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Statement by Mr. Vernikov and Mr. Lushin on
A Methodology for Exchange Rate Assessments and its Application
in Fund Surveillance over Major Industrial Countries
(Preliminary)
Executive Board Seminar 97/6
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The paper presented provides an interesting and informative description of the staff's approach to addressing the problem of exchange rate misalignments. Since the oversight over the exchange rate policies of member countries is an issue of top priority for the Fund, it is obvious that Executive Directors must be aware of the methodology being used for these purposes. We, therefore, welcome the staff's intention to share its views on this important issue with the Board. Our comments on the topics suggested for discussion are as follows.

1. To the extent that one believes that markets are not always perfect in identifying "equilibrium" exchange rates, an attempt to measure possible exchange rate misalignments is a step in the right direction, since otherwise the concept of the exchange rate equilibrium would be purely speculative. At the same time, we agree with the staff that, whatever definition of the equilibrium is utilized, it is hardly possible to arrive at its precise quantitative estimates. In this respect even determining the right sign of an assumed misalignment is a big job, not to mention the possibility to obtain reasonable, although rough estimates of the magnitude of this misalignment.

2. The macroeconomic balance approach used by the staff to define a medium-run equilibrium of an exchange rate and also to derive a model for quantitative assessments of misalignments seems to be more adequate than a widespread PPP approach. Also the combined RES trade and saving-investment model can produce estimates of equilibrium exchange rates within a theoretically consistent framework. Therefore, we share the staff's view that analytic work to further improve this model is warranted (we presume that this is what has been asked in a rather vague wording of item 3 of the topics list).

3. The advantage of the RES model is its transparency as well as a multilateral framework, allowing globally consistent assessments of current accounts and exchange rates. In our understanding, this means that the model allows a balancing of world exports and imports, perhaps with a reasonable discrepancy, and also world saving and investment. However, the reverse side of these advantages is a simplified analytic framework of the model

which is based on cross-country estimates and hence, employs common equation specification and parameter values across countries. Besides a lack of country-specific detail, the endogenously explained part of a current account balance is actually reduced in the model to a trade balance. Such simplifications, while possibly being tolerable in the case of industrial countries, may appear to be inadequate for emerging market economies.

4. It is, therefore, difficult to disagree with the staff that, in the framework of the suggested methodology, it was right to focus the analysis mainly on the exchange rates of industrial countries. However, we presume that the "systemic importance" of the major world currencies was not the only reason for concentrating on the aforementioned group of countries - availability and quality of the necessary data as well as meeting some of the model's basic assumptions are of no less significance.

5. The question raised by the staff, "could the approach usefully be applied to a broader set of Fund members", can be twofold. If it means a deepening of the analysis of exchange rate issues for developing and transition countries in general, then the answer is "yes". If the question refers to the application of the RES model methodology as it is to the developing and transition economies, we would need to hear from the staff how to overcome evident difficulties arising in this case. Specifically,

(i) in a large number of these countries trade volumes are weakly or not at all sensitive to real exchange rate fluctuations, since such countries are usually price-takers and have non-diversified export and import structures;

(ii) the share of non-factor services and transfers in overall current account balances are usually larger for the developing countries than for the advanced economies. But as the current account model is actually a streamlined trade model, it does not take into account "any projected changes in net factor income payments or transfers over the medium run" (p.22).

(iii) one basic assumption of the CGER methodology, such as access to international capital markets, is not valid for quite a number of developing counties, and the staff emphasizes that "the framework is not applicable to cases in which access to these markets is significantly curtailed" (see p.6);

(iii) any regional group of developing or transition countries is substantially less homogeneous than a sample based on industrial economies. In this case the assumption that trade elasticities are identical across countries, as well as coefficients of the S-I model, seems to be extremely restrictive.

6. Deviations of the estimated medium-run equilibrium exchange rates from their prevailing levels should be considered very cautiously, first of all because statistical confidence bands of these estimates cannot be formally obtained. The staff believes, as one may judge from paragraph 55, that these bands could be within a range of 10 or even 15 percent of the estimated equilibrium exchange rates. This means that deviations of say, 5 or 8 percent are

statistically insignificant and any conclusion about possible misalignments on such a basis would be questionable. However, even if deviations are large enough, their meaningful interpretation requires a good deal of informal judgement on a case-by-case basis, and we agree with the staff that appropriate policy responses in such situations need to be addressed in the context of a broader perspective. The episodes of retrospective assessments based on the CGER methodology look impressive, but unfortunately, a perfect model performance on the *ex post* data does not necessarily guarantee the same quality of estimates in the current circumstances.

7. Concerning the appropriate balance between internal analysis and public statements about the constellation of exchange rates, we are not in favor of broader publicity. Given the role of this Institution in the international monetary system, any public statements on the misalignment of exchange rates, even being occasionally or accidentally correct, may result in market tensions and overshooting of exchange rate adjustments. This is especially true for the countries whose currencies are not leading in the world financial system.