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Minutes of Executive Board Meeting 86/30

3:00 p.m., February 19, 1986

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

Executive Directors	Alternate Executive Directors
A. Alfidja	
C. H. Dallara	
J. de Groote	
	S. de Forges
	M. Z. M. Qureshi, Temporary
H. Fujino	
G. Grosche	
Huang F.	
J. E. Ismael	
	J. Hospedales, Temporary
	M. Foot
	H. Fugmann
	L. Leonard
	A. Abdallah
F. L. Nebbia	
	J. E. Suraisry
P. Pérez	G. Ortiz
J. J. Polak	
C. R. Rye	
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

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

Also Present

African Department: 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. Guitian, Deputy Director; G. Belanger, J. T. Boorman, A. Chopra, R. Pownall. External Relations Department: M. Goldstein. Legal Department: F. P. Gianviti, Director; W. E. Holder, A. O. Liuksila. Middle Eastern Department: P. Chabrier, Deputy Director; 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: A. P. Bhagwat, 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, S. Ganjarerndee, G. Nguyen, J.-C. Obame, Song G., A. Vasudevan, M. A. Weitz, K. Yao. Assistants to Executive Directors: B. Bogdanovic, G. Ercel, R. Fox, S. Geadah, V. Govindarajan, G. D. Hodgson, L. Hubloue, H. Kobayashi, R. Msadek, K. Murakami, J. Reddy, S. Simonsen, L. Tornetta, 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 continued from the previous meeting (EBM/86/29, 2/19/86) their consideration of 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 review of surveillance and proposals for changes in surveillance procedures (SM/86/4, 1/10/86; and Sup. 1, 1/28/86).

Mr. Zecchini considered that the Fund should not miss the present opportunity to strengthen surveillance, thereby increasing the consistency of economic policies of members and improving the working of the international monetary system. Both the G-10 and G-24 reports included suggestions for strengthening the system through the development of multilateral surveillance procedures and the use of supplemental surveillance procedures. The reports contained different views on other aspects of surveillance, but he hoped that agreement could be reached on at least procedures for multilateral surveillance and supplemental surveillance.

The effectiveness of surveillance had been somewhat impaired by a series of developments that had resulted from not only exogenous shocks but also weaknesses in the design of surveillance, Mr. Zecchini continued. Surveillance had also been negatively affected by the excessive reliance on bilateral procedures that were best suited to identifying the imbalances of individual countries--such as excessively large government deficits or current account deficits--but did not provide an adequate frame of reference for ensuring greater consistency of economic policies among members, especially the largest countries. In addition, surveillance had not had an equal impact on the economies of all members; it had been less effective in dealing with countries that did not have a Fund-supported program. That conclusion was applicable to all groups of members--large, small, industrial, and developing countries.

Surveillance had been excessively narrowly focused on exchange rate policies, Mr. Zecchini commented. That focus had been broadened on a de facto basis over the previous several years, when attention had been paid to a broader range of economic and financial policies, but the restrictive scope of the 1977 decision had kept the Fund from exercising the full degree of authority needed to make its recommendations for policy changes more constraining. In implementing policies designed to correct economic imbalances, members had not taken sufficient preventive actions at an early stage and had not adequately introduced adjustment measures following the Fund's recommendations because of weaknesses inherent in the present surveillance procedures.

Nevertheless, the present broad approach to surveillance was fundamentally correct, Mr. Zecchini said. The changes in surveillance which he favored were not meant to overturn that approach. They were meant to build on the experience of recent years with a view to making the present approach more effective by broadening its coverage and by defining surveillance tasks and procedures more precisely than hitherto.

The focus of the general principles of surveillance should be on assessing and monitoring the appropriateness and sustainability of members' economic, financial, exchange rate, and external policies, and their coherence in an international context with a view to promoting lasting growth in the world economy, Mr. Zecchini commented. The most important possible changes in the instruments of surveillance were a strengthening of multilateral surveillance and the introduction of a procedure to follow up on the Fund's policy recommendations. He did not favor a rigid mechanism for quantifying macroeconomic policy objectives and instruments in order to assess their consistency in an international context; that approach would be unacceptable for technical and political reasons. However, quantitative indicators related to the most relevant macroeconomic variables, including the exchange rate, could be considered in the assessment of a member's policy stance.

Those variables should be used as indicators of the outcome of recent policy results, as signals of current unsustainable trends, and as benchmarks for recommended policy changes or adjustments, Mr. Zecchini went on. The direction of the movement of the variables, rather than their target values, would be most relevant in terms of signaling the need for corrective action. A soft version of the target zone proposal would be consistent with that approach and could be easily implemented if it had the required support. The indicators that he favored could help to define the macroeconomic framework in which to appraise the international repercussions of policies; that appraisal was at the core of multilateral surveillance and should include the international compatibility of national policy mixes. The staff could prepare a set of macroeconomic variables that could be used to provide a quantitative framework within which to make the judgmental assessment and to maintain the monitoring of international policy consistency.

A special chapter in the World Economic Outlook paper would be an appropriate vehicle for presenting the appraisal of the international repercussions of policies. Although attention should be focused on a limited group of relatively large countries, other groups, such as the oil exporting countries or the largest developing countries, also could be covered by the appraisal whenever their policies had a significant impact on the rest of the world economy. An important feature of the special chapter in the World Economic Outlook paper would be recommendations for policy adjustments, possibly including a quantified assessment of the size of the required corrections under alternative scenarios, preferably in a medium-term perspective. The chapter should be discussed by the Executive Board and transmitted to the Interim Committee for its consideration. Of course, other international economic institutions, such as the OECD, could base their debate on international compatibility of national policies on the World Economic Outlook chapter and other relevant Fund documents.

The G-24 proposal to implement a two-stage multilateral surveillance procedure went much farther than his proposal, Mr. Zecchini noted. The G-24 proposal had some merit, especially the proposed structuring of discussions and follow-up reports. However, the G-24 proposal was unworkable for technical and political reasons, as it would involve the sophisticated development of the notions of international consistency of policy objectives and instruments and would require a strong political will by authorities to accept the results of the exercise. There was little chance that such an approach would be accepted and properly implemented.

His proposal was in the same direction of Mr. Sengupta's recent proposal to provide quarterly information notices and discussions on exchange rate misalignments, Mr. Zecchini remarked. The special World Economic Outlook chapter that he favored should include an appraisal of exchange rate movements and their consistency with economic fundamentals. The relevant discussions would not always have to be held on a quarterly basis; such frequent discussions would overemphasize short-term developments and would run the risk of becoming repetitive and routine.

A follow-up to multilateral and bilateral surveillance would be crucial to ensuring the effectiveness of surveillance, Mr. Zecchini considered. He fully supported the G-10 proposal to request members to indicate the measures that would address the problems that had been identified during consultations and perhaps to respond to specific policy suggestions. In addition, the staff should circulate information notices for cases of deviations from or delays in the implementation of suggested policy changes. Those steps would be inadequate if they were not followed by continuing pressure for changes, perhaps through supplemental surveillance. There should be more automaticity in the triggering of the supplemental surveillance procedure to avoid difficult judgmental choices by management and to keep the procedure from being used only rarely. The procedure should be applied in the following circumstances: when the conclusions of an Article IV consultation or of the discussion of the special chapter of the World Economic Outlook called for supplemental surveillance because of serious doubts about the appropriateness of a country's policies; when there was continued disagreement with a member's authorities on domestic and external policies; as a result of the discussion of information notices on major policy actions and economic developments, a failure to implement specific adjustments recommended by the Executive Board, or major exchange rate developments affecting the economic performance of a country as well as the international monetary system; and when countries had arrears or were making prolonged use of the Fund's resources.

Commenting on bilateral surveillance procedures, Mr. Zecchini said that few adjustments in Article IV consultations were needed, as most of the recently proposed changes had been gradually made. The emphasis in bilateral consultations should be on the comprehensiveness of the appraisal of policies and of the real and financial weaknesses in the structures of a member's economy, on the analysis based on medium-term perspectives and scenarios, and on the specification of suggested policy changes or, at least, of policy goals. In operational terms, that approach would require a strengthening of the empirical and analytical basis of policy judgments and a clear presentation of the analytical assumptions that might explain differences between the different policy approaches favored by the staff and the authorities. No change seemed to be needed in the consultation cycles. Any tendency toward semiannual cycles--which would overload the Executive Board, reduce the effectiveness of its work, and make its work merely routine in nature--should be resisted.

Amendments to the 1977 surveillance document were called for both to make it more consistent with current practices and with the proposals that he favored and to define more precisely the cases in which the supplemental surveillance procedure should be used, Mr. Zecchini commented. The sections on the principles for the guidance of members' exchange rate policies and the principles of Fund surveillance over exchange rate policies defined too narrowly the obligations of members and the policies that were subject to Fund surveillance, limiting them respectively to the manipulation of exchange rates and to domestic policies adopted for balance of payments purposes.

He favored changing the 1977 surveillance document in three ways, Mr. Zecchini remarked. First, a member's responsibilities vis-à-vis the Fund should be broadened to include all economic policies. That could be accomplished by having the text include a fuller reference to Article IV and by stipulating that members should adopt economic and financial policies that would support orderly economic growth in a noninflationary environment, financial stability, and exchange rate stability. That amendment would merely state what was already provided for in Article IV, Section 1 and would reflect current practice with respect to Article IV consultations and the World Economic Outlook exercise. Such a change could however have psychological effects and could send the signal to all members that there was a renewed willingness to strengthen surveillance. Second, the 1977 document should be consistent with agreements reached on multilateral surveillance and on target zones or other indicators that were to be considered in a judgmental fashion in the context of multilateral surveillance procedures. Third, the document should include a more precise definition of the criteria for the application of the supplemental surveillance procedure. That proposal could be related to his second point, if a form of soft target zones were introduced as a mechanism to trigger supplemental surveillance.

Mr. Foot considered that the present discussion was meant to clarify the ways in which surveillance could be strengthened at the multilateral and bilateral levels. The three-stage strategy for considering issues related to surveillance mentioned on pages 26-27 of SM/86/3 was acceptable.

Commenting on the general principles of surveillance, Mr. Foot said that his authorities agreed that to be effective, surveillance must include an examination of the domestic policies that affected the interests of other members, as they were often the principal cause of inappropriate exchange rates. However, he did not agree that the effectiveness of surveillance had been constrained by the guideline requiring surveillance to apply only to "exchange rate policies." The Fund was obliged under Article IV to oversee members' compliance with their obligation to foster orderly underlying economic conditions. In his view, the limited effectiveness of surveillance was a reflection of the lack of will on the part of certain members to take into account fully the international repercussions of their domestic policies rather than to any shortcomings in the guidelines under discussion. It would be premature to propose amendments today to the general principles, although he had an open mind on possible future modifications.

As to the principles for the guidance of members' exchange rate policies, he favored the fourth option mentioned in the final paragraph of Section 2 on page 27 of SM/86/3, Mr. Foot remarked. Accordingly, the guidance to members should be left essentially unchanged, and the Fund should focus on other ways of enhancing the implementation of surveillance. For the reasons that he had given during the recent discussion on the floating exchange rate system, he saw no value in defining guidance to be given to members through the setting of a target or zone for the exchange rate. For broadly similar reasons, he did not favor setting objective indicators; there would likely be great difficulty in interpreting deviations from such indicators. The staff had also suggested defining guidance in terms of actions to be avoided by introducing more specific language than simply a reference to the avoidance of manipulation. He doubted whether merely changing the guidelines in the 1977 document would lead to any improvement in the effectiveness of surveillance. Attention should be focused instead on strengthening the implementation of existing surveillance procedures.

There was no need for a formal agreement to extend the indicators used to trigger consultations with the Fund to include domestic policies, Mr. Foot commented. The present guidelines had not prevented--and need not prevent in the future--the Fund from expressing its views on a range of policies which were not undertaken by a member specifically for balance of payments reasons. However, he was willing to discuss the matter further, if others saw the need to amend the guidelines.

By contrast, the procedures for surveillance should be changed, Mr. Foot considered. In particular, he agreed with the G-10 report on the need for wider use of the supplemental surveillance procedure when important exchange rate developments had occurred. Indeed, he attached importance to establishing that procedure as a regular feature of the Fund's operations, and he was prepared to include a reference to it in the appropriate guidelines. However, he doubted whether it would be wise to use automatic triggers for the supplemental consultation procedure. Supplemental consultations should be based on requests, including formal or informal approaches by Executive Directors to the Managing Director, or the Managing Director could take the initiative. No process--other than a fully mechanical trigger mechanism--could avoid some awkwardness in that respect, but that was the necessary price to pay for that worthwhile development in surveillance, and even the use of automatic triggers would not eliminate the problem.

He agreed with the main proposals for change contained in the staff paper on the annual review of surveillance, Mr. Foot said. He agreed with Executive Directors who had called for further improvements in the availability of comprehensive and reliable data on a timely basis. Some progress in that area had already been made. For example, the practice of including in Article IV consultation reports a section on statistical issues was welcome. In many countries--including some industrial countries--the provision of data could be further improved and, in that connection, the Fund had a role to play in the context of regular consultations and by providing technical assistance.

