NOT FOR PUBLIC USE

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/29

10:00 a.m., February 19, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	M. K. Bush
J. de Groote	
	S. de Forges
M. Finaish	
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
A. Kafka	
T. P. Lankester	M. Foot
	H. Fugmann
M. Massé	L. Leonard
E. I. M. Mtei	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	
J. J. Polak	J. de Beaufort Wijnholds
C. R. Rye	
G. Salehkhou	O. Kabbaj
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

A. Wright, Acting Secretary
K. S. Friedman, Assistant

1. Surveillance Over Exchange Rate Policies - Review; and Implementation of Procedures for Surveillance - Review and Proposals for Change . . . . Page 3
2. Assistant to Executive Director . . . . Page 43
3. Approval of Minutes . . . . Page 43
4. Executive Board Travel . . . . Page 44

Also Present

African Department: G. E. Gondwe, Deputy Director; J. M. T. Paljarvi. Asian Department: A. Ariyoshi. European Department: A. López-Claros. Exchange and Trade Relations Department: C. D. Finch, Counsellor and Director; W. A. Beveridge, Deputy Director; M. Guitián, Deputy Director; G. Belanger, J. T. Boorman, E. H. Brau, A. Chopra, B. Christensen, R. Pownall. External Relations Department: M. Goldstein. Fiscal Affairs Department: V. Tanzi, Director. Legal Department: W. E. Holder, A. O. Liuksila. Middle Eastern Department: B. A. Karamali. Research Department: W. C. Hood, Economic Counsellor and Director; A. D. Crockett, Deputy Director; R. R. Rhomberg, Deputy Director; J. M. Boughton. Secretary's Department: G. Djeddaoui. Treasurer's Department: 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, S. Ganjarerndee, S. M. Hassan, J. Hospedales, G. Nguyen, J.-C. Obame, P. Péterfalvy, M. Z. M. Qureshi, Song G., D. C. Templeman, A. Vasudevan, M. A. Weitz. Assistants to Executive Directors: B. Bogdanovic, J. J. Dreizzen, G. Ercel, R. Fox, V. Govindarajan, G. D. Hodgson, L. Hubloue, Z. b. Ismail, S. King, K. Murakami, J. K. Orleans-Lindsay, J. Reddy, J. E. Rodríguez, S. Simonsen, L. Tornetta, A. J. Tregilgas, H. van der Burg, E. L. Walker, B. D. White, Yang W.

1. SURVEILLANCE OVER EXCHANGE RATE POLICIES - REVIEW; AND IMPLEMENTATION OF PROCEDURES FOR SURVEILLANCE - REVIEW AND PROPOSALS FOR CHANGE

The Executive Directors considered a staff paper on the biennial review of the 1977 document on surveillance over exchange rate policies (SM/86/3, 1/10/86) and a staff paper on the annual review of surveillance and proposals for changes in the procedures of surveillance (SM/86/4, 1/10/86). They also had before them as background material a paper providing factual information on the implementation of surveillance procedures in 1985 (SM/86/4, Sup. 1, 1/28/86).

Mr. Dallara made the following statement:

Introduction

I welcome today's discussion of Fund surveillance, including, as it does on this occasion, the biennial review of the 1977 surveillance decision. This year's discussion takes on added significance, in light of the broad interest that is emerging in strengthening the international monetary system and, in particular, the exchange rate system, of which Fund surveillance is an integral part.

As I noted during our discussion the previous week, although the current exchange rate system has provided needed flexibility to deal with the economic shocks of the 1970s, it has not been as stable as we would have liked nor as stable as many might have expected in light of the convergence that has occurred toward lower rates of inflation in recent years. The fact that inflation performance has, on the whole, improved, while exchange rates have shown considerable variability, is a point to which I will return in my statement when discussing the need for a broad range of factors to be evaluated when assessing the causes of exchange rate problems.

As many Directors noted last week, exchange rates have not only been characterized by considerable short-run variability but also at times have not fully reflected underlying fundamentals and policy commitments. Related to both of these is the fact that under the current system policies of members have not been as sound or consistent, nor performance as convergent, as would have been preferred. The extent to which this is due to inadequacies in the system is, of course, unclear. But, to the extent that there is a view that the system could have prompted, in some instances, sounder policies at an earlier stage, then we must look to how the system could have done this in the past, and could do so in the future.

This brings me to the subject of surveillance, since it is firm Fund surveillance in the current system that is to help prompt sound policies and international cooperation. It has generally been agreed that closer international economic cooperation, particularly among major countries, is a necessity for strengthening the current international monetary system. Surveillance can be an important mechanism to promote sound policies and such cooperation, perhaps by helping to strengthen the political will to follow sound policies that are consistent with national and international interests and to prompt the need for discussion and action. Any effort to strengthen the current exchange rate system should begin, therefore, with an effort to strengthen surveillance. How this can be done, and whether and how we might need to go beyond that, are of course among the important questions that we need to address.

Secretary Baker, in his address to the G-10 Finance Ministers the previous June, reiterated the U.S. commitment to surveillance and our desire to strengthen surveillance, with the goal of promoting more sound and compatible policies amoung members in an environment of low inflation and growth. He noted at the time that the provisions for Fund surveillance had not been fully developed and that he was somewhat disappointed that the G-10 Deputies had not gone further in suggesting additional measures to improve surveillance. He felt that if surveillance were to be effective, we needed to implement promptly the measures recommended in the G-10 report, as well as to look beyond them, as we continue our efforts to improve the capacity of the system to encourage and foster the kinds of policies that will produce greater international economic stability.

We have an opportunity today to further that effort, by examining the specific measures proposed in both the G-10 and G-24 reports to improve surveillance procedures, as well as to consider possible revisions in the principles of surveillance as part of the biennial review of surveillance.

Background

Before I discuss specific measures to improve surveillance, I would like to comment briefly on some points raised in the beginning of the staff paper on the biennial review of the 1977 surveillance document (SM/86/3). First, I found it helpful to review the underlying premises of surveillance and how the changing nature of the system has altered the thrust of surveillance. One basic premise of surveillance, however--in fact, a basic philosophical underpinning of the amended Articles--has not changed; that is, as the staff states on page 9, "the expectation that restoration of stability in domestic economies of member countries would be the main requirement for restoring better stability in the international exchange system more generally." This is as applicable today as when the Articles were amended in 1978.

In the evolution of surveillance--and the evolution of thinking which has motivated surveillance--one can see a broadening of the focus beyond "manipulation" of exchange rates, and indeed a general broadening of the notion of what constitutes exchange rate policies.

As the staff paper points out, for example, the identification of certain actions such as prolonged one-way intervention and excessive borrowing originally conceived of in the context by being seen of exchange rate manipulation--became part of surveillance in a somewhat broader context by being seen as constituting developments "which might indicate the need for a discussion with a member." This list, of course, includes a range of policy areas, such as the pursuit for balance of payments purposes of monetary and other domestic financial policies that provide abnormal encouragement to or discouragement of capital flows.

I refer to it here to this list to indicate how the early evolution of surveillance involved a broadening of the concept of exchange rate policies. This has, of course, been borne out increasingly in, inter alia, the Article IV consultations with individual members.

I might take the opportunity to point out here that the need to take such an approach was not only reflected in the drafting of the Principles of Fund Surveillance over Exchange Rate Policies, but was also foreseen by some of the analysts of the day. Two experts, writing in a May 1978 article on surveillance, stated:

> Because of the real divergence in interests among countries and the many uncertainties inherent in the appraisal of exchange rate policies--in particular, the difficulty of assessing the appropriateness of an exchange rate for the longer term--such surveillance cannot be based on a single objective indicator or even on any precise set of rules. Thus, in arriving at a judgment as to whether a country's exchange rate policies constitute an unwarranted hindrance to the proper working of the international adjustment process, the Fund must make a comprehensive appraisal of these policies. These points have been taken into account in the new Article IV and in the Fund decision of April 1977.

We have the benefit of knowing that one of the authors of this statement, Andrew Crockett, has not changed his mind, since he and his colleagues tell us on page 18 of SM/86/3 that "to be effective, surveillance must be extended to all policies having such effects"--that is, effects on exchange rates and stability of the system.

Efforts to improve surveillance

Efforts to improve surveillance could take a number of forms and directions. For purposes of organization, I will discuss the ways to strenghten surveillance under four different headings: amendments to the General Principles of Surveillance; amendments to the Principles for Guidance of Members' Exchange Rate policies; amendements to the Principles of Fund Surveillance over Exchange Rate Policies; and measures to strengthen surveillance procedures, including possible amendments to the Procedures for Surveillance. These possible approaches dealing with the three sets of Principles, as well as the Procedures for Surveillance, are not, of course, mutually exclusive; it is conceivable that each, in fact, could serve in some way to increase the effectiveness of surveillance.

General principles

There is no doubt that domestic policies and their international interaction do have an impact on exchange rates, other members, and the stability of the system as a whole. Therefore, surveillance should focus--and, indeed, has increasingly focused--on a broad range of policies, including domestic policies. The Fund clearly does have explicit surveillance responsibilities over domestic policies as they relate to the international system, as set forth in Article IV, Section 3(a), which calls on the Fund to oversee the compliance of each member with its obligations under Section 1 of Article IV. As the staff paper points out, Article IV, Section 1, of course, outlines not just exchange rate obligations, but members' general obligations to, inter alia, ensure that they endeavor to direct economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability.

As noted above, and as we have observed in this Board on so many occasions, surveillance over domestic policies has been carried out increasingly in the context of individual Article IV consultations, and in the world economic outlook as well as on other occasions. The question is whether it would be necessary, helpful, or appropriate to codify existing practice and to affirm more explicitly the Fund's broad surveillance responsibilities. We do not think that it is absolutely essential to do this, but are inclined to believe that it may be both helpful and appropriate. Therefore, we would suggest that the staff provide us with draft language for possible revisions of the General Principles in this direction, perhaps for our consideration when we return to this issue after the spring Interim Committee's meeting, if this were consistent with the Interim Committee's guidance.

Principles for guidance of members' exchange rate policies

The weaknesses in the current system imply that, as the staff states on page 15, "the current principles for the guidance of members' exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability." This points to the possible need for the Fund to provide more specific guidance to members with respect to their exchange rate and related economic policies.

We would agree with the premise taken in the staff paper that any amendments to the principles for guidance of members' exchange rate policies should focus on the first principle, section A, and not principles B or C. Principle A currently reads that "a member shall avoid manipulating exchange rates for the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."

The staff paper presents three approaches, on page 18, which go in the direction of amending these principles for the guidance of members' exchange rate policies with the goal of providing more specific guidance. The first approach involves the establishment of target zones. This was discussed at some length during our recent Board meeting on the exchange rate system. It clearly raises a number of fundamental issues which would have to be addressed before the concept of target zones could be incorporated into surveillance principles. Since I believe that those issues are perhaps more appropriately considered in discussions focusing more direclty on the exchange rate system, I will not comment further in detail on them today but rather at the time of our next discussion of these issues. I would, however, make one point in this regard that might help focus the issue, as I believe that it is relevant for today's discussion. Regardless of whether one supports the concept of target zones, as many did last week, or perhaps the notion of target directions, as Mr. de Groote outlined, or whether one can support neither, there is broad recognition, including by my authorities, that the exchange rate can be a useful variable as an indicator, or barometer, of policies and performance in two or more countries. Whether the exchange rate is the best or only indicator, however, is another question.

