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GROUP OF TEN

THE FUNCTIONING OF THE INTERNATIONAL MONETARY SYSTEM

A REPORT TO THE MINISTERS AND GOVERNORS
BY THE GROUP OF DEPUTIES

June 1985

GROUP OF TEN

June 1, 1985

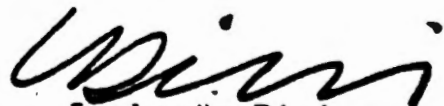
LETTER OF TRANSMITTAL

To the Ministers and Governors:

In their Communiqué of September 24, 1983, the Ministers and Governors of the Group of Ten instructed their Deputies to identify the areas in which progressive improvements in the functioning of the international monetary system might be sought and to report to them.

At their meeting in Rome on May 19, 1984 the Ministers and Governors reviewed the work of the Deputies, and instructed them to submit a final report during the first half of 1985.

On behalf of the Deputies, I have pleasure in transmitting the report they were instructed to prepare. This was finalized at their meeting in Basle on May 15-16, 1985.



Lamberto Dini

Chairman, Group of Deputies

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CHAPTER I INTRODUCTION

1. Following the invitation to Ministers of Finance recorded in the Declaration of the 1983 Williamsburg Summit, the Ministers and Governors of the Group of Ten met in Washington on September 24, 1983 and had a preliminary exchange of views on the conditions necessary to improve the functioning of the international monetary system. They instructed their Deputies to meet in the next few weeks "to identify the areas in which progressive improvements may be sought and to report to them at their next meeting to be held in early 1984".

2. In compliance with those instructions, in November 1983 the Deputies outlined a work program, subsequently approved by the Ministers and Governors, which identified the following four areas for investigation:

- (a) The functioning of floating exchange rates.
- (b) Strengthening multilateral surveillance.
- (c) Management of international liquidity.
- (d) The role of the International Monetary Fund (IMF).

3. In the organization of their work, the Deputies decided to undertake the elaboration of policy papers themselves, and to request the preparation of background studies to the international institutions represented in the Group - namely the IMF, the Organization for Economic Cooperation and Development (OECD), the Bank for

International Settlements (BIS) and the Commission of the European Communities. The Deputies had the benefit of hearing the views of a senior representative of the the International Bank for Reconstruction and Development (IBRD) at one of their meetings.

4. The Chairman of the Deputies presented a progress report on the Deputies' work to the Ministers and Governors at their Rome meeting on May 19, 1984. In the Communiqué issued at the end of that meeting the Ministers and Governors "instructed their Deputies to continue their work, with a view to submitting a final report during the first half of 1985".

5. Following this Introduction, Chapters II, III, IV and V deal in turn with the four subjects of the work program. They present an analytical overview of the issues and of the Deputies' discussions, including both the proposals on which a consensus was reached and those on which it was not. Chapter VI contains the Deputies' conclusions and their recommendations to the Ministers and Governors.

CHAPTER II

THE FUNCTIONING OF FLOATING EXCHANGE RATES

6. The Deputies have conducted a thorough examination of the working of the present system of floating exchange rates, taking stock of both the real experience acquired during the past decade and academic discussion. This chapter is devoted to a description and assessment of the system and to recommendations for improving its functioning, with a view to promoting greater exchange rate stability.

General considerations

7. The present exchange rate system came into being against a background of unsound domestic policies and divergent economic performances resulting in wide inflation differentials and large and persistent payments imbalances which rendered the previous par value system unsustainable. The sharp rise in oil prices and the widely differing policy responses exacerbated these problems and placed added strains on the international financial system. Following a transitional period, a more flexible exchange rate system was agreed upon in the 1976 meeting of the Interim Committee in Jamaica, which recommended changes in the Articles of Agreement permitting countries to choose their exchange rate regime while imposing on them certain general obligations (see Article IV).

8. Inflation, external disturbances, and divergent economic performances continued to affect exchange market

developments. The rapid expansion of international banking, the increasing sophistication and progressive deregulation of national financial markets, and the gradual removal of restrictions on capital flows have led to greater financial integration and capital mobility; while these developments may have contributed to short-term exchange rate movements, they have facilitated balance of payments financing and world economic growth.

9. Although most countries maintain some form of pegging, the main currencies all float separately or jointly against each other. These currencies are used to invoice and finance the bulk of world trade, are the basis for most of the eurocurrency markets and dominate foreign exchange trading. Over time, the system has evolved into a multicurrency reserve system in which the US dollar is predominant while other main currencies have assumed secondary reserve roles. Since some three quarters of world trade and most invisible and capital transactions are conducted at floating rates, the present system can be described as a floating exchange rate system. In addition, regardless of their formal exchange rate arrangements, most countries have shown a greater willingness to let their exchange rates vary to prevent or to correct balance of payments disequilibria than under the par value system.

10. Since 1979 an arrangement which limits exchange rate fluctuations to narrow margins around agreed adjustable parities has been in operation within the context of the European Monetary System (EMS), involving a high degree of monetary cooperation and mutual surveillance. The

arrangement is part of an effort to create an area of monetary stability and to achieve economic and monetary integration among countries closely linked by commercial flows as well as by institutional and political affinity.

11. The Deputies recognize that a country's choice of exchange rate regime is influenced by a number of factors, including the scale, composition and direction of its trade as well as its openness to capital flows. Consequently, the degree of exchange rate stability deemed appropriate differs from country to country.

12. While countries have freedom in their choice of exchange rate arrangements, they must meet certain obligations in connection with their exchange rate policies. These obligations are set out in Section I of Article IV of the IMF Articles of Agreement, which reads as follows: "Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

- (1) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

- (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
- (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
- (iv) follow exchange policies compatible with the undertakings under this Section."

The Deputies reaffirm the overriding importance of these principles and policies and of ensuring their full implementation.

Assessment of floating exchange rates

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

14. The Deputies agree that the existing exchange rate regime has shown valuable strengths. Exchange rate flexibility has made a positive contribution to external

payments adjustment and to the maintenance of an open trade and payments system in a period of massive external shocks. It can help countries, especially the larger ones, to insulate their domestic price levels from inflation abroad, and can facilitate the pursuit of sound monetary policies geared more directly to domestic conditions. Furthermore, it is questionable whether any less flexible system would have survived the strains of the past decade, while attempting to preserve it would probably have led to increased reliance on restrictions on trade and capital flows.

15. The Deputies agree, however, that the functioning of the present system has also shown weaknesses. In particular the system has not adequately promoted sound and consistent policies. It has not prevented inadequate policies and divergent economic performances which have contributed to a high degree of short-term volatility of nominal exchange rates and to large medium-term movements in real exchange rates.

16. The Deputies have noted that short-term exchange rate volatility has been substantial and has not shown any tendency to diminish over time. Although empirical studies conducted by the IMF have been unable to find a significant systematic link between short-term exchange rate volatility and the volume of international trade, concern has been expressed that volatility may discourage investment and trade by adding to uncertainty and to financial risks for investors and traders. However, foreign exchange markets appear to have developed effective hedging

techniques available to most operators to reduce the risks associated with exchange rate volatility, generally at comparatively little cost.

17. Changes in real exchange rates are appropriate when they facilitate desirable adjustments by reflecting changes in underlying economic conditions and inducing corrections in policies. However, large movements in real exchange rates may lead to patterns of international transactions that are unlikely to be sustainable and that can pose difficult problems for domestic economies, involving a risk of protectionist pressures building up and resources being misallocated. If these exchange rate movements are subsequently reversed, a further disruption of trade and investment may result over the medium term.

