GRAY/97/370

October 24, 1997

**Statement by Mr. Sivaraman 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**

The oversight over exchange rate policies of members is a key concern of this institution in its role to foster an orderly development in the international monetary system. Hence, there cannot be two opinions regarding the need for a continuous update on various instruments available with us to strengthen this particular function. At the same time, we equally recognize the difficulties associated with estimating the exact value of equilibrium exchange rates or even determining the misalignment amongst currencies excepting probably in the case of the industrialized countries where macro-economic parameters like interest rates, growth rates do not differ vastly and there is also a free convertibility.

2. I support the present policy of the Fund to avoid public pronouncement on exchange rates as it is bound to have repercussions in the market particularly because it may be treated as an oracular pronouncement when it comes from the Fund. Our responsibility is to only advise member countries to put in place strong macroeconomic policies to avoid undue volatility. I support CGER exercises especially to look for cases where exchange rates are way out of what can be considered as normal rate so that authorities can be adequately cautioned.

3. It is said that the daily turnover in the currency market is a multiple of the transaction in goods and services which clearly indicates the significant speculative activity in this area. Although it is our belief that exchange rates should adequately represent economic fundamentals, very often, they will be far removed from equilibrium norms due to speculative trading in currencies. The recent South East Asian currency crisis is a clear example on hand. In this paper, I could not find any reference to this big dichotomy in the absolute volume of currency trading and trade in goods and services which the former is supposed to subserve. How does this dichotomy affect exchange rate is not clear. Staff may please clarify.

4. With reference to the estimation of each country's underlying current account position, the research department standard trade model is a simple structure and employs common conclusions, specification and parameter values across countries. The limitations of this model, as explained in para 29, clearly indicate the reasons for the divergence between the actuals and the estimates at arrived using this model. As this exercise is based on assumptions

which are removed from actual situation, no doubt the results do not correspond with actuals. I think any exercise to determine misalignment has to start from the point of an equilibrium rate of exchange which again is difficult to estimate. Probably one can estimate it only by intuitive reasoning based on judgement. But then, the problem is that of the base date of estimation. In the case of economies which are undergoing changes, and are growing fast, the structure of the economy will change rapidly; so will its price structure. It will be difficult to take account of movements in prices over time to construct a composite index and to estimate the real effective exchange rate for checking misalignment. I can appreciate the difficulties of economists and econometricians as ultimately it may be the case of chasing the will o' the wisp. You are there you can see it, but you cannot grasp and hold it.

5. With reference to cyclical and related monetary and financial conditions to explain exchange rate misalignments, staff has suggested in para 49 that an overvaluation of country-one's currency (vis-a-vis currency two) by ten or fifteen percent relative to estimates of its medium run equilibrium position would probably be interpreted as a normal and desirable reflection of cyclical conditions, rather than as an indication of exchange rate misalignment. But on the same note, the under evaluation of currency by 10 or 15 percent would raise serious concerns about a possible exchange rate misalignment. While the rationale for this asymmetry is somewhat understandable, how the staff came to this quantification is not clear and staff comments are welcome.

6. Another issue that I want to raise here is how much the circulation of currencies in the world market influence exchange rate; for example, a large proportion of US currency issued is held by outsiders. The Indian authorities believe that their currency is not tradable as there is no full convertibility but the reality is that it is freely exchangeable in many markets of the world. The exchange rate is different than the accepted market rate. Is the market exchange rate influenced by these factors?

7. I am not able to comprehend what has been stated in para 6 *"large interest rate differentials may indicate a need for policy adjustment - for example, when they reflect market concerns about fiscal imbalances - but such situations should not be regarded as serious misalignments when countries' macroeconomic policies are fundamentally sound"*.

8. I wonder whether a situation of fiscal imbalance can co-exist with macroeconomic policies which are fundamentally sound. One would expect not!

9. While the complex CGER and RES exercises could be useful tools for academicians to play with, in a situation where exchange rates are fluctuating from hour to hour and day to day, driven by forces unleashed by currency traders who rely more on their intuition, rather than econometrics, how far they are going to help in policy formulation is a big question. I think for this purpose we have to look at the trend in the movement of the exchange rate of the country's currency via-a-vis its trading partners if it is in a free float. It is only the trend movement when interpreted in the light of economic policies and other macroeconomic parameters can throw light on misalignment with other currencies. Where the exchange rates

are managed, it has to be examined in the light of authorities decisions over a period in regard to the exchange rate of the currency.

10. Overall, in my view, I see no single tool which enable us to come to a conclusion about the exchange rate of a currency. All these factors have to be looked at together to arrive at a judgement. Experts in this area on such an examination would definitely be able to say the extent of misalignment and corrections required. Like in other areas, one has to take some chance here.

11. In regard to the specific issues for discussion, I agree that the IMF should seek continuously to strengthen its analysis of exchange market developments. I have already commented earlier about my views on the ways of determining exchange rates. Our efforts would be only to find out on the basis of the movement of exchange rate of a currency over a period of time via-a-vis its trading partners the extent of its misalignment so that macroeconomic policies can be adjusted to correct fluctuations.

12. As regards the complicated CGER exercises, which has focused on the exchange rates of major industrial countries, I have my doubts whether this will have any utility in regard to other developing countries. In the case of the developed countries, there is a convergence of major economic policies and a serious attempt is made to correct deviations. There is hardly any such exercise carried out in regard to other countries even though some of them may have full convertibility and others free float but not full convertibility. The CGER again works with strong assumptions which may be far removed from reality. I would suggest that in order to test the usefulness of this tool, such exercise may be conducted in respect of a few countries which have become relatively open rather than extending it to a whole lot of countries as it is bound to take a lot of staff time.

13. One problem that has been raised in para 3 of the issues is the influence of exchange rate on current account. To what extent current account will influence exchange rate is also very important. Can we not say that widening current account deficits in the South East Asian countries have had influence on the fall in value of their currencies witnessed recently.

14. Deviations of prevailing exchange rate from their medium run equilibrium levels (provided we can determine accurately what is the medium run equilibrium level) could be temporary and could also indicate a serious misalignment. This again will depend on a whole lot of other factors which will have to take into account before a conclusion is reached.

15. In conclusion, I would like to repeat that looking for an equilibrium rate of exchange is indeed a case of chasing the will o' the wisp. However, for purposes of determining the misalignment of a country's currency vis-a-vis its trading partners it would be a helpful exercise apart from other judgmental factors. The equilibrium rate even though may not be determined precisely could be estimated on the basis of past trends in the movements of exchange rates in which a lot of judgmental element would be involved. I believe experts who have been handling this for a long period of time would be in a position to apply their intuitive reasoning apart from the tools of econometric analysis to arrive at this rate.