This question is addressed in part by the staff's second proposal, which would involve the establishment of limits on certain domestic policy variables. I could not endorse the precise formulation of the staff, but I do believe that the general direction of thinking embodied in this approach may have some merit--that is, a focus on underlying policies, and I would add, on performance. This could help focus attention on the main problems which underlie divergences of economic performance and exchange rate problems. Such an approach is, of course, consistent with--although not necessarily linked to--the thought outlined earlier of developing general principles for members' economic policies, not just exchange rate policies. It is also consistent with the G-10 report, which called for more explicit analysis of domestic policies so that interdependencies and mutual repercussions could be fully brought out and taken into account.

There are many questions that would need to be addressed in considering the practical possibilities of such an approach, such as: how to incorporate structural policies or developments into this approach; the appropriate degree of quantification; the appropriate setting for discussions--bilateral or multilateral--whether any quantification would represent general goals or, as the staff paper suggests, "limits" on the development of certain variables, a notion which I suggest may be too precise in this context; and whether any variables should focus on policy outcomes or policy instruments. These are only a number of the questions that arise.

The staff suggests that focusing on instruments, such as the stance of domestic fiscal or monetary policy, would be preferable. I am not so sure. I wonder whether the staff might not wish to do further work on this question, with less emphasis on "targets" or "limits," per se, and with some attention to the identification of the range of policy areas, as well as perhaps some consideration to the feasibility and/or desirability of using notional ranges for final economic outcomes or objectives in such areas as growth, inflation, employment, and--extending into the external sector-current account positions. In this approach, a basis for considering the need for discussions could be a substantial deviation from the notional range of a particular outcome in one of these areas. In considering how to approach any additional work along these lines, I would stress the need for economic and political realism. To be frank, we should be searching for a system that actually has a chance of working with major countries.

Principles of Fund surveillance over exchange rate policies

This brings me to a third means of strengthening Fund surveillance, as mentioned by the staff, which might be to modify the Principles of Fund Surveillance over Exchange Rate Policies to include a wider range of developments which might indicate the need for discussion with a member or perhaps members. Under this approach, consideration could be given to adding to the list of "negative indicators" currently contained in Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies. Such additions might comprehend explicitly such areas as fiscal, monetary, wage, and structural policies. Such an approach need not, at least in the early stages, involve any quantification, consistent with the emphasis in the G-10 report on judgmental assessments.

It would be helpful to have the staff provide a paper, or section of a paper, outlining policy areas, with specific language suggestions that might be added to Section 2 in the Principles of Fund Surveillance over Exchange Rate Policies. Of course, if new, broader general principles of Fund surveillance were developed, this would have implications for how this section of the Principles of Fund Surveillance would be modified.

As a final thought on this section, I would agree with the suggestion that the phrase "for balance of payments purposes" is not needed in the various subsections of Section 2. It is clear that economic policies enacted for other than balance of payments reasons can also affect the economies of other members and the system as a whole.

Proposals for changes in procedures

I will briefly summarize our views on the particular points presented in the G-10 and G-24 reports relating to strengthening surveillance procedures--as summarized on page 12 of SM/86/4. First, I will comment on proposals to improve the analytical basis of surveillance.

Proposals related to the analytical basis for surveillance

Regarding data, we strongly support the effort of the Fund and member countries to improve the availabilily, coverage and accuracy of data, including those related to structural developments. Subsumed in that latter category would be labor market developments, such as wages, employment and regulations; and financial market developments, including policy tools and institutional characteristics. Without accurate and timely data, the task of economic policy formulation is made difficult, and the danger arises that inappropriate policies may be implemented. We welcome and lend further encouragement to the Fund's efforts to improve data collection.

Regarding the policy coverage of surveillance, as I have indicated earlier, we believe that the areas covered should be extensive. Here I would fully associate myself with the G-10 report, which states in paragraph 43:

> The Deputies agree that Article IV consultations should continue to be primarily concerned with the broad range of macroeconomic policies, including exchange rate policies, bearing on a country's external position and on international adjustment. Within this overall framework, they propose that consultations should also give more emphasis to analysis of capital account developments, government policies which hinder the efficient operation of exchange and capital markets, and, more generally, impediments to the international adjustment mechanism caused by trade restrictions and other protectionist measures, such as policies to provide special incentives to exports or discourage imports, other market-distorting policies and structural rigidities. In order to achieve greater consistency and continuity of action, policy analyses and recommendations should be viewed in a medium-term framework.

This paragraph might have some useful ideas for the staff as they go about developing various alternative drafts of possible amendments to the Fund's principles, as I discussed earlier. It could be relevant, for example, to an effort to extend the "negative list" incorporated into Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies.

One further comment on this issue relates to the statement on the bottom of page 13 of SM/86/4, where it is suggested that the "discussions be tailored to reflect the relative importance of the urgency of corrective actions in various areas of policy." While I would not disagree that discussions must be focused and must involve a sense of priorities, we should avoid focusing so narrowly on immediate problems that we lose sight of the longer-term policy implications of specific actions, which may only appear to have an effect with a considerable lag, such as policy measures in the structural/institutional arena. After all, a medium-term framework is not just a financing framework, but one in which to outline policies and performance over the medium term as well.

This brings me to the next point, the time horizon for reviewing prospects and policies. We have been pleased to see the growing inclusion of medium-term outlooks in staff papers and view them as being helpful to us both as a member of the Board exercising surveillance over other countries and as the representative of the largest member country. We agree that the emphasis should be on policy sustainability, and in this regard we believe that stronger emphasis should be placed on structural inadequacies in member countries, including those relating to tax policies, while continuing to analyze and make suggestions on the macroeconomic policies reviewed by the Fund. I stress this since, while structural misalignments may not appear to be the direct cause of a balance of payments problem or inadequate growth, it is clear that in many countries structural rigidities are contributing to delayed exposure to domestic and foreign competition and to slower growth and diversification. This can damage export prospects, impede resolution of debt problems, heighten protectionist pressures, and erode confidence in and the attractiveness of a member's currency.

Finally, we would welcome more detailed presentation of assumptions and of the analytical framework underlying the medium-term outlooks, especially since this will increase the usefulness of such an exercise to the member's authorities. This is particularly important in the 25 largest countries and with respect to any policy areas in those countries where there may be differences of view regarding the economic relationship between policy actions and economic outcomes.

Turning to the suggestions made for improving policy assessment, we agree that major policy inconsistencies should be clearly identified in a medium-term context. In fact, a strong emphasis on the medium-term implications of action, or lack of action, can bring home more forcefully the need for immediate action and can perhaps help generate a broader base of support for unpopular actions if positive benefits over the medium-term could be more clearly identified. The identification of policy trade-offs may also help to focus attention on the policy options realistically available.

The final set of suggestions relating to the staff's presentation of specific policy recommendations to a member's authorities deserves our full support. In particular, we would place a high priority on the staff presenting, where appropriate, precise policy steps to help achieve generally agreed-upon policy goals. We would recommend precision with regard to both the content and timing of specific policy actions recommended by staff.

Proposals related to the multilateral setting of surveillance

Let me begin by recognizing the work done by the Group of Twenty-Four in formulating specific proposals regarding multilateral surveillance. We understand the basic objectives of their suggested approach and share some of the general interest reflected in developing multilateral surveillance. However, we find that the specific proposal put forth in their report goes too far; it is in our view too ambitious and unworkable, involving, as it would, not only multilateral discussions but also negotiations on a mutually consistent set of objectives and policies to achieve these objectives. We believe that it would not be feasible at one point in time to expect to be able to reach a uniformity of views among so many countries, in such a precise fashion, that could lead to specified actions.

The ideas put forth in the G-10 report regarding multilateral surveillance are less ambitious and could serve as a useful starting point for further efforts in this area. In particular, the world economic outlook report currently discusses developments in the major groupings of countries. This discussion could be broadened to form two separate chapters. One would review the policies of the major industrial countries--and here I refer to the Group of Ten--highlighting interrelationships and any possible inconsistencies between national policies and broadly agreed objectives. For example, in current circumstances one could assess whether the policies of the United States, Germany, and Japan are mutually supportive of the agreed objective of reducing external imbalances in an acceptable time frame.

We believe that a comprehensive discussion of this world economic outlook chapter in the Board--on a separate day--could increase the awareness among members of the international and ultimate domestic implications of their policies, particularly in the medium term. In the next Board meeting, following this discussion on the basis of a separate chapter, we could envision a discussion of the 10-15 major developing countries, considering not only the effect of industrial countries' policies and performance on these developing countries, but also emphasizing the collective and individual roles of the largest developing countries in affecting world economic performance, including their impact on performance in the industrial countries.

Some additional possibilities come to mind, including one preliminary thought that any time the Fund might engage, under the provisions for supplemental consultations, in supplemental consultations with a single member, we might consider the possibility of conducting some limited additional discussions with those countries most closely linked--either through trade, investment or financial flows--with that particular member. This may involve some practical difficulties, but we believe that it merits further consideration.

I would like to make a final point. While the Fund Board can--and, indeed must--play a central role in strengthening multilateral surveillance in the system, it is not the only forum. Currently, multilateral surveillance occurs, for example, in Working Party 3 of the OECD. Furthermore, there may be occasions, some involving limited groups of countries, when multilateral surveillance cannot most productively take place in the Fund Board. Perhaps on such occasions the Managing Director could play a role.

Proposals related to strengthening the influence of the consultation process

At the previous year's discussion on surveillance, I was supportive of various proposals to strengthen the influence of the consultation process. This year, I can reiterate that support and make a few additonal suggestions.

Regarding the follow-up to consultations, since staff assessments should be candid, we believe that a comprehensive review of economic performance measured against the recommendations of the Board made at the close of an Article IV consultation should be included in the next consultation report. Such an assessment would be particularly important for the 25 largest members of the Fund--both industrial and developing countries--that have important roles in the world economy. We envision that this comprehensive review in the next Article IV staff report would go beyond the short summary paragraph currently included in most staff reports and could encompass detailed references in both the summary of economic developments and the discussion of policy implementation in the period since the last Board review.

We agree that internal publicity within the member government should be enhanced; in particular, it would be useful if the Fund team met uniformly with high policy level officials. Then, perhaps an improved effort could be made to ensure that these same high level officials see the final staff report and the Chairman's summing up.

Furthermore, we continue to believe that surveillance would be strengthened if management met with the the Minister of Finance at the end of the discussions, not jut in those instances where there appears to be an "urgent" problem but in those 25 or so large countries whose policies and performance are of greatest concern to the world economy. This could help indicate to those most influential members the far-reaching impact of their performance and policies on the rest of the world and would go beyond the staff suggestion that the Managing Director just "communicate directly" with the Minister of Finance. We recognize the need for flexibility in implementing this policy in order to avoid an undue time and travel burden on management. Perhaps such meetings in some cases might not always be held on the occasion of the staff level consultations. In some cases, use could be made of the presence of Ministers of Finance in Washington during Interim Committee and Annual Meetings.

