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To: Members of the Executive Board

From: The Secretary

Subject: The Chairman's Summing Up at the Conclusion
of the Discussion on Surveillance - Indicators
Relating to Policy Actions and Economic
Performance - EBM/86/115 (7/14/86)

The document on the above subject issued on July 21, 1986 as
Buff document 86/140 should have been issued in the Surveillance series.

A corrected document is attached.

Att: (1)

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The Chairman's Summing Up at the Conclusion
of the Discussion on Surveillance - Indicators
Relating to Policy Actions and Economic Performance
Executive Board Meeting 86/115 - July 14, 1986

General Comments

In presenting their views today Directors generally organized their remarks around the three subject areas identified in the staff paper, namely, the analytical focus of the proposed approach to surveillance, the nature of the indicators to be used, and the proposed procedures.

In these short closing remarks I will follow the same order, although I will begin by noting several points of a more general character that deserve emphasis. First, in welcoming today's discussion on the staff paper--which was considered to be of high quality--many speakers underlined its preliminary character. They noted that the process of developing an appropriate role for indicators in Fund surveillance would have to evolve gradually, and that it would be a mistake to be too precise or to stress operational aspects at this early stage. Second, several Directors stressed, as they have on earlier occasions, the paramount need for political will if surveillance is to be effective. As a third general point, many Directors emphasized a point made in the staff paper, namely, that the use of indicators in surveillance should be a useful complement to broad-based judgmental analysis. A fourth general point is that the purpose of the indicators exercise is, as most Executive Directors said, to strengthen the process of multilateral surveillance in order eventually to influence governments so that they will not pursue policies that would be harmful to the international community at large. The indicators exercise is not to be an end in itself.

Analytical Framework

Let me turn now to the first of the three subject areas I mentioned at the outset, the analytical framework. Most Directors agreed with the staff that the central focus of surveillance should be on developments affecting the balance of payments. A few, however, felt that a better focus of analysis would have been to look directly at exchange rates, while others favored primary concentration on domestic policy variables. In general, however, I think that it is fair to say that it was accepted that the monitoring of domestic economic variables would be undertaken in light of their domestic implications as well as in light of their implications for the world economy and for balance of payments flows, and that international consistency and compatibility of external payments

positions in a medium-term framework was the right focus for the surveillance exercise. This notion, which has been confirmed today, is an important one.

Most Directors felt that the saving/investment framework was a helpful vehicle for interpreting international economic interactions. The need to examine the factors influencing saving and investment was also recognized. However, a few Directors, and Mr. Fujino in particular, said that they were not convinced that it was helpful to explain balance of payments developments by their relationship to domestic saving/investment balances. Directors acknowledged that it was difficult to make firm judgments on such complex matters, on which interpretations can vary, but they felt that it would be desirable to make the attempt. Some speakers, however, viewed the analytical structure proposed by the staff as being too constraining and implicitly favored a more eclectic approach to the interpretation of developments in key variables. For example, a number of Directors said that they doubted whether the concept of a sustainable balance of payments, as developed by the staff, could be given a satisfactory empirical content. Directors also noted that calculations of underlying or cyclically adjusted current account positions should be approached with caution.

Choice of Indicators

Most Directors broadly agreed with the list of indicators suggested by the staff, with many speakers offering useful and sometimes critical comments and suggestions on specific indicators. Nearly all speakers expressed some reservations about particular points, although they could agree with the thrust of the staff recommendations. A few Directors questioned the usefulness of the classification system used by the staff. Nevertheless, for convenience I will follow it in this summary. Before I come to the individual variables, I would say that on the whole Directors agreed that indicators should be limited in number, quantifiable, timely, relatively easy to interpret, and comparable from country to country.

Performance Variables

Most Directors agreed with the use of real GDP (or GNP) growth as the primary measure of output, although many speakers considered that it should be complemented by a measure of domestic demand growth. In addition, and with various degrees of emphasis, some Directors expressed the view that nominal variables, including nominal GDP, should be focused on and should at least be incorporated in the analysis.

Most Directors held the view that it would be helpful to use unemployment as an indicator, perhaps together with other measures of capacity utilization. They judged that it was important to know whether a given balance of payments outcome was being achieved consistently with an adequate rate of capacity utilization and that, although unemployment

figures had to be interpreted with caution, they were nevertheless useful. It was also suggested that attention should be paid to employment and other labor market data.

On the subject of inflation, there was a division of views. There was a measure of support for the concept of normalized unit labor costs as a possible measure of underlying cost pressures. For the most part, however, Directors, especially those from larger industrial countries, expressed reservations about this concept of unit labor costs and would appear to prefer a more familiar indicator such as the GDP deflator or the wholesale price index.

In regard to the balance of payments, there was no dissent from the suggestion to use the current account, in a medium-term framework, as a primary indicator. Some speakers felt that this indicator should be complemented by information on the capital account, and by estimates and projections for the terms of trade and relative cyclical positions. The usefulness of movements in foreign reserves as a special indicator was doubted by some Directors.

Policy Variables

On monetary policy, there was broad agreement that the indicator chosen should be the one employed by the authorities of the country concerned, should be expressed in nominal terms, and should be interpreted with great caution.

