GRAY/97/373

October 24, 1997

Statement by Mr. Kaeser 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

Any exchange rate assessment is based on some idea about the 'right' rate. Making these ideas and the reasons behind them transparent is a prerequisite for fruitful discussions on exchange rate misalignments. We therefore welcome this paper which describes the analytical basis of the staff's exchange rate assessment.

The clearing price in the exchange market does not always correspond to what is considered as a medium-term equilibrium exchange rate. There are basically two possible reasons for such apparent misalignments: either the fundamentals deviate from their medium-term equilibrium levels or the exchange markets are wrong (or both of them). In our view, and despite the vast body of economic literature which shows that exchange markets can indeed move away from underlying fundamentals, any analysis has to start with the presumption that the exchange markets are right, and thus that the deviation of the market rate from the equilibrium is due to the policy mix, the cyclical position of the economy, or some other factors of temporary or more fundamental character. Therefore, the equilibrium exchange rates should not be used as a rule to measure the extent of alleged imperfections in the exchange markets, but principally as a useful tool which helps to detect problems within the macroeconomic setting. In this sense, an assessment of exchange rates has always to be seen in the context of a broader macroeconomic analysis.

Having made these introductory comments, we would like to turn to the issues proposed in the staff paper for consideration by the Board.

Issue 1: Objective of the assessment of equilibrium exchange rates

In line with the Fund's mandate to oversee the exchange rate policies of its members, the IMF staff has traditionally played an important role in the development of methods to calculate equilibrium exchange rates, and more specifically in the refinement of the macroeconomic balance approach. While the broad objective of such assessments remains the same, i.e. to provide some kind of lighthouse in the darkness surrounding exchange rate discussions, their ambitions have become more humble than in the past. Notably, the staff report carefully avoids to argue that the calculated equilibrium exchange rates are the 'right' exchange rates. Instead, it is argued that these exchange rates should form an integral part of a larger assessment aimed at identifying clearly misaligned currencies. We agree that it is impossible to give a precise estimate of equilibrium values of exchange rates. Therefore, the red warning lights should only be turned on when an exchange rate moves beyond a relatively large confidence band, and after a thorough analysis of all important factors affecting the exchange rate. Nevertheless, we note that the distinction between identifying the right rate and identifying wrong rates is somewhat artificial; or to put it differently: we cannot say a rate is wrong if we have no idea about what the right rate is.

Issue 2: Countries included in the evaluation

Staff work has until now focused on the exchange rates of the G7 countries. This concentration can be partially justified by the systemic importance of these currencies and by the complex methodology applied and the large amount of reliable data needed for the calculation of the equilibrium exchange rates. However, the Fund's mandate is not limited to the assessment the exchange rates of the major industrial countries. Since the Fund's assessments should always be based on solid analytical grounds, calculations of equilibrium exchange rates for other member countries would be desirable if only sufficient amount of timely and reliable data is available. We share the position presented in Mr. Wijnhold's and Mr. Levy's paper that the recent currency turmoil in South East Asia has demonstrated the necessity of a continuous assessment of exchange rates and exchange arrangements in a number of developing countries. We appreciate the systemic importance of the currencies of the G-7 countries but at the same time we are of the opinion that the Fund's surveillance and advice on exchange rate policies can be of great importance for countries with a current IMF arrangement, and/or for countries where a currency misalignment could trigger some broader regional disturbances.

Issue 3: Refinements of the current methodology

The approach outlined in the staff paper is highly pragmatic. This brings about some limitations identified by the staff in chapter IV of the paper. Most importantly, due to the difficulties associated with a complete inter-temporal model, the approach used by the staff is not embedded into a dynamic framework--a limitation which somewhat reduces the practical value of the calculated equilibrium rates.

Nevertheless, we believe that continued work on the current methodology would be worthwhile. Many of the possible refinements are probably too technical to be discussed at a meeting of the Executive Board. We therefore suggest that the staff prepares a more technical paper for publication in the Staff Papers or as a Working Paper in order to receive valuable inputs from specialists outside the Fund. We will come back to this point in issue 5.

In addition to the refinements proposed by the staff, it might be useful if the staff tried to quantify the effects of the factors which are only taken into account in step 4 of the current methodology, i.e. the effect of cyclical conditions, interest rate differentials, and fiscal imbalances on the short-term behavior of the exchange rate. This would allow us to give the judgmental assessment a better analytical basis. Moreover, we believe that the assessment of members' exchange rates should not be limited to levels but should give more weight to the effects of exchange rate movements. Large swings can be highly undesirable, even if the exchange rate keeps within the confidence band of the equilibrium rate. Staff studies in this area would be particularly welcome.

Issue 4: Interpretation of results

In the paper, the staff highlights the importance of a careful interpretation of calculated equilibrium rates. Such an interpretation is indeed necessary, given the various factors that can lay behind an apparent misalignment, the several judgmental elements entering the calculations, and the analytical limitations and the lack of precision of the estimates. Interpretation is also needed because positive estimates of medium-term equilibrium rates cannot easily be used as normative signpost of 'desirable' exchange rates.

As we already noted above, we fully agree that an assessment of exchange rates has always to be part of a broader macroeconomic analysis and should be done on a case-by-case basis.

Issue 5: Public statements on exchange rate misalignments

The IMF's policy regarding public statements on exchange rates is rather prudent. As noted in the paper, the Fund has until now made only a few public statements on currency misalignments. We believe that more openness in this area would be desirable.

In particular, even if public statements on exchange rates are rare, the rationale for such statements should be made more transparent. We therefore suggest that the staff publishes a paper which explains the methods used for the calculation of equilibrium exchange rates and for the exchange rate assessment in general. Ideally, such a paper would be more detailed and more specific with respect to the practice of the Fund than the recent Occasional Paper on Exchange Rates and Economic Fundamentals (Occasional Paper 115).

The Fund could also be somewhat more open concerning the results of the calculations of equilibrium exchange rates. We agree that it would not be a good idea to regularly publish lists with equilibrium exchange rates or with the percentages by which market rates deviate from the equilibrium rates. This kind of publication could give the wrong impression about the reliability of the estimated values, especially if the media disseminate these estimates without the careful interpretation of the Fund. However, we think that a publication of relatively large ranges or confidence bands for the equilibrium values of the real effective exchange rates would be useful to better explain to the public the basis of the Fund's statements on exchange rates. The publication of such estimates could take place in the context of regular consultations under Article IV, e.g. in the PINs.

To conclude we would like to invite the staff to prepare a paper in a related area, namely the future conversion rates for participants of EMU. In light of the high systemic importance of this project, an independent opinion of the Fund about the appropriate level of the future conversion rates would certainly be useful. We have the impression that the methodology presented by the staff might provide valuable inputs for the decisions planned by the European Union for May 1998. A discussion on the bilateral exchange rates and the conversion rates of EMU participants would also perfectly fit into the Fund's mandate to oversee members' exchange rate policy.