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December 18, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Enhancing the Use of Indicators as a Tool for Surveillance

Attached for consideration by the Executive Directors is a paper on enhancing the use of indicators as a tool for surveillance, which has now been tentatively scheduled for discussion on Thursday, January 15, 1987.

Mr. Crockett (ext. 8982) or Mr. Boughton (ext. 7477) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Enhancing the Use of Indicators as a Tool for Surveillance

Prepared by the Research Department

(in consultation with other departments)

Approved by R.R. Rhomberg

December 18, 1986

Contents

I. Introduction

This paper is the second prepared by the staff in response to the April 1986 request by the Interim Committee for the development of a set of economic indicators. 1/ The first paper, "Indicators Relating to Policy Actions and Economic Performance" (EBS/86/127, June 11, 1986), outlined a framework for the use of indicators in surveillance, set out a taxonomy for classifying indicators, and proposed a number of procedures for using indicators in the work of the Fund. That paper was discussed by the Executive Board on July 14, 1986 and also served as a background for the discussion of indicators by the Interim Committee on September 28. These two meetings gave rise to a number of suggestions regarding the use of indicators in surveillance. The present paper describes those suggestions and attempts to clarify and to develop a number of relevant issues.

The discussion of indicators that has taken place during the past year has suggested that the issues involved are quite complex. In particular, the choice of which indicators and which analytical approach would be most useful in policy assessment depends crucially on the question being asked. The emphasis attached to particular indicators and relationships will clearly be different, depending on whether the chief concern of policy makers is correcting payments imbalances, controlling inflation, or promoting growth--even though it would be recognized that these objectives are closely linked in the medium term.

Nonetheless, despite the complexity of the underlying issues, the central questions on which Executive Board guidance is needed at the present time are fairly straightforward, and relate to the nature of the staff's analysis of international economic interactions, especially in the World Economic Outlook. In that context, the staff proposes to continue the analysis of policy interactions among industrial countries along the lines of the most recent WEO exercise. This analysis makes use of an analytical framework that stresses the sustainability of projected external balances and their compatability with other objectives in the field of growth and price stability. The staff proposes to build on its earlier work through further consideration of the choice

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1/ The request by the Interim Committee arose from the Committee's consideration of the 1985 reports by the Deputies of the Group of Ten and of the Group of Twenty-Four. See "Report of the Deputies of the Group of Ten on the Functioning of the International Monetary System" (EBD/85/154, Sup. 1, June 21, 1985), and Report of the Deputies of the Group of Twenty-Four on the "Functioning and Improvement of the International Monetary System - Transmittal to the Interim Committee" (EBD/85/228, August 30, 1985). The staff's work in this area has drawn on these reports, as well as on the May 1986 Tokyo Economic Declaration by the Heads of State or Government of the Seven Summit Countries.

of indicators, evolution of the analytical approach, and incorporation of more information on developing countries. The essential purpose of the present paper is to seek the views of Executive Directors on how best to proceed on these issues.

An issue that is not discussed in great detail in the present paper is how indicators might be used as the basis of strengthened surveillance in individual countries. This issue involves a number of important operational questions, such as the relationship between the World Economic Outlook analysis and Article IV and supplemental consultations; the nature of the response that would result when economic developments in a member country depart from expected or targeted values; and the degree of automaticity in the procedure. These are important questions, and they will be taken up in the forthcoming staff paper that reviews the implementation of surveillance. Nevertheless, some of the issues involved will be touched on in a preliminary way in the following discussion.

II. Background

The review and analysis of world economic conditions and of the functioning of the international monetary system has always taken place through the consideration of a broad variety of indicators, and there is nothing essentially novel in the idea of applying these indicators in any of the Fund's activities. On one level, the purpose of the development of a more specific set of indicators is to attempt to select--from the full range of available information, which will still be examined in its entirety in the course of surveillance--variables that could play a central role in the process. On a deeper level, it is to be hoped that surveillance may be improved through a more explicit focus on policy interactions among countries and possibly through the development of more explicit criteria against which developments relating to policies or performance can be judged in a medium-term context.

The initial staff paper noted that there are a number of purposes of economic indicators that might be considered and that the way indicators are to be developed depends on which functions are judged to be most important. First, at a fairly general level, indicators may serve as a means by which countries can monitor and review policies and performance retrospectively. Second, they can serve as an aid in defining medium-term policy objectives. Third, indicators may be able to provide a means of signalling the need for discussions of members' policies, and fourth, they could serve more directly as a trigger for policy changes.

The first two of these purposes are closely related to the regular World Economic Outlook exercise, while the latter two would represent a substantial evolution in existing procedures. In particular, the fourth purpose would seem to go beyond what many members regard as practical, and for this reason is not considered in any detail in this paper. The Tokyo Economic Declaration of May 1986 appears to have envisaged the use of indicators primarily as a means of monitoring and reviewing policies. Specifically, the Declaration requested that the countries whose currencies constitute the SDR--and possibly others as well--should, in conjunction with the Managing Director, review their individual economic forecasts, "taking into account indicators such as GNP growth rates, inflation rates, interest rates, unemployment rates, fiscal deficit ratios, current account and trade balances, monetary growth rates, reserves, and exchange rates." However, the specific purpose identified in the April 1986 communique of the Interim Committee (paragraph 6) was related most closely to the third purpose in the above list. The communique asked the Executive Board to seek ways "to improve the scope for discussing external imbalances, exchange rate developments, and policy interactions among members." In this context, it was noted that "indicators might help to identify a need for discussion of countries' policies."

The general purpose of indicators was discussed in detail by the Executive Board in July. As the Managing Director summarized that discussion:

> "Indicators can be seen as a means of checking the consistency within a country between performance objectives and the policy measures that are to be used to reach those objectives at a given point in time. They can also be seen as a means of checking the consistency of the national forecasts and objectives of a particular country with the national objectives and forecasts of other countries.
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> "Indicators can further be seen as providing, in a more ambitious vein, a global model, or, in a less ambitious vein, a limited set of checks in order to provide signals. Indicators could be used to assess the medium-term sustainability of balance of payments developments, including sustainability in the context of an 'optimal' pattern of worldwide growth and stability. That is the most ambitious concept. Indicators can be seen as a tool for intellectual analysis or they can be used to encourage policy action and to trigger more effective international cooperation."

