INTERNATIONAL MONETARY FUND

Modernizing the Legal Framework for Surveillance— An Integrated Surveillance Decision

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I. INTRODUCTION[1]

1. **Building on previous Board discussions, this paper proposes a draft Integrated Surveillance Decision (the "ISD") for adoption.**[2] As part of broader efforts to strengthen Fund surveillance, the Fund is modernizing its legal framework to better support operations.[3] In April 2012, the Fund's Executive Board discussed *Modernizing the Legal Framework for Surveillance—Building Blocks Toward an Integrated Surveillance Decision* (henceforth referred to as the "previous paper"). That paper highlighted key weaknesses in the current legal framework for surveillance and provided proposals for addressing them. Most Directors agreed that introducing a new surveillance decision covering both bilateral and multilateral surveillance would help address these weaknesses. In particular, they agreed with the general proposed approach to fill the gaps in bilateral surveillance through multilateral surveillance. During the subsequent April 2012 Spring Meetings, the IMFC "…agree[d] that the current surveillance framework should be significantly enhanced, …welcome[d] the progress by the Fund in advancing consideration of an integrated surveillance decision, and commit[ted] to support the decision process."[4]

2. **The legal framework for Fund surveillance has lagged behind the goal of modernizing surveillance.** As discussed in the previous paper, the current legal framework does not adequately capture economic realities. It does not provide a framework for the systematic coverage of spillovers arising from members' policies. Because of the asymmetric treatment of exchange rate and domestic policies in Article IV, it also reflects an exchange rate bias that undermines the sense of ownership of surveillance by some members and undermines the traction of Fund advice with those members. In addition, there is no framework that provides guidance on how to tackle global issues requiring collective action or close policy coordination.

3. **The ISD seeks to address these weaknesses**. It establishes a comprehensive framework covering both bilateral and multilateral surveillance. In particular, it (i) lays out a conceptual link between bilateral and multilateral surveillance and clarifies the importance of focusing on global economic and financial stability in the context of multilateral surveillance, and (ii) makes Article IV consultations a vehicle not only for bilateral surveillance but also for multilateral surveillance, allowing the Fund to discuss the full range of spillovers from a member's policies that affect global stability. In the area of bilateral surveillance, the ISD

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[1] This paper was prepared by a team comprising Ritu Basu, Gilda Fernandez, Tetsuya Konuki, Hoang Pham, Pengyu He, and Nadia Rendak and led by Jean-François Dauphin and Ross Leckow.

[2] References to the ISD in this paper are to the *proposed* ISD set out in Attachment II of this paper.

[3] See *2011 Triennial Surveillance Review—Review of the 2007 Surveillance Decision and the Broader Legal Framework for Surveillance*. See also *2011 Triennial Surveillance Review—Overview Paper*.

[4] See *April 2012 Communiqué of the Twenty-Fifth Meeting of the IMFC*.

builds on the existing principles for guidance of members' exchange rate policies by adding guidance on the conduct of their domestic policies that are relevant to domestic stability. Moreover, it retains the 2007 Decision's focus on the stability of members' external accounts but recognizes that, as demonstrated by the 2008 financial crisis, the policies of members that are in a state of domestic instability may create spillovers that undermine systemic stability even if they are transmitted through channels other than the member's balance of payments (see below). In the context of multilateral surveillance, the ISD clarifies the scope of multilateral surveillance and encourages members, in the conduct of their policies, to be mindful of the impact of those policies on global stability. It also establishes the modalities for conducting multilateral surveillance, in particular through discussions of issues requiring collective action or policy coordination. As a related matter, it clarifies members' procedural obligations in the context of multilateral surveillance.

4. **As discussed in the previous Board meeting, the ISD does not—and cannot—completely remove the legal assymetry relating to the treatment of exchange rate policies and domestic policies.** In particular, while the ISD modifies the surveillance framework in a manner that ensures that domestic policies with spillover effects are the subject of surveillance even if they have no impact on the balance of payments of the member, these policies will be of relevance for bilateral surveillance only if they also give rise to the domestic instability of that member. Domestic policies that do not give rise to domestic instability will be discussed in the context of multilateral surveillance to the extent that they have important global spillover effects directly or indirectly, for instance in combination with the spillover effects of other members' policies or through their regional impact. However, in these circumstances, members would be under no obligation to modify such policies, reflecting the limited scope of members' obligations under multilateral surveillance.

5. **The ISD reflects comments expressed during the discussion of the previous paper.** While Directors were generally supportive of the building blocks presented in that paper, they expressed a number of concerns that the present draft seeks to address. In particular, they stressed the need to maintain adequate flexibility in the legal framework to adapt surveillance operations to changing circumstances, maintain the current practice of paying due regard to individual country circumstances, and ensure that the ISD could not, in any way, be understood as extending members' obligations.

6. **This paper is organized as follows.** Section II summarizes the main issues and discusses the changes the ISD would bring about. Section III lays out the elements of the ISD, discussing how the 2007 Decision is incorporated into the new decision and how comments raised by Directors have been addressed. It also sets out a proposed decision. Attachment I contains the ISD. Attachment II presents a redlined version of the ISD against the 2007 Decision.

II. WHAT WOULD CHANGE WITH THE ISD?

7. **The ISD would bring about real improvements in the conduct of surveillance.** In particular, building on the voluntary pilot exercise on spillover reports, the ISD would facilitate the more systematic coverage of all relevant spillovers, providing for richer policy dialogue with country authorities. It would strengthen the traction of Fund advice and the legitimacy of the legal framework by seeking to rebalance the treatment of external and domestic policies.

8. **Experience with past revisions to the legal framework demonstrates that such reforms can significantly influence how surveillance is conducted.** As in any institution, systemic changes do not happen overnight, but gradually. The material impact of the Fund's legal reforms for surveillance has been demonstrated by the Fund's experience with the 2007 Decision. Results from the 2008 and 2011 Triennial Surveillance Reviews (TSRs) and assessments by the Independent Evaluation Office (IEO) provide concrete evidence that the introduction of the 2007 Decision improved the coverage and quality of exchange rate analysis in surveillance, achieving a key objective of the Decision (Box 1).

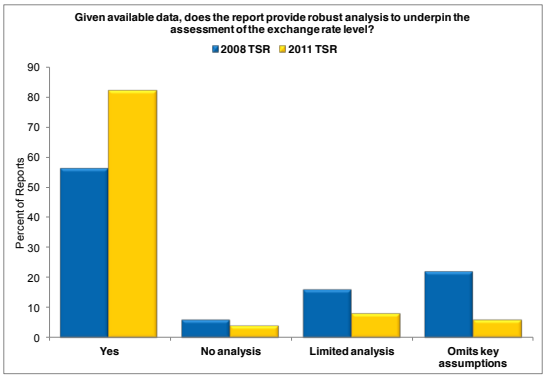
Box 1. The Impact of the 2007 Decision on Exchange Rate Analysis

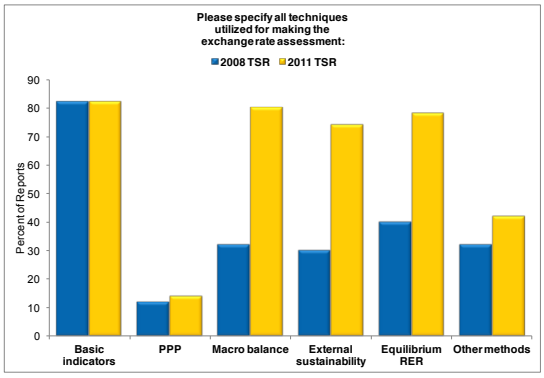
The coverage, quality of analysis, and focus on exchange rate issues have significantly improved with the adoption of the 2007 Decision.