Regarding fiscal policy, most Directors agreed that the actual fiscal deficit should be the primary indicator. There were some differences of view on how much weight should be given to cyclically adjusted fiscal deficits, with several Directors noting the analytical difficulties that are encountered in making such adjustments. There was relatively little support, at least from the larger countries, for adjusting the fiscal deficit to inflation. Mr. Fujino noted that, while it would be difficult to develop indicators of appropriate medium-term fiscal policy objectives, it would be important to examine possible ways in which to assess fiscal policy in a medium-term perspective.

Directors generally acknowledged that structural policies were difficult to quantify, but it was noted that they were nonetheless important, and several Directors requested that the staff analysis should be as explicit as possible in describing structural policies, including trade policies.

Intermediate Variables

Concerning interest rates and exchange rates, several Directors pointed out that these were market-determined variables and that staff projections of those variables would be extremely sensitive. They cautioned that the staff should not venture beyond making assumptions with respect to these variables and certainly should not publish any material that

would give the impression that we were making forecasts. Other Directors, however, pointed out that an analysis of economic interactions would be incomplete if the implications of alternative exchange rate trends were not adequately explored. These two positions are not mutually inconsistent, because the second position entails assumptions and not forecasts. But discretion is clearly of great importance in this field.

As to measures of savings and investment, several Directors pointed out the statistical shortcomings of estimates of these variables. Some speakers felt that these shortcomings, together with the underlying reservations about the basis of the staff's analysis, made it unwise to attempt to collect estimates and projections for savings and investment. On the whole, however, most Directors supported the staff's proposed approach.

Procedures

Directors generally agreed with the procedures proposed on page 25 of the staff paper. It was noted that these procedures should be considered experimental and subject to change as experience with surveillance was gathered and as guidance was provided by the Board. The role of Article IV consultations as the means of collecting and analyzing national forecasts was stressed. It was assumed that the multilateral discussions of indicators should take place at the same time as the World Economic Outlook discussion, although--and this matter will be further studied--there could be a separate discussion for which separate documentation would be provided. In that context, the analysis in a special WEO chapter or document of policy interrelations among the industrial countries--particularly the G-10 countries--and their international consequences would acquire particular importance. The analysis of other significant country groupings was also advocated by several Directors.

As far as follow-up procedures were concerned, some reservations were expressed about the use of additional information notices or special mini-discussions on the World Economic Outlook. Directors generally seem to favor the Managing Director using his discretion to judge when economic developments had reached a point at which a general discussion or special consultation would be helpful. It was also suggested that the Managing Director should participate in ministerial meetings on surveillance.

This discussion was very interesting and highlighted the complexities and the potential of the indicators exercise. The concept of indicators has indeed broad potential, and indicators could be used at different levels. 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.

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 more the international community wants to move toward the ambitious concepts and goals to which I have referred, the more convincing we would have to be, and the more the notions of sustainability, capital movements, and the models that underlie the notions of optimal growth and stability worldwide would have to be understood and would have to be based on firm and valid analysis that is acceptable to the interested members. We are not yet at that point; further elaboration of the notions to which I have referred--particularly balance of payments sustainability in a medium-term framework--is called for. I thank Mr. Polak in particular for his views on this point. Clearly we will need pragmatism, discretion, gradualism, and judgment. No one today has advocated mechanistic or automatic application of a set of indicators. As Mr. Kafka said, a set of indicators cannot of itself make a coherent system. Nor can indicators be used to automatically trigger policy actions. But indicators can and should signal the existence of potential problems for countries and for the system at large. Thus, if indicators cannot trigger direct action, they can at least trigger questions, discussions and, I would hope, eventually consideration of possible policy action.

We will take stock of the important and interesting suggestions made during this discussion. I am particularly grateful to Mr. Lankester, Mr. Polak, and Mrs. Ploix for having circulated their views, and I share Mr. Nimatallah's hope that others--especially Directors from countries that are directly involved in multilateral surveillance--will circulate their statements.

In taking stock of Directors' suggestions I believe that we will gradually, in an evolving process, be able to enrich the WEO exercise. We are in my view at a turning point in that exercise: an excessive focus on indicators could introduce rigidities and weaken the WEO exercise; but, on the other hand, indicators could give new perspectives and perhaps signal things that our classical approach was not signaling--for example, inconsistencies between national concepts, forecasts, or assumptions. In a sense, the WEO exercise is a sanitized exercise: these inconsistencies do not appear--they are eliminated because national projections are made consistent. I think that it would be interesting to present, perhaps in a parallel set of figures, all the national projections, even if they are

inconsistent, and to show how they are inconsistent and how they could be reconciled. Such an exercise should lead to a better understanding of problems and further on to more effective international cooperation.

As Directors and I myself stressed, our discussion today has been a preliminary one. We will move gradually and cautiously in coming months to respond to the Interim Committee's request to study possible indicators. The staff will carefully review Directors' comments and suggestions in the course of preparing the next WEO paper. Any changes in the WEO exercise resulting from those comments and suggestions will be explained in the introduction to the next WEO paper. The Executive Board will thus have an opportunity to review and comment on the next WEO paper--including any innovations in the use of indicators--before the September 1986 meeting of the Interim Committee; those comments by Directors will of course be instrumental in guiding the staff's further work on indicators and the WEO exercise. At the September Interim Committee meeting, I will summarize our work on indicators. In so doing I will draw on my concluding remarks in this discussion and I will supplement those remarks as necessary.