

SM/01/152
Correction 1

June 14, 2001

To: Members of the Executive Board
From: The Secretary
Subject: **Methodology for Current Account and Exchange Rate Assessments**

The attached corrected pages 25 and 26 of SM/01/152 (5/24/01) are being reissued to include the last three lines of footnote 24, which were inadvertently omitted, and to include the overflow of text.

Att: (2)

Other Distribution:
Department Heads

39. The changes in the norms from one year to the next, as derived from equation (2), reflect the changes in actual (or projected) levels of structural fiscal balances and potential output (cyclically-adjusted income) per capita. In the United States the gradual upward trend (decline in the norm deficit) during the 1990s mainly reflects an improvement in the public sector's structural budget position. In Japan the time profile of the norm reflects the widening of structural fiscal deficits and relatively slow growth of potential output during the 1990s, along with the projection for a gradual reduction in the structural fiscal deficit during the five years ahead. For the Euro Area the norm has been constructed by aggregating estimates for the individual member countries, with an adjustment to account for temporary effects of German unification in the early 1990s. For most of the other countries except Switzerland, the variation in the norms primarily reflects changes over time in relative structural fiscal balances. For Switzerland, the downward trend in the norm mainly reflects the relatively slow growth of potential output per capita.

40. The simple structure of the equation used to calculate the S-I norms is one of the reasons that CGER's assessments should be viewed as imprecise.²⁵ This confronts CGER and area departments with the challenge of continuing their efforts to generate improved econometric estimates of S-I behavior for the industrial countries in general, and to take account of specific factors or structural changes that may have major influences on S-I behavior in individual countries.²⁶ To a large extent, however, the general levels of the S-I norms reflect the average historical values of the S-I balances and would probably not be much affected by more sophisticated explanations of the observed data. Thus, the main message that emerges from recent CGER assessments—that the U.S. dollar is considerably stronger than its medium-run equilibrium level—would probably not be altered substantially by a more sophisticated explanation of the historical behavior of the S-I balance for the United States.

Multilateral exchange rate calculations

41. Step three of the process calculates the direction and magnitude of the implied exchange rate changes that, assuming no changes in policies or other variables, would bring currency values in line with medium-term fundamentals. This section highlights aspects of

a higher surplus for Denmark and lower deficits in the other two cases) to avoid discontinuities on the occasion of shifting the calculations to updated estimates of the S-I equation.

²⁵ Such oversimplification limits the usefulness of the macrobalance approach as a normative tool, just as the usefulness of a PPP-based assessment for normative purposes is limited by sensitivity to the type of price index and averaging period chosen.

²⁶ Krajnyak (2000) has developed a portfolio allocation model of S-I behavior for Switzerland.

the analytical framework that are relevant for the interpretation of these calculations and also describes the treatment of the global discrepancy.

42. As noted above, the UCUR line in Figure 4 is negatively sloped to reflect the presumption that a lower real effective exchange rate is associated with an improvement in the current account over the medium term. In the logic of CGER's WEO-based assessments, the position of the UCUR line is assumed to reflect the projected values of economic variables at the end of the 5-year WEO horizon, when output is at potential and the lagged effects of past exchange rate changes have been realized. Thus, *projected* changes in economic fundamentals, including effects of announced policy changes, are already reflected in the position of the UCUR line. By contrast, any *unanticipated* changes in relevant economic variables over the WEO horizon, including changes that arise from unanticipated policy actions, would shift the position of the UCUR line.

43. The vertical S-I line in Figure 4 shows the normal level of the saving-investment balance determined in step two. The line is vertical because the normal level of the S-I balance (at potential output) is assumed not to depend on the exchange rate.²⁷ Its position, like that of the UCUR line, reflects the projections for relevant economic variables (in this case, per capita income levels and structural fiscal balances) at the end of the medium-run WEO horizon.

44. Given the initial real exchange rate (R_1) and underlying current account position ($UCUR_1$), the amount of exchange rate adjustment that is needed to equilibrate the underlying current account with the equilibrium S-I balance depends on the slope of the UCUR line. The assumptions on which the calculations are based (see below) imply that the slope of the UCUR line depends on the openness of the economy. Countries with relatively high ratios of exports and imports to GDP have relatively flat UCUR lines and require smaller percentage changes in their real exchange rates, other things equal, to achieve given changes in their trade volumes or underlying current account positions (as shares of GDP).

45. Unexpected changes in economic fundamentals—that is, deviations from the changes projected in the WEO—can shift the position of either the vertical S-I line or the negatively sloped UCUR line and thereby alter the real effective exchange rate that is consistent with medium-run fundamentals. For example, a greater-than-projected increase in (relative) per capita income or the (relative) structural fiscal surplus will shift the S-I line in Figure 4 to the right, implying a lower medium-run equilibrium level of the real effective exchange rate. The size of the implied change in the equilibrium exchange rate will depend on the extent of the shift in the vertical S-I line and on the slope of the UCUR line. Shifts in the position of the UCUR line (due to unexpected changes in medium-run fundamentals that affect the current account through channels other than real exchange rates) also change the equilibrium level of the real effective exchange rate that is consistent with medium-run fundamentals, but they do

²⁷ As noted earlier, this simplifying assumption could be relaxed in principle (implying a non-vertical S-I line), for example to recognize the phenomenon of “Dutch disease.” However, the simplifying assumption is consistent with many other empirical models of saving and investment behavior.