The prospective role of indicators was further clarified at the Interim Committee meeting in September 1986. Paragraph 7 of the communique for that meeting included the following conclusions:

"Committee members welcomed the agreement at the Tokyo summit to use indicators in conducting surveillance as part of efforts to strengthen international economic cooperation. They also supported the greater use, in the latest World Economic Outlook analysis, of indicators of economic policies and performance. They considered that this analysis was helpful in focusing attention on potential incompatibilities in national economic policies and projections, particularly among the larger countries whose policies have substantial international impact. A key focus of indicators should be on points of interaction among national economies, in particular developments affecting the sustainability of balance of payments positions, and on the policies underlying them. It was generally agreed that a better use of indicators would be a helpful tool in strengthening the Fund's surveillance activities. The Committee asked the Executive Board to develop further the application of indicators in the context both of the periodic consultations with individual member countries and of the World Economic Outlook so as to facilitate the multilateral appraisal and coordination of economic policies."

As is clear from the quoted paragraph of the communique, the development of indicators in the Fund is to proceed along two main avenues: through further development of the analytical techniques used in the World Economic Outlook, and through a strengthening of the consultation process with individual countries. These two activities are of course related; nonetheless, the use of indicators in the multilateral appraisal of policy interactions can be regarded as the analytical starting point for the contribution that the Fund can make to assessing policies in individual countries or groups of countries. This paper is therefore largely concerned with how indicators can be used to strengthen the process of multilateral surveillance. In this context, the Interim Committee communique specifies that the principal focus of attention should be the analysis of the sustainability of balance of payments positions and the identification of policies that are consistent with sustainable positions.

Suggestions that have been offered in the course of the various meetings on this subject may be classified broadly as relating to four topics: the analytical framework, the choice of variables to be used as indicators, the coverage of countries, and procedural issues for the implementation of the exercise. That broad outline is followed in the organization of the following sections.

III. The Analytical Framework

1. General considerations

Perhaps the most essential question to be answered more fully before work can proceed on developing the use of indicators in surveillance is that of what these data are intended to indicate, and for what purposes. Because the Fund's responsibilities for multilateral surveillance involve the full range of macroeconomic variables, indicators--if they are to serve as the basis for general surveillance discussions--should be equally comprehensive. That is, they should indicate the overall economic situation and policy strategy of each member. 1/ On the other hand, if the development of a set of indicators is to bring certain key relationships into as sharp a focus as possible, then it may be desirable to concentrate particularly on a smaller subset of data.

In keeping with the perspective emphasized in the Interim Committee communique of April 1986, the staff's work in this area has stressed external variables, particularly from the perspective of their international consistency and sustainability. That is, emphasis has been placed on indicators that help to explain the actual and prospective evolution of international payments balances, the sustainability of those balances, and factors affecting either the balances or their sustainability. This emphasis, it should be noted, is not intended to narrow the focus of Fund surveillance; rather, it represents an effort to provide an appropriate perspective for the use of indicators and to avoid excessive generality in the analysis.

An alternative to the central emphasis on payments would also be consistent with the request by the Interim Committee, would be to stress the determination of exchange rates, either as a substitute for the focus on payments balances or as an important addition to it. In such an approach, the staff could assess the current or the prospective pattern of exchange rates in relation to the pattern of rates that

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1/ The Executive Board's Decision governing the "principles for the guidance of member's exchange rate policies" (Decision No. 5392-(77/63), April 29, 1977) contains the following paragraph:

"The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment."

might be regarded as "desirable" or sustainable. There is, of course, no doubt about the central importance of exchange rates in the surveillance process. Exchange rates are an important indicator of pressures that might build on payments positions, and they are a highly visible symbol of the interests of the countries involved. There are, however, a number of issues to be addressed if exchange rates are to be assigned a prominent place in a system of indicators.

The first issue relates to the fact that exchange rates are a very sensitive market variable. Quantified assessments of sustainable exchange rate levels--whether by the Fund staff or by the national authorities--would risk provoking strong market reactions. Second, neither the Fund staff nor the economics profession at large has the ability to project exchange rates with great confidence; movements in the exchange rates of the major floating currencies are strongly affected by shifts in expectations and by news of singular events, and only a small portion of observed movements has proved amenable to empirical analysis. For both of these reasons, it has always been seen as problematic to conduct multilateral surveillance discussions on the basis of projections or assessments of the sustainability of a projected evolution of exchange rates. 1/ Third, the appropriateness of a given exchange rate can be assessed only by reference to its implications for balance of payments flows. Therefore, even if exchange rates were to be a primary indicator, the role of balance of payments developments would not be diminished.

Another possibility would be to focus on internal rather than external balance. The primary advantage of such an approach would be to give a greater explicit weight to key objectives in the field of growth and price stability. Moreover, the control of inflation and the stability of monetary policy are of great importance for the overall sustainability of the policy stance and for the promotion of stable trade and financial relationships among countries. However, given the international dimension of the Fund's responsibilities, a potential disadvantage of focusing too narrowly on internal balance would be to risk losing sight of the more fundamental determinants of changes in current account balances. In that regard, fiscal policy--and perhaps supply-side policies--would be more important than monetary policy alone. The preferred approach, therefore, would seem to be to continue to focus principally on the major medium-term determinants of current account positions, while ensuring that the domestic implications for growth and inflation are taken adequately into account.

1/ It will be recalled that the standard practice of the Fund is to base economic projections on a working assumption about exchange rates. Usually, this assumption has been that nominal exchange rates either would be unchanged or would change so as to leave real exchange rates unchanged.

2. Assessment of sustainability

A key element of the analytical framework that was described in the earlier staff paper on indicators is the assessment of sustainability of economic conditions, especially as regards external positions. Conceptually, policies or economic conditions may be viewed as sustainable if they can be maintained over the medium term (generally taken to mean a period of 3-5 years), are consistent with the long-run growth potential of the economy, and are judged to be appropriate from the standpoint of both the country in question and the international community as a whole. 1/ Another way of stating this criterion is that a country's policy stance may be considered to be unsustainable if it is likely to lead to a serious disruption in the economy that would force a reversal of policies, or if it is thought to have exchange rate, interest rate, and trade effects that could severely disrupt economic conditions either at home or abroad.

