



Principles and Procedures of IMF Exchange Rate Surveillance

The Legal Foundation of IMF Surveillance

1. One of the key purposes in establishing the IMF was to promote “exchange stability” through a system of pegged but adjustable exchange rates. Article IV of the IMF Articles of Agreement initially stipulated that member countries consult with the IMF before adjusting the par values of their currencies beyond certain limits. The IMF, in turn, would concur only if it was satisfied that the proposed change was necessary to correct a “fundamental disequilibrium.”

2. In formally abolishing the par value system in 1978, however, the Second Amendment of the Articles allowed each member considerable (although not unlimited) freedom in choosing its “exchange arrangement”—the overall framework that a member uses to determine the value of its currency against other currencies (e.g., a decision to peg or float its currency). A member’s principal obligation under the amended Articles became that of collaborating “with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates” (Article IV, Section 1).

3. In addition to this general obligation, members must observe four specific undertakings, two of which concern their domestic economic and financial policies, and two of which address their “exchange rate policies.”¹ The two specific obligations respecting domestic policies are of a soft nature, requiring efforts rather than the achievement of results. They require the member to “endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability,” and to “seek to promote stability by fostering orderly underlying economic and financial conditions.” In contrast, the obligations respecting exchange rate policies require the achievement of results. In particular, these provisions require members to “avoid manipulating exchange rates or the international monetary system in order to prevent

effective balance of payments adjustment or to gain an unfair competitive advantage over other members” (Article IV, Section 1).² The provisions of the amended Article IV recognize that the promotion of a “stable system of exchange rates” is most effectively achieved by members implementing appropriate exchange rate policies and domestic policies.

4. Article IV establishes obligations for the IMF as well. Under Article IV, Section 3(a), the IMF was given the responsibility to “oversee the international monetary system in order to ensure its effective operation,” and to “oversee the compliance of each member with its obligations under Section 1 of this Article.” Moreover, Article IV, Section 3(b) requires the IMF to “exercise firm surveillance over the exchange rate policies of its members.” Thus, the IMF was given the dual responsibility of exercising oversight over both the international monetary system and members’ obligations with respect to the conduct of their exchange rate and domestic economic and financial policies. Article IV also requires the IMF to “adopt specific principles for the guidance of all members with respect to” exchange rate policies. The first set of such principles was provided in the Executive Board’s 1977 Surveillance Decision, which took effect when the Second Amendment came into force.³

Guidance for the Implementation of IMF Surveillance

5. The 1977 Surveillance Decision provides guidance to members in the conduct of their exchange rate policies under Article IV, Section 1 and to the IMF in the exercise of surveillance over those policies. It states, among other things, that the “surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop” and that the “Fund’s appraisal of a member’s exchange rate policies shall be

¹The four specific obligations are examples of the general obligation to collaborate but do not exhaust its scope.

²For greater details, see “Article IV of the Fund’s Articles of Agreement—An Overview of the Legal Framework” (SM/06/216), June 2006.

³See “Surveillance over Exchange Rate Policies,” Executive Board Decision No. 5392-(77/63), April 29, 1977, as amended.

based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness." The IMF Executive Board has since elaborated on the 1977 Surveillance Decision on several occasions, including during a discussion on "Exchange Rate Regimes in an Increasingly Integrated World Economy" held in 1999. The Chair's Summing Up of the discussion stated that "the Fund should offer its own views to assist national authorities in their policy deliberations" on exchange rate policy and "seek to ensure that countries' policies and circumstances are consistent with their choice of exchange rate regime."⁴

6. A number of basic concepts may be derived from Article IV and the 1977 Surveillance Decision, which may be summarized as follows:

- First, no single exchange rate regime is best for all countries in all circumstances.
- Second, a member country may choose the exchange rate regime that it intends to apply to fulfill its obligations under Article IV, Section 1, subject to a few limitations; and the IMF generally abides by the member's regime choice.
- Third, while considering the choice of regime to be a matter for each member country, the IMF seeks to provide clear and candid advice to members on the consistency of that regime with the member's national policies and circumstances as well as with members' obligations under the Articles of Agreement.
- Fourth, analysis and policy advice on exchange rate matters should be framed in the context of the general economic situation and policy strategy of the member.

