REPORT TO CONGRESS ON IMPLEMENTATION OF THE INTERNATIONAL MONETARY FUND'S 2007 DECISION ON BILATERAL SURVEILLANCE OVER MEMBERS' POLICIES

August 2008

This report has been prepared consistent with the Explanatory Statement in the Committee Print of the House Committee on Appropriations regarding the Consolidated Appropriations Act, 2008.[1,2] The report focuses on the International Monetary Fund's (IMF) implementation of the June 2007 *Decision on Bilateral Surveillance over Members' Policies*. The report provides progress to date in the IMF's implementation of the revised policy. Further updates, including on selected country cases, will be provided in forthcoming submissions of the *Semiannual Report on International Economic and Exchange Rate Policies*.

Summary Points

- The IMF was founded against the backdrop of the beggar-thy-neighbor competitive exchange rate practices of the 1930s with a mandate to promote a strong and cooperative international monetary system and exercise firm surveillance over members' exchange rate policies.

- IMF staff has consistently demonstrated a high level of expertise and technical proficiency in analyzing countries' fiscal, monetary, and financial sector policies. This work has been critical in helping the international community address many challenges, such as the 1980s debt crises, the transition of former Soviet economies, and emerging market financial crises.

- The IMF's focus on exchange rate policy analysis, however, had not received the priority it merited. Exchange rate analysis is inherently complex. Given the IMF's cooperative character, some members have been concerned about stigmatizing countries by identifying harmful exchange rate policies. Statements about exchange rates can also be market-sensitive, and reports on policy discussions to the Board and to the public have often been seen as inconsistent with the Fund's role as a confidential and trusted advisor.

- As a result of these and other factors (discussed below), it is the view of the U.S. Treasury Department that the IMF had historically fallen short in exercising firm surveillance over members' exchange rate policies, and ultimately in fulfilling certain of its basic responsibilities to the international monetary system.

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[1] This report was prepared by staff of the Bureau of International Affairs at the U.S. Department of the Treasury. The principal drafter was Lisa Ortiz. The report benefits from comments from Robert Kaproth, Clay Berry, Patricia Pollard, and Mark Sobel.

[2] Title V, Division J of the Explanatory Statement of the Committee Print of the House Committee on Appropriations on H.R. 2764 (Consolidated Appropriations Act, 2008, P.L. 110-161) states:

> The Secretary of the Treasury is directed to report to the Appropriations Committees not later than 120 days after enactment of this Act on the following: the implementation of the IMF Decision on Bilateral Surveillance Over Members Policies, announced on June 15, 2007, which establishes a new system for IMF bilateral surveillance on exchange rate policies of member countries; and which member countries are in violation of the Decision including those that are manipulating exchange rates for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate with the purpose to increase net exports.

- In order to demonstrate that surveillance over exchange rate policies would be restored to the heart of the Fund's systemic responsibilities, the IMF Executive Board, with the strong support of the United States, adopted a revised decision on foreign exchange surveillance in June 2007.

- The new decision stressed that bilateral surveillance should focus on whether a country's policies promote "external stability".[3] It added a new principle, "Principle D", which states that member countries should avoid exchange rate policies that result in external instability. It further defined for the first time the concept of "manipulation", modernized the "triggers" for increased IMF attention to a country's exchange rate policies, and included "fundamental misalignment" as a key trigger.[4]

- One year after its adoption, the implementation of the new decision can be viewed as mixed. On the positive side, exchange rate analysis has now returned to the core of the IMF's daily work. Article IV papers generally focus on exchange rate matters in greater detail, and there has been progress on making assessments of exchange rate levels, consistent with a country's economic fundamentals. IMF Board discussions delve to a much greater extent into exchange rate issues.

- However, while the quality of exchange rate assessments is improving, it does not yet uniformly meet a standard of excellence. Furthermore, the IMF management, staff, and Executive Board have not tackled potentially harmful exchange rate practices and shied away from the necessary and essential task of making judgments about "fundamental misalignment", especially in several key cases. While the consensus-based nature of the IMF is critical for its cooperative character, when the Fund's powers of persuasion have not resulted in meaningful change after a prolonged period, it is especially imperative that the Fund speak out forcefully and publicly about harmful country exchange rate practices.