A related issue concerns the assessment of consistency in policy settings. In the course of the discussions held by the Executive Board and the Interim Committee, two types of inconsistencies were mentioned. First, there may be inconsistency among national objectives, as when the desire for more rapid growth clashes with a desire to avoid inflationary pressures or a large external deficit. Second, there may be inconsistency between (coherent) national objectives on the one hand, and acceptable outcomes internationally on the other, as may happen when a country adopts a policy mix that has external effects that run counter to the interests of other countries.

Judgments regarding sustainability or consistency are very difficult to make, partly because of the data limitations already cited, but also because there are a great many factors that affect the sustainability of a given position. For example, safe haven considerations and shifts in saving or investment propensities can have a significant effect on the international flow of capital. Experience suggests, as one Executive Director put it, that it is often easier to agree that a particular position or a value is unsustainable than it is to agree on what constitutes an optimum position. In light of that experience, it is preferable to emphasize the identification of actual and prospective domestic fiscal and monetary policy mixes that generate unsustainable external imbalances. If existing policies are judged likely to lead to unsustainable outcomes, the World Economic Outlook could discuss different ways of dealing with the problem.

1/ See the discussion on this point in Jacques Artus and Malcolm D. Knight, "Issues in the Assessment of the Exchange Rates of Industrial Countries," International Monetary Fund, Occasional Paper 29 (July 1984), pp. 1-2.

A difficulty in assessing the implications of such policies is that unsustainability usually results in political reactions and policy reversals that are not easy to project on the basis of economic reasoning. This raises the technical issue of how the staff should develop its projections so as to illuminate the "tensions" inherent in unsustainable policies while avoiding unduly speculative forecasts about the reactions of markets and policymakers. This issue is considered later in the paper.

In spite of these difficulties, the concept of sustainability over the medium term is essential to the practice of surveillance. That is, one must be able not only to say where economies are headed but also to make judgments about whether that direction will eventually have to be changed in order to avoid running into severe tensions or inconsistencies. Under normal conditions, a judgment that policies will have to be reversed within a few years will constitute a prima facie case that the country's interests and those of its trading partners would be better served by moving toward a different policy stance at an early stage.

3. Classification of indicators

Because of the wide range of variables that might be considered as indicators, the staff felt that it would be useful to provide some order to the discussion by classifying data into different groups. Fundamentally, the criterion for such a classification should be its usefulness in specifying the role of each variable in the economy and its relevance to the policy options facing the authorities.

The initial staff paper proposed classifying data into three types: indicators of economic performance, indicators of economic policy, and intermediate variables through which policies affect performance. It was suggested that economic growth, employment, the balance of payments, and price stability would be included under indicators of performance; policy indicators would include variables such as monetary growth, fiscal balances, and exchange market intervention; and intermediate variables would include saving and investment levels, interest rates, and exchange rates.

Subsequently, some Ministers and Directors indicated a preference for emphasizing the distinction between policy instruments and policy targets. Although these two schemes are quite similar, there are two differences. First, an emphasis on targets rather than on performance could limit the range of variables under consideration, especially for countries that prefer to formulate policies in terms of nominal rather than real variables. In such cases, real output growth or unemployment might be appropriate indicators of performance, but not of policy targets.

The second difference concerns the treatment of policies. In the staff's proposed classification, the course of economic policy would be indicated by variables that are closely influenced by policy actions but that may not be under the direct control of the authorities. Monetary growth and the fiscal deficit would fall in this category. Indicators of policy instruments would presumably be somewhat more narrowly focused. Monetary policy instruments, for example, might include variables such as the growth of bank reserves or the monetary base, and the setting of the discount rate. Fiscal policy could be indicated by reference to changes in expenditure or tax plans, adjusted for cyclical or other endogenous influences. By and large, the staff would suggest a pragmatic approach to this issue, choosing as policy indicators variables that are under the effective control of the authorities within a relevant policy-planning horizon. This would suggest using as an indicator of monetary policy the variable or variables that the authorities of the country concerned perceive as most relevant. As an indicator of fiscal policy, it would seem desirable to gauge the short-term stance of policies with reference to a cyclically-adjusted measure of changes in the budgetary position. (Over a longer-term horizon, however, it may be that the actual deficit is a better indicator, especially in view of difficulties on assessing "normal" activity levels.)

A related issue concerns the emphasis that should be given to one group of variables or another. One view expressed by a number of Ministers and Executive Directors was that the role of objective or target variables should be given less prominence in the indicators exercise than would be given to policy and intermediate variables. While countries may have objectives for variables such as the growth rate of real output, the unemployment rate, or the rate of inflation, it is recognized that outcomes for these variables depend importantly on factors outside the scope of demand management policies. In contrast, variables such as monetary growth or fiscal deficits are rather more directly influenced by policy actions.

On the other hand, it was argued that performance variables are very important for the proper conduct of surveillance, for many of the same reasons described above with reference to the need for a broadly based analytical framework. That is, if the exercise does not help to ensure that economic growth is sustained at a reasonable non-inflationary level, it may be difficult to make informed judgments regarding sustainability. It was also argued that priority should be placed on monitoring and evaluating economic performance, even in the short run, because problems with performance require early attention if they are to be corrected before they assume major proportions. Overall, because of the ambiguities of delineating these categories and because of the advantages that have been cited regarding the use of both policy and performance variables as indicators, it seems best at this stage not to narrow the focus of the exercise to one particular group or the other.

4. Time period for the analysis

The Interim Committee communique of April 1986 suggested "the formulation of a set of objective indicators related to policy actions and economic performance, having regard to a medium-term framework." [Emphasis added.] The importance of the medium-term focus was widely accepted, albeit with differing emphasis being given to the importance of looking at shorter-run (one- to two-year) developments as well. It was noted that policies are always implemented in the short run, even though they may be formulated in a medium-term context. Therefore, it was argued in the course of the discussions that indicators should be projected for both the short and the medium term, but that short-term divergencies should be appraised in a medium-term framework. In any event, the avoidance of even the semblance of a "fine tuning" approach was universally viewed as quite important.

