Review of the 1977 Decision — Proposal for a New Decision, Companion Paper, Supplement, and Public Information Notice

June 21, 2007

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INTERNATIONAL MONETARY FUND

Review of the 1977 Decision—Proposal for a New Decision

Prepared by the Policy Development and Review Department and the Legal Department

In consultation with other Departments

Approved by Mark Allen and Sean Hagan

May 22, 2007

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I. INTRODUCTION[1]

1. **Reviewing the 1977 Decision on Surveillance over Exchange Rate Policies is a priority initiative of the Fund's Medium-Term Strategy.** The goal is to strengthen the effectiveness of bilateral surveillance by modernizing its underlying framework. After two Board discussions, views about how this can be accomplished have converged significantly.

2. **This paper presents a draft Decision that reflects the guidance provided by the Board.** In February, the Board endorsed three overarching principles to guide a new Decision: (i) no new obligations for members, together with confirmation that dialogue and persuasion are key pillars of surveillance; (ii) due regard for country circumstances and emphasis on the need for evenhandedness; and (iii) continued flexibility. The draft Decision builds on the approach outlined in the February paper, modified to reflect the views expressed by the Board at that time. In line with Directors' preferences, the draft Decision is limited in scope to what is necessary to achieve the objectives of the revision.[2]

3. **It has become clear that inaction in the face of the Decision's shortcomings would be hard to justify.**[3] [4] The Decision is only partially relevant to the best practice of surveillance as carried out today. Thus, in discussing the Independent Evaluation Office's evaluation of the Fund's exchange rate policy advice, most Directors noted that updating the 1977 Decision should help toward revalidating the objectives of surveillance. It would do so, in particular, by clearly setting out the Board's expectations.[5]

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[1] This paper was prepared by a team led by Tessa van der Willigen and Ross Leckow, comprising Isabelle Mateos y Lago, Jung Yeon Kim, Dmitriy Kovtun, Chris K. Marsh, Pedro Rodriguez, and Yan Sun, under the guidance of Carlo Cottarelli and Sean Hagan.

[2] The proposed changes relative to the current Decision are nonetheless sufficiently extensive to warrant, in staff's view, a new (2007) Decision, rather than a revised 1977 Decision. This would also be more in line with the modernization intent underlying this review.

[3] See *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations* (2006), *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework* (2006), *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Background Information* (2006), and *Summing Up* (2006), *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* (2007), and *Summing Up* (2007), and Spring 2007 IMFC Communiqué.

[4] Previous reviews concluded, as recently as 2004, that the Decision remained appropriate, but these effectively focused on implementation issues rather than the scope and content of the Decision itself. Against the backdrop of the Medium-Term Strategy, the present review has led to much deeper questioning.

[5] See *IEO Report on the Evaluation of the IMF's Exchange Rate Policy Advice* (2007) and *Summing Up* (2007).

4. **The remainder of this paper provides an overview of the proposed Decision**. A companion paper (CP) elaborates on the economic and legal underpinnings of the proposals and addresses technical questions that arose in previous discussions.*

II. Overview of the Proposed Decision

5. **The proposed Decision focuses on bilateral surveillance**. Like the existing Decision, it does not seek to provide guidance for the Fund's oversight over the international monetary system—what is commonly termed "multilateral surveillance." In this area, the full scope of the model has not been mapped out: some of its elements are well-established (e.g., the World Economic Outlook (WEO)), but others are still at an early stage (e.g., multilateral consultations). Trying to crystallize the model at this stage would be a major undertaking, and would risk constraining future multilateral surveillance by tying it too closely to its current modalities at a time when these are evolving.[6] Nonetheless, the proposed Decision underscores the importance of embedding bilateral surveillance in a global perspective (see paragraph 13 below).

6. **The proposed Decision comprises a preamble and three parts**. The preamble provides background and retains statements of intent contained in the existing Decision (e.g., that the Decision applies to all members). The three parts that follow are: Principles for the Guidance of the Fund in its Bilateral Surveillance; Principles for the Guidance of Members' Exchange Rate Policies; and Procedures for Bilateral Surveillance.

A. Part I—Principles of Bilateral Surveillance

7. **The proposed Decision includes a new first section providing guidance to the Fund on the scope and modalities of surveillance.** It sets out key elements of existing best practice that are at present unwritten or scattered, both to foster their consistent implementation and to make sure they are preserved as surveillance continues to evolve. Responding to views expressed in the February Board discussion, the proposed Decision no longer sets out the obligations of members in detail, nor refers to policies set out elsewhere (such as on data provision or transparency).

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* The proposed Decision contained in this paper was revised prior to consideration by the Executive Board (see the Supplement to this paper dated June 13, 2007), and then adopted by the Executive Board on June 15, 2007 with some changes relative to that revised version (see the Public Information Notice (PIN), IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies" (June 2007) for the Decision as adopted).

[6] Codification of multilateral surveillance in a Board decision could always be envisaged separately at a later stage.

Section on scope

8. **In line with previous discussions, the proposed Decision uses the concept of external stability to clarify the scope of surveillance and sharpen its focus** (Decision, paragraphs 4 and 5). Orderly exchange arrangements and a stable system of exchange rates (the ultimate objective of Article IV, Section 1) are most effectively achieved by each member adopting policies that promote its own external stability—i.e., policies that are consistent with the member's obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Sections 1(i) through (iv).[7] It is logical, therefore, that external stability—and the policies that affect it—be placed at the core of the Fund's surveillance mandate. Specifically, the proposed Decision states that surveillance examines those policies that can materially influence external stability prospects and that, in its surveillance, the Fund provides advice as to how members' policies can promote external stability.

9. **The proposed Decision recognizes the importance of domestic policies for both domestic and external stability** (Decision, paragraph 6).[8] Domestic policies promote external stability by promoting domestic stability—in the language of Article IV, Section 1, "orderly economic growth with reasonable price stability" and "orderly underlying economic and financial conditions" that do not tend to produce erratic disruptions. At the same time, a careful scrutiny of the balance of payments of all members—including those with floating exchange rates—remains critical for surveillance, not least because external instability may in some cases undermine domestic stability.[9]

10. **The proposed Decision notes that the specific coverage in surveillance of domestic policies aimed at growth will depend on the circumstances of individual members** (Decision, paragraph 6). Surveillance should focus *in all cases* on whether policies are conducive to keeping output broadly in line with capacity, as this is needed to ensure domestic stability (e.g., by avoiding overheating). *In relevant cases, s*urveillance should also focus on policies influencing *potential* growth. The potential growth rate may be more or less important to promoting domestic and external stability, and judgments must be made on a

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[7] External stability has been achieved when the balance of payments position does not, and is not likely to, lead to disruptive adjustments in exchange rates. The concept of external stability captures both the current and the capital and financial accounts, and implies, among other things, the avoidance of both excessive deficits and excessive surpluses (see CP, Chapter I). External stability is assessed at the level of each individual member, except for members of currency unions where it is assessed at the level of the currency union (although the balance of payments of the individual member remains important) (CP, Chapter II).

[8] Staff had earlier proposed that the importance of domestic policies for external stability be reflected in a new principle for the guidance of members' domestic policies, but many Directors preferred that it be stressed instead in this part of the Decision (see paragraph 14 below).

[9] CP, Chapter I.B elaborates on the links between domestic and external stability.

case-by-case basis as to whether policies seeking to increase potential growth should fall within the scope of surveillance. [10]

11. **The proposed Decision articulates a "principle of proximity," as a rule of thumb to help focus surveillance in individual cases** (Decision, paragraph 7). Under this principle, certain policies would automatically be regarded as materially influencing external stability prospects: exchange rate policies but also the macroeconomic and macroeconomically relevant structural aspects of fiscal, monetary, and financial sector policies. Other domestic policies would be covered in particular cases, but their material bearing on external stability would need to be explained.

Section on modalities

12. **Among the modalities widely seen as worth embedding in the Decision, a first set relates to the surveillance *process*** (Decision, paragraph 8):

- Surveillance is a collaborative process, based on *dialogue and persuasion*.
- The effectiveness of this dialogue requires *candor*: the Fund must be prepared to deliver clear and sometimes difficult policy messages to members.
- Surveillance must be evenhanded, i.e., the Fund must afford similar treatment to members in similar relevant circumstances. In particular, the Fund's willingness to speak up should not be affected by the size of the member.

13. **The proposed Decision also emphasizes certain modalities related to the substance of surveillance.** Drawing on the language of the current Decision where possible, it recalls that surveillance consists of an assessment of economic developments and prospects and advice on members' present and planned policies, and stresses that:

- **Surveillance must pay due regard to country circumstances** (Decision, paragraph 9). Just as countries in similar circumstances should be treated similarly, so countries in different circumstances should be treated differently to the extent that these circumstances are relevant for the conduct of surveillance. In particular, surveillance should take account of the effects of recommended policy changes on the authorities' objectives *besides* external stability.[11] This is essential to ensure the practicality and relevance of the Fund's advice, which are key to its effectiveness.

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[10] CP, Chapter I.C elaborates.

[11] Thus, for instance, the Fund's advice on policies *within the scope of surveillance* (according to the criteria set out above) should take into account, to the extent possible, members' desire to promote high growth or employment or to reduce poverty, even when policies specifically promoting these objectives are not to be covered in surveillance.

- **Bilateral surveillance must be embedded in a multilateral perspective** (Decision, paragraph 10). There are two dimensions to this requirement. First, bilateral assessments and advice should be closely informed by the outputs of multilateral surveillance exercises relating to real economic developments, cross-border capital flows, foreign exchange markets, and global stability risks generally. Second, these assessments must pay attention to the spillover effects of each country's developments and policies on others.

- **Surveillance must be cast in a medium-term perspective** and cover the member's medium-term objectives and present and planned policies, including any contingency reaction functions (Decision, paragraph 11).[12]

- Finally, consistent with the centrality of external stability in surveillance, the proposed Decision states the importance of an evaluation of the member's balance of payments, using language carried over from the existing Decision (Decision, paragraph 12).

B. Part II—Principles for the Guidance of Members' Exchange Rate Policies (PGMs)

14. **Part II provides guidance to members, limited to the conduct of their exchange rate policies.** Article IV, Section 3 (b) *requires* the Fund to adopt specific principles for this purpose. While PGMs could also be provided on domestic policies, as suggested in Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations, this is no longer proposed here. The Fund's Articles do not require the Fund to adopt principles to guide members' domestic policies. Moreover, broad support for the adoption of such principles was lacking in the February discussion.[13]

15. **The proposed Decision carries over the three existing PGMs, and would include an Annex that provides guidance on the meaning of the PGM on exchange rate manipulation "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage […]."**[14] Staff proposes that this provision be understood as

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[12] It is no longer proposed that the Decision make an explicit reference to "policy frameworks," which could create a (mistaken) expectation that members should adopt a specific kind of policy formulation *process*.

[13] The absence of PGMs for domestic policies entails an element of asymmetry in the guidance to members, reflecting the asymmetry in Article IV itself—but, as noted above, there would be no asymmetry in the proposed guidance to the Fund on the scope of surveillance.

[14] While it was previously agreed that PGMs B and C retain relevance and do not need further clarification (*Summing Up—Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations* (2006)), there was a broad sense, in February, that the meaning of PGM A on exchange rate manipulation was not fully clear.

referring, in particular, to policies that seek to secure a fundamental exchange rate misalignment for the purpose of increasing net exports.[15]

16. **In addition, the proposed Decision includes a new PGM D** providing that members should "avoid exchange rate policies that *are pursued for domestic reasons and* result in external instability*, including fundamental* exchange rate misalignment." With PGM A focused on policies pursued for external purposes, the reference to domestic reasons should be understood as capturing all other objectives. An example of such a policy would be the overly long maintenance of a fundamentally overvalued peg in a (futile) attempt to control inflation without the appropriate supporting domestic policies. This new guidance would be directed to exchange rate policies, taking domestic policies as given, but this does not mandate that adjustment should necessarily come from exchange rate policies. The explicit mention of misalignment in PGM D would be intended to support increased attention to exchange rate levels within the Fund. It would not imply greater prominence of these assessments in the Fund's external communications—the deletion provisions under the Fund's transparency policy would remain unchanged. Nor should it be read as denying the considerable measurement difficulties associated with this concept: the Fund would be expected to exercise appropriate caution in reaching conclusions about misalignments.[16]

17. **The proposed Decision also spells out the legal nature of the PGMs** (Decision, paragraphs 13-14). The February discussion stressed the need to avoid creating new obligations, while preserving the centrality of dialogue and persuasion. The existing Principle A is an obligation, as it repeats the language of Article IV, Section 1(iii). The remaining principles are only recommendations.[17] A member not following these recommendations would not be presumed to be breaching an obligation under the Articles. Being focused on exchange rate *policies*, the PGMs are fully consistent with the freedom of choice of *exchange arrangements* provided to members under Article IV.[18]

18. **In addition, the proposed Decision makes explicit two implementation safeguards** (Decision, paragraph 13). First, as directed by Article IV, Section 3(b), in assessing observance of the PGMs the Fund shall pay due regard to country circumstances. For instance, the Fund's advice on the speed of adjustment of policies would depend critically on how a member's economy would respond to such adjustment, and in particular how disruptive rapid adjustment would be. Second, in assessing whether the member is following the principles, the Fund would give members the benefit of any reasonable

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[15] CP, Chapter III.A elaborates on the rationale for this interpretation and responds to concerns expressed by Directors in February.