- Recently, Managing Director Strauss-Kahn informed the Board of Directors that he intends to initiate a process of "ad hoc consultations" in cases where he has significant concerns a member may not be observing a Principle for the Guidance of Members' Exchange Rate Policies, or when an exchange rate may be fundamentally misaligned. The "ad hoc consultation" process will be a useful and welcome tool if IMF management, staff, and the Executive Board are prepared to work intensively with particular countries to apply the new Decision in a vigorous and forceful manner.

- For the IMF to retain its central role in the international financial system, it must strengthen its efforts to exercise clear surveillance over IMF members' exchange rate policies and it must not shy away from the job of making tough judgments, especially when these policies are undertaken by large countries and have systemic implications. The IMF should also be fully transparent about the steps it is taking to bring about needed changes.

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[3] External stability, and other relevant topics, are defined in the IMF Guidance on Operational Aspects of the 2007 Surveillance Decision, available at http://www.imf.org/external/pp/longres.aspx?id=4276. Broadly, external stability is defined as a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements.

[4] See Appendix A for an explanation of Principles A, B, and C.

<u>The IMF's Role in Surveillance</u>

The IMF was founded in 1944 against the backdrop of the destructive mercantilist economic policies of the 1930s, including highly protectionist trade policies and beggar-thy-neighbor competitive exchange rate depreciations. World leaders looked to the establishment of institutions such as the IMF to prevent a return to such insular policies. Thus, the founders of the IMF envisaged it as the central institution for the international monetary system, with the mandate to promote multilateral cooperation, foster strong global growth, advance orderly exchange rate arrangements, avoid competitive exchange rate depreciation, lessen disequilibria in the international balance of payments, and enhance a multilateral system of payments. From the start, exchange rate issues were at the core of the Fund's fundamental responsibilities in the international monetary system.

Between 1944 and 1971 the global economy functioned on a dollar-gold exchange standard -- the Bretton Woods system. Under this system the majority of currencies were fixed in value to the US dollar and the dollar was fixed in value to gold. Eventually, however, the world's continual demand for dollars required that the United States run an ever shrinking current account surplus, eventually leading to deficit, in order to meet that demand, and the size of the deficit in turn became sufficiently large to weaken foreign confidence in dollar holdings, while imposing significant costs on the United States. U.S. economic policies in the 1960s aggravated these trends. In the early 1970s, the United States abandoned the Bretton Woods system and over the course of the decade, an international monetary system, increasingly based on floating rates of major economies, emerged.[5]

To continue overseeing the system, in the 1970s, the IMF overhauled its Articles of Agreement. Under the new Article IV, member countries agreed to collaborate with the IMF and with one another to promote the stability of the global system of exchange rates. In particular, IMF member countries have the right to select an exchange rate regime of their choosing but also an obligation not to manipulate their exchange rate for the purposes of preventing effective balance of payments adjustment or gaining an unfair competitive advantage in international trade. In return, the IMF is charged with overseeing the international monetary system to ensure its effective operation and monitoring each member's compliance with its policy obligations. This involves both bilateral and multilateral surveillance of exchange rates.

More specifically, obligations over **bilateral** surveillance were operationalized in the landmark 1977 Executive Board *Decision on Surveillance of Members' Exchange Rate Policies* that consisted of: (1) Principles for the Guidance of Members' Exchange Rate Policies (PGMs), (2) Principles of Fund Surveillance over Exchange Rate Policies, including indicators to be used in gauging whether members are abiding by the PGMs, and (3) Procedures for Surveillance.

In fulfillment of its responsibilities, the IMF's Executive Board conducts Article IV consultations with each member country, typically once a year, or every two years in some cases. IMF Management, or a country, may also delay the Article IV consultation for a reasonable period. During the Article IV process, an IMF staff team meets a country's economic officials at

[5] As discussed later in the report, a variety of exchange rate systems, including pure floats, pegs, crawling pegs and the use of currency boards have emerged over time. See Appendix II of the *Semiannual Report on International Economic and Exchange Rate Policies* for a more in-depth discussion of fixed and floating exchange rate arrangements http://www.treasury.gov/offices/international-affairs/economic-exchange-rates/.

the technical, senior policy, and typically the Ministerial/Central Bank Governor level. IMF staff views are then set forth in a staff report that summarizes economic developments and prospects, as well as discussions with the national authorities. The staff report is discussed by the IMF Executive Board. Publication of both the summary of the IMF Executive Board meeting and the staff paper are voluntary but presumed, though the country in question has the right to delete "market sensitive" information, and may decline to permit publication altogether.

