International Monetary Fund

IMF Executive Board Discusses Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking

Public Information Notice (PIN) No. 06/131
November 9, 2006

On August 30, 2006 the Executive Board of the International Monetary Fund (IMF) considered a paper reviewing the status of IMF staff's work on exchange rate issues: *Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking*.

Background

Over the last few years, the Executive Board of the IMF has encouraged Fund staff to pay increased attention to exchange rate issues. The 2004 *Biennial Surveillance Review* called for deeper treatment of exchange rate issues, including: (i) clear identification of the de facto exchange rate regime in staff reports; (ii) more systematic use of a broad set of indicators and analytical tools to assess external competitiveness; and (iii) a thorough and balanced presentation of the policy dialogue between the staff and the authorities on exchange rate issues. Against this background, the main aim of the paper was to assess the quality of recent work by Fund staff on exchange rate issues in 30 large economies accounting for more than 90 percent of world GDP. The paper constitutes an important element in the Fund's effort to improve further its work on exchange rate issues as part of the Fund's *Medium-Term Strategy*.

From a methodological perspective, the study goes beyond earlier reviews by attempting to assess the *quality* and appropriate *selectivity* of the coverage and to obtain a more comprehensive picture of the staff's policy dialogue with country authorities by reviewing documents other than Article IV staff reports. Given the purpose of the review, the study focuses on the most recent reports (2004 until May 2006), but also takes account of reports back to 2001 and other documents (e.g., internal briefings and memoranda) to compare the treatment of exchange rate issues in recent reports with that in older ones.

The key findings of the paper were:

• Exchange rate surveillance was considered for all but a few of the economies surveyed, broadly adequate in three of the four dimensions reviewed in the paper: description of the regime, assessment of the regime, and consistency of policies with external stability. Identified areas of improvement include better assessment of the exchange rate level.

• In the fourth dimension—assessment of exchange rate levels—weaknesses were found in about one third of the cases. They mostly relate to the limited scope of the discussion: while an assessment on the exchange rate level is provided in all but a few cases, the depth of the analysis could be improved. However, even in this area the overall quality of the assessment seems, at least for the countries surveyed, to be stronger than suggested by the 2004 Biennial Surveillance Review.

• In some cases, a more comprehensive description of intervention policies in floating regimes was needed.

Executive Board Assessment

Directors welcomed the assessment of the quality of the treatment of exchange rate issues in the framework of bilateral surveillance and noted with interest the result of the assessment, namely that the staff's treatment of exchange rate issues for the group of countries surveyed is in many respects good. Many Directors, however, noted that broader conclusions could not be drawn, in particular given the survey's exclusion of smaller economies where issues in IMF surveillance have been observed. Directors nevertheless generally agreed that surveillance has improved appreciably since the 2004 Biennial Review of Surveillance. More specifically, Directors noted the conclusion that, for the large economies surveyed, the quality of staff's analysis was mostly adequate in three of the four dimensions reviewed—namely the description of the exchange rate regime, the assessment of the regime, and the consistency of policies with external stability—but that there was room for improvement in the analysis of exchange rate levels and external competitiveness. Directors also looked forward to the assessment of exchange rate surveillance that is under preparation by the Independent Evaluation Office.

Directors observed that staff's description of the exchange rate regime was, in most cases, appropriately candid, and that staff went beyond the *de jure* classification when required. However, most Directors underscored that a more comprehensive description of intervention policies would have been desirable in some cases, including a more consistent treatment of central bank reserve accumulation arising from public sector foreign exchange inflows.

As for the staff's assessment of exchange rate regimes, many Directors considered that appropriate focus had been placed on the underlying macroeconomic policies. These Directors felt that the observed tendency to challenge pegged regimes more than flexible ones was generally justified as most of the countries concerned were either subject to large shocks or were pursuing policies considered inconsistent with the pegged rates. Other Directors, however, felt that more discussion of the pros and cons of flexible exchange regimes would be useful. Directors also called for greater focus on the spillover effects of countries' exchange rate policies.

Directors took note of the conclusions that the staff's analysis of the level of the exchange rates and external competitiveness had improved, but that more work was needed in the analysis of these issues. They underscored that the focus should remain on the policy mix rather than the exchange rate level *per se*. Directors stressed the methodological problems in estimating the equilibrium exchange rates, and many Directors expressed caution regarding the appropriateness of making categorical statements about perceived misalignments. Nevertheless, most Directors maintained that assessments of exchange rate levels and competitiveness were of central importance for effective surveillance and encouraged staff to develop further its capabilities in this area by using a more comprehensive set of indicators and econometric methods where feasible. Some Directors observed, however, that exchange rate assessments remained very market sensitive and did not believe it was appropriate to publish staff's assessments of exchange rate misalignments, particularly numerical estimates.

On the discussion of policy consistency with external stability, most Directors concurred with the view that staff had remained adequately flexible tailoring its advice to different country circumstances and policy constraints. Nonetheless, some Directors pointed to the need to ensure that staff's views were consistent across the membership, while taking into account individual country circumstances.

Given the above findings, most Directors agreed that future work on improving the treatment of exchange rate issues in bilateral surveillance should focus on strengthening the assessment of the exchange rate levels.

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