Review of the 1977 Decision on Surveillance over Exchange Rate Policies
Preliminary Considerations, Background Information, and Summing Up of the Board Meeting, July 19, 2006

IMF documents cited in this report are available at www.imf.org or from the IMF Archives, see http://www.imf.org/external/np/arc/eng/archive.htm

INTERNATIONAL MONETARY FUND

Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations

Prepared by the Policy Development and Review Department

In consultation with the Legal and other Departments

Approved by Mark Allen

June 28, 2006

Contents Page

I. Introduction 2

II. The Framework: Surveillance In Article IV and the Decision...3
A. Members' Commitments...3
B. Fund Surveillance...7
C. The Decision 8

III. Should the Decision Be Revised, and How? 10
A. Anchoring Surveillance...11
B. The Coverage of the Principles 15
C. Procedures for Surveillance 20

IV. Issues for Discussion 22

Boxes
1. Member's Policy Commitments Under Article IV.1 5
2. Components of the 1977 Decision.. 9
3. Procedures for Surveillance in the 1977 and 1979 Decisions.............................21

Chart
Logic of Member's Commitments...6

I. Introduction[1]

1. **There is a broad consensus that, at this juncture in the evolution of the international monetary system, effective surveillance is the most critical priority for the Fund.** It is a cornerstone of the Fund's Medium-Term Strategy (MTS), which was welcomed by the Fund's shareholders and others.[2]

2. **Against this background, it is striking that the foundations of surveillance are almost thirty years old**. The 1977 Decision on Surveillance Over Exchange Rate Policies (henceforth "the Decision")—to date, the main foundation of surveillance, alongside Article IV of the Fund's Articles of Agreement—was crafted in the wake of the collapse of the Bretton Woods system of par values. At the time, uncertainty prevailed regarding the rules of the game—be they related to the role of the Fund or to macroeconomic management without fixed exchange rates—and private capital flows played a more limited role. The expectation was that the Decision would be revised with experience. In reality, while the practice of surveillance did evolve and the Decision was supplemented with various other forms of guidance, the Decision itself, though formally subject to biennial reviews, remained virtually unchanged.

3. **As foreshadowed in the MTS, it is time for a more fundamental review of the Decision.** Areas most ripe for consideration include: clarifying what members' obligations under the Articles imply for the conduct of their policies and for their engagement with the Fund; clarifying the place of exchange rate surveillance within the broader context of surveillance; bringing the principles for exchange rate surveillance into line with the evolution of the past 30 years in the global economy and economic analysis; and revisiting the range of procedures for surveillance. Granted, surveillance has been able to evolve within the constraints of the Decision by keying directly off Article IV. However, the disconnect between the practice of surveillance and the Decision purportedly supporting it does not help forceful implementation, nor is it conducive to public understanding of the Fund's operations.

4. **This review of the Decision forms part of a more comprehensive approach to strengthen the effectiveness of surveillance.** A paper to be brought to the Board within a few months will discuss a broad framework for assessing the effectiveness of surveillance and, as noted below, will address the nexus of a surveillance remit, accountability, and independence. In parallel, efforts to strengthen the implementation of surveillance continue, with a special focus on exchange rate surveillance, of which a stocktaking will be made available to the Board shortly. Promising experimentation is also underway with multilateral

---

[1] The main authors of this paper are Isabelle Mateos y Lago and Tessa van der Willigen, under the guidance of Carlo Cottarelli, and with input from Lynn Aylward, Dmitriy Kovtun, Tania Reif, and Pedro Rodriguez.

[2] *The Managing Director's Report on the Fund's Medium-Term Strategy* (2005), and *The Managing Director's Report on Implementing the Fund's Medium-Term Strategy* (2006).

consultations and streamlined Article IV consultations, which will add extra planks to the Fund's surveillance policy framework.

5. **This paper consists of two parts.** The first explains the conceptual framework of surveillance, as embodied in Article IV and the Decision (Section II). The second identifies critical issues that have arisen in its operation and proposes ways in which amending the Decision could address them (Section III). Section IV suggests issues for discussion. A companion paper sets out the legal framework of Article IV (hereafter the "Companion Legal Paper").[3] Depending on the guidance received from the Board, the present paper could be followed by a further paper discussing possible amendments to the Decision in more detail, for discussion toward the end of the year.

II. The Framework: Surveillance In Article IV and the Decision

6. **The Fund was established in 1944 to promote the stability of the international monetary system**, so as to provide a framework for the balanced expansion of trade and, thereby, contribute to growth and prosperity. A key purpose of the Fund, stemming from the bitter experience of the 1930s, was to "promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation."

7. **The present version of Article IV was incorporated into the Articles of Agreement in 1978 as part of the Second Amendment of the Articles.** The original Article IV established the "par value system" under which members maintained a fixed "par value" for their currencies in terms of gold and obtained Fund concurrence before making changes in a par value. The Second Amendment took a fundamentally different approach: members are now largely free to choose whatever "exchange arrangement" they wish—including floating—and must abide by obligations respecting the conduct of their policies, both external and domestic.

8. **The Companion Legal Paper provides an overview of members' obligations under Article IV.** It points out that the language of the present Article IV is not always clear. Its drafting reflects political compromises, and there is little by way of legislative history. While its main message is clear, it is sometimes difficult to nail down the details.[4] A number of key points made in the companion paper and the accompanying economic rationale are set out below.

A. Members' Commitments

9. **The primary focus of Article IV is *external stability*.** The Fund's focus is often rendered as "macroeconomic stability." But at root this interest in macroeconomic stability is an interest in external stability.

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

[4] Companion Legal Paper, paragraphs 3-7.

10. **The Fund's interest in external stability is rendered in Article IV as "orderly exchange arrangements and ... a stable system of exchange rates."** This latter concept should not be understood as meaning unchanging exchange rates; indeed, there was a concern that the par value system had created rigidity without stability.[5] A country should not resist an adjustment in its exchange rate if such an adjustment is needed in response to underlying conditions. In any case, in the presence of significant capital mobility and with members free to let their currency float—both features of the post-Bretton Woods world—market-driven exchange rate fluctuations are likely inevitable. Thus, the stated objective is to achieve the stability of the system—not the stability of exchange rates as such. Such stability is best served if exchange rates are permitted to move in response to underlying conditions, as long as these underlying conditions are orderly and do not tend to generate erratic disruptions and disorderly developments in exchange rates. Although the term "external stability" does not appear in Article IV, it is used here as a convenient shorthand for "orderly exchange arrangements and ... a stable system of exchange rates," as exchange rates and balance of payments flows are—ultimately—two sides of the same coin.

11. **Article IV recognizes that *external stability* cannot be achieved without *domestic stability and growth*.**[6] The link with domestic stability is obvious: disorderly economic and financial conditions will sooner or later spill over onto the balance of payments. In addition, Article IV recognizes that growth—as long as it is orderly and is accompanied by reasonable price stability—is supportive of external stability. If policies to foster orderly growth are not in place, there is a risk that countries will resort to measures that lead to disorderly growth (monetary surprises, or competitive depreciations), with adverse consequences for the international monetary system.

12. **With an eye on these various objectives, Article IV sets out obligations regarding both *external and domestic policies* (Box 1).**[7] The chapeau undertaking of members is to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In recognition of the relationship between domestic policies and exchange rates, Article IV establishes obligations (albeit of a "soft" best efforts nature) with respect to members' domestic policies (see Article IV, Sections 1(i) and (ii) in Box 1). With respect to exchange rate policies, members must "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" and follow exchange policies compatible with their undertakings under Article IV, Section 1 (see Article IV, Sections 1(iii) and (iv) in Box 1). Chart 1 traces the logic of the different policy commitments through their impact on stability and growth to the ultimate objective of external stability.

---

[5] Companion Legal Paper, paragraphs 25-26.

[6] Companion Legal Paper, paragraphs 29-30.

[7] Companion Legal Paper, paragraphs 20–39.

Box 1. Member's Policy Commitments Under Article IV.1

Article IV includes, in its chapeau, an overarching commitment: to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." The Article then clarifies that "in particular" each member is committed to the following:

Commitments on domestic economic and financial policies

(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;"

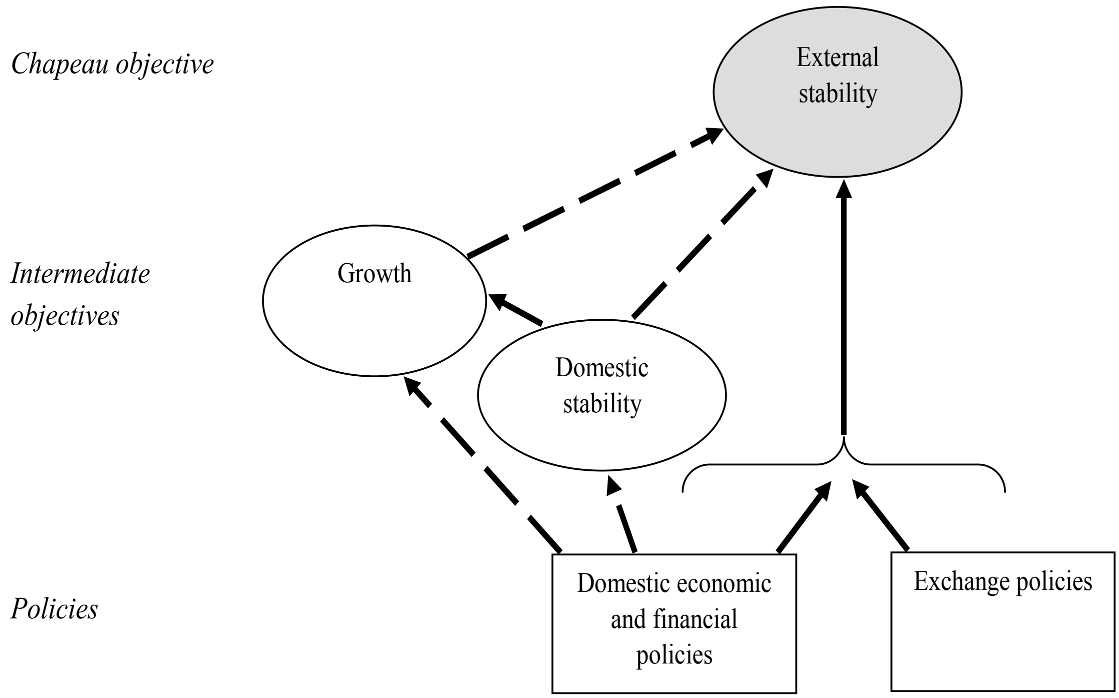
(ii) "seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;"

Commitments on exchange policies

(iii) "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;"

(iv) "follow exchange policies compatible with the undertakings in this Section" (i.e., all of the above commitments (IV.1 chapeau), and the undertakings to seek growth with price stability and orderly economic and financial conditions (IV.1.(i) & (ii)).

Chart 1. Logic of Members' Commitments 1/



1/ The arrows show the main directions of influence underlying the commitments of Article IV. They do not attempt to capture all linkages.

13. **Article IV gives members great freedom to choose their exchange rate regime, although a member's choice must be consistent with its other obligations.**[8] It is difficult to imagine a case where the regime itself would make a member unable to comply with its obligations under Article IV.1. A change in the exchange rate level should generally be able

[8] Members' freedom to choose their exchange arrangement is discussed in more detail in the Companion Legal Paper (paragraphs 2, 8–15), As explained there, references in the Articles to members' freedom to choose are actually to exchange *arrangements*, not regimes. The arrangement includes the regime (i.e., the underlying framework for determining the exchange rate), but also, in the case of peggers, the chosen rate. It is easy to see how, in the presence of other rigidities, the *exchange rate level* component of an exchange arrangement could be inconsistent with external stability. Whether the *regime* itself could ever be inconsistent with the Articles is the more complex question addressed in this paragraph.

to restore sustainability at any point in time.[9] And while it is generally recognized that the choice of regime will affect economic performance over time (at least through the economy's adjustment to shocks), it is unlikely that any particular regime would ultimately be incompatible with external stability, as long as the option of changing the exchange rate level to restore equilibrium exists.[10] There may, however, be cases (e.g., currency boards and currency unions) where a change in the exchange rate level may so undermine the credibility of the regime as to make it unviable. In these cases it is important to remember that the member's freedom to choose its exchange regime is bounded by the need to comply with its commitments under Article IV.1—even should such compliance bring about, as a by-product, a change in regime.