We could also envision these largest countries preparing a report, as part of the annual consultation process--and as suggested in--the G-10 report, paragraph 45--"outlining the measures introduced or considered to deal with the problems identified by the Fund and to respond to specific policy suggestions." Thus in our view, the staff suggestions on page 20 of SM/86/4 are too restrictive in that they would appear to apply only to those countries in which serious differences of view emerged. Even in those countries where there was apparent general agreement on the future direction of policies, follow-up reviews and reports by members' authorities could strengthen the implementation of those policies.

Such reports could be prepared by the authorities within, say, six months, of the conclusion of an Article IV consultation. The response of the authorities in that report to the specific recommendations made earlier by the staff and the Fund Board could perhaps in a few cases lead to a supplemental discussion, if the Managing Director found the report to indicate that serious differences of view or problems remained. These problems could, perhaps, be gauged by use of the negative list of indicators I mentioned earlier, which would build on Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies. Such a procedure could perhaps lead to a brief oral report to the Board of the Managing Director's discussions and would not necessarily require further analysis by the staff. We would not, of course, wish such "six-monthly" reports to lead to, in effect, semiannual consultations for the major countries and we would need to avoid that in implementation of six-monthly reports.

We would also welcome a variation of a proposal included in the G-24 Report that the Fund should broaden its coverage in information notices to include a more comprehensive grouping of policy changes, not just exchange rate and trade policy developments. While such information notices would not necessarily be discussed by the Board--and we do not see them leading to supplemental consultations--they would serve to inform all members of important changes in domestic and external policies and performance in members. We would welcome staff and other Directors' views on this possibility.

With regard to external publicity, we continue to believe that a release at the end of a Board discussion of an Article IV consultation with one of the larger industrial or developing country members of a statement that would "give a brief assessment of a country's policies and prospects and would indicate the broad direction of suggested policy changes" (G-10 Report, paragraph 48) could be quite useful in strengthening the surveillance process. We also support release of some parts of the staff reports on recent economic developments, although not the full staff report. I remain somewhat puzzled by some of my colleagues who believe that some publicity will compromise the basic confidentiality of the consultation process. We believe that confidentiality should be preserved and can be maintained with limited publicity. Such publicity could improve the accountability of national authorities regarding the international implications of their policies.

We have previously expressed interest in greater use of the supplemental surveillance procedure on the occasion of "exchange rate and other developments that may be important or may have important effects on other members, or that have implications for the operation of the international monetary system"--G-10 Report, paragraph 46--or in relation to developments which might indicate the need for discussion with members. It is clear that these other developments should include a broad array of economic developments and, as such, should encompass various structural and institutional developments. We would not preclude some degree of quantification that might help prompt the need for discussion, but such quantification should be broadly based, and we would continue to rely heavily on judgmental assessments.

One aspect of surveillance procedures that is not dealt with in the staff papers and that perhaps needs more attention relates to strengthening the influence of the consultation process. I have the impression that, too often, the main practical result of consultations is an exchange of information on economic developments and policies and that a lively, genuine give-and-take on existing policies and policy recommendations may be missing in some cases. If that is the case, it may well be due to the attitudes of the authorities and not the approach of the staff. Regardless, it is important that the staff present their analysis, projections, and arguments for preferred policies clearly and precisely to the authorities. These must be founded on a spelled-out analytical base. Staff should then use their not-inconsiderable persuasive powers--with charts and tables to back them up--to seek consideration of what they consider to be the proper policy course.

I am not suggesting a confrontational approach. However, I do think that it may be easy in some cases, particularly those involving the largest members, not just the United States, for both the staff and the authorities of the member country to engage primarily in an exchange of information and policy opinions. On the side of the national authorities, it is not a bad thing for them to hear an outside view of a country's problems and policy options in the context of a clear set of arguments on how a desired economic outcome might be most readily achieved, based on a sound analytical base. A consultation scenario which might favor such an outcome could involve a fairly clear separation between the information-gathering phase of consultations and the policy dialogue phase, with a sufficient period in between to allow for careful consideration of economic prospects and policy implications gleaned from the information-gathering phase.

In this connection, I would like to suggest that the staff should prepare a short paper, drawing on actual experience from several regional departments, on how the actual process and procedures of consultations have worked, the level and extent of discussions, and the principal information exchanged.

Conclusion

As I said at the beginning of my statement, the true test of our surveillance efforts will be whether they succeed in helping to bring about better economic policies in our member countries and a more stable system. I recognize that the larger members of this institution, both industrial and developing, have the largest impact on the world economy and on the international monetary system and that they have special responsibilities. However, all countries share these responsibilities, and all countries must be willing to participate in any reinforced surveillance effort. One sometimes gets the impression that the support for stronger surveillance is focused on stronger surveillance of the other fellow's and not of one's own country.

I cannot promise that my own authorities will always concur in the economic analysis and policy prescriptions which emerge from the Fund and its members. But, they are more likely to be inclined to participate in a strengthened surveillance process with an open mind if they believe that it is part of a general strengthening of surveillance to which all countries commit themselves, with all countries accepting the idea of exposing their policies to the light of foreign criticism based on careful economic analysis.

In closing, I would like to return to the issue of political will. Stronger surveillance, as well as possibly other approaches, could help strengthen political will. But a base of political will must exist, in order to bring about greater international cooperation. There have been many ideas put forward in today's and last week's discussions about increasing the effectiveness of the exchange rate system. Some of them are rather ambitious ideas. One could argue that the willingness of countries to commit themselves to, and to implement, a system of genuinely strengthened surveillance could provide a good indication of the willingness and ability of political systems in national capitals to adhere to other forms of international cooperation.

Mr. Massé remarked that some of the major problems in the exchange rate system in recent years, such as prolonged misalignments of exchange rates and large current account imbalances, had been the unintended result of members' domestic policy choices. To the extent possible, the Fund should improve its advice on, and increase its influence with respect to, members' policies. The objective of the present review should be to find ways of strengthening surveillance so that greater peer pressure could be exerted on members to modify those policies which, although domestic in nature, were seen by other members as destabilizing or unsustainable.

Commenting on the principles of surveillance adopted in 1977, Mr. Massé said that the basic problem with surveillance seemed to be the way in which it was implemented--particularly the unwillingness of members to submit to surveillance--rather than the language of the Executive Board's decisions on surveillance. The present language of the principles of surveillance in the 1977 document, including the section on supplemental surveillance, was sufficiently broad to permit a strengthening of surveillance. Furthermore, as a revision of the principles would likely be difficult and time-consuming, the time and effort needed to strengthen the surveillance process would be better spent on improvements in implementation. Accordingly, he wished to concentrate his comments on how the system might be improved. In passing, he recalled that during the recent discussion on the floating exchange rate system, he had indicated that his authorities generally did not support the strict use of exchange rate target zones or other objective indicators.

In the area of bilateral surveillance, he generally agreed with the recommendations that had been made in the G-10 and G-24 reports, Mr. Massé commented. For the major countries, annual Article IV consultations policy reviews in a medium-term context should be minimally adequate, provided that no extraordinary developments had occurred during the review period. However, that system could be improved. The following steps could be taken to ensure that the Fund's views would be clearly and precisely stated and conveyed to the appropriate authorities in members: policy assessments should be more candid; the perceptual or analytical differences between the Fund and the authorities should be spelled out more clearly; and the Fund's policy recommendations should be transmitted to the highest levels of government. Members should indicate the measures that they had introduced or were considering in response to problems that had been identified and the specific policy suggestions that had been made by the staff. In addition, there should be more confidential exchanges of views between the Managing Director and various Ministers of Finance, especially those in major countries. However, in the area of publicity, the basic confidentiality of surveillance consultations must be preserved. To that end, negotiated statements for public consumption and the partial release of documentation should not be used in order to avoid distortions of the Fund's position.

Surveillance could be improved through the greater use of supplemental consultations, Mr. Massé considered. The supplemental consultation procedure had existed for some time but had not been used; apparently the Fund had, for good reasons, been unwilling to single out members for supplemental consultations. The G-10 and G-24 reports suggested that improved supplemental consultations might be one way of enhancing bilateral surveillance, and the Managing Director should make greater use of his power to initiate such consultations. The Executive Board could also become involved. For example, if a member's policies differed significantly from the authorities' stated policy intentions, an interim staff report could be prepared three or six months after the authorities' policy statement and circulated to the Executive Board, which might then wish to agree that supplemental consultations should be initiated.

Alternatively, the automaticity of supplemental consultations could be increased, Mr. Massé continued. The staff had suggested using objective indicators or target zones to trigger such consultations. He was reluctant to introduce target zones because of the theoretical and practical difficulties in setting precise limits for target zones. However, greater automaticity could be introduced by expanding the use of the Fund's existing information notices on exchange rates. At present, those notices were circulated but did not necessarily lead to a review of a member's situation by the Executive Board. Provision could be made to approve an Executive Board discussion on a lapse of time basis; the Executive Board could then advise the Managing Director to initiate supplemental discussions.

During the discussion on the floating exchange rate system, Mr. Sengupta had suggested that the staff could prepare a paper every quarter on exchange rate alignments of the key currencies, highlighting possible misalignments and spelling out the effects of the alignments on the rest of the world, including the developing countries, Mr. Massé recalled. That task was admittedly a substantial one and might well go beyond the present theoretical and practical knowledge of how exchange markets actually functioned. A staff comment on how such a paper might be prepared would be helpful.

The main vehicle for multilateral surveillance was the world economic outlook exercise, Mr. Massé noted. The proposal to add a special chapter to the world economic outlook paper on the policies and performance of the major G-10 countries was acceptable. The two-stage process that had been suggested by the Group of Twenty-Four would not be beneficial. His Canadian authorities believed that more extensive discussion among the G-10 countries at the ministerial level, with the Fund's involvement, could contribute significantly to multilateral surveillance. However, it was not clear to him how more extensive policy reviews by the G-10 countries would fit into the process of the publication of the world economic outlook paper.

The finance ministers of the G-5 countries had recently held policy discussions among themselves, Mr. Massé observed. In order to ensure that the broader interests of the international community were represented during those meetings, the Managing Director should take part; he could represent the Fund, shedding light on Fund-related issues, and could describe the outcome of discussions to the Executive Board. The major countries must recognize in a concrete manner their responsibility for ensuring a stable international environment and the interest of other countries in such stability. After all, the international monetary system did not consist merely of the five major currencies; it consisted of an array of currencies of which five had the greatest impact. If the major participants in the system were interested in a stable, healthy system, it was in their self-interest to ensure that other partners were fully consulted and kept up to date on their views on monetary developments.

