IMF Publication

IMF Sharpens Exchange Rate Views at Research Gathering

Several papers presented at the IMF's eighth Jacques Polak Annual Research Conference considered the impact of economic fundamentals and policy on the exchange rate.

The IMF put the spotlight on exchange rates at its annual research conference, held in mid-November at a time of continued concern about currency market fluctuations and exchange rate misalignments. A group of leading economists met for the IMF's eighth Jacques Polak Annual Research Conference in Washington, D.C., to present papers on and discuss a wide range of exchange rate–related issues. Topics covered at the conference, which was opened by new IMF Managing Director Dominique Strauss-Kahn, included the international role of the dollar, unbalanced trade, exchange rate models, and when to abandon a fixed exchange rate.

The keynote Mundell-Fleming Lecture, "Exchange Rate Systems, Surveillance, and Advice," was delivered by Stanley Fischer, Governor of the Bank of Israel and former IMF First Deputy Managing Director. Peter Garber from Deutsche Bank, Michael Mussa from the Peterson Institute of International Economics, and David Wessel from the *Wall Street Journal* participated in the Economic Forum "The Exchange Rate and Economic Performance," which was moderated by Simon Johnson, the IMF's Economic Counsellor and Director of the Research Department.

The conference marks the 70th year of Jacques Polak's career as an international economist. At the conference, both Strauss-Kahn and First Deputy Managing Director John Lipsky paid warm tributes to Polak, acknowledging his important role in shaping the work of the IMF.

Increasing interdependence

In his opening remarks, Strauss-Kahn singled out three exchange rate–related themes—increasing macroeconomic interdependence stemming from globalization, exchange rate determination, and political economy perspectives on exchange rates—that were highlighted at the conference. On the first theme, he cited the paper, "Macroeconomic Interdependence and the International Role of the Dollar," by Linda Goldberg and Cedric Tille, who argue that U.S. or European Central Bank monetary policy can have far-reaching effects on countries that denominate trade in dollars, even if direct trade with the United States or the euro area is negligible. "This is especially important for the dollar and the euro," Strauss-Kahn said.

The interaction between exchange rates and goods trade between countries is central in analyzing cross-country interdependence and policy spillovers. In their paper on fiscal policy and the trade balance, Tommaso Monacelli and Roberto Perotti of Italy's Università Bocconi underscored the importance of fiscal policy for the real exchange rate and the trade balance. They found that, in all OECD countries that were part of their sample, a rise in government spending induces a real exchange rate depreciation and a trade balance deficit. In the United States, however, the trade balance effect is small.

On the degree of real exchange rate adjustment necessary to improve the U.S. current account balance—a topic of continuing debate—Robert Dekle, Jonathan Eaton, and Samuel Kortum calibrated a novel trade model and found that balancing current accounts may require modest changes in relative wages and real wages. For example, wages in the United States (the country with the largest deficit) need to fall by about 10 percent relative to those in Japan (the country with the largest surplus) to balance current accounts.

Exchange rate determination

The issue of how exchange rates are determined over time, Strauss-Kahn said, was of the "highest importance" for the Fund. Referring to the IMF's 2007 Decision on Bilateral Surveillance—which provides a comprehensive framework for monitoring country economies anchored on the concept of external stability—Strauss-Kahn stressed that effective surveillance would require not only an appreciation of a member's individual circumstances, but also solid analytical tools for assessing the consistency of exchange rates with medium-run fundamentals. Such tools take into account the constraint that overvaluations in some parts of the world need to be balanced out by undervaluations elsewhere—or multilateral consistency.

In this context, Strauss-Kahn underscored the work of the Fund's Consultative Group on Exchange Rates (CGER), which had been expanded to include the key emerging market countries as well as the main currencies in the industrial world.

Lipsky described the CGER as a cutting-edge analytical tool for conducting bilateral and multilateral surveillance in an evenhanded fashion. He said the scope of the Fund's analytical work on exchange rates would expand further to include producers of exhaustible natural resources and some low-income countries that have become important players in the global economy. Progress is also being made on integrating portfolio investment decisions into the CGER framework.

In the first paper presented in the exchange rate determination session, "Financial Exchange Rates and International Currency Exposures," Philip Lane and Jay C. Shambaugh highlighted how the foreign currency denomination of a country's external position can play a pivotal role in external adjustments. Several papers also considered the impact of economic fundamentals and policy on the exchange rate. Columbia University's Richard Clarida and Daniel Waldman examined the impact of monetary policy on the exchange rate, arguing that news of higher-than-expected inflation can lead to an appreciation of the nominal exchange rate if the central bank has an inflation target implemented with a "Taylor Rule."

