
Selecting and Agreeing on a Set of Reference Rates

A reference rate system would require agreement on the set of reference rates. This chapter first discusses the principles that should underlie determination of these rates and then the procedures that might best be used to achieve agreement on them.

Principles

The appropriate theory to use in calculating a set of reference rates would be the mainstream theory embodied in the macroeconomic model used explicitly or implicitly by just about every central bank in the world. According to this theory, the principal endogenous determinants of the current account are income and relative prices.¹ Income is determined by the full employment condition² and prices inherited from the past. In order for this system of equations to generate a (consistent) set of exchange rates, one needs a (consistent) set of current account targets.

Selecting a set of current account targets is by far the most politically sensitive part of the exercise. These targets play the role of “external balance” in the framework made famous by James Meade (1951). Some people argue that in this day and age there is no need for countries, or at least for major industrial countries with floating currencies and open capital accounts, to

1. Krugman (1991) termed this “the Mass. Avenue model,” since it is the theory embraced on Mass. Ave., both in Cambridge, MA, and Washington, DC.

2. Or average income over the cycle; the two will be equivalent unless some areas systematically operate at a lower pressure of demand.

bother about pursuing external balance. Markets will automatically react to ensure timely noncrisis adjustment in endogenous variables like the current account. It is easy to agree that there is a considerable amount of elasticity in the system and that it would therefore be a mistake to press countries to hit narrowly defined targets for their current accounts. At the same time, some of us are impressed by the long history of occasions when we were assured that “this time it was different” and that there was no danger of a speculative attack occurring, shortly before one occurred. We were told that about the Latin American countries before the debt crisis (“countries don’t go bankrupt”). We were told it about Mexico in 1994 (the peso was floating and Mexico had undertaken many reforms). We were told it about East Asia in 1997 (the current account deficits reflected high investment, not low saving). Now we are told it about the United States. Maybe this time the optimists are right, but it would seem safer to build in pressures for gradual adjustment. That is what a reference rate system is intended to do.

Suppose therefore that it is agreed that each country should accept a target for its current account balance in the medium term. In principle, one would want the target current account balances to reflect the saving and investment behavior of all agents so as to place economies on the intertemporally efficient path. Countries with high investment needs relative to the availability of savings from domestic sources ought to run current account deficits to supplement domestic resources with foreign savings. The problem with this proposition is that it is very general and does not serve to pin down objectively a set of quantitative figures that could be inserted in a model intended to generate reference rates. One might think of seeking to estimate a desirable current account balance by projecting sectoral balances for investment, saving, and, crucially, the fiscal balance. But if the reference rates are by construction consistent with projected fiscal policies, then the IMF necessarily cannot use this approach to try to influence fiscal policies. The role that it has up to now played in decrying large US fiscal deficits would be precluded. Those Europeans who believe that the major determinant of global imbalances is the US fiscal deficit could hardly be expected to accept that their view of the principal problem with the world economy would be ruled out by construction.

Conversely, if the IMF were to invent a set of current account targets, they would imply particular fiscal outcomes. It would be unrealistic for the IMF to try to use such assumptions to bind the fiscal policy of major countries. Moreover, it would be profoundly antidemocratic if it succeeded in binding the fiscal policy of democratic countries.

Since both uncritical acceptance of projected fiscal outcomes and IMF dictation of desirable fiscal outcomes are unacceptable, it may in practice prove necessary for the IMF staff to work with multiple scenarios. Multiple scenarios imply that multiple reference rates would emerge from the staff work. This does not necessarily imply that the Fund would ultimately have to present several sets of reference rates to the world, but it does require that

the Executive Board play a key role in agreeing on the unique set that would finally emerge.

One other point is of major importance for developing countries and emerging markets. Some of us believe that in such countries, the exchange rate can have a major impact on the growth rate. The argument (presented in Williamson 2003) is that a competitive exchange rate has a decisive influence on the propensity to invest, but of course a high propensity to invest achieves nothing if there are no funds (savings) to effect the investment. The growth-maximizing exchange rate is one where these two considerations balance at the margin. It implies a particular current account balance at full capacity output. It is this current account balance that I envisage being inserted in the set of equations as the current account target for such countries.