The process of improving surveillance would undoubtedly involve the relinquishing by members of a portion of their national sovereignty over economic policy and the sacrifice of some of their ability to influence developments in their domestic economies, Mr. Massé considered. However, it was in any event clear that the sovereignty of individual members was being slowly eroded by the growing interdependence of the international monetary and economic system. It was difficult for governments to recognize the need to relinquish some of their sovereignty in order to benefit the international community. As Mr. Dallara had stressed, such changes occurred only when individual countries found that the changes were in their own best interest.

Accordingly, Mr. Massé continued, it seemed best to try to show individual countries that their self-interest was often connected with the interest of the international community. Such a recognition was often made only very slowly. The members of his constituency often saw their domestic policies as being mainly or uniquely of interest to their citizens. Individual members would have to learn gradually to share their decision-making efforts with others. The present discussion on surveillance was an important step in the slow process of the relinquishing by some countries of the sovereignty over their domestic economies in a number of areas that until recently had been seen to have only domestic consequences. Accordingly, he intended to continue the practice of sharing with the Executive Board his summary of the latest budget of the Canadian authorities, whose policies sometimes had international effects.

Mr. Ismael said that he wished to deal first with the issues that were raised on pages 27-28 of the staff paper on the biennial review of the 1977 surveillance document (SM/86/3). The proposed strategy for considering issues related to surveillance in three stages was acceptable. The staff had raised the difficult question whether the language of the general principles of surveillance should be revised so that surveillance would apply clearly to all policies having significant effects on other members, rather than, as at present, only to policies deemed to be exchange rate policies. The actual practice of surveillance had in effect superseded the language of the general principles of surveillance; hence, any revision of the language was unlikely to have any practical effect. Nevertheless, he was willing to accept the revision that the staff had suggested.

The objective of all the proposed approaches to revising the principles for the guidance of members' exchange rate policies was to achieve greater exchange rate stability, Mr. Ismael noted. The approach mentioned on page 27 in paragraph 2(iii)(b)--"defining guidance in terms of observing quantitative or qualitative objectives for domestic policy instruments"--was an indirect method that was unlikely to be effective unless it included the instruments that were to be used and the desired policy outcomes. Otherwise, the broad policy guidance mentioned in paragraph 2 (iii)(b) was unlikely to be effective in promoting exchange rate stability. He preferred a system under which members would receive guidance in order to remain within an exchange rate zone or to observe an exchange rate target. The advantage of the exchange rate zone approach was that it would avoid the rigidities of a par value system and the destabilizing uncertainties associated with floating rates. The exchange rate zone approach offered greater hope of achieving exchange rate stability and a sustainable pattern of payments balances than other possible approaches. The exchange rate zone approach would have a direct impact, thereby providing greater assurance of the desired outcome. In addition, it gave some flexibility to members in the sense that each country would have the choice of determining the instruments to use to achieve an exchange rate target or to remain within a zone.

The principles of Fund surveillance over exchange rate policies should include a provision under which the indicators used to trigger consultations would be extended to policies that were not necessarily adopted for balance of payments purposes, Mr. Ismael remarked. Accordingly, the list of indicators should include domestic policies and should be made more specific than at present.

The procedure for initiating special surveillance consultations should be used more often than hitherto, but care should be taken to restrict its use to cases in which a member's policy developments and economy had a major impact on other countries or on the system as a whole, Mr. Ismael considered. The staff could develop a set of indicators, and the Managing Director could be informed when the indicators suggested that supplemental consultations might be warranted. The final judgment whether or not the supplemental consultations should be held should typically be left to the discretion of the Managing Director; in certain cases the Executive Board might request the Managing Director to initiate such consultations.

The staff had raised the question of the consultation cycle in its paper on the annual review of surveillance, which contained proposals for changes in surveillance procedures, Mr. Ismael noted. A number of smaller countries attached great importance to Article IV consultations. They found such consultations an invaluable source of independent analysis and policy advice, and many of the staff recommendations were implemented by the authorities. He preferred to retain the present annual consultation cycle for all the small countries that valued annual consultations and for countries where there were uncertainties about the medium-term viability of the balance of payments. The present practice of specifying the consultation interval for each country in the Managing Director's summing up of the Executive Board's discussion on the member should be continued.

Article IV consultations should continue to have a comprehensive policy coverage and to present the staff's analysis in a medium-term framework, Mr. Ismael remarked. In recent years, the problems of external debt and protectionism had received considerable attention, and they should continue to receive such attention in the coming period. However, the ultimate objective of economic policy was growth and improvement in the standard of living, and somewhat greater attention should therefore be paid in staff reports to the achievement of members' growth objectives. In that connection, the major impediments to growth should be clearly identified, and the suggested policy response to those impediments should be clearly stated.

Each staff appraisal should be as candid as possible, and there should be consistency in staff appraisals across countries, Mr. Ismael considered. There had occasionally been inconsistencies. For example, the staff had recommended that some countries should increase their tax effort in order to reduce their fiscal deficits. At the same time, in making recommendations for other countries--where the revenue efforts had been even less satisfactory--the staff had been less forthcoming in advocating new revenue measures which, the staff had argued, would have adversely affected incentives. The effect of tax increases on incentives should be carefully studied before tax increases were recommended for any member, and the staff's policy advice should be uniform for all countries in similar circumstances. Another example of inconsistent recommendations was the staff's assessment of exchange rate policies. The staff appraisal of a number of countries' exchange rate policies had been less than candid. For members with a floating exchange rate the staff should assess whether the rate or the trend in the rate was consistent with the economic fundamentals in the country concerned; for countries where there was official exchange market intervention, the staff should assess the appropriateness of the intervention. There also seemed to be inconsistent assessments of exchange rates of members using Fund resources in comparison with members that were not using those resources. Exchange rate assessments were admittedly difficult to make and involved a considerable element of judgment, but the staff's assessments should be as uniform as possible.

The multilateral approach to surveillance was essential, as it was the means of ensuring that the appraisal of members' policies would take into account the effects of one member's policies on other members, Mr. Ismael said. Consistency in the underlying policies in major reserve currency countries made a significant contribution to exchange rate stability. As to specific mechanisms to enhance the multilateral approach, the G-10 Deputies' recommendation to include a separate chapter in the world economic outlook for review by the G-10 ministers and governors was too weak. There was no guarantee that such reviews would lead to any consensus on the source of problems or on needed remedial actions. Even if a consensus were reached, the need to balance domestic social, political, and economic objectives against international goals might make it difficult for an individual country to adopt policies designed to minimize the adverse impact of its policies on other members. However, the G-24 Deputies' suggestion of a two-tier approach to improving multilateral surveillance was likely to be much more effective than the G-10 suggestion. Under the G-24 approach, problem areas would have to be clearly identified and solutions agreed upon first; thereafter, procedures for implementing corrective policies and for conducting reviews would have to be followed. The G-24 approach was more logical than the G-10 proposal, and he hoped that it would be accepted.

Mr. Polak remarked that it was useful to bear in mind two basic aspects of the surveillance activities under amended Article IV and the 1977 decision on surveillance. First, a distinction was made between the Fund's surveillance over exchange rate policies under Section 3(b) of Article IV, and the more general oversight by the Fund over members' economic policies under Section 3(a) of Article IV. That distinction was stated explicitly in the 1977 decision on surveillance: "The principles and procedures set out below...are adopted by the Fund in order to perform its functions under Section 3(b)." That decision dealt with Section 3(b) and not with Section 3(a); the basic purpose of exchange rate surveillance was to ensure that members would not have an incorrect exchange rate and to place pressure on members to adjust incorrect rates. The oversight function was much more general in character and was designed to ensure that members would comply with their obligation to foster orderly underlying conditions.

It was important to stress that the two surveillance tasks that he had described were entirely separate; each was important in its own right, and the one could not be subsumed under the other, Mr. Polak went on. The distinction between the two surveillance functions was evident in the Fund's response to parallel inflation in all members, which was incompatible with financial and economic stability with which the Fund was concerned under Article IV, Section 3(a), but which had no effect on exchange rates, the area of concern under Article IV, Section 3(b). There were no guidelines on the Fund's activities under Article IV, Section 3(a), and one of the issues at hand was whether such guidelines should be defined. Whatever the answer to that question might be, it would certainly be wrong to produce such guidelines by inferring them from the text of the 1977 decision on surveillance or by making slight changes in that text.

A second basic distinction that was made through the 1977 decision on surveillance was that between members with floating exchange rates and members with pegged exchange rates, Mr. Polak continued. In Section 2 of the principles of Fund surveillance over exchange rate policies, the first four subsections all referred to measures adopted by countries to defend a pegged rate. The fifth subsection dealt with surveillance over floating rates and referred to "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions...."

It was important to refer to paragraph 3 of the principles of Fund surveillance over exchange rate policies in assessing paragraph 2, Mr. Polak continued. Paragraph 3 contained a long list of items that were to be taken into account in the Fund's exercise of surveillance over pegged and floating exchange rates. The main purpose of that section was to mitigate the rigor of paragraph 2; it gave a member with an exchange rate that was incorrect in the eyes of the Fund a variety of arguments why the authorities need not change that rate or, as in the case of members with floating exchange rates, why the members need not take measures to influence the rate away from a particular rate. For example, members could claim that a promotion of sustained, sound economic growth or the maintenance of reasonable levels of employment would not permit them to introduce exchange rate measures that, on the face of it, seemed necessary.

Paragraphs 2 and 3 of the principles of Fund surveillance over exchange rate policies contained many variables that would also find a place in the broader surveillance under Article IV, Section 3(a) of a member's general economic policies, Mr. Polak commented. That fact might have been a cause of confusion between the two separate surveillance functions that he had mentioned, but the separation was nevertheless clearly the intention of the original 1977 decision on surveillance. Although the two surveillance functions could not in practice be kept fully separate, especially as both were applicable in the context of annual Article IV consultations, there was no reason to move toward their full integration, the net effect of which would almost certainly be to weaken exchange rate surveillance rather than to strengthen the Fund's oversight over members' policies in general. The Fund's concern about exchange rate surveillance at the present was obviously not excessive. During the recent discussion on Canada, it had been noted that the staff appraisal contained no reference to the exchange rate even though that factor was obviously an important one in Canada. Moreover, integrating the two separate surveillance functions would require much more than some minor amendments to the 1977 surveillance decision; on the contrary, the decision would have to be completely rewritten.

Commenting on the issues raised in SM/86/3, Mr. Polak said that it probably would be unnecessary to ask the Interim Committee at its next meeting for guidance on a large number of the substantive issues concerning surveillance. The Executive Board should be able to inform the Interim Committee that it had again reviewed the 1977 surveillance document and still found it appropriate in present circumstances, and that the Board would take the analytical suggestions in SM/86/3 and SM/86/4 into account in its administration of surveillance.

He did not favor completely revising the general principles of surveillance to include members' policies in general or, in other words, to make the text applicable to the Fund's functions under both Sections 3(a) and 3(b) of Article IV, and nothing would be gained by making minor revisions of the text, Mr. Polak continued. Moreover, eliminating the reference to "for balance of payments purposes" in the principles of Fund surveillance over exchange rate policies would clearly be a mistake within the framework of the existing decision on surveillance, which listed certain measures that were taken as prima facie evidence that a member was defending an unsustainable exchange rate. The drafters of the text had wished to take account of the possibility that some of those measures might be introduced for other than balance of payments reasons, in which event they would not be an indication of an inadequate exchange rate policy.