Charles Engel, Nelson C. Mark, and Kenneth D. West found in their paper, "Exchange Rate Models Are Not as Bad as You Think," that when flexible exchange rates incorporate news about future macroeconomic fundamentals, as implied in standard models, these models should be expected to have low forecasting power and thus should not be subject to the standard critiques of the literature. The authors proposed a number of ways to evaluate models and showed that these models might be able to account for observed exchange rate volatility.

Eugenio Salazar/IMF photo

Dominique Strauss-Kahn: Effective surveillance allows that overvaluations in some places be balanced by undervaluations elsewhere.

Political economy

The political constraints faced by country authorities in making economic policy decisions are well known. Two conference papers focused on how the preferences of different interest groups over exchange rate movements may play out in practice.

In their paper on exchange rate policy attitudes, Lawrence Broz, Jeffry Frieden, and Stephen Weymouth used survey data to show that decisions made by different players in the private sector can hinge on exchange rate movements. Citing this paper as one that highlights the theme of political economy, Strauss-Kahn said this research could be applied to explain why it is that countries often resist pressures toward both currency depreciation and appreciation.

Irineu de Carvalho Filho and Marcos Chamon of the IMF explored the "distributional impact of exchange rate movements" in their paper on the political economy of exchange rate populism. Their research showed that, in Brazil and Mexico, effects of currency appreciations on consumer goods prices tend to benefit poor households more than richer ones. However, the income of the rural poor is more adversely affected when a currency appreciates.

Policy issues

Two conference papers focused on policy responses when the economy is hit by shocks, paying particular attention to the reaction of the exchange rate. MIT's Ricardo J. Caballero and Guido Lorenzoni explained foreign exchange interventions in countries experiencing capital inflows and persistent real exchange rate appreciations. According to them, intervention in the foreign exchange market has a role to play when there are risks of overshooting and when the export sector is financially constrained. Sergio Rebelo and Carlos Végh, who studied optimal exit strategies from pegged exchange rate regimes following an unexpected increase in government spending, showed that, when fiscal shocks are large, countries should abandon a peg as soon as possible, even if international reserves are plentiful.

On the issue of the exchange rate regime, Adolfo Barajas, Lennart Erickson, and Roberto Steiner examined why emerging markets fear declaring their exchange rate regime choice. In their paper, "Fear of Declaring: Do Markets Care What Countries Say about Their Exchange Rate Policies?" the authors suggested that international capital markets tend to reward countries with exchange rate regimes classified as flexible. And in their paper on estimating de facto exchange rate regimes, Jeffrey Frankel and Shang-Jin Wei developed a new technique for estimating the de facto degree of exchange rate flexibility of a currency. ■

Julian Di Giovanni
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Exchange Rate Regime Bipolarity Continues, Slowly

The economic crises of the 1990s forced many countries to reexamine their choice of exchange rate regimes and to move away from more crisis-prone arrangements. This resulted in a shift from soft pegs—the use of pegged but adjustable rates—toward either a hard peg or a free-floating regime.

In his popular 2001 essay, "Exchange Rate Regimes: Is the Bipolar View Correct?" Stanley Fischer, then First Deputy Managing Director of the IMF and now Governor of the Bank of Israel, predicted that the move toward bipolarity by many advanced and emerging market countries, which was strikingly visible in the 1990s, was likely to continue. Soft pegs had proved to be unviable over time, Fischer said in 2001, for countries with open capital accounts. Various currency crises dating as far back as the 1970s had shown that countries could not simultaneously maintain fixed exchange rates, capital mobility, and domestically oriented monetary policies—the so-called impossible trinity.

Delivering this year's Mundell-Fleming Lecture—"Exchange Rate Systems, Surveillance, and Advice"—at the IMF's eighth Jacques Polak Annual Research Conference on November 15, Fischer revisited the topic of bipolarity and updated it in the light of the experience of the past decade. The shift by developed and emerging market countries from the more crisis-prone soft pegs, in which the government commits itself to defending a particular exchange rate value or narrow range of values, toward hard pegs or floating regimes, Fischer found, had continued over time, though at a reduced pace (see chart). However, this trend had reversed among other (mostly developing) countries, which had seen a move away from the floating rate to the intermediate regimes.

But why has the pace of the bipolar shift slowed in advanced and emerging market countries? The introduction of the euro and the 1990s' emerging market financial crises were largely responsible for the faster pace of the shift, he said. The current decade has not seen any events on a similar scale, though the slowly growing number of Europe's Economic and Monetary Union countries means the shift to bipolarity for the advanced and emerging market country grouping is likely to continue, he explained.

Two qualifications

Although the recent exchange rate regime developments in developed and emerging market countries had been broadly consistent with the bipolar view, Fischer emphasized two important qualifications to the hypothesis. First, the shift to bipolarity applies to countries with open capital accounts, he said, though some countries in the emerging market grouping (in the chart) had significant capital controls.