18. The Deputies have noted that the influence on exchange rates of financial transactions not directly related to trade flows has steadily increased during the past decade. In turn, exchange rate variability may have contributed to greater capital movements. As a result, exchange rate determination has been increasingly influenced by conditions in capital markets, including relative interest rates and expectations regarding the impact of national policies and current and future economic performance.

19. The Deputies recognize that some variability is inherent in freely floating exchange rates. Since trade flows tend to adjust more slowly than financial flows,

the impact of changes in current conditions is first reflected in financial and foreign exchange markets. Furthermore, in an uncertain environment the difficulty of assessing policy stances and underlying economic fundamentals may lead markets initially to overreact to unexpected developments. Finally, structural rigidities, including legal and regulatory constraints, may distort exchange rate relationships and retard adjustment.

20. While some events affecting exchange rates have been beyond the immediate control of national authorities, the Deputies are of the opinion that exchange rate instability has been fuelled by inadequate and inconsistent policies that have led to divergent economic performance. Expectations in financial markets that inappropriate policies might not be quickly corrected have sometimes resulted in large exchange rate movements. Moreover, the perceived instability in current and future policy courses has made it difficult for market participants to find an anchor for exchange rate expectations.

21. While their study of the functioning of the exchange rate system has focussed primarily on the objective of achieving greater stability among floating currencies, the Deputies are fully aware that attempts to maintain exchange rates at levels not in line with economic fundamentals and market forces can be very damaging, both to the countries concerned and to their trading partners. They have expressed their strong support for efforts regularly made by the IMF to persuade countries to adopt realistic exchange rate policies.

22. Given the high degree of interdependence and financial integration in the world economy, the Deputies recognize that no exchange rate system can provide full insulation from the effects of economic policies and performance in other countries. A stable international environment certainly requires sound and consistent policies that promote convergence of economic performance. But even if there were widespread and persistent application of non-inflationary policies, exchange rates and exchange rate expectations would be influenced by a number of factors, including the international configuration of fiscal policies, monetary policies, structural rigidities, domestic savings and investment patterns, and political uncertainties. More generally, different policy responses to exogenous disturbances can exert an impact on exchange rates.

Proposals to improve exchange rate stability

23. The G-10 Ministers and Governors have already concluded that a return to a generalized system of fixed parities is unrealistic at the present time. In the view of the large majority of the Deputies, the adoption of alternatives to a system based on the floating of key currencies is unrealistic under current and foreseeable circumstances. All Deputies agree, however, that improvements are needed in the functioning of the present system.

24. While useful lessons can be drawn from the experience of the EMS as regards the promotion of policy convergence and exchange rate stability, the Deputies recognize that that system cannot be dissociated from the particular political and economic environment in which it operates and therefore cannot be readily extended to a broader and more heterogeneous context characterized by the presence of a plurality of reserve currencies. Such a system would run a much greater risk of being exposed to pressures similar to those which arose during the final phase of the par value system.

25. The Deputies agree that controls on international capital flows do not offer a desirable or effective means of achieving greater exchange rate stability. Their economic costs would be substantial. Given the close interrelationship between current and capital transactions, free capital movements are beneficial to the expansion of trade and to efficient resource allocation. Barriers to capital movements tend to hamper the smooth financing of current payments, distort market signals, and transfer more of the burden of external adjustment to exchange rates. Moreover, there is a constant danger of escalation and retaliation, with further negative consequences for trade growth and resource allocation.

26. The Deputies have also reviewed the role that official intervention in foreign exchange markets can play in reducing exchange rate volatility. They recognize that intervention has a role to play, if only a limited one, and in the light of recent experience they continue to

endorse the conclusions reached on the basis of the Report of the Working Group on Intervention (1), namely that:

- (i) intervention can be useful to counter disorderly market conditions and to reduce short-term volatility;
- (ii) intervention may also on occasion express an attitude toward exchange markets;
- (iii) intervention will normally be useful only when complementing and supporting other policies;
- (iv) countries should be willing to undertake coordinated intervention in instances when it is agreed that such intervention would be helpful.

27. Neither capital controls nor intervention can be relied upon to attain lasting stability of exchange rates. The Deputies have therefore focussed on other means of achieving this goal through improved international cooperation.

28. The Deputies agree that the adoption of sound, credible and stable policies in all countries, especially the major ones, can contribute fundamentally to exchange rate stability. Sound, non-inflationary macroeconomic policies contribute to greater convergence of economic performance among countries. Credible commitment to and

- (1) Report of the Working Group on Exchange Market Intervention (chaired by P. Jurgensen), January 1983.

persistent pursuit of such policies can also play an essential role in providing the foreign exchange markets with a firmer anchor for exchange rate expectations. Liberalization of capital markets and, more broadly, removal of restrictions and structural rigidities which hamper adjustment can reduce the burden placed on foreign exchange markets in absorbing short-term disturbances.

29. In view of the present high degree of economic interdependence, mutually consistent policies would also promote greater convergence of economic performance and thereby enhance exchange rate stability. Recognizing that the importance of external repercussions of national policies has often been underestimated, the Deputies agree that, in setting national policies, the international implications and interactions of those policies should receive an appropriately high priority.

30. In this connection, the Deputies have made a detailed review of the contribution that exchange rate developments might make to the evaluation of performance and policies. They note that these developments provide information on private markets' assessments of underlying economic conditions and of current and expected policies in the various countries. However, a wide range of factors beyond exchange rate developments should also be taken into account in assessing national policies and the need for consultation and policy discussion. These include, in addition to those mentioned in the IMF's principles for surveillance, developments and performance in the areas of fiscal policy (including the level of government

expenditure), monetary policy, structural rigidities, and the openness of the economies to international trade flows.

31. Some Deputies made the proposal to introduce target zones for the exchange rates of major currencies because they believe that convergence of economic performance, while necessary, may not always be sufficient to achieve lasting exchange rate stability. They further believe that credible commitments to target zones would contribute to stabilizing market expectations and would promote greater international policy consistency by reinforcing multilateral surveillance. According to this proposal, the authorities concerned would define wide margins around an adjustable set of exchange rates devised to be consistent with a sustainable pattern of balance of payments. Target zones would be phased in progressively. They could, however, trigger consultations that would induce, step by step, more direct links between domestic policies and exchange rate considerations. This would not necessarily involve rigid commitments to intervene in exchange markets. Although the Deputies supporting this proposal recognize the difficulties of identifying equilibrium exchange rates, they believe these to be exaggerated, maintaining that arriving at a judgement about the appropriateness of the exchange rate of a currency is part of the current practices of the IMF. Some other Deputies recognize that there could be merits in this proposal and suggest that the technical aspects of a target zone approach should be further explored at an appropriate time.

32. Most Deputies, however, are of the view that reaching a consensus on the range of desirable exchange rates would prove extremely difficult. Given our imperfect knowledge of the determinants of exchange rate movements, the target zones would have to be too wide to serve as an anchor for expectations. Furthermore, even if agreement on an acceptable exchange rate pattern could be reached, there would still be the difficult task of allocating the burden of policy adjustment among the countries involved. Markets would inevitably test the zones, thereby adding to instability, and efforts to maintain exchange rates at levels incompatible with market sentiment could prove costly and ultimately unsuccessful. Above all, the constraints imposed on domestic policies by target zones might undermine efforts to pursue sound and stable policies in a medium-term framework. The majority of the Deputies, therefore, agree that the adoption of target zones is undesirable and in any case impractical in current circumstances.

