Review of the 1977 Decision on Surveillance over Exchange Rate Policies
Further Considerations, and Summing Up of the Board Meeting
February 14, 2007

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—Further Considerations

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

In consultation with other Departments

Approved by Mark Allen and Sean Hagan

January 11, 2007

**CONTENTS** **PAGE**

Chart



Table



Attachments

## I. Introduction and Executive Summary [1]

1. **The centrality of surveillance to the Fund's mission has been underscored by the growing interdependence among Fund member countries.** Against this background, the Medium-Term Strategy (MTS) has launched a series of initiatives to ensure that the Fund responds in an effective manner to the changing circumstances. The implementation modalities of surveillance are being reviewed and updated, with a special emphasis on focus, transparency, and outreach. There is also a need to review the formal underpinnings of surveillance, to evaluate whether they appropriately embody, and thoroughly guide, best practice.

2. **There is broad agreement on what constitutes best practice surveillance.** Surveillance is a process of dialogue and persuasion centered on issues of external stability, including cross-border spillovers, and covering exchange rate policies and relevant domestic policies. To be effective, it must be comprehensive in its coverage of essential issues, but carefully focused on just those; it must be informed by a multilateral perspective and must pay careful attention to spillovers; and it must encompass not only immediate concerns but also the longer-term context. It must be candid in assessing prospects and policies, and evenhanded in its treatment of different members, with due regard to their individual circumstances.

3. **However, the 1977 Decision on Surveillance Over Exchange Rate Policies—the decision that originally was adopted to make Article IV operational—embodies only a small part of this best practice model** (Box 1). It was drafted in the wake of the breakdown of the par value system, at a time when the Fund had no clear idea how the system of floating exchange rates would evolve. It discusses only a subset of members' policies covered by Article IV—namely, certain exchange rate policies—and says virtually nothing about the role of the Fund in the conduct of surveillance. All in all, there is a striking gap between the language of the Decision and the reality of surveillance today.

4. **Against this background, the Fund has launched a review of the Surveillance Decision, with the objective of ensuring that the legal framework established by the Decision reflects the best practice of surveillance.** At the first Board discussion of this review, last July, Directors' views differed on whether the Decision should be revised.[2] This paper aims to provide a basis for further consideration. The present section presents the case for a revision and provides a summary of the remainder of the paper.

---

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

[2] See *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations*; *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework*; *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Background Information*; and *The Acting Chair's Summing Up, Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations.*

**Box 1. In What Ways Is the Decision Incomplete?**

- **The Decision provides little guidance on the Fund's responsibilities in conducting surveillance**. It does not set out either the scope or the modalities of surveillance, and says little about various aspects of surveillance that the Board has found over the years to be critical for effectiveness—such as proper focus, candor, and evenhandedness.

- **While Article IV establishes obligations regarding both exchange rate and domestic policies, the Decision covers only the former.** It does so because it was adopted to meet a requirement under Article IV, Section 3(b) that the Fund adopt principles for the guidance of members' exchange rate policies. Its narrow scope also reflects the uncertainty in 1977—in the wake of the breakdown of the Bretton Woods system—as to how surveillance would operate in the area of domestic policies, and the belief at the time, with capital flows nowhere near their current massive levels, that the orderliness of exchange rate movements would hinge primarily on official intervention.

- **The Decision does not address the developments that have most challenged the stability of the system in the past thirty years.** Again reflecting its post-Bretton Woods origins, the Decision focuses on exchange rate manipulation undertaken for balance of payments reasons and on short-term exchange rate volatility. By contrast, the most prevalent exchange rate-related problems since 1977 have been the maintenance, for domestic reasons, of overvalued pegs; divergences in the stance of countries' fiscal and monetary policies; and, more recently, capital account vulnerabilities often arising from domestic balance sheet imbalances.[3]

5. **According to the analysis presented in this paper, a revision of the Decision would improve governance by eliminating a significant gap in the Fund's policy framework.** The Fund's responsibilities—whether in the area of surveillance or financial assistance—are set forth in the Articles of Agreement in general terms, with the expectation that the Fund will develop general policies that will guide the exercise of these policies in the country-specific context, thereby enhancing transparency, accountability, and uniformity of treatment. To that end, the Fund devoted considerable effort to provide guidance with respect to its financial responsibilities through the overhaul of its Guidelines on Conditionality in 2002. As surveillance moves more clearly to center stage in the Fund's work, it is striking that there is no unified, coherent, and comprehensive policy that covers all its essential aspects. Furthermore, as MTS surveillance initiatives get under way, it would be appropriate to ensure that their fundamental purpose is reflected in clear, high-level guidance.

6. **A revision of the Decision would establish a unified, coherent, and comprehensive policy on surveillance that would embody best practice while allowing room for it to evolve.** Such a policy would provide more effective guidance to both the Fund

[3] See *Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations*, paragraphs 38-39, for further elaboration.

and its members as to their responsibilities under Article IV. It would reinforce the emphasis on advice and persuasion in surveillance, and ensure that a cooperative approach continues to prevail. It would set out a framework that allows surveillance to evolve in future within the broad parameters established by the Articles. And it would communicate clearly to the public how the Fund views and conducts its core business of surveillance.

7. **A more comprehensive Decision should also help to strengthen the implementation of surveillance.** In particular, a new Decision could help with the following long-standing challenges:

- **Focus.** A revised Decision could help focus surveillance on the most important issues within the scope of Article IV.

- **Candor.** A revised Decision could entrench candor and provide a framework that would make it easier for the Fund to address difficult issues.

- **Evenhandedness.** A revised Decision could help address perceived asymmetries in the conduct of surveillance. First, because the current Decision focuses on exchange rate policies, its relevance to members with floating exchange rates (which include most systemically important countries) is limited. Second, a revised Decision, by focusing attention on external stability including cross-border spillovers, could make clearer that both deficit countries and surplus countries should share in the burden of adjustment of excessive imbalances.

- **Accountability.** A revised Decision would strengthen the Fund's accountability in conducting surveillance by providing a firmer basis for identifying shortcomings.[4]

8. **The present paper describes the kind of amendments that could be made in order to align the Decision with best practice.** In particular, these amendments would seek to ensure that the Decision accurately conveys the *scope* of surveillance (where its current coverage is partial), and provides guidance (currently almost entirely lacking) on the *modalities* of surveillance.

9. **Two broad types of amendments are considered below:**

- **Insertion into the Decision of a new, separate section describing comprehensively the scope and modalities of bilateral surveillance**. As regards *scope*, this section would center surveillance on "external stability," including spillover effects. It could also provide guidance on the kinds of policies that should always be covered in surveillance, with other policies covered if they materially influence external stability. As regards *modalities*, this new section would emphasize the cooperative nature of the surveillance relationship and the importance of clear and candid assessments. It could also clarify that surveillance

[4] In particular, the Decision should be an anchor for the periodic surveillance reviews, helping to ensure that implementation is assessed against clear and comprehensive expectations.

should be cast in terms of members' medium-term objectives and policy frameworks.

- **Expansion and clarification of the current "Principles for the Guidance of Members' Exchange Rate Policies" (PGMs) and of the accompanying economic indicators.** The PGMs form the heart of the present Decision, and will continue to be needed, as the Fund is required to adopt such principles by Article IV, Section 3(b). As noted in Box 1, the existing principles do not capture the policies at the root of most episodes of exchange rate instability since 1977. While the best practice of surveillance has evolved to take proper account of this broader range of issues, a clearer and broader set of principles, backed up by the appropriate economic indicators, would make the Decision consistent with best practice, and could help ensure that best practice is consistently followed. This broader set of principles could encompass not only exchange rate policies, but also domestic policies that directly affect exchange rates. In addition, clearer guidance could be provided on the interpretation of the first of the existing PGMs, which simply repeats the language of the obligation of members under Article IV, Section 1(iii) "to 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."

10. **With respect to the legal implications of the proposed amendments, the following should be noted:**

- Through an expanded set of principles, the Board would provide clearer guidance to members as to how to comply with their obligations under Article IV. A member that has observed all of the principles established by the Fund would be deemed to be in compliance with its obligations under Article IV, Section 1.