B. Fund Surveillance

14. **Fund surveillance has two aspects** (set out in Article IV, Section 3(a)).[11] First, an explicitly multilateral one, in that it must "oversee the international monetary system in order to ensure its effective operation." Second, a bilateral one, as a means of overseeing the compliance of members with the commitments set out in Article IV.1. In practice, the two are closely related. Since external stability by definition involves more than one country, there can be no effective bilateral surveillance without a multilateral perspective—still less so as the world economy becomes more integrated and cross-border spillovers more important.

15. **The overall scope of bilateral surveillance—though ultimately aimed at promoting external stability—is broad.** Under the more flexible system described above, surveillance has become a primary mechanism through which the Fund promotes a stable international monetary system. For this purpose, Article IV requires the Fund to assess compliance by members with *all* their obligations under Article IV, Section 1, both domestic and external.

16. **Within this framework, Article IV gives a special place to surveillance over exchange rate policies.** Article IV, Section 3(b) provides that "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." The Articles do not provide a definition of exchange rate policies, but it is evident from the 1977 Decision that the Board viewed them at that time as including intervention policies, other external policies as long as

---

[9] Of course, it is the real exchange rate that matters, but in the presence of other rigidities it may be the nominal exchange rate that needs to change. A change in other policies would also be needed to avoid the new exchange rate level becoming unsustainable.

[10] In this sentence, "external stability" is to be read as referring to "a stable system of exchange rates." As noted in the Companion Legal Paper, there may be circumstances where a particular exchange arrangement (e.g., a multiple currency practice) is inconsistent with the concept of "orderly exchange arrangements" (Companion Legal Paper, para. 27).

[11] Companion Legal Paper, paragraphs 40-41.

they are pursued for balance of payments purposes, and "monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows" when these are pursued for balance of payments purposes.[12]

C. The Decision

General structure

17. **The 1977 Decision on surveillance over exchange rate policies responds to the requirement in Article IV, Section 3(b) that the Fund adopt principles for the guidance of members on their exchange rate policies.**[13] It consists of four parts (Box 3). The **first part** (*General Principles*) clarifies that the Decision does not even *attempt* to cover all aspects of Fund surveillance, but rather deals with exchange rate policies, consistent with the specific direction provided under Article IV, Section 3(b). The **second part** defines three *Principles for the Guidance of Members' Exchange Rate Policies* (PGMs), and the **third part** (the *Principles of Fund Surveillance*) provides guidance to the Fund in monitoring the observance by members of these principles through the specification of indicators. In that context, the third part also recognizes explicitly the close relationship between domestic and external policies. The **fourth part** (*Procedures for Surveillance*) sets out the procedural framework for surveillance, including Article IV consultations.

The principles and their endurance over time

18. **The approach taken in 1977 to define the principles was minimalist, reflecting the constraints faced.** There were great uncertainties as to how the new international monetary system would work. This compounded the difficulty of finding principles that would imply equally close surveillance with respect to all members irrespective of their exchange arrangements. The solution was to adopt only minimal principles at the outset, while underscoring that the principles were "not necessarily comprehensive and subject to reconsideration in the light of experience."

[12] See Companion Legal Paper, footnote 21.

[13] Companion Legal Paper, paragraphs 43–46.

Box 2. Components of the 1977 Decision [1]

The 1977 Decision consists of:

- *General Principles*, which present the Decision as the vehicle to implement the call in Article IV for principles for the guidance of members' exchange rate policies, and stress that it is *not* meant to deal with the Fund's broader oversight responsibility over the international monetary system, nor does it cover comprehensively the Fund's oversight over members' compliance with all their obligations under Article IV.

- *Principles for the Guidance of Members' Exchange Rate Policies* (PGMs):

  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."

  Principle A repeats the obligation in Article IV, Section 1(iii), while B and C provide *guidance* as to how a member's exchange rate policies will be consistent with its obligations under Article IV.

- *Principles of Fund Surveillance over Exchange Rate Policies*, which includes:

  - a list of indicators to be used in gauging whether members are abiding by the PGMs: (i) protracted large-scale intervention, (ii) undue official or quasi-official borrowing or short-term lending for balance of payments purposes, (iii) a change, for balance of payments purposes, of restrictions on, or incentives for, current transactions and capital flows, (iv) the pursuit, for balance of payments purposes, of monetary and other domestic policies that abnormally encourage/discourage capital flows, (v) behavior of the exchange rate unrelated to underlying economic and financial conditions, (vi) unsustainable flows of private capital.

  - some broad "appraisal guidelines," which call for the appraisal of members' exchange rate policies to be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, recognizing that domestic as well as external policies can contribute to external adjustment, and taking into account the extent to which the policies of the member serve the objectives of financial stability, sustained economic growth, and reasonable levels of employment.

- *Procedures for Surveillance* (see Box 3).

[1] "Surveillance over Exchange Rate Policies," Decision No. 5392-(77/63), April 29, 1977, as amended.

19. **Thus, the Decision includes only three PGMs**:

- Principle A simply repeats Article IV.1's injunction against manipulation, and has been generally understood to be targeted at countries tightly managing their exchange rate. Note that intent plays a key role here: the principle prohibits exchange rate manipulation only when it is engaged in for specific purposes, namely gaining unfair competitive advantage or preventing external adjustment.[14]

- Principle B specifically concerns floaters: high on the list of concerns in the 1970s was the need to avoid erratic exchange rate fluctuations in thin markets, and this principle encourages members to use foreign exchange intervention to counter disruptive fluctuations.

- Principle C, applying in principle to all members, urges countries to consider the impact of intervention on other members, and was conceived in particular with a view to avoiding disruptions to reserve currency exchange rates.

20. **While the Decision was reviewed regularly after 1977, the PGMs were never amended, and the accompanying principles for Fund surveillance only once**. The continued appropriateness of the Decision as a basis for surveillance was examined in the context of 13 successive biennial surveillance reviews. However, the great majority of these reviews focused—probably rightly—much more on the *implementation* of surveillance than on a formal examination of the Decision. In the latter respect, two reviews stand out. First, the 1986-87 review proposed several possible amendments motivated by a concern that the Decision was too narrow, including broadening the scope of the Decision to domestic policies, introducing target zones for exchange rates or monitorable indicators for domestic policy instruments, and clarifying and expanding the kind of behavior that could constitute manipulation. None of these proposals met with sufficient support from the Board, reflecting both analytical and political difficulties.[15] Second, in the aftermath of the Mexican crisis, in 1995, references to private capital flows were added to the principles for Fund surveillance. Specifically, "unsustainable flows of private capital" was added to the list of indicators, and a reference to the "size and sustainability of capital flows" was added in the appraisal guidelines, among the balance of payments developments to consider.

III. Should the Decision Be Revised, and How?

21. **It could be argued that the longevity of the Decision proves its enduring value**. There are merits in this view. The Decision—with its lack of specificity—has allowed surveillance to be used flexibly, and to adapt to changing circumstances. It has been complemented over time by other Board deliberations, typically captured in summings up,

---

[14] Companion Legal Paper, paragraphs 32–34.

[15] See the background paper for an overview of the attempted amendments.

which have provided more specific guidance on the exercise of surveillance. It would be a mistake to move radically away from this approach and aim at producing a new decision that was highly prescriptive and detailed.

22. **At the same time, it must be recognized that the Decision now has limited usefulness from a practical perspective**. It remains the official bedrock and foremost display window of the Fund's surveillance mandate, yet surveillance practitioners, both on the side of Fund staff and on the side of country authorities, are often unacquainted with it—a fate that, in some respects, has been shared by Article IV itself (see below). This fading away of what was supposed to be the key anchor for surveillance may have something to do with several perceived weaknesses in surveillance: a need for improved focus; a need for more candor; and claims that the Fund is not closely monitoring countries' policies even in its core areas, including exchange rates.[16]

23. **Against this background, the rest of this paper focuses on three issues:**

- First, how could the Decision provide a better, and more comprehensive, anchor for surveillance, thus complementing the other initiatives to enhance the focus and effectiveness of surveillance undertaken as part of the MTS?
- Second, with specific reference to exchange rate policies, are the principles embedded in the Decision right, and do they provide effective guidance, or is something missing?
- Third, do the procedures for surveillance set out in the Decision provide the Fund with the right tools for the job?

The remainder of this section examines in turn each of these questions, suggesting in most cases remedies fully in the spirit of decisions made by the Board in previous summings up, and in a few others seizing the opportunity to go somewhat further.

A. Anchoring Surveillance

24. **There is scope to anchor surveillance better in two respects—both of which could potentially be reflected in a revised Decision**. The first relates to the *modus operandi* of surveillance, and, more specifically, to a perceived dualism that has emerged in the practice of surveillance between, on the one hand, surveillance as a channel to provide "trusted advice"—a channel that emphasizes persuasion as the key to effectiveness; and, on the other hand, surveillance as a channel to monitor members' compliance with their obligations under Article IV—a more "prescriptive" approach that in principle could culminate in an assessment of noncompliance. The second relates to the coverage of

[16] See inside critiques like *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview* (2004), and outside ones like Edwin Truman (2006), *A Strategy for IMF Reform*, IIE, Washington DC.

surveillance and, more specifically, to the appropriate balance between domestic and external focus. As we shall see, these aspects are related, but it is convenient to address them in turn.

The proper balance between trusted advisor and monitor

25. **While Article IV and the Decision make clear that surveillance is a means of monitoring members' compliance with their obligations, the Fund, in conducting surveillance, has sought to ensure this compliance primarily through persuasion and policy dialogue, and not through a "policing" role.** This preference originated in large part in a recognition that the effectiveness of surveillance in bringing about policy action would, in the end, depend on members' cooperation and trust. It has also been fueled by the uncertain nature of economic knowledge and the diversity of members' circumstances. Both these reasons remain fully valid today.

26. **The Fund has thus chosen a *modus operandi* for surveillance that relies more on shaded appraisals than on statements of compliance or noncompliance.** Article IV consultations are concluded by a Board summing up commenting on the past and planned conduct of policies, and issues of potential breach of obligations almost never arise.

27. **This *modus operandi*, while effective in many ways, has also brought a risk that consultations may lose sight of the commitments of Article IV.** With the emphasis on policy advice, both members and the Fund may be tempted to treat surveillance rather like technical assistance:

- Members may listen politely to the advice in areas they are interested in, and only those. Worse, the occasional member considers any discussion with the Fund an imposition, or even denies—for example in contacts with the media—that it has any obligations toward the Fund at all.

- The Fund (or its staff) may shy away from delivering tough messages, for the sake of persuasiveness, and indeed a lack of candor in surveillance has long been identified as a problem.[17] Too "cozy" a policy dialogue is already a problem in a confidential setting, but the advent of transparency has increased (and will continue to increase) the premium on clear communication to the public.

28. **A revised Decision—supporting a renewed commitment by members to the spirit of surveillance—could help ensure that surveillance remains anchored in the obligations of Article IV, without becoming a sterile exercise in compliance assessment.** In particular, the preamble to the Decision could be revised to refer more clearly to members' various commitments to the Fund and to clarify the conceptual framework underlying these commitments and Fund surveillance (drawing on Section II of this paper and the Companion

---

[17] See, for instance, the *External Evaluation Of IMF Surveillance* (the "Crow Report," IMF, 1999) on "clientism bias."

Legal Paper). Indeed, the Decision could thereby become a decision on surveillance more generally under Article IV, rather than (only) a Decision on surveillance over exchange rate policies. The International Monetary and Financial Committee (IMFC) has also recently proposed "a restatement of the commitments which member countries and their institutions make to each other under Article IV," suggesting that there may be a role for *members themselves* to restate their commitments, e.g., in a declaration ultimately endorsed by the IMFC. [18] This would underscore the original function of surveillance, which is to monitor those commitments.