33. All Deputies agree on the fundamental conclusion that greater exchange market stability requires close and continuing cooperation among countries and a strengthening of international surveillance to improve the compatibility of policies among countries and the convergence of economic performance around sustainable, non-inflationary growth.

CHAPTER III

STRENGTHENING INTERNATIONAL SURVEILLANCE

General considerations

34. The IMF plays a central role in surveillance. As mentioned earlier (paragraph 12), the IMF Articles of Agreement contain important obligations regarding members' policies. They also include specific principles and procedures for the conduct of international surveillance to assure that these obligations are fulfilled (Article IV, Section 3 and Executive Board Decision No. 5392 (77/63)).

35. Surveillance functions are also performed by other institutions and consultative groups which operate under different legal frameworks and procedures. The Deputies have noted in particular the functions performed by the OECD, the BIS, the General Agreement on Tariffs and Trade (GATT), the IBRD and the European Communities, and by various international ministerial groups. The Deputies have concentrated their attention on IMF surveillance, with a view to improving its effectiveness and consistency with surveillance in other fora.

36. The Deputies agree that no major changes are required in the present institutional setting for exercising surveillance over national policies. Nevertheless, they agree that during the period of floating exchange rates surveillance has not been as effective as desirable in influencing national policies and in promoting

underlying economic and financial conditions conducive to exchange rate stability. Surveillance has not been sufficiently effective in inducing policy changes in countries which have adequate access to external financing and do not require an IMF supported adjustment program. These countries appear to have been able on occasion to sustain policy courses not fully compatible with the goals of international adjustment and financial stability. A number of improvements, therefore, are needed in order to make the process more effective.

37. The Deputies recognize that in the implementation of surveillance the focus has tended to be on a country-specific approach, with less attention being given to the interaction of national policies and economic structures. The effectiveness of surveillance has also been weakened in certain instances by lack of mutual understanding of the impact of particular policies and of an agreed analytical framework, which have sometimes made international consensus on the appropriateness of policies more difficult to achieve.

Proposals to strengthen surveillance

38. The Deputies reaffirm that effective surveillance presupposes full cooperation by every country. Countries must therefore be ready to recognize the international implications of their policies and to give them more weight in their decision-making process. Surveillance, however, is a delicate matter, since it impinges on the conduct of national policies. The Deputies emphasize that strengthened

surveillance requires enhanced dialogue and persuasion through peer pressure, rather than mechanically imposed external constraints. All Deputies believe that mutually agreed procedures would be helpful, but some Deputies think that an element of constraint will also be required if surveillance is to be made more effective. While stressing that the sensitivity of the issues involved in surveillance necessitates preserving confidentiality, some Deputies suggest that greater publicity for policy conclusions could be an instrument to further the adoption of appropriate policies.

39. The Deputies stress the need for symmetry and evenhandedness in the exercise of surveillance. Countries should be treated in the same manner irrespective of their size, exchange rate regime, or financial position. However, equal treatment cannot mean uniformity of prescriptions. Policy advice must take account not only of different situations, economic structures and institutional settings but also of the impact of individual countries on the world economy.

40. The Deputies emphasize that to be effective surveillance over exchange rates must concern itself with the assessment of all the policies that affect trade, capital movements, external adjustment, and the effective functioning of the international monetary system. Such an assessment should cover not only macroeconomic policies but also the micro-policies and structural features that could weaken performance and induce exchange rate instability. It should also include a more explicit analysis of domestic

policies in the context of the world economy, so that interdependences and mutual repercussions are fully brought out and taken into account.

41. While the present institutional framework for surveillance is considered adequate, the Deputies agree that the existing channels need to be used more effectively and coordinated better. They also agree that the central role of the IMF in surveillance should be preserved. At the same time, they underline that other institutions, consultative bodies and groups of more limited membership should continue to play their role in the surveillance process. In this regard, they have noted the important role played by the OECD in the surveillance of the economic policies of the industrial countries.

42. In considering ways of strengthening surveillance, a distinction has been made between surveillance in the form of country-specific consultations with an international institution (e.g., bilateral surveillance), and surveillance which focusses on the international adjustment process and the interaction of national policies (e.g., multilateral surveillance). The Deputies' detailed proposals are grouped below under the headings of "Article IV surveillance" and "Multilateral⁴⁴ surveillance".

Article IV surveillance

43. The Deputies agree that Article IV consultations should continue to be primarily concerned with the broad

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

44. The assessment of the current state of individual countries and the world economy and the formulation of policy recommendations would be facilitated by better data and stronger analytical foundations. The Deputies are of the view that IMF surveillance activities can play a major role in improving the information on and analysis of individual economies. In this connection they put forward the following suggestions: (i) consultation reports should be used to identify necessary improvements in the scope, quality and timeliness of data provided to the IMF by national authorities; (ii) the empirical and analytical basis of policy judgements should be made as explicit as possible, whether by the IMF or by member governments; (iii) techniques for analyzing medium-term external debt and debt servicing scenarios should be improved as part of the ongoing work to strengthen surveillance over external

indebtedness. Where appropriate, closer cooperation with the IBRD in all these areas should be sought.

45. The Deputies agree that, in order to ensure that consultation conclusions have greater influence, the IMF should provide more candid assessments of national policies and of their domestic and international impact as well as precise suggestions for policy changes. Differences of views between the IMF and national authorities should be spelled out and discussed. For industrial and developing countries whose policies and performance are of greatest concern for the world economy, a confidential exchange of views between the Managing Director and the Finance Minister should be envisaged at the end of the consultation process. In addition, to ensure an adequate follow-up to the consultation conclusions, countries should be requested to present a report outlining the measures introduced or considered to deal with the problems identified by the IMF and to respond to specific policy suggestions. The degree of implementation and effects of policy recommendations should in all cases be reviewed in ensuing consultations and consultation reports.

46. The Deputies consider that it could be helpful if the IMF made greater use of the "supplemental surveillance procedures in the face of exchange rate and other developments that may be important or may have important effects on other members, or that have implications for the operation of the international monetary system; to this end they invite the IMF to review the arrangements set up in 1977 and 1979 for invoking these procedures.

47. The Deputies note that the IMF has played an essential role as coordinator of multilateral efforts to respond to external debt problems. In most cases this role has involved the development of adjustment programs supported by use of IMF resources, but recently some debtor countries have been working with the IMF and their major creditors to explore the possibility of "enhanced" surveillance with the aim of facilitating non-IMF financing in connection with multi-year debt reschedulings. The Deputies encourage the IMF to continue to develop such procedures on a case-by-case basis, reflecting general understandings that would be adopted by the Executive Board. Similar procedures might be considered for countries whose limited access to external finance could be improved with IMF assistance and advice.

48. The Deputies agree that the basic confidentiality of the exchange of information and discussions between the IMF and its members should be preserved. The view has been expressed, however, that giving some publicity to consultation conclusions could help make them more influential. In particular, it has been suggested that a public statement might be made by the Managing Director, on his own authority and without Executive Board approval, at the end of the consultation process; the statement, which could be based on his own summing-up of the Executive Board discussion, would give a brief assessment of a country's policies and prospects and would indicate the broad direction of suggested policy changes. It has also been suggested that the Executive Board consider authorizing the

release of consultation documents, in whole or in part, at the request of the member country concerned.