The key instruments of the IMF's **multilateral** surveillance are two semi-annual publications produced by the Fund – the *World Economic Outlook* (WEO) and *Global Financial Stability Report (GFSR).* The former is focused on the world economy as a whole and the latter on the financial sector and capital markets.[6] In addition, broad developments in multilateral exchange rates are reviewed periodically by the Executive Board, e.g., through discussions of the WEO and the GFSR and of exchange rate and financial market developments.

Thus, bilateral and multilateral surveillance make up the two prongs of the IMF's surveillance approach. They are intended to complement each other and reinforce the Fund's ability to conduct sound and effective worldwide surveillance.

Why Was a New Foreign Exchange Surveillance Decision Needed?

In June 2007, the IMF Executive Board adopted a new *Decision on Bilateral Surveillance over Members' Policies*, replacing guidance that had been in place since 1977. Several factors made it necessary to update the 1977 decision.

Since 1977, the international monetary system has changed profoundly.

- Private capital markets have grown exponentially, and private capital supplanted official resources in meeting countries' gross external financing needs.
- The former Soviet bloc countries transitioned to market economies following the fall of the Iron Curtain.
- In 1999, a majority of European Union member countries adopted the euro as their currency.
- Outside the industrial countries, many emerging markets have put in place sound economic policies and institutions, achieving strong growth and income gains, and become increasingly integrated into the global financial system.
- The emerging market financial crises at the turn of the century resulted in many countries exiting from overvalued and pegged exchange rates, followed by a period of reserve re-accumulation.

[6] The *World Economic Outlook*, published twice a year, presents IMF staff economists' analyses of global economic developments during the near and medium term. Chapters give an overview of the world economy; consider issues affecting industrial countries, developing countries, and economies in transition; and address topics of pressing current interest. The *Global Financial Stability Report* (GFSR) was created to provide a frequent assessment of global financial markets and to address emerging market financing in a global context. Thus, it focuses on current conditions in global financial markets, highlighting issues of financial imbalances, and of a structural nature, that could pose a risk to financial market stability and sustained market access by emerging market borrowers.

- The international monetary system is characterized now by the widespread use of floating exchange rates for major economies, in contrast with their more limited use in the 1970s.

In practice, while the IMF's surveillance work on members' fiscal, monetary, and financial sector policies has been technically excellent, the same could not be said for its exchange rate surveillance. This reflects many factors.

As noted, the IMF Articles of Agreement allow members to choose their exchange rate regime and there is no one-size-fits-all regime. Regardless of the exchange rate regime, a key question is whether the underlying economic policies of a country are sustainable.[7]

Further to this point, rendering conclusions about exchange rate practices and regimes is inherently complex. The interaction between the exchange rate and domestic policies can run both ways. In a fixed exchange rate regime, the exchange rate is the central target of monetary policy. In a floating regime, the exchange rate is an outcome from other policies. Exchange rate changes can be influenced as much by developments abroad as at home. Countries' exchange rate regimes can differ depending on whether an economy is relatively closed or open to trade and financial flows, the extent of pass-through from exchange rate changes to domestic inflation, the flexibility of labor and other factor markets, the concentration of trade, and/or the sophistication, credibility, and quality of a country's institutions.

Also, imbalances can be adjusted through domestic policy measures, exchange rate adjustment, or some combination thereof.[8] There is no absolutely precise way to calculate equilibrium exchange rates (though such calculations do provide useful information, and can be utilized to form judgments in conjunction with other information such as current account positions, saving/investment patterns, reserves, and a country's reliance on external demand). Further, exiting from a peg can be a difficult and potentially destabilizing undertaking.

In conducting Article IV reviews, the IMF has often seen itself as trusted advisor to countries, and sought to use its persuasive powers and candor in helping countries make necessary policy adjustments. This has tended to limit the Fund's public discussion of exchange rate policies, including the exchange rate level consistent with equilibrium.

Against this background, over time, the IMF's bilateral surveillance work increasingly centered on a country's underlying policies. In particular, the IMF heavily analyzed countries' fiscal, monetary, and more recently, financial sector policies. This analysis was and remains fully appropriate and the Fund staff has performed it excellently, with strong technical expertise.

But, unfortunately, exchange rate analysis was increasingly given less prominence in the IMF's Article IV work. In turn, the Fund – the Management, staff, and the Executive Board – failed to meaningfully debate and render decisive opinions about exchange rate analytics, even though the exercise of firm surveillance over members' exchange rate policies lies at the very heart of the Fund's global responsibilities and the basic rationale for the founding of the IMF.