- ***The coverage of exchange rate issues in staff reports increased markedly.*** The 2008 TSR and the 2007 IEO evaluation found that about less than 2/3 of staff reports discussed exchange rate issues in 2006 while more than 90 percent did so in 2008. In 2011, the coverage was nearly universal.[1] The 2008 TSR also found that the share of Selected Issues Papers dealing with exchange rate and competitiveness issues doubled from 2006 to 2008.[2] A 2011 IEO Report also concluded that the 2007 Decision on Bilateral Surveillance led to a greater emphasis on exchange rate levels and currency misalignments.[3]

- ***The quality and sophistication of the analysis of exchange rate issues also improved significantly***.
    - While a 2007 IEO evaluation found that reports rarely used analytical tools beyond a real exchange rate chart, the 2008 TSR found that more than half the reports sampled provided a clear and robust assessment of the exchange rate level, based on a multitude of techniques, such as basic indicators, PPP-approaches, and econometric techniques, including those developed by the Consultative Group on Exchange Rate issues (CGER). The description of the de facto exchange regime was adequate and advice was generally well supported.[4]
    - Compared with 2008, the 2011 TSR's review of 50 Article IV reports found a more comprehensive use of CGER methods, and more robust exchange rate analysis (see Figure below).[5]

Staff's Assessment of Article IV Reports: Progress on Exchange Rate Assessment





- ***If anything, changes triggered by the 2007 Decision may have gone farther than expected.***
  - The **2008 TSR** noted complaints about the emphasis on exchange rate levels and called for better integration of exchange rate analysis with the overall macroeconomic assessment.
  - The **2011 IEO** report noted that greater focus on exchange rate levels and currency misalignments resulted in less attention to the external sector more broadly and in some cases triggered tensions between the IMF and country authorities.

- ***However, regular TSRs ensure that corrective adjustments are taken when necessary to align the practice of surveillance with key priorities of the Fund.*** The 2011 TSR noted the excessively narrow focus on exchange rate assessments and made specific recommendations to broaden Fund's assessments of external sectors and related policy advice.

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[1] See *Review of the 1977 Decision—Proposal for a New Decision*; *2008 Triennial Surveillance Review—Overview Paper*; *Exchange Rate Analysis, 2008 Triennial Surveillance Review—Thematic Paper*, pp. 21–37, *IEO Evaluation of IMF Exchange Rate Policy Advice, 1999–2005*, and *Staff Background Studies: Chapter 1 Exchange Rate and External Stability Assessments* and *Health Check and Statistical Information*.

[2] See *Staff Background Studies: Chapter 1 Exchange Rate and External Stability Assessments* and *Health Check and Statistical Information*.

[3] Independent Evaluation Office. *The IMF's Performance in the Run-Up to the Financial and Economic Crisis*.

[4] See *2008 Triennial Surveillance Review—Overview Paper*; *Review of the 1977 Decision—Proposal for a New Decision*; and *Exchange Rate Analysis, 2008 Triennial Surveillance Review—Thematic Paper*, pp. 21–37, *IEO Evaluation of IMF Exchange Rate Policy Advice, 1999–2005*.

[5] See *Staff Background Studies: Chapter 1 Exchange Rate and External Stability Assessments* and *Health Check and Statistical Information*.

III. Elements of an Integrated Surveillance Decision

9. **This section describes the various components of the ISD.** For each section of the ISD, it explains how the 2007 Decision has been incorporated into the ISD. It also explains how the proposed building blocks set out in the previous paper have been drawn upon in the ISD, and how feedback provided by Executive Directors in the previous Board meeting has been reflected.

A. Preamble

10. **The preamble to the ISD builds on its counterpart in the 2007 Decision, but reflects the more comprehensive nature of the new decision.** Building on the language of the 2007 Decision, the revised preamble highlights the extension of the coverage of the ISD to multilateral surveillance and the importance of interconnectedness and spillovers. It also makes reference to the new guidance being provided to members on the conduct of their domestic economic and financial policies and, in the context of multilateral surveillance, on giving consideration to the impact of their policies on the effective operation of the international monetary system. As in the 2007 Decision, the preamble explains that the decision does not and cannot be construed or used to expand or broaden the scope—or change the nature—of members' obligations under the Articles.

B. Principles for the Guidance of the Fund in its Surveillance

Scope of Surveillance

11. **The ISD defines the scope of bilateral and multilateral surveillance.** As explained in the previous paper, and as emphasized by a number of Executive Directors, while bilateral and multilateral surveillance are complementary, legally they are two different functions and thus are dealt with separately in the ISD.

Bilateral surveillance

12. **The scope of bilateral surveillance in the ISD will continue to be centered on the concept of systemic stability** (¶¶5–7 of the ISD). Under the ISD, bilateral surveillance will continue to examine whether a member is conducting its policies in a manner that promotes its own stability, recognizing that the stability of the system of exchange rates (i.e., systemic stability) is most effectively achieved when members are promoting their own stability. The concept of "external stability" (defined as a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements) plays a central role in the 2007 Decision as it provides a framework that links the external sectors of members to systemic stability. The ISD, as is the case with the 2007 Decision, recognizes that, in the conduct of their domestic economic and financial policies, members promote the stability of their own balance of payments by promoting their own domestic stability. However, as pointed out by a number of Directors during the discussion of the previous paper and as

evidenced by the global crisis, there may be circumstances where domestic instability may give rise to systemic instability without a significant impact on a member's balance of payments. For instance, contagion or swings in market sentiments in reaction to policy announcements can transmit shocks across borders through asset prices without affecting balance of payments flows. To recognize this point, the bilateral surveillance section of ISD clarifies that systemic stability is most effectively achieved when a member promotes not only its own *balance of payment* stability, but also its own *domestic* stability.[5] Moreover, the ISD expressly acknowledges that there may be circumstances where a member's domestic instability may give rise to systemic instability even in the absence of instability in its balance of payments. In sum, the bilateral surveillance section of the ISD will ensure that the spillovers on systemic stability arising from the domestic policies of a member that give rise to domestic instability will be a subject of bilateral surveillance even if they have no or little impact on the balance of payments of the member. Furthermore, to underline the fact that, under the ISD, spillovers affecting systemic stability can be transmitted through two distinct channels of a member's economy (i.e., through domestic instability and through instability in the balance of payments), the term "external stability" is being replaced with "balance of payments stability"—without any change to the existing definition or existing Board guidance on the meaning of the term. This more specific terminology will also serve to clarify that the concept of "balance of payments stability" is intended to refer to an individual member's external accounts—not the stability of the overall system (the latter concept being covered by the term "systemic stability").

13. **The ISD retains the scope of surveillance of members of currency unions as laid out in the 2007 Decision, with an added reference to the domestic stability of the union consistent with the changes discussed above** (¶8 of the ISD). In addition to the fact of bringing multilateral surveillance in the Article IV consultations of individual members of a union and in Article IV discussions held at the level of the union, as discussed below, such a change will ensure that all potential spillovers from the domestic policies of a currency union member that may give rise to instability at the level of the union or globally are adequately covered in surveillance.[6] It is also worth emphasizing that the 2007 Decision provides explicitly that the Fund's assessment of the policies of a member of a currency union will always include an evaluation of the member's balance of payments—a point particularly relevant in light of the current developments in the euro area.