The general problem in this context is to determine an appropriate horizon over which projections may be made with reasonable confidence, taking account of the desirability of covering the period that is relevant for policy formulation. A number of countries do use horizons of four to five years in making general policy plans; current examples include the medium-term financial strategy in the United Kingdom, which specifies plans to 1990, and the deficit-reduction programs in the United States and Japan, which give policy paths through 1991. Nevertheless, the uncertainty of making projections that far ahead may militate against using such a long horizon in a multilateral setting. On the other hand, a two-year horizon may be too short to cover adequately the medium-term effects of demand-management policies or the role of supply-side policies.

The practice that has normally been adopted for the World Economic Outlook has been to present annual numbers for the current and the following year, and then to show either averages for the medium-term period or a value for the final year (in the most recent case, 1991). This procedure has the advantage of consistency with the short- to medium-term breakdown employed elsewhere in the World Economic Exercise, but it may be useful to consider other ways of attacking the problem at hand. An alternative that could be examined would be to provide more detailed information for one or perhaps two years immediately following the short-run period.

5. The role of saving and investment balances

The paper discussed by the Executive Board in July (EBS/86/127) proposed an analytical framework that would make use of the relationships among current account balances, fiscal positions, and private and domestic saving and investment balances. The August World Economic Outlook (SM/86/196) implemented this framework in the chapter on policy interactions in industrial countries. The framework itself is, of course, both simple and basic, and it has been used for many years in all forms of surveillance work. What was different in the treatment developed in the latest World Economic Outlook was the degree of emphasis placed on these relationships, and the additional detail that was introduced into the analysis.

The saving-investment approach begins with the accounting identity that the sum of sectoral net saving balances in any economy must be zero. That is, net domestic private saving plus net government saving plus net foreign saving will, by definition, equal zero. Another, more convenient, way of expressing this identity is that the current account deficit (which is equivalent to net foreign saving) must equal the sum of the government deficit and the financial deficit of the private sector (investment net of private saving).

By itself, of course, this identity reveals nothing about causal relationships. Its usefulness arises because if projections are made for each component of the equation, the results may be checked for consistency, both within each country and between countries. Such inconsistencies imply that the initial assumptions regarding variables such as interest rates or exchange rates, or the estimated behavioral relationships, will be invalidated. Attention is thereby directed to the emergence of tensions in the projections and possibly to the need for policy adjustments.

A key element in using the saving-investment framework to appraise potential balance of payments pressures is the assessment of factors affecting the financial position of the private sector. As with any macroeconomic data, examination of historical trends may give only a very imprecise indication of future developments. A preferred procedure is to base judgments regarding sustainability on estimated functional relationships. Here, too, the difficulties are not negligible, not least because the statistical development of private saving data is generally inferior to many other macroeconomic series; in most cases, private saving data are themselves derived residually in national accounts. Nonetheless, trends in saving and investment in the major countries have generally proved amenable to empirical estimation, and fluctuations in saving-investment balances may not have been notably more difficult to analyze or project than those of other related data.

Discussion of the saving-investment framework by the Executive Board and the Interim Committee highlighted both its potential usefulness in illuminating and clarifying surveillance and a number of practical limitations. On the one hand, some observed that the use of the saving-investment framework in the World Economic Outlook had improved the Fund's insight into the nature and determination of major trade imbalances and exchange rate misalignments. Others, however, pointed to inadequacies of data and to the incomplete picture that saving-investment relationships give by themselves. Suggestions for improvement related primarily to the need to develop an integrated analysis that accounts as fully as possible for the many complexities and differences between countries.

A number of Executive Directors observed that a given pattern of net saving-investment balances may be as compatible with a stagnating world economy as with a growing one. For example, a reduction in a country's fiscal deficit could be accompanied by a fall in personal saving or by an increase in private investment. Either shift would limit the strengthening in the country's current account balance that would follow from the fiscal shift, but the implications for sustainability of the situation could be quite different. This observation does not by itself prejudice the usefulness of the saving-investment approach as an analytical tool; however, it underlines the importance of examining saving and investment separately. It also suggests the need for an analysis of the mechanisms by which basic identities are preserved, and the implications of these mechanisms for factors such as growth and inflation.

A related point is that the ultimate function of the analytical framework must be to help policymakers focus on the broad range of underlying policies that can affect external positions and exchange rates. However one defines the framework, it must be capable of permitting an analysis of the effects of policy actions on the variables that are the objectives of policy.

Several Executive Directors pointed to the severity of data problems in this sphere. A number of issues arise. First, the huge global discrepancy in measuring current account balances makes it difficult to assess the consistency of the components of the saving-investment identity. 1/ Second, private saving data are derived residually in national accounts and may be subject to large errors. Third, some saving and investment data become available relatively late and may not be practical to use as the sole basis for policy evaluation.

1/ Since 1978, this discrepancy has fluctuated between minus $24 billion and minus $106 billion.

Other participants in the discussions, however, noted that these problems may not be much more serious than those facing empirical macroeconomic analysis generally.

A few conclusions may be drawn at this stage. First, The advantage of the saving-investment framework is that it promotes analysis of the relationship between domestic and external development and aids in the assessment of sustainability and international consistency. For example, if one were to determine that the recent surpluses in the Japanese and German current account balances and the deficits in the U.S. balance should decline over a period of several years, then a careful analysis of saving-investment balances would play an important role in drawing implications for domestic saving and investment and in formulating recommendations for policy adjustments to bring about the desired internal and external adjustment.

Second, an analytical framework based on saving-investment balances must be sufficiently flexible to permit the analysis of sustainability and consistency to develop along several lines. With reference to an individual country, one should be able to examine whether the projected patterns of domestic saving and investment are in line with historical experience, taking due account of developments that might affect these patterns over time. In addition, one should be able to examine the effects of sustained shifts in saving and investment flows on the international net asset position of the economy. Do prospective payments trends imply a buildup of international claims and liabilities that will create tensions in financial markets?

A third conclusion is that the analysis of global payments patterns is complicated by the statistical discrepancy in global current account balances. Furthermore, any global inconsistency in measuring current account balances will necessarily be mirrored by a commensurate error in the domestic saving and investment counterparts. The magnitude of this global error--and, more importantly, of its year-to-year changes--calls for caution in the application of the saving-investment framework to the assessment of the sustainability of payments positions. It may be anticipated that the forthcoming report of the Working Group on the Statistical Discrepancy will provide some guidance for incorporating at least limited information about the likely allocation of the discrepancy to individual countries or groups of countries.