Responding to requests by the Executive Board, the staff had broadened the scope of Article IV consultations to cover a broader range of policies, including microeconomic and structural policies and had placed greater emphasis on protectionism and capital flows, Mr. Foot remarked. For example, his chair, and probably many senior officials in the United Kingdom, had learned a great deal about the structural aspects of the U.K. labor market from the staff report for the latest Article IV consultation with the United Kingdom. Closer collaboration with the World Bank had become an important feature of the staff's effort to broaden the coverage of Article IV consultations. The inclusion in staff reports of statements by the World Bank staff on its policy views and objectives was welcome, although he agreed with Mr. Rye that, in some cases, the descriptions had been patchy.

There had been an increasing need to assess the sustainability of members' policies in a medium-term framework, and the staff's inclusion of medium-term balance of payments scenarios in most Article IV consultation reports in 1985 was welcome, Mr. Foot commented. Few countries prepared detailed and quantified medium-term plans, and Article IV missions could usefully focus the authorities' minds in that direction. Nevertheless, there was room for improvement in the staff's approach. For example, it was disappointing that policy assumptions had been explicitly stated in only roughly half of the medium-term scenarios produced in 1985 and that it was often unclear whether the scenarios had been discussed with the authorities and whether the authorities had agreed with the staff's analysis. The analytical foundations and quantitative assumptions underlying the staff's medium-term analysis should be spelled out much more clearly than at present if they were to focus the discussions with authorities.

The need for greater clarity extended to the shorter-term policy recommendations that emerged from the consultation process, Mr. Foot went on. A more forceful presentation of specific recommendations on, for example, the scale and speed of adjustment required and the relevant trade-offs could help to highlight problems and to speed the progress toward their solution. There had often been disagreement with members about a wide range of subjects, including pricing policies, reform of exchange and payments systems, and trade liberalization. The Fund should state its views and meet criticism in those areas in a more forthright manner than at present. Of course, that effort would not always be welcome by individual members, but that was an inevitable price to pay to make surveillance more substantive.

The staff had responded to Executive Directors' requests to increase the frequency of Article IV consultations, Mr. Foot remarked. He welcomed the fact that 90 percent of the membership was on the 12-month cycle. A number of Executive Directors had mentioned the staff's increasing work load, and that theme had been evident during a number of recent Executive Board discussions. Along those lines, after the details of the Special Disbursement Account had been agreed, the staff should prepare a paper discussing broadly the staffing implications of the various recent recommendations and decisions of the Executive Board.

As to multilateral surveillance, his authorities believed that in the context of Article IV consultations with major countries, it would be important to strengthen the analysis of the compatibility and sustainability of policies in a multilateral perspective, Mr. Foot said. His chair had stressed that point repeatedly during Executive Board discussions of staff reports for Article IV consultations with major countries. He supported the G-10 proposal for an assessment in the context of the World Economic Outlook of the interactions of economic policies of the G-10 countries followed up by a review by the G-10 Ministers. It would be appropriate to consider that assessment first in the Executive Board. A summary and report of the discussion by the Managing Director could convey the Executive Board's conclusions to the G-10 Ministers for their consideration.

He welcomed the progress that had been made in strengthening the continuity of the consultation process by including in staff reports a review of the implementation and the effects of the Fund's policy recommendations since the previous consultation, Mr. Foot commented. That effort should be taken further in two ways. First, the staff should ask the authorities to specify the measures that had been introduced or considered to deal with problems that the staff had identified. Second, there should be confidential exchanges on a selective basis between the Managing Director and the relevant Finance Minister in the event of continuing policy disagreements between the staff and the authorities. He agreed with Mr. Dallara that ensuring that consultations involved appropriate politicians and officials would be a significant improvement in the consultation process. Article IV consultations involved the highest levels of government in the United Kingdom. But he had some reservations about Mr. Dallara's idea to publish selected highlights of Article IV discussions or the Chairman's summing up.

He had sketched out a number of ways in which surveillance could be enhanced within existing channels, without the adoption of new mechanisms, trigger points, and similar proposals for which no consensus existed, Mr. Foot concluded. Taken together his proposals would not dramatically increase the present value of surveillance, and a number of his suggestions would require the use of judgment in particularly difficult situations. Such situations could not and should not be avoided, but detailed objective or automatic triggers would not ease the Fund's path toward more effective surveillance. There were no easy shortcuts.

Mr. de Forges commented that the present papers were a necessary and welcome complement to the recent discussion on the functioning of the exchange rate system. During that discussion, Executive Directors had stressed that improved surveillance was the most promising way to improve the functioning of the international monetary system. That conclusion was reflected in the present staff papers. His authorities hoped that the differences of opinion reflected in the G-10 and G-24 reports could be greatly narrowed as a result of the present discussion.

Commenting on the biennial review of the 1977 surveillance document, Mr. de Forges said that he agreed with the three-step strategy for considering issues related to surveillance mentioned on pages 26-27 in SM/86/3. Accordingly, the Interim Committee could be asked to provide guidelines on the major areas of agreement evident at the end of the present discussion, and, if necessary, a text modifying the surveillance procedures could be prepared in the period leading up to the 1986 Annual Meeting.

As to the general principles of surveillance, it seemed unnecessary to revise that section of the 1977 document, which defined the scope of the Fund's surveillance, Mr. de Forges continued. The text already gave the Fund fairly broad authority. Nevertheless, it might be useful to reflect in the language of the text the spirit in which surveillance was conducted; accordingly, the text could show that domestic policies and their international effects had an impact on exchange rates and on the stability of the international monetary system. The general principles would then convey the Executive Board's keen interest in the external consequences of members' national economic policies.

The three approaches to the principles for the guidance of members' exchange rate policies mentioned on page 27 on SM/86/3 apparently were not mutually exclusive, Mr. de Forges remarked. Nevertheless, they would introduce different degrees of constraint and should be assessed in the light of the relevant significance of shifts in the economic situation and the exchange rates of individual members for their partners and the world economy. He preferred the first approach--namely, defining the guidance given to members in terms of seeking to observe some exchange rate reference zone. That approach was especially important for members whose currencies were in the SDR basket and which had the main responsibility for stabilizing the international monetary system. Under the second approach mentioned by the staff, guidance would be defined in terms of observing quantitative or qualitative objectives for domestic policy instruments. That approach was interesting but more constraining than the first one. It would be cumbersome to implement and would run the risk of placing the Fund in a difficult position vis-à-vis members because it implied giving the Fund a substantial right of inspection of members' economic policies. The second approach would encourage members to define a comprehensive and coherent set of economic policy objectives and at least to measure and analyze slippages. However, it would not be directly aimed at, and could not guarantee, the stability and appropriateness of exchange rates. The third approach would define guidance in terms of actions to be avoided by members. It would usefully condemn policies that were unsustainable or inconsistent with the promotion of medium-term balance of payments adjustment. That third option seemed to be a complement--rather than an alternative--to the first two approaches.

In its discussion on the principles of Fund surveillance over exchange rate policies the staff had made a strong argument for deleting the proviso for "balance of payments purposes" from some of the policy developments listed in the section on the principles, Mr. de Forges remarked. In brief, the coverage of surveillance should not be restricted to measures implemented for balance of payments purposes. Surveillance could usefully be extended to factors that had an impact on external equilibrium and on other countries; for example, it could include the debt of the U.S. Government or of the developing countries. Both the G-10 and G-24 reports had recommended that indicators concerning domestic policies should be used to trigger consultations. However, the exchange rate seemed to be the most comprehensive and easily identifiable indicator of the compatibility of members' economic policies.

The surveillance procedures would be improved by introducing more automaticity in the recourse to special or supplementary consultations, Mr. de Forges said. To make such a step possible, there would have to be greater precision in the definition of the indicators that were to trigger such consultations. However, that effort would enable the Fund to use regular follow-up procedures. Excessive use of the supplementary consultation procedure could undermine its usefulness.

Continuing, Mr. de Forges said that he agreed with the G-10 report's conclusion that the analytical basis of surveillance could be improved by increasing the reliability of statistics, achieving a better balance between the development of short-term and medium-term policies, and urging the staff to make candid appraisals of members' policies.

The proposals in SM/86/4 concerning the multilateral setting of surveillance were broadly consistent with proposals in SM/86/3, especially those concerning the use of quantitative or qualitative objectives for members' internal and external policies, particularly the policies of the major industrial countries, Mr. de Forges commented. The various proposals--especially the suggestion to make surveillance more symmetrical than hitherto--in the staff papers should be acceptable to the Group of Ten and the Group of Twenty-Four. Groups that undertook multilateral surveillance could benefit from the regular participation in their efforts by the Managing Director.

Among the proposals designed to reinforce the influence of the Fund's surveillance, his authorities had strong reservations, in line with the G-10 report's conclusions, about publicity of Article IV consultations, Mr. de Forges remarked. If such publicity was thought to be necessary, his authorities could accept an arrangement under which the Managing Director would make a statement on a consultation on his own responsibility. His authorities understood the reluctance of some members to see staff reports publicized; they were convinced that such publication would be counterproductive in the long run by discouraging the openness and candor that had characterized all phases of the consultation process thus far.

In concluding, Mr. de Forges said that he agreed with Mr. Fujino that the efficiency of surveillance depended less upon the revision of the 1977 document than upon the willingness of members to coordinate their economic policies and to cooperate closely under the impartial guidance of the Fund.

Mr. Suraisry remarked that the need to strengthen the surveillance procedures was widely recognized. A sizable part of the literature on the international monetary system had been devoted to that issue, the G-10 and G-24 reports contained several proposals for increasing the effectiveness of surveillance, and the staff papers showed that past experience underscored the need for stronger surveillance. That need had become increasingly urgent because of the difficult problems facing the world economy, such as exchange rate volatility, indebtedness, protectionist pressures, and large fiscal imbalances.

Addressing those problems in a meaningful way would require greater cooperation between the Fund and members and among members themselves, Mr. Suraisry continued. Such cooperation was essential if members were to meet their obligation to maintain economic and financial policies and foster economic and financial conditions that would promote orderly economic growth with reasonable price stability. He fully agreed with the staff that recent developments in the international monetary system had led to the maintenance of inappropriate economic policies and had compounded the adverse effect of those policies on individual members' economies as well as on the world economy.

There was clearly considerable interdependence between domestic and external policies, Mr. Suraisry commented. There was also ample evidence that, given the interdependence of economies, the policies of large industrial countries affected the rest of the world. Experience showed that, unless the interdependence was fully recognized, the present international system would always be subject to shocks.

If surveillance were to be strengthened enough to enable it to achieve its objectives, both domestic and external policies would have to be evaluated to determine their contribution to the sustainability of members' balance of payments, to fostering underlying conditions required for sustained domestic economic growth, and to improving the world economy, Mr. Suraisry considered. In designing their domestic policies individual countries should take into account the repercussions of those policies on other members.

The implementation of surveillance procedures had been considerably improved over time, even though the procedures had not been formally changed since their adoption in 1977, Mr. Suraisry commented. The substance and coverage of the World Economic Outlook exercise had increased, and Article IV consultation reports had become more thorough and forward-looking. In addition, the criteria for holding annual consultations had been strictly followed.

Nevertheless, much remained to be done, and he welcomed the proposals in the G-10 and G-24 reports to strengthen surveillance further, Mr. Suraisry commented. Some of the proposals would change the surveillance exercise substantially and had major implications for the international monetary system and for the work load of the Executive Board and the staff, which would have to be examined before the adoption of such proposals. He sympathized with Executive Directors who wished to reduce the pressure on the Executive Board and the staff. To that end, there seemed to be room in which to lengthen the intervals between the Article IV consultations for some countries. However, in that connection, caution was needed, especially in dealing with countries that were on the 12-month cycle. Although he doubted whether the lengthening of intervals between consultations would significantly improve the surveillance process, suggestions to that end could be made to the Executive Board by management on a case-by-case basis.

Recent staff reports for Article IV consultations had devoted considerable attention to improving the analytical basis of surveillance, Mr. Suraisry remarked. The issue of reliable and up-to-date data had become a part of the Article IV consultation discussions with many members. The acquisition of such data, especially in most developing countries, was time-consuming and demanded considerable attention by the countries and technical assistance from the Fund. There was obviously room for improvement in providing better data, which were essential for increasing the effectiveness of medium-term scenarios. The Fund should continue its efforts to improve the availability and reliability of data through technical assistance and, perhaps, through the surveillance exercise.

The staff's analysis in Article IV consultation reports had become more candid and oriented toward the medium term, Mr. Suraisry noted. The development of that approach was important and welcome; the approach should be emphasized in particular cases, and the implications of domestic policies for the world economy should be highlighted in reports. It should be recognized that, in general, differences between authorities and the staff could arise. Hence, it was important for the staff to be careful and diplomatic to avoid the risk of weakening surveillance rather than strengthening it.

Commenting on the proposals concerning multilateral surveillance, Mr. Suraisry said that the policies of the major industrial countries had major implications for the world economy in general, and for the economies of other individual countries, in particular. There was a greater need than ever before for the major industrial countries to take the international repercussions of their domestic policies into account in the formulation of those policies. The G-24 proposal for a two-stage procedure to strengthen multilateral surveillance would significantly improve surveillance and should help to eliminate many of the fundamental weaknesses in the international monetary system. That effort would of course require sacrifices by members and a high degree of international cooperation, but the potential benefits clearly justified those costs. If the G-24 proposal were thought to be too difficult to implement, the minimum acceptable alternative would be the G-10 proposal to include a separate chapter in the World Economic Outlook paper on the international repercussions and interactions of the national policies of the G-10 countries. That chapter should include quantified statements by the major industrial countries on their policies. Such statements had been prepared for the September 22, 1985 G-5 meeting. The views of the Executive Board on those policies could be communicated to the G-10 Ministers by making the Managing Director's summing up of the relevant Executive Board discussion a supplement to the new chapter in the World Economic Outlook paper. The Managing Director could further elaborate on those views when he attended G-10 meetings.

