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Statement by Mr. Zoccali and Mr. Eyzaguirre 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

1) Staff is to be commended for its attempt to put difficult and to some extent unsolved analytical issues into a comprehensive and simple framework and into a readable paper. Further analytical and empirical refinement, as well as the extension of the analysis to other countries seem to us highly desirable. Progress in identifying the magnitude and possible causes of exchange rate misalignments, as well as eventual systemic consequences of delays in implementing corrective actions when warranted--particularly in the case of the major currencies in view of their asymmetric impact on world economic conditions--is of utmost importance and lies at the very core of the Fund's work.

2) Notwithstanding the above, there are two sets of issues that may deserve further clarification. The first one is that the assessment of whether or not the current value of the exchange rate is consistent with fundamentals may not be equivalent to the judgment regarding the strength of the country's fundamentals. The identification of misalignments is based on a comparison of the projected current account balances, once output gaps and lagged effects are accounted for, with the so-called S-I norms. While it has to be recognized that the "normal" saving-investment balance is highly dependent on some structural features including the relative income of the economy and the age structure of the population--that are not easily modifiable by policy--it also depends on factors like tax policy, fiscal prospects, health and education standards, which allow some room for changing the S-I balance over time. It is understandable that since the framework has been developed in the context of major industrial country economies where S-I norms are clearly sustainable ones, as it is apparent from Chart 3 in page 26, the assessment of the quality and sustainability of the fundamentals is not a main feature of the analysis. Although the paper recognizes that the S-I norms may be subject to modification if, in particular, fiscal policy is considered to be inappropriate, it is not clear which criteria are used for that purpose. Therefore, strictly speaking, the fundamentals behind the S-I norms can be inadequate.

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In the endeavor of extending the analysis to developing countries the assessment of the sustainability of fundamentals seems to us essential. For instance, low/middle-income emerging market economies where structural reforms have been boldly implemented and macroeconomic policy is adequate, generally exhibit quite high marginal productivity of capital and insufficient domestic savings. The S-I norms, therefore, may show large imbalances. Does it mean that the equilibrium exchange rate accommodates huge current account deficits? Not necessarily. Although high rates of investment are likely to produce high rates of growth and over time increase the rate of savings, a large current account deficit also places the economy in a more vulnerable position. It seems to us that the distinction between possible misalignments of the exchange rate with fundamentals and misalignments of the fundamentals themselves is important. In practice, market exchange rate movements can be induced by the perception of misalignments in any of the two above-mentioned concepts.

3) The second issue refers to the mechanism of adjustment. A supply and demand theory is supplemented by the theory of price determination. In this case, we lack a complete macroeconomic model that explains the adjustment mechanism, or the lack thereof, when exchange rates fail to be consistent with both the underlying current account balance and the savings-investment norms. As staff rightly points out deviations of current exchange rates from their equilibrium level may not necessarily be a matter of concern. In particular, if the desirable adjustment is implicit in the interest rate differentials one can project a smooth adjustment. But if that is not the case as in 1995, should we conclude the existence of a market failure? or that insufficient information has been provided to the markets? or that the estimated equations for the current account and the savings-investment relation are inadequate? Since different interpretations would prescribe different policy actions, this issue is very central to the topic. We agree, therefore, that problems of interpretation suggest that policy prescriptions need to be addressed on a case-by-case basis. However, such a conclusion also highlights the need for further elaboration of the causes that seem to lie behind manifest cases of currency misalignments, particularly given the increasingly globalized nature of financial transactions and Fund's undertaking to fostering their orderly liberalization.

4) A somewhat more technical doubt arises when the paper deals with empirical cases. The suggestion that fiscal and monetary policy actions where needed in 1995, although correct, seems to us as coming from outside this framework. Moreover, it is argued in the paper that interest rates are endogenous in this framework, so it is not clear what the role of monetary policy is. Additionally, fiscal policies that are the basis for calculating initial misalignments are implicit in the S-I norms. So it seems to us that when fiscal policies are corrected this would also impact on equilibrium exchange rates, with the net effect on the misalignments somewhat ambiguous. Staff comments would be welcomed.

5) Finally, although we favor further research to refine the effectiveness of this analysis, we would associate ourselves with Messrs. Wijnholds and Levy on the appropriateness of the current balance between internal Fund analysis and public statements on currency exchange rates in general and, in particular, on the need to remain extremely cautious regarding disclosure of judgments on exchange rate and exchange rate policies, since the margin of error in the calculations is high and random.