The deletion of the reference to "for balance of payments purposes" would broaden the significance of various indicators beyond the original intent. Of course, retaining that reference did not mean that the Fund had no interest in a country's mix of monetary and fiscal policies, which could result in abnormal capital flows, one of the many aspects of a country's policies that deserved scrutiny under the Fund's oversight responsibility under Article IV, Section 3(a).

As to the proposed revisions in the principles for the guidance of member's exchange rate policies in paragraph 2(iii) on page 27, he did not believe that surveillance over exchange rate policies had thus far suffered from insufficiently precise instructions to the Fund, Mr. Polak said. Accordingly, he did not favor the proposal to increase the precision of the principles by including a reference to target zones, objective indicators, or particular measures to be avoided.

The weakness of the Fund's surveillance activities was not attributable to insufficient guidelines or to procedural difficulties, Mr. Polak went on. Improvements in procedures could not substitute for greater willingness on the part of members to listen to the views of the Fund and other members on their policies and to pay attention to the international effects of all policy measures. While some of the G-10 and G-24 proposals were useful, their adoption would not make a crucial difference. The Executive Board had discussed a variety of suggestions in 1985 and had adopted some of them, and he saw no reason to go over the same ground again, except to stress two points.

First, the use of medium-term balance of payments scenarios should be extended to all industrial countries that had an external debt that was substantial and growing, Mr. Polak said. Thus, such scenarios should be available not only for Australia, Denmark, and Italy but also for Canada, Belgium, and the United States. It might also be helpful to develop such scenarios for industrial countries with large surpluses.

Second, he agreed with Mr. Dallara's suggestion that major countries should be asked to submit a report in which they explained why they were unwilling to follow the recommendations made during the latest Article IV consultation with the members concerned, Mr. Polak continued. That practice would be much more effective than merely relying entirely on the immediate response by an Executive Director to other Executive Directors' comments. However, there was no reason to intensify significantly surveillance through an effort to have more special or supplemental consultations. The Fund already had undertaken as much--and perhaps more--consultation work as the staff and the Executive Board could effectively handle. In addition, policy weaknesses persisted for years even in countries for which annual consultations were held. There was no reason to believe that, in those cases, the problems facing the members could be solved more quickly if their failure to implement recommended policies produced half-yearly, instead of annual, consultations. The Executive Board needed to consider frequently the policies of members that were using the Fund's resources, but it did not generally need such frequent consultation with other members. In exceptional cases, the Executive Board could decide on the occasion of an Article IV consultation to hold another miniconsultation in six months and not, as the staff had suggested, ask for an interim staff report after six months for discussion by the Executive Board which could then lead to a supplemental consultation, which would occur perhaps only a few months before the next annual consultation with the member. Of course, for the major countries--most of which had floating exchange rates--the Fund should have an opportunity to appraise the adequacy of their policies more than once a year. However, no additional opportunities were already available through the world economic outlook discussions and the associated miniconsultations held by the staff. Accordingly, the need for a special or supplemental consultation--with the attendant political difficulties--should arise only exceptionally. There was no convincing case that the Fund's surveillance would become more effective as a result of the acceptance of the G-10 and the G-24 recommendation to find ways to consult more frequently with some members.

The work on multilateral surveillance in the context of the world economic outlook was valuable and should be intensified, Mr. Polak considered. The climate for that work had improved as a result of the recent realization by the five major countries of the need for more consistent policies. He doubted whether the G-24 proposal to introduce a two-stage surveillance procedure would prove to be workable. However, the Fund could make a unique analytical contribution to the process in the major countries of the formulation of policies in the light of their effects on other countries. To that end, the staff should resume its work on a consistent set of underlying balance of payments calculations as a part of the world economic outlook exercise. Those calculations seemed to be the feasible and constructive ingredient of the proposal for target or reference zones. Experience would show whether such calculations should be restricted to the current account or could, in one way or another, include capital account components. The calculations would have to be based on various scenarios for such variables as growth rates or levels of activity in the different countries concerned. The resulting matrices should not lead to the calculation of a set of equilibrium exchange rates. Whatever the staff and the Executive Board could do in that area would of course be relevant to the policy consultations among the G-5 countries, which seemed to have become an established part of the institutional setting. It seemed essential to have a firm role for the Managing Director in G-5 meetings, so that he could convey during the meetings the results of the Fund staff's work on underlying balance of payments calculations.

Multilateral surveillance in the Fund and elsewhere could also be strengthened by a thorough discussion in the world economic outlook paper of the interaction between policies and developments in the main industrial countries, and he looked forward to the inclusion of a chapter on that subject in the next world economic outlook paper, Mr. Polak commented.

That aspect of surveillance should in no way minimize the attention that would be paid to the impact of industrial countries' policies on developing countries.

Mr. Rye remarked that Fund surveillance had received considerable attention in recent years, including during the comprehensive review of surveillance in 1985. There had been significant changes in the nature of surveillance, even though the formal guidelines had not been altered since their introduction in 1977.

Surveillance had not prevented the emergence of major instabilities in the world economy, particularly the growth of external debt and current account imbalances, Mr. Rye continued. Those developments might suggest that a major overhaul of surveillance was needed. However, surveillance could only be as effective as the willingness of members to accept the policy recommendations that were the product of surveillance. The deficiencies of surveillance had to do more with the responsiveness of members than with the principles and procedures of surveillance. Hence, it would be unwise to expect any great improvement in surveillance from changes in those principles and procedures alone.

Executive Directors must not lose sight of the burden that surveillance placed on the resources of the staff, the Executive Board, and members, Mr. Rye said. His authorities would be reluctant to see the adoption of new surveillance procedures that would increase that burden. In their view, better surveillance would not necessarily entail more surveillance.

In SM/86/3 the staff had reviewed the background to the current surveillance principles and had concluded that the principles remained valid but had not in themselves provided sufficient guidance to ensure medium-term exchange rate stability, Mr. Rye remarked. He agreed with the staff that exchange rate developments were more often the result of domestic policies than of policies aimed directly at foreign exchange markets. Accordingly, in theory, the surveillance guidelines should be adapted specifically to encompass references to domestic policies. However, he wondered whether that would result in any meaningful change in practice. What could actually be achieved through surveillance depended much more on members' behavior than on the particular words used in the surveillance guidelines. Moreover, Article IV consultations already provided a vehicle for comprehensive Fund surveillance of members' domestic economic policies. There was also a danger that reaching agreement on changes in the guidelines might well prove to be difficult and time-consuming. Nevertheless, he had no basic objection to an attempt to update the surveillance guidelines, provided that the effort would not detract from the Fund's mandate, which had been and should continue to be, overseeing the interaction among members' economies through the payments system. While staff reports on members' policies and performance could appropriately be wide-ranging, they must be framed with that mandate in mind. Accordingly, there were limits to how deeply the Fund should delve into some areas, particularly microeconomic areas.

On page 18 of SM/86/3 the staff had suggested three possible approaches to introducing more specific guidance into the principles for the guidance of members' exchange rate policies, Mr. Rye said. As he had indicated during the recent discussion on the exchange rate system, his authorities did not favor either target zones or objective indicators. Anything other than the softest of target zones must imply the acceptance of an increased degree of instability somewhere in the system, especially in members' domestic financial conditions, such as interest rates. Target zones probably would not remove the instability in the system; they would likely merely shift the instability from one part of the system to another.

His Australian authorities were opposed in principle to the use of objective indicators, Mr. Rye continued. Of course, if other members, such as the G-5 countries, felt that objective indicators were relevant for themselves, that would be a matter for them. The third approach mentioned on page 18--extending and refining the list of proscribed behavior--might not be easy to implement as the difficulty in attempting to develop that approach at the time of the drafting of the 1977 surveillance document attested. However, that option could be further investigated. One or two of the existing guidelines on surveillance seemed to be in need of some reformulation. The guidelines concerning the avoidance of manipulation of exchange rates and the avoidance of protracted large-scale intervention in one direction in the exchange market could perhaps be examined in the context of a general review of the principles for the guidance of members' exchange rate policies.

As to the principles of Fund surveillance over exchange rate policies, which were discussed on pages 23-24 of SM/86/3, his authorities would not oppose the suggested changes in the list of indicators that were used to trigger consultations, although they doubted whether such changes would have much practical significance, Mr. Rye commented. The idea of making supplemental surveillance more automatic was not attractive. Each decision on whether or not additional surveillance was necessary required careful judgment; the discretion should be left to management, and such surveillance should be used sparingly.

As to the frequency of Article IV consultations, there was a need to strike a balance between the need for reviews of members' economies and the additional work load caused by such reviews for the staff and the Executive Board, Mr. Rye remarked. There seemed to be scope for relaxing the existing timetable for Article IV consultations both by reducing the number of countries on the annual cycle and by lengthening the period between consultations for other countries. Except for the major industrial countries and users of Fund resources, not much would be lost by lengthening the period between consultations to 18 months and, in some cases, 24 months.

As the staff had indicated on pages 13-15 of SM/86/4, significant progress had been made in improving the analytical basis of surveillance, Mr. Rye commented. He broadly endorsed those developments, but he strongly agreed with the staff that the increased emphasis on the medium term must not be permitted to dilute the focus on fundamental short-term policy issues. There was merit in the calls for more candid staff assessments, and the inclusion of specific policy recommendations in the staff appraisal, as well as, where possible, quantified staff assessments of the size of required adjustments in a member's main policy areas. Of course, members were sensitive about some of those areas and the staff would have to judge how far it could move to intensify its assessment of policies before such efforts would become counterproductive. In addition, there was a need for due modesty on the part of the staff: although observers sometimes saw things that the authorities did not, the staff was always wise not to presume to know more about the workings of an economy, and about possibilities for changing a member's policies, than the country's authorities and politicians, who were involved in those matters on a regular basis.

He supported the G-10 proposal to enhance multilateral surveillance by using the world economic outlook paper as the basis for a discussion of the international repercussions of domestic policies, Mr. Rye said. Under that proposal, surveillance would still be limited to analysis and persuasion, but by highlighting in a published document the inadequacies of G-10 members' policies, the persuasion aspect might be made more effective. However, it would need to be understood that the policy interactions to be considered would include those with other industrial and developing countries; in other words, the new chapter would focus as much--if not more--on the interaction of the G-10 countries with the rest of the world as on the interactions of policies among the G-10 countries. In addition, the staff should have the same degree of independence in writing the new chapter that it currently had in writing the present set of chapters; the new material should not be subject to watering down by negotiation. The Managing Director's summing up of the Executive Board's discussion on a world economic outlook paper was an appropriate vehicle for reporting on the Board's views to G-10 meetings.

