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Statement by Ms. Lissakers and Mr. Sobel on 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 staff paper underscores the fact that surveillance over members' exchange rate policies remains at the core of the Fund's mandate. For this function to be effectively carried out, there must be frank discussion of exchange rate policies among the Fund's membership, and staff must continuously seek to strengthen its analytical capabilities in this area. The paper enhances our understanding of aspects of the current analytical focus and thinking in the Fund on exchange rate issues for the major industrial countries.

The CGER Framework

The quest to identify significant deviations of exchange rates from levels consistent with "appropriate" levels of savings and investment balances, to the extent this can be meaningfully done, is very useful. In this regard, the CGER process represents an interesting methodological combination of objective and subjective analysis that contains elements of a systematic framework for reflecting on the consistency of domestic and external imbalances with assessments of exchange rates. Indeed, many authorities and private sector institutions make similar types of calculations.

But as staff notes, any analysis of exchange rate determination should be approached with extreme caution and humility. Notwithstanding all of the important economic work, our knowledge of exchange markets is still rudimentary and it is hard to glean the information content of a particular exchange rate at any given time.

The limits of our understanding are also mirrored in some of the conceptual issues underlying the CGER framework, its reliance on judgment, and its econometric underpinnings. Many basic concepts in the literature are inherently subjective, do not easily lend themselves to definition, and are thus used without great precision. The concepts of exchange rate "misalignments" and "normal" savings-investment balances are relevant in this regard. Box 1, which we found very useful, highlights differing notions of a "misalignment." The sharp rise in the dollar in the early to mid-1980s is often cited as a classic case of misalignment. Many analysts feel in retrospect that U.S. monetary policies were tight at this time and fiscal policy highly expansive, thus driving U.S. real interest rates to extremely high levels. Accordingly, it was not unsurprising that the dollar's real exchange rate appreciated sharply. It did exactly what theory would tell us it should have done.

In this regard, even if the CGER process yields the conclusion that a currency has deviated substantially from its medium-term equilibrium value—and we would argue that identifying the 1985 and 1995 cases does not represent a high bar—this tells us little about the question of who should adjust and how. Indeed, most of our discussions on the major industrial countries highlight the importance of focussing domestic policies on internal balance, rather than exchange rate objectives. We noted with interest staff's conclusion that with the benefit of hindsight, the recommended increase in U.S. interest rates in the spring of 1995 would not have been helpful.

Another such concept is the "normal" level of the savings-investment balance, which CGER estimates in lieu of "normal" capital flows. The S-I norms are based on domestic determinants, which are hard to calculate and fully understand in and of themselves. But in a world in which global capital markets are playing an increasing role, it is also not easy to understand some of the interactions and causality between capital flows and the current account and between savings and the current account. For the United States, given the role of our capital markets, the current account may in some ways reflects portfolio choices and intermediation around the world. Could staff comment on the extent to which calculated S-I norms are influenced by averages for this variable in preceding periods and to what extent, in its experience, the past averages have proven an appropriate basis for forward looking assessments of S-I norms?

It also goes without saying that "equilibrium" exchange rates, "sustainability" and "desirability" are also concepts which are just as hard to define.

We would also appreciate staff's clarification as to the balance that is struck between model-driven results and judgmental assessments in the CGER framework. Staff surely is correct in noting that the host of factors cited on pages 30-31 (cyclical divergences among countries, real interest rates, large fiscal positions and structural changes) will help shape current account dynamics and exchange rate movements. But interest rate differentials in practice are not a good predictor of exchange rates; the response of exchange rates to fiscal adjustment is unclear; and it is hard to gauge how structural changes may be affecting the current account at any given time. Indeed, there was some debate on this latter point in the Board's discussion of Japan's Article IV report.

The staff paper observes that S-I norms are adjusted by the country desks, and that for Japan a different estimation model is used. Could staff discuss how much judgmental considerations cause the CGER process to yield different conclusions than would result from a strict model-based approach and why a different model is used for Japan? Also, how does staff determine what is an acceptable amount of judgment from country to country? Further, on pages 44-45, staff indicates that CGER's assessments were only one input among many in framing an assessment of exchange rate levels; what weight is given the results of the CGER methodological framework as opposed to other inputs?

The econometric underpinnings of the CGER framework are also enormously complicated and subject to a wide range of uncertainty. Most obviously, the CGER framework depends heavily on calculations of potential growth and full employment. But these cannot be quantified with precision and indeed, IMF and OECD forecasts of these variables differ markedly at times. Also, estimating trade elasticities is complicated. Different empirical approaches can yield a range of estimates and the relationships underlying these estimates may not be stable. In this regard, our authorities note that including confidence intervals for the estimates used in the analysis would facilitate gauging the usefulness of the CGER approach.

On balance, we would very much agree with staff that the CGER process is a useful, technical exercise which can shed light on economic policies and their external ramifications. We also would tend to agree with staff that given the state of our knowledge, the best we may be able to do is to identify exchange rates that deviate very substantially from some notion of consistency with medium-term fundamentals. But it is important to recognize the fundamental limitations of the CGER framework and that it cannot be used in a mechanistic or formulaic manner.

In short, paragraph 53 states the CGER process is like cooking and the proof of the pudding is in the eating. But given the numerous calculations, methodological assumptions, definitional complexities, and judgmental elements, it struck us that the CGER framework might be better viewed not in the kitchen, but on the stage of performance art.

The Role of the Fund

The foregoing discussion also raises the question of what role the CGER analysis should play in the Fund's work. Indeed, the paper invites this discussion with such unexplored, yet tantalizing, statements as: "Whether anything should be said, publicly, when such a situation (substantial deviation of exchange rate from medium-run equilibrium values) is identified is also left an open question" and "Do Directors consider that the balance between the internal analysis and public statements about major current exchange rates have been appropriate."

The CGER framework is a useful part of the Fund's surveillance over members' exchange rates and analytical approach. We would urge the Fund to continue developing its exchange rate analyses on major industrial countries and the CGER framework. This work should inform Article IV discussions and private communications between the IMF and its members. In this regard, the utility of the CGER framework may lie more in the realm of serving as a forecasting tool of medium-term sustainability of current account positions than in making precise, or imprecise, estimates of "badly misaligned exchange rates" at any given point.

We do not believe that an expanded role for public statements by the Fund on major industrial country exchange rates would be useful or productive. Nor would we view it as *helpful to publish the CGER's results. The foreign exchange market is highly sensitive to* public statements by officials and official institutions. In recent years, senior U.S. officials have strenuously avoided public commentary on the appropriateness of exchange rates. Such commentary invariably heightens nervousness in the markets, is subjected to numerous and conflicting interpretations among market participants which increase volatility, and often leads to pressures to make clarifying remarks, which can cause further problems.