[16] CP, Chapter III.B explains the proposed wording of PGM D in detail.

[17] See *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* (2007), Section IV.C, for further explanation.

[18] See *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework* (2006), Section II.

doubt—an important provision given that the application of the concepts in the PGMs, notably misalignment, requires considerable judgment.

19. **As in the current Decision, the PGMs would be complemented by a list of indicators to be considered in the Fund's surveillance over their observance by members.** The rationale for this list is to provide broad guidance for judgment about when a question of observance of the PGMs may require further examination. The indicators, pitched at a high conceptual level, guide not just the staff but the Executive Board (i.e., "the Fund"), and thereby help assure members of evenhandedness. The proposed Decision makes clear that the indicators are only the starting point for further dialogue, and not by any means sufficient by themselves to gauge observance of the PGMs (Decision, paragraph 15).

20. **Several refinements to the existing indicators are proposed** (Decision, paragraph 15). These are intended to fill gaps, by adding to the list references to sterilization of foreign exchange intervention and to current account imbalances, and to add specificity and refinements, not least to reflect the deepening of global financial markets.[19]

C. Part III—Procedures

21. **The Procedures section of the proposed Decision differs from the existing one only by the absence of "procedure (v)" and the folding in of the existing, currently separate 1979 Decision on supplemental surveillance.** The Board agreed in the first stages of this review that procedures remained adequate. It was noted, however, that "procedure (v)," a special consultation procedure, had become redundant. Accordingly, there was broad support for its abolition.

III. Conclusion

22. **The proposed Decision would provide a strong statement of the best practice of surveillance**, as reflected in earlier Board discussions. As such, it would help to make surveillance as effective as possible. And it would demonstrate the commitment of the membership to finding common ground on this key aspect of the Fund's responsibilities. Staff looks forward to hearing Executive Directors' views on the proposed Decision.

[19] CP, Chapter IV elaborates on both the purpose of the indicators and their wording. The main change compared to the proposals outlined in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* (2007), is that amendments related to the then proposed PGM on domestic policies are no longer envisaged.

IV. Proposed Decision

23. **The following Decision is proposed for adoption by the Executive Board**; it may be adopted by a majority of votes cast.

Bilateral Surveillance over Members' Policies

1. This Decision provides guidance to the Fund in its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), and guidance to members in the conduct of their exchange rate policies pursuant to Article IV, Section 3 (b). It does not deal directly with the Fund's responsibility to oversee the international monetary system in order to ensure its effective operation, referred to in Article IV, Section 3 (a).

2. Part I of this Decision sets out the scope and modalities of the Fund's oversight of members' obligations under Article IV, Section 1, including the Fund's exercise of firm surveillance over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance). Part II establishes principles for the guidance of members in the conduct of their exchange rate policies as required under Article IV, Section 3 (b); it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Part III sets out procedures for surveillance.

3. Fund surveillance over members' policies shall be adapted to the needs of the international monetary and financial system as they develop. The principles and procedures set out in this Decision, which apply to all members irrespective of their exchange arrangements

and balance of payments positions, are not necessarily comprehensive and are subject to reconsideration by the Fund in the light of experience.

Part I – Principles for the Guidance of the Fund in its Bilateral Surveillance

A. The Scope of Bilateral Surveillance

4. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most effectively achieved by each member adopting policies that promote its own "external stability"—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Sections 1 (i) through (iv). "External stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. External stability is assessed at the level of each individual member, except for members of currency unions, where it is assessed at the level of the currency union.

5. In its bilateral surveillance, the Fund will focus on those policies of members that can materially influence external stability, both at present and in future, including both exchange rate policies and domestic economic and financial policies. The Fund will assess whether these policies are, in fact, promoting external stability and advise the member on any policy adjustments necessary for this purpose.

6. In the conduct of their domestic economic and financial policies, members are considered by the Fund to promote external stability when they promote domestic stability—

that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. In particular, it will always examine whether a member's domestic policies are directed toward keeping the economy operating broadly at capacity, and will examine whether policies are directed toward fostering an appropriately high rate of potential growth in those cases where such high potential growth is of material importance to domestic, and thereby external, stability.

7. Exchange rate policies and macroeconomic and macroeconomically relevant structural aspects of monetary, fiscal, and financial sector policies will always be the subject of the Fund's bilateral surveillance with respect to each member. Other policies will be examined in the context of surveillance only to the extent that the Fund is satisfied that they materially influence prospects for external stability.

B. The Modalities of Bilateral Surveillance

8. Dialogue and persuasion are key pillars of effective surveillance. The Fund, in its bilateral surveillance, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. Such assessments and advice are intended to assist that member in making policy choices, and to allow other members to discuss these policy choices with that member. In the context of bilateral surveillance, the Fund will foster an environment of frank and open discussion and mutual

trust with each member and will be evenhanded across members, affording similar treatment to members in similar relevant circumstances.

9. The Fund's assessment of a member's policies and its advice on these policies will pay due regard to the circumstances of the member. This appraisal will be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member. Moreover, in advising members on the manner in which they may promote external stability, the Fund will, to the extent possible, take into account the member's other objectives.

10. The Fund's assessment and advice in the context of bilateral surveillance will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global economic environment, including exchange rates and key linkages among members. The Fund's assessment and advice will take into account the impact of a member's policies on other members to the extent that the member's policies undermine the promotion of its own external stability.

11. The Fund's assessment and advice in the context of bilateral surveillance will, to the extent possible, include an examination of the member's medium-term objectives, the planned conduct of policies, and the expected responses of policies to contingencies.

12. The Fund's assessment of a member's policies will always include an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserves, other external assets, and external liabilities.

Part II – Principles for the Guidance of Members' Policies Under Article IV, Section 1

13. Principles A through D set out below are adopted pursuant to Article IV, Section 3 (b) and are intended to provide guidance to members in the conduct of their exchange rate policies in accordance with their obligations under Article IV, Section 1. In accordance with Article IV, Section 3 (b), these Principles are designed to respect the domestic social and political policies of members. In applying these principles, the Fund will pay due regard to the circumstances of members and, when determining whether a member is following these principles, the Fund will give the member the benefit of any reasonable doubt.

14. Principle A sets forth the obligation contained in Article IV, Section 1(iii); further guidance on its meaning is provided in the Annex to this Decision. Principles B through D constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member was in breach of its obligations under Article IV, Section 1.

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that are pursued for domestic reasons and result in external instability, including fundamental exchange rate misalignment.

15. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market, particularly if accompanied by sterilization;

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

Part III – Procedures for Surveillance

16. Each country that becomes a member of the Fund after the adoption of this decision shall, within thirty days of the date of its membership, notify the Fund in appropriate detail of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member, regardless of its date of membership, shall notify the Fund promptly of any changes in its exchange arrangements.

17. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Facility identified in Decision No. 8240- (86/56), SAF, adopted March 26, 1986, as amended, where the Executive Board shall reach conclusions no later than three months from the termination of discussions between the member and the staff.

18. Broad developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

19. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and their policies under Article IV, Section 1, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its policies.

20. (a) Whenever the Managing Director considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the exchange rate of its currency, the Managing Director shall initiate informally and confidentially a discussion with the member. After such discussion the Managing Director may report to the Executive Board or informally advise the Executive Directors and, if the Executive Board considers it appropriate, an ad hoc Article IV consultation between the member and the Fund shall be conducted in accordance with the procedure set out in subparagraph (b) below.

(b) A staff report will be circulated to the Executive Directors under cover of a note from the Secretary specifying a tentative date for Executive Board discussion which will be at least 15 days later than the date upon which the report is circulated. The Secretary's note will also set out a draft decision taking note of the staff report and completing the ad hoc consultation without discussion or approval of the views contained in the report; the decision will be adopted upon the expiration of the two-week period following the circulation of the staff report to the Executive Directors unless, within such period, there is a request from an Executive Director or decision of the Managing Director to place the report on the agenda of the Executive Board. If the staff report is placed on the agenda, the Executive Board will discuss the report and will reach conclusions which will be reflected in a summing up.

(c) Unless otherwise decided by the Executive Board, the conduct of an ad hoc consultation with a member will not affect the consultation cycle applicable to the member or the deadline for completion of the next consultation with the member

21. The Fund shall review this Decision and the general implementation of bilateral surveillance at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

22. Decision No. 5392-(77/63), adopted April 29, 1977, as amended, and paragraph 3 of Decision No. 6026-(79/13), adopted January 22, 1979, as amended, are hereby repealed.

ANNEX

Article IV, Section 1(iii) and Principle A

1. Article IV, Section 1 (iii) of the Fund's Articles provides that "members shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The language of this provision is repeated in Principle A contained in Part II of this Decision. The text set forth below is designed to provide further guidance regarding the meaning of this provision.

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).

(a) "Manipulation" of the exchange rate involves policies that are directed at—and actually affect—the level of an exchange rate. It is recognized that a member may manipulate an exchange rate in a variety of ways, including through intervention in the exchange markets or through the imposition of capital controls. Moreover, manipulation need not cause the exchange rate to move; in some cases, manipulation may prevent such movement.

(b) Even if a member were manipulating its exchange rate, it would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (a) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (b) the purpose of securing such misalignment is to increase net exports.

3. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt. In the final analysis, however, it is the responsibility of the Fund to make an objective assessment, based on all available evidence, of whether the member's representation is correct.

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Companion Paper

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May 22, 2007

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INTRODUCTION [1]

1. **This paper is a companion paper to *"Review of the 1977 Decision—Proposal for a New Decision."*** It elaborates on the economic and legal underpinnings of the proposal for a new Decision on bilateral surveillance, and addresses technical questions that arose in previous discussions. It deals successively with: the concept of external stability and exchange rate misalignment (Chapter I), the focus of surveillance in currency unions (Chapter II), the interpretation of Principles A and D for the Guidance of Members' Exchange Rate Policies (Chapter III), and the list of indicators in the Decision (Chapter IV).*

I. EXTERNAL STABILITY AND EXCHANGE RATE MISALIGNMENT

A. The Concept of External Stability

2. **External stability is the logical focus of bilateral surveillance** (see main paper, paragraph 8. External stability has been achieved when the balance of payments position does not, and is not likely to, give rise to disruptive adjustments in exchange rates.[2] The balance of payments is the key influence on the demand and supply of foreign exchange, and hence on the likelihood of disruptive adjustments in exchange rates.

3. **A balance of payments position consistent with external stability is one in which both** (i) the underlying current account is broadly in line with its equilibrium (which, as discussed below, is equivalent to there being no fundamental exchange rate misalignment), and (ii) the capital and financial account does not create risks of abrupt shifts in capital flows. While the balance of payments refers to "flows," the assessment of these flows must take into account the existing stocks, and, in particular, the economy's net external asset position (NEAP) and the level and structure (e.g., composition by instrument or holder, maturity, currency denomination) of gross assets and liabilities. The next two sections examine the current account and the capital and financial account in turn, while a third section further clarifies the concept of external stability.

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[1] The paper was prepared by a team led by Tessa van der Willigen and Ross Leckow, comprising Isabelle Mateos y Lago, Dmitriy Kovtun, Chris K. Marsh, Isabelle Mouysset, Nadia Rendak, Pedro Rodriguez, and Yan Sun, under the guidance of Carlo Cottarelli and Sean Hagan.

[2] External stability is assessed at the level of members, except for currency unions where it is assessed at the level of the union (see Chapter II).

* The proposed Decision discussed in this paper was revised prior to consideration by the Executive Board (see the Supplement to this paper dated June 13, 2007), and then adopted by the Executive Board on June 15, 2007 with some changes relative to that revised version (see the Public Information Notice (PIN)", IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies" (June 2007) for the Decision as adopted).

The underlying current account and fundamental exchange rate misalignment

4. **External stability requires the underlying current account to be broadly in equilibrium**:

- *The underlying current account is in equilibrium when the country's NEAP is evolving in a manner consistent with the economy's structure and fundamentals.* Otherwise, the NEAP evolves in a way that creates a risk of abrupt reversal and thus of disruptive adjustments in exchange rates.[3] In general, the equilibrium evolution of the NEAP is expected to be consistent with the present and expected values of such fundamentals as productivity differentials, the terms of trade, permanent shifts in factor endowments, demographics, and world interest rates.[4] Of course, the equilibrium evolution of the NEAP is a matter of considerable judgment, especially in light of the recent trend toward financial globalization.

- *The underlying current account is the current account stripped of temporary factors,* such as cyclical fluctuations, temporary shocks, and adjustment lags.[5] If the actual current account deviates from the equilibrium current account due to temporary factors, the NEAP will evolve *for a while* in a way inconsistent with the economy's structure and fundamentals, but this will not necessarily create risks of abrupt reversal.[6] The underlying current account is thus the one consistent with a zero output gap.[7] [8]

5. **The underlying current account may deviate from equilibrium for various reasons.** Exchange rate policies may be keeping the exchange rate at a level where, in the absence of an output gap, it yields too large a current account deficit or surplus. Or the same exchange rate result may come about because of market imperfections or persistent expectational errors on the part of the private sector, such as overoptimistic assessments of

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[3] See paragraph 9 below on the unsustainability over time of NEAPs that are evolving inappropriately.

