternative to the floating exchange rate system because of the scope and considerable integration of international capital markets. In the circumstances, it seemed best to concentrate on possible ways of stabilizing the present system. There was no simple or noncontroversial means of doing so.

Effective and lasting improvements in exchange rate behavior would require a high level of discipline and policy coordination among developed countries, something that was proving very difficult to achieve, Mr. Abdallah continued. There was no shortage of institutional mechanisms for coordinating policies among the main industrial countries. The lack of sufficient coordination was essentially a political problem that was traceable to the different underlying historical experiences of the countries concerned and to the differences in those countries' assessment of their respective national interests. Moreover, there were substantial differences of opinion about the relevant theories and ideas. He hoped that the conflict of ideas would soon come to an end, and that, meanwhile, economic managers would recognize the urgent need to bring greater order to the present disorderly state of affairs.

In his view, the only viable option was the adoption of a system of target zones, Mr. Abdallah said. Critics of that proposal had argued that since the target zone system would use the exchange rate as a primary indicator, misleading signals about required macroeconomic policy adjustments might be sent; they therefore preferred to use a set of macroeconomic indicators, such as domestic credit, the budget deficit, or wage and price movements. Those two approaches were not mutually exclusive; indeed, they might reinforce one another. The adoption of target zones could offset the destabilizing features of the floating system while avoiding the rigidities of a par value system. Under a regime of target zones, the central rates and bands would be negotiated by the major countries. The negotiations would help to promote the desired harmonization of policies that was the objective of multilateral surveillance: having agreed on a target zone, each member would have concrete policy objectives on which to focus the management of its economy. That system would certainly instill greater discipline and reduce the asymmetry in the international adjustment process that was particularly costly for developing countries.

The opponents of the target zone proposal had argued that the exchange rate constraint under such a system was unlikely to instill the needed policy discipline in some countries, Mr. Abdallah commented. It was also claimed that the adoption of an appropriate mix of monetary and fiscal policies could be achieved without introducing a different exchange rate regime. The answer to those criticisms was that there did not seem to be strong political reluctance by the major countries to seek greater harmonization of economic policies; indeed, there were indications of growing cooperation. The staff had noted some ad hoc efforts to marshal the political will to harmonize macroeconomic policies, and any effort to strengthen that trend should be encouraged.

The feasibility of a target zone system was underscored by the experience with the EMS, Mr. Abdallah remarked. The necessary political will had been mobilized to establish and operate that regional arrangement, and there was widespread agreement that the EMS had contributed to greater stabilization of the exchange rates of its members. The staff had cautioned that the viability of the EMS was due to unique factors that were not likely to be evident among other groups or economic regions. However, that uniqueness should not be overstated; a number of viable currency zones of stability in Africa and the Caribbean had given useful lessons even though their members were not industrialized.

He recognized that there were a number of technical and other problems that would have to be solved before a new regime of exchange rates based on target zones could become universally accepted and operational, Mr. Abdallah said. He agreed with the G-24 report that the target zone proposal needed to be further studied with a view to gaining general acceptance of it. The present staff papers were an essential step in the process of learning about and gaining general acceptance of the target zone approach. He hoped that it would not take long to complete that process.

Mr. Nebbia remarked that the importance of the functioning and improvement of the exchange rate system and the proposal to introduce a system of target zones had been duly stressed in the G-24 and G-10 reports. The Interim Committee had asked the Executive Board to continue studying the main issues raised in those reports with a view to holding a substantive discussion on them at the Committee's coming meeting.

The staff papers identified the areas in which broad agreement seemed to exist, discussed points of contention, and suggested key issues on which further discussion might prove helpful, Mr. Nebbia continued. The papers could have usefully included a more detailed examination of some of the more significant implications of the perceived weaknesses of the present system for specific groups of industrial and developing countries. In addition, a more in-depth evaluation of the responsibility of the major industrial countries to adopt appropriate policies would have been welcome.

The main merit of the staff papers was the presentation of an orderly set of arguments for and against the present exchange rate system, Mr. Nebbia commented. That contribution was valuable but was not sufficient to enable Executive Directors to draw specific conclusions. A staff appraisal would have been helpful.

The staff had mentioned that both the G-24 and G-10 reports had concluded that there was a clear understanding that the present exchange rate system needed to be improved, that the variability of exchange rates had been a cause for concern, and that the lack of discipline in and coordination of macroeconomic policies of industrial countries had been the main cause of the volatility and misalignment of the exchange rates for the key currencies, Mr. Nebbia remarked. The weaknesses in the functioning of the present exchange rate system were clear manifestations of the inappropriate mix of policies of the major industrial countries. Those countries had the most significant effect on the functioning of the system, and efforts to improve the functioning of the system should center on the policies of those countries. It was well known that, if exchange rate variability was to be kept within reasonable limits, members must maintain stability in the formulation of their domestic policies. Most of the policies of major industrial countries had effects on other countries, and some degree of coordination of the policies of the various major industrial countries seemed to be unavoidable. The need for stability in the formulation of policies was even more important in light of the desirability of curbing speculation. Members should foster the expectation that macroeconomic policies and, therefore, exchange rates, would remain stable.

The experience with the present exchange rate system was far from satisfactory, Mr. Nebbia said. Volatility and misalignment of real exchange rates had occurred often, with varying effects on different kinds of countries, depending upon their ability to isolate their economies from undesirable fluctuations or to respond with meaningful policy adjustments. In that connection, variability had been particularly costly for developing countries, which had faced abrupt increases in interest rates, reduced export proceeds, and unstable access to financing, which had impaired their economic growth. Those problems were the results of the instability of exchange rates among the key currencies which, in turn, was traceable to the lack of policy coordination among the major industrial countries. It was clear that exchange rate volatility and other uncertainties associated with the present exchange rate system had been particularly harmful to the developing countries.

That conclusion was applicable to international trade, Mr. Nebbia went on. Traders in industrial countries could use well-developed forward markets to cover future foreign exchange transactions, thereby insulating exporters and importers from most foreign exchange risks. However, financial markets in developing countries were not as deep or sophisticated as those in industrial countries, as a result of which developing country exporters and importers were more exposed to foreign exchange risk. The policy stance that a major country might see as favorable might well have unfavorable effects on other members; accordingly, in formulating their economic policies major countries should pay attention to the possible international repercussions of those policies.

Dealing with the factors that contributed to the instability in the present exchange rate system would be the best way to improve the functioning of the system, Mr. Nebbia considered. The short-term volatility of exchange rates undermined efficient allocation through its effects on trade and investment. Volatility was associated with reductions in trade and investment and should be seen as an additional cost of the weaknesses of the present system--costs that were particularly high for economies that lacked well-developed financial markets--making it difficult to cover exchange rate risks. Reducing short-term exchange rate volatility and eliminating misalignments of real exchange rates would depend upon greater policy coordination by major industrial countries. The symmetry of adjustment might be increased if the industrial countries enhanced their policy discipline. The present exchange rate system had been unable to prevent the formulation of inappropriate policies. Moreover, the depreciation of the currencies of developing countries had not insulated those economies from external factors and had not promoted export diversification in the short run.

The possibility of a target zone system for the key currency exchange rates should be further explored, Mr. Nebbia said. Meanwhile, the inclusion of objective indicators or targets in discussions on macroeconomic policies of key currency countries as a part of multilateral surveillance could help to promote a more stable environment. He agreed with the staff's arguments in favor of establishing a system of objective indicators, which would deal with the main cause of exchange rate misalignments, as they could be used as a trigger mechanism to initiate discussions on correcting departures from a desired outcome. Such a system would be feasible.

A target zone system could be implemented if the major countries were willing to adopt an appropriate mix of monetary and fiscal policies with a view to managing their exchange rate, Mr. Nebbia considered. Monetary policy would be aimed at stabilizing the exchange rate, and fiscal policy would be used to counter domestic inflationary and deflationary pressures. Intervention might also be useful under a target zone system. It seemed excessively pessimistic to conclude, as the staff had on page 34 of SM/86/6, that "the prognosis for using sterilized exchange market intervention as the primary instrument for controlling exchange rates is not favorable." The intervention in the exchange market since the G-5 Plaza Agreement in September 1985 had shown that intervention could have the desired effects in a reasonably short time.

The staff had suggested that the so-called correct level of the exchange rate could be calculated by using three optional methods: the purchasing power parity approach, the structural model of exchange rate determination, and the underlying balance approach, Mr. Nebbia observed. However, the staff papers did not refer to the Fund's considerable experience in judging exchange rates. The Fund was required to assess precisely the "correct" exchange rate for a large number of members that used the Fund's resources under stand-by or extended arrangements. That experience could be used in the effort to determine the appropriate exchange rates for the key currencies under a target zone system. The staff should draw on that experience to provide preliminary estimates of the appropriate values for possible target zones for the key currencies.

