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**Statement by Mr. Kiekens and Mr. Jonáš  
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. Analyzing the methods for assessing exchange rates among major industrial countries generates many useful conclusions. One conclusion concerns the difficulty of obtaining solid policy guidance from judgments about misalignments of real exchange rates. For us, the most important conclusion is that we cannot judge the proper level of real exchange rates with sufficient confidence to justify public statements about the inappropriateness of existing exchange rates. There may, however, be exceptional cases where the Fund could indicate that an exchange rate movement in a particular direction would better reflect the fundamentals.

2. Although the current state of the art imposes limits on our understanding of exchange rate levels and movements, it is still essential for the Fund to maintain its surveillance over members' exchange rates. It is important for staff reports to candidly reflect discussions about countries exchange rate policies, and equally necessary for the Board to form timely opinions about discussions of exchange rate issues between the staff, the Management, and the authorities. In this connection, we are encouraged by the staff's observation (p. 45) that staff reports "on occasion" contain more candid and pointed recommendations. Given the Board's long-standing emphasis on open discussion of exchange rate issues, we hope that more candid and pointed recommendations become a normal, rather than an occasional, feature of staff reports.

3. Calling for more candid discussions of exchange rate issues begs the question of what, specifically, should be the goal of the Fund's surveillance over members' exchange rates. Given the limitations of the available models and the present state of knowledge about exchange rates, it is easier to say what the goals should not be. We must accept that it is inherently difficult to identify "equilibrium values" for exchange rates.

We are concerned about how extending our judgments from the academic realm into the arena of publicly debated policies could actually affect exchange rates, in case the financial markets assume that the Fund's now public views about exchange rates imply policy decisions that affect both actual and equilibrium exchange rates. Under such circumstances, the consequences of an erroneous judgment that an actual exchange rate is out of line with fundamentals could be costly for both the country concerned and its trading partners, and undermine the Fund's credibility and its ability to continue exchange rate surveillance. We therefore agree that the staff should continue prudently to leave open the question of actions to be taken when exchange rates appear to deviate substantially from their medium-term equilibrium values.

4. The staff's account of its experience with the methodology devised by the *Coordinating Group on Exchange Rate Issues* (CGER) for assessing the most obvious recent episodes of exchange rate misalignment illustrates that this prudent approach is justified. In the spring of 1995, the staff's calculations served as one input to the Surveillance Committee's judgment that recent movements in G-3 exchange rates had gone farther than was justified by the fundamentals. This judgment subsequently resulted in a confidential recommendation to the G-3 countries to undertake concerted interest rate action. However, it was recognized *ex post* that because in the following months, the U.S. economy was not as strong as had been assumed, it would have been inappropriate to raise interest rates as suggested by this particular exchange rate assessment. And indeed, later on the federal fund rate moved in the opposite direction from what had been suggested by the use of the CGER methodology. In view of the weakening of the U.S. economy, this latter move turned out to be justified. We think that this episode illustrates well the perils of making strong policy recommendations based on judgments about the appropriateness of actual exchange rates based on the CGER methodology.

5. This is far from saying that the CGER methodology is useless. We think that the results of the present methodology provides a useful input into policy discussions in the form of the Fund's views on exchange rates. Since exchange rate surveillance is one of its responsibilities, the Fund cannot avoid making judgments about actual exchange rates and recommendations on exchange rate policies. But we remain convinced that in most cases, only the authorities should receive the Fund's judgments and recommendations. This is the best the Fund can do. Improving the analytical quality of its work on exchange rates is the way to increase the weight the Fund's recommendations carry with the recipients.

6. For this reason we encourage the staff to continue its analytical work to quantify the influence of exchange rates on current accounts and to calculate medium-term levels for savings-investment balances. Continued research may help reduce the limitations of the present CGER framework. These limitations explain why the results produced by the model illustrated in Chart 2 are not always aligned either with reality or with intuition. We would like to make some more detailed observations on this model and invite the staff to comment on them.

7. In paragraph 43, the staff explains how changes in economic fundamentals shift the UCUR or SI lines shown in Chart 2, and how the real effective exchange rate consistent with medium-term fundamentals is altered by these shifts. This analysis produces two results that we cannot entirely square with intuition: namely, that the higher the relative real per capita income, or the larger the relative structural fiscal surplus, the lower will be the medium-term level of the real effective exchange rate. We would normally expect that an increase in a country's relative real per capita income would mostly result from higher relative productivity growth, and we would expect this to lead to a higher real effective exchange rate, instead of the lower rate predicted by the model. As to the increase in the relative structural fiscal surplus, it could, in theory, have the effect on the real effective exchange rate predicted by Chart 2 through its reduction of long-term interest rates. But in practice, this theoretical

result is not supported by the experience of industrial countries. The May 1996 WEO has analyzed episodes of successful fiscal consolidation in industrial countries. These episodes can be viewed as a proxy for increases in relative structural fiscal surpluses, whose theoretical impact on the real effective exchange rate is discussed by the staff. Contrary to the predictions of the model in Chart 2, the WEO concludes (p. 60) that "between the year before the fiscal consolidation and the end of two-year contraction, the real exchange rate appreciated slightly in the successful cases, and depreciated slightly in the unsuccessful cases."

8. Nor do the relationships between changes in the normal savings/investment balance for the major industrial countries (Chart 3) and the changes in nominal and real effective exchange rates (Chart 1) always follow the theoretical predictions of the model. For example, in Japan, the normal savings/investment balance continuously strengthened from 1982 to 1992 (reflected as a shift to the right of the SI line in Chart 2), but the real effective exchange rate continued to appreciate during this period instead of weakening as it should have according to the model. For the United States, the gradual weakening of the normal savings/investment balance up until the mid-1990s should have led to an appreciation of the real effective exchange rate according to the model, but the actual outcome was a weakening of the real effective exchange rate.

We understand that the model refers to equilibrium and not actual exchange rates, but can this explain the contradiction between the model's predictions and actual experience? Perhaps an explanation can be found in the fact that changes in the variables that shift the SI line to the right (such as higher real relative per capita income) also have the effect of shifting the UCUR line upward and to the right (indicating, for example, that higher relative productivity means that the same UCUR can now be sustained at a higher real exchange rate), and that these two shifts together produce intuitively "correct" real exchange rate effects.

9. On the issue of which countries to include in the exchange rate assessment, we see some merit in expanding the list beyond the G-3 countries to include systemically important countries. The trend toward more flexible exchange rates is worldwide. We recognize that this trend does not necessarily reflect free choice, since in the less developed countries, specific factors that have nothing at all to do with domestic conditions may influence exchange rate policies. This might make this kind of assessment even more difficult than for the G-3 countries.

10. Finally, let us repeat what we said three years ago, namely that according to the Articles, the Fund should exercise firm surveillance over exchange rate *policies*. Recent experience has shown that there are still many problems with countries' exchange rate policies, and we continue to think that the Fund should pay more attention to the consistency of countries' exchange rate *policies* with the overall macroeconomic framework, than to the consistency of actual exchange rates with theoretical equilibrium exchange rates.