- The adoption of new principles would not create new obligations. Rather, these principles would constitute recommendations, and would be adopted by the Fund pursuant to Article IV, Section 1, which sets forth a general obligation of members to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." Nonobservance of a recommendation set forth in the new principles would not give rise to a breach of obligation: a number of additional steps would need to be taken by the Executive Board before a member could possibly be found in breach.

- Separately, by clarifying the meaning of Article IV, Section 1(iii) (see paragraph 9 above), the proposed amendment would provide further guidance to members on the scope of their existing obligation regarding the avoidance of exchange rate manipulation.

At the same time, a revised Decision, by emphasizing that surveillance is a process of dialogue and persuasion, would underscore that the purpose of expanding and clarifying the principles would be to support dialogue—*not* to lay the basis for a more compliance-based approach to surveillance.

11. **The structure of the remainder of the paper is as follows.** Section II summarizes the legal framework for surveillance. The remaining sections discuss possible changes to the Decision, beginning with the more general proposal for a new section describing the framework for surveillance, and moving on to the specifics of the PGMs and indicators.[5] Illustrative text is provided, in boxes, but is not intended to prejudge whether the Decision should be revised, nor to make formal proposals for an amendment. Its purpose is to clarify the content of possible revisions, in order to clarify whether revisions along these lines—or any subset of them—would garner sufficiently broad support. The text of Article IV and the existing Decision are provided as attachments for reference.

## II. The Legal Framework for Surveillance

12. **Before examining specific possible amendments to the Decision, it is important to keep in mind the essential features of the legal framework set out in Article IV,** which was incorporated into the Fund's Articles at the time of the Second Amendment in 1978. While this framework is discussed in detail in *Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework* (the "Legal Paper"), this section highlights those aspects that are of particular relevance when considering the scope for—and merits of—possible revisions to the Decision.

13. **Article IV establishes rights and obligations for members.** It gives members considerable (though not unlimited) freedom in the choice of their "exchange arrangements"—the overall method that a member uses to determine the value of its currency against other currencies (e.g., a decision by a member to peg or float its currency).[6] However, it also requires members to observe certain obligations. In particular, Article IV, Section 1 requires members to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." In addition to this general obligation, members must observe four specific undertakings, two of which concern their domestic economic and financial policies and two of which address their "exchange rate policies."[7] The two specific obligations regarding domestic policies are of a soft nature, requiring efforts rather than the achievement of results.

---

[5] This paper does not discuss possible changes to the section of the Decision on Procedures. The July discussion identified a need for only one change, namely the abolition of Procedure (v), the "special consultation" procedure to be used when a member's exchange rate policies do not seem to be in accord with the PGMs, which was effectively supplanted by the "supplemental consultation" procedure introduced in 1979 (*Review of the 1977 Decision on Surveillance Over Exchange Rate Policies—Preliminary Considerations*, Box 3 and paragraph 55).

[6] A member's choice of exchange arrangement is subject to certain limitations and, in particular, must be consistent with members' obligations under the Articles.

[7] An exchange rate policy may be taken to mean actions or inactions of members in the operation of their exchange arrangements, and more specifically not only intervention policies but also other external policies and certain domestic policies that are specifically pursued for BOP purposes (*Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework*, footnote 22).

14. **As indicated in the Legal Paper, two aspects of these obligations are of particular importance when considering a possible amendment of the Decision:**

- **The provisions of Article IV make it clear that the promotion of "a stable system of exchange rates" is most effectively achieved through the adoption of appropriate exchange rate policies and domestic policies.** In particular, there is a recognition that the stability of the system of exchange rates will be enhanced by the pursuit of domestic and external policies that are directed toward this end. With respect to exchange rate policies, the overall "system" will be more stable if exchange rates are permitted to reflect underlying conditions—even if this results in exchange rate fluctuation. Regarding domestic policies, the overall system is enhanced by the pursuit of domestic policies that create the underlying conditions for economic and financial stability.

- **The specific obligations set forth in Article IV, Section 1(i)-(iv) do not exhaust members' general obligation to "collaborate with the Fund and other members to…promote a stable system of exchange rates."** As a result of this general obligation, the Fund has the authority to call on members to take specific actions—or refrain from taking specific actions—that it considers to be part of the general obligation, but that are not explicitly stipulated in the specific obligations set forth in Article IV, Section 1(i)-(iv). While such a call could potentially constitute an obligation, the Fund could also—consistent with past practice when applying the general obligation to collaborate prior to the Second Amendment—exercise this authority by making recommendations. Failure to abide by such recommendations would not constitute a breach of the obligation to collaborate (see Section IV.C for further discussion of the legal status of recommendations).

15. **Article IV also imposes obligations on the Fund.** In particular, Article IV, Section 3(a) requires the Fund to "oversee the compliance of each member with its obligations under Article IV, Section 1"—i.e., both the general obligation to collaborate and the specific obligations set forth in Article IV, Section 1(i) through (iv). This activity is generally known as "bilateral surveillance."

16. **Article IV, Section 3(b) provides the Fund with more specific direction as to how to oversee members' compliance with their obligations in the area of exchange rate policies.** Specifically, it requires the Fund to "exercise firm surveillance over the exchange rate policies of members" and to "adopt specific principles for the guidance of all members with respect to those policies." These principles "must respect the domestic social and political policies of members," and, in applying them, the Fund must "pay due regard to the circumstances of members." The requirement to adopt principles for the guidance of members' exchange rate policies under Article IV, Section 3(b) is the legal basis for the principles contained in the 1977 Decision.

17. **While the principles required under Article IV, Section 3(b) only concern a member's exchange rate policies, the Fund could, in addition, adopt principles for purposes of guiding members with respect to their domestic policies that are considered to be of relevance under Article IV, Section 1.** Such a step would help members in

complying with their obligations under Article IV, Section 1, and the Fund in overseeing compliance under Article IV, Section 3(a). This possibility is discussed in greater detail in Section IV.B below.

18. **As a procedural matter, Article IV consultations provide the vehicle for the Fund to perform its surveillance responsibilities.** Members are required to engage in this consultation process and to provide the Fund with the information necessary for surveillance. During this consultation process, members are also free to seek out the Fund's advice on policies that are not the subject of Fund surveillance.

## III. Expanding the Decision to Describe the Framework for Surveillance

19. **A key goal in revising the Decision would be to provide a more complete framework for surveillance.** As noted above, the Decision could start with a new section describing comprehensively the framework for bilateral surveillance, and in particular its scope and modalities. Such a statement would give the Fund clear guidance on how to fulfill its surveillance responsibilities, and could also promote a reaffirmed commitment on the part of all members to the code of conduct of Article IV. At the July discussion, many Directors were interested in this idea. Although some of the objectives that would be pursued by such an expansion of the Decision could be achieved by other means, the objectives could not be met completely, or without serious drawbacks (Box 2).

**Box 2. Drawbacks to Other Means of Setting Out Guidance on the Framework for Surveillance**

- Most other vehicles in which guidance on the overall framework for surveillance could be set out—e.g., a compendium of surveillance best practices, a new guidance note, a public fact sheet on the essentials of surveillance—would not have the status or long-lasting nature of a decision of the Executive Board. Since it is the Board that is responsible for establishing policies that guide the Fund in the exercise of its responsibilities, it is the Board that needs to play the central role in this exercise.

- While a "surveillance remit"—currently under consideration by the Board, primarily as a means of prioritizing surveillance in light of conjunctural and other emerging challenges—could include a Board-endorsed statement on the essential and permanent features of surveillance, this would naturally draw on a revised Decision.

20. **This broader coverage of the Decision could be delimited as follows:**

- The Decision would explicitly cover the Fund's responsibility to oversee members' compliance with *all* their obligations under Article IV, Section 1—not just those that relate to exchange rate policies. It could also clarify that this oversight constitutes bilateral surveillance.

- While the Decision could more clearly emphasize that bilateral surveillance inherently includes a multilateral perspective and consideration of cross-border issues (see below), it is not proposed to expand it to cover multilateral surveillance, which is a separate function of the Fund. Multilateral surveillance stems from the Fund's responsibility under Article IV, Section 3(a) to "oversee the international monetary system in order to ensure its effective operation," and, unlike bilateral surveillance, does not entail an assessment of members' compliance with their obligations under Article IV, Section 1.