However, those steps alone might not be sufficient, Mr. Suraisry continued. They should be reinforced by increased use of the supplemental surveillance procedure. Certain obstacles to increasing the use of supplemental surveillance were inherent in the relevant 1979 decision. To overcome those obstacles, greater automaticity in the use of the supplemental surveillance procedure and greater emphasis on policies other than exchange rates in such surveillance were required. Increased automaticity would make it easier to identify cases in which supplemental surveillance would be required. The adoption of target zones would provide a good mechanism for triggering such consultations. In the absence of that approach, he agreed with the staff that supplemental surveillance could be recommended in the staff's appraisals in staff reports. Placing more emphasis on improving policies in addition to exchange rate policies was required, as it was clearly recognized that exchange rate volatility--one of the major problems with the current exchange rate system--was the result mainly of inappropriate domestic policies. However, it would be important to exercise caution in identifying cases requiring supplemental surveillance. Those cases should be limited to countries--such as the G-7 and G-10 members--that affected the entire system.

Once supplemental surveillance was initiated, the Fund should use persuasion and peer pressure to convince the members concerned to introduce appropriate economic policies, Mr. Suraisry went on. Much stronger steps would not be appropriate, as in taking them the Fund might run the risk of creating friction with members. After all, surveillance was only one means of encouraging members to adopt appropriate policies; and an even more important factor was the willingness of members to make the system work.

In its discussion on the 1985 annual review of the implementation of surveillance the staff had devoted considerable attention to possible ways of strengthening the influence of the consultation process, Mr. Suraisry remarked. As had been concluded during that review and as had been noted in the G-10 and G-24 reports, external publicity was risky, as it could weaken the relations between the Fund and members by undermining members' trust in the Fund. If external publicity was routinely given to consultations, authorities would always have that publicity in mind during their discussions with the staff, and the candor of the discussions with the authorities and therefore of the staff's reports would suffer. Hence, he continued to have strong reservations about external publicity. Internal publicity involving contacts between the Managing Director and the Minister of Finance of a member would be acceptable.

In summarizing his views, his answer to the questions raised in subparagraphs (2)(i) and (ii) on page 27 of SM/86/3 was in the affirmative, Mr. Suraisry said. He agreed with much of Mr. Polak's comments on the question raised in subparagraph 2(ii). As to the proposals regarding the principles for the guidance of members' exchange rate policies, target zones constituted the best approach. A number of questions about that approach had been raised, but many of them could be dealt with if sufficient attention were paid to them. He agreed with the staff that the indicators used to trigger consultations with members should be extended to policies that were not necessarily adopted for balance of payments purposes. However, the impact of those policies on the balance of payments should be clear. Finally, there should be greater automaticity in the initiation of supplemental surveillance, but caution should be exercised in selecting the countries for which such surveillance was needed.

Mr. Grosche recalled that during the discussion on the exchange rate system Executive Directors had mentioned a number of ideas to improve the functioning of the international monetary system, including mechanisms to increase policy discipline by mechanically imposing external constraints on national policies. He continued to have strong reservations about such mechanisms, including target zones and objective indicators. The main way of achieving greater exchange rate stability was to increase the convergence of economic performance of members, which could be achieved mainly by strengthening surveillance. The G-10 Deputies had made a number of proposals to that end which required no major changes in the existing institutional setting but which would result in significant improvements. The key to any success in increasing the convergence of economic performance was the willingness of participants to commit themselves fully to maintaining mutually consistent policies; procedures were not the key issue. The G-5 Plaza Agreement showed that developments were moving in the right direction and that chances to make further progress had greatly increased.

The effort to increase the coordination of members' economic policies should continue to be pragmatic and flexible, Mr. Grosche considered. In that connection, the implications for the Fund's work load, which were mentioned on page 11 of SM/86/4, should be borne in mind. He agreed with the suggestion to lengthen the interval between consultations for members that were already on longer cycles and the specific proposals in SM/86/4 for intervals longer than 12 months.

Considerable progress had been made in the previous several years in improving the analytical basis of surveillance, Mr. Grosche said. The data and analysis in staff reports for major industrial and developing countries appeared to be sufficiently extensive. However, further improvements in the statistical base of a number of other countries was required. The increased use of medium-term scenarios was welcome, as they were particularly helpful in assessing the medium-term sustainability of members' policies. With additional experience, further improvements in the quality of the scenarios were likely.

In most cases the staff had provided a candid assessment of a member's policies and had clearly spelled out its policy recommendations, Mr. Grosche remarked. He agreed that greater use should be made of quantified staff assessments of the size of a member's required adjustments. However, such quantification should be confined to the main economic variables.

The most sweeping and controversial proposals to improve the functioning of surveillance had been made in the area of multilateral surveillance, Mr. Grosche commented. While there was broad agreement that additional steps could be taken in that area, the views of various members on specific mechanisms differed substantially. He supported the relevant G-10 proposals, which were more flexible than the comparable proposals in the G-24 report.

He had commented in detail on objective indicators and target zones during the recent discussion on the exchange rate system, Mr. Grosche recalled. Those proposals still seemed to be unrealistic, mainly because it was not realistic to expect to reach agreement on a global strategy for economic policies against which the Fund could assess the actual performance of individual members. The same difficulties were apparent with the proposal outlined in the first paragraph on page 17 of SM/86/4. There was already ample opportunity under present procedures for individual members to explain their economic policy intentions in staff reports as well as during the discussions of those reports by the Executive Board. Serious imbalances in a member's economy should be clearly described in the relevant staff report. The proposed miniconsultations should not be used extensively. They would be appropriate only for cases in which the consultations would be expected to lead to a significant change in the assessment of a member's economic policies.

The easiest way in which to convey the outcome of the Executive Board's discussions on a separate World Economic Outlook chapter to the G-10 authorities would be through the Executive Directors from those countries, Mr. Grosche considered. In addition, the idea of having a summing up of the discussion by the Managing Director agreed by all the countries concerned was worth considering, but there was some question whether such a summing up would serve a useful purpose, since the G-10 countries would in any event be informed about the discussion by their Executive Directors and the procedure could entail substantial discussion about the precise language of the summing up.

He continued to support follow-up procedures to strengthen the influence of the consultation process, Mr. Grosche remarked. He was interested in Mr. Dallara's proposal to have the authorities of a country provide a separate explanation of their differences of view with the staff. He also continued to support the idea of confidential talks between the Managing Director and a Finance Minister in certain circumstances. In addition, supplemental surveillance would be appropriate, although the major countries were already reviewed by the staff three times each year in the context of the preparation of the World Economic Outlook papers and annual Article IV consultations. Hence, there was already ample opportunity for the Executive Board to discuss the economic policies of those members and the staff's recommendations. Moreover, the policies of the major countries were discussed on other occasions, for example, during discussions on the exchange rate system and international debt. In fact, supplemental surveillance and follow-up discussions six months after annual consultations apparently already occurred. Nevertheless, there was likely some scope for using supplemental surveillance more extensively in cases involving prolonged users of the Fund's resources, members with arrears to the Fund, and countries that did not have a Fund-supported program but were particularly important in the context of the Fund's operations. For those countries, the Executive Board might wish to ask the staff to prepare short interim reports six months after a consultation on the member's implementation of the Executive Board's policy recommendations; the handling of that procedure should be left to the discretion of management.

On the possibility of increasing publicity in order to enhance the influence of the consultation process, Mr. Grosche said that his authorities continued to have reservations about increasing publicity of Article IV consultations; such publicity could undermine the frankness and quality of consultations. However, Mr. Dallara's clarification with respect to publicity, at the previous meeting, especially his reference to the need to maintain the confidentiality of consultation reports, was welcome.

Commenting on the biennial review of the 1977 surveillance document, Mr. Grosche said that the existing institutional framework for surveillance was adequate and there was no need to make major changes in the present guidelines. Moreover, he agreed with the staff that the main principles in the 1977 document were still valid. Nevertheless, some changes merited consideration in order to clarify certain issues and to give more precise guidance to members. It seemed reasonable and desirable to revise the language for the general principles of surveillance to show clearly that exchange rate surveillance encompassed all policies that significantly affected other members.

There was no need to make major changes in the principles for the guidance of members' exchange rate policies, Mr. Grosche continued. The proposal to introduce target zones or objective indicators was unacceptable. Accordingly, the language changes proposed in paragraphs (a) and (b) on page 18 of SM/86/3 were unacceptable. However, the proposal in paragraph (c) to define guidance in terms of actions that were to be avoided was interesting, although, as the staff noted on page 23, it would be difficult to reach agreement on the precise nature of the policies that were to be avoided. That problem could be solved by adopting fairly general language, such as the text proposed in the first paragraph on page 23. That text could be added to, rather than substituted for, the relevant present text on the principles for the guidance of members' exchange rate policies.

Some amendments to the principles of Fund surveillance over exchange rate policies might be useful, Mr. Grosche said. In particular, he agreed with the staff that the reference to "for balance of payments purposes" should be deleted in order to broaden the scope of the Fund's responsibility. However, Mr. Polak's comments at the previous meeting on that point were interesting, and he looked forward to hearing the staff's response. While the idea to extend the list of indicators used to trigger consultations was interesting, it might be difficult to judge the unsustainability of capital flows in industrial countries, especially reserve currency members. Nevertheless, the presumption that capital flows had become unsustainable should trigger a consultation.

There was no need for major revisions of the institutional framework of surveillance, Mr. Grosche commented. Accordingly, the proposed changes in the existing guidelines should not be a cause for a substantial addition to the work program. Moreover, there was no need to involve the Interim Committee closely in the procedural aspects of surveillance.

Mr. Huang remarked that the staff papers clearly described the problems with surveillance. The task facing Executive Directors was to explore various possible pragmatic and effective ways of enhancing surveillance in order to meet the requirements of Article IV, Section 3(b). Reviews of surveillance had revealed a widespread concern that the objectives of surveillance were not being fully met. Short-term exchange rate volatility had increased significantly after the introduction of generalized floating and had recently shown no sign of diminishing. In addition, the floating exchange rate system had been characterized by persistent swings in exchange rates. The conversion of inflation rates in the major industrial countries toward lower levels had not brought about the expected reduction in exchange rate volatility in either the short or longer run: quarterly movements in key exchange rate relationships had been considerably greater in 1984-85 than in 1975-76; medium-term exchange rate strings had also been greater.

One of the reasons for the unexpectedly wide movements in key exchange rates was the growing importance of the divergence in members' economic policy mix, which had created an incentive for capital flows, Mr. Huang went on. It was clear that the volume of internationally mobile capital was sufficient to finance current account imbalances that were considerably larger and more prolonged than had been considered possible in earlier years. The current principles for the guidance of members' exchange rate policies did not by themselves provide sufficient guidance to generate medium-term exchange rate stability. The choice of the policy mix that members used to create orderly domestic economic and financial conditions was left to individual members; accordingly, divergent choices could lead to undesirable exchange rate patterns.

All those points underscored the weaknesses and shortcomings of the present surveillance mechanisms and procedures, Mr. Huang remarked. The unsatisfactory developments in surveillance were inconsistent with the intentions of the Articles in general, and with Article IV, Sections 1 and 3 in particular, under which surveillance was required to promote exchange rate stability, to ensure orderly exchange arrangements, and to promote a stable system of exchange rates. Those developments were the result of several factors. First, the international monetary system and Fund surveillance had lagged behind the rapid changes in the international environment, especially the substantial expansion and integration of the international capital markets, the emergence of official reserve currencies in addition to the U.S. dollar, and the move toward greater flexibility in the key currency exchange rates. Second, the key currency countries had not been given the highest priority to maintaining exchange rate stability. Third, Fund surveillance over the exchange rate policies of the key currency countries had not been exercised as firmly as was required under Article IV, Section 3(b).

Surveillance over the exchange rate policies of the major industrial countries should be exercised more vigilantly, especially as those policies significantly affected the stability of the entire system, Mr. Huang commented. Exchange rate instability adversely affected developing countries. Because of that and other exogenous factors, many developing countries had had to use the Fund's resources in recent years. The conditions on the use of those resources were usually harsh and intensified the pressure on the exchange rate policies of developing countries with Fund-supported programs, as their performance was subject to regular reviews by the Fund. The issue of surveillance over exchange rate policies was a meaningless one for most developing countries, many of which pegged their currencies to one or more key currencies, thereby placing themselves in a subordinate position.

The effort to improve surveillance over exchange rate policies should focus on the major industrial countries, Mr. Huang considered. The problems with surveillance could be solved only if the industrial countries were willing to accept surveillance and to collaborate with the Fund and other members--developing and developed--to ensure orderly exchange arrangements and to promote a stable system of exchange rates. Improving surveillance, rather than introducing a major reform of the international monetary system, would merely temporarily moderate exchange rate volatility. The review of surveillance should be merged with the review and assessment of the system of floating exchange rates, target zones, and the role of the SDR with a view to introducing permanent reforms in the international monetary system. Improvements in surveillance would be possible only if progress were made in reforming the international monetary system. Surveillance could be effective only when policy objectives and means of measuring the achievement of those objectives were explicitly defined.