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[5] As discussed later in the paper, the global spillover effects of a member's domestic policies in circumstances when the member is domestically stable would be covered under the Fund's multilateral surveillance mandate.

[6] In particular, where a member of a currency union continues to conduct domestic economic and financial policies at the national level, it promotes the domestic stability of the union by promoting its own domestic stability. Conversely, where the member conducts such policies in a manner that leads to its own domestic instability, the spillovers arising from such policies may undermine systemic stability whether or not they are transmitted through the member's own or the union's balance of payments.

Multilateral surveillance

14. **The ISD defines the scope of multilateral surveillance, which includes all issues relevant for global economic and financial stability** (¶¶9–11 of the ISD). As foreshadowed in the previous paper, the ISD, for the first time, provides comprehensive guidance on the scope of the Fund's mandate to oversee the international monetary system to ensure its effective operation. In that respect, it builds on the legislative history for Article IV and previous Board papers to describe the elements of the international monetary system and to lay out factors to consider in determining whether it is operating effectively.[7] It explains how the stability of the system of exchange rates relates to the effective operation of the international monetary system thereby providing a conceptual bridge between bilateral and multilateral surveillance. The ISD also explains that global economic and financial stability is typically a condition for the effective operation of the international monetary system, and that, in order to promote the latter, the Fund needs to focus on all issues relevant to the former. Accordingly, it clarifies that, in its multilateral surveillance, the Fund will focus on issues including global economic and financial developments, and significant spillovers from a member's policies (including exchange rate, monetary, fiscal, financial sector and capital flow management policies) that have important global effects directly or indirectly, for instance in combination with the spillover effects of other members' policies or through their regional impact, regardless of their transmission channels. As a result, even if domestic policies do not give rise to domestic instability (and accordingly are not subject to bilateral surveillance) those policies will still be a relevant topic of multilateral surveillance to the extent that they may materially impact the effective operation of the international monetary system.

15. **The ISD does *not* alter members' obligations** (¶12 of the ISD). As is made explicit in the ISD, and, unlike bilateral surveillance, multilateral surveillance does not involve an assessment of substantive obligations (i.e., members are under no obligation to modify their economic policies in light of the views expressed by the Fund in the context of multilateral surveillance). Rather, they are only subject to a procedural obligation to consult with the Fund and provide the relevant data so that the Fund can exercise its multilateral surveillance responsibility. Accordingly, to the extent that outward spillovers from domestic policies fall outside the scope of bilateral surveillance (i.e., the member is not domestically unstable but such spillovers significantly affect the operation of the international monetary system), the Fund may *not require* a member to change those policies. The Fund may only *discuss* with members the implications of their policies and, to the extent possible, suggest potential alternatives to better promote the effective operation of the international monetary system. Moreover, in the context of these discussions, a member's own stability will always be given priority in the event that there is a conflict between the domestic policies needed to promote

[7] See, inter alia, *2011 Triennial Surveillance Review—Review of the 2007 Surveillance Decision and the Broader Legal Framework for Surveillance* and *The Fund's Mandate—The Legal Framework*.

the member's own stability and those to minimize adverse effects on global stability. This is not only a matter of legal precedence, but also of economic optimization as domestic instability in an economy of systemic importance would also affect global stability.

Modalities of Surveillance

16. **The ISD preserves the key modalities for surveillance as laid out in the 2007 Decision, extending most of them to also apply to multilateral surveillance** (¶¶13–18 of the ISD).[8] As indicated in the previous paper, staff proposes only minimal changes to this part of the 2007 Decision. Thus, the ISD confirms the key pillars of effective surveillance, noting that they apply equally to the conduct of bilateral and multilateral surveillance. These are: the importance of dialogue and persuasion; clarity and candor; fostering an environment of frank and open dialogue and mutual trust; and evenhandedness. The ISD provides that the Fund's advice on a member's policies will pay due regard to the member's circumstances, including its implementation capacity. It also notes that the Fund's assessment and policy advice will be informed by, and consistent with, a multilateral framework. Moreover, it clarifies that, in advising members on how to promote their own domestic and balance of payments stability and the effective operation of the international monetary system, the Fund should, to the extent permitted under Article IV, take into account members' other policy objectives. The Fund's policy advice will be placed in a medium-term perspective.

C. Principles for the Guidance of Members' Policies

17. **The ISD builds on the 2007 Decision by introducing guidance to members in the conduct of their domestic economic and financial policies for the purpose of bilateral surveillance, and guidance on all policies related to multilateral surveillance.** It also explicitly recognizes the economic reality that it is a member's overall mix of economic and financial policies, including both exchange rate and domestic policies, that contributes to the balance of payments and domestic stability of the member's economy, a point discussed in previous papers (¶19 of the ISD).

Bilateral Surveillance

18. **The ISD preserves the existing principles for the guidance of members' exchange rate policies and adds a new principle on domestic policies (i.e., Principle E)** (¶¶20–21 of the ISD). As noted in previous papers, the addition of a principle for the guidance of members' domestic economic and financial policies under bilateral surveillance seeks to fill an important gap in the 2007 Decision and, to the extent consistent with the Articles, help address the perceived exchange rate bias in the legal framework for surveillance. Reflecting

[8] The provision of the ISD (paragraph 16) specifying the circumstance in which spillovers from a member's policies will be taken into account in the Fund's assessment of those policies (i.e., the Fund's assessment of the member's compliance with its policy obligations) only applies in the context of bilateral surveillance.

the asymmetry that exists in Article IV Section 1 itself, the proposed new principle is cast in terms of "best efforts" in light of the "soft" nature of members' obligations respecting the conduct of domestic economic and financial policies. Moreover, in response to concerns expressed in the previous Board discussions that the illustrative Principle E provided in that paper might be interpreted as expanding members' obligations, the ISD proposes the following revised language: "A member should seek to avoid domestic economic and financial policies that give rise to domestic instability."[9] As discussed above, these revisions clarify that members' obligations with respect to their domestic policies are limited to the promotion of their own domestic stability. In line with the previous paper, the proposed ISD retains the list of indicators that provides additional guidance on assessing members' compliance with their obligations (¶22 of the ISD).

Multilateral Surveillance

19. **For the purpose of multilateral surveillance, the ISD encourages members to implement policies conducive to the effective operation of the international monetary system** (¶23 of the ISD). In line with the illustrative language in the previous paper, the ISD includes a provision recognizing that a member's policies may have a significant impact on other members and on global economic and financial stability. It encourages members to implement policies that, in themselves or in combination with the policies of other members, are conducive to the effective operation of the international monetary system. It notes that such encouragement is provided "beyond members' obligations", explicitly recognizing that the new provision does not in any way amount to an expansion of members' obligations.[10] As discussed earlier in this paper, to the extent that a member is promoting its own stability, a member cannot be required to change its policies to better support the effective operation of the international monetary system.

D. Procedures for Surveillance

Article IV Consultations

20. **The ISD makes Article IV consultations a vehicle for both bilateral and multilateral surveillance** (¶26 of the ISD). With regard to bilateral surveillance, Article IV consultations would continue to assess a member's compliance with its obligations under

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[9] The previous Board paper included the following illustrative language: "A member should seek to avoid domestic economic and financial policies that result in external instability."

[10] As noted above, the only obligations to which members are subject in the context of multilateral surveillance is a procedural obligation to consult with the Fund and to provide information. As discussed in earlier Board papers, Article VIII, Section 5 authorizes the Fund to require members to provide it with such information as the Fund deems necessary for its activities. Under this provision, the Fund may, by Executive Board decision, require members (either all members or individual members) to provide information that it needs for multilateral surveillance. See *The Fund's Mandate—The Legal Framework*.