This qualification was noted in Fischer's 2001 bipolar hypothesis: "for countries open to international capital flows: (i) soft exchange rate pegs are not sustainable; but (ii) a wide variety of flexible exchange rate regimes remain possible; and (iii) it is to be expected that policy in most countries will not be indifferent to exchange rate movements. . . . For countries not yet open to international capital flows, [possible exchange rate regimes] include the full gamut of exchange rate arrangements." But perhaps the original qualification "was not adequately stressed," Fischer said.

Second, the floating group consists of not only free floaters but also managed floats. In fact, for the emerging market and the "other" categories in Fischer's sample, there are more managed than independent floaters. Even among independent emerging market floaters, there are many countries that intervene significantly and often, a fact that shows that "very few countries, if any, are indifferent to the behavior of the exchange rate," he remarked.

Surveillance worries

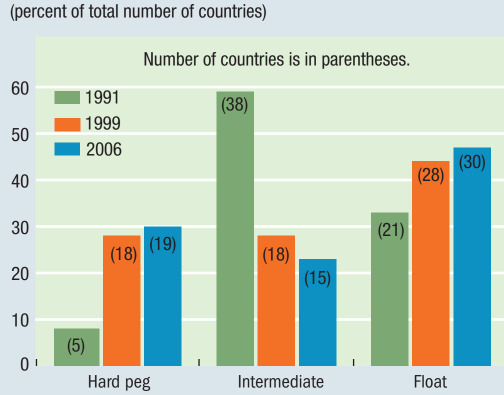
In his comments on IMF surveillance and advice, Fischer noted that the IMF's 2007 Bilateral Surveillance Decision "puts exchange rate policies at the center of the surveillance process." But he voiced concern that the new decision's focus on exchange rate policies—rather than on domestic and exchange rate policies or "overall policies"—was a drawback, because the focus on exchange rates alone was "too narrow." He hoped that the new decision would not reduce the scope of small economies' Article IV staff reports, which he characterized as "the most thorough and professional evaluation of a country's economy and economic policies." ■

Archana Kumar
IMF External Relations Department

Increasing bipolarity

The move toward bipolarity for advanced and emerging market countries continues, though at a slower pace.

(percent of total number of countries)



Source: IMF.

Major Reforms for German Budget System

Germany is expected to introduce performance budgeting and accrual accounting into its budget system as part of a package of reforms recently recommended by a Finance Ministry task force. The reforms were proposed by the ministry's Budget and Accounting Reform Task Force after more than a year's work, in which it was assisted by staff of the IMF's Fiscal Affairs Department. The aims of the proposed reforms are to improve expenditure efficiency and strengthen fiscal policy.

At present, Germany has a traditional "line-item" budget, in which ministries receive budget allocations based on the anticipated costs of their inputs, such as staff costs and supplies. This method of funding has little to do with the types of services ("outputs") to be delivered, or with the intended outcomes of those services. As an increasing number of countries have recognized, it is not a budget structure that facilitates good decision making about expenditure priorities.

To remedy this situation, the task force envisages the introduction of "product budgets"—often known elsewhere as "programs"—based on outputs and outcomes. The intention is to focus greater attention in the budget formulation stage on choices about how much money to allocate to, say, preventative health versus health treatment, or to primary versus tertiary education.

Product budgets

Under the task force's proposals, the product budgets would not in the first instance be used for parliamentary budget appropriations. The idea is that they would initially be used internally within the government in the process of formulating the budget. The logical next step would, however, be to also shift the annual budget law to a programmatic basis.

Fabrizio Bensch/Reuters

Chancellor Angela Merkel at a German school: Budget reforms focus on such choices as primary versus tertiary education funding.

The proposed move to accrual accounting is inspired by both fiscal policy and expenditure efficiency considerations. Germany recognizes that, as the IMF has argued since the promulgation of the accruals-based *Government Finance Statistics Manual* in 2001, accrual accounting gives fuller information about fiscal sustainability than does traditional cash accounting.

This is because accrual accounting systematically recognizes, in the government's balance sheet, financial assets and liabilities that are not conventional debt—such as money owed to suppliers or liabilities to pay pensions to civil servants—but that are just as relevant to fiscal sustainability. There is also a growing recognition that accrual accounting helps improve asset management and service delivery by providing better measures of the costs of production.

Golden rule

In Germany's case, there is an important additional fiscal policy consideration for the adoption of accruals. This relates to the "golden rule" enshrined in the country's constitution that requires, roughly speaking, that borrowing be used to fund only investment and not consumption.

The interpretation placed to date on the golden rule in Germany is that it permits the financing of all capital expenditure—in other words, gross investment—through debt. However, as the German Council of Economic Experts pointed out in a March 2007 report, using debt to finance gross investment means that debt is financing not only new public capital formation but also the consumption of existing assets. This allows the costs of citizens' use of public infrastructure today to be transferred to future taxpayers.