The need to convene a world monetary conference in order to undertake a thorough review and assessment of the current international monetary system had become increasingly apparent, Mr. Huang remarked. Recent statements in favor of such a conference were encouraging. The idea of convening such a conference was not a new one; a proposal to that end had been made during the summit meeting in Cancun in 1982.

Commenting on the biennial review of the 1977 surveillance document, Mr. Huang said that he agreed with the three-stage strategy for considering issues related to surveillance described by the staff on pages 26-27 of SM/86/3. In addition, the proposal on page 27 to revise the language in the section on the general principles of surveillance was acceptable. Moreover, the proposals in paragraphs 2(iii)(a) and (b) were also acceptable, provided that the guidelines concerned would be applicable only to the key currency members; the fourth option mentioned in section 2 on page 27 would be acceptable for the rest of the membership. The questions posed by the staff in its discussion on page 27 of the principles of Fund surveillance over exchange rate policies should be answered in the affirmative. Finally, the procedures for surveillance should be consistent with the various surveillance guidelines; pending the revision of the guidelines, he preferred to maintain the existing procedures.

Mr. Nebbia commented that the G-10 and G-24 reports suggested that there was basic agreement among both groups on the need to strengthen surveillance. His authorities attached considerable importance to the present discussion and looked forward to having the Executive Board reach an agreement that would facilitate the making of greatly needed improvements in surveillance. Thus far, the impact of surveillance had been felt almost exclusively by the users of Fund resources as a result of the associated conditionality. The absence of effective surveillance over countries that did not require the Fund's financial assistance had meant that the users of those resources had had to make particularly harsh adjustments. The external environment remained unfavorable, especially because of high real interest rates, protectionism, and the deterioration in developing countries' terms of trade. The continued problems facing the world economy were due at least partly to the lack of policy coordination among the major industrial countries and to the weaknesses in the Fund's surveillance. The unwelcome large movements in exchange rates in the recent past were directly or indirectly attributable to the monetary, fiscal, and other domestic policies of the major countries, and the effective monitoring of those policies should be an essential element of surveillance. He fully supported the G-24 report's proposals to improve surveillance.

He agreed with the strategy for considering issues related to surveillance mentioned on pages 26-27 of SM/86/3, Mr. Nebbia said. To obtain clear guidance by the Interim Committee, and given the need to implement changes that would increase the effectiveness of surveillance, the Managing Director's report to the Interim Committee on surveillance should include concrete descriptions of the various options for changes.

The section on the general principles for surveillance should be revised so that surveillance would clearly cover all the policies of an individual member which affected other countries, Mr. Nebbia considered. The exchange rate movements that had been a cause for international concern were clearly the result of the divergence and inadequacy of domestic policies. Because those policies and their international effects had an impact on exchange rates, they should be covered by surveillance.

In assessing the principles for the guidance of members' exchange rate policies Executive Directors could usefully recall the agreement at the recent discussion on exchange rates that improving the exchange rate system should be based on greater economic policy discipline and increased international consistency of policies, Mr. Nebbia said. Moreover, many Executive Directors had said that they favored some form of target zones. There had also been a preference to include in the system an automatic mechanism to enforce discipline, and most Executive Directors had said that a system of target zones should consist of soft zones, should indicate concrete directions of exchange rates, and should trigger discussions. In addition, Executive Directors had stressed that the exchange rate should be only one of the elements that were to be covered by surveillance, and that objective indicators would be needed to trigger economic coordination. He supported those conclusions. The establishment of target zones would imply important changes in the guidance that would be given to members and in the implementation of surveillance.

The adoption of a set of objective indicators would not be inconsistent with the introduction of target zones; indeed, the two could be mutually complementary, Mr. Nebbia continued. Given the willingness of major industrial countries to maintain a framework for international policy coordination, it should be possible and convenient to reach a basic agreement on the soft target zone approach. That approach would require the Fund to determine equilibrium exchange rates around which the target zones would be established. Exchange rates would be changed in line with variations in underlying conditions and in the prospects for capital flows. The exchange rate system must be able to guide the direction of exchange rate changes.

Commenting on the principles of Fund surveillance over exchange rate policies, Mr. Nebbia said that the indicators used to trigger consultations should be extended to include policies that were not necessarily adopted for balance of payments purposes. As to the procedures for surveillance, the G-10 report favored using "peer pressure." That suggestion warranted further consideration, but he favored the surveillance procedures described in the G-24 report. Bilateral consultations with the major industrial countries should focus on policy evaluation in a multilateral adjustment framework. Deviations from the Fund's policy recommendations should give rise to the circulation of information notices. Each country concerned could bring a notice to the Executive Board's agenda for a full discussion on the need for and means of implementing the suggested policies. If the Executive Board was not convinced by a member's explanations, it could request the Managing Director to discuss the matter with the country and to report to the Board on the outcome of the discussions and on proposals for any further action.

The role of the World Economic Outlook should be broadened, Mr. Nebbia considered. The World Economic Outlook paper could serve as a background for multilateral consultations on a mutually consistent set of policies and objectives for the major countries.

Surveillance should focus on international policy interactions and on economic links among the major industrial countries, which had the main responsibility for the course of world economic developments, Mr. Nebbia said. The need to modify surveillance was reinforced by the fact that, except for the adoption of the supplemental surveillance procedure in 1979, no changes had been made in the formal surveillance procedures even though world economic conditions had changed significantly in recent years. Multilateral surveillance had been conducted through the World Economic Outlook exercise, which had provided the basic analytical framework for the Fund's review of the world economy and the exchange rate system. Since 1982, World Economic Outlook papers had been examined in detail, and discussions had taken into account some of the policies and developments in major industrial countries and the interactions among those policies, but there was room for further improvement. World Economic Outlook papers could usefully serve as the background material for multilateral consultations on mutually consistent objectives and policies in industrial countries, as the G-24 report had recommended. The World Economic Outlook papers must spell out the international repercussions and interactions of national policies of the major industrial countries and should contain specific recommendations with respect to the policies of those countries.

The trend toward more frequent Article IV consultations had increased the work load of management, the staff, and the Executive Board, Mr. Nebbia commented. He agreed that it would be desirable for the Fund to focus its efforts on the countries that were in greatest need of its attention. The interval between consultations for countries that were already on longer cycles could be lengthened, although he was prepared to support other options favored by the majority of Executive Directors.

He fully supported the proposals in the G-24 report to improve the content of Article IV consultations, Mr. Nebbia said. As was recommended in the G-24 report, the content of Article IV consultations with major industrial countries should be clearly distinguished from the content of consultations with developing countries. The confidentiality of the exchange of information and the discussions between members and the Fund should be preserved. Hence, no publicity should be given to the conclusions of the consultations through the release of either statements or reports.

The supplemental surveillance procedure might have to be used in the context of bilateral consultations with the major industrial countries, Mr. Nebbia remarked. Once an agreement on the policies required of a member had been reached, deviations from the agreement should lead to the preparation of information notices and possibly to the use of supplemental surveillance.

He agreed with Mr. Sengupta that the Executive Board's task of reviewing surveillance and the exchange rate system would be facilitated by the establishment of a subcommittee of Executive Directors to analyze optional proposals, to formulate several possible scenarios, and to review the possible operations of different policy instruments for aligning exchange rates properly, Mr. Nebbia said. In addition, the staff could usefully prepare for the Executive Board on a quarterly basis a paper on the exchange rate alignments of the key currencies. The paper should analyze possible misalignments among those currencies and should describe the effect of the alignments on the rest of the world.

Mr. Alfidja remarked that the present review was taking place at a time when the international financial community was trying to find ways to introduce greater stability into the present exchange rate system and to ensure that major currency countries maintained sound and consistent policies. Both the Group of Twenty-Four and the Group of Ten had identified areas in which progressive improvement in the international monetary system should be made. The keen interest that had been shown by those groups in exchange rate developments and the recognition of the interrelationships of the various issues that had been raised in their respective reports underscored the fact that the fundamental objective of the Fund's activities in the field of surveillance continued to be the efficient operation of the international monetary system.

While the basic surveillance principles remained broadly valid, it was clear that the economic and financial policy objectives of some members had not been conducive to the development of stable underlying conditions, Mr. Alfidja continued. On pages 10-15 of SM/86/3, the staff had adequately identified and analyzed the major changes in the world economy since the introduction of the basic surveillance principles in 1977. The main change was the inefficient functioning of the exchange rate system, which was characterized by misalignment and considerable volatility of the major currencies, especially the long-lasting shifts in exchange rates which had created uncertainty about the functioning of the international monetary system and which had adversely affected the adjustment efforts of developing countries. Fundamental changes in the present exchange rate system were called for and, to that end, some modifications of the basic surveillance principles should be agreed.

The general principles of surveillance in the 1977 surveillance document should be amended to extend the coverage of the principles and include more specific language on the guidance that was given by the document to members, Mr. Alfidja remarked. The coverage of surveillance should be extended beyond exchange rate matters to include an examination of members' domestic economic policies for promoting stability and ensuring orderly underlying economic and financial conditions. He fully agreed with the staff's conclusion on page 18 of SM/86/3 that the experience of recent years clearly showed that domestic policies and their international interaction affected exchange rates and the stability of the system, and that to be effective surveillance must be extended to all policies that had an impact on exchange rates and the system. Accordingly, surveillance over exchange rate policies should include an examination of members' efforts to meet their obligation under Article IV, Section 1 to endeavor to achieve economic and financial stability.

In its discussion on the principles for the guidance of members' exchange rate policies the staff had correctly concluded that the exchange rate manipulation of the kind envisaged in the 1977 surveillance document had not been a serious problem, Mr. Alfidja commented. However, the staff had noted that there could be conflicting interpretations of the principles, and he supported the proposal to make the text more specific. In that connection, the establishment of target zones for the major currencies merited further consideration. That approach would go a long way toward establishing exchange rate stability, which was an important factor in the efficient operation of the international monetary system and would help to promote economic convergence among the major countries.

There would admittedly be practical difficulties in quantifying the indicators that would be used to determine the need for the Fund to initiate discussions with a member, Mr. Alfidja said. However, the Fund already had experience with the use of objective indicators under Fund-supported stabilization programs, and the use of the indicators had recently been extended to enhanced surveillance. The use of indicators for the major industrial countries would help to ensure the maintenance of the multilateral nature of surveillance. The staff should be able to find appropriate language to describe objective indicators, and it should continue to explore possible ways of resolving the various issues involved.

The present arrangements for initiating discussions under the surveillance decision should be retained, Mr. Alfidja considered. Thus far, the exercise of judgment by the Managing Director in that area had been appropriate. Management should continue to use its judgment in determining whether special or supplemental surveillance consultations should be initiated.

The staff had made proposals to improve surveillance procedures with a view to making the Fund's surveillance more symmetrical and effective, Mr. Alfidja noted. The considerable evolution in the implementation of the formal surveillance procedures in recent years was a reflection of the appropriate and prompt response by management and the Executive Board to the considerable changes in the world economy. Article IV consultations should continue to be the main vehicle for bilateral surveillance, and the World Economic Outlook should continue to provide the basic analytical framework within which to review developments in and prospects for the world economy and the exchange rate system, including evaluations of the exchange rate policies of individual members in a multilateral context.

Important progress had been made toward achieving the objective of a 12-month consultation cycle for each member while preserving the necessary flexibility to accommodate members' preferences for different consultation cycles, Mr. Alfidja said. The improvements that had been made in 1984 and 1985 in the analytical focus and content of Article IV consultation reports were welcome. There was further room for improvement in the scope, quality, and currentness of data, and the members of his constituency would continue to cooperate with the staff in working toward the achievement of that objective.

The policy coverage of Article IV consultations should continue to be as comprehensive as possible, Mr. Alfidja remarked. However, there should be a proper balance between the relative importance that should be attached in staff reports to discussions with the authorities, and the need to focus on the urgency in making the policy changes that the staff had recommended. That balance should be provided in each staff report and should reflect the particular circumstances of individual members.

He agreed with the staff that smooth and productive relations with members would continue to require that differences between the staff and authorities be handled with discretion and diplomacy, Mr. Alfidja said. Such differences should be fully explained in each staff report.

The steps that had recently been taken to enhance multilateral surveillance--for example, the G-5 September 22, 1985 meeting--and the significant role that the World Economic Outlook exercise was expected to play in the assessment of the effects of members' policies on others, were welcome, Mr. Alfidja commented. He endorsed the G-24 proposal to adopt a two-stage approach involving the preparation of objective indicators or quantified statements of policies of major countries and an appraisal of the actual performance of those countries. There would admittedly be difficulties in establishing such quantified indicators and in making quantified policy statements, but the staff should start by using an experimental approach to quantified indicators for developing countries; the staff should explore the possibilities for such an approach with interested members.

He attached paramount importance to maintaining the confidentiality of relations between the Fund and members, Mr. Alfidja said. Confidentiality should continue to be carefully maintained in order to promote free and frank exchanges of views between the Fund and members. In that context, Mr. Dallara's comments on publicity at the previous meeting were somewhat reassuring. An effort was being made to bring policy issues and the findings of the Fund more closely to the attention of policy makers at the highest level in the countries in his constituency and in other developing countries. Internal publicity required discretion and diplomacy, and ways should be found to extend it to a larger number of countries along the lines suggested by Mr. Dallara at the previous meeting.