Finally, it should be noted that, although the saving-investment framework has been an integral part of the staff's initial approach to the use of indicators in surveillance, this framework is not intended to be all-inclusive or to exclude the introduction of other relevant information. It is particularly useful for studying the effects of large shifts in fiscal policies or of external shocks affecting current account balances, but in the absence of such events it may prove to be less useful in capturing the implications of smaller shifts in saving or investment patterns. Furthermore, an analysis of net saving balances does not by itself provide an explanation of changes in economic growth rates. Nonetheless, although the complexities of the problems and the limitations of the framework should not be underestimated, the analysis of saving and investment data does provide the means for integrating diverse information into a coherent framework focusing on the sustainability of the balance of payments position.

IV. The Choice of Indicators

In the general conduct of surveillance, it is appropriate and desirable to use all available information about each economy, and the issue of limiting the set of variables to examine does not normally arise. However, if indicators are to serve to focus attention systematically on particular developments or trends that require collective international review, it may be useful to speficy a more limited set of variables that--as the earlier staff paper noted--should be timely, quantifiable, relatively easy to interpret, and adequately comparable, both across countries and in relation to objective standards. These principles were broadly accepted during the ensuing discussions, but a number of points were made regarding specific issues.

1. Specification of a concise list

A minimum list of indicators of performance might include, as measures of economic performance, growth (real GNP and domestic demand), inflation (GNP/GDP deflators and consumer prices), and current account balances; as intermediate variables, exchange rates and interest rates (in nominal and real terms); and, as indicators of economic policies, fiscal positions (for central and general governments) and growth rates for relevant monetary aggregates. In order to analyze each of these indicators, information on private saving and investment, structural budgetary policies, supply-side policies, changes in international reserves, employment and unemployment, and other data could be introduced as needed. Clearly, these lists would have to be allowed to evolve over time, as experience was gained, and the problems confronting the world economy changed.

The difficulty with attempting to focus on a limited list of indicators is that different indicators acquire prominence for different purposes. It is possible to focus on the international or the domestic manifestations of unsustainability, and on the symptoms or the underlying causes of potential disorders. Furthermore, regardless of the purpose, it may be necessary to examine more than one variable in order to gain a clear picture of a given dimension of economic policies or performance.

Policy indicators may be especially difficult to cover with a short list that is both comprehensive and internationally comparable. To take only one example, fiscal policy can be represented by the budgetary deficit at the central or the general government level, and can be measured with or without adjustment for cyclical factors. Moreover, with several major countries giving prominence to fiscal reform, analysis of the structure of fiscal revenues and expenditures is important to provide an adequately rounded picture of the economic effects of a particular budgetary stance.

Performance indicators are also subject to possible proliferation. As was noted in the first staff paper, nominal domestic demand may provide important information that is not contained in GNP figures. The rate of growth of domestic demand is important in judging whether a given rate of GNP growth is consistent with the reduction of external disequilibria. Moreover, the composition of domestic demand is important in judging the sustainability of a given rate of output growth. In addition, even if employment data prove difficult to work with as performance indicators, data on potential output or capacity utilization would be indispensable in some circumstances. If it is desirable to have only one measure of income, GNP has the advantages of being widely understood and comprehensive. But there clearly will be occasions when supplementary information will be called for.

The appropriate role for structural (i.e., supply-side) indicators was also considered. It was pointed out that these indicators are critical for certain purposes, and they play an increasingly prominent role in surveillance. However, in the context of the indicators exercise, the criteria of commensurability and importance for the linkages among countries might make it reasonable to exclude such variables. Some felt that it could be useful for countries to provide descriptive material on structural indicators, and others called for additional research. As for employment indicators, if they were used it would be essential for them to be supplemented with indicators of the utilization of capital capacity.

Because of the difficulties in reaching agreement on a relatively short list of indicators, it was argued by some that it would be preferable to have as complete a list as possible. It was noted that, in order to promote stability of exchange rates through convergence of performance toward sustainable, noninflationary growth, analysis is needed of a wide range of indicators, including real output, inflation, budget deficits, and monetary growth. In assessing the balance of payments, the current account balance may need to be supplemented with indicators of quantities, terms of trade, and capital flows. In addition, it would help to have indicators that reflect the impact of trading activities on, inter alia, countries engaged in adjustment programs.

The foregoing considerations argue against being too ambitious about trying to specify a limited set of indicators. On the other hand, if the development of indicators is to play a significant role in furthering the implementation of surveillance, it will be essential to define a limited and clearly relevant list. The objective of this task should not be to eliminate consideration of a subset of available information, but rather to select those variables that might be able to play a special role in the process by providing an early warning system and signalling the need for a deeper analysis.

2. Treatment of market-sensitive variables

A common theme in the discussions of the Board and Interim Committee was that market-sensitive variables, in particular exchange rates and interest rates, should be handled with care so as not to give misleading signals to the markets. In particular, it has never been seen as appropriate for the Fund to make explicit projections of exchange rates, and most Ministers and Directors would consider that the development of a system of indicators should be consistent with that constraint.

The difficulty is to reconcile the avoidance of exchange rate projections with the desirability--cited by a number of speakers--of making the assessment of exchange rate levels a prominent part of the exercise. Present practice for the World Economic Outlook is to assume unchanged real exchange rates throughout the medium-term period. In general, however, it must be recognized that treating both policies and exchange rates as variables that are given exogenously creates potential inconsistencies in projections; the farther into the future the projections are made, the more serious these inconsistencies are liable to become.

One means of reconciling the desire to assume a given set of policies with that of avoiding making explicit projections of exchange rates would be to exclude exchange rates from the analysis of policy interactions among industrial countries. That is, the staff would treat exchange rates as endogenous variables for the purpose of generating projections of economic performance, and it would acknowledge that the projections of policy instruments and current account balances might imply changes in exchange rates, but it would not reveal in its circulated papers what it estimated these implications to be. Alternatively, at least one policy variable could be made endogenous and not constrained. That approach would enable one to develop a consistent medium-term scenario with unchanged real exchange rates.