21. **This delimitation could be presented in a revised preamble to the Decision** (Box 3). The preamble should distinguish clearly between the two parts of the Decision, the first describing the framework for surveillance, and the second focusing on members' exchange rate policies and—if the Board agrees to the expansion proposed in this paper—domestic policies that directly affect exchange rates. The preamble could also explain the relationship of the various sections of the Decision to the requirements of Article IV, and retain the elements of the current text relating to the applicability of the Decision to all members and the need to keep it under review.

22. **The title of the Decision would need to be amended to reflect its new scope.** For example, it could be retitled "Decision on Bilateral Surveillance."

**Box 3. Illustrative Preamble—Taxonomy and Roadmap**

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

Part I of this Decision sets out the scope and modalities of the Fund's oversight of members' obligations under Article IV, Section 1, including, but not limited to, the Fund's exercise of firm surveillance over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance"). Part II establishes principles for (i) the guidance of members in the conduct of their exchange rate policies as required under Article IV, Section 3(b) and (ii) the guidance of members in the conduct of their domestic economic and financial policies that directly affect exchange rates. It also sets out indicators which the Fund will use in assessing members' observance of these principles. Part III sets out procedures for surveillance. The principles and procedures set out in this Decision, which apply to all members, irrespective of their exchange arrangements and balance of payments positions, are subject to reconsideration in the light of experience.

## A. The Objective of Surveillance

23. **The new part of the Decision could begin with a statement of the "vision" for surveillance, reaffirming the spirit of multilateralism embedded in Article IV** by recalling the benefits of the adherence by members—and the Fund—to their obligations under Article IV (Box 4). In particular, the Decision could emphasize the interdependence of members' policies and, by extension, the cooperative nature of the Fund.

**Box 4. Illustrative Statement of the "Vision" for Surveillance**

Recognizing that the essential purpose of the international monetary system is to provide a framework for the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, members of the Fund undertake to observe a code of conduct set out in Article IV, Section 1. Specifically, they undertake to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter referred to as the obligation to "collaborate to promote systemic stability"). This code of conduct is premised on a conviction that, in an interdependent world, members' own interests are enhanced through cooperation. As an institution established to promote international monetary cooperation, the Fund has the responsibility to engage in a dialogue with its members regarding their adherence to this code of conduct, thereby facilitating the achievement of the above-stated objectives.

## B. The Scope of Surveillance

24. **To provide adequate guidance on the scope of surveillance, the Decision should include a clear description of which policies and developments surveillance should cover.** The scope of surveillance should be anchored in members' obligations under Article IV (Box 5):

- **In defining this scope, the starting point is the concept at the heart of Article IV, Section 1—the obligation to collaborate "to assure orderly exchange arrangements and to promote a stable system of exchange rates."** Article IV does not aim at exchange rate rigidity: the par value system was perceived as creating rigidity without stability. Rather, it contemplates (i) exchange arrangements that are "orderly" (e.g., in which there are no multiple rates), and (ii) a stable *system*, in which exchange rates are permitted to reflect underlying conditions—even if this results in exchange rate fluctuation—and where unnecessary disruptive exchange rate movements are avoided by the pursuit of appropriate domestic policies.[8] While the concept of "orderly exchange arrangements and a stable system of exchange rates" is a systemic one, it is

[8] See Legal Paper, p. 2.

recognized that this objective is most effectively achieved when each member implements policies that promote "external stability" at the country level—"external stability" being a balance of payments position that does not, and is not likely to, give rise to unnecessary disruptive exchange rate movements.[9] (It is important to remember that this term encompasses not only the stability of the country in question, but also the effect of the member's external position on the stability of other countries.) Thus, the policies affecting external stability should be at the core of surveillance.

- **Article IV, Section 1 also includes specific obligations, which help clarify further the scope of surveillance.** They recognize that both exchange rate and domestic policies contribute to external stability directly (that is, have direct effects on the balance of payments), and indirectly through their influence on domestic stability (that is, price and financial sector stability) and growth (see Chart 1).

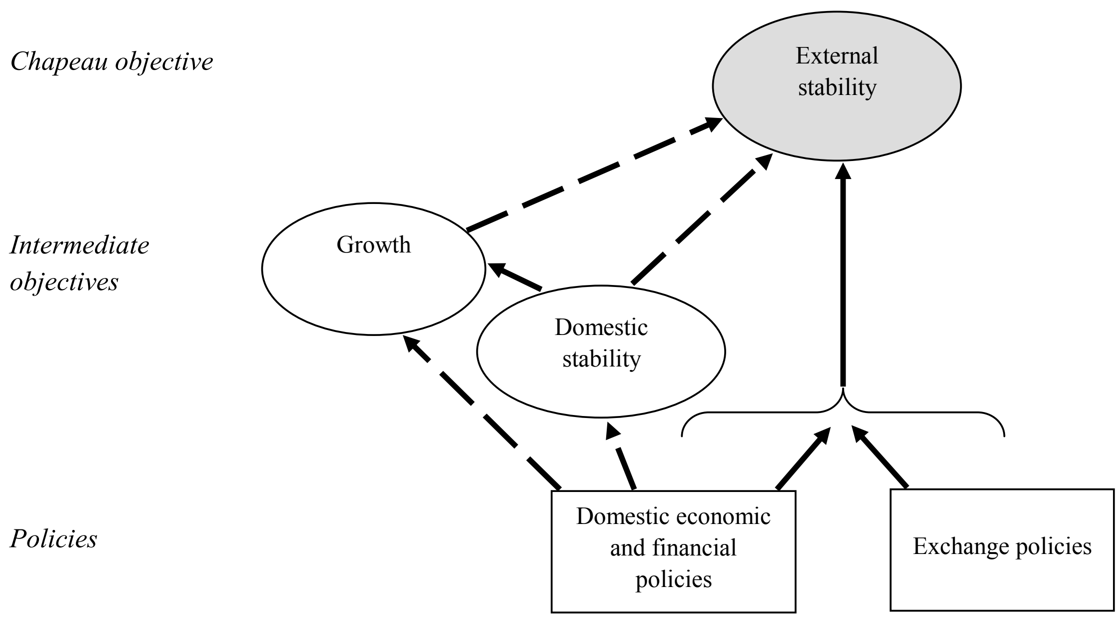
- **It is important to clarify the role of growth (and of policies affecting growth) in the promotion of external stability and, thereby, its relevance to surveillance.** The Decision could clarify that growth is an important means by which external stability is promoted, through its effects on sustainability and on long-term developments in macroeconomic policies: Article IV, Section 1(i) makes clear that the promotion of a stable system of exchange rates entails domestic policies directed toward economic growth—albeit growth that is orderly and accompanied by reasonable price stability. Moreover, in adopting policies to promote external stability, members of course take into account the impact of such policies on growth. Article IV, Section 1, recognizes the importance of taking this impact into account by acknowledging that "an essential purpose of the international monetary system is to provide a framework that…sustains sound economic growth."

[9] This definition of "external stability" is not meant to suggest that all problems that may lead to disruptive adjustments in exchange rates are reflected in the balance of payments today. Rather, all such problems must eventually impact the balance of payments.

**Box 5. Illustrative Section on Scope of Surveillance, Part 1**

In identifying the policies that are the subject of bilateral surveillance, the Fund will focus on those policies that are most relevant for purposes of assessing observance of the member's general undertaking to collaborate to promote systemic stability. It is recognized that systemic stability is most effectively achieved by each member pursuing policies that promote "external stability" at the country level, "external stability" being a balance of payments position that does not, and is not likely to, give rise to unnecessary disruptive exchange rate movements. It is further recognized that both exchange rate and domestic policies have an impact on external stability. They do so directly by influencing the balance of payments and the exchange rate, and indirectly, by influencing domestic stability and growth in the manner contemplated in Article IV, Sections 1 (i) and 1 (ii). In particular, it is acknowledged that members promote external stability by endeavoring to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances. It is also recognized that in pursuing policies promoting external stability, members have a strong interest in fostering sustainable growth.

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.

25. **The Decision could build on this analysis to anchor the coverage of surveillance and thus help enhance its focus** (Box 6). In the July discussion, Directors generally concurred that clarification of the Fund's primary interest as being rooted in external stability could help focus surveillance and counter mission creep.