Article IV Section 1 and therefore the contribution of the member's policies to its *own* balance of payments and domestic stability. In particular, the proposed ISD retains the 2007 Decision's emphasis on exchange rate policies which, under Article IV Section 3, are subject to "firm" surveillance. In addition, through a new multilateral surveillance component, Article IV consultations would also focus on spillovers from policies of individual members that may significantly influence the effective operation of the international monetary system, for example by undermining global economic and financial stability. Thus, outward spillovers arising from an individual member's policies, irrespective of the type of economic or financial policy from which they stem or the channels through which they transmit, could be discussed in Article IV consultations even if they fall outside the scope of bilateral surveillance (i.e., because they do not undermine domestic stability). The policies of members that may be relevant for the purpose of multilateral surveillance include exchange rate, monetary, fiscal, and financial sector policies and policies on capital flows.

21. **To ensure that Article IV consultations remain focused, the concrete topics for discussion will need to be carefully chosen and prioritized.** Following the adoption of the ISD, guidance to staff would be developed to help focus the consultations on the most significant issues relating to a member's stability and global stability. Analyses of global risks and policy spillovers from the Fund's multilateral surveillance products, along with the internal review process, will play a key role in selecting topics for Article IV consultations. Staff is also encouraged to exchange views on such topics with the authorities at an early stage of a consultation cycle. This will be important to ensure that Article IV discussions are not overburdened.

22. **The ISD does *not* change other aspects of the Article IV consultation procedures laid out in the 2007 Decision** (¶¶27–29 of the ISD). The expectations on the lags between the end of staff discussions with the authorities and the Board completion of the Article IV consultations remain unchanged. Article IV consultations continue to comprehend the regular consultations under Articles VIII and XIV. In addition, staff does not propose any changes to paragraphs 19 and 20 of the 2007 Decision regarding ad hoc Article IV consultations, which remain a vehicle for bilateral surveillance only**.**

Other Multilateral Surveillance Activities

Periodic Reports on the International Monetary System

23. **The ISD provides for the Fund's monitoring of global economic and financial developments and assessments of outlooks and risks** (¶30 of the ISD). Such assessments may take the form of the preparation by staff, for discussion by the Board, of regular or ad hoc reports tackling issues relevant for global stability and the effective operation of the international monetary system. In light of Directors' emphasis on the importance of preserving flexibility to accommodate changing circumstances, the proposed ISD does not prescribe any specific format for these assessments beyond retaining existing references to

the WEO from the 2007 Decision. The ISD also clarifies that the Managing Director may collaborate with other international bodies as necessary in the surveillance of the global economy.

Multilateral Consultations

24. **The proposed ISD articulates a framework for the multilateral discussion of global issues requiring collective action** (¶¶31–33 of the ISD). Multilateral consultations may facilitate collective action or policy collaboration among a group of members to address systemic issues. While the ISD sets out a framework for such discussions, it seeks to respond to comments from Executive Directors by ensuring that the framework allows for flexibility in application. Therefore, the provisions on multilateral consultations have been streamlined compared with the illustrative language laid out in the previous paper.

25. **The proposed ISD sets out in general terms the key elements of the Fund's and members' roles and procedures under a multilateral consultation.** First, it clarifies that the Fund may initiate a multilateral consultation on an "as needed" basis. Specifically, when the Managing Director forms the view that there is a need for a multilateral consultation, she/he would recommend to the Board that such a consultation be held. The Board could then decide to initiate the multilateral consultation. Second, the proposed ISD clarifies that duplication with another forum such as the G-20 MAP would be avoided. Third, it states that the relevant members would be required to consult with the Fund in accordance with the Board decision to initiate the multilateral consultation. Fourth, it makes explicit that, while the Fund would serve as a facilitator for discussions, agreement on specific policy actions would be left to the relevant members. Finally, it states that the Board would conclude the multilateral consultation by formally considering the Managing Director's report. However, it does not specify any format for the report with a view to retaining flexibility.

Data Provision

26. **Reflecting Directors' comments in the previous Board meeting, the ISD does not include a provision that would encourage members to voluntarily share data on relevant individual institutions.** However, it should be noted that the Articles of Agreement already allow the Fund to obtain such information from members on a voluntary basis.[11]

[11] Under Article VIII, Section 5, the Fund may require a member to report any information it deems necessary for its activities, including surveillance. Although Article VIII, Section 5 (b) makes it clear that members are under no obligation to furnish information in such detail as to disclose the affairs of individuals or corporations, Article VIII Section 5 (c) clarifies that the Fund may obtain key financial sector information through voluntary agreements with members.

Transitional provisions

27. **Transitional arrangements need to be put in place to ensure the smooth implementation of the ISD.** The ISD would become effective five months following its adoption by the Executive Board and, as of that date, the 2007 Decision on Bilateral Surveillance would be repealed. With respect to Article IV consultations, the ISD would apply to all consultations that have not been completed by the Executive Board before the effective date of the ISD. The five-month lag would allow time for developing guidance to staff on the implementation of the framework set forth in the ISD on time for missions to receive it at the preparatory stage of consultations that will be concluded under the new regime.

PROPOSED DECISION

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

1. The Executive Board adopts the Decision on Bilateral and Multilateral Surveillance set forth in Attachment I. The Decision on Bilateral and Multilateral Surveillance will become effective 5 months after the date on which the Decision is approved.

2. Decision 13919-(07/51), adopted June 15, 2007, as amended, (the "2007 Surveillance Decision") is repealed as of the effective date of the Decision on Bilateral and Multilateral Surveillance.

3. The Decision on Bilateral and Multilateral Surveillance will apply to all Article IV consultations that have not been completed by the Fund before the effective date of the Decision.

ATTACHMENT I.
INTERNATIONAL MONETARY FUND
Bilateral and Multilateral Surveillance
Executive Board Decision—[ ]

Preamble

Since the adoption in 2007 of the Decision entitled "Bilateral Surveillance over Members' Policies" (the "2007 Decision"), there have been significant developments in the global economy that have highlighted the extent of trade and financial interconnections and integration and the potential benefits and risks of spillovers across national borders. In light of these developments and in recognition of the increasingly important international dimensions of surveillance and of cross-country spillovers, the Fund is of the view that better integrating bilateral and multilateral surveillance, including through the adoption of an integrated surveillance decision covering both activities, would play an important role in providing guidance to both the Fund and its members regarding their mutual responsibilities under Article IV. The Fund emphasizes that the guidance being provided to members in this Decision relates to the performance of their existing obligations under Article IV; no new obligations are created for members by this Decision. Moreover, the Fund recognizes that members have legitimate policy objectives that are beyond the scope of Article IV and, accordingly, beyond the scope of this Decision, although when adopting policies to achieve these objectives, members need to ensure that such policies are consistent with their obligations under Article IV. They are also encouraged to be mindful of the impact of such policies on the international monetary system.

Part I of this Decision is designed to give guidance to the Fund in its conduct of bilateral and multilateral surveillance. This Decision does not, and cannot be construed or used to, expand or broaden the scope—or change the nature—of members' obligations under the Articles of Agreement, directly or indirectly. The principles for the guidance of members set forth in this Decision regarding their exchange rate and domestic economic and financial policies respect the domestic social and political policies of members and will be applied in a manner that pays due regard to the circumstances of members, and the need for evenhandedness in the practice of surveillance. Finally, looking forward, flexibility will be maintained to allow for the continued evolution of surveillance.