Mr. Lundstrom considered that the present discussion was a step in a continuing process of examination of the exchange rate system. The discussion, which was based on the recommendations in the G-10 and G-24 reports, should be aimed at reaching agreement on measures designed to increase exchange rate stability.

There were significant problems in the functioning of the present exchange rate system, Mr. Lundstrom said. Those problems were due only partly to so-called external shocks. The short-run exchange rate fluctuations had obviously been excessive, and the exchange rate misalignments had been large and prolonged, negatively affecting resource allocation, including trade and investment. The expectation that the floating exchange rate system would reduce protectionism had not been met. Indeed, because of the misalignments, the system had contributed to an increase in protectionist pressures. A fundamental weakness of the present system--as well as of the Bretton Woods system--was that it contained no incentives to stimulate members to adjust their economic policies. That problem was clearly reflected in the prolonged exchange rate misalignments.

An attempt should be made to improve the exchange rate system, Mr. Lundstrom remarked. It was difficult to determine the precise pace at which the improvements should take place and which exchange rate system would be appropriate in the long run. In both areas, caution was required, and changes should be made in stages.

The willingness of members, especially the large industrial countries, to maintain economic discipline and cooperation was crucial to increasing exchange rate stability, Mr. Lundstrom continued. The political will to act was the foundation for achieving an increase in exchange rate stability. Recent actions by the large industrial countries indicated that there was a growing willingness to consider the international repercussions of national economic policies and to work toward achieving an exchange rate pattern that would better reflect economic fundamentals. The Plaza Agreement of September 22, 1985 showed that a clear political announcement together with intervention could influence expectations and, thereby, exchange rate relations. However, as many Executive Directors had stressed, the achievement of lasting changes would depend upon the persistent con consistency of economic policies in the major countries. If the necessary political will existed, the exchange rate system itself could make an important contribution to increasing policy discipline and coordination. An exchange rate regime and/or a surveillance mechanism that could strengthen incentives to correct economic policies would certainly be preferable to the present system, which was based entirely on discretionary decisions. In assessing such regimes, Executive Directors would naturally wish to focus attention on the role of the major countries.

The three options for increasing exchange rate stability described by the staff overlapped one another to some extent, Mr. Lundstrom remarked. The concept of target zones was not equivalent to a specific exchange rate system. For example, a system of soft target zones could imply merely that certain exchange rate indicators would trigger discussions on the economic policies of the major currency countries. Therefore, one had to look at the substance rather than at the classification of the system.

An effort to increase exchange rate stability within the existing institutional framework should be concentrated on the important and urgent task of enhancing the effectiveness of the Fund's surveillance procedures, Mr. Lundstrom said. However, additional steps should be taken. A set of objective indicators should automatically trigger discussions on the coordination of economic policies among major countries. A set of automatic indicators should be used only to trigger discussions on measures that should be taken by the countries concerned. The proposal that the indicators should have more far-reaching objectives--for example, that they should be combined with quantitative targets, as suggested in the G-24 report--seemed unrealistic. Economic variables in addition to exchange rates should be seen as potential indicators, although, if a trigger mechanism were to prove to be workable, it would have to be limited to a few indicators. The initial formulation of such indicators might be left to the industrial countries.

There should be a detailed study of the potential improvements from and risks of a system of target zones, Mr. Lundstrom considered. The study should consider how such a system would facilitate the needed coordination of economic policies and how it could contribute to stabilizing expectations. Further study should highlight the feasibility of alternative models for establishing equilibrium exchange rates and should examine other operational aspects of a target zone system. The studies should examine the advantages and disadvantages of starting with relatively soft target zones. A gradual shift from softer zones to harder zones should reduce the potential difficulties in operating a target zone system, including the fixing of equilibrium exchange rates. The Plaza Agreement could be seen as a first step toward a very soft target zone system that could be gradually tightened with experience. In the present relatively favorable conditions, studies on a possible target zone system should be actively pursued.

Mr. Chatah remarked that there were clearly considerable difficulties in assessing the performance of the floating exchange rate system. It was impossible to attribute with any certainty particular developments or outcomes since the implementation of the floating exchange rate system to the system itself. Moreover, it was difficult to choose a benchmark, or alternative system, against which to compare the floating exchange rate system, and it was nearly impossible to determine with any confidence how well an alternative system might have performed in the period in which the floating exchange rate system had been in existence. Despite those and other difficulties in assessing the floating system, there was a widespread feeling that the performance of the floating exchange rate system had been mixed, and, even more important, a consensus had recently emerged that improvements in or a reform of the system were called for. Any such reform should be aimed at preserving, to the extent possible, the positive aspects of the present system while minimizing its negative aspects. The strengths and weaknesses of the floating exchange rate system had been thoroughly analyzed in the staff papers. Any reform of the system would obviously be constrained by political factors.

One of the positive features of the present system had been its robustness during a particularly difficult period in the evolution of the international economy, Mr. Chatah remarked. The enhanced exchange rate flexibility under the current system had provided, to some extent, an automatic safety valve that had enabled members to avoid relying on policy decisions that might have occasionally proven to be untimely. There was also clear evidence that the flexibility had reduced the pressures for capital and other restrictions. However, there had also been excessive and costly short-term exchange rate volatility. One of the aims of reforming the present system should be to reduce short-term exchange rate volatility without introducing any undue rigidities, such as those existing before 1973, which had contributed to the collapse of the Bretton Woods system.

Another, perhaps more serious, problem with the floating exchange rate system was the persistence of large misalignments of real exchange rates which, for one reason or another, had not been corrected by market forces, Mr. Chatah said. The fixed exchange rate system had not been immune from such misalignments, and delays in correcting misalignments had been one of the major weaknesses of that regime. It had been expected that simply by permitting exchange rates to be determined by the market, the problem of persistent misalignments would be solved. However, in practice, market forces had proved to be insufficient to solve that problem. The growing appreciation that market forces had not prevented persistent exchange rate alignments underscored the need to improve the exchange rate system. Given the cost of persistent misalignments--in terms of resource misallocation and pressures to increase trade restrictions--any reform of the exchange rate system must give priority to providing a mechanism for avoiding such misalignments. Although smaller countries and commodity producing developing countries were particularly vulnerable to exchange rate instability, the costs of exchange rate distortions for the major currency countries and the international economy as a whole were sufficient to warrant a global effort to increase exchange rate stability.

Although direct action to influence exchange rates--for example, exchange market intervention--could sometimes help to stem excessive variability and persistent misalignments of exchange rates, it clearly was not a fundamental or long-lasting solution to such problems, Mr. Chatah commented. Both the G-10 and G-24 reports stressed possible ways of encouraging the major currency countries to maintain macroeconomic policies that would enhance exchange rate stability.

The concept of target zones, with predetermined and even preannounced desirable paths of exchange rates, was based at least partly on the idea that the mere notion of a desirable path would give the major currency countries an incentive to maintain more disciplined domestic economic policies and to increase policy coordination among themselves, Mr. Chatah remarked. The target zone proposal had other positive aspects, such as providing the market with some limits, however loose, on the expected path of exchange rates. Even if zones were not announced, the mere realization by the market that the monetary authorities had an exchange rate movement target was bound to dampen speculation. The staff should comment on Mr. Lankester's argument that target zones might encourage speculation when the exchange rate approached the target zone boundaries. Presumably such speculation--which would be stabilizing--would be the main mechanism by which volatility would be reduced under a target zone system.

There were admittedly some questions that would have to be answered before firm conclusions about the workability of a target zone system could be drawn, Mr. Chatah went on. One of those questions was whether target zones would encourage the needed degree and kind of policy discipline and coordination or whether such zones would lead to situations in which an exchange rate could be maintained within certain bounds only at the expense of the achievement of other fundamental economic objectives. Such questions were clearly difficult to answer. The authors of the G-24 report were aware of such questions and of other difficulties that stood in the way of the implementation of a system of target zones. Nevertheless, the concept of target zones, especially softer zones, had enough positive elements to warrant further examination.

The suggestions to improve the working of the exchange rate system by strengthening Fund surveillance of major currency countries were particularly useful, as they addressed the main problem that had hindered the performance of the present system as well as the fixed exchange rate system in its final years, Mr. Chatah commented. Of course, an important consideration in an attempt to strengthen surveillance over the major currency countries was the extent to which particular surveillance mechanisms were practical and realistic. Mr. Fujino's remarks in that connection were particularly relevant. Although there were some clear differences of view reflected in the G-10 and G-24 reports on what would be considered feasible ways of strengthening surveillance, there was sufficient common ground to proceed in that direction even if that effort fell short of including the changes that some would like to see made, such as the introduction of objective indicators and the two-stage approach to the surveillance of key currency countries--changes that the major currency countries clearly were not ready to accept. He intended to make further comments on surveillance during the coming review of surveillance.