One of the reasons for the occasional delays in scheduling Executive Board discussions on Article IV consultation staff reports was the need to translate the reports--as well as reports on recent economic developments in members--into the official working language of the countries concerned, Mr. Alfidja remarked. For example, only 1 of the 23 members in his constituency was able to respond to Executive Board documents in English. The other members expected that all the documents would be translated into their own official language before they would be asked to react to them. Despite the progress that had been made in accelerating the translation of documents, much needed to be done. Improving the translation situation would help to prevent requests for postponement and would improve the surveillance process by establishing better communications between the Fund and the members concerned.

The staff had noted on page 31 of SM/86/4 that the persistence of high rates of unemployment in several industrial countries was reflected in the fact that the examination of structural issues in those countries by the Fund had frequently focused on labor markets, Mr. Alfidja commented. The unemployment situation in developing countries was even worse, and many countries were required under their Fund-supported programs to reduce dramatically the level of employment in the public sector. Accordingly, the staff should urgently take the steps needed to include in reports a comprehensive analysis of the overall labor market situation in developing countries. Such information would greatly help the staff, management, and the Executive Board to assess better some of the complex problems facing developing countries in the labor market area and would therefore place the Fund in a better position to make realistic policy recommendations to the countries concerned.

Mr. de Groote said that facilitating the expansion and balanced growth of world trade was one of the Fund's major goals, and promoting international monetary and financial stability was the principal means by which the Fund tried to reach that goal. The Fund had three equally important mechanisms at its disposal to help it to support the expansion and balanced growth of world trade and the efficient operation of the international monetary system: its ability to allocate SDRs; its conditional balance of payments assistance; and its surveillance over members' exchange rate policies. Surveillance was perhaps the most difficult of those functions to exercise; unlike the principles governing the provision of balance of payments assistance, surveillance lacked the reinforcement of coercion and was meant to achieve goals that were perceived by members to go beyond their immediate interests. That inherent difficulty with surveillance raised two basic questions that confronted Executive Directors during each annual and biennial review of surveillance. First, how far should the Fund's judgments and assessments of the compatibility of a member's policies with the general objectives of international monetary stability and balanced growth of world trade extend? That question was clearly related to the content of surveillance. Second, what procedures should be devised to ensure the optimal effectiveness of surveillance given its noncoercive character?

With the benefit of hindsight, it was clear that, during the mid-1970s, the scope of surveillance had been contracted at a time when firm assessments and monitoring of exchange rate behavior would have been most desirable, Mr. de Groote continued. The increasing role of expectations in the determination of exchange market behavior, the emerging dominant influence of international capital flows over the international adjustment process, and the divergence in Governments' responses to the major shocks of the 1970s called for a much more comprehensive kind of surveillance than had been provided by the legal basis for surveillance which the Executive Board had approved in 1977. That mistake seemed to be attributable to the fact that the Fund had seriously overestimated the power of relative price performance to determine exchange rate developments and had seriously underestimated the role of international capital flows in creating substantial exchange rate misalignments. The overemphasis on the influence of relative price performance had created the expectation that the adoption of stable domestic policies would basically be sufficient to regain stability in the exchange rate system; that basic philosophy was reflected in the amended Article IV.

That philosophy had implied that the major objective of the Fund's attempt to influence members' exchange rate policies was to ensure that the supposedly close relationship between domestic stabilization and exchange rate stabilization would operate naturally and fully, Mr. de Groote went on. Accordingly, the guidelines for surveillance over exchange rate policies adopted in 1977 focused on such principles as the need to avoid exchange rate manipulation and the need to intervene in exchange markets to counter disorderly short-term movements. Since then, the shortcomings of the limited, short-term perspective for examining exchange rate issues had become clear. Perhaps the most important factor that had been overlooked in the approval of the decision on surveillance in 1977 was the predominant and often undesirable influence of international capital flows on exchange rate patterns of industrial and developing countries in the medium term. Divergent trends in domestic savings and investment among the major industrial countries in recent years had induced massive capital flows that in turn had created exchange rate patterns and trade imbalances that were unsustainable over the medium term. Easy access to borrowing from the private markets had permitted the developing countries to maintain or increase their imbalances between savings and domestic investment at unsustainable levels and had delayed their adoption of adjustment policies, including exchange rate actions. A general lesson to be drawn from those events was that conflicting savings and investment balances among the major industrial countries and serious imbalances in developing countries had created over the previous decade a pattern of capital flows that had undermined both the proper functioning of the exchange rate system and the smooth operation of the international adjustment process.

That experience had obvious implications for the effectiveness of the Fund's surveillance over exchange rate policies, Mr. de Groote remarked. It was clear that the existing guidelines were no longer adequate. Surveillance should be exercised in a medium-term framework and should focus on all relevant aspects of domestic policies that were likely to affect the exchange rate pattern in the medium term. Accordingly, surveillance should extend beyond the short-term implications of exchange rate policies and should take fully into account the external implications of monetary and fiscal policies as well as any structural rigidities in an economy which might hinder the balanced expansion of investment and capital flows among members. Members' policies should be tested for their internal consistency and for their external compatibility with other members' policies; that conclusion was particularly applicable to the members that had a dominant influence on the operation of the international exchange rate system.

He was pleased that, over time, many of the issues that he had mentioned had been gradually reflected in the bilateral and multilateral surveillance exercises through the Fund's efforts to oversee the operation of the international monetary system and to observe the compliance of each member with its general obligations under Article IV, Mr. de Groote commented. Hence, his first reaction to the staff papers was to feel inclined to build further on experience with surveillance and to improve its effectiveness by further extending its coverage of policies and by strengthening its procedures. However, he would not wish to be content with such a low-profile approach at the present early stage of the Executive Board's discussions on the G-10 and G-24 reports. Their political authorities had given Executive Directors a strong mandate to explore possible ways of strengthening the stability of the exchange rate system and to examine the role that enhanced surveillance could play in that effort. Some Executive Directors apparently were hesitant to consider modifying the legal texts on surveillance so that the emerging consensus on the need to broaden the scope of surveillance over exchange rate policies could be reflected in those texts. It was true that the usefulness of surveillance depended significantly on members' willingness to cooperate with the Fund, but if the institution were to exercise firm surveillance over all policies related to the exchange rate, it must have a firm legal text on which to rely.

Experience showed that it would be very difficult to increase the influence of the consultation process through perfections of procedures in the absence of a comprehensive set of principles for guiding members' exchange rate policies, Mr. de Groote went on. Any improved procedures could be effective only if they referred to a set of guidelines that would be supported by members and on which the Fund could base frank and candid judgments of the appropriateness and compatibility of members' policies in the context of their impact on exchange rate stability.

The approach that he favored should not result in the adoption of a set of rules that would attempt to influence members' policy choices in a much more compelling way than could be justified by the sole aim of achieving greater exchange rate stability, Mr. de Groote continued. He agreed with Mr. Polak that such a set of rules might well weaken surveillance. The surveillance process should include a degree of agreement on the desirable direction of exchange rate movement between currencies, especially key currencies. The integration of such a system of target directions into the formulation of domestic policies would be much less compelling than a complete system of rules but would be no less effective, as the objective indicators that would be devised to support discussions on target directions would not be coercive in character and would be used only to signal the appropriate direction of major exchange rate relationships.

Under his proposal, Mr. de Groote went on, target directions could be incorporated into the present set of surveillance principles in a way that would not make the directions mandatory but would encourage members to agree with the Fund on desirable trends for their exchange rates; members should be willing to support their agreement with understandings on some nonautomatic indicators. Such an agreement would of course be judgmental in nature and would take into account information provided during consultations on such factors as market shares and relative prices. Under his proposal the Fund would have the right to initiate discussions with a member on its policy intentions whenever the Fund felt that the member's policies were inconsistent with sound exchange rate developments or that the member's adherence to the Fund's recommendations was essential for the proper functioning of the exchange rate system. Departures from the proposed exchange rate direction would provide an occasion for reviewing a member's policies and would considerably facilitate the exercise of the Chairman's authority to initiate special discussions with members on their exchange rate policies and to use the special consultation procedure.

Other proposals to enhance surveillance procedures recommended in the G-10 and G-24 reports could be included in a system of target directions, Mr. de Groote commented. The provision of an anchor for the understanding on policies that were especially relevant to the exchange rate would automatically extend the range of policies covered by surveillance in an efficient way and would greatly facilitate the staff's formulation of candid policy assessments and recommendations. The influence on members' policies of the World Economic Outlook exercise would be considerably enhanced, as the exercise would provide a natural framework within which to reach understandings among major industrial countries on the compatibility and international repercussions of their domestic policies. In addition, agreement on exchange rate directions would provide an appropriate framework in which to arrange more intensive follow-up procedures from one consultation to the next and would provide a sound legal basis for the Managing Director to communicate directly with the Governor of a member in cases in which there was continued disagreement between the staff and the authorities about the appropriate exchange rate policy for the member.

He hoped that at its next meeting the Interim Committee would give the Executive Board a mandate to ask the staff to formulate the necessary language that would enable the Board to consider seriously, within a few months, a realistic and pragmatic extension of the existing surveillance guidelines, Mr. de Groote remarked. The present guidelines were difficult to interpret and were not actively considered during the exercise of surveillance. The clarity and coherence of the rules on surveillance would add little to the willingness of members to submit to those rules. However, such an effort should be made; otherwise, members would be given the impression that, despite their support of the G-10 and G-24 reports, the Executive Board had been unable to react positively to the recognition by members of the need to establish greater exchange rate stability. A limited remodeling of the text on surveillance in the direction that he had suggested seemed advisable.

Mr. Abdallah said that the effectiveness of surveillance continued to be an important element in the proper functioning of the international monetary system. The staff papers showed that the Fund's surveillance activity had increased considerably in recent years: the number of Article IV consultations had risen from 120 in 1983 and in 1984 to 131 in 1985. The World Economic Outlook exercises had become increasingly comprehensive and had given Executive Directors a useful framework in which to review the world economy and the exchange rate system.

Article IV consultations remained a major mechanism with which the Fund could perform the important function of an international economic counsellor, Mr. Abdallah continued. Even countries that apparently did not consider the Fund to be a reliable partner in the adjustment process had found that Article IV consultations involved useful economic analysis and policy advice. The expanded coverage of policy and technical issues in consultations, aa well as the recent shift in the focus of such consultations toward structural adjustment, fiscal policy, external debt, and trade matters, were welcome. To be effective, however, the reports for consultations with the major industrial countries should clearly review the policy recommendations that the Fund had made during the preceding consultation and the measures that had been adopted in response to those recommendations. That procedure--which was strongly advocated in the G-10 and G-24 reports--could increase the pressure on the members concerned, thereby enhancing the effectiveness of surveillance. The World Economic Outlook papers and Article IV consultations must clearly examine the underlying need for balance of payments assistance, should indicate the optimal ways of providing such support, and describe the impact of exogenous factors on the adjustment efforts of developing countries.

The number of information notices on changes in real effective exchange rates had increased in recent months, Mr. Abdallah commented. Such notices were an important means of encouraging members to focus attention on the exchange rate, which was a basic measure of overall policy performance. However, information notices would be more effective if there was a means of issuing them automatically, so that developments could be brought to the Executive Directors' attention quickly enough for the developments to be discussed on a timely basis and for the countries concerned to be given the opportunity to present their views on why the policies recommended by the Fund had not been implemented.

The Fund's surveillance had not met the objective, stated in Article IV, Section 1, of ensuring orderly exchange arrangements and promoting a stable system of exchange rates, Mr. Abdallah considered. Exchange rate variability had continued unabated, generating unnecessary uncertainty in the international trading and exchange system which had adversely affected the management of developing countries' meager reserve assets and the flow of private capital to the low-income countries. Indeed, the exchange rate volatility had increased the pressure on multinational corporations operating in developing countries to obtain all their finance from local sources and to distribute their dividends and profits as quickly as possible. Those who wished to encourage private flows into the developing countries would have to address the issue of exchange rate volatility.

The working of the exchange rate system had not been consistent with the expectations that had led to the adoption of the 1977 document on surveillance, Mr. Abdallah remarked. There was a compelling need to make certain changes in the existing surveillance procedures in order to enhance the effectiveness of surveillance.

The future program of work mentioned on pages 26-27 of SM/86/3 should be undertaken as quickly as possible, Mr. Abdallah considered. As to the general principles of surveillance, the staff had argued that since domestic policies and their interaction abroad affected exchange rates and the stability of the system, surveillance must be extended to all policies that affected exchange rates and should not be limited to exchange rate policies alone. Domestic policies, especially those of the key currency countries, had international implications for exchange rate stability. Accordingly, the coverage of surveillance should be extended to include all national economic policies, and the language of the general principles of surveillance should be amended with that goal in mind. That change would be consistent with the G-24 position on the coverage of surveillance.

The staff's proposals concerning the principles for the guidance of members' exchange rate policies were based on the G-10 and G-24 reports, Mr. Abdallah noted. The experience with the present exchange rate system was clearly unsatisfactory: currency markets had behaved in a highly unpredictable manner. There was an urgent need to introduce a degree of stability, and target zones were the best means of doing so. That suggestion had a long way to go before it would gain general acceptance, and he agreed with Mr. Kafka that the key currency countries should consider adopting target zones on an experimental basis. That approach would help to achieve the objective of exchange rate stability and a sustainable pattern of payments balances. Some of the other suggestions that the staff had made as alternatives to target zones were not necessarily inconsistent with the target zone mechanism. Targets that were thought to be sustainable in the medium term could be used as triggers for consultations with members.