Multilateral surveillance

49. The Deputies agree that multilateral surveillance should be strengthened. It should concentrate on countries which have a large impact on the world economy. Effective multilateral surveillance may require a reinforcement of existing procedures as well as consideration of the introduction of new arrangements.

50. The specific content of multilateral surveillance should be the examination of the external repercussions of national policies and their interaction in the determination of the global environment. The Deputies agree that the approach to these issues should be mainly judgmental in nature. In this respect, the regular monitoring of key economic developments can help to assess the consistency and mutual compatibility of national policies in the light of the objectives of international adjustment and financial stability, and hence to identify situations that warrant policy reviews and consultations. Special attention should be devoted to developments in exchange rates, trade and capital flows, which are the principal elements of international interaction, as well as to the broad range of economic policies underlying them.

51. The Deputies propose that the IMF should periodically prepare documents analysing the international

repercussions of national policies of G-10 countries and of their interaction in the determination of exchange rate developments and international adjustment. More specifically, they consider it appropriate that the World Economic Outlook (WEO) paper should devote a separate chapter to these issues, setting out the principal quantitative aspects and providing an analytical framework for policy discussions.

52. The Deputies propose that the G-10 Ministers and Governors should review the main conclusions emerging from the chapter of the WEO on the international repercussions and interaction of their policies, as appropriate. Some Deputies propose that the conclusions of these reviews should be summarized in the form of a statement by the Chairman, containing the views of the Group on the appropriateness of its members' policies.

53. The Deputies agree that Working Party No. 3 of the OECD should continue its regular review of major countries' fiscal and monetary policies and the way these interact internationally, with particular reference to the evolution of external positions and exchange rates. While these interactions are in many respects of a short-term nature, it has become increasingly appropriate for the Working Party's deliberations to have a medium-term perspective, and to pay greater attention to structural features, such as rigidities in goods, labour and financial markets, that have a bearing on the international adjustment process. In the latter connection, it is to be welcomed that the annual examinations of national economies in the Economic and

Development Review Committee of the OECD now cover selected structural issues in depth.

54. The key role in fostering trade liberalization and the removal of barriers which restrict or hamper free trade pertains to the GATT. The Deputies believe that the GATT should have broad powers to exercise surveillance over all forms of trade restriction including bilateral restraint agreements and other national trade-restricting practices and policies. Close cooperation between the IMF and the GATT should be maintained. The IMF should place emphasis in its policy analyses and recommendations, whether within a bilateral or a multilateral framework, on the removal of trade-restricting practices and on the implementation of GATT recommendations and policies.

CHAPTER IV

THE MANAGEMENT OF INTERNATIONAL LIQUIDITY

55. The Deputies have in the main confined their discussions to two aspects of the management of international liquidity. The first and more general issue related to the changes in the international financial system since the transition to floating exchange rates, and the implications of these changes for the creation and distribution of international liquidity. The second and more specific issue was the present and future role of the SDR in the international monetary system.

General considerations

56. Under the gold-exchange standard, international liquidity was virtually equated with monetary authorities' holdings of reserve assets, comprising gold, foreign currencies, and reserve claims on the IMF. Reserves were generally "owned", since international liquidity acquired through credit arrangements played only a minor role. The demand for reserves was generally seen as a fairly stable and predictable function of the value of world trade and payments imbalances.

57. The ending of the obligation to defend fixed exchange rates has substantially changed the rationale for holding international reserves. It does not appear, however, to have led to any appreciable decline in the overall demand for reserves. There appear to be several reasons for

this. Most floating countries have continued to intervene in foreign exchange markets to varying extents. Other countries have also continued to manage their exchange rate or to peg it to another currency or to a currency basket. Thus reserve balances have been maintained for intervention purposes. In addition, many countries have held precautionary reserve balances in an attempt to protect themselves from the uncertainties arising from larger payments disequilibria and exchange rate fluctuations. Finally, reserves have been acquired as a means of demonstrating creditworthiness and preserving access to financial markets.

58. On the supply side, the international credit markets have provided new channels for meeting the rapid growth in external financing requirements and the demand for reserves quickly and efficiently. However, those countries that do not have access to international capital markets or that have lost creditworthiness have continued to rely primarily on official channels and conditional credit to finance current account imbalances and acquire reserves.

59. As a result of these changes, international liquidity has come to embrace not only monetary authorities' actual holdings of reserve assets, but also credit arrangements which permit the acquisition of reserves from private and official sources. Thus, the adequacy of international liquidity can no longer be assessed primarily on the basis of recorded reserve holdings, but must also take account of countries'

creditworthiness and the availability of official sources of financing.

60. Countries can obtain reserves from financial markets provided they maintain their creditworthiness, which is mainly a function of their own domestic policies and performance. However, conditions in international markets are affected by the financial policies of reserve-currency countries. Therefore, the terms on which reserves are supplied by the markets are likely to reflect not only the borrowers' own policies and performance, but also those of the major industrial countries.

61. The preponderance of market-supplied international liquidity has reduced the scope for influencing the process of reserve creation directly. Only a small share of total liquidity, arising from IMF-related reserve assets and credit provided under bilateral and multilateral official credit arrangements, is amenable to some form of direct control. These developments have increased the importance of pursuing sound domestic policies in order to safeguard creditworthiness. The strictness of the resulting discipline inevitably varies with countries' economic structures and state of development.

62. As a result of the evolution of the international monetary system in the post-Bretton Woods era, financial markets have thus acquired a crucial role in the provision of liquidity in the world economy. In the process, the concept of international liquidity has widened and become

more complex, and the smooth functioning of the system has come to depend more on countries' national policies and creditworthiness and on the working of market mechanisms.

63. The Deputies agree that, while the process of liquidity creation has been made more flexible and the scope for countries to manage their international reserve position has generally increased, the working of the system has not been entirely satisfactory. The strong inflationary pressures of the seventies and the major external debt problems of the eighties suggest that during most of this period the supply of international liquidity has been ample, if not excessive. Instances of sharp contraction in the availability of international credit have also occurred. In the view of some of the Deputies this suggests that present arrangements for the provision of liquidity have not been optimal and that, while ultimately producing very powerful effects, they have not always been conducive to a gradual adjustment toward steady non-inflationary growth of the world economy. They believe that sudden and marked shifts in the terms and conditions on which international liquidity has been made available, late recognition of and abrupt response to changes in creditworthiness, and the very limited access certain groups of countries have to market borrowing, are factors that cannot be ignored. Other Deputies emphasize that sharp shifts in liquidity have generally reflected inadequate underlying policies and that the stability of the system depends primarily on all countries pursuing sound policies to achieve sustainable non-inflationary growth.

Proposals concerning international liquidity

64. The Deputies agree that improvements in the provision of international liquidity need not be sought through fundamental changes in the system. They also recognize that for the foreseeable future financial markets must be expected to continue to supply the bulk of international liquidity and that official channels will have a significant supplementary role. The Deputies have considered a number of measures designed to strengthen the working of the system by enhancing the efficiency of market processes and by fostering the pursuit of appropriate policies in all countries. The Deputies have also considered various proposals relating to the IMF's ability to meet systemic liquidity needs.