[4] The initial position of the NEAP is also important. If it is low because of earlier negative shocks, it may be appropriate for a country to run temporarily stronger current account balances. In general, the equilibrium evolution of the NEAP is not one in which the NEAP is necessarily constant.

[5] Including lags in the current account with respect to previous exchange rate movements.

[6] These temporary factors are assumed to offset each other over time, so that any temporary accumulation of assets does not affect the long-term position of the NEAP.

[7] In low-income countries, defining an output gap and an associated underlying current account is likely to be challenging because cyclical fluctuations are typically less important than structural changes. The judgment required is similar, however, to the commonly-made judgment whether aggregate demand is consistent with the economy's "absorptive capacity."

[8] Since the assessment should be conducted in a multilateral setting, the underlying current account should also be calculated assuming other countries have no output gap.

future productivity growth. Alternatively, a current account disequilibrium may also stem from domestic policies that tend to lead to excessive accumulation of assets or liabilities. Unsustainable fiscal policy is an obvious example.

6. **When the underlying current account differs from the equilibrium current account, the exchange rate is "fundamentally misaligned."**[9] In these circumstances, the exchange rate is not at its equilibrium level—the one required to generate an equilibrium current account, in the absence of an output gap—be it because of exchange rate policies, market imperfections, or unsustainable domestic policies. The exchange rate of interest here is the one that affects the current account, hence the *real effective* exchange rate,[10] and its equilibrium level will also depend on factors affecting the relationship between the exchange rate and the equilibrium current account (such as trade restrictions). Of course, in practice an exchange rate would only be judged to be fundamentally misaligned if the misalignment was found to be significant.

7. **Although "equilibrium" exchange rates can be defined in various ways, the definition above is the one of prime relevance to Fund surveillance.** It differs from the short-term market equilibrium, and assessments about misalignments are not intended to try to anticipate market outcomes over any specific time horizon. Rather, the goal here is to assess the potential for significant real exchange rate adjustments, that might occur when fundamental forces eventually prevail. Accordingly, the concept of equilibrium exchange rate described above is the one used in best practice Article IV consultations and the one that underlies the work of the Fund's Consultative Group on Exchange Rates (CGER) (backed up by three different methodologies), which embodies a multilateral consistency constraint and serves as an input for consultation teams.[11]

The role of the capital and financial account

8. **Even if the underlying current account is in equilibrium (and, thus, there is no fundamental exchange rate misalignment), the capital and financial account may be a separate source of external instability:**

- First, the NEAP may be evolving appropriately, and yet the country may be building up, or maintaining, *vulnerable external balance sheet structures*, which could be abruptly unwound. The importance of such structures has been amply demonstrated in the capital account-driven crises of the last decade. The level and structure of gross

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[9] An exchange rate will be misaligned in a manner that is not "fundamental" when the *actual* current account differs from the equilibrium current account. Such misalignment may thus include a cyclical component.

[10] Of course, the concept of misalignment could equally be cast in terms of the exchange rate at a *particular point in time* and measured in nominal terms—that is, *given* the relevant price levels. To form a view on misalignment through time, however, it is clearly necessary to account for the evolution of price levels.

[11] *Methodology for CGER Exchange Rate Assessments* (2006), discusses econometric methods of estimating the equilibrium exchange rate.

capital flows is key in this regard—against the background, as noted above, of the level and structure of existing external assets and liabilities.

- Second, even temporary fluctuations in the current account may cause disruptions in the presence of market imperfections leading to *financing constraints*. Inability to finance an excessive current account deficit due to cyclical fluctuations (overheating) or to temporary shocks is thus another possible source of external instability. The level of reserves and access to international capital markets are key factors here.

Three clarifications

9. **The concept of external stability takes account of spillovers across countries, and applies to both surplus and deficit countries.** External instability—the mirror image of external stability—captures instances where a member's balance of payments creates a risk of disruptive adjustments in exchange rates, where the trigger for such an adjustment may come from within the member's balance of payments or from within that of its partners. A country building up excessive net liabilities clearly becomes vulnerable to disruptions, as it would be regarded to be breaching its intertemporal budget constraint, and would face financing constraints. By contrast, a country building up excessive net assets, inconsistent with the economy's fundamentals, might be able to do so for a long period. However, at least one of its partners is likely to be building up an excessive net liability position, at risk of abrupt reversals.

10. **Although the concept of external stability is anchored in the balance of payments position *today*, this does not mean that surveillance can ignore policies and developments that will only affect the balance of payments position *tomorrow*.** Problems yet to influence the balance of payments—e.g., domestic problems—but that risk leading to external instability are also relevant for surveillance. For example, domestic financial sector weakness might eventually spill over onto the balance of payments when a crisis occurs.

11. **Eliminating external instability does not necessarily mean exchange rates *need to adjust*, but external instability, if not addressed, risks being *reflected in disruptive exchange rate adjustment*.** The definition of external instability should not be read as describing a situation requiring exchange rate adjustment at all times. Rather, it is meant to acknowledge that without remedial action, there is a risk of disruptive adjustment in exchange rates. Consistent with paragraph 5 above, action to promote external stability is not necessarily sought in exchange rate adjustment, but in a range of policies to ensure a balance of payments position consistent with external stability.[12]

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[12] This said, if domestic prices are rigid downward (and inflation is low in other countries), there will be limits to what domestic policies can achieve to make an *overvalued* exchange rate consistent with external stability. In this situation an adjustment in exchange rate policies may be necessary.

B. Domestic Policies, Domestic Stability, and External Stability

12. **Article IV requires members to seek to direct their domestic policies to promoting domestic stability.** Under Article IV, Section 1, each member must, in particular, (i) "endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances" and (ii) "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions"—(i) and (ii) being here called, together, the promotion of "domestic stability." It should be noted that Article IV does not require members to *achieve* domestic stability, or, by extension, external stability; as discussed in earlier papers, members' obligations respecting domestic policies are of a best efforts nature.

13. **By promoting domestic stability, members promote external stability.** The philosophy underlying Article IV is that the system of exchange rates will be more stable if domestic policies create the conditions for domestic stability.[13] Indeed, domestic stability is conducive to external stability in various ways: orderly growth and reasonable price stability (as discussed further below) will tend to keep the current account deficit within financeable levels and will moderate the risk of capital outflows; sustainable domestic policies will contribute to keeping the current account close to its equilibrium; low and stable inflation creates the conditions for orderly movements in nominal and real exchange rates; and orderly underlying economic and financial conditions will tend to translate into appropriate structures of external assets and liabilities.

14. **In light of the above, the Fund in its surveillance should assess whether a member's domestic policies promote domestic stability, although a thorough examination of the member's balance of payments remains critical.** In the great majority of cases, domestic stability will be sufficient to secure external stability. In some cases, inconsistencies between domestic and external stability may arise, but these will typically be apparent rather than real. For example, some apparent inconsistencies will be the result of cyclical developments;[14] or domestic stability may apparently have been achieved, but in the presence of certain external instabilities which are likely to have major domestic effects sooner or later.[15] Cases of real inconsistency between domestic and external stability are likely to be rare, requiring substantial and sustained market failures. In such cases, the Fund

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[13] *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework (2006)*, page 2.

[14] For example, in an economy at a cyclical low point, domestic policies may promote domestic stability—for example, through loose monetary policy—in a way that causes the exchange rate to depreciate temporarily with respect to the economy's structure and fundamentals. As noted above, such a deviation—being temporary—would not be considered inconsistent with external stability.

[15] For example, a country with low inflation and relatively stable growth today could hardly be regarded as having reached domestic stability if this is accompanied by an unsustainable current account deficit that is likely to lead to a balance of payments crisis, with severe domestic implications.

should, in the context of surveillance, discuss with the member whether a different policy mix might be more conducive to external stability, while being equally conducive to domestic stability. Thus in all cases—including for members with freely floating exchange rate regimes—a thorough examination of a member's balance of payments, and related spillovers, is critical for surveillance. It should be emphasized, however, that a member that is complying with its domestic policy obligations under Article IV, Sections 1 (i) and (ii) (i.e., the promotion of domestic stability) could not be required by the Fund to change its domestic policies in the interests of external stability.

C. Growth and External Stability

15. **Under Article IV, Section 1(i), each member is required to "endeavor to direct its economic and financial policies toward the objective of fostering orderly growth with reasonable price stability, with due regard to its circumstances."** Inherent in this "best efforts" obligation is, on the one hand, the notion that members should seek growth, and, on the other hand, the notion that such growth should be orderly and accompanied by reasonable price stability. Both these components are thus part of "domestic stability." The obligation recognizes that each member should endeavor to pursue the objective set out in Article IV, Section 1(i) "with due regard to its circumstances." The discussion below aims to provide an indication of what kinds of circumstances are relevant in this context, with a view to helping to determine the policies surveillance should focus on in specific cases.

16. **How does growth enter into domestic stability, and hence affect external stability?**

- ***Growth performance relative to capacity* is always a key ingredient of domestic stability and crucial for external stability.** As discussed above, disorderly growth or growth above or below potential is likely to spill over onto the current account, affecting external stability.[16] In turn, high or unstable inflation will likely spill over through the current or financial account to influence external stability.

- **Depending on country circumstances, the level of *potential growth* may also matter for domestic and external stability:**

    - **Higher potential output creates a larger resource base from which a country can meet domestic and external obligations.** Growth allows governments to meet their domestic obligations by raising the tax base, contributing to domestic and thereby external stability. And growth allows countries to meet their external obligations and therefore stay more easily within their budget constraint vis-à-vis the rest of the world.

[16] As noted in Chapter I.A, temporary deviations from an equilibrium current account position can raise external stability problems if the financing constraint is binding. Moreover, policy-induced attempts to keep growth consistently above potential (or below potential, although this is unlikely to happen in practice) may drive the current account away from its equilibrium path.

- **Low growth can tempt policymakers to adopt policies that could cause instability.** When growth disappoints, policymakers might intervene to push it above what has turned out to be its potential level—including through competitive devaluation, undue fiscal expansion, or inflationary monetary policies—endangering orderly growth and price stability and creating the spillovers on the balance of payments discussed above.

17. **Thus, surveillance should always focus on policies affecting growth performance relative to capacity, but should focus on policies influencing potential growth only in relevant cases.** The policies at issue from the point of view of growth performance relative to capacity are likely to be primarily demand management policies, i.e., monetary, fiscal, and exchange rate policies, which are identified by the proposed "principle of proximity" (see main paper, paragraph 11) as being automatically regarded as within the scope of surveillance. Examples of policies seeking to raise the rate of potential growth include, for instance, policies affecting the business environment, or certain labor market policies. Whether these policies fall within the scope of surveillance will depend on members' circumstances, or, more specifically, whether these policies affect domestic and external stability. They are more likely to do so, for example, when members have large public or external liabilities, or where growth has been inadequate by a larger margin and for longer. Gauging in which cases coverage of policies seeking to raise potential growth is appropriate requires judgment.

18. **While the above discussion seeks to help determine the policies surveillance must focus on, the Fund in its surveillance must also bear in mind the impact of its advice on growth.** As noted explicitly in the proposed Decision, the Fund, in providing recommendations on the policies that are the focus of surveillance, should seek to identify ways in which members would achieve domestic and external stability while also attaining their other objectives—and high potential growth is typically a critical objective of members. Thus, for instance, in advising on policies to reduce an excessively large fiscal deficit, surveillance should, to the extent possible, recommend those solutions that are most supportive of growth (as well as of the authorities' other objectives, such as, potentially, income distribution).

II. Focusing Surveillance on External Stability in Currency Unions

19. **The application of the concept of external stability presents particular challenges for the Fund in its surveillance over members of currency unions,** both in assessing their compliance with the obligations of Article IV, Section 1 and in identifying the policies that should be the subject of surveillance. This section examines these issues.

A. Background

20. **Members of currency unions have the same obligations under Article IV as all Fund members, even though they have delegated certain policies to union-level**

institutions.[17] They retain full responsibility for the performance of all of these obligations and, accordingly, are accountable under Article IV for those policies conducted by union-level institutions on their behalf that are relevant to these obligations. When conducting surveillance, the Fund considers the policies of the union-level institutions as being conducted on behalf of the currency union's members.[18]

21. **Article IV consultations in currency unions involve a combination of:**[19]

- **Bilateral discussions with individual union members on the policies conducted at their level.** These discussions typically focus on the relevant aspects of the members' domestic policies not delegated to the union. Monetary and exchange rate policies are taken as given, although their impact on the national economy is of course discussed.[20]

- **Discussions with union-level institutions on the common policies for which they are responsible.** These discussions are considered to be an integral part of the bilateral Article IV consultations with individual members. They cover all the policies under the purview of Article IV for which the union is responsible, against the background of the policies and prospects of each member.