The Fund's surveillance role under a system of target zones would be less cumbersome than its present surveillance role, Mr. Abdallah remarked. Target zones would provide relatively concrete guidelines for exchange rates and would minimize conflicting interpretations about manipulations of exchange rates. The G-24 report also supported complementary measures to enhance discipline, policy coordination, and surveillance. Under a target zone regime, the principles for the guidance of members' policies could specify more precisely than hitherto the kinds of policies that members should use. That process was unlikely to involve considerable debate about members' policies; as the Group of Twenty-Four Deputies had concluded, monetary policy aimed at enhancing exchange rate stability should complement the use of fiscal policy to counter inflationary pressures as well as the use of other policy instruments. The adoption of target zones for the exchange rates of major currencies would probably minimize the asymmetry that had characterized the Fund's surveillance. Since the target zone system would emphasize policy coordination among and surveillance over developed countries, it would tend to encourage evenhandedness in surveillance. At present, Fund surveillance over deficit developing countries was relatively strict, while the Fund had virtually no influence over countries that were not using its financial resources.

The indicators used to trigger consultations should be specific and should be extended to include domestic policies, Mr. Abdallah considered. It might be difficult to establish objective criteria or indicators, but a genuine effort to do so should result in a clear framework within which consultations between members and the Fund could be triggered. He agreed with both the G-10 and G-24 reports that the Fund could usefully make greater use of the supplemental surveillance procedure, and he would support any modification that could make supplemental surveillance more automatic.

Mr. Fugmann said that, as a matter of principle, his authorities continued to attach great importance to the Fund's surveillance. The recent discussion on the exchange rate system had clearly showed that strengthening the Fund's surveillance might well be one of the few avenues available to improve the functioning of the exchange rate system through more effective coordination of economic policies. Recent actions by the large industrial countries were grounds for hope that such an approach would prove to be feasible. Hence, the Executive Board should push ahead in its efforts to find areas where agreement could be reached, and his authorities were willing to support several of the proposals in the present staff papers. They would do so in the hope that the proposals would not merely add to the bureaucracy and work load of the staff and the Executive Directors, but that the end result would be to instill more bite into the Fund's surveillance activities, especially countries that significantly affected international economic developments.

He agreed with the general strategy described by the staff on pages 26-27 of SM/86/3, Mr. Fugmann continued. To the extent possible, noncontroversial changes in, or additions to, surveillance activities should be made without waiting for the final outcome with respect to the possible revision of the 1977 surveillance document.

The text on the general principles of surveillance should be amended so that surveillance would clearly apply to all policies having significant effects on other members, Mr. Fugmann considered. Such an amendment should, at least in theory, considerably strengthen the Fund's surveillance role. The new text should underscore the global aspects of surveillance and the interaction between members' economic policies. However, any such text should be formulated in a way that would clearly show that surveillance of exchange rate policies was the main objective of surveillance.

As to the principles for the guidance of members' exchange rate policies, the fourth option mentioned on page 27 of SM/86/3--namely, generally strengthening the surveillance mechanism--was an urgent task, Mr. Fugmann said. However, the Executive Board's efforts should go further: the concept of soft target zones should be in the forefront of further studies on means of providing the more specific guidance for members mentioned in paragraph (iii)(a) on page 27. He favored a much softer version of the option described in paragraph (iii)(b). At the present stage, quantitative objectives for domestic policy instruments were an unrealistic option. However, qualitative objectives, such as those described on page 21 of SM/86/3--for example, avoiding sudden disruptive shifts in monetary and fiscal policy, or promoting the efficient working of the adjustment process--could be used to provide more specific guidance than hitherto on members' exchange rate policies. Such an approach might also make it easier for the Fund to initiate discussions with a member, as such discussions would no longer take place solely on the basis of the somewhat loaded concept of exchange rate manipulation. The option mentioned in paragraph (iii)(c) was far too weak to bring surveillance into play except in extreme cases; it would not significantly increase the practicability of surveillance.

As to the principles of Fund surveillance over exchange rate policies, he agreed that the existing limitation of indicators to policies adopted "for balance of payments purposes" had proved to be far too narrow, Mr. Fugmann said. The indicators should be extended to include measures that were primarily domestic in character, although the extension should be limited to measures that had important international economic implications. He agreed with the staff that "unsustainable capital flows" should be included in any new set of indicators. He wished to consider the staff's further views on the extent to which the indicators should be made more specific before taking a final position on that matter.

Special consultations were undertaken on the presumption that a member had failed to comply with the Articles, Mr. Fugmann remarked. Accordingly, such consultations automatically stigmatized the country concerned. In the cases that seemed to require special consultations, the management should undertake a comprehensive evaluation of the country's situation based mainly on a judgmental approach. Automatic consultations based on indicators would not be appropriate. Supplemental consultations did not involve the same presumption and should be used more extensively than hitherto. One way to do so would be to introduce a greater degree of automaticity in such consultations through the use of indicators: for example, large exchange rate movements giving rise to information notices that in turn could lead to supplemental consultation. Information notices had not been used thus far to initiate discussions in the Executive Board. For the more important currencies, each exchange rate change exceeding 10 percent should automatically be the subject of an Executive Board discussion. That approach should lead to an increase in supplemental consultations.

The procedures for surveillance mentioned in SM/86/4 should be strengthened, Mr. Fugmann considered. The proposals in the G-10 report to improve the analytical basis of surveillance were acceptable. The analysis of medium-term prospects should not dilute the focus on fundamental short-term policy issues, something that would reduce the usefulness of the Executive Board's discussions on members' policies. The staff should formulate medium-term scenarios for surplus countries as well as deficit ones.

He supported the G-10 proposals to strengthen multilateral surveillance, Mr. Fugmann said. If the G-10 countries adopted the follow-up mechanism in the form of a review by the G-10 Ministers and Governors, the result of the Executive Board's discussion, in an extract from the Chairman's summing up of the relevant discussion, should be communicated to the G-10 members. The extract should be limited to an evaluation of the consistency of the economic policies of the countries concerned. The communication must be kept confidential.

He supported most of the proposed means of strengthening the influence of the consultation process, Mr. Fugmann remarked. However, his authorities continued to oppose increased external publicity for reasons that previous speakers had mentioned. However, if a member so desired, the staff report on recent economic developments in the country could be published on the basis of a decision by the Executive Board for each such case. He supported the G-10 proposal to request that members indicate measures introduced or being considered to address problems that had been identified through the consultation process and the various procedures that the staff had suggested in that connection.

He could accept the staff's various suggestions for using the supplemental surveillance procedure, but Mr. Polak's suggestion in that area also deserved active consideration, Mr. Fugmann said. However, in one respect, the supplemental surveillance procedure should be used very selectively--*namely, in cases involving the failure by a member to implement* within a set period policy actions of the kind that were considered essential and had been identified as such at the conclusion of a consultation. He attached importance to the two key aspects of that proposal, namely, that the measures in question must be considered to be essential and should have been identified as such at the conclusion of the previous consultation.

Article IV consultations were a cornerstone of the Fund's activities in general, and of surveillance in particular, Mr. Fugmann considered. Reductions in the frequency of consultations should be decided on a case-by-case basis rather than as the result of a general guideline. However, in order to reduce somewhat the staff's work load, the continued efforts to reduce the volume of staff reports on recent economic developments in member countries should be renewed and strengthened.

The increased demands on the Executive Board and the staff resulting from the growing work load, owing partly to the new arrangement for using Trust Fund loan repayments, were a cause for concern, Mr. Fugmann said. His authorities attached great importance to strengthening surveillance and expected that it would be given a high priority. Although any increase in the number of staff should be as limited as possible, the staff had perhaps been excessively cautious in concluding on page 11 of SM/86/4 that "the implications for the Fund's work load may need to be considered more carefully at a later stage." Such a consideration had become unavoidable, and he hoped that in 1986 management would submit to the Executive Board a paper suggesting priorities for the Fund's activities and the necessary staffing implications. Otherwise the Fund might run the risk of reducing the quality of the staff's work and the Executive Board's discussions. The Fund's role could be strengthened only if the work of the staff and the Executive Board continued to be of a high quality.

Mr. Sengupta stated that he welcomed Mr. Dallara's statement at the previous meeting, which was a clear affirmation of his authorities' willingness to encourage policy coordination among the major countries. During the recent discussion on the exchange rate system, he had commented on some of the main issues concerning surveillance and he would supplement those comments during the present discussion by responding to the main points that had been made on pages 26-27 of SM/86/3. He agreed with Mr. Kafka's comments on the program of work described on pages 26-27 of SM/86/3. The Executive Board might need a number of meetings on a report seeking the Interim Committee's guidance on the various substantive questions. If there were no time to do so before the coming meeting of the Interim Committee, the report to the Committee should contain all the suggestions and points of view expressed during the present discussion, including the main points made in the G-10 and G-24 reports, and should request the Interim Committee's guidance concerning subsequent discussion by the Executive Board. It would be premature to attempt at the present stage to draft a report for the Interim Committee, as a consensus on the substantive issues had not yet emerged. Such a consensus could be reached only when the implications of the various models of surveillance had been fully examined through simulations or scenarios involving a number of different countries and the World Economic Outlook exercise.

On page 27 of SM/86/3 the staff had suggested four broad approaches to revising the principles for the guidance of members' exchange rate policies, Mr. Sengupta noted. He would not wish to take a final position on the proposals until the implications of each one had been examined. However, it was useful to recall that during the discussion on the exchange rate system he had made the following statement:

> On the understanding that everyone desires to work toward a system of better policy coordination, centering around the exchange rate alignments of major international currencies, let us work out through a series of meetings of this Board or a subcommittee of this Board a number of alternative proposals which can be examined for taking decisions after a few months by the international community, perhaps at a future meeting of the Interim Committee. These proposals should clearly spell out the modus operandi based on alternative scenarios and the possible operation of the different policy instruments by different countries to achieve the alignments of the exchange rates at the international level. The feasibility and the actual outcome of target zones of different varieties--hard, soft, loud, or quiet--the EMS kind of system, or objective indicators should be brought out as part of the detailed examination of these proposals. If it so desired, these proposals may also consider how the policy coordination would develop if a purely judgmental approach, as suggested by some in the Group of Ten, were to be adopted. Such an effort should be made before the Interim Committee was asked to take a view on the various options and the Executive Board were to begin the process of changing the language of the decision on surveillance.

Commenting on the general strategy for considering issues related to surveillance and the general principles of surveillance, Mr. Sengupta said that the main issue was not the particular language of the decision on surveillance, but the political will of the major industrial countries, whose policies affected the developing countries, to accept the need for policy coordination. To achieve such coordination, individual countries would have to give up some of their national sovereignty. The Group of Twenty-Four did not favor reverting to the rigidities of the par value system. It believed that the floating rate system could support the orderly development of the international economy if exchange rate stability was a policy objective and not a residual of the policies of the key currency countries and if those countries could achieve a substantial degree of policy discipline and coordination. The target zone proposal could help to achieve the objectives of exchange rate stability and policy coordination. A commitment to harmonizing national policy instruments was needed. If such a commitment were made, a mechanism to trigger consultations would also be required. The mechanism could be a soft target zone that roughly approximated an equilibrium exchange rate, a target direction, or a set of objective indicators, based on the real effective exchange rate alone or with other domestic variables, such as the money supply or fiscal balance.

As to the principles of Fund surveillance over exchange rate policies, the indicators that were used to trigger consultations could be extended to policies that were not necessarily adopted for balance of payments purposes, Mr. Sengupta remarked. However, there was no particular reason to delete the words "for balance of payments purposes" from the principles. He agreed with Mr. Polak that the difference between the treatment of surveillance under Article IV, Sections 3(a) and (b) should be maintained. As Mr. Polak had noted, if members had similar but high rates of inflation, exchange rates might not be misaligned but the world economy would be under severe stress. The Articles provided for surveillance of all policies--in addition to exchange rate policy--which affected the world economy. There was a clear need to improve the procedures of surveillance.

The policy coverage of surveillance over all major industrial countries should be as extensive as possible, Mr. Sengupta continued. The policy coverage of developing countries was already substantial. However, given the way in which the international economy operated, it was inappropriate to equate the policy coverage of developing countries and the major industrial countries. The G-10 report itself recognized that the asymmetry in the operation of the world economy suggested that similar approaches to the surveillance of the two groups of countries was not necessary. Developing countries faced serious problems which should be tackled, but those problems were rarely significant for the world economy; in contrast, problems facing the key currency countries affected the entire world economy all the time. Only the debt problems of developing countries were likely to effect the world economy, and even those problems were not due entirely to the actions of the developing countries alone.

The recommendations concerning surveillance procedures should be set in a medium-term framework, Mr. Sengupta commented. However, current and short-term factors should not be ignored in surveillance reports.

The staff should clearly identify the policies of a member which the staff believed would be affected and explain why. Such explanations should be provided in a multilateral setting, and the G-24 report contained a proposal for a two-stage procedure. The World Economic Outlook paper could include a chapter on the international repercussions of the policies of the key currency countries. The position of those countries was particularly important, and the analysis in the extra chapter should be limited to the G-10 countries. The chapter should be thoroughly discussed in the Executive Board, whose views could be communicated to the authorities concerned and could be used to initiate multilateral discussions about the objectives and policies of the major industrial countries. There should also be follow-up reports on the implementation of policy recommendations.