During the previous discussion on surveillance, Mr. Rye recalled, Mr. Sengupta had made the following statement:

> Because major countries might be more amenable to discussions among themselves rather than to so-called public opinion, it might be useful if the Executive Board discussed the international implications of the policies of such key currency countries at some time preceding the annual summit meeting of those countries.... The Managing Director could report to the summit meetings about the discussions in the Board, the exact form of the report being left to the Managing Director. A paper prepared by the staff for consideration by the Executive Board on those countries' policies and their implications might strengthen the forces of reason that were often displayed by some member countries at those summit meetings.

He agreed with that position. The relevant recent G-24 proposals were more far-reaching: they would entail the use of objective indicators--which he did not support--and supplemental consultations to an inappropriate extent. Those two elements aside, the approach that he favored was basically similar to that which Mr. Sengupta had proposed.

The appendices to staff reports on the World Bank's relations with members seemed rather patchy and inconsistent, Mr. Rye commented. Some of them had gone as far as to include the World Bank's assessment of a member's investment and structural policies, while others had provided little, if anything, more than a factual list of the World Bank's operations in the country concerned. Given the increasing interest in Fund-Bank collaboration, he hoped that the Bank's relevant views and analysis would be included in all staff reports on countries in which the Bank was actively involved.

Mr. Kafka said that SM/86/3 and SM/86/4 represented an interesting effort to respond to recent demands to strengthen surveillance and to change some of the characteristics of surveillance. In discussing the general principles of surveillance the staff had raised the question whether surveillance should not be broadened to include all policies that had significant effects on other members. The answer to that question might well be in the affirmative, but a distinction would have to be made according to the economic "weight" of the country adopting the policies. Obviously, any codification of such a change would be a departure from present practice and would therefore require considerable thought and time.

The staff had mentioned four possible ways of revising the principles for the guidance of members' exchange rate policies, Mr. Kafka noted. It was too early to take firm views on the various issues that the staff had raised concerning target zones or target directions. However, in principle, he favored the idea of experimenting with target zones or target directions, as well as with Mr. Sengupta's proposed periodic calculations of a consistent exchange rate grid or, as Mr. Polak had suggested, a consistent set of balance of payments positions. However, it was too early to formulate in any detail proposals concerning target zones, target directions, or other indicators. Moreover, in its surveillance activities the Fund must be careful to avoid giving the impression that it was trying to establish a world government. It must also avoid engaging in kinds of surveillance activities that would have an asymmetrical impact on the international community.

In discussing the principles of Fund surveillance over exchange rate policies, the staff had asked whether the coverage of surveillance should be extended beyond measures that were introduced for balance of payments purposes, Mr. Kafka remarked. The Fund's specific functions were based on exchange rates and the balance of payments. The Fund should avoid moving beyond those areas unless a member's policy actions significantly affected the world economy. In exercising his discretion to initiate supplemental consultations the Managing Director should take the same considerations into account. Accordingly, for the reasons that Mr. Polak had mentioned, he would not wish to delete the reference to "for balance of payments purposes" from the principles of surveillance over exchange rate policies.

Commenting on the surveillance procedures, Mr. Kafka said that the Fund should rely on peer pressure, without structured sanctions, to encourage members to maintain appropriate policies. Sanctions would probably have an uneven impact on members.

The staff had suggested a three-stage approach to a possible revision of the 1977 surveillance document, Mr. Kafka noted. First, Executive Directors were to give preliminary views on the questions raised in SM/86/3 and SM/86/4. Second, there would be a report to the Interim Committee identifying the central issues on which guidance from the Committee was required. Third, draft language would be prepared on the basis of the Interim Committee's guidance for consideration by the Executive Board in the period leading up to the 1986 Annual Meeting. The first and second stages would require careful thought in addition to the present discussion before even a very general report could be made to the Interim Committee.

The period between Article IV consultations should be lengthened for countries that had no significant effect on the international financial community, were not using Fund resources, and were current in their obligations to the Fund, Mr. Kafka said. In recent years the Fund had consistently increased the staff's work load while limiting the growth of the staff. There should be a balance between the demands placed on the staff and the size of the staff. In addition, consultations were a major part of the growing work load of management and the Executive Board.

He agreed with the staff that surveillance should be strengthened, Mr. Kafka remarked. However, efforts to that end should not result in asymmetrical surveillance and should be justified by the significant impact of a member's policy actions on the international community. Moreover, it was important to remember that economic analysis was often imprecise. Accordingly, even if the Fund were not to hesitate to make policy recommendations to members, it should be careful in any attempts to encourage compliance by members with the recommendations.

The staff had suggested that improving the analytical basis of surveillance would strengthen surveillance, Mr. Kafka continued. The Fund should encourage members to improve their economic and financial data. In addition, the Fund should describe the model that it used and the assumptions that it made in analyzing the economic situation of members. In that connection, the long-promised staff paper on the theory of the design of Fund programs should be helpful.

The surveillance procedures, including the presentation of the staff's conclusions about a member's policies, should never be confrontational in nature, Mr. Kafka stated. Moreover, the staff visiting a member should not engage in discussions with persons other than the authorities except with the authorities' consent. Even when such discussions were permitted, the staff should not describe them in its report; written descriptions could give the impression that there had been significant disagreement between the authorities and the staff. Discussions with nonofficials might be useful, but the opinions of nonofficials need not be reported to the Executive Board; after all, a consultation with a member was designed to elicit the opinions of officials.

The staff had also suggested that surveillance could be strengthened by placing surveillance in a multilateral setting, Mr. Kafka remarked. The additional chapter on the G-10 countries which had been suggested by the G-10 Deputies could be discussed by the G-10 deputies and ministers as well as by the Executive Board. However, any discussion by the G-10 Deputies and Ministers of the additional chapter should not reduce the intensity of the discussions in the Executive Board, the Interim Committee, and the Development Committee. The G-10 countries should not be encouraged in any way to isolate themselves from the rest of the world. Mr. Dallara's suggestion to include in the world economic outlook papers a second additional chapter on the other major countries merited further examination. The G-24 suggestion to negotiate a set of consistent objectives on the basis of the world economic outlook paper was interesting. The negotiations might well be difficult; at the least, discussions--if not formal negotiations--on a consistent set of objectives might be helpful.

He was pleased that in his opening statement Mr. Dallara had apparently qualified his position on the publication of staff reports, Mr. Kafka commented. As he understood it, Mr. Dallara no longer favored the publication of reports. However, he continued to object strongly to any proposals to publish summings up or other indications of Executive Board discussions; nor should the Managing Director be authorized to make statements on his own responsibility about Board discussions or otherwise report on individual countries. Such reports would not be helpful; indeed, they would be counterproductive. However, the Managing Director could usefully undertake confidential consultations with individual countries, although he was unlikely to need to do so often.

Mr. Finaish said that the surveillance mechanism was the key means by which the Fund carried out its responsibility for ensuring the effective operation of the international monetary system, whose principal objectives were defined by Article IV as facilitating international trade and capital flows, sustaining sound economic growth, and fostering orderly underlying conditions that were necessary for financial stability. As was well known, there had been some serious problems in the functioning of the system in recent years, such as the volatility and misalignment of exchange rates, the emergence of large financial imbalances in the industrial world, and severe debt servicing problems in the developing world. The experience with those problems had brought into sharper focus some of the weaknesses in the operation of the Fund's surveillance.

While it would be unrealistic to expect surveillance alone to be able to prevent and tackle such problems, there was sizable room for practical actions that could strengthen the role of surveillance and enhance its effectiveness; the present review, together with the G-10 and G-24 reform proposals, provided a good opportunity to consider such actions.

A crucial weakness in the ability of the Fund to ensure the smooth functioning of the international monetary system and members' compliance with their obligations under Article IV was the lack of adequate means by which the Fund could exert effective influence over the policies of major industrial countries which, in turn, was a reflection of the much weaker force carried by the Fund's policy advice under surveillance than the policy advice given in the context of conditionality, Mr. Finaish continued. As a result, the Fund's influence over members' policies was the weakest in respect of precisely the members whose policies mattered the most for the functioning of the international financial system. The implications of that conclusion for the Fund's ability to influence movements in major currency exchange rates were immediately obvious, but there were broader implications for the international adjustment process. For example, the adjustment effectively commanded by the Fund was concentrated in developing countries, resulting in an uneven distribution of the burden of international adjustment and making the adjustments by the countries concerned even more difficult.

The recent staff paper on the review of conditionality had concluded that a major factor in respect of the difficulty that many members had in achieving their adjustment objectives was the unfavorable world environment, with regard to which the policy stance of industrial countries played an important role, Mr. Finaish continued. The staff had further concluded that its review of conditionality had clearly shown that an increase in the effectiveness of Fund surveillance would improve the conditions under which Fund programs operated. In other words, weaknesses in surveillance over the policies of major countries affected the outcome of conditionality. For all those reasons, the efforts to strengthen surveillance should focus on enhancing the effectiveness of surveillance over major industrial countries.

In SM/86/3 the staff had suggested a number of changes in the text of the 1977 document on surveillance, Mr. Finaish noted. The broad strategy for the future program of work on surveillance issues which was suggested on pages 26-27 seemed reasonable. The question posed by the staff regarding the section on the general principles of surveillance in the 1977 document was whether the language should be revised to make surveillance cover all policies having significant effects on other members rather than only policies that were deemed to be "exchange rate policies." It was of course clear that exchange rates and the general functioning of the international monetary system were affected not only by policies that were aimed directly at the exchange market or the balance of payments but, also importantly, by economic and financial policies that were aimed primarily at the domestic economy. Hence, to be effective, exchange rate surveillance must encompass an examination of relevant domestic policies; that conclusion could be reflected more clearly in the text of the general principles of surveillance.

The possible changes in the principles for the guidance of members' exchange rate policies in the 1977 document were closely linked to the ongoing discussion on the review of the exchange rate system and should be further considered after that review was completed, Mr. Finaish commented. In the light of the detailed discussion on the exchange rate system at EBM/86/25 and EBM/86/26 (2/12/86), he would make just two points on the proposed changes in the principles for the guidance of members' exchange rate policies. First, his chair had already expressed its interest in a target zone scheme with soft margins for the key currencies. Any changes in the principles for the guidance of members' exchange rate policies which a target zone scheme might entail could be examined fully and usefully only if sufficient agreement developed on a particular format of a target zone scheme. Second, whether or not such an exchange rate scheme was introduced, some revision in the principles for the guidance of members' exchange rate policies would be warranted. The existing guidance focused rather narrowly on policies that were directed at the exchange market. Experience showed that exchange rate movements that had been a cause for international concern had resulted mainly from inadequate domestic policies rather than from deliberate exchange market actions or manipulation. Accordingly, the principles for the guidance of members' exchange rate policies could usefully include guidance on appropriate domestic economic policies or objectives that were conducive to exchange rate stability.

The existing principles for the guidance of members' exchange rate policies included the obligation to avoid exchange rate manipulation, which was mentioned in Article IV, Section 1(iii), Mr. Finaish went on. Perhaps the obligations under Article IV, Sections 1(ii) and possibly (i) as well, or some suitable version thereof, could be included among the principles for the guidance of members' exchange rate policies.