B. External Stability in Currency Unions

22. **The application of the concept of external stability at the level of the union as a whole is relatively straightforward.** External stability—a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements—must be understood as relating to the balance of payments of the union, as it is only at this level that disruptive adjustments in exchange rates can arise. Thus, where union-level institutions implement policies that promote the external stability of the union, such policies would be consistent with the obligations of the currency union's individual members under Article IV, Section 1. Moreover, in identifying the policies to be discussed for the purposes of surveillance over union-level institutions, the Fund would apply the principle of proximity (main paper, paragraph 11) with reference to the external stability of the union.

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[17] See *The European Economic and Monetary Union and the International Monetary Fund—Main Legal Issues Relating to the Rights and Obligations of EMU Members in the Fund* (1998), particularly paragraphs 4 and 12.

[18] Ibid.

[19] See *Fund Surveillance over Currency Unions* (2005), for a detailed explanation.

[20] This chapter assumes that each member's exchange rate and monetary policies are delegated to the union, as is the case with most currency unions, and that individual members remain responsible only for domestic economic and financial policies other than monetary policy. It also abstracts from the possibility of exit from the union that exists in certain currency unions. If such exit was the result of intolerable balance of payments pressures in one member, it would likely impact the "stable system of exchange rates." A similar risk is also present for the few Fund members who use the currency of another member.

C. Surveillance Over Individual Members of Currency Unions

23. **Surveillance at the level of individual currency union members examines their domestic policies and assesses the extent to which these policies promote their own domestic stability, which in turn fosters the domestic and external stability of the union.** Surveillance at the level of the individual currency union member is necessarily focused on domestic policies. As discussed in Chapter I.B, all Fund members—including those that are members of currency unions—should, through their domestic policies, promote domestic stability. It is by promoting their own domestic stability that individual currency union members promote the domestic and external stability of the union.

24. **There are several channels of transmission between the domestic stability of the member and the external stability of the union**:

i. *Aggregation*. Since the union's balance of payments is the net sum of developments in individual members' balances of payments, aggregation of imbalances of the same sign would result in imbalances at the union level. For example, excessively loose fiscal policies in one large or several smaller members risk translating (absent countervailing action at the union level) into an excessive current account deficit at the union level, or disruptive capital movements caused by an unsustainable accumulation of debt into capital outflows at the union level.

ii. *Pressures for inappropriate relaxation of policies at the union level.* Domestic instability at the level of the individual member can turn into pressures for painful domestic adjustment, which can translate into pressures on union policies. For example, excessive wage growth—given union-level exchange rate and monetary policies—will sooner or later affect competitiveness and growth, potentially putting the union under pressure to relax policies. Chronically low potential growth may create the same pressures. Similarly, liquidity problems in one or a few financial institutions in one member may put pressure on union-level authorities to relax monetary policy.

These effects can also be magnified through repercussions on policies in *other* members of the union. For example, each individual member's "bad" policies may spur similar ones from others, on account of political pressures, perceived risks of "free-riding," or both. The existence of these various channels explains why individual members' domestic policies contribute to promoting the external stability of the union, and hence why surveillance over them is as necessary as for members with different currency arrangements.[21]

25. **Because some of these channels operate through the balance of payments of the individual member, the latter remains an important element in surveillance.** Of course,

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[21] It also provides the rationale for the strictures on the conduct of domestic policies in force in some currency unions, e.g., the Stability and Growth Pact for the Euro area.

by virtue of the absence of intra-union currency risk and, often, the integration of financial markets in a currency union, the threshold at which balance of payments imbalances become disruptive is typically significantly higher for members of currency unions than for members with their own currency. Nonetheless, the possibility of balance of payments pressures exists.[22] As some of the channels above illustrate, these pressures may be either transmitted to the external stability of the union, or reflected back onto the member in the form of a need for adjustment, making it more difficult for the member to maintain domestic stability.

26. **The application of the "principle of proximity" at the level of an individual currency union member should be guided by the impact of policies on the external stability of the union.**[23] [24] The task of focusing surveillance would be easier if it were possible to identify a concept *at the level of the individual union member* that would capture all the possible influences of policies at this level on the external stability of the union. The diversity of channels above, however, suggests that there is no single such concept, and that the choice of policies to be examined in surveillance must be guided by the concept of the external stability of the union, taking account of the various possible transmission channels. As in countries with their own currency, the judgment as to which policies materially influence external stability—in addition to those automatically regarded by the principle of proximity as doing so—must be made on a case-by-case basis, taking into account the circumstances of the member.

III. Selected Principles for the Guidance of Members (PGMs)

27. This chapter elaborates on the guidance that could be provided in an Annex to the proposed Decision regarding the meaning of PGM A. It also explains the meaning and wording of the new proposed PGM D.

A. PGM A / Article IV, section 1 (iii)

A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

[22] The Fund has previously recognized the difficulties that arise in interpreting BOP imbalances in individual members of currency unions, but also reaffirmed the importance of looking at these imbalances for the Fund's work. See *EMU and the Fund—Use of Fund Resources and Use of Euros in the Operational Budget—Preliminary Considerations* (1998) , for a discussion of the concept of balance of payments in a currency union member.

[23] See paragraph 11 of the main paper for a discussion of the principle of proximity.

[24] Small union members may impact the external stability of the union either by aggregation (several smaller members may have the same impact as one large member), or by imitation or contagion.

28. **In previous discussions, many Directors saw merit in providing further guidance on the meaning of PGM A.**[25] PGM A merely repeats Article IV, Section 1(iii), and therefore does not, in itself, provide any additional guidance as to what policies should be avoided. Taking into account the February discussion, it is proposed that guidance be given by clarifying the meaning of a manipulation of exchange rates for the purpose of "gaining an unfair competitive advantage over other members."[26]

29. **Article IV, Section 1(iii) was discussed in an earlier paper on the legal framework of Article IV.**[27] It is understood that "manipulation" of the exchange rate involves policies that are directed at—and actually affect—the level of an exchange rate.[28]

30. **What further guidance can be given regarding the concept of "gaining an unfair competitive advantage" over other members?** It was uncontroversial in February that seeking a "competitive advantage" should be understood to refer to the purpose of increasing the country's net exports. There was less agreement, however, about when a competitive advantage should be considered an "unfair" competitive advantage over other members. Unfairness can be defined only relative to an agreed benchmark. Neither Article IV nor the legislative history provides explicit guidance on what the benchmark should be, but it is open to the Fund to identify it. Three possible benchmarks might be considered—the market rate, purchasing power parity (PPP) rate, and the equilibrium exchange rate (as defined in Chapter I.A):

- The **market rate** (namely, the rate that would prevail in the absence of any intervention or other exchange rate policy action) does not seem a sensible benchmark, as it would result in labeling any intervention resisting appreciation as a source of "unfair" advantage.

- The **PPP** rate does not seem a sensible benchmark either, as it cannot generally be deemed "unfair" that prices in lower-income countries tend to be lower than in higher-income countries.

- The **equilibrium real effective exchange rate** is a more appealing benchmark. This would amount to treating as "unfair" deviations in the exchange rate that result in a

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[25] While Article IV, Section 1(iii) also prohibits members from manipulating the international monetary system for certain purposes, it is not clear how a member would do so and no guidance is proposed on this issue.

[26] Given the uncertainty regarding the meaning of the other specified purpose ("in order to prevent effective balance of payments adjustment") it is not intended to provide guidance on that aspect of the provision at this time, although the Board could return to this issue at a later time.

[27] *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework* (2006), in particular paragraphs 32-34, footnote 22.

[28] Manipulation need not cause the exchange rate to move, however; in some cases, it may prevent such movement.

sustained *excessive* accumulation of net external assets. As discussed in Chapter I.A, this would occur when the exchange rate is fundamentally misaligned—more specifically, undervalued. This benchmark would be directly consistent with the key objective of Article IV, namely a stable system of exchange rates, since rates that are fundamentally undervalued are inherently inconsistent with longer-term stability. Of course, in using this concept, the usual uncertainties in estimating equilibrium exchange rates should be duly recognized.

31. **The Executive Board could thus provide guidance as to what constitutes manipulation of the exchange rate "in order to gain an unfair competitive advantage over other members" under Article IV, Section 1(iii) and PGM A.** Specifically, it could clarify that a member would only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (i) the member is engaged in these policies for the purposes of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate, and (ii) the purpose of securing such misalignment is to increase net exports.[29]

32. In determining whether the purpose of a member's policies was to gain an unfair competitive advantage over other members, the Fund would make its own assessment, while giving the member's representation the benefit of any reasonable doubt. The Fund would give the member the opportunity to represent the purpose of its actions and would give the member's representations the benefit of any reasonable doubt. Ultimately, however, the Fund would make an independent assessment as to whether the member's representation was correct, taking into account all relevant information.[30]

B. PGM D

33. **This section explains the meaning of the proposed wording of the new PGM D.**

34. ***"A member should avoid exchange rate policies..."* clarifies the legal nature and object of the principle.** "Should" indicates that PGM D is a recommendation and that following it is not mandatory. It identifies a subset of exchange rate policies that should be *avoided*. Thus, the Fund could not, on the basis of this PGM, recommend to a country that

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[29] As noted earlier, "manipulation" requires an impact on the nominal exchange rate (either to move it or to prevent it from moving). In determining the purposes of the manipulation, however, what matters is the intent to cause a fundamental exchange rate misalignment and not whether such misalignment has been achieved. For example, a competitive depreciation of the nominal exchange rate may not succeed in affecting the real exchange rate if domestic prices are fully flexible, but may still be regarded as inconsistent with PGM A.

[30] See *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework*, (2006) paragraph 34.

does not have an exchange rate policy—i.e., that has a freely floating exchange rate—to adopt one. Finally, although the object of the PGM is exchange rate policies, adjustment would not necessarily have to come from exchange rate policies.[31]

35. ***"…that are pursued for domestic reasons…"* ensures both comprehensive coverage and a clear demarcation between PGMs A and D.** The reference to domestic reasons ensures that the PGMs together cover the range of reasons that may motivate exchange rate policies. As the only external objectives imaginable are those that are specifically enumerated in PGM A, "domestic reasons" should be understood as capturing any objectives not captured by PGM A. When determining the policy intentions of members for purposes of PGM D, the Fund would take the same approach it does in determining whether a member was engaged in exchange rate manipulation for the purposes identified in PGM A (see paragraph 32 above).[32]

36. ***"… and result in external instability, including fundamental misalignment"* indicates the result to be avoided.** Accordingly, for members to be found not in observance of this PGM, they must engage in exchange rate policies that are pursued for domestic reasons and these policies must result in external instability. "Result in" makes clear that what is at issue is the result of the member's exchange rate policies.[33] Explicitly adding that external instability includes fundamental misalignment does not change the substance of the PGM in any way, as fundamental exchange rate misalignment is inherently part of the definition of external instability. However, it would be more transparent—as a practical matter, fundamental misalignment is the form that external instability would be expected to take in many cases. Such mention could be questioned on the grounds of the empirical uncertainties that prevail in estimating the precise extent of misalignment, but a reference to misalignment in PGM D would be a useful reminder of the importance of performing this assessment in all cases—qualitatively if empirical difficulties prevent a precise quantitative estimation.

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[31] For instance, a member that is maintaining a fundamentally overvalued exchange rate peg alongside domestic policies that do not provide this peg appropriate support could, in principle, achieve observance of PGM D by adjusting its domestic policies (so as to bring inflation below the average of partner countries, until the real exchange rate has sufficiently depreciated).

[32] What matters is the ultimate objective of the policy in question. By relying on exchange rate policies, this objective is achieved through an adjustment in the balance of payments—that is, the immediate objective is external. For instance, monetary policy may be conducted with a view to maintaining a pegged exchange rate (i.e., "for balance of payments purposes"), but for the ultimate objective of promoting price stability.

[33] The wording "lead to" proposed in *Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Further Considerations* (2007), has been changed to "result in" for clarity.

IV. INDICATORS

37. **This chapter elaborates on the proposed list of indicators in the Decision,** highlighting both changes from the existing text, and, where relevant, changes relative to the illustrative text presented in the previous paper for the review of the Decision. The list of indicators is intended to provide broad guidance for judgment about when a question of observance of the PGMs may require further examination. The indicators are a "filter," indicating the need for thorough review and discussions with a member; their triggering would not, in itself, lead to the conclusion that a member was not observing a PGM. The list is not intended to capture all developments that will be useful for Fund surveillance.

38. **The proposed changes to the existing Decision aim at two goals.** First, adding new indicators on notably missing policies (sterilization accompanying protracted large-scale one-way intervention) and outcomes (current account balance). Second, refining existing indicators (adding liquidity risks associated with both public borrowing and private capital flows; replacing official short-term lending with accumulation of foreign assets; clarifying the existing indicator on misalignment). The changes are explained in detail below.

39. **These revisions are based on those previewed in the illustrative text in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations*, but reflect the changes in the proposed PGMs since then, as well as suggestions from Executive Directors.** In particular, with the proposed PGMs limited to exchange rate policies, existing references to "balance of payments purposes" are retained in the proposed list, as these serve, in these cases, to distinguish exchange rate policies from other policies.