The extra chapter in the World Economic Outlook paper could cover alignments and misalignments in exchange rates along the line of his proposal during the recent discussion on the exchange rate system, Mr. Sengupta continued. He did not feel strongly about the periodicity of the discussion on the pattern of exchange rates, but the information provided should be different from the present information notices on exchange rates. The exchange rate alignments and misalignments should be discussed by the Executive Board in a multilateral context. Such a discussion had been held on the information notice on the U.S. exchange rate and on the annual review of surveillance on March 25, 1985.

The Managing Director should participate in G-5 discussions, Mr. Sengupta considered. He could then present the Fund's views as a part of the important process of multilateral surveillance. Multilateral policy coordination should be systematic and should be under the umbrella of the Fund.

Mr. Salehkhou recalled that his chair had made a detailed statement during the discussion on the 1985 annual review of the Fund's surveillance (EBM/85/47, 3/22/85). The protracted asymmetry and ineffectiveness in the Fund's surveillance which had been noted on that occasion had persisted and, in some cases, had triggered additional imbalances in the management of the international economy. For the purpose of the present discussion, Executive Directors should bear in mind his comments on surveillance during the 1985 annual review.

Given the common themes in the G-10 and G-24 reports, such as the acknowledged need to improve the functioning of the exchange rate system and to strengthen the Fund's surveillance role, the present discussion was an opportune one to review both the 1977 surveillance document and to conduct the annual review of surveillance, Mr. Salehkhou continued. A brief review of the evolution of surveillance and of the underlying reasons for the agreement on the 1977 surveillance document had led him to make the following broad conclusions. First, if the implementation of surveillance were to be effective, the close relationship between domestic policies and international policy interactions must be taken into account. Second, the Fund had placed more emphasis on its bilateral contacts with members than on its multilateral role in regulating the international monetary system. The multilateral aspect of surveillance should be substantially strengthened. Third, while surveillance over the policies of developing countries--especially the users of Fund resources--had been effective, the industrial countries' policies, especially the policies of the major currency countries, remained ineffective, even though the domestic policies of the major currency countries had a relatively substantial impact on the world economy. Fourth, while reference was often made to the principles of economic interdependence and international cooperation among developed and developing countries, the policies of developing countries were particularly affected by the policies of industrial countries. Fifth, the present general framework of surveillance procedures was sufficient for the effective exercise of surveillance. However, the procedures had not been used scrupulously and uniformly. In that connection, there should be no reinterpretation of the relevant Articles.

Sixth, as a result of the weak implementation of surveillance, exchange rate variability and misalignments had greatly contributed to the uncertainty that was damaging the world economy, Mr. Salehkhou went on. Seventh, the source of the uncertainty was not so much the principles and procedures of surveillance, as the degree of the individual and collective political will of the membership, particularly the major industrial countries. To meet some of the deficiencies that he had mentioned, a future program of work and issues for discussion were presented for the Executive Board's consideration in SM/86/3.

Commenting on the main features of the 1977 surveillance document, Mr. Salehkhou said that the general principles of surveillance stated that "the Articles do not give the Fund powers of surveillance in areas where members' policies do not affect the interest of other members." He wondered what the Fund's responsibilities should be when a member's domestic policies and their international interactions had an impact on exchange rates and on the stability of the system and, therefore by definition affected the interest of other members. He wondered what measures could be applied when a member failed to fulfill any of its obligations under the Articles. Nevertheless, he agreed with the staff that, to be effective, surveillance must be extended to all domestic policies that had an international impact. Accordingly, in exercising its surveillance responsibilities, the Fund should take into account the recognized relationship between domestic and international economic policies. Any change in the language of the 1977 surveillance document should clearly indicate how that relationship should be taken into account as the G-24 report had suggested.

Given the logical discussion in SM/86/3 on the principles for the guidance of members' exchange rate policies and given the need for effective implementation of surveillance, he welcomed the three possible approaches to revising the principles mentioned on page 27, Mr. Salehkhou said. As to the principles of Fund surveillance over exchange rate policies, it was clear that a more specific set of guidelines for the

Fund's formal or informal action would make surveillance over the industrial countries somewhat more automatic. However, the Managing Director should continue to have the general responsibility for ensuring that the effectiveness of surveillance was symmetrical.

His views on the procedures for surveillance of members' policies and of international policy interactions within the framework of the World Economic Outlook exercise paralleled those expressed in the G-24 report, Mr. Salehkhou said.

The general strategy for considering issues related to surveillance described on pages 26-27 of SM/86/3 seemed to be appropriate, Mr. Salehkhou continued. However, despite the complexity of the issues involved, an effort should be made to prepare draft language as precisely as possible so that further guidance on it would not be required of the Interim Committee. The language of the general principles of surveillance should be applied evenly to industrial countries so that exchange rate surveillance would apply clearly to all policies of the major currency countries having significant effects on other members.

Commenting further on the principles for the guidance of members' exchange rate policies, Mr. Salehkhou said that the need for closer coordination among key currency countries and the adequacy of domestic policies, measured against an agreed norm within the framework of multilateral surveillance, should be assessed. As to the principles of Fund surveillance over exchange rate policies, the list of indicators should be specifically extended to domestic policies of the industrial countries. The procedure for initiating special or supplemental consultations should be used only for key currency countries, and the norms against which the need for such procedures were judged could be those agreed upon during the World Economic Outlook exercise and could be translated into objective indicators.

An impressive number--131--of Article IV consultations with members had been concluded during 1985, Mr. Salehkhou noted. Management and the staff had made unceasing efforts to assist members in their efforts to achieve financial and economic stability. He had noted with great interest the factual information on the implementation of the surveillance procedures in 1985. It was a manifestation of the Fund's expertise, which, he hoped, had benefited each member. However, the Fund's influence had been most effective on developing countries, especially the users of the Fund's resources. The major industrial countries, which had often given priority to domestic objectives over international economic ones, had remained unaffected by the Fund's surveillance.

Subject to the position of the Group of Twenty-Four, he broadly agreed with the staff's summary of main issues on pages 22-24 of SM/86/4, Mr. Salehkhou said. Certain aspects of the proposals for changes in procedures should be stressed. The G-24 report did not contain explicit proposals concerning the data needed for the analytical basis of surveillance, but paragraphs 78 and 79 of the report implicitly referred to the need for such data. The substantial attention that had been given to the quality of statistics in staff reports was welcome. He hoped that the staff would continue to help the developing countries to improve their data base.

The extensive policy coverage in the preparation of Article IV consultation reports was commendable, Mr. Salehkhou remarked. However, it was important to stress that a thorough assessment of all domestic policies of the industrial countries was essential for effective and symmetrical surveillance. Specific policy objectives of the industrial countries should be assessed, and appropriate measures should be taken when objectives were not achieved.

The G-10 and G-24 reports agreed that to be effective surveillance must involve an examination of members' policies in a multilateral framework, Mr. Salehkhou continued. Given their size and weight, it was mainly the macroeconomic policies of the industrial countries that shaped the world economic environment. That was not to say that developing countries' policies did not affect the international economy; however, their influence was minimal. Hence, as the G-24 report noted, the international repercussions and interaction of national policies of the major industrial countries should be spelled out precisely during the World Economic Outlook exercise under the proposed two-stage procedure. If the Fund's multilateral surveillance over the industrial countries was to be effective, the policies and performance of those countries should be appraised, and any divergence from an agreed norm should be identified.

He agreed with the G-24 report that to strengthen the influence of the consultation process, there should be follow-up consultations, publicity, and supplemental consultations with the major currency members, Mr. Salehkhou said. Given the work load of the staff in the Area Departments, he could go along with less frequent Article IV consultations for some members. The determining factor in that respect should be the member's general economic conditions and the impact of its policies on the international economy. In addition, efforts should be made to prevent confrontation between the Fund and any member. Moreover, the Fund's presence and influence as the helm of the international monetary system should be reaffirmed. In that connection, contributions by the Managing Director were essential.

While bilateral relations between the Fund and individual members would continue, greater emphasis should be placed on the Fund's multilateral surveillance functions, Mr. Salehkhou continued. As to the collaboration between the Fund and the World Bank, coordination of relations between the two institutions in the exchange of information on members' economic performance should continue, but their respective roles--the World Bank's policy dialogue with members and the Fund's surveillance--should be strictly complementary in order to prevent asymmetrical surveillance.

Despite the surveillance principles, procedures, and mechanisms, the Fund's surveillance role would be inoperative in the absence of the individual and collective political will and cooperation of members, Mr. Salehkhou remarked. Surveillance over the major currency countries should be much more fundamental simply because of the influence of their policies on the global picture. That conclusion was in no way inconsistent with the principle of the uniform treatment of members, because individual economies did not have a uniform impact on the international system. The Fund must carry out its surveillance in a symmetrical and effective manner and should be willing to use its international power and influence, particularly in the face of a lack of cooperation by members.

Mr. Polak remarked that it seemed best to leave the 1977 decision on surveillance as it was. After all, the Fund had been able to operate somewhat differently in the area of conditionality than had been provided for without changing the original guidelines on conditionality. Still, leaving the text of the 1977 decision on surveillance as it was might not be adequate. During the present discussion, some Executive Directors had stressed that a superficial reading of the principles of surveillance could cause difficulty, as the reference to "for balance of payments purposes" might imply that the Fund was not interested in such issues as the buildup of debt or members' inappropriate policy mixes. A major effort had been made in the 1977 decision to define principles for the surveillance over exchange rate policies, as provided for under Article IV, Section 3(b). However, the 1977 decision did not contain a comparable set of principles for the Fund's oversight activities under Article IV, Section 3(a). He doubted whether the effectiveness of surveillance would be considerably increased if the 1977 decision contained the additional principles. However, if there was a general wish to amend the 1977 decision, it could be done by adding principles on the Fund's oversight activities under Article IV, Section 3(a).

The Director of the Research Department said that prospects for the 15 major borrowing members and the interaction of their policies with other developing and developed countries were important and deserved to be discussed in the World Economic Outlook paper. He was not convinced that that subject required a separate chapter; he was reluctant to add a number of new chapters to the paper. The staff could certainly pay adequate attention to the subject of the major borrowing countries within the present structure of the World Economic Outlook paper.

He doubted there would be any problem in relating the G-10 discussion on the special World Economic Outlook paper chapter and the publication schedule for the paper, the Director commented. The World Economic Outlook paper was normally published five to six weeks after a meeting of the Interim Committee. Presumably the G-10 discussion of the new chapter in the World Economic Outlook paper would take place before the coming meeting of the Interim Committee.

Medium-term scenarios for surplus countries would be useful; they would be a natural counterpart of the scenarios for deficit countries, the Director commented. The staff already prepared a number of medium-term scenarios for major deficit countries that were not users of the Fund's resources, and it could be argued that scenarios for surplus countries would be a useful check and would enhance surveillance. Medium-term scenarios were difficult to prepare, but he doubted whether scenarios for surplus countries were more difficult to prepare than scenarios for deficit members.

The difficult question of what steps should be taken if members did not adhere to the revised principles of surveillance was a difficult one, the Director of the Research Department commented. It in turn raised the question of the sanctions that were available to the Fund. Those sanctions were limited, and it was apparently for that reason that a number of Executive Directors had stressed that the political will of members, rather than the specific surveillance procedures, were especially important in the conduct of surveillance.

The Director of the Exchange and Trade Relations Department said that the staff would carefully consider Executive Directors' various comments. Considerable interest had been shown in medium-term projections and in more forthright statements by the staff on judgments on members' exchange rates. He fully agreed that the exercise of surveillance depended more on the political will of members to act appropriately than on particular legal texts. In that connection, much would depend on the quality of the Fund's analysis, the extent of the acceptance of its analysis, and the responsiveness of the authorities to the Fund's views.

The Chairman made the following summing up:

1. General points

This was an extremely important and useful discussion. Directors agreed that enhancing the effectiveness of surveillance is essential to improving the international monetary system, whatever the particular modalities of the exchange rate system itself. They also agreed that domestic policies of members--particularly major countries--can have significant repercussions on other countries' economies and on the working of the international monetary system, and that the Fund has a unique role to play in carrying out its surveillance function: it should seek to promote higher quality and more mutually consistent economic policies by encouraging national authorities to take into account as fully as possible the international consequences of their domestic policies.

Directors noted that the effectiveness of surveillance had been far from adequate in recent years, as major payments imbalances had developed and the functioning of the exchange rate system had been characterized by substantial volatility and misalignments.

A number of Directors considered that surveillance has been marred by a deep asymmetry: they noted that the conditionality on the use of Fund resources significantly affected developing countries--whose economies generally did not have a substantial impact on the rest of the world--while surveillance had had little practical effect on the countries that had a major impact on the world economy. Thus, in the view of a number of Directors, the objectives of surveillance had not been met. More important, the situation had considerably deteriorated in this respect since the beginning of the floating system and the introduction of the surveillance principles and procedures. A number of Directors felt that the inadequacies of surveillance had complicated the task of those countries which had had no option to adjusting to external circumstances and in the process had compounded the difficulties in the adjustment mechanism itself.

Many Directors stressed that the causes of these shortcomings were to be found in the fundamental changes that had occurred in the international financial and economic environment, as well as in the lack of sufficient political will among governments to adapt their domestic policies to a set of consistent international objectives. In other words, the shortcomings were caused more by those phenomena than by the inadequacy of the surveillance guidelines and principles, and of the way in which they had been implemented. Some of the Directors who made those points also stressed that no set of surveillance guidelines and procedures can be effective unless all members, recognizing their interdependence within the international monetary system and their mutual self-interest in the smooth operation of the system, are willing to sacrifice a portion of their national sovereignty to ensure that surveillance will be effective.