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[7] See U.S. Treasury, "Report to the Committees on Appropriations on Clarification of Statutory Provisions Addressing Currency Manipulation"; March 11, 2005.
[8] See Tim Adams, "Working with the IMF to Strengthen Exchange Rate Surveillance", February 2, 2006.

From the standpoint of the IMF's internal governance, the 1977 Decision was, in practice, no longer read by IMF staff, or countries, as offering operational guidance on exchange rate policies. For example, the 1977 Decision was silent on the dangers of an overvalued exchange rate, despite the experience with many emerging market financial crises since the mid-1990s. Similarly, the Fund had failed to engage rigorously on exchange rate matters, despite having an explicit mandate and procedures to do so. Although IMF staff work had remained current with changing economic conditions, the 1977 Decision had not been amended to account for the profound changes in the international monetary system over the last thirty years.

A major report by the IMF's Independent Evaluation Office (IEO) found, in April 2007, that the IMF was simply not as effective as it needed to be in both its analysis and advice on exchange rates, and in its dialogue with member countries.[9] In particular, it found: a lack of understanding of the role of the IMF in exchange rate surveillance; a failure by member countries to understand and commit to their obligations to exchange rate surveillance; a strong sense amongst some member countries of a lack of evenhandedness in surveillance; a failure by management and the Executive Board to provide adequate direction and incentive for high-quality analysis and advice on exchange rate issues; and the absence of an effective dialogue between the IMF and many of its members on exchange rate issues.

Apart from its analytic work, the Fund still retained a variety of important tools and approaches at its disposal that could have been used to highlight strongly undesirable exchange rate practices. In 1979, the IMF developed a "special consultation" mechanism under which the Managing Director of the IMF could consult with member countries whose exchange rate policies might not be in line with the Article IV principles. However, a fear of stigmatizing countries highly constrained its use and special consultations were only undertaken twice over three decades.[10]

Over time, it became clear that the Fund had drifted away from its core responsibility on exchange rate surveillance. Further, the Fund had failed to engage rigorously on exchange rates, despite having an explicit mandate and procedures to do so.

In this context, IMF management decided that it would be useful to completely update the 1977 Decision in order to reflect the changes that had occurred in the international monetary system and to give renewed relevance to the Decision as fundamental policy guidance for IMF staff, and for IMF members.

The New Surveillance Framework

The 2007 *Decision on Bilateral Surveillance over Members' Policies* replaced the 1977 *Decision on Surveillance over Exchange Rate Policies* as the guiding document on surveillance. The new decision was strongly backed by the U.S. Treasury Department in an effort to refocus the Fund on its core mandate and thereby help to ensure the IMF's continued value added to the international community.[11]

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[9] *IEO Report on the Evaluation of the IMF Exchange Rate Policy Advice, 1999-2005*, (SM/07/132), April 18, 2007.

[10] Special consultations were undertaken with Sweden and South Korea. Although the concept of special consultations was further refined in 1993 in order to broaden its application and promote greater use, the approach was not used.

[11] See, for example, remarks by Under Secretary for International Affairs Tim Adams at the American Enterprise Institute Seminar, *Working with the IMF to Strengthen Exchange Rate Surveillance*, February 2, 2006.

In addition to formalizing the *de facto* coverage of fiscal, monetary and financial sector policies in the conduct of bilateral surveillance, the new IMF surveillance framework reaffirmed the central role of exchange rate work in the Fund's daily life. Specifically, it stressed that bilateral surveillance should be focused on: (1) assessing whether a country's policies promote external stability; (2) what is and is not acceptable in bilateral exchange rate policies; and (3) stressing that surveillance should be a collaborative process between the Fund and its members, which takes into account country-specific circumstances and has a multilateral, medium-term perspective. More importantly, the 2007 Decision brought several specific improvements over the 1977 Decision:

- It defined for the first time the concept of "manipulation" by breaking it into two parts. Manipulation exists when there is: (a) fundamental misalignment of the exchange rate[12]; and (b) intent to manipulate the exchange rate for the purposes of gaining an unfair advantage in international trade.

- It modernized the "triggers" for increased IMF attention to a country's exchange rate policies by dividing them into "policies" and "outcomes" and by including fundamental misalignment and excessive accumulation of foreign assets as two key triggers.