1. This Decision provides guidance to the Fund in:

   (a) its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), including the Fund's exercise of firm surveillance over the exchange rate policies of members, (hereinafter referred to as "bilateral surveillance"); and,

   (b) the exercise of its responsibility to oversee the international monetary system in order to ensure its effective operation pursuant to Article IV, Section 3 (a) (hereinafter referred to as "multilateral" surveillance).

This Decision also provides guidance to members in the conduct of their domestic economic and financial policies and their exchange rate policies.

2. Part I of this Decision sets out the scope and modalities of bilateral and multilateral surveillance. Part II establishes principles for the guidance of members in the conduct of their exchange rate policies and their domestic economic and financial policies for the purposes of ensuring compliance with their obligations under Article IV, Section 1; it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Beyond members' obligations under Article IV, Section 1, Part II also encourages members to consider the effects of their policies on the effective operation of the international monetary system. Part III sets out procedures for surveillance. Part IV makes provision for a review of this decision.

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

PART I - PRINCIPLES FOR THE GUIDANCE OF THE FUND IN ITS SURVEILLANCE

A. The Scope of Surveillance

4. Article IV, Section 3 requires the Fund to conduct both bilateral and multilateral surveillance. While these responsibilities are legally distinct, it is recognized that bilateral and multilateral surveillance are mutually supportive and reinforcing and, accordingly, need to be operationally integrated.

(i) Bilateral surveillance

5. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most effectively achieved by each member adopting policies that promote its own balance of payments stability and domestic stability—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, Section 1, (i) through (iv). "Balance of payments stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph 8 below, balance of payments stability is assessed at the level of each member.

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

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

8. This Decision applies to members of currency unions, subject to the following considerations. Members of currency unions remain subject to all of their obligations under Article IV, Section 1 and, accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. In its surveillance over the policies of members of a currency union, the Fund will assess whether relevant policies implemented at the level of the currency union (including exchange rate and monetary policies) and at the level of members are promoting the balance of payments and domestic stability of the union and will advise on policy adjustments necessary for this purpose. In particular, the Fund will assess whether the exchange rate policies of the union are promoting its balance of payments stability, and whether domestic policies implemented at the level of the union are promoting the domestic, and thereby balance of payments, stability of the union. Because, in a currency union, exchange rate policies are implemented at the level of the union, the principles for the guidance of members' exchange rate policies and the associated indicators set out in paragraph 21 of this Decision only apply at the level of the currency union. With respect to

the conduct of domestic policies implemented at the level of individual members, the Fund will assess whether a member of a currency union is promoting its own domestic stability and will consider the member to be promoting the balance of payments and domestic stability of the union when it is promoting its own domestic stability. In view of the importance of individual members' balances of payments for the domestic stability of the member and the balance of payments and domestic stability of the union, the Fund's assessment of the policies of a member of a currency union will always include an evaluation of developments in the member's own balance of payments.

(ii) Multilateral Surveillance

9. The scope of multilateral surveillance is determined by the obligation of the Fund under Article IV Section 3 (a) to oversee the international monetary system in order to ensure its effective operation. The international monetary system comprises: (a) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (b) the rules governing the making of payments and transfers for current international transactions between countries; (c) the rules governing the regulation of international capital movements; and (d) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements.

10. The international monetary system is considered to be operating effectively when the areas its four elements govern do not exhibit symptoms of malfunction such as persistent significant current account imbalances, an unstable system of exchange rates including foreign exchange rate misalignment, volatile capital flows, or the excessive build up or depletion of reserves. It is recognized that, typically, the international monetary system may only operate effectively in an environment of global economic and financial stability, and that its effective operation contributes to such stability. Both global economic and financial stability and the effective operation of the international monetary system may be affected by, among other factors, members' own balance of payments and domestic stability, economic and financial interconnections among members' economies and potential spillovers from members' economic and financial policies through balance of payments and other channels.

11. Therefore, in its multilateral surveillance, the Fund will focus on issues that may affect the effective operation of the international monetary system, including (a) global economic and financial developments and the outlook for the global economy, including risks to global economic and financial stability, and (b) the spillovers arising from policies of individual members that may significantly influence the effective operation of the international monetary system, for example by undermining global economic and financial stability. The policies of members that may be relevant for this purpose include exchange rate, monetary, fiscal, and financial sector policies and policies respecting capital flows.

12. In the context of multilateral surveillance, the Fund may not and will not require a member to change its policies in the interests of the effective operation of the international monetary system. It may, however, discuss the impact of members' policies on the effective operation of the international monetary system and may suggest alternative policies that, while promoting the member's own stability, better promote the effective operation of the international monetary system.

B. The Modalities of Surveillance

13. The Fund's assessment of an individual member's policies and its advice to a member in the context of surveillance will be conducted in a manner that is consistent with the following modalities. Except where they are expressly limited in their application to bilateral surveillance, these modalities shall apply to policy discussions between the Fund and individual members whether they take place in the context of bilateral or multilateral surveillance.

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

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

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

17. The Fund's assessment of a member's policies and its advice to a member will, to the extent possible, be placed in the context of an examination of the member's medium-term

objectives and the planned conduct of policies, including possible responses to the most relevant contingencies.

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

PART II - PRINCIPLES FOR THE GUIDANCE OF MEMBERS' POLICIES

19. It is recognized that a member's overall mix of economic and financial policies, including both exchange rate and domestic policies, contributes to the members' balance of payments stability and may impact the stability of the international monetary system. Set out below are (i) principles that are adopted for the purposes of bilateral surveillance and that provide guidance to members in the conduct of their exchange rate policies and their domestic economic and financial policies; and (ii) guidance that is adopted for the purpose of multilateral surveillance and that provides encouragement to members in the conduct of economic and financial policies with a view to ensuring the effective operation of the international monetary system.

(i) Bilateral surveillance

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

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

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

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

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

D. A member should avoid exchange rate policies that result in balance of payments instability.

E. A member should seek to avoid domestic economic and financial policies that give rise to domestic instability.

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

- (i) protracted large-scale intervention in one direction in the exchange market;
- (ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;
- (v) fundamental exchange rate misalignment;
- (vi) large and prolonged current account deficits or surpluses; and
- (vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

(ii) Multilateral surveillance

23. Beyond members' obligations under Article IV Section 1, and recognizing that a member's policies may have a significant impact on other members and on global economic and financial stability, members are encouraged to implement external and domestic economic and financial policies that, in themselves or in combination with the policies of other members, are conducive to the effective operation of the international monetary system.

PART III - PROCEDURES FOR SURVEILLANCE

24. In conducting surveillance, the Fund will make use of various procedures and will adapt these to changing circumstances. As described below, Article IV consultations with members serve as vehicles for both bilateral and multilateral surveillance, except for ad hoc consultations which are a vehicle for bilateral surveillance. Other procedures serve as vehicles for multilateral surveillance.

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

A. Article IV Consultations

26. Members shall consult with the Fund regularly under Article IV to enable the Fund to (i) assess members' compliance with their obligations under Article IV, Section 1 and, in particular, to exercise firm surveillance over the conduct of their exchange rate policies, and (ii) discuss with members the impact of their policies on the operation of the international monetary system. 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 and guidance set forth in paragraphs 21 and 23 of this Decision as well as of a member's obligations under Article IV, Section 1. In addition, they shall include a discussion of the spillover effects of a member's exchange rate and domestic economic and financial policies that may significantly influence the effective operation of the international monetary system, for example by undermining global economic and financial stability.