26. **More specifically, based both on Article IV and the Fund's experience with surveillance, the Decision could state a "principle of proximity:"**

- Such a principle would state that certain policies—not only exchange rate policies, but also monetary, fiscal, and financial sector policies—will always be the subject of surveillance, as they have a direct material bearing on the promotion of external stability and thus are clearly relevant for purposes of members' obligations under Article IV. Specifically, surveillance would always consider both the macroeconomic aspects and the macroeconomically relevant structural aspects of fiscal, monetary, and financial sector policies. In practice, coverage of exchange rate, fiscal, and monetary policies has long been at the heart of Article IV consultations. Explicit identification of financial sector policies as needing similar treatment should support stronger and more integrated treatment of these issues.

- Other policies—e.g., structural policies in other areas—would not always be an appropriate subject of surveillance, but would be covered to the extent that they are relevant to the promotion of external stability, *inter alia* because they have critical implications for sustainable growth. The relevance of these policies for the promotion of external stability would not, however, be universally presumed, and would need to be argued if the link was not obvious.

By setting out this framework, the Decision could provide clear guidance to the Fund in the conduct of surveillance and lay a basis for members to challenge the Fund if they considered that it was overstepping (or underfilling) its mandate.

**Box 6. Illustrative Section on Scope of Surveillance, Part 2**

For purposes of assessing whether a member is pursuing policies that promote external stability, bilateral surveillance shall focus on those policies that can materially influence external stability, both at present and in future. On this basis, exchange rate policies and monetary, fiscal, and financial sector policies will always be the subject of surveillance with respect to each member. Other policies will be examined in the context of surveillance only if the Fund is satisfied that they materially influence prospects for external stability.

27. **The Decision should emphasize that surveillance should examine policies in the context of the overall economic situation and policy strategy of the member**. This is the subject of the appraisal guidelines currently in Paragraph 3 of the Decision, which could appropriately be moved into the new first section of the Decision. An appropriately amended paragraph would emphasize that, in exercising surveillance, the Fund takes members' objectives into account to the maximum possible extent (Box 7).

28. **Finally, the multilateral dimension of surveillance needs to be reflected in the Decision**, and could be incorporated into a revised Paragraph 3. In particular, two points could be underscored. First, the appraisal of a member's external situation and exchange rate should be cognizant of international developments and be consistent with the multilateral view derived from the appraisals of other members' exchange rates and related policy advice. In addition, the appraisal should be made in light of the impact of a member's policies on other members to the extent that it undermines the promotion of systemic stability.

**Box 7. Illustrative Redlined Amendments to Paragraph 3 of the Decision**

~~The Fund's appraisal of a members' exchange rate policies~~ Bilateral surveillance shall ~~be based on~~ incorporate an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall be informed by, and consistent with, a multilateral framework that incorporates relevant aspects of the global economic environment, including exchange rates and other key linkages among members. It shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment. It shall also take into account the impact of these policies on other members to the extent that it undermines the promotion of systemic stability.

## C. The Modalities of Surveillance

29. **A comprehensive description of the framework for surveillance should include a section on implementation modalities.** Such a section could clarify (Box 8):

- **The collaborative nature of the surveillance relationship**. Through Article IV, members have undertaken to "collaborate with the Fund and other members…." While Article IV mandates the Fund to oversee members' compliance with their obligations, the process itself is one of cooperation and dialogue. The Fund needs to promote an atmosphere of mutual trust and pay due regard to the circumstances of members.

- **The nature of the Fund's responsibilities in surveillance**. The Decision could reflect that the essence of surveillance consists of clear, candid, and evenhanded assessments of relevant developments and associated policy advice.

- **The various links in the surveillance process**. To foster candor, the Decision could clarify that a key purpose of surveillance is to inform country authorities—both of the member at issue (whom it aims to influence) and of other members (who may in turn exercise peer pressure and use this information in their own economic management—e.g., to protect themselves against contagion risks). The

Decision could also note that surveillance can play a key role in informing the public, to promote the efficient functioning of markets and ownership of sound policies. In this regard, the Decision would simply reflect the balance between the Fund's confidential advisor and public monitor roles embodied in the Fund's transparency policy; it would not seek to change this balance.

**Box 8. Illustrative Section on Modalities of Surveillance, Part 1**

In its bilateral surveillance, the Fund will clearly and candidly assess relevant economic developments, prospects, and policies of the relevant member, and advise on these. Such assessments and advice are needed to assist that member in making well-informed policy choices, and for other members to be able to discuss these policy choices with that member. In the context of bilateral surveillance, the Fund will foster an environment of frank and open discussion and mutual trust with each member, respect the principle of uniformity of treatment of members, and pay due regard to members' circumstances. Within the scope of the Fund's transparency policy (as well as in the circumstances described in Article XII, Section 8), and in order to promote the efficient functioning of markets and broad ownership of sound policy choices, the Fund may communicate its views on a member's policies to the public.

30. **The Decision might also clarify that Fund surveillance is most effectively conducted if it is cast in terms of members' medium-term objectives and policy frameworks** (Box 9).[10] The dialogue should cover (i) medium-term objectives, (ii) present and planned policies, and (iii) contingency reaction functions, and the consistency of all these elements with Article IV, Section 1. This approach is already best practice, and is consistent with the forward-looking nature of the concept of external stability and with the need to focus on the interaction between policy components rather than looking at each individually. Where countries have explicit formal "policy frameworks" encompassing the elements listed above, the dialogue would be centered on these. Elsewhere, the Fund would still attempt to understand these elements. While members would never be pressured to formulate their policies within frameworks encompassing all these elements, surveillance could provide a helpful impetus to countries that are willing and able to develop such policy formulation mechanisms.

**Box 9. Illustrative Section on Modalities of Surveillance, Part 2**

To the extent possible, the Fund's appraisal shall be placed in the context of a member's policy framework—that is, its medium-term objectives, the planned conduct of policies, and the expected responses of policies to contingencies.

[10] These elements could also be woven in the current Paragraph 3 (Box 7). They are presented separately here for ease of exposition.

31. **Finally, the Decision could recall that members' participation in the surveillance process requires their engagement in open discussions of their policies** (Box 10). The Decision could note the requirements of Article IV, Section 3(b) and Article VIII, Section 5 that members provide the Fund with the information it considers necessary for surveillance.

**Box 10. Illustrative Section on Modalities of Surveillance, Part 3**

For purposes of enabling the Fund to conduct bilateral surveillance, members shall consult with the Fund. In order for such surveillance to be effective, these consultations need to be open and frank. In accordance with Article IV, Section 3(b) and Article VIII, Section 5, members shall provide the Fund with the information that the Fund considers necessary to conduct such surveillance.

## IV. Complementing the Principles for the Guidance of Members

32. **The Principles for the Guidance of Members' Exchange Rate Policies—required of the Fund under Article IV, Section 3(b)—are at the heart of the current Decision** (Box 11). This section seeks to clarify the meaning of PGM A, regarding exchange rate manipulation; as discussed in July, PGMs B and C, dealing with intervention policies, are straightforward and retain significant applicability today, without requiring further interpretation. The section then discusses in detail two possible new principles.

**Box 11. Existing Principles for the Guidance of Members' Exchange Rate Policies**

Principle 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.

Principle 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.

Principle 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.

### A. Clarifying Manipulation

33. **A shortcoming of Principle A is that it merely repeats the text of Article IV, Section 1(iii) and, therefore, does not provide additional guidance to members as to what policies should be avoided to ensure compliance with this obligation.** During the July discussion, a number of Directors saw merit in trying to provide greater specificity to the concepts used in this provision, while emphasizing that this should not lead to undue rigidity. Drawing on the legislative history and the analysis contained in the Legal Paper, the Board

could clarify the following points, which could potentially be included in an Annex to the Decision.

34. **Article IV, Section 1(iii) prohibits two types of manipulation—manipulation of the international monetary system and manipulation of exchange rates.** As discussed in the Legal Paper, the legislative history is unclear as to how a member could manipulate the international monetary system. Manipulation of the exchange rate is pursued through exchange rate policies (as defined in footnote 7). Moreover, manipulation does not necessarily require that the actions of the member—whatever their form—result in exchange rate movements. In some cases, manipulation may be designed to *prevent* such movement.