29. **At the same time, in examining members' policies in light of their commitments under Article IV.1, surveillance could devote greater attention to the need for a medium-term orientation and the identification of policy frameworks.** Members' commitments relate to external stability over the short and longer term, and so Fund surveillance cannot focus merely on today's policies, but must also consider how policies will develop and adjust as circumstances change. Surveillance must thereby focus on the underlying objectives and logic of policies—the policy "framework." At the same time, it is important to recognize that frameworks will differ not just in content but also in form (e.g., the degree to which they are based on rules or are made transparent), and there is no case here for a one-size-fits-all approach. The medium-term orientation of policies is nonetheless a necessary subject for Fund surveillance.

30. **The new Decision could, thus, underscore the importance of examining members' adherence to their commitments in the light of policy frameworks that they spell out**, at least in the key areas of monetary, fiscal, and financial policies, in addition, of course, to exchange rate policies.[19] Such "frameworks" would comprise the set of medium-term orientations and policy reaction functions within which contingent policy decisions are taken (including possibly, but not necessarily, policy rules). Surveillance would then provide an assessment of (i) the consistency of the framework with members' commitments under Article IV; and (ii) whether the member is actually implementing the specified framework.

31. **Such an approach would have several advantages.** First, a focus on policy frameworks as described above would bring benefits of its own. The Fund has already increasingly emphasized the formulation of policy within such frameworks as an important aid to policy-making. Moreover, when robust and credible frameworks are made public—with a concomitant increase in policy predictability—they should play a stabilizing role in financial markets, with important cross-border externalities. While the intent would by no means be to force members to adopt explicit frameworks and make them transparent, surveillance could provide a helpful impetus for countries where a framework is missing but the willingness and capacity to move in this direction exist. Second, and key from the

---

[18] IMFC Communiqué, April 22, 2006.

[19] See for instance proposals by Mervyn King, in *Reform of the International Monetary Fund*, speech at the Indian Council for Research on International Economic Relations (ICRIER) in New Delhi, India, February 20, 2006.

perspective of the present paper, more emphasis on the discussion of frameworks could elicit a higher standard of cooperation from countries, going beyond a discussion of the immediate policy measures envisaged, and would help anchor Article IV consultations.

The proper focus of surveillance

32. **The conceptual framework set out in Article IV and the Decision poses challenges for the focus of surveillance.** A broad range of policies impact external stability, and choosing which ones to focus on is no mean task. The Decision, moreover, with its concentration on exchange rate policies, risks being misread to mean these policies should be the *only* concern of surveillance—and in any case does not help much in identifying what *should* be the central concerns.

33. **Anchoring the scope of surveillance in the Decision on the concept of external stability would help focus surveillance, as well as place exchange rate policies in their proper context.** Avoiding "mission creep" in surveillance has long been identified as a challenge. Nor does current guidance help much in this regard. The latest surveillance review defined a list of matters at the "apex of the Fund's hierarchy of concerns," namely "external sustainability; vulnerability to balance of payments or currency crises; sustainable growth and the policies to achieve it; and, for systemically important countries, conditions and policies affecting the global or regional economic outlook."[20] While fully consistent with Article IV, this guidance—especially the inclusion of "sustainable growth and the policies to achieve it"—hardly restricts the range of appropriate topics for surveillance. Rather, the selection of policies to be covered by surveillance should be guided by the overarching objective of Article IV and thus be based on the extent of their potential contribution—whether positive or negative—to external stability. The further the Fund moves from the issues that are most likely to have a direct impact on external stability—that is, fiscal, monetary, and financial policies, in addition to exchange rate policies—the higher should be the burden of proof that the policies at issue are critical to external stability. Embedding this notion explicitly in the Decision could be useful.

34. **Greater focus in surveillance could also be attained through strengthened means of setting priorities, including potentially through a surveillance remit.** The country-specific multi-year surveillance agendas recently introduced as part of the MTS should help in this regard. The definition of an annual remit for the Fund—as recently suggested by the IMFC—could also strengthen focus. A thorough and integrated examination of the nexus between remit, independence, and accountability is needed. Work is already in train in this area, as part of staff's work on the methodology for assessing the effectiveness of surveillance. Since operational independence is a precondition for accountability, it would need to be part of an integrated review of these issues, with careful attention given to the Fund's current governance structures and existing and potential checks and balances, including the role of transparency. These questions go beyond the framework of the 1977

[20] *IMF Executive Board Reviews the Fund's Surveillance (PIN No. 04/95; 8/24/04).*

Decision, and will be examined separately as part of the forthcoming paper on a possible framework for assessing the effectiveness of surveillance.

B. The Coverage of the Principles

The focus of the principles on exchange rates

35. **Even if surveillance needs to cover a broad range of policies, there are good reasons why Article IV specifically calls for—and the Decision provides—principles for exchange rate policies.** On the one hand, sound exchange rate policies are a necessary, albeit not sufficient, basis for external stability, and the most direct of influences on it. On the other hand, and paradoxically, exchange rate issues have proved one of the most difficult areas for surveillance to cover. Although there has been considerable progress, constructive engagement with members in this area is still hindered by analytical uncertainties, sensitivity concerns, and the common misreading of Article IV as prohibiting questioning of members' choice of exchange arrangement.[21]

36. **By contrast, it is not obvious that there is need for specific principles providing comprehensive and detailed guidance for members' domestic policy commitments under Article IV, Section 1, (i) and (ii).** Article IV, though it fully recognizes the importance of domestic policies for external stability and hence for surveillance, does not require the adoption of principles in this area. Specific principles on various aspects of domestic policies—e.g., fiscal, monetary, labor market, etc.—could be adopted nonetheless, but such an effort seems at this stage neither worthwhile nor practical. Successive reviews of the implementation of surveillance have not found shortcomings that might suggest a need for them. Moreover, it would be difficult to specify principles that would be both sufficiently concrete to be helpful and sufficiently general to take proper account of the diversity of members' circumstances and avoid overconstraining members' policy choices. Rather, greater clarity on the overall importance of domestic policies could be provided in a revised preamble to the 1977 Decision.[22]

The coverage of the PGMs

37. **While existing principles remain valid, experience has revealed problems in the coverage of the PGMs.** Preventing competitive depreciations is one of the key purposes of the Fund, giving perennial validity to Principle A. And while, as a result of the integration and deepening of capital markets, intervention—the focus of Principles B and C—may not be

---

[21] See background paper on the evolution of guidance to staff on exchange rate surveillance, and, for recent assessments, *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview* (2004) and the forthcoming paper providing a stocktaking of the treatment of exchange rate issues in bilateral surveillance. See also Companion Legal Paper, paragraphs 13-14.

[22] In addition, paragraph 40 below discusses the possibility of providing guidance on aspects of domestic policies that bring about exchange rate misalignment.

as critical an influence on exchange rate determination as it used to be, it remains important in some cases and a potential policy lever in others, which lends continued relevance to these PGMs.[23] Even so, the PGMs do not comprehensively cover the key links between exchange rates and external stability and indeed do not capture the two factors that have proved the most significant sources of exchange rate disorder over the last 30 years.

38. **First, the PGMs cover exchange rate policies that cause under- and overvaluations only in a circumscribed set of cases.** Principle A proscribes undervalued exchange rates, but only when these are pursued with a "balance of payments" or "competitive" intent; yet undervalued exchange rates may do damage to international stability even if they arise for other, e.g. domestic, reasons. Principle A also applies in theory to overvalued exchange rates, and here the requirement of balance of payments intent is even more problematic: keeping an overvalued exchange rate can only damage the balance of payments, so that intent is almost a logical impossibility. Thus, a country that fixes its exchange rate at a greatly overvalued level, setting itself (and possibly other countries) up for a crisis, is unlikely to contravene the PGMs. The history of the last 30 years affords a number of examples of such crises.

39. **Second, the PGMs do not cover under- or overvaluations brought about by policies other than exchange rate policies.** Misalignments may result from domestic policies pursued for domestic purposes—for instance, fiscal policies, or monetary policies aimed at the containment of inflation.[24] This type of misalignment would include, for instance, the dislocations in major currency exchange rates brought about, in the early 1980s, by divergences in the stance of fiscal and monetary policies.

40. **In this context, two additional principles could be introduced**. These would direct members to avoid, respectively, exchange rate policies and domestic policies that give rise to a misaligned exchange rate and, in the former case, are pursued for reasons other than gaining unfair competitive advantage or preventing effective balance of payments adjustment.[25] Importantly, these principles would be intended to undergird the surveillance

[23] See IMF's 2001 Survey On Foreign Exchange Market Organization for the diminishing role of intervention in industrialized countries.

[24] Under the 1977 Decision, certain monetary and other domestic financial policies are considered to be exchange rate policies when pursued for balance of payments purposes, but not otherwise (see paragraph 16).

[25] The first of these principles, being a principle on exchange rate policies, would be adopted under Article IV, Section 3(b). The second would focus on other policies that give rise to exchange rate misalignments and are thereby inconsistent with the central undertaking of Article IV, namely to collaborate to promote external stability. Given its focus on policies that are not exchange rate policies (e.g., certain domestic policies), this latter principle would go beyond the requirements of Article IV, Section 3(b) to adopt principles for the guidance of members' exchange rate policies. However, it is open to the Fund to establish principles providing guidance on such policies that fall within the obligation of members 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." (Companion Legal Paper, paragraphs 43-44).

dialogue and to serve as guidance. Non-observance would not, in itself, constitute a breach of obligation under Article IV, but observance of all the principles would be a "safe harbor" that would assure a member that it was complying with its obligations under Article IV.1.

41. **While these principles would be new to the Decision, they would not introduce any great innovation to the practice of exchange rate surveillance.** Practice already includes, in particular, an assessment of the exchange rate level (whether or not related to balance of payments intent), and of the consistency of domestic policies with the exchange regime or, more generally, external stability. Addition of these principles to the Decision would bring it in line with practice, thus providing the latter with a better grounding. Given the limits to the profession's ability to pinpoint the presence and extent of misalignment, these new principles would require the exercise of considerable judgment and the use of a variety of approaches.[26] No greater precision would be expected in the assessment of "misalignment" than is implicit in the (equivalent) assessment of the exchange rate level already required in Article IV consultations.

Issues with the principles of Fund surveillance

42. **The basic structure of the principles of Fund surveillance—a list of indicators and appraisal guidelines—has proven useful, but there may be some scope for improvement.** Now as in 1977, no list of indicators can, in and of itself, provide definitive evidence that a member is or is not observing the PGMs, let alone its commitments under Article IV. Such indicators can at most signal a potential problem warranting closer examination. Hence the usefulness of spelling out broader appraisal guidelines. Gaps can be identified, however, in both components. These are not fatal, as practice has evolved over time, with best practices gradually incorporated into surveillance guidance notes to staff—where, unlike the more architectural issues discussed in the previous section, they rightfully belong. Nonetheless, if a broader revision of the 1977 decision is undertaken, it may be worth taking this opportunity to fix the main shortcomings.

Surveillance indicators

43. **A key shortcoming of the surveillance indicators mirrors the gap identified above in the coverage of misalignment in the PGMs.** Most of the indicators capture policies undertaken with a "balance of payments purpose," and in particular may help establish the presence of currency manipulation, but not other problems which may be equally worrisome. A simple way to make the current list of indicators more relevant would be to treat policy intent separately from observable developments, by removing the phrase "for balance of payments purposes." "Intent" would have to be demonstrated, as necessary for the relevant principle, separately.

---

[26] Whether an exchange rate is misaligned will also depend on the underlying structural characteristics (e.g., trade policies and capital controls), which are typically taken as given in the analysis.

44. **Consideration could also be given to additional indicators, especially of vulnerability and of obstruction to external adjustment** relating primarily to over- and undervaluation.[27] A prime candidate in the latter category would be the extent to which intervention is being sterilized—as sterilization prevents a monetary adjustment which should ultimately lead the real exchange rate to adjust through price changes. The first category, drawing on the literature on early warning systems, might include various indicators of crisis risk and underlying vulnerabilities, including in particular balance-sheet mismatches. Estimates of misalignment compared to medium-term equilibrium could contribute to either category. However, while there would be advantages in including more detailed indicators whose usage has come to characterize "best practice" exchange rate surveillance, such a change would also bring the risk that the list might become outdated rather quickly. An alternative would be to pursue such an expansion—as resources permit—by means of guidance notes.