Mr. Sengupta made the following statement:

> The staff has gone into the pros and cons of different issues, but there is not much point in carrying on the debate in conceptual terms.
>
> Listening to the debate and reading the G-10 and G-24 reports, it is evident that there is a general agreement that the flexible exchange rate system has not worked the way it was expected to work. The main concern has been about the variability of exchange rates. The problem of defining in operational terms, short-term volatility and misalignment, or laying down clear-cut criteria for concluding when the volatility is excessive and the exchange rate movements are misaligned, need not deflect us from our examination of some obvious implications of the working of the system. Its predominant effects are on the perception of the market participants, the associated uncertainty and difficulty in modeling behavioral expectations, producing large capital movements leading to misallocation of resources, and lowering of

investment as well as reducing the volume of trade and increasing protectionist pressures. Empirical investigations of the effects of exchange rate volatility, as the staff seems to believe, have not been very definitive. That is not surprising, considering the state of knowledge about exchange rate determination and deficiencies in technical exercises with innumerable measurement and specification problems. But this lack of definitiveness in empirical investigations does not detract from the obvious effects of exchange rate variability or misalignment. There was no disagreement, for example, that the dollar was grossly overvalued in 1985 and that the yen and the franc had to be appreciated to move toward a better alignment of exchange rates.

So it is universally agreed that something should be done to improve the system, and the disagreement regards what should be done and how it should be done. The Group of Ten, or, to put it more correctly, the majority of the Group of Ten, do not see the need for a change in the exchange rate system but do accept the need for better policy coordination to avoid misalignments. Close cooperation among countries and peer pressure are the main suggested ways of strengthening international surveillance. The fact that peer pressure had not worked in influencing the major policies of important countries hitherto, and that in the case of exchange rates the threat of a possible collapse of the dollar and an ever widening current balance deficit exposing the system to the risk of protectionist pressures were necessary to produce a fragile arrangement between a few countries at the Plaza Hotel in New York in September 1985, do not apparently detract from this optimism regarding peer pressure.

The alternative view is that even if consultation among the major industrial countries could be the basis for any kind of policy coordination leading to appropriate exchange rate alignments, it would require a supporting mechanism. The G-24 view of the target zone, and this chair is committed to that view, is that that mechanism to enhance international policy coordination should be provided.

The G-24 report reconfirmed that "an exchange rate system should be devised to overcome the recognized rigidities of a par value system and the destabilizing uncertainties of floating rates." It also stated that the floating rate system would improve in its functioning if there is "greater effort on the part of the developing countries to achieve a substantial degree of discipline and coordination in the conduct of their national policies." In the view of the Group or Twenty-Four, the target zone proposal "could help achieve the objective of exchange rate stability and a sustainable pattern of payments balances." Its report stressed that, until the target zone proposal is accepted, "a mechanism has to be devised to enforce policy coordination among the developed, especially the key currency countries." It pointed out that the framework of policy coordination already exists under the Fund's Article IV which deals with obligations regarding exchange arrangements. The G-24 report added that, apart from regular multilateral consultations, "a mechanism or procedure that could trigger consultations among the concerned countries and between them and the Fund is necessary whenever the indicators available suggest that excessive short-term movements of one or more major currencies are taking place or that any major currency is already or is in the process of being seriously misaligned."

I submit that this process is consistent with a set of objective indicators, a soft target zone, or even an EMS kind of system globalized. I listened to Mr. Polak and Mr. Kafka with great attention. If the world wants to move toward an EMS "type of arrangement, maybe anchoring the exchange rate to the dollar, it would have to discipline itself much more than in the case of soft target zones. It would depend to a large extent on the degree to which a country is willing to submit its domestic monetary policy to exchange rate management. Indeed, if stabilization has to be achieved by nonsterilized intervention, which is probably the only kind of intervention that works, monetary policy practically becomes subservient to exchange rate policy. Most countries do not like this and would like to retain enough degree of freedom to pursue other domestic objectives by allowing some flexibility in exchange rates. A target zone would allow such flexibility where exchange rate objectives can be traded off with other domestic objectives and the instruments used can be a mix of monetary and fiscal policies.

Too much is made of the difficulty in determining the equilibrium exchange rate around which the target zone has to be set. A soft zone can be based on a rough approximation to such an equilibrium. Exchange rates may have to be changed, and sometimes should be changed, with changes in underlying conditions and in the prospects for capital flows. But, for policy purposes, what is important is the ability of the exchange rate system to guide the directions of exchange rate changes or, as Mr. de Groote says, the "target directions" of the exchange rates. If a mechanism of consultation is built up around this exchange rate system, bringing within its purview a commitment to harmonize different national policy instruments, monetary as well as fiscal, it is the direction of the change that is important and not so much the validity of the underlying equilibrium of exchange rates.

So long as the commitment is to consultation and there is a willingness to follow an internationally coordinated policy framework, where the national policies take into account their international implications, I do not see why there should be any unwillingness on the part of the principal actors to agree to the basics of the soft target zone approach. If, however, the view is against any kind of policy coordination, we have nothing to stand upon. But if the willingness to coordinate and cooperate is genuine, we can surely build upon that and work toward a more rational and systematic mechanism than ad hoc responses to crisis situations in the market.

It is in the belief that the willingness expressed for cooperation is genuine that developing countries made their suggestions in the G-24 report. Today, listening to the discussion, I would like to put the suggestions somewhat differently for consideration, which may be taken up with the Interim Committee. On the understanding that everybody desires to work toward a system of better policy coordination, centering around the exchange rate alignments of major international currencies, let us work out through a series of meetings of this Board or a subcommittee of this Board a number of alternative proposals which can be examined for the taking of decisions after a few months by the international community, maybe at a future meeting of the Interim Committee. These proposals should clearly spell out the modus operandi based on alternative scenarios and the possible operation of the different policy instruments by different countries to achieve the alignments of the exchange rates at the international level. The feasibility and the actual outcomes of target zones of different varieties--hard, soft, loud, or quiet--the EMS kind of system, or objective indicators should be brought out as part of the detailed examination of these proposals. If it is so desired, these proposals may also consider how the policy coordination would develop if a purely judgmental approach, as suggested by some in the Group of Ten, were to be adopted.

A second suggestion, which is not a substitute for the first but is necessary for the first or for that matter any other way of approaching the problem, is as follows: Let the staff bring to the Board every quarter a paper on the exchange rate alignments of the key currencies bringing out possible misalignments between them according to alternative models of the operation of the international economy and spelling out the effect of such alignments on the rest of the world, including the developing economies.

The second suggestion can be implemented immediately, even if the first one takes time to be ready for discussion in the next Interim Committee. This would be a great help to settle the debate about the feasibility of the target zone approach, once we have before us a few such intensive discussions on such key currency reports. Moreover, this would help the Managing Director a great deal, if and when he is invited to participate in the select group of the Group of Five. This exercise should be much more detailed and exhaustive than the exercise on exchange rate developments in the World Economic Outlook. It should reflect all concrete policy measures that may be adopted to correct any misalignments based on "fundamental economic conditions." I hope that you, Mr. Chairman, and my other colleagues, would find this proposal acceptable.

Mr. Salehkhou said that the staff papers did not present an overall summary of previous discussions on the matters at hand and understandably did not draw any firm conclusions about the proposals in the G-24 and G-10 reports. The staff's analysis was informative, although a synthesis of the sections on "Issues for Discussion" would have helped Executive Directors to assess important issues and to reach conclusions. In addition, inclusion of tables on at least the major sectors of economic activity under the floating exchange rate system would have been helpful, although he understood that even the most sophisticated calculations of the floating exchange rate system's quantitative components and elusive behavior might not necessarily lead to firm conclusions; there was considerable competition and speculation under the system, which was often affected by political and value judgments by the major currency countries.

While the staff's comprehensive and logical analysis might be technically convincing, it was important to remember that exchange rate stability relied more upon the existence of political will and commitment than upon technical mechanisms, Mr. Salehkhou commented. The same conclusion was applicable to the consideration of SDR allocations in the recent past: the staff had provided sufficient technical data and objective analysis to warrant an SDR allocation in the current allocation period, but the lack of the needed political will of the major industrial countries had thus far prevented an allocation.

A thorough and more substantive appraisal of the G-24 and G-10 reports would be facilitated by the provision of relevant quantitative information to supplement the staff's descriptive analysis in the present papers, Mr. Salehkhou continued. Such information had been provided to some extent in the paper on the exchange rate system (SM/84/5, 1/3/84) for the seminar on that topic.