It may be that neither of the latter two approaches is really practicable, and that the best strategy would be to adhere to existing practices and to deal with any inconsistencies as they arise, in whatever way seems most appropriate in each particular case. An example of this flexible approach was the assumption made for the World Economic Outlook in early 1985; the staff's analysis at that time, while retaining the conventional working assumption of unchanged exchange rates in the short term, assumed that the U.S. and Canadian dollars would depreciate gradually over the medium term against the currencies of other industrial countries. Following the substantial depreciation that actually occurred during 1985, the World Economic Outlook analysis then returned to the standard assumption of unchanged real exchange rates in the medium term.

3. Emphasis of nominal or real magnitudes

During the Executive Board discussion in July, some Directors argued that variables such as nominal GNP should be emphasized, because demand management policies do not have a predictable impact on real magnitudes. It was argued in particular that multilateral surveillance should follow the practice of the major industrial countries in recent years by giving a central role to the control of nominal magnitudes. Others, however, felt that real GNP should be of primary interest in the exercise of surveillance. 1/ In this view, the use of indicators should be consistent with the fact that the promotion of high levels of employment and real income was one of the original objectives of the Fund, as embodied in the Articles of Agreement, in recognition of the possibility that a balanced current account accompanied by weak growth could conceal an unsustainable situation.

A related issue arose with regard to the emphasis that might be given to real or nominal exchange rates. It was observed that concentration on the real exchange rate could tend to abstract from the problem of inflation. However, others pointed out that balance of payments developments depend on international competitiveness, which is better reflected by trends in real exchange rates; such indicators are already used in the Information Notice System.

The essence of the argument in favor of giving primary emphasis in policy formation to nominal rather than real values is that for some variables, there is less agreement about the real than about the nominal effects of financial policies. For example, an increase in the growth rate of the money stock should lead eventually to an increase in nominal GNP; how that increase will be split between real growth or

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1/ If either nominal or real GNP is used as an indicator along with the GNP deflator, then the other can be readily derived. Nonetheless, there is a substantive issue concerning which of the two should be highlighted.

prices will depend on market structures and the expectations of various economic agents. Because those factors may be volatile and hard to analyze, it is less easy to find a common ground for discussion of these effects. Similar arguments may be advanced regarding effects on real interest rates and real exchange rates.

The advantage of focusing on real values is that it is real exchange rates and interest rates that affect spending decisions and, in a more general sense, it is essential to have a view of how economies are evolving in real terms. A prerequisite for effective surveillance is to know whether an economy is growing near its potential, whether real interest rates are positive or negative, and what the international competitive situation is.

The key issue in this regard is empirical: is it possible to develop enough of a consensus regarding the effects of policies on real variables to permit meaningful discussions about the appropriate actions to take when economies drift off course? This question is really part of a broader issue regarding the compatibility of the implicit models that the different participants in a debate have in mind. If surveillance is to be effective--and, a fortiori, if countries are going to seek to coordinate their policies--it is essential for there to be sufficient common understanding of how economies work. One potential benefit of a more systematic use of indicators will be in distinguishing more effectively international disagreements that result from different policies and assumptions and those that result from the use of different implicit models.

V. Country Coverage

During the discussions of indicators by the Executive Board and the Interim Committee, many speakers noted the importance of maintaining the symmetrical and even-handed nature of surveillance, and argued that this concept should be applied to the use of indicators as well. However, it was also noted that the nature of the proposals that have been made for using indicators in multilateral surveillance requires them to be applied with special reference to the larger countries. Only a relatively few countries, it was argued, have a large enough weight in world or regional trade that their policies have to be assessed with international repercussions explicitly in mind.

There are three important reasons that emerged from these discussions for incorporating material relating to countries other than the large industrial countries. First, it is important to consider the effects of the large countries' policies on the rest of the world, both for the sake of understanding fully the implications of policy changes and to enable the Fund to examine the feedbacks that might be expected on the major countries themselves. Second, the larger developing countries, as well as some of the smaller industrial countries, play an important role in the international trading system, and their policies should be examined in the same way as those of the large industrial countries. Third, there is a need to ensure not only consistency among the policies implemented by the industrial countries, but also consistency between financial and trade policies adopted by the developed world, on the one hand, and the adjustment policies implemented by the developing countries as a group, on the other. For example, policies that imply a change in the aggregate current account balance of the large industrial countries will give rise to tensions if they are not compatible with the objectives and policies of the rest of the world.

In considering the extension of indicators to developing countries, two additional issues arise. The first concerns whether it would be preferable to emphasize developments pertaining to major analytical or regional groups of countries, or to include information relating to individual countries. The other concerns the choice of indicators that would be appropriate given the particular characteristics of developing countries and the problems that they face.

One reason that the discussion of economic indicators might be confined to the larger industrial countries for purposes of multilateral surveillance is that only for those countries do policy actions have substantial repercussions for the world economy. This distinction reflects the large share of each of these countries in both world trade and capital movements. In this regard, no single developing country approaches in size the five countries whose currencies constitute the SDR (Table 1). Furthermore, the use of indicators for borrowing countries is a subject that is properly considered as part of an integrated approach to program design and performance criteria. 1/ Consequently, for the purpose of multilateral surveillance, developing countries could be considered as groups. This need not, of course, prevent the inclusion of relevant country-specific detail in considering the situation and prospects of developing countries in the World Economic Outlook. The staff intends to increase the attention given in the WEO to the situation of individual developing countries and would welcome the Board's guidance on how best to to this.

In grouping developing countries, criteria utilized should be relevant to the assessment of the performance of countries, the sustainability of their current account, and the role of domestic and foreign

1/ See "Program Design and Performance Criteria" (EBS/86/211, September 8, 1986) and Supplements 1 and 2 (September 11 and November 11, 1986, respectively).