Appraisal guidelines

45. **Experience has also brought to light two possible limitations of the Principles' appraisal guidelines in ensuring the consistency of exchange rate surveillance** across the Fund's membership:

- **The appraisal guidelines could better recognize the need for a global perspective.** The predominantly bilateral tack of current principles raises the question of whether individual bilateral appraisals "add up" as a whole. In particular, the Decision could recognize explicitly—though at a general level—that the Fund's appraisals of the exchange rate policies of all its members need to be globally consistent and informed by a multilateral perspective, in particular by considering exchange rates in light of developments in partner countries and the global environment more generally.

- **Consideration could also be given to specifying more clearly which country-specific circumstances are relevant** for the implementation of general exchange rate surveillance guidelines, rather than just making a general injunction to pay due regard to country circumstances. Country circumstances that would appear particularly relevant include: membership in a currency union; structural transformation process underway; and extent of capital account liberalization. In this area, however, the risk of micromanagement may outweigh the potential benefits.

More specificity to provide an objective anchor to judgment

46. **There may be scope to reduce the need for judgment and interpretation in the implementation of the Principles.** The main rationale for more specificity is the familiar need to avoid inaction when action is controversial with members. Making the PGMs or the

[27] Additional indicators, like the existing ones, would relate to external sector developments or policies.

principles of Fund surveillance more specific could in principle help.[28] But there is also a risk that for every behavior or development better apprehended, there may be just as many unforeseen ones unwittingly defined out of the net of legitimate concerns. Given the scale of both theoretical and empirical uncertainties and the pace of change of the global economy, attempts to provide greater specificity—particularly regarding quantified benchmarks—may result in a false sense of precision. In any case, it would be important not to lock exchange rate surveillance into the current state of the world. Thus, it changes in this area are to be pursued, it should be in most cases separately from the Decision itself (perhaps in a technical appendix). Two possible avenues are discussed in what follows: definition and quantification.

Better defined concepts?

47. **As regards the PGMs, one possibility would be to provide more specific guidance on the meaning of some of the key concepts used, for instance through a commentary**. Concepts such as "preventing effective balance of payments adjustment" or "gaining unfair competitive advantage" would be prime candidates.[29] A similar approach could be applied to some of the concepts used in new PGMs, if needed.

48. **Regarding the principles for surveillance**, **such an approach could involve specifying the methodology** through which the non-strictly factual indicators are to be observed or construed. For instance, for the indicator "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions," indicating what these underlying conditions include and what is the relevant time frame; or with regard to "unsustainable flows of private capital," how to identify unsustainability.

Quantified benchmarks?

49. **It should be, in principle, possible to develop a set of quantified benchmarks to *inform* the usage of the main indicators**, utilizing empirical regularities and accumulated experience. In general, this would be more easily undertaken for indicators of overvaluation or unsustainability than for undervaluation, reflecting the much more abundant coverage of the former in the literature on crisis prevention and early warning indicators. However, it may be possible to develop quantified stylized facts that would be suggestive of undervaluation. Also, historical cross-country data on intervention could support the development of indicators of abnormally protracted and large one-way intervention.

[28] This point was highlighted by, among others, US Treasury Undersecretary Tim Adams as a key area for improvement in exchange rate surveillance (see for instance *Working with the IMF to Strengthen Exchange Rate Surveillance,* Speech at the American Enterprise Institute, February 2006).

[29] Such an approach would effectively amount to an interpretation of these provisions under the Articles.

C. Procedures for Surveillance

50. **Among the procedures for surveillance laid out in the Decision and its 1979 companion (Box 3), regular Article IV consultations clearly take pride of place.**[30] Complemented by mechanisms for more continuous surveillance, at least at the staff level, regular Article IV consultations have served the Fund well—though there is scope for strengthening them further, and ensuring that they contain pointed appraisals of exchange rate developments and policies is in fact a prime objective.

51. **Also of central importance is the procedure whereby members must notify the Fund of their exchange arrangement.** The Fund cannot exercise sound exchange rate surveillance without knowing what members' exchange rate arrangements and policies are. Indeed, in this context, the requirement that members must notify the Fund of their exchange arrangement, stemming from Article IV, Section 2, is complemented by a requirement that members provide the Fund with certain information necessary for surveillance stemming from Article VIII, Section 5—and including for instance, of special relevance for the monitoring of the conduct of exchange rate policies, "reserve assets and reserve liabilities..., specifying separately any reserve assets which are...encumbered as well as net derivative positions."[31] It is important for the effective exercise of Fund surveillance that members provide the Fund with all this information.

52. **By contrast, the Fund's special surveillance procedures are almost never used.**[32] They have given rise to related concerns about excessive stigma, market sensitivity, and uniformity of treatment that have all but prevented their use.

53. **The new multilateral consultations may have some role to play in fulfilling the objectives for which special procedures were created.**[33] While multilateral consultations

---

[30] The 1979 Decision is Decision No. 6026-(79/13), as amended.

[31] *Strengthening the Effectiveness of Article VIII, Section 5*, Decision No. 13183-(04/10), January 30, 2004.

[32] There are two separate procedures: (i) the procedure set out as paragraph V of the Procedures for Surveillance specified in the Decision; and (ii) a separate procedure for "supplemental surveillance" adopted by the Fund in 1979, and modified in 1993. In this section, these procedures are referred to as the "special procedures." See the background paper for a presentation of "procedure V" and the supplemental surveillance procedures and a discussion of their limited use over time.

[33] Interestingly, the new multilateral consultations seem close in spirit to the multilateral procedures laid out in the 1977 Decision. The special consultations with systemic members referred to in the Decision were created informally when the WEO was launched, in the early 1970s, and discontinued in the 1980s, and the Board reviews of "broad developments in exchange rates" essentially turned into the informal Board sessions on World Economic and Market Developments.

Box 3: Procedures for Surveillance in the 1977 and 1979 Decisions

The last section of the 1977 Decision, together with a supplementary Decision taken in 1979, lay out several modalities of interaction between members and the Fund:

Normal procedures

- Each member shall notify the Fund "in appropriate detail" of their choices of exchange arrangements and any changes thereto.
- Members shall consult, in principle annually, with the Fund under Article IV, to consider observance of the Principles and members' obligations under Article IV, section 1.
- The Managing Director is to maintain close contact with members in connection with their exchange arrangements.

Multilateral procedures

- Broad developments in exchange rates shall be reviewed periodically by the Executive Board, including in the context of discussions on the international adjustment process prepared by special consultations with systemic members.

Special procedures

- Two special consultation procedures, that may be initiated by the Managing Director in between Article IV consultations: (i) "Procedure V" (originally put forth by subsection v of the decision)—to be used when a member's exchange rate policies do not seem to be in accord with the Principles; and (ii) "Supplemental Procedures," added in 1979 to facilitate the use of the special consultations by removing the presumption of fault implicit in Procedure V, whenever the Managing Director considers that important economic and financial developments are likely to affect a members' exchange rate policies or the behavior of its exchange rate.

were not conceived for this purpose, they could on occasion be used when exchange rate issues affect more than one country. In such cases, the collective and cooperative nature of multilateral consultations—which the Fund at this stage has chosen to engage in as part of its multilateral surveillance responsibilities, and not as a means of monitoring members' compliance with Article IV—should help to defuse some of the concerns that have stymied the use of special procedures.

54. **Special procedures have their place in the Fund's toolkit, although the prime vehicle for strengthening exchange rate surveillance must be regular Article IV consultations.** The purpose of special procedures is to provide a means of apprising the Board relatively quickly when there are important developments *in between* regular Article IV consultations. The Fund needs an instrument for this purpose, even though it is not one that would be expected to be used very often. While it is true that it may have been used too rarely in the past, strengthened accountability on the Fund's part, as discussed in paragraph 34, would in itself reduce the risk of inaction where the use of special procedures is warranted, by ensuring that such inaction is properly stigmatized. By contrast, it is not the function of special procedures to provide, *through their mere activation*, a sign of concern on the Fund's part. After all, the Fund will not typically know the appropriate degree of concern to express until *after* the procedures have been activated, and the use of special procedures as a mechanism for conveying concern would increase, rather than reduce, the stigma attached to them, thereby making them still less likely to be used. The sign of the Fund's concern needs instead primarily to be given through pointed exchange rate surveillance in the context of the regular Article IV consultations, and ongoing efforts to strengthen such surveillance are crucial in this connection.

55. **Finally, there may be scope to rationalize the array of procedures.** In particular, since procedure V was already effectively supplanted by supplemental consultations in 1979, there seems to be no reason to retain it in the Decision.

IV. Issues for Discussion

1. Do Directors believe that, although the Decision has served the Fund well, there is a case for revising it?

Framework

2. Do Directors see a case for broadening the Decision so that it would provide a more effective basis for surveillance as a whole (not just surveillance over exchange rate policies), by clarifying, in the preamble to the Decision, the conceptual framework underlying members' commitments to the Fund and the Fund's role in surveillance? (¶28)

3. Would it be useful to embed in the conceptual framework for surveillance the notion that members are expected to discuss with the Fund their policy frameworks? (¶30)

Principles

4. Do Directors agree that attempting to include in the Decision detailed principles for the Guidance of Members that cover **all** of members' commitments under Article IV, and corresponding guidance for Fund surveillance, would be unnecessary and impractical? (¶36)

5. Do Directors agree that there is merit in pursuing an expansion of the PGMs beyond manipulation and intervention, to address other sources of exchange rate misalignments? (¶40)

6. Do Directors see a need to update and clarify the principles of Fund surveillance, putting less exclusive emphasis in the indicators on balance of payments purposes, and more on the multilateral and/or country-specific dimension of exchange rate policy appraisals? (¶43–45)

7. Do Directors support further work by staff toward providing greater specificity to the concepts and indicators used in the principles, within the limits indicated in ¶47–49?

Procedures

8. Do Directors agree that the primary mechanism for strengthening exchange rate surveillance should be regular Article IV consultations? As a housekeeping matter, do Directors support the abolition of procedure V? (¶54-55)

Moreover

9. Do Directors agree that it will be critical also to address, by way of complement to a revision of the Decision, the nexus between remit, independence, and accountability? (¶34)

INTERNATIONAL MONETARY FUND

Review of the 1977 Decision Over Exchange Rate Policies Background Information[1]

Prepared by the Policy Development and Review Department
(in consultation with the Legal Department)

Approved by Mark Allen

June 30, 2006

Contents Page

I. Introduction 2

II. The Framing of the 1977 Decision 2

III. Reappraisals, Surveillance Reviews, and Amendments of the 1977 Decision 4
Reappraisal of Surveillance and the Interest in a Global Strategy 4
Revisiting of the Principles: the 1986—87 Reviews 5
Amendment of the Decision: 1995 7

IV. Experience with Surveillance Over Exchange Rate Policies and Evolution of Operational Guidance on Exchange Rate Surveillance 7

V. Attempts to Firm Up Procedures for Exchange Rate Surveillance 10

Box
1. Guidelines to Staff of 1978: Consultation Practices and Procedures 9

Annex
I. Evolution of Guidance on Exchange Rate Surveillance 15
Guidance from Summings Up Following Reviews of the 1977 Decision 15
Guidance on Treatment of Exchange Rate Issues from Surveillance Guidance Notes 17
II. Reviews of the 1977 Decision Over 1979–2004 19

[1] The main authors of this paper are Lynn Aylward and Dmitriy Kovtun.

I. Introduction

1. **This paper provides background historical information for the review of the 1977 Decision on Surveillance over Exchange Rate Policies (henceforth referred to as the Decision).**[2] It lays out the events leading to the adoption of the Decision; reviews the proposals for updating the Decision discussed over time; describes the evolution of operational guidance on exchange rate surveillance; and summarizes the Fund's experience with special consultation procedures. Each section may be read separately.