The staff papers did not contain an overall summary and conclusion section but covered many topics that could not be dealt with in a single intervention, Mr. Salehkhou remarked. His comments would parallel the points made in the G-24 report on selected major issues. Despite disagreements among policy makers and market observers about various quantitative and qualitative aspects of the current exchange rate system, there was general agreement that the system had not been functioning well and had not met the expectations that had existed when the system had been introduced. The floating system had not prevented the abrupt increase in actual exchange rate variability; in fact, the short-term variability in the nominal exchange rates of the seven major currencies had been five times greater under the floating system than under the par value system. Hence, there was a clear need at least to improve, if not to change, the functioning of the present floating regime, which had been marked by short-term volatility, large and persistent misalignments, destabilizing speculation, and a lack of macroeconomic policy discipline and coordination.

Contrary to original expectations, the floating system had adversely affected developing countries by creating destabilizing uncertainty, especially as a result of wide, volatile, and unpredictable short-term exchange rate fluctuations, Mr. Salehkhou said. Those developments had significantly contributed to investment, trade, monetary, and financial imbalances in developing countries. In the absence of well-developed financial markets, developing countries had been exposed to considerable exchange and financial risks that had increased their reserve and capital requirements.

Large and persistent misalignments of the exchange rates of the major currencies had serious global consequences, especially for developing countries, Mr. Salehkhou went on. At the beginning of the floating rate era, it had been expected that gradual changes in the pattern of competitiveness would restore equilibrium to members' external current accounts. In fact, the floating era had been characterized by capital outflows, idle resources, wasteful shifts in resources, and protectionist pressures. As in the case of short-term volatility, due attention had not been paid to the impact on the world economy of long-term exchange rate misalignments, which often resulted from the divergent national policies of the industrial countries. Moreover, assessments of exchange rate alignments and misalignments had taken into account only the balance of payments of individual countries, rather than the effect of a member's overall economic performance on the international economy.

A major weakness of the present system--namely, the lack of discipline in and coordination of macroeconomic policies--should be the focal point of the present discussion as it was directly or indirectly related to the Fund's role, Mr. Salehkhou considered. Unfortunately, the Fund had been kept from participating in policy discussions involving the major industrial countries, whose policies were often conflicting.

The staff papers explained the global consequences of the inadequate discipline in and coordination of macroeconomic policies of major industrial countries, Mr. Salehkhou commented. Experience showed that no exchange rate system could function properly without macroeconomic policy discipline and coordination. Policy discipline and coordination under any exchange rate system required an unwaivering commitment by all the parties concerned, especially the major currency countries, to consider exchange rate stability as an integral policy objective and not merely a residual of policy goals and actions. Moreover, the major currency countries in particular should see the implementation of their macroeconomic policies in an international perspective, rather than be pressured into changes in monetary and fiscal policies as a result of external imbalances and international crises. Exchange rate stability required the cooperation of all participants in the system, and especially the industrial countries and the major currency countries among them, whose exchange rate policies affected the economic performance of the majority of members.

None of the three main proposals in the staff paper for improving the exchange rate system, or any combination of those proposals, was particularly preferable, Mr. Salehkhou said. However, the fact that the principle of international policy consistency in promoting exchange rate stability was common to all three proposals was encouraging. That fundamental principle had been emphasized most in the staff's analysis of target zones. If that principle had been observed in the past, there would have been greater symmetry in the implementation of Fund surveillance. The staff had usefully described the underlying factors in favor of the adoption of target zones.

He broadly supported the G-24 position on target zones and was interested in exploring the possibility of creating regional exchange rate systems similar to the EMS, Mr. Salehkhou continued. As the G-24 report had suggested, the target zone proposal needed to be "further studied and pursued to gain general acceptance." The target zone proposal should not be rejected at the present stage because of potential operational problems. The staff should comment on the possibility of solving such problems by refining a target zone system in the course of its implementation.

The Fund should take the lead in closely monitoring the proper functioning of any exchange rate system, Mr. Salehkhou considered. In playing its role in encouraging policy coordination and in conducting firm and symmetrical surveillance over the exchange rate system, the Fund should pay particular attention to the major currency countries. Multilateral consultations among members in order to encourage exchange rate stability should be encouraged, but they should be seen as a mechanism for presenting the concerns of the countries involved to the Fund.

Improving the exchange rate system and adopting precautionary global measures would become possible only if major industrial countries demonstrated the political will and commitment to the principles and procedures of the Fund, Mr. Salehkhou said. Only then could the present exchange rate system avoid the fate of the Bretton Woods system.

Mr. Dallara stated that he hoped that members could continue to work together to strengthen the functioning of the exchange rate system so that it would better serve all of them. A smoothly functioning system was critical to promoting global economic growth and to maintaining an open trading system. At the G-10 meeting in Tokyo in 1985, Secretary Baker had stated that "if we can first agree on the measures recommended by our Deputies, and then move forward to build on this framework in a new spirit of cooperation, I believe we can enhance the stability of the international monetary system and assure a more productive and growing global economy." In his recent State of the Union message, President Reagan had said that "the constant expansion of our economy and exports requires a sound and stable dollar at home and reliable exchange rates around the world.... We have begun coordinating economic and monetary policy among our major trading partners. But there is more to do, and (tonight) I am directing Treasury Secretary Jim Baker to determine if the nations of the world should convene to discuss the role and relationship of all currencies." Those statements clearly indicated the interest at the highest levels of the U.S. Government in the proper functioning international monetary system. His comments on the important issues raised in the staff papers would be preliminary and would point toward the April 1986 Interim Committee meeting at which Ministers could give the Executive Board further guidance on issues raised in the G-10 and G-24 reports.

He wished to make three general comments, Mr. Dallara continued. First, each country shared the responsibility for promoting a stable exchange rate system. No single country could by itself assure stability, although he recognized that the United States had a special role and responsibility in the system, as its currency was the most widely used and the U.S. economy was the largest in the world. Developments over the previous two decades had underscored the fact that no single country could have its external accounts serve as the residual of its own and other countries' economic policies. Any effort to improve the exchange rate system was likely to be unsuccessful if it was based on the idea that the supposed inadequacies of any one country's policies were the sole explanation of international disequilibria, or if it was based on the assumption that what was needed were constraints that were focused on a particular country or category of countries. Each country, especially the large industrial countries, had responsibilities in the overall effort to promote stability, and if any system were to work, those responsibilities must be balanced.

Second, the integration and growth of international capital markets, as well as the integration of trade flows, had limited any single country's ability to maintain independent macroeconomic or structural policies that paid little attention to external developments, Mr. Dallara said. That conclusion would be valid under any exchange rate system.

Third, a number of recent developments were in the direction of strengthening the system and might be a basis for continued improvement in the system, Mr. Dallara remarked. A convergence in economic performance among major countries was occurring, although large external imbalances remained and, on the basis of current exchange rates and growth projections, were likely to remain. There was widespread agreement that resort to trade protection and capital controls should be avoided. In addition, there was an important, growing consensus that the key to greater exchange rate stability was enhanced cooperation among the largest countries with a view to maintaining sound, compatible policies to achieve sustainably low rates of inflation and high rates of growth. The major countries had demonstrated a growing willingness to make mutual as well as independent policy commitments to reduce domestic and external imbalances in an effort to promote sound, stable growth and exchange rates that were more fully reflective than hitherto of economic fundamentals.

The present exchange rate system had shown certain strengths, Mr. Dallara commented. It had an essential flexibility that had enabled it to deal with the economic shocks of the 1970s. On the whole, the system had been able to absorb those shocks without capital controls and excessive pressures for trade protection. Under a fixed exchange rate system, the severe shocks of the previous 10-15 years, including two oil price increases, could have led to increased controls over trade and capital flows, which would have reduced the growth of real and financial flows between countries and economic growth in general. While it was difficult to make definitive judgments about the relative costs of such shocks under different systems or the relative capacity of various systems to respond to shocks, the flexibility in the current exchange rate system had helped to moderate the cost of adjusting to those shocks and therefore had perhaps avoided some of the costs, in the form of real output losses, which might have occurred under a fixed exchange rate system. Recent abrupt changes in the oil markets, resulting from a range of economic developments and the explicit policies of certain members, underscored the need for flexibility in the exchange rate system in order to enable the system to respond to shocks.

Under the present system, exchange markets had provided appropriate signals to market participants about changes in real economic conditions, Mr. Dallara went on. Exchange rate movements--even sizable ones--had facilitated balance of payments adjustment and underlying structural adjustment, thereby encouraging sound economic growth. Most analysts agreed that the general direction of exchange changes over the previous 10-15 years had often reflected differences in economic performance and policies and had in many cases promoted adjustment. Furthermore, while the insulating property of flexible exchange rates had not been as substantial as some proponents of the flexible rate system had expected, the adoption of flexible rates had given members some independence in maintaining certain policies, including monetary policy.