40. **Additional clarification of the indicators can be, and to some extent already is, provided in guidance notes.** This avoids overloading the text and allows easier updates to keep pace with developments in the international financial system and in economics.[34]

Indicator (i)—Intervention

41. **The proposed text places particular emphasis on the need to examine sterilization that accompanies protracted large-scale one-way intervention.** Exchange rate intervention *coupled with* sterilization—i.e., mopping up liquidity associated with reserve gains or injecting liquidity to offset reserve losses—prevents domestic prices from adjusting and hence impedes the adjustment of not only the nominal but also the real exchange rate. It therefore warrants special scrutiny.

[34] For example, guidance notes could clarify the use of reserve adequacy indicators to assess intervention (some guidance exists), the use of debt sustainability analysis to assess external borrowing (guidance exists), and how off-balance-sheet arrangements should be viewed in assessing intervention, official borrowing, and private sector capital flows (some guidance exists).

Box. Proposed Redlined Amendments to Indicators [1]

(i) protracted large-scale intervention in one direction in the exchange market, *particularly if accompanied by sterilization*;

(ii) ~~an unsustainable level of~~ official or quasi-official borrowing that either is unsustainable, or brings unduly high liquidity risks, or excessive and prolonged ~~short-term~~ official or quasi-official ~~lending~~ accumulation of foreign assets for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment; ~~behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements; and~~

(vi) large and prolonged current account deficits or surpluses; and

~~(vi)~~ (vii) ~~unsustainable flows of private capital.~~ large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

[1] Redlines are relative to the existing text of the Decision.

42. **The explicit mention of sterilization is by no means intended to indicate that sterilization will always be a cause for concern.** Some Directors in February were concerned that such reference would risk surveillance making no allowance for well-justified sterilization such as would, for example, take place in the course of normal reserve buildup or in response to large temporary or cyclical capital inflows.[35] The indicator, however, does not call for special scrutiny of all sterilization, but only of sterilization that accompanies protracted large scale one-way intervention. Moreover, in applying it, it is critical to assess whether the sterilized intervention occurs in the presence of a misaligned exchange rate, or

[35] Of course, the practical effectiveness and viability of sterilized intervention would depend on the elasticity of capital inflows to interest rate differentials, as well as on its costs.

whether sterilized intervention aims at preventing market forces from moving the real exchange rate away from its equilibrium, as in the case of speculative capital inflows.[36]

Indicator (ii)—Official and quasi-official borrowing and lending

43. **The proposed changes are largely refinements of the existing text.**

- On borrowing, the changes would capture liquidity risks in addition to sustainability/solvency risks. This reflects the concern that liquidity risks raise the probability of crises even where solvency is reasonably assured.

- As regards official lending, as noted in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations*, the objective of the indicator is to capture excessive "recycling" of balance of payments surpluses—an objective that would be better served if its purview was not limited to lending (generally understood as non-marketable). Great care would continue to be needed in the interpretation of what constitutes "excessive and prolonged"—taking account, for instance, of limits on domestic absorptive capacity, the prudent saving of temporary current account surpluses, and more generally the requirements of prudent asset management in response to changes in fundamental conditions (e.g., drawdown of nonrenewable resources, population aging).

Indicator (iii)—Current and capital account restrictions

44. **No change is proposed for this indicator.**

Indicator (iv)—Monetary and financial policies

45. **No change is proposed.** Absent a PGM on domestic policies, changes suggested in the illustrative text in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* are no longer appropriate. In particular, there is a need to retain the reference to "balance of payments purposes" to distinguish monetary and financial policies that are exchange rate policies from those that are not.[37]

Indicator (v)—Exchange rate misalignment

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[36] For example, particular attention should be paid to sterilization of current account surpluses and deficits, rather than of capital account flows, as such sterilization is more likely to point to a misaligned exchange rate.

[37] Similarly, the existing text of "monetary and financial policies" is retained, rather than the list of domestic policies—"fiscal, monetary, and financial sector policies"—that had been suggested in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* (2007) in light of the then proposed PGM on domestic policies. Also, the proposed references to "excessive sectoral saving-investment imbalances" and "excessively high vulnerabilities in the financial system," which were meant to cover the main channels through which domestic policies could impact on external stability, are no longer appropriate.

46. **The proposed change clarifies the existing text.** As discussed in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations*, the existing indicator should be viewed as an indicator of misalignment, with the "underlying conditions"—including "factors affecting competitiveness and long-term capital movements"—conceptually equivalent to the fundamentals affecting equilibrium exchange rates (and hence misalignment), discussed in Chapter I.A. In addition, as discussed in paragraph 58, the "underlying conditions" referred to in the existing text should be interpreted as including only *sustainable* policies, which are also to be used in assessing equilibrium exchange rates (Chapter I.A). The proposed explicit reference to fundamental misalignment serves to clarify this interpretation.

Indicator (vi)—Current account deficit/surplus

47. **This new indicator addresses one notably missing external sector outcome—the current account balance.** As noted in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations*, the original drafters may have considered the current account redundant with the indicator on exchange rate misalignment (indicator (v)). But given the central role of the current account in the assessment of external developments, and since some redundancy in the list of indicators would be acceptable and even helpful, it is proposed to add an indicator on the current account, mirroring that on the capital account (indicator (vii)).

48. **The proposed text takes into account some Directors' suggestion that the indicator should treat deficit and surplus cases symmetrically.** The text now refers to "large and prolonged" current account deficits or surpluses, instead of "unsustainable" deficits or "excessive and prolonged" surpluses as suggested in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations*. (The word "large" is suggested, instead of "excessive," to minimize the judgment involved at this stage, in keeping with the "filter" nature of the indicators.) As further explained in Chapter I.A, in assessing whether a member's "large and prolonged" current account imbalance is of concern, the Fund must of course take into account underlying structural conditions and exercise careful judgment in gauging the equilibrium current account.

Indicator (vii)—External sector vulnerabilities

49. **This indicator is proposed to be revised to capture explicitly liquidity risks and a wider concept of external vulnerabilities.** The changes are motivated by the fact that liquidity risks, alone or concomitant with solvency risks, can trigger crises.[38] Capital flows

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[38] The reference to "balance sheet vulnerabilities" suggested in *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Further Considerations* (2007) has been replaced by "external sector vulnerabilities." Absent a PGM on domestic policies, the reference to balance sheet vulnerabilities is no longer appropriate because it includes both domestic (inter-sectoral) and external components.

should include various kinds of cross-border financial operations that carry different type of risks including currency, maturity, and rollover risks.

INTERNATIONAL MONETARY FUND

Review of the 1977 Decision—Proposal for a New Decision
Supplement

Prepared by the Policy Development and Review Department and the Legal Department

Approved by Mark Allen and Sean Hagan

June 13, 2007

Contents Page

I. INTRODUCTION

1. This supplement responds to questions and suggestions that Executive Directors have communicated to management and staff since the issuance of *Review of the 1977 Decision—Proposal for a New Decision* and its companion paper (CP), and puts forward a revised proposed Decision (Section IV, with a redlined version provided as an Attachment for convenience). Section II explains the proposed changes to the Decision, and Section III discusses issues that might be clarified in the summing up of the forthcoming Board discussion.*

II. CHANGES IN THE PROPOSED DECISION

2. In addition to a number of minor editorial changes, the revised proposed Decision includes a number of more significant modifications. These are discussed below.

A. Addition of Preamble

3. **It is proposed to add a preamble to the Decision to clarify its context and general intent.** The preamble would place the new Decision in the context of the significant developments that have taken place since 1977, both in the global economy and in the best practice of surveillance. It would also clarify how the Decision relates to certain key elements of Article IV, including an explicit statement that it does not create new obligations for members, and emphasize the need for due regard to members' circumstances. This will help the document stand on its own.

B. Scope of Surveillance Over Domestic Policies

4. **The revised proposed Decision further clarifies the scope of surveillance over members' domestic policies**. It is proposed to add a sentence stating that the Fund will not require a member that is complying with Article IV, Section 1 (i) and (ii) to change its domestic policies in the interest of external stability (paragraph 6). This brings into the Decision a point already made in the CP, paragraph 14.

C. Application of the Decision to Currency Unions

5. **A new dedicated paragraph is proposed to clarify the manner in which the Decision applies to members of currency unions** (paragraph 7). The version of the proposed Decision set out in *Review of the 1977 Decision—Proposal for a New Decision* contained only one specific reference to currency unions (paragraph 4) and, for some

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* The proposed Decision discussed in this paper was adopted by the Executive Board on June 15, 2007 with some changes, identified as follows in section IV: paragraphs with drafting changes are preceded by a "plus" sign (+). Text not adopted is preceded and followed by double plus signs (++). See the Public Information Notice (PIN), IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies" (June 2007) for the Decision as adopted.

Directors, it was unclear how the Decision's various provisions applied to currency unions. It is proposed to replace the reference to currency unions in paragraph 4 with a new paragraph (paragraph 7) drawing on the CP to provide a comprehensive description of the scope of surveillance over members of currency unions.

D. Safeguards in the Application of the Principles

6. **Paragraph 13 of the revised proposed Decision provides clearer guidance on how the Principles will be applied by the Fund. Specifically:**

- Paragraph 13 now states explicitly that members are presumed to be implementing policies consistent with the Principles. This reflects the general understanding that the burden of proof would be on the Fund to demonstrate, based on all available evidence, that the member was implementing policies that are inconsistent with a Principle.

- Paragraph 13 also explicitly mentions assessments of fundamental exchange rate misalignment as one of the areas where the member will be given the benefit of any reasonable doubt.

- Finally, paragraph 13 clarifies that in circumstances where the Fund has determined that the member is implementing policies inconsistent with the Principles, the Fund, when informing the member as to what corrective actions should be taken, would take into account the disruptive impact that an excessively rapid adjustment would have on the member's economy (in line with *Review of the 1977 Decision—Proposal for a New Decision*, paragraph 18).

E. Wording of the New PGM D

7. **The proposed Decision no longer refers to "domestic reasons" in PGM D.** Based on consultations with Executive Directors, there appears to be broad support for the removal of this reference. As a result of this deletion, PGM D will apply when exchange rate policies result in external instability, including fundamental exchange rate misalignment, irrespective of the motivation for these policies.[1]

F. Miscellaneous Editorial Changes

8. **The revised proposed Decision includes a number of other changes of a presentational nature** that aim to convey more accurately what is at issue. The main ones are, in order of appearance in the text:

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[1] In contrast, PGM A applies where a member is manipulating its exchange rate for one of the specific purposes set forth in Article IV, Section 1 (iii)—even if fundamental exchange rate misalignment does not arise.

- Simplifying the text relating to the scope of surveillance and the principle of proximity (old paragraph 7 merged into 5, with minor editorial changes);
- Clarifying the sentence on the treatment of growth in surveillance, with a view to setting clearer limits on the scope of surveillance (paragraph 6);
- Replacing a reference to "discussion" with "dialogue" to emphasize the two-way nature of the surveillance process (paragraph 8, last sentence);
- Adding a reference to implementation capacity as one of the circumstances of members to which surveillance must pay due regard (paragraph 9);
- Clarifying that the only limits to the scope for taking into account members' other policy objectives are the ones set by Article IV (paragraph 9);
- Clarifying that surveillance must pay attention to relevant regional developments (paragraph 10) and to international capital markets (paragraphs 10 and 12);
- Replacing the reference to "expected responses of policies to contingencies" with "possible responses to the most relevant contingencies" (paragraph 11);
- Removing "special" in a potentially misleading reference to "special consultations" to prepare the WEO (paragraph 18);
- Introducing in the Annex some editorial changes designed to address the perception that certain types of exchange rate policies were being stigmatized, and to state explicitly that the Fund's assessment of a member's observance of PGM A would involve consultation with the relevant member.

III. Issues that Might be Clarified in the Summing Up

9. **Several of the key concepts used in the Decision are explained in detail in the Board papers.** The Board could endorse such explanations in the summing up of the Board discussion, possibly by referring to specific sections of the Board papers. The explanations thus endorsed by the Board would be particularly relevant to help guide the application of the Decision in future. Areas where this approach might be found useful include the following:

External stability

10. Since the concept of external stability plays a key role in the Decision, the summing up could endorse the definition of this concept elaborated in paragraphs 3–8 of the CP.

Fundamental exchange rate misalignment

11. In this context, the summing up could specifically endorse paragraph 6 of the CP as containing the definition of fundamental exchange rate misalignment. Notably, this

paragraph of the CP includes an explanation that an exchange rate would only be judged to be fundamentally misaligned if the misalignment was found to be significant.

IV. REVISED PROPOSED DECISION*

The following Decision is proposed for adoption by the Executive Board; it may be adopted by a majority of votes cast.

Preamble

+Since the adoption in 1977 of the Decision entitled "Surveillance over Exchange Rate Policies" (the "1977 Decision"), there have been significant developments in the global economy, characterized by growing trade and financial integration. In light of these developments and in recognition of the increasingly important international dimensions of surveillance and of cross-country spillovers, the Fund is of the view that, by incorporating existing best practice in the area of surveillance, an update of the 1977 Decision would play an important role in providing guidance to both the Fund and its members regarding their mutual responsibilities under Article IV. The Fund emphasizes that the guidance being provided to members in this Decision relates to the performance of their existing obligations under Article IV; no new obligations are created for members by this Decision. Moreover, the Fund recognizes that members have legitimate policy objectives that are beyond the scope of Article IV and, accordingly, beyond the scope of this Decision, although when adopting policies to achieve these objectives, members need to ensure that such policies are consistent with their obligations under Article IV. The principles for the guidance of members set forth in this Decision regarding their exchange rate policies respect the domestic social and political policies of members and will be applied in a manner that pays due regard to the circumstances of members and the need for evenhandedness in the practice of surveillance. Finally, looking forward, flexibility should be maintained to allow for the continued evolution of surveillance.