II. The Framing of the 1977 Decision

2. **With the breakdown of the par value system over 1971─1973, the Fund faced fundamental questions as to how the global economy, and hence the institution, would operate.** At the broadest level, the Fund was charged by its Board of Governors in 1972 with overseeing a wholesale reform of the international monetary system. Among the most crucial challenges, it needed to work out the legal and operational implications of floating rates for the institution's mandate to promote exchange stability and international monetary cooperation. The Committee of Twenty, whose membership was composed of Fund Governors, was established in 1972 to begin the work on systemic reform that would eventually culminate in the Second Amendment of the Fund's Articles of Agreement, including a major overhaul of Article IV, which previously enshrined the par value system and the Fund's role in exchange stability.[3]

3. **Drafting a new Article IV was a contentious and difficult process, with two main areas of dissent regarding the new Fund oversight of exchange rates: the scope of members' policies to consider and the degree of prescription.** Executive Directors and Governors wrangled over whether the Article should revive fixed exchange rates or instead legitimize floating rates and give the Fund broad responsibility to oversee the evolving international monetary system. The US in particular argued for the latter, with members to follow domestic policies that would help lead to a stable system of exchange rates.[4] The French, who strongly supported a revamped par value system, took some comfort in the provision in Article IV that directed the Fund to exercise "firm surveillance" over exchange rate policies.[5] Early proposals had advocated a mechanistic approach to payments imbalances and variable exchange rates—such as rules whereby changes in a country's reserves from an established base level would signal the need for exchange rate adjustment, or whereby countries would keep their exchange rates within certain ranges. However, in the end the new Article IV, agreed by the Interim Committee (the predecessor to the International Monetary and Financial Committee) in January 1976, set out members' commitments without specific criteria or guidelines that would trigger a requirement for balance of payments adjustment or exchange rate changes in specific circumstances.

---

[2] Decision No. 5392-(77/63), as amended.

[3] Although the Committee's proposal for reform of the international monetary system was not adopted, its work was part of the chain that led to the Second Amendment.

[4] de Vries, Margaret Garritsen. The International Monetary Fund 1972-1978: Cooperation on Trial, Volume II. Washington, DC: IMF, 1985. See chapter 37.

[5] Ibid. See in particular page 747.

4. **While discussions on a possible amendment of Article IV were proceeding, the Executive Board considered a staff paper on Guidelines for the Management of Floating Exchange Rates.** The Guidelines, which were adopted in 1974 after twelve Board discussions and eight revisions, "provide[d] a basis for a meaningful dialogue between the Fund and member countries with a view to promoting international consistency during a period of widespread floating."[6] It was specified that they were guidelines rather than rules, and that the formulation of procedures for their implementation would be left for later consideration. Concepts of medium-term norms and target zones for exchange rates, introduced in early drafts of the Guidelines, raised concerns from Directors; they were watered down in the final version, although the idea that the Fund would devise a "range of reasonable estimates of the medium-term norm for [a member's] exchange rate" remained prominent.

5. **In the interregnum between the end of the par value system and adoption of the new Article IV, the Fund's oversight of floating exchange rates was rocky.** Many members avoided discussing their exchange rate policies with the Fund, which was often excluded when key players exchanged information on these issues. Principles and procedures for members' obligations and Fund surveillance to implement the proposed Article IV were tackled in two staff papers issued in 1976.[7]

6. **Staff and Board struggled with defining the sphere of influence of surveillance, including the role and nature of "exchange rate policies."**[8] Absent a definition in the new Article IV, the staff papers speculated whether exchange rate policies, at the limit, could not be extended to embrace all policies affecting supply and demand conditions in the foreign exchange market, but concluded that this would be "unhelpful in providing the necessary focus for the Fund's surveillance activities."[9] In the event, the staff initially approached the crucial Principle A—that became the injunction against exchange rate manipulation—principally with an eye on exchange rate outcomes. The staff originally favored a formulation whereby "a member shall not [have/maintain] an exchange rate that prevents effective balance of payments adjustment, or that gives it an unfair competitive advantage over other members."[10] The Board was initially divided between this formulation and one that would merely repeat the anti-manipulation injunction in the new Article IV, Section 1(iii), i.e., "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." The eventual choice to reproduce the wording of Article IV.1(iii) was based primarily on arguments that "it seemed best to use language that had already been extensively debated and accepted,"[11] although concerns were also expressed with the difficulty of defining over- and

---

[6] *Guidelines for the Management of Floating Exchange Rates*.

[7] *Surveillance of Members' Exchange Arrangements Under the Amended Draft Article IV*; *Surveillance Over Exchange Rate Policies*.

[8] See the foreground paper, *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations*.

[9] Surveillance of Members' Exchange Arrangements Under the Amended Draft Article IV, pp. 2-3.

[10] See first two drafts of the Decision.

[11] Intervention of Mr. Kharmawan, Executive Board Meeting 77/44 (4/1/1977).

undervaluations and about the appropriate degree of Fund influence over policies not directly targeting the exchange rate.[12]

7. **Considerable debate then focused on the specification of the indicators for Fund surveillance over exchange rate policies** and particularly on the inclusion or otherwise of the qualifiers "for balance of payments purposes." The assumption was apparently that these indicators would provide guidance to the Fund in monitoring observance of the Principles for the Guidance of Members' Exchange Rate Policies (and hence, implicitly, the scope of "exchange rate policies"), although it was also recognized that these indicators did not provide an exhaustive list and that the Fund's appraisal would have to take into account the overall economic situation and economic policy strategy of each member.

8. **The Decision adopted by the Board on April 22, 1977 reflected the challenges in formulating the principles, and the Board's wish not to be overly prescriptive and to let exchange rate surveillance develop on a case-by-case basis**. Considerable room was created for the exercise of judgment by the Fund in the light of members' particular circumstances, and emphasis was placed on the procedures for surveillance, through which a body of experience was expected to be built up. The Decision itself noted that its principles and procedures were "not necessarily comprehensive and [were] subject to review in the light of experience." Consistently, the Decision stipulated that it would be reviewed biennially, with the implementation of Fund surveillance to be reviewed annually.

III. Reappraisals, Surveillance Reviews, and Amendments of the 1977 Decision[13]

9. **The conceptual challenges that the Fund faced in the 1970s have proven difficult to overcome.** The Decision has survived until the present virtually intact despite thirty years of experience with its implementation and 13 reviews, with no proposals for changes since the 1995 review, and only two procedural and one substantive amendment to the Decision over the years.[14] On a few occasions, however, far-reaching initiatives were proposed to clarify, augment, or otherwise update the Decision and surveillance, though eventually they were not pursued.

Reappraisal of surveillance and the interest in a global strategy [15]

10. **The interest in rules for surveillance made a reappearance in an ambitious proposal advanced through the 1979 surveillance review.** The Board considered a US proposal that "a bolder action" to strengthen surveillance would be for the Fund to assess the performance of individual countries against an agreed global strategy for growth, adjustment, and price stability.

[12] Minutes of EBM/77/9 (1/17/1977), and EBM/77/10 (1/19/1977).
[13] A list of all previous reviews of the 1977 Decision is provided in Annex II.
[14] The amendment of 1987 allowed the Fund to conduct consultations under Articles VIII and XIV independently from Article IV consultations in certain circumstances. The amendment of 1988 placed the reviews of the general implementation of the Fund's surveillance on a biennial rather than an annual cycle. The amendment of 1995 gave recognition to the increased role of capital flows in the world economy.
[15] This section draws on Part I in Boughton, 2001, "Silent Revolution: the International Monetary Fund, 1979–1989."

The proposal envisioned that “any nation with an exceptionally large payments imbalance—deficit or surplus—submit for IMF review an analysis showing how it proposes to deal with that imbalance.” It was ultimately decided not to proceed with this proposal because “the success of the surveillance process depends completely on sustaining confidence and trust in relations.”[16] (The staff paper for the first surveillance review also included an alternative proposal whereby the seven largest industrial country members would each give the Fund a quantified policy strategy, but the Board doubted whether this was practical).[17]

Revisiting of the principles: the 1986-87 reviews

11. **The 1986-87 reviews stand out in calling for a reappraisal of the principles of surveillance, against the backdrop of ambitious proposals by the G-10 and the G-24.** In the 1986 review, staff asserted the validity of the principles, but noted that “[T]he current principles for the guidance of members’ exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability” citing, as an example, divergent choices of policy mix leading to undesired exchange rate patterns. Therefore, staff proposed that the Fund extend, clarify, or make more specific guidance given to members with respect to their exchange rate policies. Driving forces for the reappraisal were heightened concerns about exchange rate variability; about the nexus between debt management by developing countries and exchange rate policies, including these of large trading partners; and about the functioning of the international monetary system and Fund surveillance, the latter as noted in reports of the G-10 and G-24.[18] The G-10 report advocated greater use of the existing supplemental surveillance procedures; enhanced surveillance procedures to facilitate members’ debt management; and greater release of information about consultation conclusions. The report of the G-24 developing countries recommended for the major currencies a system of target zones and a mechanism for policy coordination whenever indicators suggested excessive volatility or misalignment.

12. **The staff paper for the 1986 review—which was followed by the review of 1987[19]—put forward a number of proposals motivated by a concern that the Decision was too narrow** and by a recognition that “exchange rate movements that cause international concern are more often the unintended result of divergences and inadequacies in domestic policies rather than the deliberate consequences of policies aimed at influencing conditions in the foreign exchange market:”

---

[16] Minutes of EBM/80/19 and EBM/80/20 (2/6/1980). See also *Surveillance over Exchange Rate Policies - Annual Review of Surveillance and Review of Proposals for Changes in Procedures* for a retrospective discussion of the proposal and the Managing Director’s reaction to it.

[17] Instead, on this occasion the Board directed that the G-7 consultation discussions be bunched together in time, “so that those countries could be considered in relation to one another and discussed in a consistent manner,” hoping that “If all of the major countries could be asked to discuss their economic outlook and their intended policy course at the same time, then perhaps something akin to a global strategy might emerge spontaneously.”

[18] Report of G-10 Deputies on the Functioning of the International Monetary System and Report of the Deputies of the Group of Twenty-Four on the Functioning and Improvement of the International Monetary System.

[19] *Surveillance Over Exchange Rate Policies—Biennial Review of 1977 Document* (1986), *The Use of Indicators in Surveillance—Review of 1977 Decision on Surveillance over Exchange Rate Policies* (1987). The earlier paper also made proposals on special consultations that are discussed in Section IV below.

- **Expanding the General Principles** to capture "all policies having significant effects on other members, rather than...only policies deemed to be 'exchange rate policies.' " (With the same objective in mind, the 1987 review considered that a separate decision might be written on Article IV, Section 3(a).)
- **Three options for revising or expanding the guidance to be given to members,** all aimed at increasing the coverage of policies not directly targeted at influencing the exchange rate:
    - **Defining the guidance given to members in terms of seeking to observe some exchange rate target or zone**.
    - **Introducing principles for the guidance of members' domestic policies, using "indicators"—**limits on the development of certain domestic policy variables, which could also provide an automatic trigger for a review of a member's policies by the Fund.
    - **Identifying in greater detail the kinds of behavior that could constitute manipulation,** with such behavior "presumably extending beyond actions narrowly directed at the exchange market."
- **Removing the clause "for balance of payments purposes"** that appears in pointers (ii) through (iv) of the surveillance indicators, consistent with the desire to encompass a wider range of policies.

13. **These proposals generated some support from the Board.** Some Directors "wished to revise the text to include the principles of oversight by the Fund over members' economic policies …stipulated in Article IV section 3(a)," but many observed that surveillance as implemented already covered a broad range of policies.[20] There was scant support for target zones. The Managing Director noted, however, "a growing momentum in favor of the notion of indicators—not necessarily quantified, rigid indicators, but more systematic guidelines that could be used to characterize a stance of policies and to help the Fund to detect deviations and inconsistencies."[21] This led to follow up discussions in 1987, which also explored the possible use of indicators in the context of multilateral surveillance.

14. **However, the momentum for updating the Decision was eventually lost**. At the end of the 1987 paper, staff asked Directors whether they wished to proceed as soon as possible to the preparation of a (draft) decision, or first await experience with a strengthened use of indicators under existing decisions. The Board chose to gain more experience and proceed only "after two WEO rounds have been completed, (some time in Spring 1988) [when] it might be possible to proceed with the consideration of a draft decision on this subject." Then, the 1988 surveillance review itself "proposed that the subject be considered further at an appropriate time, and that the present review be completed without extending the scope of the principles in the document." In the 1989 discussion of the Work Program, the Board asked that the main emphasis of the

[20] Minutes of Executive Board Meeting 86/30 (2/19/1986).
[21] Minutes of Executive Board Meeting 86/29, (2/19/1986).

forthcoming surveillance review be placed on the implementation of surveillance rather than on a reassessment of the principles themselves. Directors' view in many subsequent surveillance reviews appears to have been that effectiveness was to be gained not through amending the Decision but through improving its implementation. Since 1986-87, and excepting the 1995 amendment of the Decision described below, no review to date has returned to possible revisions of the principles.

