GRAY/97/369

October 24, 1997

Statement by Mr. O'Donnell and Mr. Kell on A Methodology for Exchange Rate Assessments and its Application in Fund Surveillance over Major Industrial Countries (Preliminary)
Executive Board Seminar 97/6
October 27, 1997

1. There is no question that the oversight of exchange rate policies remains at the core of the Fund's surveillance mandate. There should equally be no question that the Fund's surveillance of exchange rates must be underpinned by a rigorous, consistent and transparent framework. I am grateful for staff for their work, which clearly takes us forward in the assessment of "equilibrium" exchange rates. And I very much welcome the opportunity for this discussion--it is something for which this chair has called for a while.

2. There is no global shortage of analysis of exchange rates. So we need to be clear about the Fund's comparative advantage in this field. I would highlight two areas where the Fund has a comparative (and possibly absolute) advantage: the first is its near-universal multilateral perspective; the second is the blend of technical expertise and breadth of practical experience of its staff in the analysis of exchange rates. I think the approach outlined in the staff paper plays to both those strengths.

3. Before discussing the CGER methodology itself, one preliminary point prompted by Box 1 of the staff paper. I, for one, do not subscribe to the view that exchange rates are always appropriate given the current policy environment. Nevertheless, it is a useful discipline for the burden of proof to be on explaining why the market might be "wrong". In this context, it might be helpful to have a short paper rounding up the recent research which tries to explain, in terms of the micro structures of foreign exchange markets, why exchange rates can and do deviate from economic fundamentals. (There might also be some implications for policy.)

<u>The CGER Approach</u>

4. I basically agree with the CGER approach to assessing equilibrium real exchange rates, and I think the staff paper does a good job of explaining the approach. The macroeconomic balance approach, of which the CGER methodology is a variant, is clearly preferable to the main alternative of PPP. I find it intuitively plausible that the equilibrium real exchange rate can be explained primarily in terms of real economy "fundamentals", and that the equilibrium real exchange rate can change over time.

5. Against that background, it is not really surprising that there is little or no role for monetary factors in the CGER approach. The assumption of the neutrality of monetary variables over the medium to long run can of course be challenged, but is reasonable to my mind. Of course, as the paper makes clear, we do have to take account of cyclical factors, monetary policy, financial market developments and other "short term" considerations in thinking about the dynamics of exchange rates (real and nominal). But the CGER approach is essentially one of comparative statics, on which dynamics have to be "superimposed".

6. I think there are very good reasons for taking this approach, in terms of keeping the exercise transparent and tractable. But I was intrigued by the reference in footnote 50 on page 32 to an attempt to integrate short-run dynamics (via MULTIMOD) into the CGER framework. Since we cannot avoid undertaking this kind of exercise--either in our heads or on the back of an envelope--when coming to an overall view on whether exchange rates are misaligned or not, I can see merit in formalising this analysis, to make explicit our assumptions. I appreciate that integrating MULTIMOD and CGER, on a multilateral basis, would be a formidable and expensive operation; but I would be interested to hear staff's views on whether they think this ought to be considered for future work.

7. I have a number of other comments on specific aspects of the CGER approach. First, in estimating the underlying current account position, I agree that it makes sense to use two sources, namely desk economists and the RES trade model. Each has its advantages and drawbacks, as explained in the paper. But I wondered whether the trade model estimates could be improved by relaxing some of the cross-country restrictions, to allow for country-specific elasticities and dynamics. I appreciate that this would complicate, and possibly compromise, the multilateral consistency of the model's estimates; but is this an avenue worth pursuing?

8. Second, in the calculation of the Saving-Investment Norms, I was surprised that the proxy used for demographic structure was not explicitly forward looking. However, staff tell me that forward-looking demographic variables were found to be insignificant. But there could be a problem with the preferred variable to proxy the current demographic structure (ie, the ratio of young and old to those of working age). You could imagine two countries having the same ratio, but one with lots of young people and one with lots of old people and therefore with very different implications for the "normal" S-I balance. Do staff consider this possibility to be empirically important?

9. Third, I was a little confused by the use of "actual" structural budget positions in the calculation of S-I "norms". This would be inappropriate if a country's fiscal position was unsustainable. Staff do acknowledge this possibility, and I take their point that the use of actual budget positions is not meant to imply the budget position is "desirable". But a more systematic and transparent treatment of unsustainable fiscal positions may become more important if the CGER analysis was extended to a wider group of countries.

10. Fourth, I would also have welcomed more discussion of the uncertainty surrounding the estimates of "equilibrium" exchange rates. This is a key issue. I can see that the combination of different sources of uncertainty (eg, concerning trade elasticities and S-I balances) makes it very difficult to derive confidence intervals analytically; but is there scope for using simulations to get more of a handle on confidence intervals? I would be grateful for staff's views.

The Application of the Approach

11. I would definitely agree with the approach being applied to a wider set of Fund members. Indeed, while I do think that the Fund can and does add value to the (extensive) debate on G7 exchange rates, the Fund's value-added is likely to be greater in the analysis of other countries' exchange rates. Data problems and deficiencies might complicate the task, but should not be a reason for doing the analysis as best we can.

Publication Issues

12. I would certainly support the publication of this paper, perhaps with some supporting background papers. The CGER represents an important advance in the Fund's thinking on exchange rates, and we should expose this to outside scrutiny.

13. Concerning the numbers generated by the approach, we need to distinguish what information is made available to the Board, what is included in Article IV and program papers, and what is made public.

14. I believe that Board discussions of exchange rate issues would benefit from having more information on CGER assessments of equilibrium exchange rates, including some of the underlying numbers, along the lines of Tables 2 and 3 in the paper. Similarly, I believe that more Article IV papers should include a CGER assessment of exchange rate developments, perhaps referring to ranges rather than point estimates, and accompanied by the usual disclaimers about the limitations of the exercise.

15. How much of this kind of analysis is made public is a more sensitive and controversial issue. I can certainly see the potential risks in the Fund making a pronouncement that an exchange rate is significantly misaligned, particularly when markets are turbulent. There is of course the danger of self-fulfilling prophesy. But on the other hand, I believe, as a general rule, that the more information markets have, the better they will work. If Fund estimates of equilibrium exchange rates were made available on a regular basis-- perhaps in the WEO-- there would be less risk of the markets being surprised by the information at a difficult time. This objective may be some way off, but is worth considering.