The next step is to establish the exchange rate implications of a set of current account balances. This task can be approached in several ways (good selections are presented in Hinkle and Montiel 1999 and Williamson 1994). My own approach was to appeal to large macroeconometric models in order to identify exchange rates that would have generated (in equilibrium) current account balances that would have matched the targets simultaneously in all the countries modeled (when they were all at internal balance). It has often proved difficult to secure convergence within a reasonable time horizon, leading many analysts who started from a similar intellectual position to use instead a partial equilibrium approach. Such an approach uses estimated trade and income elasticities to calculate where the equilibrium exchange rate is, given estimates of deviations from internal and external balance. Another approach uses an adjusted purchasing power parity approach, with adjustment being made for changes in factors that are known to influence the equilibrium exchange rate (like net foreign assets, relative productivity growth, the proportion of output accounted for by manufacturing, and commodity prices). The disadvantage of this approach is that it requires identification of a base period that was reasonably close to equilibrium. Yet another approach is used by Goldman Sachs to calculate their dynamic equilibrium exchange rates (GSDEERs), which are estimated by a single dynamic ordinary least squares estimation for all 35 countries now in the Goldman Sachs panel. This approach amounts to assuming that (apart from the country-specific dummies) the parameters of the equation (for productivity, terms of trade, and net international investment position/GDP) are identical for the 35 countries (O'Neill et al. 2005).

One popular way of estimating equilibrium exchange rates seems to me to be inappropriate: the calculation of a behavioral equilibrium exchange rate (BEER). I regard this as inappropriate because the calculation of BEERs uses current values of variables that have a clear cyclical component. For example, it is common to use interest differentials or the terms of trade of a particular year to estimate a BEER. This means that one will get an estimate much more akin to my concept of a current equilibrium exchange rate

(the rate incorporating cyclical though not speculative elements) than to my FEER, which is what one wants in this context.

Procedures

Establishment of a set of reference rates would require agreement on a series of procedural issues as well as the questions of principle discussed above. The first of these is where to put the responsibility of negotiating the reference rates. The obvious location for this would be the IMF, especially now that the members of the Fund have agreed that its central mission should be surveillance conducted multilaterally.

I would envisage such a process starting by the IMF staff using their favored approach, or perhaps a variety of approaches, on one or more sets of current account targets. This process would generate one or several sets of suggested reference rates for all IMF member countries, or at least for the larger countries (which certainly ought to include the larger emerging markets). The staff would present these to the IMF Executive Board at regular intervals (say half-yearly). A first issue would be whether there were major differences between alternative estimates of reference rates, and if so, which set should be chosen. It would of course be important to ensure that the set finally chosen was mutually consistent, and not to allow horse-trading to result in a set of inconsistent rates, but Executive Board views on the relative merits of different sets of estimates would surely be the decisive factor in choosing among them.

A second issue would be whether countries found the suggested reference rate appropriate for their country: Some countries might object that their proposed reference rate was too strong, and occasionally one might also complain that a proposed rate was too weak. The relevant executive director would make this case to the Board, using a mix of technical arguments (challenging some aspect of the IMF's model or claiming that the current account target was inappropriate or arguing that the Fund staff had overlooked certain special factors) and political pleading, as is customary in such contexts. The Board might find itself impressed or unimpressed by the case it heard. Where it declared itself impressed, the staff would take account of the arguments raised in developing a revised set of recommendations, making sure that the set of reference rates remained globally consistent.

The staff would then present their revised recommendations to the Board. It would be appropriate to show also the implied set of current account outcomes, even though at this stage, after choosing among multiple sets of estimates, it might be difficult to regard the projected outcomes as targets. If some countries remained dissatisfied, the process might be repeated, in principle more than once. But it would be necessary for the Board to reach agreement by a defined date, and it would therefore be nec-

essary to agree ex ante to a process for resolving any differences of opinion that could not be argued out in this way. I do not see that there is an alternative to allowing the (weighted) majority of the Board the ultimate right to impose its views on a minority. One would hope that this process would prove an acceptable way of choosing a set of reference rates: At least these only limit what countries are allowed to do rather than compel them to do what they might not want to.

Once agreement is reached, the set of reference rates would apply for the next six months. They would be expressed as effective exchange rates rather than bilateral dollar rates, so that movements of third currencies would not lead to policy distortions. Rapidly inflating countries (those with an inflation rate of more than, say, 10 percent a year) could also have their reference rates adjusted periodically—perhaps monthly, after publication of a prespecified relevant price index—so as to keep their real reference rates more or less constant.