To address this problem, the Council of Economic Experts recommended that the interpretation of the golden rule be tightened to restrict borrowing to net investment—in other words, to capital expenditure minus depreciation. This calls for a measure of depreciation, for which accrual accounting is required.

However, no decision has yet been made on the status of the golden rule or on a broader reform of the fiscal framework.

Funding based on payments

The task force has recommended that the adoption of accrual accounting not be accompanied, at least at this stage, by accrual budgeting. Thus, the German budget will continue to give ministries funding based primarily on the payments they are permitted to make, rather than on the costs that they will incur.

There is much to be said for this approach. The handful of countries that have adopted accrual budgeting (notably Australia, New Zealand, the United Kingdom, and Denmark) all did so some years after having moved to accrual accounting—and nevertheless even then found accrual budgeting a demanding and complex reform. ■

Marc Robinson
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Saudi Arabia Enjoys Growth, Low Inflation

Saudi Arabia, buoyed by record-high oil prices, is enjoying solid growth and low inflation, a trend that is expected to continue over the medium term. The main downside risk is the unlikely event of a decline in global oil demand, says the IMF in its annual health check of the Saudi economy.

Growth for 2007 is projected at 4.1 percent, despite an expected contraction in oil production, and is supported by strong activity in the non-oil sector. Inflation will remain in the range of 3 percent.

Over the next five years (2008–12), real growth is expected to average 5.6 percent. Although public sector demand will continue to be an important engine for growth, non-oil activity in the private sector will expand further because of the government's continued implementation of structural reforms, which have improved the business climate.

Poverty Reduction Loan Installments for Nepal, Mali

The IMF Executive Board approved disbursements totaling $19 million to Nepal and Mali under the countries' Poverty Reduction and Growth Facility (PRGF) arrangements.

The Board approved releasing $16.9 million to Nepal following the fifth and final review of its three-year arrangement, under which the strife-torn country received a total of $79.1 million. "The Nepalese authorities are to be commended for implementing prudent macroeconomic policies and structural reforms under difficult political circumstances," IMF Deputy Managing Director Takatoshi Kato said in a statement.

Mali received $2.1 million in the sixth and final disbursement of a $14.6 million arrangement approved in June 2004. The concessional PRGF loans, which carry an interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period, support poverty reduction strategies devised by poor countries.

Kenya Gets $59 million as Reforms Progress

The IMF's Executive Board approved a disbursement to Kenya of $59 million under its three-year Poverty Reduction and Growth Facility arrangement of 2003. First Deputy Managing Director John Lipsky noted in a statement that the country's economy is growing strongly against the background of sound macroeconomic management and progress in structural reforms. At the same time, its external position has strengthened. "The sharp increase in spending envisaged in the 2007/08 budget entails some risks. However, the authorities are taking steps to address these risks," Lipsky added.

Flexible Exchange Rate Helps Colombia

Colombia's flexible exchange rate had helped it weather well the recent turbulence in global financial markets, the IMF noted on November 9 after its annual health check of the economy. The Fund said growth will remain strong in 2007 and slow to 5 percent in 2008, while inflation will decline. Colombia's economic performance has been impressive, with economic growth last year equaling its fastest pace since the late 1970s and topping the Latin American average, the IMF noted.

Daniel Munoz/Reuters

Claire Soares/Reuters

IMF Endorses Senegal's Program

The IMF Executive Board approved a three-year Policy Support Instrument (PSI) for Senegal to back the country's efforts at consolidating macroeconomic stability, increasing its growth potential, and reducing poverty. The program focuses on keeping a sound fiscal policy and enhancing fiscal governance.

PSIs are designed for low-income countries that may not need, or want, IMF financial assistance, but still want IMF advice, monitoring, and endorsement of their policies. The instruments are voluntary and requested by the country. IMF Managing Director Dominique Strauss-Kahn said that despite "temporary setbacks suffered in the last two years, Senegal has achieved a high degree of macroeconomic stability and robust growth over the last decade. The Policy Support Instrument is viewed as the appropriate next step in the Fund's relations with Senegal."

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Booknote

Postconflict Case Studies—How the IMF Is Helping

Restoring monetary and financial systems in postconflict countries features in a new IMF book. Case studies include tales of the personal courage of people in countries emerging from conflict. The study on Rwanda notes that the National Bank of Rwanda "was faced with quite a different situation from the one prevailing before the genocide: a large number of senior positions were now held by new staff" because the previous staff had lost their lives or had to flee the country.

Building Monetary and Financial Systems: Case Studies in Technical Assistance, Charles Enoch, Karl Habermeier, Marta Castello-Branco (eds.), International Monetary Fund, Washington, D.C., 2007, $29.