27. It is expected that no later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board will reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Trust established by Decision No. 8759- (87/176), ESAF, as amended, where it is expected that the Executive Board will reach conclusions no later than three months from the termination of discussions between the member and the staff.

B. Bilateral Surveillance – Ad hoc Article IV Consultations

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

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

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

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

C. Other Multilateral Surveillance Activities

(i) Periodic Reports on the International Monetary System

30. The Fund will assess all issues relevant for the effective operation of the international monetary system, as described in paragraph 11 of this Decision. These assessments may take the form of periodic or ad hoc reports produced by staff for discussion by the Executive Board. In particular, broad developments in exchange rates will be reviewed periodically by the Fund, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct consultations in preparing for these discussions. In order to inform the Fund's oversight of the operation of the international monetary system, the Managing Director may collaborate with other international bodies in conducting assessments of relevant issues.

(ii) Multilateral Consultations

31. Whenever the Managing Director considers that an issue has arisen in a policy area or a member country that may affect the effective operation of the international monetary system, and that requires collaboration among members that is not already effectively taking

place in another forum in which the Fund is a party, the Executive Board may decide, upon the Managing Director's recommendation that a multilateral consultation will be held. Members shall consult with the Fund in a manner that is consistent with the decision of the Executive Board.

32. A multilateral consultation will consist of discussions between Fund staff and management and officials of relevant member countries. The Fund will facilitate discussions among participating members and encourage them to agree on policy adjustments that will promote the effective operation of the international monetary system. In these discussions, the Fund will provide analysis and propose policy options that participating members may adopt, and may advise on the effect of different combinations of policy adjustments.

33. After the conclusion of these discussions, the Managing Director will report to the Executive Board on the discussions, any agreed policy adjustments and their impact on the participating members and the operation of the international monetary system. The Executive Board will conclude the multilateral consultation with the formal consideration of this report.

PART IV - REVIEW

34. It is expected that the Fund will review this Decision and its general implementation at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

ANNEX

Article IV, Section 1(iii) and Principle A

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

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

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

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

ATTACHMENT II.
DRAFT INTEGRATED SURVEILLANCE DECISION
REDLINE VERSION AGAINST THE 2007 DECISION

INTERNATIONAL MONETARY FUND
Bilateral and Multilateral Surveillance
~~over Members' Policies~~

Executive Board Decision ~~June 15, 2007 [as subsequently amended]~~ [ ]

Preamble

Since the adoption in ~~1977~~2007 of the Decision entitled "Bilateral Surveillance over ~~Exchange Rate~~Members' Policies" (the "~~1977~~2007 Decision"), there have been significant developments in the global economy~~, characterized by growing~~ that have highlighted the extent of trade and financial interconnections and integration and the potential benefits and risks of spillovers across national borders. In light of these developments and in recognition of the increasingly important international dimensions of surveillance and of cross-country spillovers, the Fund is of the view that~~, by incorporating existing best practice in the area of surveillance, an update of the 1977 Decision~~ better integrating bilateral and multilateral surveillance, including through the adoption of an integrated surveillance decision covering both activities, would play an important role in providing guidance to both the Fund and its members regarding their mutual responsibilities under Article IV. The Fund emphasizes that the guidance being provided to members in this Decision relates to the performance of their existing obligations under Article IV; no new obligations are created for members by this Decision. Moreover, the Fund recognizes that members have legitimate policy objectives that are beyond the scope of Article IV and, accordingly, beyond the scope of this Decision, although when adopting policies to achieve these objectives, members need to ensure that such policies are consistent with their obligations under Article IV. They are also encouraged to be mindful of the impact of such policies on the international monetary system.

Part I of this Decision is designed to give guidance to the Fund in its ~~exercise of~~ conduct of bilateral and multilateral surveillance~~; Part I of this~~. This Decision does not, and cannot be construed or used to, expand or broaden the scope—or change the nature—of members' obligations under the Articles of Agreement, directly or indirectly. The principles for the guidance of members set forth in this Decision regarding their exchange rate and domestic economic and financial policies respect the domestic social and political policies of members and will be applied in a manner that pays due regard to the circumstances of members, and the need for evenhandedness in the practice of surveillance. Finally, looking forward, flexibility ~~should~~will be maintained to allow for the continued evolution of surveillance.

1. This Decision provides guidance to the Fund in:

(a) its oversight over members' policies pursuant to Article IV, Sections 3 (a) and (b), ~~and guidance to members in~~including the ~~conduct~~Fund's exercise of ~~their~~ firm surveillance over the exchange rate policies ~~pursuant to Article IV, Section 3 (b). It does not deal directly with the Fund's~~of members, (hereinafter referred to as "bilateral surveillance"); and,

~~(a)~~(b) the exercise of its responsibility to oversee the international monetary system in order to ensure its effective operation~~, referred~~ pursuant to ~~in~~ Article IV, Section 3 (a~~).~~) (hereinafter referred to as "multilateral" surveillance).

This Decision also provides guidance to members in the conduct of their domestic economic and financial policies and their exchange rate policies.

~~1.~~ 2. Part I of this Decision sets out the scope and modalities of ~~the Fund's oversight of members' obligations under Article IV, Section 1, including the Fund's exercise of firm~~bilateral and multilateral surveillance ~~over the exchange rate policies of members (such oversight of members' obligations is hereinafter referred to as "bilateral surveillance").~~ Part II establishes principles for the guidance of members in the conduct of their exchange rate policies ~~as required~~and their domestic economic and financial policies for the purposes of ensuring compliance with their obligations under Article IV, Section ~~3 (b);~~ 1; it also identifies certain developments which, in the Fund's assessment of a member's observance of the principles, would require thorough review and might indicate the need for discussion with the member. Beyond members' obligations under Article IV, Section 1, Part II also encourages members to consider the effects of their policies on the effective operation of the international monetary system. Part III sets out procedures for surveillance. Part IV makes provision for a review of this decision.

~~2.~~ 3. Fund surveillance over members' policies and over the international monetary system shall be adapted to the needs of the international monetary and financial system as they develop. The principles and procedures set out in this Decision, which apply to all members irrespective of their exchange arrangements and balance of payments positions, are not necessarily comprehensive and are subject to reconsideration by the Fund in the light of experience.

PART I - PRINCIPLES FOR THE GUIDANCE OF THE FUND IN ITS ~~BILATERAL~~ SURVEILLANCE

A. The Scope of ~~Bilateral~~ Surveillance

4. Article IV, Section 3 requires the Fund to conduct both bilateral and multilateral surveillance. While these responsibilities are legally distinct, it is recognized that bilateral and multilateral surveillance are mutually supportive and reinforcing and, accordingly, need to be operationally integrated.

(i) Bilateral surveillance

~~3.~~ 5. The scope of bilateral surveillance is determined by members' obligations under Article IV, Section 1. Members undertake under Article IV, Section 1 to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates (hereinafter "systemic stability"). Systemic stability is most effectively achieved by each member adopting policies that promote its own ~~"external~~balance of payments stability~~"~~ and domestic stability—that is, policies that are consistent with members' obligations under Article IV, Section 1 and, in particular, the specific obligations set forth in Article IV, ~~Sections~~ Section 1, (i) through (iv). ~~"External~~ "Balance of payments stability" refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements. Except as provided in paragraph ~~7~~ 8 below, ~~external~~balance of payments stability is assessed at the level of each member.