However, there were clearly serious weaknesses in the present exchange rate system, Mr. Dallara said. It was not as stable as had been hoped, although there was scope for improvement. He had been somewhat discouraged by the unexpected degree of short-term exchange rate volatility over the past decade. As the staff had noted, empirical evidence did not support the contention that volatility had had a significant adverse effect on world trade and investment flows, but there was a general preference for less day-to-day change in exchange rates.

Inappropriate exchange rate levels had also been a cause for concern, Mr. Dallara remarked. The market, the basic guide for exchange rates, served the important function of continuously absorbing information while reflecting and assessing changing economic prospects and policies as well as political and other developments. Nevertheless, at times, there had been a feeling that exchange rates had not fully reflected underlying fundamentals. As a result, inappropriate signals had sometimes been sent to the real sectors of the economy, leading to patterns of resource use that were less than optimal and difficult and costly to reverse. In addition, while protectionist pressures would exist under any exchange rate regime and at all exchange rate levels, recent protectionist pressures in the United States had been associated with existing external imbalances.

The G-10 and G-24 reports noted that unsound and inconsistent policies had been a problem under the current exchange rate system, Mr. Dallara noted. The extent to which that problem could be directly attributed to the exchange system itself was an important question, but whatever the answer, the international monetary system should reinforce sound policy actions and provide disincentives for inappropriate policies.

The main question at hand was the fundamental criteria against which possible means for strengthening the current exchange rate system should be judged, Mr. Dallara said. Key criteria seemed to be whether a change was likely to promote sound and consistent policies by leading to greater convergence of economic performance among countries and whether a change was likely to foster international stability and to support global economic growth.

Increased international cooperation and policy commitments by all countries, including the major ones, was necessary for any strengthening of the exchange rate system, Mr. Dallara considered. The key to that enhanced cooperation was the development within countries of the political will and institutional mechanisms to ensure that the ultimate domestic consequences of the interaction of domestic policies among countries were taken into account in national decision making. Authorities wished to consider not so much the international implications of their policies, as the ultimate domestic consequences of their policies after those policies and their results had interacted with those of other countries. Careful consideration of those consequences could motivate policymakers to consider changes in policies. The basic question in determining the appropriate exchange rate system was how the system could best ensure that those considerations would be taken into account.

A variety of ways of improving the exchange rate system had been reviewed in the G-10 and G-24 reports, Mr. Dallara observed. Target zones had been proposed on the ground that they would introduce a degree of automaticity in the adjustment process. Target zones could exert some degree of discipline, thereby encouraging countries to adopt mutually consistent policies. It had been argued that target zones could provide the desired anchor for market expectations. The wide spectrum of suggestions for the actual development of the target zone approach had various implications for domestic policy formulation and raised detailed technical questions.

He was concerned about the target zone proposal for several reasons, Mr. Dallara went on. Focusing attention exclusively on the exchange rate might divert attention from more fundamental problems and could result in inappropriate policy responses. Under a target zone system, monetary policy would have the primary responsibility for addressing external imbalances, even if the imbalances stemmed from other policy inadequacies. Without a foundation of sound, consistent policies, a system of target zones could provide a misleading indicator of governments' intentions and could promote disruptive flows. The need to keep exchange rates within zones could tend to encourage intervention or capital controls, neither of which would address fundamental policy problems. There were a number of additional issues and potential problems, including the difficulty in establishing the initial rates for each target zone and the width of the zones.

Some of the concerns that had been expressed about the current exchange rate system suggested that it might be useful to have a broad array of economic indicators that would send a signal of the need for policy action or multilateral consultations, Mr. Dallara said. The indicators should include factors in addition to exchange rates. Objectives relating to several key economic variables could help focus attention directly on the need for sound, consistent policies and could provide additional information that would serve as an indication for policy action in particular areas and/or international consultations. The indicators could cover, in addition to exchange rate levels, other objectives of economic policy, such as current account positions, rates of domestic growth, fical positions, and perhaps variables relating to such areas as monetary aggregates, government spending levels, and structural policies that might impede the achievement of adequate levels of investment, growth, and employment. Such an approach would of course not be free of problems. A possible problem was that at any given time various indicators could point in different directions, thereby making it difficult to determine not only which countries would be expected to lead the way in making policy changes but also which particular policy changes would be appropriate.

The ideas concerning indicators were related to surveillance, which was a central issue in the G-10 report, Mr. Dallara commented. Strengthened surveillance was a key to improving the functioning of the exchange rate system. Surveillance was based on the recognition of the need to consider a number of policy and economic variables in judging the appropriateness of a country's policies. The April 1977 decision on surveillance included the idea of looking at a broad range of developments and indicators in judging the need for consultations. The Principles of Surveillance over Exchange Rate Policies read in part as follows:

> 2. The Fund shall consider the following developments as among those which might indicate the need for discussion with a member:
>
> (i) protracted large-scale intervention in one direction in the exchange market;

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

Various policies could be included among the signs mentioned in that text, consistent with the broad approach to surveillance which was embodied in the whole 1977 surveillance decision.

In assessing the exchange rate system, Executive Directors should ask themselves why the surveillance principles had not been as effective as they might have been, Mr. Dallara remarked. It was important to recognize that the political will of countries to cooperate was a prerequisite for any effort to improve the exchange rate system. Effective surveillance procedures and practices could reinforce that will. The Fund had a role to play in both bilateral and multilateral surveillance, but the Fund must be more ambitious if it was to play that role. He would comment further on surveillance during the coming discussion of that subject, and he hoped that the aggressive approach of some Executive Directors to improving the exchange rate system would also be evident during the coming examination of surveillance.

Mr. Nimatallah said that he did not agree that the introduction of a system of target zones would require an increase in members' reliance on monetary policy. Indeed, under the present system, members relied more heavily on monetary policy than on fiscal policy because of persistent exchange rate misalignments. Under a system of soft target zones, monetary policy would be needed only to a limited extent to help to keep the exchange rate within the established target zone. Under a system of frequently revised and confidential soft target zones, attention would be centered on avoiding exchange rate misalignments, rather than short-run exchange rate variability, and, as a result, the system would benefit from both fiscal and monetary policy.

Mr. Dallara considered that target zones focused attention on the level of the exchange rate. In most industrial countries, monetary policy was probably the most influential basic policy instrument available to the authorities to influence the exchange rate, especially in the short run. If a member was willing to adjust promptly other policies that could affect the exchange rate, including fiscal policy as well as structural policies, such as labor market policies, those policies could have some effect on the exchange rate in the short run. But the lags with which policies other than monetary policy usually worked and the institutional difficulties in making changes in those policies were considerable. There might well be a tendency for members to rely on monetary policy to maintain exchange rates within target zones, particularly if there was political reluctance to change the zones. The experience with the EMS and the Bretton Woods system suggested that there were inevitably important political considerations in changing exchange rate target zones. Monetary policy was likely to have to play a substantial role under a target zone system, and members might have greater difficulty under such a system in using monetary policy to maintain noninflationary growth of monetary aggregates.

Mr. Nimatallah recalled that under the fixed exchange rate system, members had had to maintain policy discipline, as it was their responsibility to maintain their fixed exchange rate. No such discipline was required under the floating exchange rate system; exchange rates were in effect left on their own. Under a target zone system, exchange rates would no longer be a residual of other policies; exchange rate policy would be treated the same as other policies, greater discipline would be maintained, and persistent exchange rate misalignments could be avoided.

Mr. Kafka noted that one of the arguments against target zones was that they would make it more difficult to use monetary policy to maintain internal balance. However, the same problem might well arise if a target zone system were not introduced. In any event, it should be possible to maintain stability under a target zone system and to keep some independence for monetary policy by agreeing in advance to change the central rate of the target zone when necessary.

Mr. Rye said that he disagreed with Executive Directors who felt that policy discipline could not be maintained under a floating exchange rate system. Australia's experience suggested that when a floating rate moved beyond a certain point, a government felt pressure to explain the movement in the rate and to correct a particularly sharp movement. A rapid movement in an exchange rate tended to expose domestic firms to greater foreign competition and to increase the pressure on the government from those firms to take exchange rate action. A falling exchange rate was a cause for concern in an economy because of the effect on domestic prices. The sharp decline in the value of the U.S. dollar had increased the pressure on the Australian Government to review its monetary policy. In the final analysis, all members seemed to have in mind an appropriate exchange rate for their currency, which was often significantly different from the actual current rate.