7. Providing advice on the basis of these principles necessarily requires analysis of two closely related issues: (1) exchange rate regime choice and suitability, and (2) appropriateness of exchange rate levels.⁵ This, in turn, covers the following dimensions, as recognized in recent Biennial Surveillance Reviews:

- *Regime identification.* It is essential for staff to accurately identify and describe the de facto

exchange rate regime in place in a particular country, as regime identification is a prerequisite for providing the right context for policy advice. For their part, members are required under Article IV, Section 2 to notify the IMF of their "exchange arrangements" and of any changes thereto.

- *Regime assessment.* Assessment of the (continued) suitability of the chosen regime, given policy objectives and the economic environment, on the basis of certain criteria; staff would assess regimes in all cases and would be expected to discuss the appropriateness of an exchange rate regime if there were doubts about its conduciveness to macroeconomic stability.
- *Level assessment.* Assessment of the exchange rate level, regardless of the exchange rate regime in place, including a thorough assessment of external competitiveness.
- *Consistency.* Both exchange rate regime and valuation are to be discussed in terms of consistency with other economic policies, external stability considerations, and the country's external and domestic policy goals.

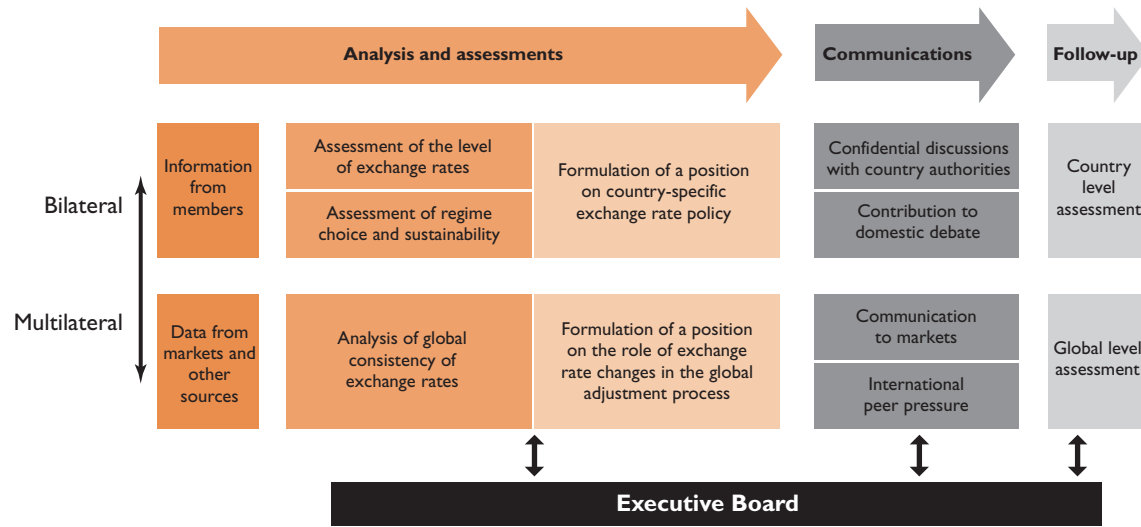
8. The Policy Development and Review Department's Surveillance Guidance Notes provide principal guidance for the practical implementation of these surveillance principles. These notes incorporate the 1977 Surveillance Decision and the results of any subsequent surveillance reviews and are intended to make them operational. The latest note was issued in May 2005 and superseded the previous guidance notes. While the first of PDR's guidance notes had emphasized the need to focus staff reports on the core area of exchange rate policies, the subsequent notes elevated the need to pay selective attention to other relevant macroeconomic and structural policies as equally important. The 2004 Biennial Surveillance Review added to previous attempts to prioritize by calling for a focus on issues at the "apex of the Fund's hierarchy of concerns," such as external sustainability, vulnerability to balance of payments crises, and international spillovers of policies in large economies. As critical steps of exchange rate surveillance, moreover, it underscored "clear identification of the de facto exchange rate regime in staff reports; more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and a through and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues."⁶

⁴Summing Up of the Board discussion on "Exchange Rate Regimes in an Increasingly Integrated World Economy," September 31, 1999; reproduced in Michael Mussa and others, *Exchange Rate Regimes in an Increasingly Integrated World Economy*, IMF Occasional Paper No. 193 (Washington: International Monetary Fund, 2000), pp. 55–58.