~~4.~~ 6. In its bilateral surveillance, the Fund will focus on those policies of members that can significantly influence present or prospective ~~external~~balance of payments and domestic stability. The Fund will assess whether ~~these~~ exchange rate policies are promoting ~~external~~balance of payments stability and whether domestic economic and financial policies are promoting domestic stability and advise the member on policy adjustments necessary for ~~this purpose~~these purposes. Accordingly, exchange rate policies will always be the subject of the Fund's bilateral surveillance with respect to each member, as will monetary, fiscal, and financial sector policies (both their macroeconomic aspects and macroeconomically relevant structural aspects). Other policies will be examined in the context of surveillance only to the extent that they significantly influence present or prospective ~~external~~balance of payments or domestic stability.

~~5.~~ 7. In the conduct of their domestic economic and financial policies, members are considered by the Fund to be promoting ~~external~~balance of payments stability when they are promoting domestic stability—that is, when they (i) endeavor to direct their domestic economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to their circumstances, and (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. It is recognized that there may be circumstances where a member's domestic instability may give rise to systemic instability even in the absence of balance of payments instability. The Fund in its surveillance will assess whether a member's domestic policies are directed toward the promotion of domestic stability. While the Fund will always examine whether a member's domestic policies are directed toward keeping the member's economy operating broadly at capacity, the Fund will examine whether domestic policies are directed toward fostering a high rate of potential growth only in those cases where such high potential growth significantly influences prospects for domestic, and thereby ~~external~~balance of payments, stability. However, the Fund will not require a member that is complying with Article IV,

Sections 1(i) and (ii) to change its domestic policies in the interests of ~~external~~balance of payments stability.

~~6.~~ 8. This Decision applies to members of currency unions, subject to the following considerations. Members of currency unions remain subject to all of their obligations under Article IV, Section 1 and, accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf. In its surveillance over the policies of members of a currency union, the Fund will assess whether relevant policies implemented at the level of the currency union (including exchange rate and monetary policies) and at the level of members are promoting the ~~external~~balance of payments and domestic stability of the union and will advise on policy adjustments necessary for this purpose. In particular, the Fund will assess whether the exchange rate policies of the union are promoting its ~~external~~balance of payments stability, and whether domestic policies implemented at the level of the union are promoting the domestic, and thereby ~~external~~balance of payments, stability of the union. Because, in a currency union, exchange rate policies are implemented at the level of the union, the principles for the guidance of members' exchange rate policies and the associated indicators set out in paragraph ~~15~~ 21 of this Decision only apply at the level of the currency union. With respect to the conduct of domestic policies implemented at the level of individual members, the Fund will assess whether a member of a currency union is ~~considered by the Fund~~ promoting its own domestic stability and will consider the member to be promoting the ~~external~~balance of payments and domestic stability of the union when it is promoting its own domestic stability. In view of the importance of individual members' balance of payments for the domestic stability of the member and the ~~external~~balance of payments and domestic stability of the union, the Fund's assessment of the policies of a member of a currency union will always include an evaluation of developments in the member's own balance of payments.

(ii) Multilateral Surveillance

9. The scope of multilateral surveillance is determined by the obligation of the Fund under Article IV Section 3 (a) to oversee the international monetary system in order to ensure its effective operation. The international monetary system comprises: (a) the rules governing exchange arrangements between countries and the rates at which foreign exchange is purchased and sold; (b) the rules governing the making of payments and transfers for current international transactions between countries; (c) the rules governing the regulation of international capital movements; and (d) the arrangements under which international reserves are held, including official arrangements through which countries have access to liquidity through purchases from the Fund or under official currency swap arrangements.

10. The international monetary system is considered to be operating effectively when the areas its four elements govern do not exhibit symptoms of malfunction such as persistent significant current account imbalances, an unstable system of exchange rates including foreign exchange rate misalignment, volatile capital flows, or the excessive build up or

depletion of reserves. It is recognized that, typically, the international monetary system may only operate effectively in an environment of global economic and financial stability, and that its effective operation contributes to such stability. Both global economic and financial stability and the effective operation of the international monetary system may be affected by, among other factors, members' own balance of payments and domestic stability, economic and financial interconnections among members' economies and potential spillovers from members' economic and financial policies through balance of payments and other channels.

11. Therefore, in its multilateral surveillance, the Fund will focus on issues that may affect the effective operation of the international monetary system, including (a) global economic and financial developments and the outlook for the global economy, including risks to global economic and financial stability, and (b) the spillovers arising from policies of individual members that may significantly influence the effective operation of the international monetary system, for example by undermining global economic and financial stability. The policies of members that may be relevant for this purpose include exchange rate, monetary, fiscal, and financial sector policies and policies respecting capital flows.

12. In the context of multilateral surveillance, the Fund may not and will not require a member to change its policies in the interests of the effective operation of the international monetary system. It may, however, discuss the impact of members' policies on the effective operation of the international monetary system and may suggest alternative policies that, while promoting the member's own stability, better promote the effective operation of the international monetary system.

B. The Modalities of ~~Bilateral~~ Surveillance

13. The Fund's assessment of an individual member's policies and its advice to a member in the context of surveillance will be conducted in a manner that is consistent with the following modalities. Except where they are expressly limited in their application to bilateral surveillance, these modalities shall apply to policy discussions between the Fund and individual members whether they take place in the context of bilateral or multilateral surveillance.

~~7.~~ 14. Dialogue and persuasion are key pillars of effective surveillance. The Fund, in its ~~bilateral~~ surveillance over the policies of individual members, will clearly and candidly assess relevant economic developments, prospects, and policies of the member in question, and advise on these. Such assessments ~~and advice~~, advice and discussion of alternative policies are intended to assist that member in making policy choices, and to enable other members to discuss these policy choices with that member. ~~In the context of bilateral surveillance, the~~ The Fund will foster an environment of frank and open dialogue and mutual trust with each member and will be evenhanded across members, affording similar treatment to members in similar relevant circumstances.

~~8.~~ 15. The Fund's assessment of a member's policies and its advice on these policies will pay due regard to the circumstances of the member. This assessment and advice will be formulated within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and will pay due regard to the member's implementation capacity. Moreover, in advising members on the manner in which they may promote ~~external stability~~their balance of payments and domestic stability and the effective operation of the international monetary system, the Fund shall, to the extent permitted under Article IV, take into account the member's other objectives.

~~9.~~ 16. The Fund's assessment of a member's policies and its advice ~~in~~to the ~~context of bilateral surveillance~~member will be informed by, and be consistent with, a multilateral framework that incorporates relevant aspects of the global and regional economic environment, including exchange rates, international capital market conditions, and key linkages among members. ~~The~~ In the context of bilateral surveillance, the Fund's assessment and advice will take into account the impact of a member's policies on other members to the extent that the member's policies undermine the promotion of its own ~~external~~balance of payments or domestic stability.

~~10.~~ 17. The Fund's assessment of a member's policies and its advice ~~in the context of bilateral surveillance~~to a member will, to the extent possible, be placed in the context of an examination of the member's medium-term objectives and the planned conduct of policies, including possible responses to the most relevant contingencies.

~~11.~~ 18. The Fund's assessment of a member's policies will always include an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserves, the size and composition of its other external assets and its external liabilities, and its opportunities for access to international capital markets.