65. Three sets of measures have been proposed by the Deputies in order to improve the operation of financial markets in the provision of international liquidity. First, international institutions should be encouraged to continue to improve the collection and dissemination of all the data relevant to the markets' assessment of individual countries' creditworthiness, and banks should seek to improve their methods of risk evaluation. Second, countries should press forward steadily with the deregulation of capital markets and the liberalization of capital movements. Third, monetary authorities should continue to place emphasis on strengthening the supervision of banks operating in the international markets, especially with a view to establishing adequate capital requirements, applying consolidated balance-sheet reporting, and encouraging greater convergence of regulatory practices.

The BIS has an important role to play in this respect. The Deputies stress that in monitoring international banking activities, the authorities should pay due regard to possible macroeconomic consequences of prudential measures.

66. The Deputies emphasize that a smooth provision of liquidity through financial markets is possible only in an environment of sound, non-inflationary policies in all countries. An appropriate evolution of international liquidity also depends on the willingness of countries to take account of the international implications of their domestic policies. The Deputies therefore agree that multilateral surveillance has a key function to play in this area as well, to foster policies consistent with a more stable evolution of international liquidity. Indeed, the IMF Articles of Agreement call on members to collaborate with the IMF and with other members in pursuit of the objective of "better international surveillance of international liquidity" (Article VIII, Section 7). In particular, surveillance should guide countries in their choice between financing and adjustment of external payments imbalances; facilitate the maintenance or, where necessary, the restoration of creditworthiness; and foster closer cooperation among countries whose policies exert an important influence on conditions in world financial markets.

67. The above considerations indicate that surveillance of exchange rate policies and surveillance of international liquidity cover a great deal of common ground. The Deputies

therefore stress the need for their implementation to be closely integrated.

68. The Deputies are aware that some countries have not had significant access to international financial markets and are therefore largely dependent on other sources of financing for the acquisition of reserves until they can restore or gain creditworthiness. They recognize that the provision of concessional financing is necessary for many of these countries, and that officially supported financing can help maintain and strengthen their external position. The Deputies therefore suggest that these countries be provided official financing on appropriate terms in support of sound policies which can help promote creditworthiness.

Present and future role of the SDR

69. The First Amendment of the Articles of Agreement enabled the IMF to allocate SDRs "to meet the need, as and when it arises, for a supplement to existing reserve assets" (Article XV, Section 1). The main purpose of creating the SDR was to make the supply of reserves less dependent on the official settlements balance of the United States and to provide an instrument to counteract reserve shortages. Moreover, by offering non-reserve countries the possibility of acquiring reserves without having to obtain balance of payments surpluses, the SDR could alleviate somewhat the asymmetry of external constraints on national policies. The Second Amendment of the Articles of Agreement called on members to collaborate, with the objective of "making the special drawing right the principal reserve

asset in the international monetary system" (Article VIII, Section 7).

70. Despite the objectives stated in the Articles, the SDR has not assumed a major role in the system, its share in total foreign exchange reserves having actually declined during the last decade. The use of the SDR as a unit of account in private transactions remains limited and the market for SDR-denominated assets and liabilities, after an initial spurt, has not shown any tendency to develop further.

71. The limited success of the SDR as an international reserve asset can be attributed in part to its features and restricted usability. Developments in the monetary system have also lessened official interest in an internationally issued and administered reserve asset. The expansion of international financial markets has provided a flexible and efficient source of reserves for many countries, and the emerging multi-currency reserve system has reduced dependence on a single currency in international settlements and reserve holdings.

72. The Deputies recognize that these developments have affected the rationale for the SDR, including the objective of placing the SDR at the center of the system as the main reserve asset. Nevertheless the Deputies, noting the SDR's owned-reserve nature, believe that the instrument may still have a useful role to play in meeting the long-term global need for supplementing reserves in a system largely based

on borrowed reserves. In this context, the Deputies have considered various ways of making the SDR available as a safety net for future contingencies, including the possibility of private markets being unable to respond adequately to a legitimate long-term global need for international liquidity. They have not agreed, however, that any of these approaches would be desirable or appropriate at this stage.

73. The Deputies have not reached a consensus on the question of whether the present situation calls for new allocations of SDRs. A number of Deputies consider that there is at present no clear evidence of a long-term global need to supplement international reserves, given the present state of total reserves and lending from international markets. Other Deputies, however, favor resumption of SDR allocations on the basis of the arguments described below.

74. According to some of the Deputies, severe strains in liquidity conditions have built up in the system and are reflected in the decline of reserves in relation to imports and foreign debt, the lopsided distribution of reserves, and the rise of barter trade. While an SDR allocation on a reasonable scale would not eliminate these strains entirely, these Deputies would see it as a means of assisting countries in their search for international liquidity and of facilitating the international adjustment process. Other Deputies, however, have expressed reservations about this analysis. In their view, the difficulties encountered by a number of countries are

primarily an indication of their lack of creditworthiness and are not related to a general shortage of liquidity. Even in the recent period of debt problems, reserves have increased significantly, particularly for non-oil developing countries in aggregate. Moreover, the decline in reserves which occurred in 1981-82 followed a period of excessive inflation and rapid reserve gains. These Deputies stress that SDR allocations are not the appropriate tool for providing finance to countries whose access to international credit markets has been jeopardized and suggest that they might result in delaying necessary adjustment. Furthermore, even a substantial allocation would provide no more than a minimal benefit to debtor nations' reserves.

75. Some Deputies have proposed that existing rules governing the conditions, the amount and the distribution of allocations should be supplemented by an arrangement whereby SDRs would be used to finance IMF adjustment programs. To this end, participants in the SDR Department would place all or part of their allocations at the disposal of the IMF. These SDRs could then be channelled to countries in need of reserves in support of appropriate adjustment programs. This proposal has been criticized on various grounds. Some Deputies doubted whether the allocation of SDRs for these purposes would be consistent with the Articles of Agreement. The proposal could also blur the distinction between the SDR and conditional IMF credit, and the lending or transfer of SDR allocations to the IMF could raise legislative difficulties within countries. Finally, the use of SDRs to expand the IMF's resources for conditional lending is viewed by these

Deputies as unnecessary since the IMF has adequate resources to fulfil its responsibilities for the foreseeable future.

76. In the view of some of the Deputies, quite apart from short-term considerations relating to the state of liquidity, a resumption of SDR allocations is justified by longer-term, systemic considerations. These Deputies point to the fact that the long-term growth of trade must be supported by an expansion of international reserves, and that an increased share of the SDR in official reserves would increase the stability of the system. These Deputies advocate that SDRs should be injected into the system in accordance with a steady quantitative rule so designed that their relative weight in official reserves would expand gradually over time without endangering discipline. Other Deputies, however, believe that international financial markets and official channels provide adequate means of meeting the global demand for reserves, and are concerned that regular SDR allocations would result in unnecessary and excessive liquidity creation.

77. A further proposal examined by the Deputies is the establishment of an SDR-based IMF. Under this scheme, which would involve merging the General Department with the SDR Department, IMF lending would result in the creation of SDRs and reimbursement in their cancellation. In the view of its proponents this proposal, while not entailing any basic change in members' rights and obligations, would equalize the characteristics of claims on the IMF, streamline the IMF's operations, and render them more

neutral with respect to exchange rates and monetary aggregates. Moreover, quota increases under the proposed scheme would not entail the provision of national currencies, thus obviating the need for national budgetary appropriations. Most Deputies consider this proposal too far-reaching and not realizable at the present time. In their view, such a major change would not enhance the IMF's ability to fulfil its responsibilities and could undermine its mutual assistance character. Moreover, the abolition of subscription payments in convertible currencies could jeopardize confidence in the institution.