Amendment of the Decision: 1995

15. **The one substantive amendment of the Decision, which added references to capital flows to the principles of Fund surveillance, was made in 1995.** The discussion of the 1995 Biennial Surveillance Review was shaped by the Mexican peso crisis of 1994-95, from which, then-Managing Director Camdessus said, "the most important lesson was that the Fund's surveillance needed to adapt to the globalization of world financial markets in the context of exchange liberalization."[22] Several Directors asked the staff to return with an amendment of the indicators for Fund surveillance over exchange rate policies to include private capital flows. In the end, the amendment of the Decision added "unsustainable flows of private capital" to the indicators that might point to the need for discussion with a member, as well as a reference to "the size and sustainability of capital flows" to the appraisal guidelines (paragraph 3 of the Decision). The amendment expanded the list of indicators but did not alter the structure of the Decision, and did not provide any practical guidance on how to identify "unsustainable flows."

IV. Experience with Surveillance Over Exchange Rate Policies and Evolution of Operational Guidance on Exchange Rate Surveillance

16. **Unlike the 1977 Decision, the implementation of surveillance over exchange rate policies has hardly been static.** Members' attitudes toward discussing exchange rate polices have gradually opened up and prompted more open discussions of exchange rate issues in staff reports, but a steady expansion of the scope of surveillance in the 1980s posed a challenge in keeping staff reports focused on exchange rate issues. The economics profession's work on exchange rate analysis has progressed, but the fundamental problems related to estimating equilibrium exchange rates have yet to be resolved.[23] In the course of reviews of the Decision,

---

[22] Managing Director's Report on his attendance at a G-10 meeting, recorded in EBM/95/17 (2/17/1995).

[23] See Peter Isard, et al., "Methodology for Current Account and Exchange Rate Assessments," IMF Occasional Paper 209; 2001, for a summary of both progress and remaining pitfalls in estimating equilibrium exchange rates. As the paper reports, different approaches include purchasing power parity (PPP), the macroeconomic balance approach, extended PPP incorporating Balassa-Samuelson effects, estimated reduced-form models of exchange rate behavior, and general equilibrium frameworks. As Isard et al. state, "Economists have achieved reasonable success in understanding the relationships between exchange rates and macroeconomic fundamentals over the medium term; trends in nominal exchange rates tend to reflect inflation differentials, and real exchange rates tend to gravitate toward levels at which the associated current account imbalances are moderate and consistent with factors that influence the relative saving and investment positions. The short term behavior of exchange rates includes a large unpredictable component, and while consensus has emerged on partial explanations for some of the large deviations of currency values from their medium-term trends, for the most part changes in macroeconomic fundamental have not provided convincing explanations of the wide swings in exchange rates." See also Jacques Polak, "Fifty Years of Exchange Rate Research and Policy at the IMF," IMF Staff Papers, 1995, pp. 734–761.

the Board frequently provided guidance for treatment of the exchange rate issues.[24] These trends have prompted the staff to adjust its operational guidelines over time.

17. **Initial discussions of exchange rate issues in Article IV consultations reflected the ultra-cautious attitude of both national authorities and the Board.** In March 1978, the Board considered issues related to implementation of procedures (Box 1), and provided guidance to staff not to discuss exchange rate policy matters in recent economic developments (RED) papers (some of which were circulated as Working Papers) and to avoid unwarranted disclosure of sensitive information or views in staff reports. In discussing early staff reports, several Directors objected to explicit references to the appropriateness of the member's exchange rate. For example, during a Board discussion of an Article IV staff report for Singapore, the Chairman stated, following concerns voiced by several Directors, that "in keeping with the consensus that had been reached in the Executive Board with respect to the procedures for Article IV consultations, an explicit reference like the one in the staff appraisal on the consistency of the exchange rate policy with the principles of Article IV would not be made in future staff reports on Article IV consultations."[25] Nonetheless, the Board sought all the information pertinent to exchange rates in order to be able to form a view about the appropriateness of members' exchange rate policies.

18. **The sensitivity of the subject prompted staff to avoid judgments about the consistency of exchange rate policies with the Principles and also permitted limited analysis.** The 1978 review of Article IV consultations reported that only about half of the reports referred to changes in effective exchange rates and very few presented information and analysis of changes in real effective exchange rates.[26] The 1980 review reported that staff eschewed explicit language in its assessments of exchange rate policies, avoiding such terms as a "satisfactory exchange rate policy" or "appropriate exchange rate." It noted that "the staff will continue to exercise caution in its treatment of policy matters related to a member's exchange rate," and "the staff's views with respect to exchange rate policy will be couched in language that is broadly indicative rather than explicit and that avoids overall conclusions regarding the appropriateness or consistency of the member's exchange rate with respect to the principles of Article IV."

19. **The situation began to change with the debt crisis, when it became apparent that the information provided in staff reports might not be sufficient for the Board to detect an early balance of payments problem.** The 1982 review of surveillance implementation acknowledged the sensitivity of exchange rate issues and the need for caution, but noted that "the practice of dealing explicitly with exchange rate issues, only when the related adjustment problems are of such magnitude as to be obvious, may err on the side of over-caution." In later reviews, the Board generally endorsed the practice in staff reports of providing clear appraisals of exchange rate polices.

20. **Perceived lack of even-handedness in exchange rate surveillance added another layer of complexity in covering exchange rate issues.** In the 1983 review of surveillance, a

---

[24] See Annex I for relevant excerpts from Summings Up following reviews of the 1977 Decision.
[25] Minutes of EBM/78/114 (7/2/1978).
[26] Annual Review of Regular Consultations and Other Issues Related to Article IV.

number of Directors noted that "precise prescriptions regarding exchange rate movements or changes are often given to small countries or countries making use of Fund resources; at the same time, quite large discrepancies between exchange rates and fundamental underlying conditions draw little attention from Fund staff when they relate to major currencies." The asymmetry of coverage was partially explained by the difficulty of judging appropriateness of exchange rates and policies in countries with access to international private capital markets that could provide financing for large and long-lasting deficits, as in such countries an assessment of the sustainable current account deficit requires a judgment on sustainable capital inflows, a difficult concept to measure.

Box 1. Guidelines to Staff of 1978:
Consultation Practices and Procedures

The paper on "Consultation Practices and Procedures" considered, inter alia, the nature and scope of staff reports on regular consultations following the Second Amendment of the Articles. The operational guidance set forth in the paper illustrates the endurance of the questions related to coverage of exchange rate policies and the broad validity of many of the corresponding answers even in 2006:

- the staff will be guided by the "Principles of Fund Surveillance over Exchange Rate Policies" (given in the 1977 Decision) in its analysis and appraisal;
- the analysis of exchange rate policies in staff reports will be presented against the background of the overall economic situation and priorities of the member country;
- the staff reports will report on and analyze factors which influence underlying demand/supply relationships in the foreign exchange markets (e.g., capital controls, exchange and other external restrictions, official borrowing, large-scale market intervention, etc.), the member's international competitiveness and, where appropriate, the impact of temporary factors bearing on the member's external position;
- the staff's presentation and assessment of members' policies will vary according to their circumstances, the nature of their exchange rate regimes and the possible impact of their exchange rate policies on other members;
- in many cases, the description and analysis of exchange rate policies could be confined to the background section of staff reports; and
- confidential information or language that would be indicative of the appraisal in the staff report would not be included in the Recent Economic Developments paper.

The paper also noted that additional emphasis would have to be given in staff reports to members' exchange rate policies, but that there would not be significant departures from the reporting on, and analysis of, members' economic policies as compared to the reports on consultations prior to the Second Amendment. More generally, it was expected that the content of staff reports on consultations under Article IV would evolve with further experience.

21. **An additional challenge that became especially pronounced with the expansion of the scope of surveillance in the 1980s was to keep the focus of Article IV staff reports on key issues, including the exchange rate.** The need for focus in surveillance has long been emphasized, with varying implications in practice. It was already a subject of debate in the run-up to the 1977 Decision (see paragraph 6), and became more challenging in the 1980s and beyond. The debt crisis, industrial country doldrums, increasing Fund involvement with planned economies and low income countries, and more generally a growing appetite for information, all led to demands for broader coverage of topics in surveillance. Surveillance reviews from 1990 onward repeatedly identified the focus of surveillance as a key challenge.

22. **The Staff Operational Guidance Note (GN), introduced in 1991 and updated in 1995, 1997, 2002, and 2004, served as a vehicle for focusing Article IV staff reports on the core issues and improving their coverage.** The first GN emphasized the need to keep staff reports focused on the "core areas of surveillance over exchange rate policies, within the framework of macroeconomic and related structural policies." The update of 1997 placed "macroeconomic and related structural policies" on an equal footing with exchange rate policies, and the 2002 update noted the expanded scope of surveillance and emphasized the need for selectivity based on country-specific circumstances. The current GN calls for a focus on issues at the "apex of the Fund's hierarchy of concerns," which relate to "external sustainability, vulnerability to balance of payments or currency crises, sustainable growth with price stability, and the systemic or regional impact of policies in large economies."

23. **The exchange rate issues, however, have kept their special place in the guidance as the evolution of the GNs reflects the Fund's increased efforts to put exchange rate issues squarely on the table.** The 1995 GN requested a candid assessment of the behavior of members' exchange rates and exchange rate policies. The revision issued following the 2002 Biennial Surveillance Review (BSR) emphasized that reports should include an accurate description of the exchange rate regime and a candid appraisal of its appropriateness and consistency with underlying policies, as well as a forthright assessment of the exchange rate level. Reflecting the conclusion of the 2004 BSR, that "clear and candid treatment of exchange rate issues remains a challenge," the current GN calls in addition for (i) clear identification of the de facto exchange rate regime in staff reports, (ii) more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and (iii) thorough and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues, particularly when views diverge.[27]

V. Attempts to Firm up Procedures For Exchange Rate Surveillance[28]

24. **In order to deal with "problem cases"—where consistency of a member's policies with the principles was questioned—section V of the 1977 Decision established a special consultation procedure (hereafter referred to as "Procedure V")**. Under this procedure, if in the interval between Article IV consultations, the Managing Director considers that a member's exchange rate policies may not be in accord with the Fund's exchange rate principles (including Principle A which is identical to the obligation for members set out in Article IV, Section 1(iii)),

[27] See Annex I for relevant excerpts of the successive summings up and surveillance guidance notes.
[28] This section draws on Boughton, 2001, "Silent Revolution: the International Monetary Fund, 1979–1989."

he is required to raise the matter informally and confidentially with the member. If he concludes that there is a question of observance, he is required to initiate and conduct on a confidential basis a discussion with the member and report to the Executive Board or informally advise Directors on the results of the discussion. In its 1978 communiqué, the Interim Committee explicitly endorsed "Procedure V" by noting with approval, in commenting on the 1977 Decision, that "particular attention will be focused on those cases in which there are questions as to whether the exchange rate policies of members are consistent with the agreed exchange rate principles."

25. **Because the activation of the procedures set out in Procedure V would suggest that the relevant member may not be observing the exchange rate principles set out in the 1977 Decision, this procedure has never been invoked.** Following the adoption of the Second Amendment, however, the Managing Director and staff were "eager to demonstrate the effectiveness of Fund surveillance."[29] Two cases presented them with the opportunity.

- **The first case was Iceland.** In September 1978, Iceland was forced to devalue its exchange rate by 15 percent as a result of a currency crisis that followed a severe loss in competitiveness of the main export industry, fishing. Staff prepared a paper on Iceland's exchange system, in which they agreed that "the present depreciation of the krona should help to improve the competitiveness of the open sector," but stressed the need for "tightening of financial policies."[30] This report detailing Iceland's exchange rate action was placed on the agenda of the Board. During the Board meeting, the Executive Director for Iceland strongly objected to "ad-hoc surveillance being carried out where the resistance is least," which generated strong support from other Board members.[31] His main concern was that Iceland was the "first and only case in which simply a movement in the exchange rate has been thought to require Board deliberation."[32] The meeting was concluded without a summing up, and the matter was not pursued further.

