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Statement by Mr. Ono on
A Methodology for Exchange Rate Assessment and Its Application in Fund Surveillance over Major Industrial Countries
(Preliminary)
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1. To begin I would like to stress that the issue of exchange rate misalignment is one of the most important issues in today's world of international finance, not only for major industrial countries, but also for developing and emerging economies. Therefore, we welcome the Fund's increasing emphasis on research in this area and find the staff's paper most interesting. Having said that, regarding the methodology introduced in the paper as well as the examples of its application in the context of Fund surveillance, I would like to make some reservations that the staff might take into account in its future work. More specifically, I would like to discuss the following four issues: the appropriateness of the level of exchange rates; macroeconomic policy as a tool to correct misalignment; the implication of the public announcement by the Fund; and the application of the CGER approach to developing economies' currencies.

Appropriateness of the Level of Exchange Rates

2. First, the policy implication of deviation from the equilibrium exchange rate derived from the methodology in the paper is not so clear to me. The equilibrium rate is basically a normative rate at which both internal and external balances are achieved simultaneously assuming that economies are at their potential growth rates. It is my understanding that the equilibrium rate does not necessarily assure us our major policy goals, such as non-inflationary sustainable growth. In other words, we can accomplish our important policy goals even under the deviation of an actual exchange rate from the CGER equilibrium rate.

3. To my mind, what is most important for the authorities to remember is not the extent of deviation from the CGER equilibrium rate, but how they accomplish their policy goals, such as sustainable growth or price stability, and what they can do if they are not sufficiently met. In that sense, my argument might be categorized in the third view on evaluating exchange rates summarized in Box 1 of the paper. For instance, in a case where monetary tightening and the resulting exchange rate appreciation are appropriate in an overheating economy, the extent of deviation from the CGER equilibrium rate cannot be so crucial in the decision making process. In practice, even in the CGER approach, although much emphasis is put on the measurement of the deviation from the medium-term equilibrium, the deviation

itself does not appear to have crucial meaning in the final step of judgmental assessment where cyclical and related monetary and financial conditions are primary considerations.

4. There is another doubt on the proposed CGER methodology. The staff paper states that, because of difficulties to precisely identify "equilibrium values", staff work has focused on identifying the inconsistency of exchange rates from medium-term fundamentals instead of searching for specific target rates. I find such an argument not fully convincing because, as far as the inconsistency from fundamentals is measured by the deviation from the target value, it cannot be immune to similar technical difficulties.

Macroeconomic Policy as a Tool to Correct Misalignment

5. Second, I wonder whether we should use macroeconomic policy as a tool to correct misalignment. Even if the equilibrium exchange rate derived from the CGER methodology has certain meaning as a reference point despite the problems I already mentioned, I do not think it is appropriate to allocate monetary or fiscal policy to correct the identified misalignment. The precise effect of monetary and fiscal policy on exchange rates is not identifiable in advance. Under such constraints, addressing macroeconomic policies primarily aimed at specific rates could undermine more important policy goals such as price stability. Macroeconomic policy, therefore, should have price stability and sustainable growth as its primary goals, while taking into account exchange rates as an important input to policy consideration. From such a perspective, in the case of the constellation of the US dollar, yen, and deutsche mark exchange rates in the spring of 1995, it seems it was inappropriate for the Fund to call for coordinated interest rate actions by the G3 in order to correct misalignment.

Implications of a Public Announcement by the Fund

6. Third, on the issue of the implication of a public announcement of the Fund's exchange rate assessment, I believe that its use should be limited. One reason being that, as I have explained, we had better be careful when using the CGER methodology for identifying misalignment. In addition, assuming the Fund's assessment is correct, the Fund's call for policy actions by the authorities through such an announcement could not be free from the risk of undermining the stability of exchange rates as well as the economies of concerned countries by inviting overreactions or speculation by markets. More importantly, given the Fund's influential status in the world of international finance, the public announcement of its assessment of exchange rate levels could deny the basic principle of the current flexible exchange rate regime which is "let the markets decide." In that sense, even when drafting the PIN for the Article IV consultation, due consideration should be given when trying to make an assessment of exchange rate levels.

Application of CGER Approach to Developing Countries' Currencies

7. Finally, I share the staff's view that the application of the CGER approach to developing economies' currencies should be limited, given that the model used in this approach assumes access to international capital markets, which is not always the case. Needless to say, assessing misalignment for developing economies' currencies is very important, but could be done by means of a more simple early warning system that monitors the deviation of real exchange rate movement from the trend. I also support the direction of ongoing work by the staff regarding the exchange rates of developing and emerging economies, including the analysis of possible problems in fixed exchange rate regimes and the related issue of exit strategy. Before concluding, I would like to stress that a public announcement of the Fund's assessment of exchange rate levels could cause more serious distortion in the developing economies whose foreign exchange rate markets are often less liquid and thin.