- It added a new Principle D, which states that member countries should avoid exchange rate policies that result in "external instability."[13]

Indicators of Exchange Rate Misalignment

A key feature of the 2007 Decision was a clarification of relevant indicators to serve as triggers in exchange rate surveillance. Indicators are an essential component of effective exchange rate surveillance. They can provide a useful warning about potential problems and spur discussion of exchange rate issues that might otherwise go undetected. These indicators, therefore, serve a critical role by eliminating subjectivity and, hence, part of the political difficulty associated with effective exchange rate surveillance. The Decision includes seven indicators to signal when observance of the Principles should be looked at more closely.

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[12] Fundamental misalignment occurs when the real effective exchange rate (REER) deviates from its equilibrium level. Equilibrium is the level of the REER that is consistent with an underlying current account balance (the balance adjusted for temporary factors) that is in line with economic fundamentals. Fundamental misalignment may result from a country's exchange rate policies, from domestic polices that affect the exchange rate, or from market imperfections. Given the difficulty in measuring the equilibrium REER only misalignments that were significant would be considered fundamental misalignments (see the next section for more discussion). Further, as previously noted, given that misalignments cannot be precisely measured, it is important to integrate other indicators into analysis and in forming judgments.

[13] See Appendix A for an explanation of Principles A, B, and C.

Indicators

Policies

(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;

Outcomes

(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

Rendering Exchange Rate Judgments

In helping to formulate its judgments about exchange rate misalignments, the IMF has maintained a semi-annual review, known as the Consultative Group on Exchange Rates (CGER) (discussed in Annex B). CGER incorporates three different models of the equilibrium exchange rate. The models are complementary but reflect important differences that are designed to capture relevant aspects of exchange rate determination. The methodologies are publicly available.[14]

A key drawback of the CGER methodology for use in bilateral surveillance is its limited country coverage. CGER currently provides internal estimates of exchange rate misalignment for only 27 currencies. Although these countries represent the majority of global economic output, there are important gaps in country coverage. For example no major oil exporting country is included.

As noted previously, there is no precise way to identify equilibrium exchange rates and deviations from them. Equilibrium exchange rate calculations are based on models, which make various assumptions. However, equilibrium exchange rate models offer useful information, especially when various models reach generally similar conclusions in direction and magnitude, (but even when they do not). Further, as noted, when such model results are coupled with other available data, composite judgments can be reached.[15,16] In the final analysis, rendering

[14] See, "Methodology for CGER Exchange Rate Assessments," November 8, 2006. http://www.imf.org/external/np/pp/eng/2006/110806.pdf.
[15] See Ashby McCown, Patricia Pollard, John Weeks, "Equilibrium Exchange Rate Models and Misalignments:; Treasury Occasional Paper 7, March 2007; and Mark Sobel, "Symposium of the Bretton Woods Committee on China"; March 14, 2008.

judgments about exchange rates – such as a finding of "fundamental misalignment" – is inherently complex, but it is the Fund's basic responsibility to do so.

Progress in Implementation

The Fund is making progress in implementing the 2007 Decision in several areas, but considerably more needs to be done.

A key test for the IMF is to improve the quality of and focus on exchange rate analysis in bilateral surveillance through its Article IV work. On this front, the tremendous technical strengths of the Fund staff are already on exhibit.

Article IV papers focus to a much greater extent on exchange rate analysis and staff is more consistently examining exchange rate issues in its papers. Nearly all Article IV papers now include a clear assessment of whether the exchange rate level is consistent with fundamentals. There also has been a substantial increase in the number of detailed technical analyses of exchange rate issues. In addition, Board discussions now entail far greater debate about exchange rate issues. Some examples of the Fund's improved work are to be seen in the following Article IV reports, available on the IMF website:

- The 2008 reports for the Euro Area and the United States present the results of the three CGER methodologies supplemented by staff's own analysis. CGER estimates indicate an overvaluation of the real exchange rate of the euro in the range of 5 to 20 percent; the staff report indicated the overvaluation is at least 10 percent. For the United States, the CGER and staff analysis indicate that the real exchange value of the dollar is modestly overvalued. Staff also used a new analytic technique developed by economists at the Federal Reserve – based on price levels rather than relative prices – to measure the real effective exchange rate (REER).[17] This technique observes that a shift in the pattern of trade to lower-cost countries, as has been the case for the United States, will result in further real appreciation.