Table 1. Twenty-Five Largest Countries, by GNP/GDP and by Total Trade, 1984-85

(In percent of world total) 1/

GNP/GDP 2/			Total Trade 3/		
1.	United States	34.9	1.	United States	16.1
2.	Japan	11.7	2.	Germany, Fed. Rep. of	8.8
3.	Germany, Fed. Rep. of	5.6	3.	Japan	8.5
4.	France	4.5	4.	United Kingdom	5.6
5.	United Kingdom	3.9	5.	France	5.5
6.	Italy	3.2	6.	Canada	4.6
7.	Canada	3.1	7.	Italy	4.4
8.	Brazil	3.1	8.	Netherlands	3.3
9.	China, People's Rep. of	2.2	9.	Belgium	2.9
10.	India	1.7	10.	Hong Kong	1.7
11.	Australia	1.5	11.	Saudi Arabia	1.7
12.	Spain	1.5	12.	Sweden	1.6
13.	Mexico	1.4	13.	China, People's Rep. of	1.6
14.	Iran, Islamic Rep. of	1.3	14.	Switzerland	1.6
15.	Netherlands	1.1	15.	Korea	1.6
16.	Sweden	0.9	16.	Taiwan, Prov. of China	1.5
17.	Saudi Arabia	0.8	17.	Spain	1.5
18.	Switzerland	0.8	18.	Singapore	1.4
19.	Argentina	0.8	19.	Australia	1.4
20.	Nigeria	0.7	20.	Brazil	1.2
21.	Korea	0.7	21.	Mexico	1.1
22.	Indonesia	0.7	22.	Austria	1.1
23.	Belgium	0.7	23.	Indonesia	1.0
24.	South Africa	0.6	24.	Norway	1.0
25.	Austria	0.6	25.	Denmark	0.9

1/ The world total excludes certain nonmember countries for which statistical data are not maintained. The term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice.
2/ Converted to a common currency using average exchange rates for 1984-85.
3/ Exports plus imports.

factors in current account developments. For these purposes, the current analytical grouping of countries in the framework of the World Economic Outlook exercise--by predominant export and by financial criteria--would appear to suffice.

The second major issue concerning the use of indicators for groups of developing countries is the choice of indicators to be monitored. It may be noted that the problems facing developing countries differ from those of industrial countries, and the availability of data will in general be more limited. For instance, of importance in the case of developing countries is the role of external financial constraints in affecting economic performance, especially the growth of real GDP. The existence of such constraints would imply that attempts to monitor the aggregate performance of developing countries could benefit from explicit examination of export growth and changes in net capital inflows to these countries.

The financing of current account deficits of developing countries often takes the form of debt-creating flows that are either to the government or government-guaranteed. The sustainability of current account positions in such cases becomes closely associated with the sustainability of the public sector borrowing that is occurring. In this context, the size and rate of increase of external public debt and debt service in relation to exports and GDP become economic variables to be carefully monitored.

The economic performance of developing countries and the sustainability of their current account positions are influenced by economic developments in, and outlook for, industrial countries. There may therefore be some benefit in the use of indicators that help clarify the extent to which aggregate current account developments in the developing countries are traceable to changes in economic variables of industrial countries. In the evaluation of the compatibility of economic policies of industrial countries, and hence of their policy options, the usefulness of economic indicators would be enhanced pari passu with their ability to capture effectively the implications of such policy options for the performance and the sustainability of the current account positions of developing countries. Indeed, indicators that focus attention on such points of interaction between developing and industrial countries would help in appraising the policy options facing the major industrial countries.

Apart from the indicators discussed above for industrial countries, there are a number of other variables that appear to be important in assessing the sustainability of current account positions of groups of developing countries. Taking into account the role that they have played in the past, and in the context of the discussion in this section, additional variables that would be suggested either as indicators or as a means of analyzing the basic indicators could include the real value of official development assistance and the net inflow of commercial bank credit. As a first approximation, movements in those variables provide some indication of the external financing constraints that developing countries face, even though the magnitudes of the flows are affected by the domestic economic policies of the developing countries themselves. Also useful for inclusion would be the terms of trade, the stock of external debt (in relation to exports), and the magnitude of debt service (also in percent of exports). Finally, the growth in the volume of exports and imports would appear to be useful as indicators in light of the role that these variables play in the growth process of the developing countries.

VI. Implementation

The role of the Fund in the implementation of a system of indicators also came under discussion by the Executive Board and the Interim Committee. It was acknowledged that, although the Fund had a broad representation of countries in the world economy, it would not be the most effective setting for the actual implementation of decisions regarding the coordination of policies among the larger countries. Nonetheless, even in cases where economic developments and policy issues are reviewed within a fairly small group of member countries, great importance was attached to involvement by the Fund (for example, through the participation by the Managing Director in ministerial meetings).

An approach to multilateral surveillance that many saw as potentially useful would be for the Fund staff to collect and analyze national forecasts, and for the Fund to establish procedures for discussing the consistency of objectives and policies and for reconciling discrepancies among the forecasts. A variant on this approach would be for national authorities to provide projections concerning policy and performance indicators; the Fund's role would be to try to make them comparable and globally consistent. Other variables could be projected by the staff, perhaps with the assistance of Executive Directors and national authorities.

Others stressed the problems that might arise under such a scheme. To base a surveillance exercise on national forecasts could lead to problems of widely different methodology and coverage. In addition, while national forecasts are indicative of expected trends, they should not be viewed as rigid policy targets that could be negotiated or agreed through multilateral discussions.

Another difficult issue concerning implementation concerns the treatment of unsustainable or inconsistent situations in the projections presented in the World Economic Outlook. The difficulty is that if the indicated policies are judged to be unsustainable, it may not be easy to describe adequately the most likely scenario that follows from them.

For example, excessive reliance over time on foreign savings for financing a fiscal deficit--even for the largest reserve-currency countries--could lead eventually to a forced reversal of fiscal policy, to a shift to greater monetary accommodation, or to a sudden change in financial market conditions if an event occurred to cause a loss of investor confidence. The particular way in which unsustainability eventually manifests itself is hard to predict and depends on non-economic factors. Moreover, forecasting quantitatively a disruption in economic relationships may be viewed as unnecessarily alarmist, when most observers would accept that a policy change could pre-empt such an outcome.

In the past, the staff has usually dealt with unsustainability in an indirect way, through reference to "tensions" or difficulties that might arise through the continuation of current policies. Underlying this practice is a notion of ex ante "consistency" of payments balances at existing real exchange rates. However, at times of particular difficulty in projecting the medium-term consequences of unsustainable policies, it is all the more important to be as explicit about these consequences as possible, in order to clarify the reasons for concern.