Bilateral Surveillance over Members' Policies

1. This Decision provides guidance to the Fund in its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), and guidance to members in the conduct of

*See the note marked with an asterisk in paragraph 1.

their exchange rate policies pursuant to Article IV, Section 3 (b). It does not deal directly with the Fund's responsibility to oversee the international monetary system in order to ensure its effective operation, referred to in Article IV, Section 3 (a).

2. Part I of this Decision sets out the scope and modalities of the Fund's oversight of members' obligations under Article IV, Section 1, including the Fund's exercise of firm surveillance over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance"). Part II establishes principles for the guidance of members in the conduct of their exchange rate policies as required under Article IV, Section 3 (b); it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Part III sets out procedures for surveillance.

3. Fund surveillance over members' policies shall be adapted to the needs of the international monetary and financial system as they develop. The principles and procedures set out in this Decision, which apply to all members irrespective of their exchange arrangements and balance of payments positions, are not necessarily comprehensive and are subject to reconsideration by the Fund in the light of experience.

Part I – Principles for the Guidance of the Fund in its Bilateral Surveillance

A. The Scope of Bilateral Surveillance

4. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most

effectively achieved by each member adopting policies that promote its own "external stability"—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Sections 1 (i) through (iv). "External stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph 7 below, external stability is assessed at the level of each member.

5. In its bilateral surveillance, the Fund will focus on those policies of members that can significantly influence present or prospective external stability. The Fund will assess whether these policies are promoting external stability and advise the member on policy adjustments necessary for this purpose. Accordingly, exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects). Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective external stability.

6. In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting external stability when they are promoting domestic stability—that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. While the Fund will always examine whether a member's domestic policies are directed toward keeping the member's economy operating broadly at capacity, the Fund will examine

whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby external, stability. However, the Fund will not require a member that is complying with Article IV, Sections 1(i) and (ii) to change its domestic policies in the interests of external stability.

7. This Decision applies to members of currency unions, subject to the following considerations. Members of currency unions remain subject to all of their obligations under Article IV, Section 1 and, accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. In its surveillance over the policies of members of a currency union, the Fund will assess whether relevant policies implemented at the level of the currency union (including exchange rate and monetary policies) and at the level of members are promoting the external stability of the union and will advise on policy adjustments necessary for this purpose. In particular, the Fund will assess whether the exchange rate policies of the union are promoting its external stability, and whether domestic policies implemented at the level of the union are promoting the domestic, and thereby external, stability of the union. Because, in a currency union, exchange rate policies are implemented at the level of the union, the principles for the guidance of members' exchange rate policies and the associated indicators set out in paragraph 15 of this Decision only apply at the level of the currency union. With respect to the conduct of domestic policies implemented at the level of individual members, a member of a currency union is considered by the Fund to be promoting the external stability of the union when it is promoting its own domestic stability. In view of the importance of individual members' balances of payments for the domestic stability of the member and the external stability of the union, the Fund's assessment of the policies of a member of a currency union will always include an evaluation of developments in the member's balance of payments.

B. The Modalities of Bilateral Surveillance

8. Dialogue and persuasion are key pillars of effective surveillance. The Fund, in its bilateral surveillance, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. Such assessments and advice are intended to assist that member in making policy choices, and to enable other members to discuss these policy choices with that member. In the context of bilateral surveillance, the Fund will foster an environment of frank and open dialogue and mutual trust with each member and will be evenhanded across members, affording similar treatment to members in similar relevant circumstances.

9. The Fund's assessment of a member's policies and its advice on these policies will pay due regard to the circumstances of the member. This assessment and advice will be formulated within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and will pay due regard to the member's implementation capacity. Moreover, in advising members on the manner in which they may promote external stability, the Fund shall, to the extent permitted under Article IV, take into account the member's other objectives.

10. The Fund's assessment and advice in the context of bilateral surveillance will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global and regional economic environment, including exchange rates, international capital market conditions, and key linkages among members. The Fund's assessment and advice will take into account the impact of a member's policies on other

members to the extent that the member's policies undermine the promotion of its own external stability.

11. The Fund's assessment and advice in the context of bilateral surveillance will, to the extent possible, be placed in the context of an examination of the member's medium-term objectives and the planned conduct of policies, including possible responses to the most relevant contingencies.

12. The Fund's assessment of a member's policies will always include an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserves, the size and composition of its other external assets and its external liabilities, and its opportunities for access to international capital markets.

Part II – Principles for the Guidance of Members' Policies Under Article IV, Section 1

13. Principles A through D below are adopted pursuant to Article IV, Section 3 (b) and are intended to provide guidance to members in the conduct of their exchange rate policies in accordance with their obligations under Article IV, Section 1. In accordance with Article IV, Section 3 (b), these Principles respect the domestic social and political policies of members. In applying these Principles, the Fund will pay due regard to the circumstances of members. Members are presumed to be implementing policies that are consistent with the Principles. When, in the context of surveillance, a question arises as to whether a particular member is implementing policies consistent with the Principles, the Fund will give the member the benefit of any reasonable doubt, including with respect to an assessment of fundamental exchange rate misalignment. In circumstances where the Fund has determined that a member is implementing policies that are not consistent with these Principles and is informing the

member as to what policy adjustments should be made to address this situation, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

14. Principle A sets forth the obligation contained in Article IV, Section 1(iii); further guidance on its meaning is provided in the Annex to this Decision. Principles B through D constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is in breach of its obligations under Article IV, Section 1.

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange rate of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that result in external instability, ++including fundamental exchange rate misalignment.++

15. In its surveillance of the observance by members of the Principles set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market, ++particularly if accompanied by sterilization;++

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

Part III – Procedures for Surveillance

16. Each country that becomes a member of the Fund after the adoption of this decision shall, within thirty days of the date of its membership, notify the Fund in appropriate detail of the exchange arrangements it intends to apply in fulfillment of its obligations under

Article IV, Section 1. Each member, regardless of its date of membership, shall notify the Fund promptly of any changes in its exchange arrangements.

17. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Facility identified in Decision No. 8240- (86/56), SAF, adopted March 26, 1986, as amended, where the Executive Board shall reach conclusions no later than three months from the termination of discussions between the member and the staff.

18. Broad developments in exchange rates will be reviewed periodically by the Fund, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct consultations in preparing for these discussions.

19. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and their policies under Article IV, Section 1, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its policies.

20. (a) Whenever the Managing Director considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the

exchange rate of its currency, the Managing Director shall initiate informally and confidentially a discussion with the member. After such discussion the Managing Director may report to the Executive Board or informally advise the Executive Directors and, if the Executive Board considers it appropriate, an ad hoc Article IV consultation between the member and the Fund shall be conducted in accordance with the procedure set out in subparagraph (b) below.

(b) A staff report will be circulated to the Executive Directors under cover of a note from the Secretary specifying a tentative date for Executive Board discussion which will be at least 15 days later than the date upon which the report is circulated. The Secretary's note will also set out a draft decision taking note of the staff report and completing the ad hoc consultation without discussion or approval of the views contained in the report; the decision will be adopted upon the expiration of the two-week period following the circulation of the staff report to the Executive Directors unless, within such period, there is a request from an Executive Director or decision of the Managing Director to place the report on the agenda of the Executive Board. If the staff report is placed on the agenda, the Executive Board will discuss the report and will reach conclusions which will be reflected in a summing up.

(c) Unless otherwise decided by the Executive Board, the conduct of an ad hoc consultation with a member will not affect the consultation cycle applicable to the member or the deadline for completion of the next consultation with the member

21. The Executive Board shall review this Decision and the general implementation of bilateral surveillance at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

22. Decision No. 5392-(77/63), adopted April 29, 1977, as amended, and paragraph 3 of Decision No. 6026-(79/13), adopted January 22, 1979, as amended, are hereby repealed.

ANNEX

Article IV, Section 1(iii) and Principle A

1. Article IV, Section 1 (iii) of the Fund's Articles provides that members shall "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The language of this provision is repeated in Principle A contained in Part II of this Decision. The text set forth below is designed to provide further guidance regarding the meaning of this provision.

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).

+ (a) "Manipulation" of the exchange rate is only carried out through policies that are targeted at—and actually affect—the level of an exchange rate. ++For this purpose, such policies may be implemented in a variety of ways, including through intervention in the exchange markets or through the imposition of capital controls.++ Moreover, manipulation need not cause the exchange rate to move; in some cases, manipulation may prevent such movement.

(b) A member that is manipulating its exchange rate would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (B) the purpose of securing such misalignment is to increase net exports.

3. It is the responsibility of the Fund to make an objective assessment of whether a member is observing its obligations under Article IV, Section 1 (iii), based on all available evidence, including consultation with the member concerned. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.

Proposed Decision—Redlined Version (compared to *Review of the 1977 Decision—Proposal for a New Decision*, Main Paper, section IV)

Preamble

Since the adoption in 1977 of the Decision entitled "Surveillance over Exchange Rate Policies" (the "1977 Decision"), there have been significant developments in the global economy, characterized by growing trade and financial integration. In light of these developments and in recognition of the increasingly important international dimensions of surveillance and of cross-country spillovers, the Fund is of the view that, by incorporating existing best practice in the area of surveillance, an update of the 1977 Decision would play an important role in providing guidance to both the Fund and its members regarding their mutual responsibilities under Article IV. The Fund emphasizes that the guidance being provided to members in this Decision relates to the performance of their existing obligations under Article IV; no new obligations are created for members by this Decision. Moreover, the Fund recognizes that members have legitimate policy objectives that are beyond the scope of Article IV and, accordingly, beyond the scope of this Decision, although when adopting policies to achieve these objectives, members need to ensure that such policies are consistent with their obligations under Article IV. The principles for the guidance of members set forth in this Decision regarding their exchange rate policies respect the domestic social and political policies of members and will be applied in a manner that pays due regard to the circumstances of members and the need for evenhandedness in the practice of surveillance. Finally, looking forward, flexibility should be maintained to allow for the continued evolution of surveillance.

Bilateral Surveillance over Members' Policies

1. This Decision provides guidance to the Fund in its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), and guidance to members in the conduct of their exchange rate policies pursuant to Article IV, Section 3 (b). It does not deal directly

with the Fund's responsibility to oversee the international monetary system in order to ensure its effective operation, referred to in Article IV, Section 3 (a).

2. Part I of this Decision sets out the scope and modalities of the Fund's oversight of members' obligations under Article IV, Section 1, including the Fund's exercise of firm surveillance over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance"). Part II establishes principles for the guidance of members in the conduct of their exchange rate policies as required under Article IV, Section 3 (b); it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Part III sets out procedures for surveillance.

3. Fund surveillance over members' policies shall be adapted to the needs of the international monetary and financial system as they develop. The principles and procedures set out in this Decision, which apply to all members irrespective of their exchange arrangements and balance of payments positions, are not necessarily comprehensive and are subject to reconsideration by the Fund in the light of experience.

Part I – Principles for the Guidance of the Fund in its Bilateral Surveillance

A. The Scope of Bilateral Surveillance

4. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most

effectively achieved by each member adopting policies that promote its own "external stability"—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Sections 1 (i) through (iv). "External stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph 7 below, external~~External~~ stability is assessed at the level of each ~~individual~~ member~~, except for members of currency unions, where it is assessed at the level of the currency union~~.

5. In its bilateral surveillance, the Fund will focus on those policies of members that can significantly~~materially~~ influence present or prospective external stability~~, both at present and in future, including both exchange rate policies and domestic economic and financial policies~~. The Fund will assess whether these policies are~~, in fact,~~ promoting external stability and advise the member on ~~any~~ policy adjustments necessary for this purpose. Accordingly, exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects). Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective external stability.

6. In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting ~~promote~~ external stability when they are promoting~~promote~~ domestic stability—that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth

with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. While the Fund ~~In particular, it~~ will always examine whether a member's domestic policies are directed toward keeping the member's economy operating broadly at capacity, the Fund ~~, and~~ will examine whether domestic policies are directed toward fostering a~~an appropriately~~ high rate of potential growth only in those cases where such high potential growth significantly influences prospects for ~~is of material importance to~~ domestic, and thereby external, stability. However, the Fund will not require a member that is complying with Article IV, Sections 1(i) and (ii) to change its domestic policies in the interests of external stability.

