April 8, 1987

To: Members of the Executive Board

From: The Secretary

Subject: Final Minutes of Executive Board Meeting 86/114

The following correction has been made in the final minutes of EBM/86/114 (7/14/86):

Page 53, last para., line 4: for "to measure inflationary expectations, and"

read "to measure an expected rate of inflation and".

A corrected page is attached.

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indicator of domestic economic performance. He agreed with the staff that it should be supplemented by a systematic presentation of developments and prospects concerning final domestic demand. The staff seemed to believe that the potential growth rate of an economy also should be an indicator of performance, but it was important to remember that a precise estimate of the potential growth rate of an economy was difficult to make, and that the productive potential of an economy tended to be overestimated when the economy was in the process of structural change. In addition, it was difficult to judge the appropriate speed at which the gap between existing and potential output should be closed; in making that judgment a variety of factors, including the risk of emerging bottlenecks in some sectors of the economy and the limitations of policy instruments, should be taken fully into account. Although it was not included in the list of indicators on page 25, the rate of unemployment would be a significant indicator.

As to inflation, the key objective from a domestic standpoint was stability in consumer prices, and his authorities believed that the consumer price index was an important performance indicator in the context of international surveillance, Mr. Fujino remarked. Timely data on the consumer price index were usually available. His authorities shared the concern that had been expressed by Mr. Lankester concerning the drawbacks of using unit labor costs, and such costs should not be a central indicator of inflation.

In its discussion of indicators for the balance of payments the staff seemed to have placed excessive emphasis on the current account position, Mr. Fujino commented. Since the effects of capital flows on exchange rate movements had become significant, a more balanced analysis of balance of payments statistics, including the capital account, seemed to be appropriate. In developing an analytical framework for the balance of payments, the staff should look not only at the data for the major industrial countries, but also at the data for the rest of the world; a balance of payments position could not be judged solely on the basis of bilateral comparisons. In addition, as Mr. Polak had noted, statistical discrepancies in the balance of payments across the membership had amounted to about $100 billion in 1984, roughly equivalent to the size of the U.S. current account deficit in that year.

Commenting on the so-called intermediate variables, Mr. Fujino said that the possibility of relying too heavily on real interest and exchange rates as quantitative indicators should be approached with caution. It was difficult to measure an expected rate of inflation and in certain circumstances capital flows were induced by the level of nominal interest rates or nominal interest rate differentials. In his view, the nominal rates should be the central indicator of interest rates; they could be supplemented by real interest rates as needed. Nominal exchange rates should include nominal bilateral rates as well as nominal effective rates. The Fund should be certain that the authorities did not typically set targets for those intermediate variables and that it was impossible to make projections of those variables. The published version of the world economic outlook paper should not give any direct or indirect market-sensitive information on projected movements of exchange and interest rates.

The staff paper seemed to suggest that an analysis of interest and exchange rates could show the direction--not the precise path--of their expected evolution, Mr. Fujino remarked. That conclusion was correct when large disequilibria had persisted for a long time. In other circumstances, it would be difficult or even dangerous to indicate the direction in which the rates were likely to move. For example, once adjustments had started to occur, it would be extremely difficult to send a signal regarding even the direction of the adjustments, because the Fund would have to judge the appropriateness of the speed of the adjustment.

The function of interest and exchange rates as intermediate variables was significant, and he did not agree with the suggestion that it would be useful to monitor domestic savings and investment as intermediate variables, Mr. Fujino commented. If it was not sensible to use the external current account position as an intermediate variable, it was by definition not useful to use the savings and investment balance as an intermediate variable.

Mr. de Groote remarked that Mr. Lankester and Mr. Fujino had clearly spelled out the views of their authorities on policy indicators. While Mr. Lankester had criticized the staff's approach, he himself felt that the staff's proposals were on the right track. Making domestic financial stability the sole important indicator for assessing the validity of the major countries' policies, as Mr. Lankester had suggested, would run the risk of narrowing the exercise of multilateral surveillance to an unfruitful discussion of relative price performances that would exclude the many factors that must be taken into account in judging the medium-term sustainability of balance of payments and exchange rate patterns.

The underlying reasoning of the U.K. authorities was best illustrated by their preference for nominal rather than real GDP as an indicator and by the difficulty they saw in including unemployment in a set of objective indicators for discussions on international adjustment, Mr. de Groote continued. Mr. Lankester's assertion that unemployment projections had no direct repercussions on the balance of payments seemed to disregard the possibility that a balanced current account that was accompanied by a poor growth and employment performance might well conceal the existence of a situation that was unsustainable over the medium term. That possibility was implicitly addressed by the Articles, which made the promotion of the high levels of employment and real income one of the original objectives of the Fund. The staff had made various welcome references to that fact in their attempt to identify areas of concern with respect to multilateral surveillance.

The staff and Mr. Lankester also disagreed on the appropriateness of explicitly introducing possible exchange rate patterns into the analytical framework for conducting multilateral surveillance discussions, Mr. de Groote remarked. During previous discussions on surveillance, he