BACKGROUND DOCUMENT

2 Executive Board Guidance on Exchange Rate Surveillance, 1999–2005

1. Beyond Article IV itself, the 1977 Surveillance Decision, as amended, remains the foundation of modern IMF exchange rate surveillance. Over the period 1999–2005, however, the Executive Board provided additional guidance, mainly through the Summings Up of discussions of periodic reviews of surveillance and selected policy papers.

The Content of Exchange Rate Surveillance

Exchange rate regime

2. Board views cover several aspects of exchange rate regimes, including regime choice, regime classification, preferred regime, and inflation targeting.

- *Choice*. During the 2002 Biennial Surveillance Review (BSR), Directors welcomed the increased candor with which "soft" exchange rate pegs were assessed in countries with access to international capital markets. They noted, however, that exchange rate arrangements were not questioned in many other cases, and urged the staff to treat "exchange rate issues" candidly in all countries.[1]
- *Classification*. In the 1999 *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*), the IMF staff changed its regime classification from a de jure (as reported by the members) to a de facto basis. The Executive Board, however, made no call for using the *de facto* classification in Article IV consultations until 2004.[2] Directors noted that a clear and candid treatment of exchange rate issues remained a challenge, and recommended the identification of de facto regime as a first step to address this challenge.
- *Preferred regime*. During the evaluation period, the Executive Board did not fully endorse the bipolar view of exchange rate policy that management and staff seemed to express from time to time.[3] The Board, while acknowledging the challenges posed by increasing capital mobility, supported intermediate regimes as viable alternatives.[4] In the context of the 2004 BSR, Directors reiterated the idea that "no exchange rate regime is appropriate for all countries or for all circumstances" and stressed that discussion of exchange rate issues should permit consideration of a variety of options and take full account of country-specific circumstances.
- *Inflation targeting*. The Board has not fully endorsed the merits of greater exchange rate flexibility with inflation targeting—a monetary policy regime that management and staff has pursued in more recent years.[5] In discussing the paper "Inflation Targeting and the IMF," the Board as recently as 2006 noted that a number of preconditions remained important for success; many Directors,

[1]Summing Up by the Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 02/37 (April 10, 2002).

[2]This de facto classification was introduced in the 1999 Review of Exchange Arrangements, Restrictions and Current Account Regulations. A recent MCM report proposed refinements to the methodology and broader use within the IMF. The report was discussed in an Executive Board seminar. See "Review of Exchange Arrangements, Restrictions and Markets" (SM/06/358), October 2006.

[3]For example, the First Deputy Managing Director, addressing the 2001 American Economic Association Meetings, noted a secular trend toward polar regimes among developed and emerging market economies and attributed this to the fact that "soft peg systems have not proved viable over any lengthy period, especially for countries integrated or integrating into the international capital markets." See Distinguished Lecture on Economics in Government, American Economic Association and the Society of Government Economists, New Orleans, January 6, 2001 (available via the Internet: www.imf.org/external/np/speeches/2001/010601a.htm).

[4]Such a view was expressed, for example, in a 2003 informal seminar in which the Board discussed a paper prepared by the IMF's Research Department. The seminar paper, based on a de facto classification called "Natural Classification," showed that polarization was not as clear as had been thought and that intermediate regimes remained prevalent.

[5]See, for example, A. Singh and M. Cerisola, "Sustaining Latin America's Resurgence: Some Historical Perspectives," IMF Working Paper No. 06/252 (Washington: International Monetary Fund).

moreover, stated that "adoption of inflation targeting should not be seen as a macroeconomic panacea" and that inflation targeting may not be appropriate in all cases.[6]

Exchange rate level

3. The views of the Executive Board on exchange rate level refer both to the need for level assessment and to the CGER methodology used by the staff for such assessment.