Mr. Nimatallah remarked that he agreed with Mr. Rye that a volatile exchange rate intensified pressures within a country for an appropriate policy response by the government. Some Executive Directors wished to provide a mechanism for increasing pressure by the world community on individual members to correct their exchange rates. The kind of pressure that Mr. Rye had mentioned was the product of an exchange rate policy that was a residual of other economic policies. That kind of pressure was not the sort of economic policy discipline that he had in mind. The discipline that he favored would result from pressure by international as well as domestic sources. A target zone system would create outside pressure on a country to meet its commitment to keep the exchange rate within an agreed range of levels.

Mr. Polak remarked that the improved functioning of the exchange rate system would depend on the willingness of major countries to take into account properly the international implications of domestic policies. As to the 1977 decision on surveillance, the final operative statement in the section that Mr. Dallara had noted was that "the Fund's appraisal of a member's exchange rate policy should be based on an evaluation of" a number of factors. There were different views on how broad and specific the Fund's surveillance should be, but there was broad agreement on the general purpose of the 1977 decision.

Mr. Dallara said that he had meant to indicate the breadth of the approach to surveillance over exchange rate policies embodied in the 1977 decision. The text that he had cited contained a relatively broad definition of exchange rate policies and went far beyond policies that directly affected the exchange rate. For example, the text stated in part that "the Fund's appraisal of a member's exchange rate policies should be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member." The exchange rate policies covered by Article IV consultations had been defined very broadly.

Mr. Grosche commented that the issue of policy discipline had an important bearing on the kinds of improvements in the exchange rate system which Executive Directors were striving for. He agreed with Mr. Rye that adequate attention had to be paid to the connection between exchange rates and domestic policies. It was important to stress that domestic policies affected the exchange rate and that the exchange rate in turn affected the domestic economic situation. One of the major disappointments with the floating exchange rate system was that it had not insulated domestic policies from external developments. Experience clearly showed that a member must carefully take into account the repercussions of exchange rates on domestic policies.

Mr. Dallara remarked that self-interest was the essence of international cooperation. For example, in the United States, the serious external imbalances had attracted considerable attention only after it had become clear that they had direct consequences for the domestic economy, especially in the form of rising protectionist pressures. A strengthened exchange rate system would help policymakers to understand that cooperation was in their own best interest.

The Director of the Research Department said that the staff had deliberately decided not to include a staff appraisal in the staff papers under discussion. The present discussion was seen by the staff as an early stage in the examination of the issues at hand. The staff believed that at the present stage, its role was to present the array of arguments for and against the various proposals under discussion. Executive Directors' preferences would become clearer in the coming stages of the examination of the issues. The staff expected to receive guidance from Executive Directors at a later stage and would then wish to express its opinions about the modalities of achieving specific objectives. The staff believed that there were weaknesses in the present exchange rate system and wished to improve the working of the system. The staff was exploring various ideas and welcomed opportunities to continue its examination and to report its findings to the Executive Board.

The question had been raised whether speculation tended to become one-sided as an exchange rate moved closer to the edge of a target zone, the Director recalled. His experience suggested that speculation did become more one-sided in such a situation. The stronger the movement of an exchange rate toward the limit of an agreed zone, the more favorable the situation was for those who would speculate against the government concerned. In that connection, the velocity at which the rate approached the margin and the market's impression of the authorities' determination to defend the rate and of the authorities' ability to do so were crucial.

Under a fixed rate system--and to a smaller degree under a target zone system--the exchange rate was given priority in the formulation of policies in all the countries that were participating in the system, the Director of the Research Department remarked. That fact encouraged policy coordination as the exchange rates were interrelated; the priority given to defending the rates throughout the system supported policy coordination. Policy discipline was therefore encouraged by the desire to achieve a common objective. With the disappearance of the Bretton Woods system, that discipline had been weakened, and the Executive Board had tried to replace that discipline with surveillance. Of course, consultations with members had been taking place for a long time prior to the adoption of the decision on surveillance, but the end of the Bretton Woods system and the associated decline in policy discipline had led the Fund to stress the importance of surveillance. It was true that the movement of an exchange rate under a floating system exerted some policy discipline, but there could be long delays, even though the sources of discipline could be both domestic and external. The effects of that discipline had been evident in the September 22, 1985 G-5 agreement.

The staff representative from the Research Department noted that all Executive Directors had underscored the need for an increase in policy coordination and greater international consistency of policies, particularly the policies of major industrial countries. There were three possible ways to achieve those objectives. One was to have an explicit trigger mechanism--target zones, objective indicators, or even a par value system--to encourage policy coordination. All those mechanisms had in common the fact that they would provide more automatic means of increasing policy coordination than the present system. Alternatively, there could be a regular schedule of meetings to consider policies and the configuration of exchange rates; under that approach, the kind of discussions that had taken place on September 22, 1985 among the G-5 countries would be regularized. That approach was akin to preventive medicine, as it could enable the countries concerned to identify problems--especially exchange rate misalignments--before they reached the crisis stage. A third option would be to rely on existing forums but to hold special meetings to encourage policy coordination and to make announcements on exchange rate policies in particular circumstances. The advantage of that approach was that it could be employed at just the right moment; countries could agree to give an exchange rate a nudge in the direction it was already taking in the market, and announcements could be withheld until there was certainty that the members involved in an exchange rate action were firmly committed to introducing the needed supportive policies.

Another issue was how precise or formal members wished to be in establishing the international implications of each country's policies, including exchange rate policies, the staff representative commented. Members could rely on enhanced dialogue and greater peer pressure to encourage more internationally consistent policies and on the market to translate those policies into the appropriate pattern of exchange rates. Alternatively, members could calculate exchange rates that were implied by various policy configurations. The calculations need not be publicized, although announcements of at least the desired direction of exchange rate movement--similar to the September 22, 1985 communiqué--could be made. Such calculations could be made under a system of soft target zones with wide margins, frequent changes in the zones, and moderate attention to the exchange rate in the conduct of monetary policy. Such zones could be announced. At one end of the spectrum of possible solutions was a return to fixed exchange rates; the target zones would have narrow margins, and members would be firmly committed to maintaining exchange rates within the zones. In sum, there was considerable leeway in the effort to increase coordination. The staff papers examined the options mentioned in the G-10 and G-24 reports, but other options--possibly combining various elements of the G-10 and G-24 proposals--might be more pragmatic than the individual proposals in the reports. The staff would wish to hear further comments from Executive Directors on possible ways of improving coordination before the staff attempted to make specific proposals.

One Executive Director had said that the consensus forecast of an equilibrium exchange rate might not be convincing, the staff representative recalled. The kinds of consensus forecast described in the staff paper would not involve merely taking the exchange rate forecast from three different models and assigning weights to them in a mechanical fashion to arrive at a "consensus" forecast that could be used for a target zone or some other system. The staff had meant to say that the various methods of trying to calculate equilibrium exchange rates had strengths and weaknesses, and that, given the weaknesses especially, it seemed appropriate to combine the three approaches to arrive at a broad judgment on the appropriateness of a particular exchange rate. Even under that approach there would still be considerable margin for error, and it might still be difficult to agree on precise rates. However, in some cases, a combination of the three calculations would yield a fairly firm judgment about where an exchange rate should or should not be. Indeed, to some extent, the staff had already made such judgments. Whenever the Fund was asked to take a view on a member's exchange rate, the staff did its best to make such a judgment using existing methods. The only alternative to that approach was to rely on the market and thus to conclude that the market rate was always the appropriate one.

Some Directors had remarked that the optimal degree of exchange rate flexibility might well differ from one country to another, the staff representative commented. For example, countries with a sizable proportion of energy products in total exports might require a relatively large degree of flexibility. The staff agreed with that assessment, but agreement did not mean that such countries could not participate in an exchange rate system. One way to handle such members would be to permit them to have relatively wide margins. He agreed with Mr. Polak that one of the striking features of the present exchange rate system was the wide diversity of exchange arrangements, owing probably to, inter alia, the different structural characteristics of various members. The establishment of a set of regional currency blocks was conceivable. However, in the final analysis, a decision would have to be made on an arrangement for the three largest participants in the system--the United States, Japan, and Germany--to which essentially regional systems could be linked. It was interesting to consider whether the September 22, 1985 Plaza Agreement foreshadowed a more concerted view on exchange rates and policy commitments among the largest countries.

Some Executive Directors did not agree that developing countries could protect themselves from exchange rate variability by using the Euromarkets even if they did not have their own forward cover arrangements, the staff representative commented. The staff had merely tried to present both sides of the issue. In that connection, however, it was interesting to note the development over the previous several years of options markets for currencies--especially the Philadelphia Exchange--which gave traders an opportunity to gain some protection against exchange rate variability at a relatively modest cost. Although the coverage was for a relatively short period--three to six months--the development of such options markets was promising.