35. **Article IV, Section 1(iii) prohibits members from engaging in manipulation for two specific *purposes*—to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.** The fact that the member's actions may have the effect of preventing effective balance of payments (BOP) adjustment or gaining an unfair competitive advantage is not sufficient. The Fund must demonstrate intent. This does not mean, however, that the Fund must accept the member's own representation of its motives. Rather, the Fund would give the member the opportunity to represent the purpose of the action and give this representation the benefit of any reasonable doubt. Ultimately, however, the Fund would make an independent assessment of the correctness of the member's representation of its purpose, taking into account all available and relevant information.

36. **The legislative history of Article IV does not provide guidance as to the meaning of "preventing effective BOP adjustment" or "gaining unfair competitive advantage"** (although the use of the term "or" indicates that the two purposes must be given a different meaning). Nonetheless, the following observations may be made.

- **Regarding the meaning of manipulation of the exchange rate to "prevent effective balance of payments adjustment."** From an economic perspective, BOP adjustment is the process of restoring BOP equilibrium—a "condition in which a current account surplus or deficit is equal to capital outflow or inflow, defined in some way as normal or sustainable, without undue resort to restrictions on current international transactions or on payments and transfers for them or to incentives for inflows or outflows of capital, and without excessive unemployment."[11] This condition defines a (real effective) equilibrium exchange rate—the rate consistent with current and future underlying conditions (such as productivity growth, terms of trade movements, demographics) that determine a "normal" current account, and with internal balance. An exchange rate that has the effect of preventing BOP adjustment is thus one that keeps the current account away from its equilibrium in the steady state, and which can be defined as one that is "fundamentally

[11] Joseph Gold, *Exchange Rates in International Law and Organization*, 1988, page 35.

misaligned" (whether over- or undervalued).[12] That said, it is not clear why a member would *intend* to prevent BOP adjustment as an end in and of itself—more likely, a member would intend such outcome as a means to another objective.

- **Regarding the meaning of manipulation of the exchange rate "to gain unfair competitive advantage."** It is relatively clear that a country seeking a "competitive advantage" through its exchange rate policies would be pursuing these policies for the purpose of increasing its net exports. What is less clear, however, is when such an advantage should be considered "unfair" within the meaning of Article IV. One approach would be to rely on the concept of fundamental misalignment that is set forth in the previous bullet.

Altogether, while there is some uncertainty regarding the meaning of intending to "prevent balance of payments adjustment," the Board could provide guidance as to what it means to manipulate the exchange rate "in order to gain unfair competitive advantage" within the meaning of Article IV, Section 1(iii): namely such policies would be understood as policies designed to secure fundamental exchange rate misalignment in the form of an undervalued exchange rate, for the purpose of increasing net exports.

37. **When assessing whether a member's policies are consistent or inconsistent with the above definitions, the Fund would give the member in question the benefit of any reasonable doubt**, both in terms of determining intent and for the purposes of measuring exchange rate misalignment (the latter being particularly appropriate because of the considerable uncertainties surrounding exchange rate misalignment estimates).

### B. The Case for New Principles

38. **Experience since 1977 suggests that the current set of principles is incomplete.** As noted in Box 1, most episodes of exchange rate instability since 1977 were caused by policies that did not offend against the PGMs. While the best practice of surveillance has evolved to take proper account of this broader range of issues, a key benefit of an expanded set of principles would be to help ensure that the Decision is consistent with best practice, and to support a consistent focus of the surveillance dialogue on policies that may lead to exchange rate instability. As noted above, the purpose of new principles would not be to lay the basis for a more compliance-based approach to surveillance; there would, however, be certain legal implications, which are set out in Section C below.

39. **In seeking to complement existing PGMs, two new principles could be considered, focusing respectively on exchange rate policies and domestic policies:**

- The new principle for exchange rate policies would, like the existing ones, be adopted under Article IV, Section 3(b), while the principle on domestic policies would be adopted under Article IV, Section 1.

[12] Misalignment is here characterized as "fundamental" to distinguish it from temporary misalignments, e.g., misalignments driven by cyclical or other transient factors.

- Moreover, reflecting the soft nature of members' obligations respecting domestic policies under Article IV, Section 1, any principle on domestic policies should be phrased on a "best efforts" basis (e.g., "members should *seek to* avoid ...").

40. **The new principle on exchange rate policies would focus on exchange rate policies that are adopted for domestic purposes but lead to external instability.** This principle would complement Principle A, which focuses on external purposes such as "gaining unfair competitive advantage." Domestic purposes could include attempts to contain inflation (which, in the presence of expansionary monetary policy, will ultimately prove unsustainable), or to bring unemployment below its natural rate. This principle would caution members against the detrimental impact on external stability of the overly long maintenance, for domestic reasons, of fundamentally misaligned pegs.

41. **The new principle on domestic policies could focus specifically on monetary, fiscal, and financial sector policies that lead to external instability.** Although other domestic policies could contribute to external instability, monetary, fiscal, and financial sector policies have the most direct impact, and focusing the new principle on these policies would be the natural counterpart to introducing a "principle of proximity" (paragraph 26). For peggers, this principle would buttress the new PGM on exchange rate policies, since problems with pegs are always problems of *inconsistency* between exchange rate and domestic policies. For floaters, this principle would caution members against domestic policy mixes that jeopardize external stability. Note that the proposed principle would not cover all domestic policies that are relevant to Article IV—in particular, structural policies outside the fiscal, monetary, and financial sector policy areas would not be covered. (The Board already indicated in July that it considered exhaustive coverage of Article IV in the principles impractical.) Nevertheless, as explained below (paragraph 49), policies that are not captured by the principles would still be the subject of Article IV surveillance.

42. **While various options are possible for wording the new principles, the one preferred by staff (Box 12) would focus directly on the avoidance of external instability, and specifically refer to a fundamentally misaligned exchange rate as a manifestation of external instability.** The concept of external instability encompasses sources of disequilibrium arising from both the current and capital account. As regards the former, external instability would reflect a current account position that deviates in either direction from its equilibrium level, once cyclical and other transient influences are removed. This occurs when the exchange rate is fundamentally misaligned. As to the capital account, a focus on external instability would cover anomalies that are not sustainable over the medium term (in particular, sustained capital outflows) and liquidity risks that may generate unpredictable and destabilizing unwinding. It would thereby appropriately provide coverage of the vulnerabilities related to the size, cost, and maturity of capital flows that have been prominent in recent capital account-driven crises.

**Box 12. Illustrative Draft New Principles**

Principle D
A member should avoid exchange rate policies that, while pursued for domestic reasons, lead to external instability, including fundamental exchange rate misalignment.

Principle E
A member should seek to avoid monetary, fiscal, and financial sector policies that lead to external instability, including fundamental exchange rate misalignment.

43. **Even though fundamental misalignment is part of the broader concept of external instability, having the new principles refer to it explicitly would have several advantages.** It would offer continuity with Principle A, which implicitly relies on a notion of equilibrium exchange rate (paragraph 36). (Indeed, the notion of misalignment is already in the Decision in the form of an indicator, namely "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions…" (see paragraph 58).) It could also, in principle, help sharpen the treatment in surveillance of an issue that has long proved difficult to handle, namely assessment of exchange rate misalignments.[13]

44. **Other options are also worth considering—in particular, an exclusive focus on fundamental misalignments, or a formulation only in terms of external stability.** An exclusive focus on the avoidance of fundamental misalignments would have the advantage of simplicity and would concentrate attention on an issue that is of particular, direct concern to external stability. The coverage of this option, however, would be limited to current account disequilibria, and as a result the principles would not caution members against a buildup of vulnerabilities in the capital account. With a formulation exclusively in terms of external stability, the coverage of the principles would be the same as under the staff's preferred option. Only the presentation would change, in a way that could be justified by the desire to avoid putting excessive emphasis on a concept—that of exchange rate misalignments—that is subject to considerable estimation challenges. The downside of this option would, of course, be forsaking the benefits noted in the previous paragraph.

45. **For both external instability and fundamental misalignment, only policy-driven developments would be targeted by these principles, and cyclical and transitory factors would not be captured.** For instance, fundamental misalignment would be defined as a significant and sustained deviation of the prevailing real effective exchange rate, adjusted for cyclical and transitory factors, from its medium-term equilibrium level, consistent with sustainable macroeconomic fundamentals.[14] Because the equilibrium

---

[13] See, for instance, *Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision* (2004).