As to the principles of Fund surveillance over exchange rate policies, Mr. Finaish said, exchange rates and the external adjustment process could be affected considerably by policies that were not introduced specifically for balance of payments purposes, and the staff had correctly noted the limiting effect of the provision "for balance of payments purposes" in the indicators that were used to trigger discussions with a member. However, some of those indicators were not so limited. The final indicator included in the list had a much broader scope, as it covered "behavior of the exchange rate that appeared to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements." Nevertheless, he had an open mind on the suggestion to delete the proviso "for balance of payments purposes" from some of the indicators. As to the suggestion to add to the list of indicators or to make them more specific, much would depend on the outcome of the review of the exchange rate system and possible revisions of the principles for the guidance of members' exchange rate policies.

The main question that had been raised by the staff concerning procedures for surveillance was whether the procedure for initiating supplemental consultations could be made more automatic than at present and less dependent on the exercise of judgment by the Managing Director, Mr. Finaish remarked. Greater and more effective use of supplemental consultations could be useful. However, it did not seem to be advisable to link the initiation of such consultations in a fully automatic way to certain triggers or indicators. The procedure for supplemental consultations should continue to provide reasonable room in which to exercise judgment about whether the developments in question called for further investigation through such consultations. Such a provision for supplemental consultations would recognize that changes in a variable or variables covered by a certain trigger mechanism could be caused by a variety of circumstances and would serve to limit the use of supplemental consultations to cases in which it was felt that the consultations were genuinely necessary, thereby keeping the consultations to a minimum and avoiding an undue increase in work load. However, trigger mechanisms could usefully serve as a basis for initiating a staff information notice to the Executive Board explaining the developments in question. That document could then be discussed by the Executive Board, which could determine whether a special consultation was called for. By leaving such a determination to the Executive Board, the procedure for special consultations would help to avoid the difficulty--mentioned by the staff--in initiating such consultations if that determination were left to the Managing Director.

The question had been raised as to what kind of developments or range of policies could trigger the consideration of the need for supplemental consultations, Mr. Finaish noted. Apparently the potential usefulness of such consultations would be greater if they could be initiated as a result not only of exchange rate developments but also of other developments that were considered to have important effects on other members. At the same time, to avoid a proliferation of Executive Board meetings to consider the need for supplemental surveillance, the approach to such surveillance should be sufficiently selective so that the cases referred to the Executive Board would be limited to those that had significant international implications. As to exchange rate developments, if a target zone arrangement were in place for the major currencies, exchange rate movements outside the zones could of course serve as an automatic trigger for the preparation of a brief staff paper or information notice on the basis of which the Executive Board could review the developments in question and decide whether to call for special consultations. In the absence of a target zone arrangement, the staff could be asked to prepare quarterly or semiannual papers analyzing and assessing movements among the key currencies--say, the currencies in the SDR basket--along the lines suggested by Mr. Sengupta during the recent discussion on the exchange system. Executive Directors could ask to have those papers brought to the agenda of Executive Board, which could decide whether a special consultation or consultations should be initiated.

With respect to important policy developments other than those connected directly with the exchange rate, supplemental consultations, where needed, could be initiated in one of the following two ways, Mr. Finaish remarked. First, in concluding a consultation, and upon recommendation by the staff, the Executive Board could indicate specific policy areas on which the staff would prepare an interim report. On the basis of a review of that report, the Executive Board could decide whether to call for a supplemental consultation. To keep the use of the supplemental consultation procedure to the minimum necessary, the procedure could be used only in response to policy developments that were deemed important on account of their international implications. Alternatively, significant deviations from an agreed set of objective indicators or targets for policy instruments in key currency countries--as envisaged, for example, in the G-24 proposed two-stage approach to surveillance over such countries--could trigger the preparation of staff information notices that could serve as the basis for the Executive Board's review of the need for supplemental surveillance.

Commenting on other issues concerning surveillance procedures and implementation mentioned in SM/86/4, Mr. Finaish said that he generally agreed with the ideas for improving the analytical basis of surveillance. He would focus the rest of his comments on procedures on the proposals to enhance the multilateral setting of surveillance and to strengthen the follow-up to consultations.

There was a clear need to make more effective use of surveillance in ensuring the mutual consistency of the policies of major industrial countries, Mr. Finaish continued. Such consistency was crucial to the stability of the international financial system. Policy coordination among the major industrial countries had fallen far short of what was required to ensure the choice of compatible policies. That experience had given rise to the search for mechanisms that could provide greater inducement to those countries to coordinate their policies. An adaptation of the Fund's surveillance procedures pertaining to those countries could provide such a mechanism.

To that end, Mr. Finaish went on, several steps could be taken. First, the analysis in the world economic outlook paper of the repercussions and interactions of the policies of key currency countries should be strengthened. On the basis of such analysis, the world economic outlook paper should provide clear conclusions on the desirable, consistent policy courses for those countries. Second, the analysis and conclusions in the world economic outlook paper should be put to effective use in achieving the objective of improved policy coordination. A review by G-10 ministers and governors would certainly be useful. However, it would also be desirable to follow up the world economic outlook exercise within the framework of the Fund. The two-stage approach to surveillance over key currency countries which had been proposed by the Group of Twenty-Four provided such a follow-up procedure. The formal proposal might seem to be impractical to some, but the main ideas embodied in the proposal were certainly useful and could be translated into practice.

First, using the findings of the world economic outlook exercise as a background for policy discussions between the Fund and key currency countries would help to promote policy consistency among those countries, even though the policy discussions did not take the form of multilateral consultations as suggested in the G-24 proposal but were instead separate Article IV consultations. Second, the suggestion to use objective indicators or policy targets for the specification and monitoring of the policy strategy that was to be agreed with the key currency countries was also useful. The use of such indicators or targets would give a better focus to the consultations with those countries, make the policy strategy agreed with the authorities at the time of the consultation more concrete, provide a more systematic way of monitoring subsequent performance, and assist in the checking of the consistency of policies among those countries. Significant deviations from such indicators could serve as a trigger for an Executive Board review of the need for supplemental surveillance.

There were admittedly practical difficulties in establishing quantitative targets for policy instruments, but they were not insurmountable, Mr. Finaish continued. After all, quantitative policy targets were regularly specified in Fund-supported programs and were used for enhanced surveillance. There would inevitably be some experimentation involved. A start could be made with a rather broad quantification of agreed policies, which could be refined over time, in the light of experience.

Direct communication between management and a Minister of Finance on the outcome of consultations could be another useful procedure to follow up consultations but should be used in carefully selected cases in which high-level attention was considered to be urgently needed, Mr. Finaish commented. As to the proposal to request members to indicate the measures that they had taken or were considering to address the problems that had been identified during a previous consultation and to respond to specific policy suggestions, the staff had correctly advised against making such replies a formal requirement. However, a consultation mission should raise those questions with the authorities and report on their response in the staff report. That procedure would strengthen the current practice in the preparation of Article IV reports of including a review of developments against the background of the conclusions of the previous consultation.

He continued to believe that it would be counterproductive to make a general move toward greater publicity for the consultation process, either through the release to the public of staff reports or through a public statement by the Managing Director drawn from his summing up of the discussion on a country, Mr. Finaish said. The confidential relationship between the Fund and its members was a key element of the consultation process, and a change in that relationship could jeopardize the continuation of the openness of policy discussions between the Fund and members.

Some of the current proposals to strengthen surveillance could involve a significant increase in the work load of the Executive Board and the staff, Mr. Finaish remarked. A reduction in the frequency of consultations--which had increased sharply in recent years--could help to moderate the work load and to focus the efforts of Executive Directors and the staff on countries that most needed their attention. Greater differentiation in the frequency of consultations could be sought both by lengthening the interval between consultations for members that were already on longer cycles--for example, to two years instead of 18 months--and by placing more countries on longer cycles. The rationale for recommending Executive Board approval of the annual consultation cycle should be examined closely in individual cases in the light of the guidelines for the specification of the frequency of consultations.

Mr. Fujino recalled that during the recent discussion on the exchange rate system, he had stated that the adoption of any alternative to the system of floating exchange rates for the key currencies, including the target zone approach, was unrealistic in the present circumstances. However, there was no reason to be complacent about the current situation, and he fully agreed that improvements in the functioning of the present exchange rate system were needed.

Official intervention in foreign exchange markets had a role--albeit a limited one--to play in reducing exchange rate volatility, but lasting exchange rate stability could not be achieved without greater convergence of economic performance among countries, Mr. Fujino continued. The adoption of sound, noninflationary macroeconomic policies in all countries was the necessary condition for exchange rate stability. Given the interdependence of countries, mutually consistent policies were needed to promote greater convergence of economic performance and thereby to enhance exchange rate stability. The international implications of national macroeconomic policies, especially in major countries, should be taken into account in the setting of those policies. International surveillance should be strengthened to increase the convergence of economic performance among countries toward sustainable, noninflationary growth. The Fund had a central role to play in that effort.

As the staff had noted, the emergence of widespread debt servicing difficulties since mid-1982 had underscored the need to strengthen the exercise and influence of surveillance, Mr. Fujino commented. He fully agreed with the G-10 report that although no major changes were needed in the present institutional setting for surveillance, a number of improvements were needed to make surveillance more effective.

Commenting on the general principles of surveillance, Mr. Fujino said that it was widely believed that Article IV consultations should cover the broad range of macroeconomic policies--in addition to exchange rate policy--which affected international economic developments. Although the

1977 decision on surveillance itself noted that the decision had been adopted under Article IV, Section 3(b), and that the principles and procedures under the decision did not deal directly with the broader responsibilities of the Fund which were referred to in Article IV, Section 3(a), the language had been drawn widely enough to permit surveillance to cover a broad range of macroeconomic policies. Accordingly, the question raised by the staff whether it would be desirable to revise the language on the general principles of surveillance so that surveillance would clearly apply to all policies that significantly affected other members was of little practical importance. However, it might be theoretically consistent to revise the language to that effect, provided that a positive conclusion on the principles of the guidance of members' exchange rate policies could be reached.

The proposed revisions of the principles for the guidance of members' exchange rate policies mentioned in subparagraphs (iii)(a) and (b) on page 27 of SM/86/3 were unacceptable, Mr. Fujino said. Attention should be centered on the suggestion in subparagraph (iii)(c) to explore the possibility of defining guidance in terms of actions--in addition to manipulation--that were to be avoided. That approach was worth considering in view of the fact that given the increasing interdependence of countries, mutually consistent policies would promote convergence of economic performance and thereby enhance exchange rate stability, as well as in view of members' experience related to the outbreak of the debt crisis in 1982. While the specificity of such provisions could vary, it would be difficult to reach an agreement on the precise nature of the policy actions that were to be avoided; that difficulty was reflected in the fact that the language in the present decision on surveillance with respect to the avoidance of manipulation was identical to a part of Article IV, Section 1. The approach under subparagraph (iii)(c) would raise delicate issues, as it would impinge upon the conduct of national policies. The staff had hinted at such difficulties on page 23 of SM/86/3 and had suggested that "members should avoid measures that were inconsistent with the goal of promoting balance of payments adjustment in the medium term." Executive Directors should consider whether it would be of much practical use to introduce such broad language.