It may be useful to consider several alternatives for presenting the tensions inherent in a set of projections. One possibility would be to base the projections on actual policies, and follow the data wherever they lead. The advantage of this approach would be to emphasize very clearly the dangers of continuing on a present course. Nonetheless, this option raises potentially serious problems. As already noted, if the policies are unsustainable, it is generally impossible to determine the form that the rupture will take or even when it is likely to come. It also becomes especially difficult in such cases to defend the use of unchanged real exchange rates as a working assumption.

A second possibility would be to base the projections on assumed alternative policies, modified so as to make the outcome "sustainable." This option, however, would seem to be inconsistent with the need for the Fund to discuss the implications of existing policies and to offer warnings if policies are thought likely to lead to undesirable outcomes, especially with respect to external balances.

A third option is to present projections in which the outcome avoids unsustainable paths--perhaps by simply assuming that domestic and external imbalances will be financed at the assumed interest and exchange rates--and then to discuss the various difficulties that might prevent this outcome from materializing. This option, which is the general approach that has been taken by the staff, may be the only feasible one, in view of the problems with the others. Nonetheless, it too raises dilemmas. In practice, this approach amounts to saying, "Here are the projections, but here are some reasons why they might not be the most likely outcome." A surface reading of such a document could give the impression that the forecast is basically optimistic, with some possible concerns being raised. The deeper message would be that in order for the forecast to turn out all right, policies will have to be changed, or a shift in exchange rates will have to be accepted.

A fourth option would be to present a central scenario based on unchanged policies, with alternatives based on "preferred" policies. If the pursuit of unchanged policies were thought to lead to unpredictable outcomes, then a truncated set of projections could be set out. For example, for the period during which U.S. fiscal policy was thought to be on a path leading to an unsustainable medium-term outcome, a path could have been given for U.S. deficits and debt through the medium term, but with only short-term projections for output, inflation, current account balances, and so forth. A second scenario would have given the outlook under the assumption of stricter budgetary control. For purposes of depicting medium-term scenarios for developing countries, the international economic environment could have been described by reference to that second scenario.

A final question that generated a great deal of interest was whether and in what manner indicators should be used to trigger discussions or adjustments in policies. Some would prefer to see a strong role in order to give more content to the process. Others cautioned against the risk of introducing inappropriate rigidities into the surveillance process. The issue of whether and how supplementary discussions with individual member countries should be triggered is one that is properly dealt with in the context of the Board's regular review of the implementation of surveillance. As such, detailed consideration of this issue is left to the forthcoming Board paper on this subject. One possible procedure that might be of assistance would be to circulate a list of current economic indicators in major countries (which the staff already prepares for internal purposes) for the information of Executive Directors.

VII. Issues for Discussion

This paper has raised a number of questions regarding the use of indicators in the conduct of surveillance and in the coordination of economic policies. To some extent, these open questions call for further research on particular issues, and the staff is undertaking or plans to undertake a number of research projects that relate to policy coordination. The guidance of Directors concerning priorities for these projects, as well as suggestions for additional topics, would be welcome.

First, a Staff Study for the World Economic Outlook is being prepared that will discuss critically the available theoretical and empirical literature on policy coordination and the relevance of that literature to the Fund. Second, a study is under way that will develop an analytical framework that emphasizes the international spillovers resulting from policy actions, and the way in which specific indicators can provide information about past or prospective developments. Third, a model has been developed and estimated for the purpose of studying the likely current account implications of different medium-term fiscal policy stances in the three largest industrial countries. Fourth, the saving-investment framework is being investigated in greater depth, with an eye toward making further progress in analyzing the sustainable current account positions of industrial countries.

As a fifth project, the indicators of real effective exchange rates that were developed in conjunction with the Information Notice System are being refined for both industrial and developing countries, as are estimates of potential output in industrial countries. Sixth, a review is being made of the forecasting track record of the World Economic Outlook; a similar review could be undertaken of past episodes in which complex policy interactions were at play, in order to determine whether and how the analysis of those circumstances might have been improved through the use of indicators or of the analytical framework discussed above. Seventh, with regard to developing countries, studies are being developed that will examine the prospects for import-saving growth and export diversification; these studies will discuss the implications of various indicators for policy adjustments and for medium-term growth prospects.

The resolution of broader issues, of course, cannot rely simply on research; the guidance of Directors is also sought in determining the best ways to deal with a number of the issues raised throughout this paper. Perhaps the most difficult issue concerns the assessment of sustainability of external positions. The staff has proposed strengthening its existing procedures for analyzing saving and investment balances. The major empirical question--which can probably be resolved fully only through experience--is whether enough is known about the fundamental determinants of private domestic saving and investment to warrant drawing conclusions about the sustainability of the movements that are implied by projections of current account and fiscal balances.

A second question about the analytical framework is whether there exists enough of a consensus about the effects of policy actions on economic performance to enable a substantive dialogue to occur. Obviously, disagreements will always exist, and there is no firm line between healthy dissent and the absence of a common ground. A related issue is whether agreement can be reached concerning a range of acceptable values, or at least the desired direction of change, for key variables such as current account balances, exchange rates, fiscal deficits, inflation, or output growth. Again, it would appear that experience will provide the only means of answering these questions.

On a more technical level, the best way to approach the medium term remains open. The question is whether it is feasible to extend forecasts beyond the normal two-year period over which the World Economic Outlook exercise is conducted, and whether the linkages between medium-term (three- to five-year) scenarios and shorter-term forecasts can be made sufficiently clear.

The staff also would seek advice on the best ways to develop a list of indicators that is both concise and reasonably complete. The paper has suggested that, while it will always be desirable and necessary to bring in as much information as possible in the course of surveillance discussions, the indicators themselves should be limited to the variables that contribute most clearly to an understanding of international linkages and that provide reliable information about impending unsustainable situations. It may, however, prove difficult to establish a consensus regarding a short list of variables that would apply to all of the countries concerned.

A related question concerns the role of sensitive variables. The key problem centers on exchange rates. These data must play a central role, and some would prefer that they be made the basis of a set of reference zones that would help to signal the need for policy adjustments. Regardless of how far one would wish to go in that direction, the sensitivity of projections and of assessments of appropriate levels cannot be ignored.

In spite of these complexities, there do not appear to be major obstacles that would limit the usefulness of indicators as a means of improving the dialogue among countries and of furthering a mutual understanding of policy interactions. But it is apparent that much remains to be done before this type of exercise could provide the basis for a more systematized approach to the coordination of economic policies.