- *Assessing the level.* In discussing the 2000 BSR, most Directors "stressed that an assessment of . . . the exchange rate level is to be made in all cases," while recognizing the risk that explicit judgments in staff reports on the exchange rate level could exert an undue and disruptive influence on markets.[7] During the 2004 BSR, the Board called for the use of a broad range of indicators and other analytical tools to assess external competitiveness.[8]
- *Methodology.* In the discussion of a methodological note[9] produced by the Consultative Group on Exchange Rate Issues (CGER) in 2001, the Board welcomed the improvement made since 1997 and its prospective extension to emerging markets. While noting the contribution of the CGER methodology as a tool of ensuring global and temporal consistency, however, it recognized the dominant role of subjective judgment and therefore called for a judicious use of equilibrium exchange rate estimates in Article IV consultations.[10] Directors also stressed that further work was needed before CGER assessments could be used consistently in emerging markets.

Spillover issues—intervention and exchange rate manipulation

4. The Executive Board increasingly stressed the need to pay attention to global and regional spillovers, but gave little guidance on issues related to official foreign exchange market intervention during this period.

- *Global and regional issues.* Though not specific to exchange rate issues, the Executive Board on several occasions called for greater attention to cross-country issues and policy interdependence. During the 2002 BSR, for example, many Directors stressed that "the spillover effects of policy changes in systemically important countries on other economies need to be more carefully explored." The discussion of the 2004 BSR called for fuller treatment of the global impact of domestic policies in the largest members.
- *Intervention and exchange rate manipulation.* Both the Articles of Agreement and the 1977 Surveillance Decision contain a specific provision prohibiting members from manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.[11] It is not easy to make a case for exchange rate manipulation because it would require the IMF to establish the intent of a particular exchange rate practice. The Board, however, has not made use of the procedures to discuss such issues—special and supplementary consultations—that could have been used during this period.[12]

Financial stability

5. Financial stability issues assumed greater importance during the period, with balance sheet analysis becoming part of the toolkit of IMF surveillance. During the 2000 BSR, Directors noted that "all issues related to external sustainability and vulnerability to balance of payments or currency crises will continue to be at the apex of this [surveillance] hierarchy." During the 2004 BSR, Directors stressed that the "current strategy to improve vulnerability assessments and balance sheet analysis is having a positive impact, and urged staff to continue refining the analytical techniques, while recognizing data constraints."[13]

[6]The Acting Chair's Concluding Remarks, Inflation Targeting and the IMF, Executive Board Seminar 06/1 (February 17, 2006).

[7]Summing Up by the Acting Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 00/24 (March 21, 2000).

[8]Summing Up by the Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 04/72 (August 2, 2004).

[9]See "Concluding Remarks by the Acting Chairman: Methodology for Current Account and Exchange Rate Assessments," BUFF/01/89, June 19, 2001.

[10]A similar view was expressed during an informal Board seminar on "Methodology for CGER Exchange Rate Assessments" (SM/06/283), held on September 8, 2006.

[11]Article IV, Section 1(iii) states: "each member shall . . . avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." To help identify such practice, a set of indicators was suggested by the 1977 Decision, including "protracted large-scale intervention in one direction in the exchange market."

[12]For details, see Background Document 1.

[13]During an informal Board seminar on "The Balance Sheet Approach and Its Applications at the Fund" (SM/03/227) held in July 2003, Directors welcomed the approach and its increasing use at the IMF but did not reach consensus on country coverage. While some Directors stated that the analysis should be confined to emerging markets, other Directors saw merit in extending the methodology to industrial countries.

The Process of Surveillance

The locus of surveillance

6. Despite the fact that the Executive Board is the main locus of surveillance, market sensitivity and other confidentiality concerns may dictate that the Board is kept out of some issues that are being discussed between staff/management and national authorities. This issue was raised during the 2000 BSR, when some Directors suggested that the staff should explore using an alternative mechanism (such as oral presentation) to communicate their views to the Board when an explicit statement in a staff report could lead to market instability. In subsequent Board discussions, the concerns of Directors have focused more narrowly on point estimates of equilibrium exchange rates or the size of currency misalignment. Directors have also expressed concern about the de facto classification of exchange rate regimes in some cases.