- **The second case involved the US and was judged to be much more successful.**[33] On November 1, 1978, the US Federal Reserve issued a press release on a significant policy package aimed at reversing a rapid depreciation of the dollar. The staff prepared a report outlining the implications of the measures and concluded that the actions taken by the US had helped to bring a better balance to exchange markets.[34] In a subsequent Board discussion, Executive Directors unanimously welcomed the measures.[35] Some Directors pointed out that "...this was the first occasion on which the Board has undertaken special surveillance of the exchange rate and of the underlying policies of a major member country...", and that "this kind of surveillance should always be conducted whenever situations develop in major countries that have an important bearing on the economies of other countries."

---

[29] Boughton, 2001, "Silent Revolution: the International Monetary Fund, 1979–1989," page 104.
[30] Iceland—Exchange System.
[31] Minutes of EBM/78/136 (9/8/1978).
[32] Ibid.
[33] In the Summing Up, the Managing Director referred to this supplemental consultation as a "successful experiment" (EBM/78/198, 12/13/1978).
[34] United States—Recent Developments and Policy Actions.
[35] Minutes of EBM/78/198 (12/13/1978). The Minutes noted that the report was based on "a special consultation under Article IV."

26. **Following the successful experience with the US, a decision was adopted in January 1979 to establish the "supplemental surveillance procedures."**[36] [37] These procedures authorized the Managing Director to initiate informal and confidential discussions with a member "whenever the Managing Director considers that a modification in a member's exchange arrangements or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members, whatever the member's exchange arrangements may be."[38] If the Managing Director considered, after this prior discussion, that the matter was of importance, he was to initiate and conduct an "ad hoc consultation" with the member and report to the Executive Board, or informally advise the Executive Directors, on the consultation as promptly as the circumstances permitted. Thus, the supplemental surveillance procedure was designed to be used in a much larger set of circumstances than "Procedure V" of the 1977 Decision.

27. **Despite this attempt to lessen the stigma attached to Procedure V consultations, the Fund has held only two consultations under the supplemental surveillance procedures**, (neither of which resulted in the Board's finding that the member in question was in breach of its obligations under the Articles):

- **Sweden, 1982.** In October 1982, Sweden devalued its currency by nearly 16 percent, which seemed overly large. The staff prepared a brief paper that was circulated to the Board. [39] Several Directors urged the Managing Director to follow "Procedure V," as the devaluation did not seem to be justified. The Board's recommendation, however, was to conduct a special consultation under Article IV and the decision of 1979 on supplemental surveillance procedures.[40] Staff prepared a comprehensive report on the devaluation, which concluded that a smaller devaluation would be enough to correct the balance of payments problem.[41] The Board agreed that "a lesser move would be appropriate," and that Sweden should have taken additional fiscal and structural measures to correct the balance of payments problem. They stressed that "the Swedish case was not to be seen as an isolated experience, but as part of a broad and nondiscriminatory application of established surveillance procedures to all members."[42]

- **Korea, 1987.** On May 8, 1987, the Managing Director reported to the Board that the recent strengthening of Korea's current account position raised questions about the appropriateness of Korea's exchange rate and other external policies.[43] He informed the Board that he had decided to initiate and conduct a supplemental consultation with Korea, with full consent of the authorities, and—curiously, considering that special consultations

---

[36] The procedures themselves were redesigned in 1993, see paragraph 30.
[37] Decision No. 6026-(79/13), adopted on January 22, 1979.
[38] Original text of the Decision No. 6026-(79/13), adopted on January 22, 1979.
[39] Sweden—Change in Exchange Rate.
[40] The text of the decision (Dec No. 7225-(82/135) read as follows: "The Executive Board, acting under Article IV and Decision No. 6026-(79/13), adopted January 22, 1979, invites the Managing Director to conduct special consultations with Sweden."
[41] Sweden—Staff Report for the 1982 Special Consultation Under Article IV.
[42] Restricted Session—Sweden—1982 Special Consultation Under Article IV.
[43] Minutes of EBM/87/72 (5/8/1987).

were intended to be for developments occurring in between Article IV consultations—proposed to combine the discussions between the staff and the authorities for the supplemental and Article IV consultations. In a paper prepared shortly after the mission, staff reported on a set of policies that Korea envisaged to deal with the surplus.[44] In the subsequent Board discussion, Executive Directors noted that the surplus was helpful to decrease the stock of Korean external debt, but suggested more forceful use of exchange rate policy. Over the years, the surplus disappeared and the issue faded away.

28. **During the supplemental consultation with Sweden in December 1982, it was suggested that staff should develop a regular and quantitative procedure for initiating Board discussions of significant changes in exchange rate policies so that Directors could indicate in a more neutral framework whether they wished to hold a discussion on a country.** That led to the establishment of the Information Notice System (INS) the following year. Under that system, significant changes in real effective exchange rates were to be brought to the attention of the Board both through quarterly reports and, in cases of changes in real effective exchange rates in excess of 10 percent since the last Board consideration of a member's exchange rate policy, through information notices which analyzed and assessed recent developments and policies. However, the system, as defined, was too sensitive to be of use. During seven years starting in 1983, 152 separate notices of large changes in real effective exchange rate were issued (not including notices issued as part of a more general staff report), covering 67 different countries. None of those notices led to a special Board discussion, and the system of individual country notices was discontinued in 1990.

29. **Answering the G-10 call for greater use of supplementary procedures, the staff paper for 1986 review proposed to reevaluate "the degree of discretion the Managing Director is called upon to exercise in invoking specific consultations."** Staff proposed to make supplemental consultations more automatic by one of the following options: (i) adopting target zones for exchange rates or "indicators for domestic policy variables as an automatic trigger; (ii) providing for "more automatic discussion" in the framework of the INS; and (iii) requiring the Managing Director to notify the Board "whenever a member's policies departed from those found by Executive Directors to be appropriate on the occasion of the last Article IV consultation, as expressed in the Chairman's summing up." The proposals, however, did not get support from the Board—the summing up indicated broad support for relying heavily on the discretion of management to determine when supplemental consultations are needed.[45]

30. **In a further attempt to increase the use of special consultations, the supplemental surveillance procedures in the 1979 Decision were amended again in 1993, but to no avail.** The 1993 biennial review recognized that the supplementary surveillance decision, designed as an instrument for bringing important developments into the surveillance process in a timely manner, had not been implemented as intended, despite repeated calls for its use. In an attempt to make supplemental consultations more palatable, staff proposed to change the wording for what would trigger supplemental consultations from "modifications in policies" to "important economic or financial developments [that] are likely to affect a members' exchange rate policies or the behavior of the exchange rate of its currency" in describing the set of circumstances

[44] Korea—Staff Report for the Supplemental Consultation.
[45] The Chairman's Summing Up Following the Discussion on Surveillance over Exchange Rate Policies.

calling for attention of the Managing Director. In addition, changes were made to the effect that an ad hoc Article IV consultation would be initiated only "if the Executive Board considers it appropriate," after receiving the Managing Director's report, or upon being informally advised by him, on his discussion with the member. The Board adopted an amendment in January 1993.[46] In spite of the amendment, there has yet to be another case of a supplemental consultation.

[46] Decision No. 10273-(93/15), 01/29/1993, as amended.

Evolution of Guidance on Exchange Rate Surveillance

A. Guidance from Summings Up Following Reviews of the 1977 Decision

***Summing Up at the Conclusion of the Review of the Document "Surveillance over Exchange Rate Policies* (1984)**

"In view of the Fund's obligation to form a view on the exchange rate policies of members, Directors generally endorsed the practice in staff reports of providing clear appraisals of exchange rate policies. Several Directors felt that the Fund staff was still less explicit in its exchange rate policy pronouncements for large industrial countries than it was in the case of smaller countries. The view was also put forward that an appraisal of the exchange rate policy of a member in an Article IV consultation should be made, whenever appropriate, in a multilateral framework."

***Summing Up Following the Discussion on Surveillance over Exchange Rate Policies* (1986)**

"First, the surveillance mechanism should be strengthened in order, as one Director said, to get more bite and not more bureaucratic work. Second, there is a need to broaden the coverage of policies that are subject to surveillance and, in particular, to integrate, through more precise analysis, exchange rate assessments and the assessments of fiscal, monetary, and structural policies within a medium-term framework. Third, the multilateral framework of the exercise of surveillance should be improved. The lack of an adequate multilateral framework has been one of the main weaknesses of the surveillance mechanism and should be a focus of attention for action in the future."

***Summing Up—Biennial Review of the Fund's Surveillance Policy* (1993)**

"There was also support for the staff's efforts to improve its analysis of exchange rates, including updating and expanding the coverage and relevance of the Information Notice System. A number of Directors cautioned against attempts to estimate equilibrium exchange rates or the establishment of formal monitoring zones for exchange rates…"

***Summing Up—Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies* (1995)**

"Directors supported increased attention to issues of possible exchange rate misalignments, including through increased use of alternative scenarios in cases where the member had chosen to use the rate as an anchor. Some Directors cautioned, however, that advice in the area of exchange rate policy would necessarily need to take into account the sensitive nature of the issues involved, and the risk of dissemination of confidential information. In this connection, several Directors suggested that assessments and specific recommendations regarding exchange rates might need to be made orally by the staff at the Board and followed up, if needed, with central banks and governments in a most confidential manner."

***Summing Up—Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision* (1997)**

"Directors endorsed the attention given to exchange rate issues. They generally agreed that the effectiveness of Fund surveillance in that area depended on frank discussions between the authorities and the staff, and on the Board being fully informed of the content of the discussions. Several Directors noted that such frankness could only be maintained if the confidentiality of the discussions and of Board deliberations continued to be reasonably assured. Several Directors, while agreeing that the Fund's spoken advice on exchange rates should be as frank as possible in discussions with country authorities, pointed to the sensitivity of that topic, and emphasized the need for discretion in staff reports. Several Directors encouraged discussion of alternative exchange rate regimes and the viability of fixed exchange rate regimes in staff reports. Directors expressed interest in a staff paper on the analysis and methodology of exchange rate assessments later this year, possibly for discussion in an informal Board seminar. At the same time, some Directors stressed the difficulties in providing an adequate basis for determining equilibrium exchange rates."

***Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (2000)**

"On exchange rates, most Directors observed that surveillance over exchange rate policies has been strengthened and better focused, but, while recognizing a member's prerogative to choose its own regime, they stressed that an assessment of both the exchange rate regime and the exchange rate level is to be made in all cases. Directors welcomed the use of more sophisticated analytical techniques and the greater candor of staff assessments and policy advice, and recommended, in general, that the use of these techniques be spread to a greater range of countries. However, some Directors cautioned that explicit judgments in staff reports on either the exchange rate level or the exchange rate regime could, in some situations, risk an undue and disruptive influence on markets. These Directors suggested that where there are such risks, the views of staff should be presented to the Board orally or through some other mechanism. It was acknowledged that the potential trade-offs between transparency and candor would have to be kept under review, especially in the context of the pilot project for publication of Article IV staff reports."

***Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (2002)**

"As regards exchange rate policies, they welcomed the greater degree of candor in the evaluation of "soft" exchange rate pegs in countries with market access, which they saw as a proper reflection of one of the key lessons of the currency crises of the 1990s. Conversely, noting that exchange rate arrangements were not questioned in many other cases, Directors urged that exchange rate issues be treated candidly throughout the membership. Some Directors, noting the sensitivity of these issues, saw a trade-off between candor and transparency with respect to the assessment of exchange rate policy. All Directors agreed that a thorough discussion of exchange rate issues is essential to effective surveillance."

Summing Up—Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision **(2004)**

"Directors observed that clear and candid treatment of exchange rate issues remains a challenge. While recognizing the sensitivity of these questions, they stressed that a thorough discussion of exchange rate issues remains critical for surveillance. To enhance such discussions, Directors endorsed the following steps: clear identification of the *de facto* exchange rate regime in staff reports; more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and thorough and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues, particularly when views diverge. Some Directors indicated that discussion of exchange rate issues in a regional context would also be helpful. Directors reiterated that no exchange rate regime is appropriate for all countries or for all circumstances. Thus, they stressed that discussion of exchange rate issues should permit consideration of a variety of options and take full account of country-specific circumstances, most importantly the macroeconomic framework. They underscored the need to assist countries that are contemplating a move toward greater exchange rate flexibility."