7. This Decision applies to members of currency unions, subject to the following considerations. Members of currency unions remain subject to all of their obligations under Article IV, Section 1 and, accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. In its surveillance over the policies of members of a currency union, the Fund will assess whether relevant policies implemented at the level of the currency union (including exchange rate and monetary policies) and at the level of members are promoting the external stability of the union and will advise on policy adjustments necessary for this purpose. In particular, the Fund will assess whether the exchange rate policies of the union are promoting its external stability, and whether domestic policies implemented at the level of the union are promoting the domestic, and thereby

external, stability of the union. Because, in a currency union, exchange rate policies are implemented at the level of the union, the principles for the guidance of members' exchange rate policies and the associated indicators set out in paragraph 15 of this Decision only apply at the level of the currency union. With respect to the conduct of domestic policies implemented at the level of individual members, a member of a currency union is considered by the Fund to be promoting the external stability of the union when it is promoting its own domestic stability. In view of the importance of individual members' balances of payments for the domestic stability of the member and the external stability of the union, the Fund's assessment of the policies of a member of a currency union will always include an evaluation of developments in the member's balance of payments~~ Exchange rate policies and macroeconomic and macroeconomically relevant structural aspects of monetary, fiscal, and financial sector policies will always be the subject of the Fund's bilateral surveillance with respect to each member. Other policies will be examined in the context of surveillance only to the extent that the Fund is satisfied that they materially influence prospects for external stability~~.

B. The Modalities of Bilateral Surveillance

8. Dialogue and persuasion are key pillars of effective surveillance. The Fund, in its bilateral surveillance, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. Such assessments and advice are intended to assist that member in making policy choices, and to enable~~allow~~ other members to discuss these policy choices with that member.~~.~~ In the context of bilateral surveillance, the Fund will foster an environment of frank and open dialogue~~discussion~~ and

mutual trust with each member and will be evenhanded across members, affording similar treatment to members in similar relevant circumstances.

9. The Fund's assessment of a member's policies and its advice on these policies will pay due regard to the circumstances of the member. This assessment and advice~~appraisal~~ will be formulated~~made~~ within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and will pay due regard to the member's implementation capacity. Moreover, in advising members on the manner in which they may promote external stability, the Fund shall~~will~~, to the extent permitted under Article IV~~possible~~, take into account the member's other objectives.

10. The Fund's assessment and advice in the context of bilateral surveillance will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global and regional economic environment, including exchange rates, international capital market conditions, and key linkages among members. The Fund's assessment and advice will take into account the impact of a member's policies on other members to the extent that the member's policies undermine the promotion of its own external stability.

11. The Fund's assessment and advice in the context of bilateral surveillance will, to the extent possible, be placed in the context of~~include~~ an examination of the member's medium-term objectives and~~,~~ the planned conduct of policies, ~~and~~ including possible ~~the expected~~ responses ~~of policies~~ to the most relevant contingencies.

12. The Fund's assessment of a member's policies will always include an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserves, the size and composition of its other external assets~~,~~ and its external liabilities, and its opportunities for access to international capital markets.

Part II – Principles for the Guidance of Members' Policies Under Article IV, Section 1

13. Principles A through D ~~set out~~ below are adopted pursuant to Article IV, Section 3 (b) and are intended to provide guidance to members in the conduct of their exchange rate policies in accordance with their obligations under Article IV, Section 1. In accordance with Article IV, Section 3 (b), these Principles ~~are designed to~~ respect the domestic social and political policies of members. In applying these Principles, the Fund will pay due regard to the circumstances of members. Members are presumed to be implementing policies that are consistent with the Principles. When, in the context of surveillance, a question arises as to ~~and, when determining~~ whether a particular member is implementing policies consistent with the Principles ~~following these principles~~, the Fund will give the member the benefit of any reasonable doubt, including with respect to an assessment of fundamental exchange rate misalignment. In circumstances where the Fund has determined that a member is implementing policies that are not consistent with these Principles and is informing the member as to what policy adjustments should be made to address this situation, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

14. Principle A sets forth the obligation contained in Article IV, Section 1(iii); further guidance on its meaning is provided in the Annex to this Decision. Principles B through D constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is~~was~~ in breach of its obligations under Article IV, Section 1.

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange rate~~value~~ of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that ~~are pursued for domestic reasons and~~ result in external instability, including fundamental exchange rate misalignment.

15. In its surveillance of the observance by members of the Principles~~principles~~ set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market, particularly if accompanied by sterilization;

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

Part III – Procedures for Surveillance

16. Each country that becomes a member of the Fund after the adoption of this decision shall, within thirty days of the date of its membership, notify the Fund in appropriate detail of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member, regardless of its date of membership, shall notify the Fund promptly of any changes in its exchange arrangements.

17. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII

and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Facility identified in Decision No. 8240- (86/56), SAF, adopted March 26, 1986, as amended, where the Executive Board shall reach conclusions no later than three months from the termination of discussions between the member and the staff.

18. Broad developments in exchange rates will be reviewed periodically by the Fund~~Executive Board~~, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct ~~special~~ consultations in preparing for these discussions.

19. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and their policies under Article IV, Section 1, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its policies.

20. (a) Whenever the Managing Director considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the exchange rate of its currency, the Managing Director shall initiate informally and confidentially a discussion with the member. After such discussion the Managing Director

may report to the Executive Board or informally advise the Executive Directors and, if the Executive Board considers it appropriate, an ad hoc Article IV consultation between the member and the Fund shall be conducted in accordance with the procedure set out in subparagraph (b) below.

(b) A staff report will be circulated to the Executive Directors under cover of a note from the Secretary specifying a tentative date for Executive Board discussion which will be at least 15 days later than the date upon which the report is circulated. The Secretary's note will also set out a draft decision taking note of the staff report and completing the ad hoc consultation without discussion or approval of the views contained in the report; the decision will be adopted upon the expiration of the two-week period following the circulation of the staff report to the Executive Directors unless, within such period, there is a request from an Executive Director or decision of the Managing Director to place the report on the agenda of the Executive Board. If the staff report is placed on the agenda, the Executive Board will discuss the report and will reach conclusions which will be reflected in a summing up.

(c) Unless otherwise decided by the Executive Board, the conduct of an ad hoc consultation with a member will not affect the consultation cycle applicable to the member or the deadline for completion of the next consultation with the member

21. The Executive Board~~Fund~~ shall review this Decision and the general implementation of bilateral surveillance at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

22. Decision No. 5392-(77/63), adopted April 29, 1977, as amended, and paragraph 3 of Decision No. 6026-(79/13), adopted January 22, 1979, as amended, are hereby repealed.

ANNEX

Article IV, Section 1(iii) and Principle A

1. Article IV, Section 1 (iii) of the Fund's Articles provides that members shall "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The language of this provision is repeated in Principle A contained in Part II of this Decision. The text set forth below is designed to provide further guidance regarding the meaning of this provision.

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).

(a) "Manipulation" of the exchange rate is only carried out through ~~involves~~ policies that are ~~directed~~ targeted at—and actually affect—the level of an exchange rate. For this purpose, ~~It is recognized that a member may manipulate an exchange rate~~ such policies may be implemented in a variety of ways, including through intervention in the exchange markets or through the imposition of capital controls. Moreover, manipulation need not cause the exchange rate to move; in some cases, manipulation may prevent such movement.

(b) A~~Even if a~~ member that is ~~were~~ manipulating its exchange rate~~, it~~ would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A~~a~~) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (B~~b~~) the purpose of securing such misalignment is to increase net exports.

3. It is the responsibility of the Fund to make an objective assessment of whether a member is observing its obligations under Article IV, Section 1 (iii), based on all available evidence, including consultation with the member concerned. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt. ~~In the final analysis, however, it is the responsibility of the Fund to make an objective assessment, based on all available evidence, of whether the member's representation is correct.~~

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 07/69
FOR IMMEDIATE RELEASE
June 21, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Adopts New Decision on Bilateral Surveillance Over Members' Policies

On June 15, 2007, the Executive Board of the International Monetary Fund (IMF) adopted a new Decision on Bilateral Surveillance over Members' Policies , concluding a year-long review of the 1977 Decision on Surveillance Over Exchange Rate Policies, and repealing and replacing that Decision.

Background

The adoption of the 2007 Decision on Bilateral Surveillance is a keystone of the effort to upgrade the foundations of the IMF's bilateral surveillance—the activity whereby the IMF monitors the economic and financial policies of its member countries, in the interest of international monetary stability. Modernizing surveillance is a central element in the IMF's Medium-Term Strategy, which has reexamined the future directions of the IMF in light of economic and financial globalization. The new Decision crystallizes a common vision of the best practice of surveillance, as it has evolved over the last 30 years, for greater clarity, and hence more accountability. By setting clear expectations for the practice of surveillance, the new Decision should help improve the quality, evenhandedness, and effectiveness of the IMF's surveillance. The new Decision also brings greater clarity and specificity to what exchange rate policies countries should avoid and when these policies may be of concern to the international community.

The adoption of the 2007 Decision is the culmination of a long and thorough effort to analyze gaps in the 1977 Decision, to distill the best practice of surveillance, and to crystallize a common vision of modern surveillance in a comprehensive statement.[1]

[1] In July 2006, the Board explored the rationale for a possible revision of the 1977 Decision that would build more comprehensive links with Article IV and better align the Decision with modern best practice ("Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Preliminary Considerations", "Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework", "Review of the 1977 Decision on Surveillance over Exchange Rate Policies—

(continued…)

The1977 Decision was crafted shortly after the collapse of the Bretton Woods system, in the midst of considerable uncertainty as to how the new system would work. It focused exclusively on surveillance over exchange rate policies, and its coverage was relatively narrow even in that area. The Decision was expected to be revised with experience. However, it remained virtually unchanged even as the practice of surveillance evolved (including to encompass domestic policies as a key element), and a disconnect developed between the Decision and the best practice of surveillance.

The 2007 Decision is a comprehensive statement on bilateral surveillance. It does not create new obligations for members, but updates the 1977 Decision in a number of important ways:

- In order to help focus surveillance on issues crucial to international monetary and financial stability, the new Decision introduces a concept of external stability as an organizing principle for bilateral surveillance. (External stability encompasses both the current account of the balance of payments—and thereby also issues of exchange rate misalignment—and the capital account of the balance of payments.) In this connection, the new Decision also elaborates on the scope of bilateral surveillance in the context of currency unions.

- The new Decision specifies the essential modalities of effective modern surveillance. It underscores the collaborative nature of surveillance, the importance of dialogue and persuasion, and the need for candor and evenhandedness. It also emphasizes the importance of paying due regard to country circumstances and the need for a multilateral and medium-term perspective.

- The new Decision clarifies the concept of exchange rate manipulation in order to gain an unfair competitive advantage over other members, which is prohibited under Article IV and referred to in the previous Decision. In particular, the new Decision relates such behavior to the concept of fundamental exchange rate misalignment.

- The new Decision provides more complete guidance to members for the conduct of their exchange rate policies, so as to cover all major causes of external instability rooted in these policies. The 1977 Decision enjoined members to avoid exchange rate manipulation for specific purposes, in particular to gain an unfair competitive advantage over other Fund members. The new Decision adds a principle recommending that members avoid exchange rate policies that *result* in external instability, regardless of their purpose, thereby capturing exchange rate policies that have proven to be a major source of instability over the past decades.

Background Information," and the associated Summing Up of the Executive Board discussion). In February 2007, the Board held a follow-up discussion in which Directors explored the principles on which a revised Decision should be built, and discussed illustrative text for a new Decision ("Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Further Considerations" and the associated Summing Up of the Executive Board discussion). The latest staff papers made a proposal built on the approach outlined in the February staff paper, and reflecting the views expressed by the Board at that time ("Review of the 1977 Decision—Proposal for a New Decision," its more technical "Companion Paper," and its Supplement presenting a revised draft).

- Overall, the 2007 Decision is better aligned with current practices, covering both exchange rate policies and relevant domestic economic and financial policies.

Chairman's Summing Up of June 15, 2007 Board Discussions

Following extensive discussions over recent months, the Executive Board has adopted a new Decision on bilateral surveillance over members' policies. Reflecting the momentous changes in the world economic and financial system since the previous Decision on surveillance over members' exchange rate policies was adopted in 1977, the new surveillance Decision updates guidance to both the Fund and its members regarding their obligations under Article IV of the Articles of Agreement. The discussions leading up to the Decision have served to build a broadly shared understanding of its purpose and its key elements. I am particularly grateful that in arriving at this agreement on a new surveillance Decision, members with a spectrum of views have made their best efforts to meet the dual objective of commanding the broadest support and achieving the best outcome possible. Today's decision is also an important step forward in the implementation of the Fund's Medium-Term Strategy, and helps pave the way for positive outcomes on its other elements, including quota and voice reforms and the Fund's income model.

The new surveillance Decision focuses on bilateral surveillance, and provides guidance both to the Fund in the conduct of surveillance—in Part I of the Decision—and to members in the conduct of their exchange rate policies—in Part II of the Decision—including through an Annex that provides guidance with respect to the meaning of Article IV, Section 1 (iii). In their discussions on the text of the Decision, Directors reaffirmed the understanding, consistent with the Fund's legal framework, that references to the "Fund" in a Board decision are generally understood to mean the Executive Board, supported by management and staff as appropriate. A few Directors would have preferred that the Decision also cover multilateral surveillance—that is, the Fund's responsibility to oversee the international monetary system, under Article IV, Section 3(a)—and expressed the hope that this would be included at a later stage. Most Directors agreed that a number of sections of the Companion Paper identified below would provide particularly important guidance as to how the Fund should apply the Decision.

