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**Statement by Mr. Djojosubroto on Methodology for Current Account and Exchange Rate Assessments (Preliminary) Executive Board Meeting 01/62 June 15, 2001**

There is no doubt that a formal analysis based on the methodology used for the industrial country assessment exercises does have the merit of at least imposing an important degree of rigor in the assessment of possible tensions among currencies. Indeed, as part of the early warning system, it is useful to have a technique which can highlight cases where the exchange rates appear to be substantially out of line with macroeconomic fundamentals. Staff should certainly be commended for their efforts not only in developing the methodology but also in using other methods as well to compare the findings. While the congruence of findings from different studies does not guarantee that the findings are correct, it is still helpful, particularly if the different methods can help shed light on aspects that are not covered by the macroeconomic balance framework used by the CGER. Nevertheless, as staff have also admitted, the margin of error can be substantial in view of the strong simplifying assumptions behind the model and staff admit on page 49 that "a number of factors important in assessing medium term sustainability are precluded".

Since the main objective of this exercise to identify whether exchange rates are out of line with economic fundamentals is to provide an early warning of vulnerabilities to crises, it is important to ask ourselves whether the variables used to assess misalignment are in fact the best predictors of crisis? Looking back at the experience of the Asian crisis, many would admit that the episodes showed clearly that the *composition* of debt and reserves was at least as important, if not more important, factor than the *level* of debt and reserves in assessing vulnerability. This is one important weakness in the methodology employing the macroeconomic balance framework. Furthermore, in the present environment where the amount of portfolio capital that is shifted between countries can far outweigh the trade flows and have a significant impact on the exchange rate and market participants base their currency positions more on "technical analysis" than on macroeconomic fundamentals, the *relevance* of the CGER approach may perhaps be questionable, especially for developing countries.

In terms of transparency, the CGER approach may not score that high as a large element of judgment is involved. Where the exchange rate is found to be 10-15 percent out of sync with the "equilibrium exchange rate" it is still a matter of judgment, albeit informed judgment, if area department staff do have good and timely data, whether the misalignment called for policy action or whether it was due to structural factors which were not taken into account by the methodology. As acknowledged in the paper, it is often easy on hindsight and not apparent at the time of the assessment that the so-called misalignment was in fact not a misalignment but a reflection of structural change. In those cases, the call for a particular course of action may in fact become a self-fulfilling prophecy. This impact would be more poignant in the case of developing countries which have limited access to the international capital market. While staff have argued that this is true only for the short run and not the medium term, the fact remains that this short run may be long enough in certain cases to wreak havoc in those countries. Hence, while we consider the CGER assessment as a useful complementary tool as part of the early warning system, we would still advocate that the CGER keeps the Board informed of its assessments but that these should still be considered highly confidential. In addition, if staff are provided with these assessments when they go on Article IV surveillance missions, staff should be more transparent and provide the authorities with these assessments so that both parties can have a more open and informed discussion on the realism of the assumptions and the interpretation of deviations from the medium term equilibrium level as this will differ depending on a country's stage of development, cyclical considerations and the appropriateness of the country's policy response.

The simplifying assumptions of the CGER methodology are not entirely appropriate even for developed countries but the problem is compounded in the case of developing countries. One very basic problem would be the lack of data as well as its quality. If this were the main problem, the solution would be relatively simple in the sense that staff could begin with the 22 countries referred to in footnote 39 and add other countries as data becomes available. However, a more fundamental problem is whether the existence of market imperfections in developing countries is so significant as to raise doubts on the appropriateness of the model. The capital markets in developing countries are largely underdeveloped, their access to the international capital market is limited and many are still in the process of important structural transformation, including the development of a strong and modern banking system. Since structural change significantly affects the position of the S-I curve and differences in the composition of debt, reserves and net foreign liabilities may be more important than the levels of these variables, perhaps stress tests to take into account varying levels of access to capital markets, projected levels of current account deficit, capital flight and so on might be more useful as the identification of major liquidity risks is more important for developing countries. However, in view of differences in microeconomic conditions across countries and the importance of monitoring external vulnerability, it is still useful to conduct these assessments in the context of a medium term scenario. Hence, it would be useful for staff to adapt the methodology that they have used for industrial countries by using the four criteria suggested in the paper and to provide a comparison of this assessment against that used for industrial countries so that Board members can evaluate if the assessment is a good complement to the use of macroprudential indicators as part of the early warning system. Nevertheless, in view of the sensitivity of these findings and the large scope for differences of interpretation of results, we feel that these findings should still be treated as preliminary work and should be kept confidential and be reserved for the information of the Board.