78. In conclusion, the Deputies have not reached agreement on any of the specific proposals described above. However, they recognize that the SDR may still have a useful role in meeting the long-term global need for reserves and in this context in providing a safety net for future contingencies. In these circumstances, the Deputies support the intention of the IMF Executive Directors to carry out a comprehensive review of the future role of the SDR in the system.

CHAPTER V THE ROLE OF THE IMF

79. The IMF plays a key role in the international monetary system. It oversees and guides the operation and the evolution of the system, providing a legal framework for consultation and cooperation. It promotes the adoption of domestic policies consistent with balance of payments adjustment and financial stability, the maintenance of a trade and payments system free from restrictions, and exchange rate stability. It supplements the stock of official reserves through SDR allocations and its credit activity, which results in the creation of reserve positions. The main instruments available to the IMF to further its objectives are the exercise of surveillance over countries' policies, the extension of financial assistance conditional on the adoption of adjustment policies, and the authority to allocate SDRs. The IMF's surveillance functions have been examined in Chapter III of this Report, and issues concerning the SDR in Chapter IV. This Chapter concentrates on the functions of the IMF in providing temporary balance of payments assistance and promoting adjustment.

General considerations

80. The policies governing the use of IMF resources, embodied in the Articles of Agreement (notably Article V) and in Executive Board Decisions, stipulate that IMF financing is to be provided (i) on a temporary basis; (ii)

in amounts related to members' quotas; (iii) conditionally upon the adoption of policies to correct payments problems over the short-to-medium-term. These policies are designed to ensure that the revolving nature of IMF resources is preserved and that claims on the IMF can be mobilized quickly in cases of balance of payments need. The Deputies wish to stress that IMF resources through the year have been used and provided by all categories of members, a factor which has reinforced the universal character of the institution and helped maintain the broad support of its membership.

81. An unprecedented conjunction of large and persistent external imbalances in many countries over the last twelve years has led the IMF to expand considerably its financial assistance in support of external adjustment programs. Lending policies have been modified, leading to a lengthening of program periods and to the introduction of a temporary policy of enlarged access which allows members to obtain credit up to a multiple of quotas in support of comprehensive adjustment programs. As a result the IMF has borrowed substantially from official sources to supplement its quota resources. In addition, the IMF has come to play a role as a catalyst and coordinator of external finance from other sources for countries facing severe problems in servicing their external debt. The Deputies note that in recent years requests for IMF credit and assistance have come almost entirely from developing countries.

82. The Deputies consider that the IMF has responded flexibly and effectively in the face of disturbances which were threatening world financial stability and that its adjustment programs have been most valuable in the process of restoring confidence and viable external positions. They encourage the IMF to continue its efforts in this area. They stress, however, that as more normal payments and creditworthiness situations in debtor countries return, the IMF should revert to its traditional role.

83. The Deputies recognize that the IMF has managed its operations prudently and that its liquidity position is currently strong. Nonetheless, they are concerned that, if they persist, the lengthening of program and repayment periods and the prolonged use of IMF resources may adversely affect the revolving nature of its financing and the liquidity of members' claims on the IMF. This in turn would weaken the IMF's ability to grant financial assistance and members' willingness to provide resources.

84. The Deputies recognize that the correction of payments imbalances requires complementary measures in the areas of demand management and structural adjustment, including realistic exchange rates. However, they are concerned that in some cases countries with balance of payments difficulties have not adopted adequate adjustment policies early enough, or have adopted programs that were not sufficiently rigorous and comprehensive. This has been a factor in the lengthening of adjustment periods and the more extended use of IMF credit, and hence in the requests for the injection of additional resources. Recourse to

frequent increases in resources, including borrowing, on the one side, and less effective adjustment on the other, tend to confuse the IMF's functions with those of a development finance institution.

Strengthening the role of the IMF

85. The Deputies emphasize the importance of preserving the monetary character of the institution and the revolving nature of its resources. The ability of the IMF to continue to play its role in promoting adjustment and providing conditional financing when the need arises depends on these fundamental features being preserved. In turn this requires that four conditions be met: (i) that the IMF be able to command adequate resources; (ii) that it normally finances its lending from quota resources; (iii) that the conditionality in IMF programs continues to place emphasis on the need to restore a sustainable balance of payments and external debt position in the short-to-medium term; (iv) that the universal character of the IMF be maintained.

86. The Deputies reiterate that quotas should represent the basic source of IMF financing and that recourse to borrowing to supplement these resources should be made only in exceptional circumstances. They recognize, in this connection, that the ability of the IMF to perform its functions effectively depends on the adequacy of its resources relative to the legitimate needs of its members. While the bulk of balance of payments financing should continue to be met through other private and official sources, IMF credit should be available on a sufficient

scale to provide meaningful support to members and to serve as an important catalyst for other lending by providing confidence that the borrower is pursuing sound policies.

87. The IMF's resources are intended to deal both with balance of payments financing needs that arise in normal conditions and with exceptional situations involving a threat to the stability of the system. The Deputies agree that, barring unforeseen circumstances, the recent increase in IMF quotas and the enlargement and expansion of the GAB provide the IMF with an adequate basis to fulfil its responsibilities over the next few years. However, they recognize that negotiations on quotas and borrowing arrangements are complex and time consuming. They therefore suggest that the IMF undertake a study of alternative techniques that would provide resources to deal with exceptional circumstances without involving an immediate increase in members' subscriptions, thus adding to the operational flexibility of the IMF.

88. The Deputies consider that the IMF should continue to implement the policies on the use of its resources in a prudent manner, and that a return to normal access policies is desirable. In this respect, they reaffirm that the policy of enlarged access is temporary, should continue to be phased down, and should be terminated as soon as the situation of external payments permits.

89. The Deputies reiterate the importance of effective conditionality in the implementation of IMF programs. They

stress the need for high quality and sufficiently comprehensive adjustment programs, including measures tackling structural problems, to be undertaken promptly in order to allow balance of payments difficulties to be dealt with quickly and effectively. The Deputies also see a need for a systematic examination by the IMF of the issues of prolonged use of its resources by some members and of the arrears it is owed. They consider that steps should be taken to deal with these problems.

IMF/IBRD cooperation

90. The Deputies note that, while the IMF and the IBRD share certain broad objectives and while their activities are closely interconnected, their functions differ. The Bank's responsibilities relate primarily to the provision of long-term finance to developing countries and the promotion of development, while those of the IMF are concerned with exchange stability, international payments, and balance of payments adjustment of industrial and developing countries. In the case of developing countries these functions are complementary, since macroeconomic balance is a precondition for growth and development, and over the longer run, project and sectoral efficiency and realistic investment priorities can be crucial to sustained balance of payments adjustment. Coordination between the two institutions is therefore essential to ensure the effective achievement of their common objectives, but it needs to be based on their separate responsibility for implementing the several tasks entrusted to each.

91. The Deputies agree that there is considerable scope for closer cooperation between the two institutions. The main purpose of such cooperation should be to ensure that their financing programs provide a comprehensive and mutually supporting approach to countries' adjustment problems and that they provide consistent policy advice. This would increase the effectiveness of both institutions and enhance the prospects for increasing private investment flows to developing countries.

