

**FOR
AGENDA**

EBS/86/127
Correction 2

CONFIDENTIAL

June 25, 1986

To: Members of the Executive Board
From: The Acting Secretary
Subject: Indicators Relating to Policy Actions and Economic Performance

The following correction has been made in EBS/86/127 (6/12/86):

Page 19, 4th full para., line 1: for "and inflation rates"
read "and exchange rates"

A corrected page is attached.

Att: (1)

whether economic developments are following their anticipated path during the interval before measures have their effect on ultimate objectives. Intermediate variables can also be used to identify emerging problems of international consistency of policies.

(a) Interest rates and exchange rates

An important channel by which policies influence ultimate economic objectives is through their effect in conditions in financial markets. In this connection, a key role is played by money and capital markets and the foreign exchange market. It is therefore of considerable interest to monitor developments in interest rates and exchange rates.

With regard to interest rates, a major determinant of the incentive to save or invest is probably the level of the real interest rate. Notwithstanding the fact that inflationary expectations can only be measured indirectly, it nevertheless seems desirable to use some estimate of the real interest rate as the primary indicator for monitoring purposes. A helpful approximation in this connection, that is generally not seriously misleading, is to deduct from the nominal interest rate the rate of change in the GNP deflator over some recent period. While the level of real interest rates is of importance as an indicator of the incentive to save and invest, it is less significant than interest differentials in determining incentives to capital movements, and therefore exchange rate pressures. In monitoring real interest rates, it is therefore necessary to pay attention to international differentials in rates as well as to absolute levels.

As far as exchange rates are concerned, the indicator that is most relevant for purposes of international competitiveness and adjustment is the real effective exchange rate. This can be obtained by combining a measure of the nominal effective exchange rate (using currency weights derived from, say, the Multilateral Exchange Rate Model) with a relative inflation estimate from the inflation indicator described above.

Since both interest rates and exchange rates are intermediate variables, it would be unrealistic to expect policy authorities to prescribe in advance any precise path for their expected evolution. Nevertheless, to the extent that the analysis of other indicators reveals underlying disequilibria in foreign exchange and capital markets, this analysis could signal the direction of possible changes in interest and exchange rates.

(b) Saving and investment balances

As already implied, movements in interest rates and exchange rates are in turn influenced by underlying shifts in domestic saving

and investment. Indeed, it is movements in interest and exchange rates that give causal content to the identity that makes the current account of the balance of payments equal to the domestic savings minus domestic investment.

Any ex ante inconsistency at the global level between countries' balance of payments objectives or forecasts must be reflected in a similar global inconsistency between projected saving and investment trends. It may therefore be useful to keep track of actual or expected trends in savings and investment, in order to provide advance warning of possible inconsistencies. As noted earlier, the aggregate saving/investment balance of a country can be divided into the balance attributable to the public sector and that attributable to the private sector. The financial position of the public sector is, of course, the fiscal balance and has been discussed above. This can be complemented, for analytical purposes, with supplemental indices of saving and investment in the private sector.

V. Procedures for Using Indicators in Surveillance

The use of indicators to facilitate discussion of international economic interactions has two aspects beyond the development of an analytical framework and the definition of a set of indicators to be used. These additional aspects are: (i) the establishment of procedures that allow indicators to be monitored effectively, both at the initial stage when objectives are being set and subsequently when performance is being assessed; and (ii) the devising of criteria that would help the international community decide when given developments are a matter of concern.

The present paper does not seek to fully resolve these issues. To some extent, it can be expected that the way in which indicators are used will evolve over time, through the accumulation of theoretical and empirical evidence, as well as through experience with their practical application in surveillance. The suggestions made in this section should therefore be seen as preliminary, designed to launch an exercise in the more systematic use of indicators, rather than as a firm set of proposals. The suggestions themselves relate to ways in which indicators might be used in surveillance undertaken by the Fund. They do not address directly the questions of how indicators would be used in other forums, such as those referred to in the Tokyo declaration. Nevertheless, the procedures described below could, if desired, be adapted to these other contexts.

1. Procedures for monitoring indicators

Discussions on the role of Fund surveillance have sometimes drawn a distinction between Article IV consultations, undertaken with all