PART II - PRINCIPLES FOR THE GUIDANCE OF MEMBERS' POLICIES ~~UNDER ARTICLE IV, SECTION 1~~

19. It is recognized that a member's overall mix of economic and financial policies, including both exchange rate and domestic policies, contributes to the members' balance of payments stability and may impact the stability of the international monetary system. Set out below are (i) principles that are adopted for the purposes of bilateral surveillance and that provide guidance to members in the conduct of their exchange rate policies and their domestic economic and financial policies; and (ii) guidance that is adopted for the purpose of multilateral surveillance and that provides encouragement to members in the conduct of economic and financial policies with a view to ensuring the effective operation of the international monetary system.

(i) Bilateral surveillance

~~12.~~ 20. Principles A through D below are adopted pursuant to Article IV, Section 3 (b) and are intended to provide guidance to members in the conduct of their exchange rate policies in accordance with their obligations under Article IV, Section ~~1. In accordance with Article IV, Section 3 (b), these~~ 1. Principle E is adopted pursuant to Article IV, Section 1 and is intended to provide guidance to members in the conduct of their domestic economic and financial policies. These Principles respect the domestic social and political policies of members. In applying these Principles, the Fund will pay due regard to the circumstances of members. Members are presumed to be implementing policies that are consistent with the Principles. When, in the context of surveillance, a question arises as to whether a particular member is implementing policies consistent with the Principles, the Fund will give the member the benefit of any reasonable doubt, including with respect to an assessment of fundamental exchange rate misalignment. In circumstances where the Fund has determined that a member is implementing policies that are not consistent with these Principles and is informing the member as to what policy adjustments should be made to address this situation, the Fund will take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

~~13.~~ 21. Principle A sets forth the obligation contained in Article IV, Section 1(iii); further guidance on its meaning is provided in the Annex to this Decision. Principles B through ~~D~~E constitute recommendations rather than obligations of members. A determination by the Fund that a member is not following one of these recommendations would not create a presumption that that member is in breach of its obligations under Article IV, Section 1.

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

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

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

D. A member should avoid exchange rate policies that result in ~~external~~balance of payments instability.

E. A member should seek to avoid domestic economic and financial policies that give rise to domestic instability.

~~14.~~ 22. In its surveillance of the observance by members of the Principles set forth above, the Fund shall consider the following developments as among those which would require thorough review and might indicate the need for discussion with a member:

- (i) protracted large-scale intervention in one direction in the exchange market;
- (ii) official or quasi-official borrowing that either is unsustainable or brings unduly high liquidity risks, or excessive and prolonged official or quasi-official accumulation of foreign assets, for balance of payments purposes;
- (iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments, or (b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;
- (iv) the pursuit, for balance of payments purposes, of monetary and other financial policies that provide abnormal encouragement or discouragement to capital flows;
- (v) fundamental exchange rate misalignment;
- (vi) large and prolonged current account deficits or surpluses; and
- (vii) large external sector vulnerabilities, including liquidity risks, arising from private capital flows.

(ii) Multilateral surveillance

~~15.~~ 23. Beyond members' obligations under Article IV Section 1, and recognizing that a member's policies may have a significant impact on other members and on global economic and financial stability, members are encouraged to implement external and domestic economic and financial policies that, in themselves or in combination with the policies of other members, are conducive to the effective operation of the international monetary system.

PART III - PROCEDURES FOR SURVEILLANCE

24. In conducting surveillance, the Fund will make use of various procedures and will adapt these to changing circumstances. As described below, Article IV consultations with members serve as vehicles for both bilateral and multilateral surveillance, except for ad hoc consultations which are a vehicle for bilateral surveillance. Other procedures serve as vehicles for multilateral surveillance.

~~16.~~ 25. Each country that becomes a member of the Fund after the adoption of this decision shall, within thirty days of the date of its membership, notify the Fund in appropriate detail of the exchange arrangements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member, regardless of its date of membership, shall notify the Fund promptly of any changes in its exchange arrangements.

A. Article IV Consultations

26. Members shall consult with the Fund regularly under Article IV to enable the Fund to (i) assess members' compliance with their obligations under Article IV, Section 1 and, in particular, to exercise firm surveillance over the conduct of their exchange rate policies, and

(ii) discuss with members the impact of their policies on the operation of the international monetary system. 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 and guidance set forth ~~above~~in paragraphs 21 and 23 of this Decision as well as of a member's obligations under Article IV, Section 1. In addition, they shall include a discussion of the spillover effects of a member's exchange rate and domestic economic and financial policies that may significantly influence the effective operation of the international monetary system, for example by undermining global economic and financial stability.

~~17.~~ 27. It is expected that no later than sixty-five days after the termination of discussions between the member and the staff, the Executive Board will reach conclusions and thereby complete the consultation under Article IV, except in the case of consultations with members eligible for financing under the Poverty Reduction and Growth Trust established by Decision No. 8759- (87/176), ESAF, as amended, where it is expected that the Executive Board will reach conclusions no later than three months from the termination of discussions between the member and the staff.

B. Bilateral Surveillance – Ad hoc Article IV Consultations

~~18.~~ 28. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and their policies under Article IV, Section 1, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its policies.

~~19.~~ 29. (a) Whenever the Managing Director considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the exchange rate of its currency, the Managing Director shall initiate informally and confidentially a discussion with the member. After such discussion, the Managing Director may report to the Executive Board or informally advise the Executive Directors and, if the Executive Board considers it appropriate, an ad hoc Article IV consultation between the member and the Fund shall be conducted in accordance with the procedure set out in subparagraph (b) below.

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

staff report is placed on the agenda, the Executive Board will discuss the report and will reach conclusions which will be reflected in a summing up.

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

C. Other Multilateral Surveillance Activities

(i) Periodic Reports on the International Monetary System

30. The Fund will assess all issues relevant for the effective operation of the international monetary system, as described in paragraph 11 of this Decision. These assessments may take the form of periodic or ad hoc reports produced by staff for discussion by the Executive Board. In particular, broad developments in exchange rates will be reviewed periodically by the Fund, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct consultations in preparing for these discussions. In order to inform the Fund's oversight of the operation of the international monetary system, the Managing Director may collaborate with other international bodies in conducting assessments of relevant issues.

(ii) Multilateral Consultations

31. Whenever the Managing Director considers that an issue has arisen in a policy area or a member country that may affect the effective operation of the international monetary system, and that requires collaboration among members that is not already effectively taking place in another forum in which the Fund is a party, the Executive Board may decide, upon the Managing Director's recommendation that a multilateral consultation will be held. Members shall consult with the Fund in a manner that is consistent with the decision of the Executive Board.

32. A multilateral consultation will consist of discussions between Fund staff and management and officials of relevant member countries. The Fund will facilitate discussions among participating members and encourage them to agree on policy adjustments that will promote the effective operation of the international monetary system. In these discussions, the Fund will provide analysis and propose policy options that participating members may adopt, and may advise on the effect of different combinations of policy adjustments.

33. After the conclusion of these discussions, the Managing Director will report to the Executive Board on the discussions, any agreed policy adjustments and their impact on the participating members and the operation of the international monetary system. The Executive Board will conclude the multilateral consultation with the formal consideration of this report.

PART IV - REVIEW

34. It is expected that the Fund will review this Decision and its general implementation at intervals of three years, and at such other times as consideration of such matters may be placed on the agenda of the Executive Board.

~~20. Decision No. 5392 (77/63), adopted April 29, 1977, as amended, and paragraph 3 of Decision No. 6026 (79/13), adopted January 22, 1979, as amended, are hereby repealed.~~

ANNEX

Article IV, Section 1(iii) and Principle A

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

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

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

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