B. Guidance on Treatment of Exchange Rate Issues from Surveillance Guidance Notes

Staff Operational Guidance Note following the 1990 BSR

"Staff reports will focus in each case on the core areas of surveillance over exchange rate policies, within the framework of macroeconomic and related structural policies, and will examine whether these policies are conducive to the achievement of reasonable price stability, sustainable external positions, and orderly growth."

Staff Operational Guidance Note following the 1995 BSR

"Staff reports will focus in each case on the core areas of surveillance over exchange rate policies, within the framework of macroeconomic and related structural policies, and will examine whether these policies are conducive to the achievement of reasonable price stability, sustainable external positions, and orderly economic growth. Reports will include a candid assessment of the behavior of members' exchange rates and their exchange rate policies based on an evaluation of balance of payments developments, including the size and sustainability of capital flows, against the background of reserves and indebtedness."

Staff Operational Guidance Note Following the 1997 BSR

"Staff reports should include a candid assessment of a member's exchange rate and exchange rate policy, based on an evaluation of balance of payments developments, including the size and sustainability of capital flows, against the background of reserves and external indebtedness. The assessment should be made within the framework of a comprehensive analysis of the general economic situation, recognizing that domestic macroeconomic as well as exchange rate policies can have an impact on the balance of payments."

Staff Operational Guidance Note Following the 2002 BSR

"All Article IV consultation discussions and reports should include an accurate description of the exchange rate regime, a candid appraisal of its appropriateness and consistency with underlying policies, as well as a forthright assessment of the exchange rate level."

Reviews of the 1977 Decision Over 1979–2004

1. Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies (1979).

2. Review of the Document "Surveillance over Exchange Rate Policies" and Annual Review of the Implementation of Surveillance (1982).

3. Review of the Document "Surveillance over Exchange Rate Policies" and Annual Review of the Implementation of Surveillance (1984).

4. Surveillance over Exchange Rate Policies—Biennial Review of 1977 Document, (1986).

5. The Use of Indicators in Surveillance—Review of 1977 Decision on Surveillance over Exchange Rate Policies (1987).

6. Annual Review of the Implementation of Surveillance and Biennial Review of the Document Entitled "Surveillance over Exchange Rate Policies" (1988).

7. Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision (1990).

8. Biennial Review of the Implementation of the Fund's Surveillance over Members' Exchange Rate Policies and of the 1977 Surveillance Decision (1992).

9. Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision (1995).

10. Biennial Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies and of the 1977 Surveillance Decision (1997).

11. Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision (2000).

12. Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview (2002).

13. Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision—Overview (2004).

July 28, 2006

The Acting Chair's Summing Up
Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—
Preliminary Considerations
Executive Board Meeting 06/66
July 19, 2006

Directors welcomed the opportunity to have a thorough discussion of the 1977 Decision on Surveillance over Exchange Rate Policies against the backdrop of the Medium-Term Strategy, which envisions surveillance moving to the center of the Fund's concerns. A review of the Decision also affords a means to secure a common understanding and consensus on the operational objectives of surveillance. As the issues are complex and far reaching, and in view of the wide range of views we heard today, further discussion will be necessary before we reach final conclusions. In this context, a number of Directors noted that several other surveillance-related initiatives are planned in the period ahead—including Board discussions on a surveillance remit, on assessing the effectiveness of surveillance, on the results of the first multilateral consultation, and on procedures for streamlined consultations. Today's discussion should be seen as a preliminary consideration of the issue of whether the 1977 Decision has shortcomings that need to be fixed, and if so, how best to achieve this.

Directors expressed a range of nuanced views on whether a revision of the Decision is needed. At one end of the spectrum, a number of Directors considered that the case for a revision has not been convincingly made. They noted that the Decision has not prevented the practice of surveillance from evolving over time nor impeded its effective implementation, as the Decision has been complemented by other forms of guidance, such as summings up of Board discussions, and staff guidance notes. Further, these Directors considered that at least some of the gaps in the Decision's description of "best practice" surveillance could be addressed through better internal and external communication, and other changes in the manner surveillance is conducted in practice, without an amendment of the Decision. At the other end of the spectrum, a number of Directors strongly supported a revision, taking the view that a revamped Decision would provide a more effective underpinning for Fund surveillance by improving the focus and quality of surveillance, particularly over exchange rates. They noted that the Decision is the Board's most powerful statement on surveillance policy, and that the Board now has a unique opportunity to ensure that the Decision continues to communicate the Fund's responsibility for effective surveillance clearly, above all to members in guiding them in their conduct of exchange rate policy, as well as internally to staff and externally to markets and public opinion. A number of other Directors were open to considering a possible updating of certain elements of the Decision, but were equally willing to explore alternative routes to achieve some of the desired objectives. Several Directors underscored the importance of retaining flexibility and avoiding an overly prescriptive stance in the conduct of surveillance—elements that have allowed for judgment and effective adaptation by the Fund to constantly evolving global circumstances.

On balance, Directors saw a case for continuing to explore further the rationale for a possible revision of the Decision that would build more comprehensive links with Article IV and better align the Decision with current best practice on surveillance. They welcomed management's assurance that the purpose of any revisions would not be to impose additional obligations on members. Moreover, Directors welcomed the analysis of the legal framework of Article IV that is set forth in the legal paper.

It was agreed that the effectiveness of surveillance depends crucially on preserving and enhancing the trust and cooperation between the Fund and its members. Directors stressed the responsibility of the staff and management to engage members clearly and candidly, especially on exchange rate misalignment when the direction of policies is leading to external instability. In this context, some Directors pointed out that the Fund's role of trusted advisor does not constrain, but rather strengthens, its ability to provide candid assessments of member policies. In addition, some Directors thought that the Fund should express its concerns more publicly, while some others cautioned that this could adversely affect the Fund's role as confidential and trusted advisor.

Let me now turn to Directors' preliminary reactions to staff proposals regarding some specific aspects of the current Decision. Many Directors were interested in the idea of expanding the scope of the Decision to cover not only members' exchange rate policies (which is its stated purpose) but other key aspects of surveillance as well. These Directors generally favored revising the preamble to the Decision in order to set out in the Decision the basis for surveillance as a whole, as opposed to just surveillance over exchange rate policies. In particular, they supported anchoring the Decision more firmly in Article IV, by referring explicitly to members' obligations under this Article and to the objective of these obligations and surveillance—namely, to assure orderly exchange arrangements and promote a stable system of exchange rates. Directors also considered that there is scope to explore further the precise meaning of "a stable system of exchange rates." They generally concurred that clarification of the Fund's primary interest as being rooted in external stability could help focus surveillance and counter mission creep. In this context, it was noted that the further the Fund moves from the issues that are most likely to have a direct impact on external stability—that is, fiscal, monetary, and financial policies, in addition to exchange rate policies—the higher should be the burden of proof that the policies in question are critical to external stability.

Directors agreed that effective surveillance requires that members engage openly with the Fund in a discussion of their medium-term economic strategies, including, to the extent possible, their likely reactions to unforeseen events, and recognized that policy frameworks already feature prominently in some country discussions. At the same time, views were mixed regarding the benefits of embedding in the Decision an expectation for members to discuss with the Fund their policy frameworks as part of surveillance. Many Directors considered that an explicit reference to policy frameworks in the Decision would be a significant step forward and could provide impetus to the development of such frameworks among members. Many other Directors, however, considered that a reference to policy frameworks would not add much in practice, and were concerned that an explicit requirement might turn into undue pressure on members to follow a prescribed mode of policy formulation. In addressing the issue of the treatment of policy frameworks in surveillance, staff should seek from member authorities the greatest possible clarity concerning their policy objectives and frameworks, while taking into account members' individual circumstances and institutional capacity.

Directors broadly agreed that, although Fund surveillance is rightly concerned with both external and domestic economic policies, it is neither necessary nor practical to include in the Decision detailed principles for the guidance of members to cover all of members' obligations under Article IV, and corresponding guidance for Fund surveillance.

Directors had a wide-ranging initial discussion of the principles for guidance on exchange rate policies. They considered that the current principles relating to exchange rate manipulation and intervention policies remain appropriate, although these principles do not comprehensively cover exchange rate-related sources of external instability.

Directors expressed a variety of views on the staff's suggestion to consider the establishment of new principles—first, on exchange rate policies that are not currently caught by the principles and result in misaligned exchange rates, and second, on domestic policies that result in misaligned exchange rates. Reflecting the preliminary nature of the discussion, views of Directors were divided, with support being expressed for a broadening of the coverage of the principles, it being noted that this would be in line with the current best practice of surveillance; but also concern being voiced that the new principles would not add much value, or that they might be seen as an attempt by the Fund to exercise greater control over members' policies even as it is recognized that country ownership is paramount. It was generally recognized that, in proceeding in this area, staff should be mindful of the technical difficulties involved in gauging equilibrium exchange rates and in identifying causality between domestic policies and external stability. With respect to domestic policies, Directors noted that members' obligations in this area in Article IV are on a "best efforts" basis, and that any potential guidance on domestic policies must therefore be considered similarly "soft."

Directors favoring the new principles supported an approach under which the Fund would make "recommendations" under Article IV, Section 1 on actions that members could take to comply with their obligation to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." They noted that, in doing so, the Fund would not create new obligations for members and the failure of a member to follow a recommendation would not, in and of itself, constitute a breach of obligation. Directors will return to consider these issues on the basis of future specific staff proposals.

Directors generally considered that the basic structure of the principles of Fund surveillance—a list of indicators and appraisal guidelines—has proven useful, with several Directors seeing some scope for updating and clarifying them in the event that a revision of the Decision is undertaken. A number of Directors supported the suggestion to explore an updating of the indicators that might point to the need for discussion with a member, so that these would focus more on identifying problems stemming from the external policies undertaken—whether with, or without, balance of payments intent. A number of Directors also considered that the appraisal guidelines might usefully be amended to put greater emphasis on the need for a global perspective. In this context, noting that effective surveillance requires a global and regional perspective, Directors welcomed recent efforts to strengthen the Fund's multilateral surveillance. They also considered that the Decision should remain at an appropriate level of generality, with details better provided in separate guidance. In this connection, while stressing the need for surveillance to pay due regard to country-specific circumstances, Directors were not persuaded that it would be useful to specify in the Decision which circumstances are particularly relevant. The suggestion was also made that staff should draw more systematically from past Board consideration of surveillance issues, including those arising in specific country contexts, as well as more generally.

A number of Directors saw merit—should a revision of the Decision be undertaken—in providing greater specificity to the concepts and indicators used in the principles, although this should not lead to undue rigidity. Directors strongly opposed any mechanical quantified procedures for appraising the appropriateness of policies. A number of Directors, however, were in favor of exploring, for use in a staff guidance note rather than in the Decision itself, quantified benchmarks for key concepts used in the Decision, as a means of providing input to an ultimately judgmental appraisal. It was also noted that quantified benchmarks should not give rise to a false sense of precision.

Directors agreed that regular Article IV consultations are, and should remain, the primary vehicle for strengthening exchange rate surveillance. Directors also stressed the importance of members notifying the Fund of their exchange arrangements (including modifications) and providing the Fund with the information necessary for monitoring the conduct of exchange rate policies. Directors noted that the new multilateral consultations may play a useful role in facilitating policy dialogue among members when a coordinated solution may be required. Noting that "Procedure V" in the Decision has never been used and has been effectively made redundant by the broader procedure introduced in 1979, most Directors favored its abolition.

Directors took note of the staff's intention to explore the issues of priority-setting, independence, and accountability, and looked forward to a discussion, prior to the Annual Meetings, of the issues involved in setting a "remit" for surveillance—a concept that many Directors considered unclear. In this context, Directors underlined that the Executive Board is the central organ charged under the Articles of Agreement with responsibility for the conduct of Fund surveillance.

Directors found today’s initial discussion of the preliminary considerations involved in a review of the 1977 Decision useful in identifying many key issues that will require further clarification and discussion in the period ahead. A number of the suggestions advanced by the staff may hold merit, and a further consideration of the issues will be needed. Drawing on today’s discussion, the staff will prepare another Board paper over the next six months that will further develop some of the ideas discussed today. The Board should then have a more complete basis to consider whether the review of the 1977 Decision should be completed with or without a revision of the Decision.