⁵See, for example, "Summing Up of the 2000 Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision" (SUR/00/32), which stated that "an assessment of both exchange rate level and exchange rate regime is to be made in all cases."

⁶See "Surveillance Guidance Note," May 2005; and "Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Background Information" (SM/06/227), June 2006.

Figure A1.1. The Provision of IMF Exchange Rate Policy Advice



The Process of IMF Surveillance

9. Exchange rate surveillance is conducted through various vehicles, most frequently the IMF’s regular Article IV consultation process.⁷ Surveillance is continuous. For each “cycle,” however, the process of analyzing and providing advice on members’ exchange rate policies can be represented by a stylized, multi-stage “results chain” that connects “inputs” with IMF activities and their outcomes. Figure A1.1 depicts the three main (partially overlapping) stages of this process: (1) analysis and assessments; (2) communication of policy advice (including review by the Executive Board); and (3) follow-up, including continuous monitoring between cycles. Each stage embodies bilateral and multilateral components, which are considered to be two complementary perspectives inherent in any surveillance activity.

10. At the first stage, IMF staff assess the appropriateness and sustainability of a country’s exchange rate policy (e.g., both the regime and the prevailing level), by taking into account its compatibility with the country’s overall policy environment and external

conditions. Staff also analyze the global and regional implications of policies pursued by systemically more important countries, as well as resulting implications for individual member countries. Bilateral and multilateral assessments inform each other. In this, the IMF’s dual mandate (as overseer of members’ compliance with their obligations and of the international monetary system) effectively requires consistency between the two types of assessments.

11. Once staff and management have come to a particular view, their assessment is provided to the Executive Board for its consideration under the Board’s surveillance responsibility; ultimately, the views expressed by the Board become “official” IMF views for the purposes of surveillance. A key input into these assessments, and the starting point of the surveillance process, is the provision of relevant information by national authorities—including information that is required under Article VIII, Section 5—the availability and quality of which may affect the overall effectiveness of policy advice. Another requirement is the correct identification by staff of the exchange rate regime in place, which is a prerequisite for providing the right context for accurate policy advice.

12. At the second stage, once a position on a particular issue is formed, it needs to be communicated to the relevant audience. Unless engaged in a program relationship with the respective country, the IMF relies largely on persuasion and peer pressure to influence national policies, using different channels: bilateral discussions at the staff level, review at the Board level, national and international policy debate, and—possibly—through publication of the channel of accountability via public opinion and the disciplining role of markets. To be effective, the IMF must use the most appropriate channel(s)

⁷Although the 1977 Surveillance Decision established annual Article IV consultations as the main vehicle of IMF surveillance, it also provided for special consultations on a confidential basis should the Managing Director determine that a member’s exchange rate policies might not be in accordance with the principles laid out in the decision. In addition, a 1979 decision introduced a supplementary procedure that requires the Managing Director to initiate confidential and informal discussions with a member if he “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 first procedure—special consultations—has never been applied by the IMF, while the second—supplementary consultations—has been used only twice, in the 1980s.

for a particular message, recognizing that communication with the authorities of members is the primary channel; that some information is market sensitive; and that analytical and practical difficulties in generating reliable assessments of exchange rate issues invariably lead to significant margins of error.

13. At the third and final stage, the advice given must be followed up, in view of the actual or prospective actions taken by national authorities and in light of subsequent domestic and international developments. These

assessments will feed into the next surveillance cycle and may also be reflected in other aspects of IMF operations, such as technical assistance or IMF-supported programs. To follow up on its advice for greater exchange rate flexibility, for example, the IMF may provide technical assistance on developing an appropriate institutional framework, possibly including any legal and operational aspects of implementation. Regardless of whether specific advice is given, the IMF must monitor developments continuously until the next “cycle” begins.