92. The Deputies emphasize that the two institutions have different mandates, functions, financial structures and expertise, and that these should be preserved. In particular, the strengthening of cooperation should not be in the direction of transforming the IMF into a channel for long-term finance or of shifting the IBRD away from its primary focus on development financing. The Deputies agree that improved cooperation between the two institutions does not require institutional changes, formal rules or rigid procedures. Several operational proposals were examined by the Deputies in this connection. They recommend that the implementation of these proposals should be considered by the Executive Boards of the two institutions.

93. A first group of proposals concerns ways to achieve closer contacts and exchanges between the two institutions at both Management and Staff levels. In particular, representatives of one institution could attend Board meetings of the other when the discussion concerns countries where both institutions have programs; staff of one institution could participate in the missions of the other;

and, more generally, the two institutions could maintain a continuous exchange of information on country analysis and their activities. On occasion, joint meetings of the two Boards or joint seminars or working groups on topics of common interest could be held. Finally, the pooling of some facilities, notably training activities, research programs, and data bases, as well as local representation, could be considered.

94. A second group of proposals addresses the need to ensure greater consistency in program objectives and instruments. In this regard, the Deputies stress that it is important for the two institutions to contribute, each from its own standpoint, to a consistent assessment of medium-term projections of external financial positions and economic developments and policies. In this context, greater coordination of the financial support provided by the two institutions should also be sought, particularly where a reduction in access to IMF credit might be accompanied by appropriate forms of increased IBRD lending.

95. Finally, as regards the IBRD's activities, the Deputies note that while program lending will continue to increase, primary emphasis must remain on project lending. They stress that the conditionality of IBRD lending should not be weakened. At the same time, they believe that the IBRD should be more active in encouraging external finance for investment, supporting medium-term structural adjustment, and enhancing its role as aid coordinator in developing countries.

CHAPTER VI SUMMARY AND CONCLUSIONS

General considerations

96. The Deputies have conducted a thorough review of the international monetary system, with the aim of identifying the areas for progressive improvements in its functioning. Their review has focussed in particular on the exchange rate system, international surveillance, international liquidity, and the role of the IMF.

97. The Deputies have concluded that the basic structure of the present system, as reflected in the Articles of Agreement of the IMF, has provided the essential flexibility for individual nations and the international community as a whole to respond constructively to a period of major adjustment to global change. They agree that the fundamental approach of the Articles remains valid and that the key elements of the current international monetary system require no major institutional change.

98. The Deputies recognize, however, that the international monetary system has also shown weaknesses and that there is a need to improve its functioning in order to foster greater stability by promoting convergence of economic performances through the adoption of sound and compatible policies in IMF member countries. The conclusions of the Deputies are based on this approach

and call for enhanced cooperation and a stronger role for the IMF.

The exchange rate system

99. The Deputies agree that the present exchange rate system based on the floating of key currencies has shown strengths but also weaknesses. Flexible exchange rates among the major currencies have made a positive contribution to the adjustment process and to the maintenance and growth of international trade and payments in a difficult global environment. However, there have been both a high degree of short-term volatility of nominal exchange rates and large medium-term swings in real exchange rates due mainly to unsound policies and divergent performance, as well as to adverse external developments. The Deputies agree that such conditions are a potential threat to the open trading and payments system, and that greater exchange rate stability is desirable.

100. The G-10 Ministers and Governors have already concluded that a return to a generalized system of fixed parities is unrealistic at the present time. In the view of the large majority of the Deputies, the adoption of alternatives to a system based on the floating of key currencies is unrealistic under current and foreseeable circumstances. All Deputies agree, however, that improvements are needed in the functioning of the present system.

101. While their study of the functioning of the exchange rate system has focussed primarily on the objective of achieving greater stability among the floating currencies, the Deputies are fully aware that attempts to maintain exchange rates at levels not in line with economic fundamentals and market forces can be very damaging, both to the countries concerned and to their trading partners. They have expressed their strong support for efforts regularly made by the IMF to persuade countries to adopt realistic exchange rate policies.

102. The Deputies agree that the achievement of greater exchange rate stability would require close and continuing cooperation among major countries. In particular, they emphasize the following:

- (i) an essential condition of exchange rate stability is convergence of economic performance in the direction of sustainable non-inflationary growth;
- (ii) this in turn requires not only sound, consistent policies, but also the removal of artificial barriers and structural rigidities which inhibit market flexibility;
- (iii) the international implications and interactions of domestic economic policies should be given close attention in the domestic policy-making process and in international consultations;
- (iv) a wide range of factors, including developments in exchange rates, fiscal and monetary policies, structural rigidities, and barriers to international trade and capital flows should be taken into account

in determining the need for consultations and policy discussion;

- (v) the role of exchange market intervention can only be a limited one, as intervention will normally be useful only when complementing and supporting other appropriate policies. However, intervention can be useful to counter disorderly market conditions and reduce short-term volatility. Countries should be willing to undertake coordinated intervention on occasions when it is agreed that it would be helpful.

103. Some Deputies have proposed the introduction of target zones for exchange rates as more formal and binding indicators for the conduct of macroeconomic policies, maintaining that convergence of economic performance, while necessary, may not always be sufficient to achieve lasting exchange rate stability. Some other Deputies recognize there could be merits in this proposal and suggest that the technical aspects of a target zone approach should be further explored at an appropriate time. The majority of the Deputies, however, consider that such a move would be undesirable and in any case impractical in current circumstances.

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Surveillance

104. In considering ways to promote the convergence of economic performances towards sustainable non-inflationary growth through the adoption of sound, compatible policies, the Deputies have agreed that surveillance, especially by the IMF, is the basic tool for

moving toward these objectives. They recall that the amended Article IV of the Articles of Agreement gives the IMF increased responsibility to exercise firm surveillance over the exchange rate policies in order to ensure that members fulfil their obligations inter alia to:

- (i) pursue economic and financial policies aimed at orderly economic growth with reasonable price stability;
- (ii) foster underlying economic and financial conditions that do not tend to produce erratic disruptions;
- (iii) avoid manipulating exchange rates or the international monetary system to prevent effective balance of payments adjustment or to gain an unfair competitive advantage.

105. For this purpose, the IMF has developed principles and procedures for surveillance which have been implemented and evolved over time. The Deputies recognize, however, that it would be necessary to strengthen the substance and procedures of surveillance to maximize its potential usefulness. To this end they suggest that:

- (i) the surveillance process should involve the senior level in governments in order to have an impact on policy-making;
- (ii) possibilities for public scrutiny playing an increased role in the surveillance process should be explored;

- (iii) governments should be more ready to take other countries' advice into account, and the policy discussions of the surveillance process should allow greater emphasis on the international interaction and repercussions of policies, the working of the international adjustment process, and the progress of convergence of economic performances of major countries.