[14] In theory, with perfectly functioning markets, such sustained and substantial deviations from equilibrium should not occur. However, in practice markets are not perfectly efficient, nor are exchange rates fully market determined.

exchange rate is one consistent with both external and internal balance, the definition excludes deviations related to cyclical factors. And because the deviation must be durable, the definition also excludes deviations caused by reversible exogenous factors, such as erratic market behavior or exogenous shocks in thin markets. Similarly, capital account disturbances caused by temporary exogenous factors, such as erratic market behavior or contagion, would not be considered a manifestation of external instability.

46. **External instability—including fundamental misalignment—would be identified as such only if it could be concluded beyond reasonable doubt that it was present.** Uncertainties relating for instance to measurement and estimation problems, instabilities, and structural change, would need to be taken into account.

### C. The Legal Implications of Principles for the Guidance of Members

47. **The new principles proposed above, if adopted, would take the form of recommendations.** As discussed in Section II, the Fund can recommend to members that they engage in or refrain from certain types of conduct in order to comply with their general obligation under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates. These recommendations can relate to a member's exchange rate policies or to its domestic policies that are relevant to Article IV, Section 1.

48. **Notwithstanding that the principles would not cover all policies that may be of relevance to the promotion of external stability, a member that follows all of the recommendations issued by the Fund would be deemed to be in compliance with its obligations under Article IV, Section 1.** Observance of the principles for the guidance of members would thus constitute a "safe harbor." Accordingly, the establishment of additional principles by the Fund has the effect of giving members more specific guidance as to what policies would ensure compliance with Article IV, Section 1.

49. **A member that followed all the principles issued by the Fund would still be required to consult with the Fund for purposes of surveillance.** Surveillance is a process of oversight over a wide range of policies. It is a continuous process under which the Fund constantly monitors members' policies with a view to identifying and discussing the broad range of issues that may be of importance for the member's compliance with Article IV, Section 1—including issues in areas for which recommendations have not been issued.

50. **As noted earlier, the failure of a member to follow a recommendation would not, in itself, give rise to a breach of obligation under Article IV, Section 1. Rather, several steps would be necessary before a member that was not following a recommendation could be found in breach of the general obligation of collaboration under Article IV, Section 1.** First, the Fund would need to adopt a policy of general applicability that provided that observance of the conduct contemplated in the recommendation (i.e., engaging in or refraining from a particular action) is required for members to comply with the general obligation of collaboration under Article IV, Section 1. This decision would need to be general in application because the principle of uniformity of treatment would preclude the Fund from requiring certain conduct from one country and only

recommending it from another in the exact same circumstances. After such a policy was introduced, members, having been placed on notice that the conduct in question is now mandatory, would also need to be given a reasonable time to engage in or refrain from such conduct. Only if a member were to fail to do so would it be open to the Fund (i.e., the Executive Board) to adopt a decision finding the member to be in breach.

51. **Even if the Fund did take a decision to make "recommended" conduct mandatory, it would not be creating new obligations under the Articles.** As noted in Section II and described in the Legal Paper, the Fund has the authority to require members to take specific actions—or refrain from taking specific actions—that are not included in the specific obligations set forth in Article IV, Section 1(i)-(iv), provided that the Fund has made a determination that such actions—or the avoidance of such actions—are required in order for a member to discharge its undertaking to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

## V. Updating the Principles of Surveillance Over Exchange Rate Policies

52. **Following the PGMs, the Decision includes "principles of Fund surveillance over exchange rate policies."**[15] At the heart of this section are "indicators"—developments which, "in its surveillance of the observance by members of the PGMs, the Fund shall consider...as among those which might indicate the need for discussion with a member." After reviewing the role of the indicators, this section considers possible updates to the list.[16]

### A. Role of Indicators

53. **The *role* of the indicators could be clarified.** The indicators are intended to guide the Fund in its surveillance over members' observance of the principles, and are not exhaustive. When an indicator is "triggered," it does not necessarily mean that the member is not observing a principle. Rather, it is the first step in a process of enquiry by the Fund. The introduction to the list of indicators (Decision Paragraph 2) could make clearer that, where indicators are triggered, thorough review is needed, and thereby encourage staff to report clearly on such reviews and associated discussions in Article IV reports, even when it concludes there is no cause for concern (Box 13).

**Box 13. Illustrative Redlined Amendments to Paragraph 2 of the Decision**

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

---

[15] If the changes proposed above are introduced the title of this Section could be changed (e.g., to *Indicators for Assessment of Observance of the Principles*).

[16] As noted above, in a revised Decision, the paragraph that follows—the "appraisal guidelines"—might be moved into the first part of the Decision.

## B. Indicators

54. **This section presents broad preliminary staff views on how the indicators might be refined and expanded.** Corresponding illustrative wording is provided in Box 14 *in fine*. Additional guidance could be included in guidance notes, where quantification of some benchmarks could also be pursued if that were considered desirable.

### The existing indicators

55. **Appropriately, the existing indicators focus on both relevant policies and external sector outcomes** (Table 1). A first set of indicators focuses on developments manifesting the use of policies that appear *designed to* engineer a misaligned exchange rate—specifically, major types of exchange rate policies including intervention, and other policies conducted "for balance of payments purposes" comprising (a) official borrowing and lending, (b) new current and capital account restrictions, and (c) monetary and financial policies. Another set focuses on outcomes suggesting the existence of an exchange rate misalignment or BOP disequilibrium, including exchange rate developments divorced from underlying conditions and unsustainable private capital flows.

Table 1. Taxonomy of Existing Indicators

| Policies | Outcomes |
|---|---|
| (i) protracted large-scale intervention in one direction in the exchange market; | (v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements; |
| (ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes; | (vi) unsustainable flows of private capital. |
| (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital; | |
| (iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; | |

**Adding missing indicators**

56. **The existing set of indicators appears reasonably complete as regards observance of existing PGMs, with two notable omissions:**

- **On the policy side, sterilization of foreign exchange intervention.** Sterilized intervention may impede not only adjustment of the *nominal,* but also the *real* exchange rate. Large-scale and protracted sterilization may thus be indicative of impediments to necessary BOP adjustment.

- **On the outcomes side, the current account balance (unsustainable deficit or excessive surplus).** This omission perhaps reflects, on the part of the original drafters, a view that the exchange rate (as a price) and the current account (as a quantity) are two sides of the same coin, and hence an indicator on the former (indicator (v)) would suffice. However, given the central role of the current account in the assessment of external developments, and since some redundancy in the list of indicators could be acceptable and even helpful, an indicator on the current account balance could be added, mirroring the indicator on the capital account (indicator (vi)).

**Adding specificity and refinements to the existing indicators**

57. **The indicator on official and quasi-official lending could be expanded to focus on a wider concept of external asset accumulation by the public sector.** The objective of this indicator is to capture excessive "recycling" of BOP surpluses to avoid effective adjustment—an objective that would be better served if its purview was not limited to lending (generally understood as non-marketable).[17] Great care would continue to be needed in the interpretation of what constitutes "excessive and prolonged"—taking account, for instance, of limits on domestic absorptive capacity, the prudent saving of temporary current account surpluses, and more generally the requirements of prudent asset management in response to changes in fundamental conditions (e.g., drawdown of nonrenewable resources, population aging).

58. **Indicator (v), on exchange rate behavior unrelated to underlying conditions, should be interpreted as an indicator of misalignment and could be clarified as such.** The underlying conditions explicitly include such fundamentals as "factors affecting competitiveness and long-term capital movements." Moreover, the underlying conditions should be interpreted as including *sustainable* (not necessarily actual) policies.[18] The indicator thus seeks to track exchange rate behavior relative to the equilibrium determined by

---

[17] There would be some overlap, in the form of changes in reserves, between this indicator and indicator (i) on intervention.

[18] See Boughton, James, *Silent Revolution—The International Monetary Fund 1979-1989,* pages 71-72, for a description of the surveillance discussions with the United States in the early 1980s, in which it became clear that fiscal policy that was unsustainable could not be treated as an underlying condition.

fundamentals, and redefining it as a misalignment indicator would make this interpretation clear. For consistency with the focus of the principles, the indicator could be defined as one of *fundamental* misalignment, so that it would not be triggered by deviations related to cyclical or other transient factors.