Most target zone schemes were based on the assumption that each participant would use monetary policy mainly to keep the exchange rate within the zone, the staff representative remarked. Monetary policy was assumed to be much more flexible than fiscal policy, which, as recent experience showed, usually could not be adjusted quickly. At the same time, much of the misalignment of key currency exchange rates over the previous several years had been due to the divergence of fiscal policies across countries. Accordingly, participants in a target zone scheme would have to maintain appropriate fiscal policies as well as correct monetary policies. Perhaps consultations called for as a result of a trigger mechanism under a target zone scheme should encompass the whole range of policies--monetary, fiscal, and structural--rather than monetary policy alone.

He agreed with Mr. Kafka that the autonomy of monetary policy would be greater under a target zone scheme that permitted the zones to be changed, the staff representative from the Research Department said. However, the cost of such an approach would be the reduced credibility of the zones resulting from the frequent changes in the zones; such target zones could not provide an anchor for market expectations. Still, the difference between target zones and a fixed rate system was that the target zones were to be reviewed occasionally and, if necessary, changed.

Mr. Kafka commented that very frequent changes in target zones would of course undermine their credibility. However, infrequent changes, in response to a movement of an exchange rate away from its equilibrium level, would not harm the system's credibility.

Mr. Nimatallah said that to be credible target zones would have to be supported by the adoption of appropriate policies in individual members. As long as such policies were maintained, he doubted whether speculation would intensify when an exchange rate approached one of the limits of its target zone.

The staff had implied that developing countries had not made use of available options to hedge against exchange rate risk, Mr. Nimatallah commented. In fact, the problems for developing countries caused by exchange rate volatility were even more serious. Executive Board discussions on Article IV consultation reports and reviews under arrangements with members had clearly shown that many countries had had great difficulty in affording foreign exchange to purchase imports; they had had to increase production and divert resources to the export sector in order to increase exports without necessarily recording a corresponding increase in reserve assets because of the growing costs of those assets. As a result, resources in developing countries often had been misallocated, and the standard of living had not been increased.

The Director of the Research Department remarked that if the movement of a currency toward the margin of its target zone was increasing in velocity and there was no strong feeling that the authorities would or could defend the rate, speculators would be tempted to act. Of course, the authorities could conceivably successfully defend their currency by introducing sufficiently credible steps to discourage speculation.

Mr. Chatah said that he suspected that speculation trends under a target zone system would be stabilizing and in the worst case would not differ significantly from the trends under the current exchange rate system. The considerable upward and downward movements of exchange rates under the present system obviously encouraged speculation.

The Director of the Research Department commented that target zones would represent a degree of commitment by the authorities to defend an exchange rate at a certain point. That fact alone would discourage speculation. However, when potential speculators doubted the willingness or the ability of the authorities to defend the exchange rate margins, speculators would feel encouraged to act. In the absence of the margins, the speculators would not have as precise an idea of the exchange rate limits to which the authorities were committed.

Mr. Dallara considered that the staff's approach to the papers under discussion was prudent. The decision not to include a staff appraisal was fully appropriate. He agreed with the staff that, for any exchange rate system to be effective, it must encourage a range of appropriate fiscal and structural policies, as well as correct monetary policies.

A number of ideas had been discussed at the present meeting, and the question naturally arose about the additional work that the staff might undertake before the coming Interim Committee meeting, Mr. Dallara said. He had been reluctant to see the staff discuss in a paper the question of target zones, because he had been worried that such a discussion might be seen as drifting in the direction of the adoption of such a system. In fact, the staff papers under discussion had helped Executive Directors to focus their thinking on the various issues. The coming discussion on surveillance would help Executive Directors to determine the appropriate additional steps that could be taken in preparation for the Interim Committee meeting.

Mr. Sengupta remarked that a significant highlight of the present discussion was the support expressed by a number of speakers, especially Mr. Dallara, for including policies in addition to monetary policy in the coverage of surveillance. Presumably surveillance over exchange rates which encompassed fiscal and structural policies as well as monetary policies would have to include an assessment of exchange rate misalignments which, in turn, would involve the notion of equilibrium exchange rates. The inclusion of a measure of the equilibrium exchange rate implied that there would be considerable independence of monetary policy; after all, an equilibrium exchange rate was affected by other policies--especially fiscal policy--in addition to monetary policy. It should not be very difficult to move to a target zone system, which need not be precisely the same as the various systems described in the staff papers.

The staff representative from the Research Department said that, as he understood it, Mr. Sengupta had suggested that it would not be possible to assess the whole array of a member's policies without in some sense making a judgment about the exchange rate. The notions of an assessment of an array of policies and a judgment about the exchange rate were indeed close; much depended on the particular definition of equilibrium exchange rate. It could be defined as the rate that provided a reasonable balance of payments structure, including a current account balance that on a cyclically adjusted basis, equaled normal capital flows, given the expected path of monetary and fiscal policies over the medium term. On the basis of that popular definition of the equilibrium exchange rate, the rate obviously was directly related to domestic policies and to assumptions about the structure of the balance of payments. Any inconsistency between the actual and equilibrium exchange rates could be corrected by changing the fiscal and monetary policies.

Mr. Sengupta commented that if the authorities in a country or the Fund considered that a current exchange rate was not the right one, the authorities or the Fund must have a notion of the appropriate--or equilibrium--rate. The equilibrium rate would be assumed to be the rate that would make the medium-term external current account balance consistent with normal capital flows, which, in turn, were functions of monetary and fiscal variables. Hence, any observer who suggested that, for example, the U.S. dollar was substantially overvalued must have in mind an equilibrium exchange rate.

Mr. Nimatallah remarked that improving surveillance would involve perfecting and improving the instruments for that exercise. He agreed with Mr. Sengupta's most recent comments, which seemed to be based on meeting that objective.

Mr. Dallara said that he did not agree that a conclusion that an exchange rate was wrong was necessarily based on a notion of an equilibrium rate.

Mr. Zecchini remarked that he too did not believe that surveillance over exchange rates involved a comparison between an actual rate and some unpublished target rate. One of the main questions at hand was whether a member's exchange rate was an appropriate indicator to use in judging the correctness of the country's policies not only in the context of that country's domestic situation but also in relation to the policies of other relevant countries. That judgment was the essence of any effort to encourage policy discipline, consistency, and coordination. He doubted whether a member's current exchange rate was an accurate indicator of both the appropriateness of a member's policies and the correctness of the policies vis-à-vis the policies of other countries. He also doubted whether an equilibrium exchange rate could give an accurate signal of the consistency of a member's policies with policies of other countries. The present discussion had underscored the existence of many gray areas in the working of the exchange rate system and in the relationship between the system and the economy of a country. There was a variety of interpretations of the experience with the EMS, and a seminar discussion--with no record--on the significance of that experience for the world economy might well be helpful.

Mr. Sengupta said that by "equilibrium exchange rate" he meant the rate that was the outcome of the solution of a set of simultaneous equations. There must be a yardstick against which to measure the current exchange rate. Such measurements were difficult to make, but they were made routinely by market participants and policymakers.

Mr. Zecchini considered that it was impossible to measure an equilibrium exchange rate; the number of simultaneous equations was enormous, and the task would exceed the present capacity of economic analysis. That conclusion had been reaffirmed by his own experience with the exchange rate link system that had preceded the EMS. Hence, he had had in mind a more realistic interpretation of the concept of an equilibrium exchange rate--namely, a rate that was based on the entire balance of payments, including capital movements. Even that interpretation involved substantial difficulties, as the exchange rate model would have to be based on past experience that could not take into account the future objectives of the authorities concerned; the calculation of the equilibrium rate would have to involve considerable guesswork.

Mr. Nimatallah remarked that the staff seemed to believe that equilibrium exchange rates could be calculated within a certain margin of error. error. Presumably the kind of judgmental yardstick that he and Mr. Sengupta had mentioned could be found. It would not have to be constantly available on a short-term basis; the rate concerned could be the appropriate rate over the longer run. Even an estimate with a margin of error of about 10 percent could be a useful indicator in making judgments about an exchange rate.

The staff representative from the Research Department said that in his earlier comments he had not meant to underestimate the difficulty in estimating a pattern of equilibrium exchange rates among the key currencies. In some cases the results of the application of the various methods described in the staff reports would point in the same direction, but in other cases each method might yield significantly different results. Many strong proponents of the target zone proposal admitted that it would be unrealistic to have zones with margins of less than 10 percent. A number of legitimate arguments could be made about the various factors involved. For example, it would be difficult to agree on what constituted normal capital flows into the United States. It would also be difficult to estimate precisely the delays with which exchange rate changes affected trade balances. However, the task of estimating a pattern of equilibrium rates was not an impossible one. The international community had maintained a par value system for a long period, and the EMS had been in operation for a number of years. Appropriate exchange rates could be estimated, although the margin of error could be significant.