Transparency policy

7. Although Board advice on transparency became increasingly detailed during 1999–2005, some tension between transparency and candor persisted. During the 2005 Review of the IMF's Transparency Policy, most Directors were satisfied with the finding that an increased rate of publication of Board documents had not led to a significant erosion of candor,[14] but other Directors interpreted the finding as "distinct evidence of a loss of candor associated with the current publication policy." Although the majority of the Directors agreed with staff recommendations for improving the timeliness of publication, preserving candor, and reducing implementation costs, other Directors were concerned that some of the proposed changes could undermine the efforts to increase the publication rate or that strict enforcement of the publication guidelines could affect the balance between candor and greater openness or else compromise the quality of staff reports.

8. The policy on deletions in Board documents remained broadly unchanged during the period. The deletions policy, however, was occasionally challenged by some Directors, particularly regarding politically sensitive material (which is not contemplated in the policy). During the 2003 Review of Transparency Policy, many Directors favored the extension of the deletions policy to politically sensitive material but the Board did not approve the move; the majority of Directors pointed to the difficulty of designing an objective test of what is "highly politically sensitive" and to the risk of undermining the candor and comprehensiveness of Board documents. During the 2005 Review of Transparency Policy, some Directors considered that the deletion of politically sensitive issues that fall outside the current policy would "help better reconcile the objectives of candor and transparency"—although no amendment to the policy was made.[15]

Policy dialogue and outreach

9. Though not specific to exchange rate issues, Directors stressed during the 2004 BSR the importance of a close and frank policy dialogue between the IMF and its members, and encouraged countries to prepare policy statements (which would be an input to policy discussions); frequent contacts outside the Article IV consultations; and greater continuity of staff assignments to promote the accumulation of country-specific knowledge. Directors also supported the staff proposal to produce a one-page note to enhance communications with senior policymakers as a complement to the Article IV mission's concluding statement. At the same time, Directors encouraged staff to develop outreach programs and enhance contacts with local think tanks.

The Provision of Data for Exchange Rate Surveillance

10. Although the Articles of Agreement (Article VIII, Section 5) remain the basis for members' obligations in furnishing data to the IMF, the Executive Board, in early 2004, approved an important decision that was designed to strengthen the effectiveness of the information reporting regime set out in Article VIII, Section 5.[16] This 2004 Board decision essentially expanded the scope of data that members are required to report under Article VIII, Section 5 and, in particular, added "any reserve assets which are pledged or otherwise encumbered as well as net derivative positions." The Board also put in place a procedural framework governing cases of noncompliance to provide the IMF with a more graduated set of responses,[17] in line with

[14]In 2003 the Executive Board agreed to move to a policy of voluntary but presumed publication for all Article IV staff reports, Article IV Public Information Notices, and other Article IV-related papers.

[15]While accepting the language proposed by staff for the definition of "high market sensitivity," the Board acknowledged that judgment must continue to be made on a case-by-case basis. Directors agreed, however, that the deletion of references to a policy that is not yet in the public domain and that the authorities of a member country intend to implement could be permitted when the premature disclosure of the operational details of the policy would undermine the ability of the authorities to implement it.

[16]Executive Board Decision No. 13183-04/10, January 30, 2004.

[17]The sanctions for noncompliance as stipulated in the Articles include declaration of ineligibility to borrow, suspension of voting rights and, in the event of persistent noncompliance, compulsory withdrawal.

the institution's preference for a cooperative mechanism, to strengthen transparency in the diffusion of national data by members.[18]

11. Guidelines on the provision of data, established pursuant to the Board discussions in the 2000 and 2002 BSRs, go beyond the core data specified in Article VIII, Section 5 and the 2004 Board decision. According to these guidelines, staff are expected to assess, in the context of Article IV consultations, whether the quality of the data provided by national authorities is adequate for surveillance purposes and to discuss the implications of any data deficiency for effective surveillance.[19] Further details on the requirements for staff to discuss the quality of data were provided in early 2005.[20]

[18]Another type of cooperative mechanism (in the context of dissemination of data to the public) is the Special Data Dissemination Standard (SDDS), introduced in 1996, which relies on the voluntary subscription of member countries. Upon subscription, however, a country agrees to observe the standard and its underlying principles.

[19]See "Operational Guidance Note for Staff," SM/02/292, September 2002.

[20]See "Guidance Note on Data Provision to the Fund for Surveillance Purposes," SM/05/39, January 2005.