59. **Finally, the two indicators on unsustainable borrowing/capital flows—which have acquired special importance in today's world—could usefully be expanded to capture liquidity risks.** Indicator (ii) as it relates to official borrowing and indicator (vi) on private capital flows currently emphasize only sustainability/solvency risks. However, liquidity risks can trigger crises even where solvency is reasonably assured, and these two indicators could be expanded to capture these risks explicitly.

60. **In order to avoid overloading the text of the Decision, additional clarification could be provided in guidance notes,** to keep pace with developments in the international financial system and in economics. This could include, for instance, (a) incorporating flows associated with off-balance sheet arrangements into the indicators on intervention, official and quasi-official borrowing, and private sector capital flows, (b) the use of reserve adequacy indicators to assess intervention, and (c) the use of debt sustainability analysis to assess external borrowing.

**Changes related to possible new principles**

61. **A new principle on policies targeting domestic objectives (Principle D above) would mean reconsidering the reference to "balance of payments purposes" in several of the existing policy indicators.** In particular, it would seem appropriate to remove this reference from the indicators on borrowing/lending and monetary and financial policies (indicators (ii) and (iv)).[19] By contrast, there is a case for keeping the reference in the indicator on current and capital account restrictions (indicator (iii)). When such restrictions are imposed for reasons other than BOP purposes, it seems appropriate to regard them as part of the structural characteristics of the economy that determine its equilibrium position, not as policies that could cause a deviation from that equilibrium.

62. **In addition, introduction of a principle on monetary, fiscal, and financial sector policies (Principle E above) could justify broadening the indicators on monetary and other financial sector policies and on unsustainable private capital flows.** The former could be reformulated to refer instead to "monetary, fiscal, and financial sector policies," and to cover the main channels through which these policies impact on external stability, namely excessive sectoral saving-investment imbalances (public or private), now or in the future, and, for financial sector policies, vulnerabilities in the financial system. Similarly, the outcome indicator on unsustainable private capital flows could be broadened to capture vulnerabilities not only in the external accounts but also in domestic balance sheets.

[19] These indicators would thereby encompass both exchange rate policies and domestic policies (see the definitions in footnote 7). If they were triggered, which principle might not have been observed would not be clear without further enquiry as to the purpose of the relevant policies.

**Box 14. Illustrative Redlined Amendments to Indicators**

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

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

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

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

**Box 14. Illustrative Redlined Amendments to Indicators (Cont'd)**

(iv) the pursuit~~, for balance of payments purposes, ~~of monetary, fiscal, and~~ other domestic~~ financial sector policies that contribute to excessive sectoral saving-investment imbalances, provide abnormal encouragement or discouragement to capital flows~~;~~, or contribute to excessively high vulnerabilities in the financial system;

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

(vi) unsustainable current account deficits, or excessive and prolonged current account surpluses; and

~~(vi)~~ (vii) ~~unsustainable flows of private capital.~~ an excessive increase or insufficient reduction in balance sheet vulnerabilities, including *inter alia* through private sector capital flows that are unsustainable or bring unduly high liquidity risks.

## VI. Conclusions and Issues for Discussion

63. **What would change in the practice of surveillance if the Decision were amended along the lines discussed above?**

- Transparency and accountability would be enhanced. The MTS shone a spotlight on surveillance. A revised Decision would clarify that this new prominence is a lasting turning point, and would set out a unified, coherent, and comprehensive policy on surveillance, thereby enhancing governance. With greater transparency as to what is expected of surveillance, shortcomings in implementation on the part of the Fund, whether at the country level or institution-wide, would also be easier to detect and remedy.

- A revised Decision would be aligned with the agreed best practice model. In particular, under a revised Decision, perceived shortcomings on the part of members would, as in the past, be handled through collaboration and persuasion, with due respect for country circumstances. Surveillance would not become a mechanical compliance exercise.

- Regarding the practice of surveillance, the momentum of a revised Decision, initially, and over time, its letter, could also help foster improvements in key but difficult areas—the candor and focus of staff reports; attention to spillovers; greater evenhandedness; and a more effective policy dialogue.

64. **Against this background, Executive Directors may wish to discuss the following issues:**

i. Would Directors see merit in turning the 1977 Decision into one that covered, and by the same token anchored, the whole scope of bilateral surveillance, rather than only surveillance over exchange rate policies, through a new first part of the Decision (paragraphs 19-31)?

   a. Do Directors agree this new section should restate why surveillance exists, that it is primarily concerned with external stability, and that it should always cover, in addition to exchange rate policies, monetary, fiscal, and financial sector policies, with other policies considered as necessary (paragraphs 23-28)?

   b. Would Directors see merit in also entrenching in this new section that surveillance should be practiced as a cooperative and candid dialogue among peers, and what members are entitled to expect from the Fund and from each other in surveillance (paragraphs 29-31)?

ii. Would Directors support the adoption of new principles recommending that (i) members avoid exchange rate policies that, while pursued for domestic reasons, lead to BOP disequilibrium, and (ii) members seek to avoid monetary, fiscal, and financial sector policies that lead to BOP disequilibrium (paragraphs 39-41)? If so, would Directors agree that such principles should refer to policies that "lead to external instability, including fundamental exchange rate misalignment" (paragraphs 42-44)?

iii. Would Directors be willing to revise and update the current indicators for Fund surveillance (paragraphs 52-62)?

iv. Would Directors wish to clarify the concepts in Article IV, Section 1(iii) as proposed in this paper (paragraphs 33-37)?

**Attachment I**

## Article IV of the Articles of Agreement

Article IV - Obligations Regarding Exchange Arrangements

Section 1. *General obligations of members*

Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(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;

(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; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. *General exchange arrangements*

*(a)* Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

*(b)* Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right of another denominator, another than gold, selected by the member, or (ii) cooperative arrangements by which members maintain he value of their currencies in relation to the value of the currency or currencies of other members, of (iii) other exchange arrangements of a member's choice.

To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. *Surveillance over exchange arrangements*

(*a*) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(*b*) In order to fulfill its functions under (*a*) above, 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. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. *Par values*

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well a to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule C apply.

Section 5. *Separate currencies within a member’s territories*

*(a)* Action by a member with respect to its currency under this Article shall be deemed to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXXI, Section 2*(g)* unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

*(b)* Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in *(a)* above unless the Fund declares otherwise.

**Attachment II**

SURVEILLANCE OVER EXCHANGE RATE POLICIES

1. The Executive Board has discussed the implementation of Article IV of the proposed Second Amendment of the Articles of Agreement and has approved the attached document entitled "Surveillance over Exchange Rate Policies." The Fund shall act in accordance with this document when the Second Amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled "Surveillance over Exchange Rate Policies" at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

*Decision No. 5392-(77/63)*
*April 29, 1977,*
*as amended by Decision Nos. 8564-(87/59), April 1, 1987,*
*8856-(88/64), April 22, 1988, and 10950-(95/37),*
*April 10, 1995*

Surveillance over Exchange Rate Policies

*General Principles*

Article IV, Section 3(*a*) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(*b*) provides that in order to fulfill its functions under 3(*a*), "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." Article IV, Section 3(*b*) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(*b*) requires that "each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the

Fund in order to perform its functions under Section 3(*b*). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(*a*), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: "Recognizing ... that a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

*Principles for the Guidance of Members' Exchange Rate Policies*

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.

*Principles of Fund Surveillance over Exchange Rate Policies*

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

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

> (i) protracted large-scale intervention in one direction in the exchange market;
>
> (ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;
>
> (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or

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

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

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

(vi) unsustainable flows of private capital.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

*Procedures for Surveillance*

I. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

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

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

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(*b*). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Board shall review the general implementation of the Fund's surveillance over members' exchange rate policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

February 21, 2007

**The Chairman's Summing Up**
**Review of the 1977 Decision on Surveillance over Exchange Rate Policies**
**Further Considerations**
**Executive Board Meeting 07/13**
**February 14, 2007**

Directors welcomed the opportunity to continue the review of the 1977 Decision. Noting that this review involves issues that are critical to the Fund's mandate and its relationship with its members, Directors welcomed the efforts to build the broadest possible support on the way forward and the assurance that the process would not be rushed. Today's discussion has been fruitful and productive, and will facilitate the development and refinement of areas of broad agreement going forward, while also helping us to build common ground in other areas requiring further reflection and discussion.