The approach that the staff had outlined in paragraph (iv) on page 27 of SM/86/3 to the principles of surveillance over exchange rate policies--namely, extending the list of indicators which were used to trigger consultations, seemed to be realistic and practical, Mr. Fujino said. The reference to "for balance of payments purposes" in the principles of surveillance over exchange rate policies could be deleted from some of the policy developments mentioned in the text on the principles. His authorities wished to study the various suggestions before taking a final position.

Commenting on procedures for surveillance, Mr. Fujino said that the procedure for supplemental consultations should be used more actively than hitherto. The use of the supplemental procedure adopted under the 1979 decision did not presume that the member concerned had failed to comply with its obligations under Article IV. Both the 1977 and 1979 decisions clearly provided that the supplementary consultation procedure should be initiated by the Managing Director on the basis of his comprehensive assessment of performance, policy consistency, and information notices. His authorities believed that there should be no change in that basic approach. Still, care should be taken to avoid a proliferation of Executive Board meetings on cases that were of marginal significance.

Commenting on the annual review of surveillance, Mr. Fujino said that he agreed with the staff that recent experience showed that two of the main causes of the strain in the international economy in recent years were the emergence of widespread debt servicing difficulties and the large and growing U.S. current account deficit. He agreed with the three conclusions in the first full paragraph on page 3 of SM/86/4 with respect to the key lessons of recent experience for the implementation of surveillance.

He was pleased that a number of improvements had already been made in the data used for surveillance, the coverage of policies and analyses in staff reports, assessments made in a medium-term framework, and the making of specific policy recommendations together with candid assessments in staff reports, Mr. Fujino continued. As to the multilateral setting of surveillance, the G-10 Ministers had decided to devote more time to the discussion of the world economic outlook in their future meetings and, in that connection, had asked the Fund to prepare a separate chapter in the world economic outlook paper which would serve as a framework for the discussion of their policies. However, while some believed that strengthened surveillance required enhanced dialogue and persuasion rather than mechanically imposed external constraints, the policies and the policy objectives of the G-10 countries were not amenable to negotiation. Moreover, he doubted whether objective indicators could be employed effectively in members that were not using the Fund's resources. In addition, a statement quantifying the policies of members in connection with the world economic outlook would involve technical problems.

He supported the proposal that the Managing Director should release to the public a brief assessment of a country's policies and prospects at the end of each Article IV consultation discussion by the Executive Board, Mr. Fujino remarked. However, his authorities believed that specific policy advice in staff reports should not be made public, as such a step would endanger the frankness and informality of consultation discussions in the future. He saw no reason at the present stage to change the threshold of the exchange rate movement that triggered the issuing of information notices.

The strong political will of members was required to support the Fund's efforts to intensify surveillance, Mr. Fujino commented. The major industrial countries had shown evidence of that will during their September 1985 meeting, and his authorities attached great importance to the coming meeting of the Interim Committee.

Mr. Pérez stated that he agreed with the three-stage strategy for considering issues related to surveillance which was described on pages 26-27 of SM/86/3. He also agreed with Mr. Sengupta that the Executive Board should hold a series of meetings to examine in detail optional proposals which had been made during the recent discussion on the exchange rate system. Those discussions could be a part of the first stage of the strategy mentioned on page 26 and presumably would be held over several months. Accordingly, the proposed report to the Interim Committee at its next meeting could only contain preliminary views on the substantive questions and perhaps request some guidance on the conduct of a systematic examination of the issues. If the Interim Committee accepted that proposal, it might be excessively ambitious to set the 1986 Annual Meeting as the target date for achieving concrete results, including the modification of the 1977 document on surveillance.

In its discussion on the principles for the guidance of members' exchange rate policies in SM/86/3, the staff had made a compelling case for extending surveillance to include domestic policies that had a clear impact on the behavior of exchange rates, Mr. Pérez said. During the recent discussion on the floating exchange rate system, his chair had mentioned that the problems associated with that system could not be satisfactorily analyzed exclusively within the context of exchange rate arrangements. The international financial system did not provide an adequate setting for either policy coordination and discipline or symmetrical adjustment, as experience over the previous decade had clearly shown. It was essential for the major industrial countries to agree on the establishment of a multilateral framework for policy coordination in order to achieve a stable and growth-oriented world economic environment. Some form of target zones or target directions could provide such a framework, and he still had an open mind on other workable mechanisms for establishing such a framework.

The establishment of target zones would imply significant changes both in the nature of the guidance that was given to members and in the implementation of the Fund's surveillance, Mr. Pérez continued. The target zone proposal raised a number of issues, including a possible amendment of the Articles, which could be examined in detail during future discussions. His authorities believed that the use of objective indicators need not be in conflict with the establishment of target zones. Of course, there should be sufficient flexibility in the implementation of surveillance. Workable arrangements for effective surveillance would require the full cooperation of all members--especially the major industrial countries--and the limits of surveillance should be realistic, taking into account the many domestic policy actions by the industrial countries which had significant international repercussions. In any event, surveillance arrangements probably should be based on policy commitments rather than on economic outcomes, although the expected results from the application of policies might need to be stated explicitly.

The third broad approach to modifying the principles for the guidance of members' exchange rate policies--namely, the introduction of more specific descriptions of policies to be avoided--seemed to be the least promising avenue of reform, Mr. Pérez considered. The difficulty in defining more precisely the actions that might constitute manipulation of exchange rates equaled the difficulty in establishing target zones and objective indicators and probably would not make an equally positive contribution to exchange rate stability and to improving the economic environment in general. Multilateral surveillance could best be strengthened by having members make commitments to follow appropriate policies rather than by stating more precisely which policies should be followed.

In discussing the principles of Fund surveillance, the staff had suggested two actions to broaden the scope of surveillance within the framework of the 1977 decision on surveillance, Mr. Pérez remarked. The first suggestion was to delete the reference to "for balance of payments purposes" from the description of policy developments that might indicate that a member was manipulating its exchange rate, thereby triggering consultations. The second suggestion was that the list of indicators should be extended to domestic policies and should be made more specific. At the present stage, little would be gained by moving in those directions. The principles of surveillance over exchange rate policies followed naturally from the general principles of surveillance, and modifications of the former should be derived from changes that might eventually be made in the latter.

Commenting on the proposals concerning surveillance procedures, Mr. Pérez said that he agreed with the staff that both the G-10 and G-24 reports emphasized the need for comprehensive policy coverage and for the use of medium-term scenarios. However, the G-24 report had suggested that consultations with major industrial countries should focus on policy evaluation within a multilateral framework of international adjustment. The G-10 report placed more emphasis on the issue of individual country policy coverage and on the need to frame policy analysis in a medium-term perspective.

The staff had stressed the importance of assessing the sustainability of policies in a medium-term context, as the availability of capital from commercial sources might prevent timely policy corrections if the consequences of those policies were not viewed in an appropriate time horizon, Mr. Pérez continued. However, that option was no longer available to most developing countries, and the increased integration of world capital markets had made it increasingly difficult for all but a few major countries to delay adjustment to any significant extent. Hence, there was a clear need for comprehensive multilateral surveillance over the policy actions of the major countries.

On previous occasions, his chair had underscored the importance and usefulness of examining a country's program in a medium-term framework, Mr. Pérez commented. However, it was unrealistic to expect a substantial improvement in the quality of consultations or program design as a result of the use of medium-term scenarios. As the staff had noted, few countries prepared detailed quantified medium-term policy plans, and it would be unreasonable to ask the staff to undertake that task for the countries that were unable to do so themselves. It was difficult to estimate precisely the impact of policy actions on target variables, and there were occasionally doubts about even the direction in which such variables might move in the future. Such measurement problems were particularly evident in assessing the effects of structural policies. Still, medium-term scenarios served a useful purpose, and an effort should be made to increase the use of sensitivity analysis and the presentation of alternative scenarios against which broad policy actions and different assumptions regarding the behavior of exogenous variables could be evaluated.

As to the question of how forthcoming and candid the staff should be in assessing members' policies during consultations, he agreed with the staff that the cooperative nature of the relationship between the Fund and members was not consistent with a confrontational approach, Mr. Pérez remarked. Staff and management should hold open and frank discussions with authorities and clearly state their assessment of the authorities' policies, but consultation reports should be drafted with great care. The fairly wide circulation of those reports and the potential for leaks suggested that a relatively forceful presentation of the difference of views between the authorities and the staff in such reports might make members reluctant to engage in open discussions.

During recent discussions on multilateral surveillance his chair had emphasized that the key currency countries had a special responsibility to adopt policies that were consistent with the establishment of stable economic and financial conditions and that those countries should therefore coordinate their policies more closely, Mr. Pérez said. The world economic outlook exercise provided an opportunity to assess policies in the major countries, and the G-10 Ministers' suggestion to have a follow-up procedure in the form of a review of the assessment by the G-10 countries was welcome. The Managing Director should actively participate in G-5 meetings, which played a crucial role in determining the exchange rate performance of the major industrial countries.

As a follow-up to a consultation, it would be useful to review developments in a member against the background of the conclusions that had been reached during the previous consultation, Mr. Pérez remarked. In addition, internal publicity should be intensified, and there should be a follow-up consultation between the Managing Director and the Minister of Finance in cases in which the Executive Board felt that high-level communcations were needed to stress certain policy recommendations. It would be inappropriate to make public the discussions between the Fund and the authorities for the reasons mentioned in the first paragraph on page 20 of SM/86/4.

Both the G-10 and G-24 reports endorsed making greater use of supplemental surveillance, especially for countries that had an important weight in the world economy, Mr. Pérez commented. Supplemental consultations had not been used in the past, probably for two reasons--namely, the relatively narrow focus of surveillance on exchange rate policies, and the reliance on judgment--rather than the use of an automatic triggering mechanism--in determining when the use of supplemental surveillance was called for. The staff had suggested that a broader range of policies than hitherto, or a lack of desired action in policy areas other than those specifically related to exchange rates, could trigger supplemental consultations. The staff had also suggested that the application of a supplemental consultation procedure could be made more automatic. The explicit recognition that a wider range of policies should be subject to supplemental procedures was compatible with his views on multilateral surveillance. The implementation of a variant of target zones or domestic policy indicators would provide the framework for the establishment of more effective procedures for supplemental consultations which, however, should be held only for very selected cases in which such consultation could be fully justified.

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

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/86/28 (2/14/86) and EBM/86/29 (2/19/86).

2. ASSISTANT TO EXECUTIVE DIRECTOR

The Executive Board approves the appointment of an Assistant to Executive Director as set forth in EBAP/86/35 (2/12/86).

Adopted February 14, 1986

3. APPROVAL OF MINUTES

The minutes of Executive Board Meetings 85/67 through 85/70 are approved. (EBD/86/36, 2/10/86)

Adopted February 14, 1986

4. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director and by an Advisor to Executive Director as set forth in EBAP/86/37 (2/13/86) is approved.

APPROVED: October 16, 1986

LEO VAN HOUTVEN
Secretary