Frequency Asked Questions: Observance of the Principles on Exchange Rate and Domestic Economic and Financial Policies—Legal Considerations

Q1. What is the role of the Principles?

Principles A through E aim to provide guidance to members for the conduct of their exchange rate and domestic economic and financial policies and to the Fund in conducting surveillance over these policies. In applying the Principles, the Fund will pay due regard to the circumstances of members. When concerns arise as to whether a particular member is implementing policies consistent with them, the Fund will always give the member the benefit of any reasonable doubt. Since policies work together to produce outcomes, attribution of outcomes to exchange rate or domestic economic and financial policies will typically be difficult, and, consequently, cases where such attribution can be made beyond any reasonable doubt are expected to be very rare.

Q2. In Principles A and D, how are exchange rate policies defined, and how are "floaters" affected?

Exchange rate policies are defined to be intervention policies and certain other policies conducted for the purpose of influencing the balance of payments and hence the exchange rate. Principles A and D are, therefore, not relevant for countries that do not intervene or take other actions aimed at affecting the level of the exchange rate.

Q3. When would a member be found in nonobservance of Principle D?
Principle D guards against exchange rate policies that result in balance of payments instability. Finding a member in nonobservance of Principle D would require, *beyond any reasonable doubt,* that:

(i) there is balance of payments instability; (ii) the member has exchange rate policies; and (iii) those exchange rate policies are a significant contributor to balance of payments instability. Balance of payments instability can be traced either to the current or capital and financial account, or to a combination of the two. On the current account side, balance of payments instability takes the form of a "fundamental misalignment," and occurs when (i) there is a misalignment between the prevailing REER and the level that would bring the underlying CA in line with the equilibrium CA, (ii) the misalignment is significant, (iii) the significant misalignment is expected to persist under established exchange rate policies, and (iv) the significant and persistent misalignment is established beyond any reasonable doubt. Because balance of payments instability would normally result from the policy *mix*, it would inevitably be difficult to attribute it unambiguously to exchange rate policies. Instability would be attributed to exchange rate policies to the extent that making the exchange rate sustainable requires domestic policies inconsistent with the objective of domestic stability in Article IV (e.g., "overtightening" and creating deflation). The difficulty of attribution is a key reason why "reasonable doubt" will typically prevail in an analysis of observance of Principle D. Note that even in a case where the member is in nonobservance of Principle D, it would not necessarily follow that the Fund would recommend changing exchange rate policies, and the Decision explicitly requires the Fund to take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

Q4. When would a member be found in nonobservance of Principle A?

Principle A repeats the obligation in the Articles to avoid manipulating exchange rates for the purpose of gaining unfair competitive advantage over other members. An assessment of observance of Principle A is needed, in particular, if a member has failed to observe Principle D because its exchange rate policies result in fundamental misalignment in the form of an undervaluation. The thrust of any analysis of Principle A concerns establishing the authorities' intent. If the intent is to secure a fundamental misalignment in the form of an undervaluation and the purpose of securing such misalignment is to increase net exports, and if the Fund can reach this conclusion beyond any reasonable doubt, then Principle A (and Article IV, Section 1(iii)) has not been observed. The Fund must make an objective assessment as to the intent behind a member's exchange rate policies, based on all available evidence, including consultation with the member. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.

Q5. In Principle E, how are domestic economic and financial policies defined?

Domestic economic and financial policies include monetary, fiscal, and financial policies (both their macroeconomic aspects and macroeconomically relevant structural aspects).

Q6. When would a member be found in nonobservance of Principle E?

Principle E provides that members should seek to avoid domestic economic and financial policies that give rise to domestic instability. As reflected in Article IV, Sections 1 (i) and (ii), domestic stability refers to orderly economic growth with reasonable price stability, with due regard to the circumstances of the relevant members, and orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. Finding a member in nonobservance of Principle E would require a finding, *beyond any reasonable doubt,* that:

(i) there is domestic instability; and
(ii) the member has not sought to avoid domestic and economic financial policies that have given rise to domestic instability.

Because domestic instability would normally result from the policy *mix*, it would inevitably be difficult to attribute it unambiguously to particular domestic economic and financial policies. Moreover, members are only called upon to "seek to avoid" domestic policies that give rise to domestic instability, i.e., in contrast to the principles for guidance of members' exchange rate policies (Principles A-D), a member is only called to exercise its best efforts to avoid certain policies.

Q5. How should nonobservance of the Principles for the guidance of members

be reflected in staff reports?

When a Principle for the guidance of members is not observed, the staff appraisal should state this clearly (either by referencing a named Principle or by referring to the content of a Principle). Nonobservance of Principle A would also give rise to a breach of obligation under Article IV, Section 1(iii) and, if this is the case, the staff appraisal should indicate that.