As we work toward completing this review, Directors agreed that three overarching principles should remain at the forefront of our consideration, and guide any revision of the Decision. First, a revised Decision should not introduce new obligations, and should enshrine dialogue and persuasion as key pillars of effective surveillance. Second, the Decision should pay due regard to country circumstances, and emphasize the need for evenhandedness in practice as well as in theory, thereby endeavoring to correct the asymmetry perceived by a number of Directors in the way surveillance affects advanced and other countries. Third, a revised Decision should retain flexibility—a merit of the current framework highlighted by many Directors—to allow surveillance to continue evolving.

Most Directors agreed in today's discussion that the 1977 Decision is cast narrowly and only partially relevant to surveillance as carried out today. Many Directors accordingly firmly favored, and some others were open to consider, a revision of the 1977 Decision that meets the above three principles. Many Directors considered it critical to fill this significant gap in the Fund's policy framework, underscoring that it is the Board's responsibility to set out the fundamentals of surveillance, and that doing so in a revised Decision would offer the benefit of clarity and conciseness. These Directors further felt that an appropriately revised Decision would enhance the Fund's ability to carry out one of its key responsibilities in the broader context of the ongoing medium-term reform process, while inaction could pose serious risks to its credibility. They considered that, by setting out clear expectations for the conduct of surveillance, a revised Decision would serve to improve the overall quality of surveillance, especially with respect to focus, candor, and evenhandedness—thus bringing average practice closer to best practice. At the same time, a number of Directors were not convinced about the need for a revised Decision. These Directors questioned whether a revision would be the best vehicle for more comprehensive guidance on surveillance, and suggested that the same purpose could be achieved through revised Surveillance Guidance Notes. They also questioned whether a revision would make a material difference in enhancing the effectiveness of surveillance. In any case, there was broad agreement that a revised Decision should not introduce fundamentally new elements into the best practice of surveillance.

Directors had the following comments on the specific suggestions for revision put forward in the staff paper, which would guide future work towards a revision.

**Expanding the Decision to Describe the Framework for Surveillance**

Most Directors considered that it would be useful to include in the Decision a description of the scope and modalities of bilateral surveillance, and broadly agreed with the content set out in the staff paper for a possible new section to this effect. Several Directors also considered that it would be useful to clarify further which changes in the Decision set out the responsibilities of the Fund, and which relate to the responsibilities of members.

Directors noted that a revised Decision should emphasize that bilateral surveillance needs to be conducted with a multilateral perspective, and pay due attention to cross-country spillovers. Beyond this, some Directors suggested not limiting the Decision to bilateral surveillance only, but also including multilateral surveillance, in view of their complementarity and the emphasis being accorded to external stability and the interdependence of members' policies.

Most Directors supported the use of external stability as an organizing principle for surveillance. Directors underscored that the focus of surveillance on external stability does not imply that domestic policies should be formulated with the direct goal of achieving external stability. Indeed, Article IV recognizes that domestic policies should seek to promote domestic stability and orderly growth, which are key ingredients for external stability. Nonetheless, several Directors considered that further clarification of the concept of external stability would be helpful. Some Directors asked the staff to explore in greater detail how the concept of external stability would be applied to members of currency unions.

Many Directors emphasized that stable growth is an important means of promoting external stability, through its effects on sustainability and on developments in macroeconomic policies. Views differed on the adequacy of the emphasis put on growth in the current paper—with some stressing that growth and domestic objectives should not be subordinated to external objectives, and with some others concerned about diluting the focus of surveillance by overemphasizing growth. Any revised Decision will, within the framework of Article IV, need to find the right balance in addressing this issue.

Most Directors favored the proposed "principle of proximity," stating that certain policies—not only exchange rate policies, but also monetary, fiscal, and financial sector policies—would always be the subject of surveillance, whereas other policies should be covered only to the extent that they are relevant to the promotion of external stability.

Directors agreed that the essence of surveillance consists of clear, candid, and evenhanded assessments of relevant developments and associated policy advice. They noted that a new, general part of the Decision would be an opportunity to emphasize the importance of dialogue and persuasion, and the need to take account of country circumstances. Directors agreed that surveillance should take a medium-term perspective, and many were open to the specific mention of policy frameworks in the Decision, emphasizing that such a mention should not constrain members' policy formulation processes. Some other Directors considered such a mention to be inappropriate.

Many Directors saw merit in ensuring that the description of the framework for surveillance in a revised Decision is reasonably self-contained. Many others cautioned, however, that a description that reiterated elements of related policies—for instance, on transparency and data provision—might inadvertently change these other policies, or constrain their evolution in the future, with some considering it imperative that a revised Decision refrain from such references. A concise description was seen as also enhancing the scope for broad support.

**Completing the Principles for the Guidance of Members**

Many Directors saw a need to clarify Principle A, and supported the analysis in the staff paper—in particular, that manipulation of the exchange rate for the purposes of gaining an unfair competitive advantage should be understood as policies designed to secure fundamental exchange rate misalignment in the form of an undervalued exchange rate for the purpose of increasing net exports. A number of Directors were not persuaded that this principle should be interpreted as referring to exchange rate misalignment.

Directors had a wide-ranging discussion on the need for and implications of expanding the current Principles for the Guidance of Members (PGMs). They emphasized that the introduction of new principles should not shift the emphasis of surveillance from dialogue and persuasion to a compliance-based approach. Noting that most episodes of exchange rate instability since 1977 had been caused by policies that were not inconsistent with the existing PGMs, most Directors considered that there is a case for at least one new principle. Directors who supported the introduction of new principles considered it critical in this regard that the new principles are proposed to be recommendations, not obligations, and that any new principles be drafted in such a manner as to avoid an unduly rigid application.

Most Directors considered that, in order to discharge its responsibilities under Article IV, Section 3(b), the Fund should adopt an additional principle on exchange rate policies. Because external instability is often rooted in domestic policies that are the subject of obligations under Article IV, Section 1, many also considered it appropriate to add a principle on domestic policies—which would also make the Decision more relevant to floaters. At the same time, many other Directors questioned the need for the introduction of a principle on domestic policies, noting that such a principle is not called for by Article IV, Section 3(b). These Directors considered that the importance of domestic policies for external stability could be conveyed in the section of a revised Decision providing guidance for Fund surveillance, not for members. A number of Directors were not convinced that the new principles would not introduce new obligations, with a few suggesting that the proposed additions are biased against countries with a fixed exchange rate regime.

Directors who favored new principles generally considered that they should have external stability as their focus, in line with Article IV. Directors expressed a range of views on the desirability of incorporating in the new principles an explicit reference to exchange rate misalignment, with many Directors urging caution in the use of this concept due to its theoretical weaknesses and empirical complexities. I suggest we explore this issue further.

**Updating the Principles of Surveillance over Exchange Rate Policies**

Directors saw merit, in principle, in updating the list of indicators in the Decision, although they were keen to guard against a false sense of precision, and in this connection some suggested moving the indicators to a guidance note. Directors emphasized that the indicators need to be interpreted carefully, in the context of individual country circumstances, and should not be used mechanically. They welcomed the clarification that there is no proposal to introduce quantitative benchmarks for indicators. Varied views were expressed on the merits of the different additions and refinements to indicators suggested in the staff paper, which staff will consider carefully in the formulation of any specific proposal.

**Conclusion**

All in all, I have concluded from today's discussion that most Directors agree or are willing to consider that the current Decision should be revised, with a varied range of views as to what exactly such a revision should include. A number of Directors remain unpersuaded that the benefits of such a revision justify what they see as the risks. Many Directors emphasized that it would be helpful for the Board to discuss the IEO evaluation of exchange rate policy advice before completing the review, with some suggesting that the review could best be concluded following the next comprehensive review of surveillance implementation, and a few noting the links to the work under way on remit, independence, and accountability. The goal remains to achieve the best possible solution, not the fastest one, while bearing in mind the need to make the best use of the opportunity now provided by the process of ongoing medium-term reforms. The staff has taken careful note of the guidance and concerns expressed by the Board today, and will return with specific proposals for a revised Decision, with some proposals modified in light of our discussions with a view to garnering the broadest possible support.