106. The Deputies recommend that the IMF consider the following steps to strengthen surveillance:

- (i) increasing the ability of the Managing Director and the staff to bring international concerns to the attention of members by the following measures:
 - (a) a confidential exchange of views between the Managing Director and the Finance Minister should be envisaged at the end of the consultation process in the case of industrial and developing countries whose policies and performance are of greatest concern for the world economy;
 - (b) participation in Article IV consultation should be at an appropriate high level, and the IMF report and summing-up should be brought to the attention of key economic policy-makers;
- (ii) making more candid assessments and proposals for policy changes and, when necessary, follow-up reports to the Executive Board on actions taken by the member to respond to IMF suggestions;

- (iii) broadening the scope of Article IV documents to provide certain additional information and analysis;
- (iv) making greater use of the supplemental surveillance procedures in the face of exchange rate and other developments that may be important or may have important effects on other members, or that have implications for the operation of the international monetary system. The Deputies invite the IMF to review the relevant decisions for invoking these procedures;
- (v) continuing to develop "enhanced" surveillance procedures to be applied on a case-by-case basis at the request of members, with the aim of facilitating non-IMF financing in connection with multi-year debt rescheduling or in cases where IMF assistance and advice would improve the member's limited access to external finance.

107. The Deputies have agreed that new arrangements for multilateral surveillance should be introduced to promote greater consistency of policies among countries in order to provide the basis for greater exchange market stability. They recommend that:

- (i) the IMF periodically prepare as a special chapter of the World Economic Outlook (WEO) an expanded analysis of the international repercussions of national policies of G-10 countries and of their interaction in influencing exchange rate developments and international adjustment;

- (ii) the G-10 Ministers and Governors contribute to the process of multilateral surveillance by cooperating with the IMF in reviewing, under appropriate procedures, the policies and performances of G-10 countries as well as the policy recommendations of the special chapter of the WEO.

International liquidity

108. The Deputies have concentrated their attention on the supply and distribution of international liquidity by international capital markets and official channels. They have agreed that the liberalization and integration of national capital markets have permitted a significant increase in international capital flows and enhanced the ability of creditworthy countries to meet their financing needs, although some countries continue to have little or no access to capital markets. While creditworthiness of borrowers will continue to be the principal factor in determining access to financial markets, the Deputies recognize that the availability and cost of liquidity are also affected by factors such as interest rates and credit policies in major countries. The combination of these factors does not necessarily ensure that the requirements of the international monetary and financial system are met.

109. In order to improve the stability of the international monetary system, the Deputies have agreed that it would be desirable to avoid excessive swings in the

availability of liquidity. To this end they have reached a consensus on the need:

- (i) to improve the creditworthiness of debtor countries by encouraging economic adjustment;
- (ii) to improve IMF surveillance over the policies of countries which affect the availability and terms of credit in international financial markets; such surveillance is an integral part of the broad surveillance process on exchange rate policies and should be implemented in a closely integrated manner with other aspects of surveillance;
- (iii) to deregulate further capital markets and liberalize capital movements;
- (iv) for monetary authorities to pay due regard in the monitoring process of international banking activities to possible macroeconomic consequences of prudential measures;
- (v) to maintain the ability of the IMF to respond to systemic liquidity problems;
- (vi) to provide official finance on appropriate terms to developing countries which, despite adjustment efforts, lack sufficient access to capital markets.

110. The Deputies have reviewed the role of the SDR. They recognize that the international monetary system has changed considerably since the original creation of the SDR scheme and that this has affected the rationale for

the SDR, including the objective of placing the SDR at the center of the system as the main reserve asset.

111. The Deputies have discussed both normal SDR allocations and other ideas for developing the SDR, but found no consensus within the Group on any specific proposal. However, they recognize that the SDR may still have a useful role in meeting the long-term global need for reserves and in this context in providing a safety net for future contingencies. In these circumstances, the Deputies support the intention of the IMF Executive Directors to carry out a comprehensive review of the future role of the SDR in the system.

The role of the IMF

112. The Deputies recognize that the IMF has played a vital role in promoting international financial stability and external adjustment. They stress the need to safeguard its monetary character and the revolving nature of its financing, as well as the importance of keeping it as a quota-based financial institution and its lending normally in line with quota resources. They also stress the need to continue to phase down the policy of enlarged access and to terminate it as soon as the situation of external payments permits, and to deal with the problem of prolonged use and arrears.

113. The Deputies underline that the IMF conditionality plays an essential role in encouraging adjustment and the

restoration of creditworthiness. They stress the importance of maintaining the effectiveness of conditionality in order for the IMF to promote sound conditions in the world economic and financial system. They also stress that IMF credit should be available on a sufficient scale to provide meaningful support to members and to serve as an important catalyst for other lending by providing confidence that the borrower is pursuing sound policies.

114. The Deputies agree that, barring unforeseen circumstances, the recent increase in IMF quotas and the enlargement and expansion of the GAB provide the institution with an adequate basis to fulfil its responsibilities over the next few years. However, they recognize that negotiations on quotas and borrowing arrangements are complex and time consuming. They therefore suggest that the IMF undertake a study of alternative techniques that would provide resources to deal with exceptional circumstances without involving an immediate increase in members' subscriptions, thus adding to the operational flexibility of the institution.

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115. Finally, the Deputies recognize that a number of countries are facing both macroeconomic and structural difficulties which result in balance of payments problems, and that cooperation between the IMF and the IBRD should therefore be strengthened to address these problems in a coordinated manner, without jeopardizing the unique purposes of each institution. They recommend that the Executive Boards of the IMF^H and the IBRD continue their efforts to ensure that policy advice and the provision of

financial resources by the two institutions be coordinated more than in the past, particularly where a reduction in access to IMF credit might be accompanied by appropriate forms of increased IBRD lending. The Deputies have also reviewed a number of specific proposals and recommend that they be submitted to the Executive Boards for consideration.

ANNEX

MEMBERS OF THE GROUP OF DEPUTIES (1)

<u>Chairman:</u>	Lamberto Dini	Bank of Italy
Belgium:	R. Lauwerijns G. Janson	Ministry of Finance National Bank of Belgium
Canada:	B. Drabble A. Jubinville	Department of Finance Bank of Canada
France:	D. Lebègue J. Waitzenegger	Ministry of Economy, Finance and Budget Bank of France
Germany:	H. Tietmeyer L. Gleske	Ministry of Finance German Federal Bank
Italy:	M. Sarcinelli R. Masera	Ministry of the Treasury Bank of Italy
Japan:	T. Oba S. Ogata	Ministry of Finance Bank of Japan
Netherlands:	P. Korteweg A. Szasz	Ministry of Finance Netherlands Bank
Sweden:	E. Åsbrink K. Eklöf	Ministry of Finance Bank of Sweden
Switzerland:	D. Kaeser H. Meyer	Department of Finance National Bank of Switzerland
United Kingdom:	J.G. Littler A.D. Loehnis	H.M. Treasury Bank of England
United States:	D.C. Mulford H.C. Wallich	U.S. Treasury Department Federal Reserve System

Representatives of International Organizations

International Monetary Fund:	W.O. Habermeier Wm.C. Hood
Organization for Economic Cooperation and Development	D. Henderson
Commission of the European Communities:	M. Russo
Bank for International Settlements:	H. Bockelmann

Secretaries

P. Atkinson (OECD)
G. Baer (BIS)
G. Taplin (IMF)

Assistants to the Chairman

F. Saccomanni (Bank of Italy)
S. Micossi (Bank of Italy)

(1) The following officials, who were Deputies at the time, participated in some of the meetings: Mr. Kestens (Belgium), Mr. Bussièrès (Canada), Mr. Camdessus (France), Mr. Lefort (France), Mr. Languetin (Switzerland), and Mr. Sprinkel (United States). Mr. Lamfalussy was the BIS representative at most of the meetings.