However, a number of Directors considered that the implementation of surveillance had also been faulty in some respects and had, to some extent, negatively affected the functioning of the system. Directors mentioned several shortcomings of the surveillance mechanism. First, some Directors said that the mechanism has relied excessively on a bilateral concept or the juxtaposition of a number of bilateral approaches, and that not enough emphasis had been given to analyzing interactions of economic policies and to designing an international framework for surveillance which would favor greater consistency of policies. Second, some Directors mentioned that the surveillance mechanism, as it had been implemented, had failed to assess the importance of a major component of the international system, namely, unsustainable capital flows. A third criticism was that the surveillance mechanism had not captured some major exchange rate misalignments and economic policy inconsistencies at a sufficiently early stage. Another criticism, which was made by a number of Executive Directors from developing countries, was that the surveillance mechanism had not sufficiently taken into account the fact that some countries have a greater influence on the system than others and have to be treated accordingly within the framework of surveillance. In that connection, some Directors stressed the need for more evenhanded surveillance. In their view, the Fund, in carrying out its surveillance function, had been very demanding in its response to the exchange rate policies of smaller countries and had been relatively easy in its assessment of the exchange rate policies of major industrial countries.

Another view was that one should not underestimate the importance, for the system, of a number of developing countries. A number of those countries do have an impact on trends in the world economy.

Given those observations, I think that it is fair to say that all Directors agreed that a strengthening of surveillance is essential at the present juncture. The proposals or ideas mentioned by Directors today to strengthen the effectiveness of surveillance were clearly colored by the more general attitudes expressed by Directors on the related question, discussed last week, of the exchange rate system. Some Directors felt that automatic quantitative indicators, or targets, or systems of reference were needed to trigger consultations and possibly policy actions. Others considered that what is of the essence is to improve the practical effectiveness of surveillance without creating unnecessary, or perhaps undesirable, mechanical triggers that could lead, in their view, to an excessively heavy work load rather than to a more effective application of the surveillance mechanism.

Despite the differences of view on these matters, the discussion today was heartening in the sense that all Directors--and I wish to stress the unanimity of views in this respect, although there were some differences on the precise modalities involved--agreed on the following fundamental points.

First, the surveillance mechanism should be strengthened in order, as one Director said, to get more bite and not more bureaucratic work. Second, there is a need to broaden the coverage of policies that are subject to surveillance and, in particular, to integrate, through more precise analysis, exchange rate assessments and the assessments of fiscal, monetary, and structural policies within a medium-term framework. Third, the multilateral framework of the exercise of surveillance should be improved. The lack of an adequate multilateral framework has been one of the main weaknesses of the surveillance mechanism and should be a focus of attention for action in the future. Fourth, the follow-up mechanism should be improved, so that deviations can be spotted early and appropriate action taken quickly.

In the light of those observations, I would like to deal next with the more precise points that were covered by the staff papers and on which Directors commented today.

2. The biennial review of the 1977 document on surveillance

First, the three-step work program outlined in SM/86/3 was accepted by most Directors. It is clear that the Interim Committee's guidance should be sought on the ideas contained in the G-10 and G-24 reports that Directors discussed today. It is also clear that this will take some time, as Mr. Sengupta stressed. He would like us to assess more systematically the practicability of the different specific proposals before we crystalize our views in a report and seek the guidance of the Interim Committee. Other Directors said that we should not lose too much time on drafting, and that in any event drafting should not delay action.

Second, some Directors said that they wished to revise the present text of the general principles of surveillance to include the principles of oversight by the Fund over members' economic policies which, as Mr. Polak in particular noted, are stipulated in Article IV, Section 3(a). We will therefore start considering how those general principles could be revised. But, as Mr. Polak correctly stressed, the revision will not involve just a few words of the text here and there; it should be more systematic and fundamental.

Third, in commenting on the principles for the guidance of members' exchange rate policies Directors restated the positions that they had taken last week on target zones and indicators. While the target zone idea is favored by Directors with only a minority (less than 30 percent) of the total voting power, I was interested to note today a growing momentum in favor of the notion of indicators--not necessarily quantified, rigid indicators, but more systematic guidelines that could be used to characterize a stance of policies and to help the Fund to detect deviations and inconsistencies. Although this was not a majority view, there was an inclination to explore what we could do in a practical and flexible way. In stressing the need for surveillance to focus on domestic policies, Mr. Dallara asked the staff to explore the feasibility of what he called notional ranges for the outcome in such policy areas as growth, employment, inflation, and the external current account. Mr. Dallara further suggested that any substantial deviations from the notional range of outcomes in a country in any one of those policy areas could be a basis for considering the need to hold discussions with the member.

In their comments on principles of surveillance over exchange rate policies, Directors expressed some interest in extending the coverage of indicators used to trigger consultations to include policies that are not necessarily adopted "for balance of payments purposes." However, there were divided opinions on the suggestion to delete the reference to policies adopted "for balance of payments purposes." The final decision on the disposition of those words should perhaps be taken in the light of the final position on other important aspects of the 1977 document. Some Directors suggested extending the list of "negative indicators" in Section 2 of the current principles of surveillance to include fiscal, monetary, wage, and structural policies.

3. Possible improvements in surveillance procedures

Most Directors called for an improvement in the quality, timeliness, and coverage of data. As far as policy coverage is concerned, I thought that there was a broad consensus--which reflected the positions in the G-10 and G-24 reports--that all policies which affect the performance of members and the international system, including of course structural and trade policies, should be included in the coverage of our surveillance exercise. Mr. Dallara mentioned that paragraph 43 of the G-10 report gives a good indication of the possible broader policy coverage of surveillance. He suggested that the text of paragraph 43 1/ could be relevant for an effort to extend the list of "negative indicators" in Section 2 of the Principles of Fund Surveillance over Exchange Rate Policies.

1/ The text of paragraph 43 reads, in part, as follows: "... 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... 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 suggestion is in line with the emphasis placed by a number of other Directors on the potentially significant role of surveillance in identifying members' policies that impede the achievement of economic growth objectives and should therefore be avoided to the extent possible. These ideas complement another proposal for strengthening surveillance that was mentioned by Mr. Zecchini in particular: the surveillance exercise could include a careful examination of the continuity of a member's policy efforts over time. In that context, Mr. Dallara suggested that the current Article IV consultation report for a member could include a comparison of the member's recent policy decisions with the Fund's recommendations concerning the policies that the member should adopt or avoid in order to promote economic growth, policy consistency, and exchange rate stability. Some Directors also remarked that in presenting its suggestions to a member's authorities the staff should include, where appropriate, precise policy steps to help achieve generally agreed policy goals; in their view, priority should be given to precision in both the content and timing of specific policy actions recommended by the staff.

All Directors agreed on the importance of the medium-term analytical framework that has been introduced in recent years, and some Directors asked the staff to be more precise in presenting the underlying assumptions behind medium-term scenarios. One Director made the interesting suggestion that the use of medium-term scenarios should be extended to all industrial countries that had a substantial and growing external debt and to all industrial countries with large external surpluses. In addition, there was a strong call for more candid and specific presentations in the staff appraisal for Article IV consultation reports of the staff's assessment of a government's policies and of any differences of views between the staff and the authorities. Directors also said that a staff report for an Article IV consultation should to the extent possible provide precise suggestions for policy changes, although, as Mr. Rye rightly reminded us, we have to exercise some modesty in this respect because we might not know all the intricacies of each member's situation. I also noted a call for more specific and fuller indications in staff reports of Fund/Bank collaboration and, where relevant, of the World Bank's views on a member's policies.

Directors also commented on proposals related to the multilateral setting of surveillance. Indeed, as I mentioned, this was a focal point of the discussion. The G-24 proposed two-step procedure was supported by a number of Directors. They stressed what they considered was the inherent logic of negotiating a framework of mutually consistent objectives and policies for the major industrial countries and then following that up by assessing individual policies in the context of that framework in the course of the Article IV consultations with those members. However, a number of other Directors considered that such an approach, and in particular the first leg of that approach--the negotiation of an agreed set of consistent objectives and policies--would not be practicable and would entail excessive complications and rigidities. They advocated instead a separate chapter in the World Economic Outlook paper which would provide the sort of framework that the Group of Twenty-Four favors but in a less rigid way and without the complication of negotiations; the chapter would provide a framework within which to discuss the international repercussions and interactions of the policies and objectives of the major industrial countries. Mr. Polak suggested that, by developing a consistent set of underlying balance of payments calculations as a part of the World Economic Outlook exercise, the Fund could make a unique analytical contribution to the process in the major countries of devising policies in the light of their international effects. Those calculations would not involve the definition of a set of equilibrium exchange rates. A number of Directors considered that a discussion on the G-10 countries within the framework of each World Economic Outlook paper would be more effective if the Managing Director were to make a report at the subsequent G-10 meeting on the discussion in the Board. Mr. Dallara made an interesting suggestion, which was picked up by a few Directors, that another World Economic Outlook chapter could focus on the interactions and international repercussions of the policies of 10-15 major developing countries.

In their comments on the multilateral setting of surveillance a number of Directors said that the meetings of the G-5 countries were a welcome manifestation of the desire of those countries to increase international economic cooperation. But a large number of Directors today noted that it would be important for the effectiveness of the Fund's surveillance function to have the Managing Director attend G-5 meetings so that the Fund's perspectives, as reflected in Board discussions, could be conveyed to the G-5 countries.

Considerable emphasis was placed today on the use of supplemental surveillance. A number of Directors would like more supplemental surveillance consultations to be held. They noted that the supplemental surveillance procedure had not been used in the past, and they underscored the significant potential usefulness of that procedure in certain circumstances. Some of you remarked that the number of cases in which supplemental surveillance would be necessary was likely to be very small. In addition, care would be needed to keep from drifting into a pattern of semiannual consultations as a result of the excessive application of the supplemental surveillance procedure. My sense of the discussion is that, on the whole, Directors would rely heavily on the discretion of management to determine when supplemental consultations are needed.

Emphasis was also placed on the importance of follow-up procedures. Considerable attention was given to the suggestion that after the completion of an Article IV consultation with a member whose views differed from the thrust of the staff appraisal, the country would be asked to produce a separate report stressing its views; the report could conceivably be integrated into a further Board discussion.

There were two basic views on the frequency of Article IV consultations. One group of Directors would like a more flexible attitude toward countries that do not pose major problems to the system, do not face immediate economic and financial problems, and are not using Fund resources; they were willing to have a longer consultation cycle--say, 24 months--for those countries. Some other Directors, however, said that a number of those countries might have good reasons to rely on frequent, annual Article IV consultations, and that they would be reluctant to lengthen the consultation cycle for those countries.

My personal view is that we should leave open the options for that group of countries. If any of those countries is not interested in an annual Article IV consultation, I see no reason why we should not move toward an 18-24 months' rule for such members. If, on the contrary, any of the countries concerned feels that it is important for that country to benefit from the advice of the Fund through an annual consultation, I think that we should probably go along with the member; we may wish to use smaller staff teams in handling some of these consultations.

On the whole, I did not sense much change in Directors' views on publicity since the previous discussion on surveillance. However, I noted with great interest Mr. Dallara's position, as he has stated it today, which I think has alleviated much of the concern that many Directors had felt about wider external publicity. There appears to be broad agreement that external publicity in the form of the publication of full consultation reports would not be consistent with the great importance that members and Directors attach to maintaining confidentiality. The main question at this stage is whether the Managing Director should make, on his own responsibility, a short statement on the outcome of a Board discussion in concluding an Article IV consultation. On this matter I have heard some positive views, including the opinion of some Directors that so-called internal publicity could help decision makers in individual countries to identify all the available policy courses as well as inconsistencies in policies. But this is not a majority view. Considerable attention was devoted to information notices, which is consistent with the interest that Directors showed today in achieving more precision in the carrying out of surveillance. Information notices are a useful tool to which we should give further attention. Such notices could occasionally be discussed by the Executive Board. The discussions could conceivably be helpful to the Managing Director in reaching his decision whether or not a supplemental consultation was warranted. To that end, information notices would be particularly useful if they were to concentrate on a member's deviations from the Fund's policy recommendations. There was some interest in the notion of wider indicators, and we will continue to work on that idea.

As to Mr. Sengupta's suggestion to have a quarterly paper on an ideal or optimum grid of exchange rates, there were a number of views that showed some sympathy for that idea, but there were also warnings and a counsel of prudence by several Directors which could perhaps be synthesized in the following way: the staff could explore balance of payments patterns, rather than make quarterly assessments of exchange rates, which present considerable difficulties because of quarterly fluctuations and members' sensitivities about information on rates. I thought that Mr. Polak made an interesting suggestion on how we might proceed in that respect, and I will consult him on a bilateral basis to gain a better understanding of his idea. There was also an interesting suggestion to have the staff discuss in a paper the nature, level, and effectiveness of its contacts with the authorities in individual countries during Article IV consultation discussions.

The decisions concluding the review of surveillance of exchange rate policies and the review of the implementation of surveillance procedures were circulated for approval on a lapse of time basis (SM/86/3, Sup. 1, 3/28/86; SM/86/4, Sup. 2, 3/28/86; and EBM/86/60, 4/4/86).

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LEO VAN HOUTVEN
Secretary