Looking ahead, Directors generally viewed the adoption of the Decision as an important starting point, but not by any means the end of the road, in the Fund's efforts to discharge its surveillance responsibilities effectively and in an evenhanded manner. It will be important that the adoption of the Decision is followed up by ensuring that both staff and national authorities are fully familiar with the new framework and that they deepen their shared understanding of how surveillance can be effectively enhanced.

Under the new Decision, the concept of external stability becomes an overarching organizing principle of surveillance. In that regard, the Executive Board endorsed the meaning ascribed to this term in paragraphs 3 through 11 of the Companion Paper, with many Directors emphasizing that, in applying the Decision, the text of those paragraphs will provide particularly useful guidance.

Directors considered that the adoption of a new principle for the guidance of members' exchange rate policies, PGM D, is an important step forward for the Fund. They noted that this principle should guide members in avoiding external instability arising from their exchange rate policies.

The Executive Board endorsed the definition of fundamental exchange rate misalignment as set forth in paragraph 6 of the Companion Paper. Directors underscored, however, that this needs to be applied with appropriate caution. They stressed, in particular, that it should be used with due acknowledgement of the considerable measurement uncertainties involved, and that estimates of misalignment require the exercise of careful judgment. In practice, an exchange rate would only be judged to be fundamentally misaligned if the misalignment is found to be significant. Directors also attached considerable importance to the provisions of the Decision whereby the benefit of any reasonable doubt would be given to the authorities in establishing whether fundamental misalignment is present. Directors noted that any judgment on misalignment should be applied in an evenhanded manner irrespective of the nature of the exchange rate regime and the size of the economy. Also, a number of Directors emphasized the potential market-sensitivity of estimates of misalignment and the need for care in communicating them.

With regard to the indicator in paragraph 15 of the Decision on protracted large-scale intervention in one direction in the exchange market, Directors noted that such intervention is worthy of special scrutiny when it is accompanied by sterilization. Of course, sterilization—often appropriately engaged in to promote domestic stability—may very well be perfectly justified. The Executive Board endorsed the discussion contained in paragraphs 41–42 of the Companion Paper.

With respect to the guidance which the Board has provided in the Annex to the Decision on the meaning of Article IV, Section 1 (iii), Directors recognized that exchange rate manipulation can take many different forms, including intervention in the exchange markets and the imposition of capital controls for the purpose of directly targeting the exchange rate. They noted that, as explained in the Annex to the Decision, under Article IV, Section 1 (iii), a member is only required to avoid exchange rate manipulation when such manipulation is engaged in for one of the purposes identified in that provision. A number of Directors stressed that the above mention of intervention and capital controls should not be construed as stigmatizing the use of these legitimate policy options per se, or removing them from the toolkit of members.

Today's discussion completes the review of the 1977 Decision, which is now replaced by the 2007 Decision on Bilateral Surveillance over Members' Policies.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

INTERNATIONAL MONETARY FUND

BILATERAL SURVEILLANCE OVER MEMBERS' POLICIES

Executive Board Decision—June 15, 2007

Preamble

Since the adoption in 1977 of the Decision entitled "Surveillance over Exchange Rate Policies" (the "1977 Decision"), there have been significant developments in the global economy, characterized by growing trade and financial integration. In light of these developments and in recognition of the increasingly important international dimensions of surveillance and of cross-country spillovers, the Fund is of the view that, by incorporating existing best practice in the area of surveillance, an update of the 1977 Decision would play an important role in providing guidance to both the Fund and its members regarding their mutual responsibilities under Article IV. The Fund emphasizes that the guidance being provided to members in this Decision relates to the performance of their existing obligations under Article IV; no new obligations are created for members by this Decision. Moreover, the Fund recognizes that members have legitimate policy objectives that are beyond the scope of Article IV and, accordingly, beyond the scope of this Decision, although when adopting policies to achieve these objectives, members need to ensure that such policies are consistent with their obligations under Article IV. Part I of this Decision is designed to give guidance to the Fund in its exercise of surveillance; Part I of this Decision does not, and cannot be construed or used to, expand or broaden the scope—or change the nature—of members' obligations under the Articles of Agreement, directly or indirectly. The principles for the guidance of members set forth in this Decision regarding their exchange rate policies respect the domestic social and political policies of members and will be applied in a manner that pays due regard to the circumstances of members and the need for evenhandedness in the practice of surveillance. Finally, looking forward, flexibility should be maintained to allow for the continued evolution of surveillance.

1. This Decision provides guidance to the Fund in its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), and guidance to members in the conduct of their exchange rate policies pursuant to Article IV, Section 3 (b). It does not deal directly with the Fund's responsibility to oversee the international monetary system in order to ensure its effective operation, referred to in Article IV, Section 3 (a).

2. Part I of this Decision sets out the scope and modalities of the Fund's oversight of members' obligations under Article IV, Section 1, including the Fund's exercise of firm surveillance over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance"). Part II establishes principles for the guidance of members in the conduct of their exchange rate policies as required under Article IV, Section 3 (b); it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Part III sets out procedures for surveillance.

3. Fund surveillance over members' policies shall be adapted to the needs of the international monetary and financial system as they develop. The principles and procedures set out in this Decision, which apply to all members irrespective of their exchange arrangements and balance of payments positions, are not necessarily comprehensive and are subject to reconsideration by the Fund in the light of experience.

Part I – Principles for the Guidance of the Fund in its Bilateral Surveillance

A. The Scope of Bilateral Surveillance

4. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most effectively achieved by each member adopting policies that promote its own "external stability"—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Sections 1 (i) through (iv). "External stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph 7 below, external stability is assessed at the level of each member.

5. In its bilateral surveillance, the Fund will focus on those policies of members that can significantly influence present or prospective external stability. The Fund will assess whether these policies are promoting external stability and advise the member on policy adjustments necessary for this purpose. Accordingly, exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects). Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective external stability.

6. In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting external stability when they are promoting domestic stability—that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. While the Fund will always examine whether a member's domestic policies are directed toward keeping the member's economy operating broadly at capacity, the Fund will examine whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby external, stability. However, the Fund will not require a member that is complying with Article IV, Sections 1(i) and (ii) to change its domestic policies in the interests of external stability.

7. This Decision applies to members of currency unions, subject to the following considerations. Members of currency unions remain subject to all of their obligations under Article IV, Section 1 and, accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. In its surveillance over the policies of members of a currency union, the Fund will assess whether relevant policies implemented at the level of the currency union (including exchange rate and monetary policies) and at the level of members are promoting the external stability of the union and will advise on policy adjustments necessary for this purpose. In particular, the Fund will assess whether the exchange rate policies of the union are promoting its external stability, and whether domestic policies implemented at the level of the union are promoting the domestic, and thereby external, stability of the union. Because, in a currency union, exchange rate policies are implemented at the level of the union, the principles for the guidance of members' exchange rate policies and the associated indicators set out in paragraph 15 of this Decision only apply at the level of the currency union. With respect to the conduct of domestic policies implemented at the level of individual members, a member of a currency union is considered by the Fund to be promoting the external stability of the union when it is promoting its own domestic stability. In view of the importance of individual members' balances of payments for the domestic stability of the member and the external stability of the union, the Fund's assessment of the policies of a member of a currency union will always include an evaluation of developments in the member's balance of payments.

B. The Modalities of Bilateral Surveillance

8. Dialogue and persuasion are key pillars of effective surveillance. The Fund, in its bilateral surveillance, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. Such assessments and advice are intended to assist that member in making policy choices, and to enable other members to discuss these policy choices with that member. In the context of bilateral surveillance, the Fund will foster an environment of frank and open dialogue and mutual trust with each member and will be evenhanded across members, affording similar treatment to members in similar relevant circumstances.

9. The Fund's assessment of a member's policies and its advice on these policies will pay due regard to the circumstances of the member. This assessment and advice will be formulated within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and will pay due regard to the member's implementation capacity. Moreover, in advising members on the manner in which they may promote external stability, the Fund shall, to the extent permitted under Article IV, take into account the member's other objectives.

10. The Fund's assessment and advice in the context of bilateral surveillance will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global and regional economic environment, including exchange rates, international capital market conditions, and key linkages among members. The Fund's assessment and advice will take into account the impact of a member's policies on other members to the extent that the member's policies undermine the promotion of its own external stability.

11. The Fund's assessment and advice in the context of bilateral surveillance will, to the extent possible, be placed in the context of an examination of the member's medium-term objectives and the planned conduct of policies, including possible responses to the most relevant contingencies.

12. The Fund's assessment of a member's policies will always include an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserves, the size and composition of its other external assets and its external liabilities, and its opportunities for access to international capital markets.

Part II – Principles for the Guidance of Members' Policies Under Article IV, Section 1

13. Principles A through D below are adopted pursuant to Article IV, Section 3 (b) and are intended to provide guidance to members in the conduct of their exchange rate policies in accordance with their obligations under Article IV, Section 1. In accordance with Article IV, Section 3 (b), these Principles respect the domestic social and political policies of members. In applying these Principles, the Fund will pay due regard to the circumstances of members. Members are presumed to be implementing policies that are consistent with the Principles. When, in the context of surveillance, a question arises as to whether a particular member is implementing policies consistent with the Principles, the Fund will give the member the benefit of any reasonable doubt, including with respect to an assessment of fundamental exchange rate misalignment. In circumstances where the Fund has determined that a member is implementing policies that are not consistent with these Principles and is informing the member as to what policy adjustments should be made to address this situation, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

14. Principle A sets forth the obligation contained in Article IV, Section 1(iii); further guidance on its meaning is provided in the Annex to this Decision. Principles B through D constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is in breach of its obligations under Article IV, Section 1.

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange rate of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

D. A member should avoid exchange rate policies that result in external instability.

15. In its surveillance of the observance by members of the Principles set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

(iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;

(v) fundamental exchange rate misalignment;

(vi) large and prolonged current account deficits or surpluses; and

(vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

Part III – Procedures for Surveillance

16. Each country that becomes a member of the Fund after the adoption of this decision shall, within thirty days of the date of its membership, notify the Fund in appropriate detail of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member, regardless of its date of membership, shall notify the Fund promptly of any changes in its exchange arrangements.

17. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Facility identified in Decision No. 8240- (86/56), SAF, adopted March 26, 1986, as amended, where the Executive Board shall reach conclusions no later than three months from the termination of discussions between the member and the staff.

18. Broad developments in exchange rates will be reviewed periodically by the Fund, inter alia in discussions of the international adjustment process within the framework of the

World Economic Outlook. The Fund will continue to conduct consultations in preparing for these discussions.

19. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and their policies under Article IV, Section 1, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its policies.

20. (a) Whenever the Managing Director considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the exchange rate of its currency, the Managing Director shall initiate informally and confidentially a discussion with the member. After such discussion the Managing Director may report to the Executive Board or informally advise the Executive Directors and, if the Executive Board considers it appropriate, an ad hoc Article IV consultation between the member and the Fund shall be conducted in accordance with the procedure set out in subparagraph (b) below.

(b) A staff report will be circulated to the Executive Directors under cover of a note from the Secretary specifying a tentative date for Executive Board discussion which will be at least 15 days later than the date upon which the report is circulated. The Secretary's note will also set out a draft decision taking note of the staff report and completing the ad hoc consultation without discussion or approval of the views contained in the report; the decision will be adopted upon the expiration of the two-week period following the circulation of the staff report to the Executive Directors unless, within such period, there is a request from an Executive Director or decision of the Managing Director to place the report on the agenda of the Executive Board. If the staff report is placed on the agenda, the Executive Board will discuss the report and will reach conclusions which will be reflected in a summing up.

(c) Unless otherwise decided by the Executive Board, the conduct of an ad hoc consultation with a member will not affect the consultation cycle applicable to the member or the deadline for completion of the next consultation with the member

21. The Executive Board shall review this Decision and the general implementation of bilateral surveillance at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

22. Decision No. 5392-(77/63), adopted April 29, 1977, as amended, and paragraph 3 of Decision No. 6026-(79/13), adopted January 22, 1979, as amended, are hereby repealed.

ANNEX

Article IV, Section 1(iii) and Principle A

1. Article IV, Section 1 (iii) of the Fund's Articles provides that members shall "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." The language of this provision is repeated in Principle A contained in Part II of this Decision. The text set forth below is designed to provide further guidance regarding the meaning of this provision.

2. A member would only be acting inconsistently with Article IV, Section 1(iii) if the Fund determined both that: (a) the member was manipulating its exchange rate or the international monetary system and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1(iii).

(a) "Manipulation" of the exchange rate is only carried out through policies that are targeted at—and actually affect—the level of an exchange rate. Moreover, manipulation may cause the exchange rate to move or may prevent such movement.

(b) A member that is manipulating its exchange rate would only be acting inconsistently with Article IV, Section 1(iii) if the Fund were to determine that such manipulation was being undertaken "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." In that regard, a member will only be considered to be manipulating exchange rates in order to gain an unfair competitive advantage over other members if the Fund determines both that: (A) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (B) the purpose of securing such misalignment is to increase net exports.

3. It is the responsibility of the Fund to make an objective assessment of whether a member is observing its obligations under Article IV, Section 1 (iii), based on all available evidence, including consultation with the member concerned. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.