Mr. Nimatallah remarked that he fully understood that it would be difficult to make the initial calculations required to establish a target zone system. However, the difficulty in making the calculations would probably decrease with experience.

Mr. Lankester said that he assumed that Mr. Nimatallah and Mr. Sengupta had been referring to the appropriate level of real exchange rates. The nominal exchange rate had to be adjusted in order to achieve a particular real exchange rate, and the desired real exchange rate could not be achieved if domestic prices offset the nominal exchange rate movement. If the authorities depreciated the exchange rate but the domestic price level offset the depreciation, the result would be undesired inflation to which the authorities would have to respond with an effort to disinflate the economy. The appropriateness of an exchange rate had to be assessed in terms of domestic monetary conditions as well as the balance of payments.

Mr. Fujino commented that an assessment of the level of an exchange rate should be based on a variety of economic indicators. For example, in Japan, the exchange rate was appreciating, but any assessment of the appropriate rate for the yen must take into account the fluidity of the Japanese economy and the structural adjustments that were being made in Japan.

The staff representative from the Research Department remarked that most target zone schemes were based on the assumption that the real exchange rate could be controlled through changes in the nominal rate. The objective was to control real exchange rates--rather than nominal rates--because the real rates were relevant for the balance of payments. However, it was also assumed that target zones would be set in nominal terms for operational purposes. In the short run, the correspondence between nominal and real exchange rates was typically very close. Over time, it became increasingly difficult to control the real exchange rate by adjusting the nominal exchange rate, especially in open economies. Hence, it was important to take into account the effects of exchange rate changes on domestic prices and to determine the extent of control over the real exchange rate, which was likely to be smaller in the long run than in the short run.

The Chairman commented that there would have to be some flexibility in the operation of any kind of target zone system. The operation of the system would probably have to be based on nominal exchange rates, and participants in the system would have to consider the need to respond to the consequences of a real exchange rate that had become significantly out of line.

Mr. Sengupta remarked that experience seemed to suggest that there was not a close relationship between real and nominal exchange rates in the short run in developing countries. Some time was usually required for nominal and real exchange rates to converge.

The Chairman made the following concluding remarks:

There is clearly widespread concern among Executive Directors about the way in which the exchange rate system has operated in recent years. In this connection, I wish to make several points.

First, there was broad agreement that, in present circumstances, a return to a fixed exchange rate system would be impracticable and undesirable. Given the magnitude of the external shocks that the world economy has suffered over the past ten years or so, and given the size, the openness and the integration of capital markets, Directors considered that an element of flexibility in the working of the exchange rate system has been--and remains--essential, as it has helped to preserve an open trading system. Its flexibility has contributed to the absorption of shocks by the system.

Second, it was widely recognized that the floating system has not functioned without substantial problems. Massive balance of payments imbalances have developed, there has been excessive short-term exchange rate volatility, and, perhaps more important, significant and persistent misalignments in exchange rates have appeared. These problems have entailed substantial costs in terms of market uncertainty, misallocation of resources, and protectionist pressures. A number of Directors considered that these costs have been particularly acute for developing countries--which have greater difficulty than industrial countries in utilizing hedging mechanisms--and for small, open countries, which are more vulnerable to external shocks stemming from exchange rate volatility and/or misalignment. The staff was asked to study further the possible differences in the impact of exchange rate variability and misalignment on the various groups of members.

Third, a number of Directors considered that the payments imbalances, exchange rate volatility, and exchange rate misalignments were not due directly to the floating rate regime itself; rather they were the reflection of the divergent and sometimes incompatible economic policies of the major industrial countries. However, a large number of Directors recognized that the way in which the floating regime had operated has some systemic implications. Indeed, the system had not helped to promote discipline and coordination in the setting of economic and financial policies in the major industrial countries. Moreover, the system had not--as had been hoped by some before the launching of the system--fully protected monetary policy autonomy. In sum, there was a clearer recognition that exchange rates do count, and that a more "active approach" toward improving the system was called for. The Plaza Agreement of September 22, 1985 and President Reagan's recent statement on currencies in his State of the Union Address are manifestations of the need for that approach.

In the light of those general points, the question naturally arises what is to be done to improve the functioning of the system? A number of interesting views were expressed.

Directors generally agreed that the potential improvements in the exchange rate system rely heavily on the extent to which individual major industrial countries in particular will show the political will to increase policy discipline and pursue more internationally consistent policies. In other words, the basic questions are whether the international consequences of domestic policies will be taken more fully into account by the interested authorities when they formulate and implement those policies, and how the exchange rate system can enhance such mutual consistency.

The practical suggestions that have been presented and analyzed by the staff have to be looked at in the light of the objective of improving the functioning of the exchange rate system in order to achieve better policy coordination and consistency.

Twelve Directors said that they have an open mind on or a favorable attitude toward some form of target zones. The basic idea behind that line of thought is that target zones would introduce an automatic or quasi-automatic mechanism which would enhance the discipline in the system. There were some nuances of opinion among those who held that basic view. But several Directors were interested in a target zone system that would have the following characteristics: it would consist of a version of "soft" targets, at least at the start; it would give at least an indication of the direction of appropriate exchange rate movements, if not a precise pattern; it should trigger discussions in the event of emerging misalignments or other problems; it should provide a framework for regular discussions among major countries with a view to preventing problems; and the exchange rate indicator would be only one element of a broader set of criteria to be utilized in assessing the position of economic policies of different countries. Some Directors felt that an expanded version of the EMS was worth considering.

Other Directors were skeptical about, or had reservations on the idea of, setting a pattern of exchange rates and using that pattern as an operational mechanism. They made in particular the following points. First, it would be very difficult, if not impossible, to reach an agreement on a pattern of equilibrium exchange rates. Second, such a system could in some circumstances facilitate or foster destabilizing speculation. Third, and perhaps more important, concentrating on one indicator, the exchange rate, as a guide for policy adjustments, and using only monetary policy--the most flexible instrument--to maintain a predetermined pattern of exchange rates, could together result in inappropriate policy responses in some circumstances; monetary policy could become excessively subservient to the attainment of external policy objectives, and the system could then encourage inflation or deflation.

Whatever the mechanism, most Directors agreed that, without sound and consistent economic policies, a target zone system would not be an appropriate tool in itself, and could send misleading signals.

Most--if not all--Directors considered that the September 22, 1985 Plaza Agreement was a favorable--although belated in the view of several--development, as it was a manifestation of closer convergence of economic policies and had encouraged a more rational pattern of exchange rate developments. Most Directors also agreed that improved cooperation among the largest players in the exchange rate markets--especially the major industrial countries--was crucial for the successful working of any exchange rate regime. Most Directors further agreed that the appropriateness of exchange rates should be one, but only one, of the elements involved in the exercise of multilateral surveillance.

I come now to the possible role of objective indicators in the conduct of surveillance. A number of Directors stressed what they felt were the imperfections of the peer pressure mechanism and of the present surveillance procedures. They urged the Fund to adopt a negotiated set of broad objective indicators that could trigger policy discussions or even policy actions. But many Directors were skeptical or had reservations--indeed, some of them had strong reservations--about the mechanical use of such indicators, because of the complexity and possible shortcomings of such an exercise. In any event, several of them doubted whether it would be practicable to attain a consensus on such a complex array of indicators. But all agreed that the efficiency of surveillance should be reinforced, and I expect that to be the major theme of next week's discussion on surveillance.

In concluding I would note 11 precepts that were mentioned during the discussion. (1) The existence of a broad political will to take appropriate actions is a prerequisite for the successful working of any exchange rate system. The needed political will would be fostered by an appreciation by policymakers of how their own actions can affect the exchange rate system and in turn their own economies. (2) The major currency centers must maintain stable, anti-inflationary, sound and balanced economic policies if any exchange rate system is to work. (3) Surveillance must be reinforced and should encompass a wide range of indicators, including exchange rates. (4) The Fund must play a central role in the operation of and surveillance over the exchange rate system. (5) Directors should build on the strengths of the present system and correct its imperfections. (6) Whatever system is devised, it must have sufficient flexibility. (7) Directors should not overemphasize the significance of the differences in the various possible approaches to obtaining improvements in the exchange system; they should concentrate on the basic substantive objectives of those improvements. (8) The Fund should study more deeply the merits and limits of the EMS system as an aid in assessing possible improvements in the overall exchange rate system. (9) The improvements should aim, in particular, at avoiding the major misalignments that have marred the present system in recent years. (10) In discussing these matters we should not have in mind ideal, textbook situations and solutions. Instead, we should consider proposals and actions that are realistic and which are based on an understanding of how the markets function and are likely to react to changes in the exchange rate system. (11) We should do nothing that might encourage trade and payments restrictions.

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