- Chile is an emerging market economy with an independently floating exchange rate that is included in the CGER model. Staff analysis indicates that an improvement in its terms of trade account for much of the real appreciation of the peso over the past few years, indicating that the peso is roughly in equilibrium.[18]

- Bulgaria's exchange rate is not included in CGER but staff uses similar techniques to estimate the current account norm and equilibrium REER.[19] The analysis accounts for the effects of Bulgaria's status as a transition economy and a new member of the European Union on the path of the current account. Staff found that the REER was not misaligned but noted that Bulgaria's current account deficit is not sustainable. Staff believes the deficit is a

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[16] See Treasury Semi-Annual Report on International Economic and Exchange Rate Policies, Appendix 1: Pattern of Indicators; November 2005 through June 2007.

[17] See Charles P. Thomas, Jaime Marquez, and Sean Fahle, "Measuring U.S. International Relative Prices: A Warp View of the World, Board of Governors of the Federal Reserve System: International Finance discussion Paper No. 917, January 2008.

[18] As in the U.S. Article IV report, staff includes a WARP measure of the real effective exchange rate to capture Chile's increasing trade with countries with lower price levels.

[19] A detailed analysis of the real exchange rate is in chapter 2 of the Selected Issues Paper that accompanies the staff report. <<http://www.imf.org/external/pubs/ft/scr/2008/cr0857.pdf>>

result of a temporary investment boom that will diminish over the medium-term. Staff cautioned that this scenario depends on maintaining prudent fiscal policies. Romania provides another example of detailed analysis of a similarly situated EU accession country.

- Botswana is a resource-dependent developing economy with a crawling peg exchange rate regime. Staff used several approaches to assess Botswana's REER and adapted one especially for an economy dependent on exports of non-renewable resources. Staff analysis highlights the role of the 2004 devaluation and subsequent move to a crawling peg regime in reversing the overvaluation of the REER.

- Hong Kong is a global financial center whose currency is pegged to the U.S. dollar but allowed to fluctuate within a narrow trading band. Although not included in CGER, staff adapted the CGER methodology to analyze the REER. In the macro balance and equilibrium real exchange rate approaches, staff accounted for Hong Kong's status as a financial center by only including countries in the model where the financial sector accounts for a large share of the economy. The REER was considered in line with fundamentals.

The progress being made on this front is not fully evident from a public review of IMF documentation. As noted previously, Article IV publication is voluntary but presumed. Further, the publication policy for Article IV documents allows countries to delete "market-sensitive" items from reports, and exchange rate analysis can be perceived as market-sensitive.

Despite this progress, the IMF's efforts to implement the new surveillance decision have fallen short in other key respects. First, difficult cases have been repeatedly and unnecessarily delayed for considerable periods due to debates about the meaning of the 2007 Decision. For example, the scheduled 2007 Article IV review for China has yet to be completed.

Second, the Fund has been reluctant to draw clear and crisp judgments about exchange rate issues in general when members may not be observing the Principles for the Guidance of Members' Exchange Rate Policies, even when a finding of "fundamental misalignment" might be warranted. When exchange rate practices give rise to serious questions for sustainability, and particularly when these practices are undertaken by large countries and have systemic implications, it is the Fund's job as the lynchpin of the international monetary system to shine a spotlight on the issue. While the consensus-based nature of the IMF is critical for its cooperative character, when the Fund's powers of persuasion and candor have not resulted in meaningful change after a prolonged period, it is imperative that the Fund speak out forcefully and publicly about harmful country exchange rate practices.

New Guidance on Operational Aspects to Implement the 2007 Decision

The Fund has recently reviewed the first year of experience with the new 2007 decision and in turn: a) issued guidance to help IMF staff apply many of the operational concepts in the 2007 Decision; and b) developed a new procedure for holding "ad hoc consultations" with selected members.

In practice staff has until recently largely been left on its own to determine the procedures for assessing the exchange rate. Given the wide diversity of country circumstances, questions have arisen as to how to implement the new Decision in a consistent manner across the membership. However, the Fund in August 2008 circulated new guidance for Fund staff intended to educate

staff on proper implementation of the Decision. In particular, the Guidance includes *Frequently Asked Questions* on *external stability*, *current account assessments*, *exchange rate assessments*, *fundamental misalignment*, *capital account-based external instability*, and *principles for the guidance of members' exchange rate policies*. Collectively, the guidance is intended to clarify how the Decision is to be applied by providing a common set of terminology, definitions, and approaches. The Fund has published these guidelines on its external website. [http://www.imf.org/external/pp/longres.aspx?id=4276]

In an attempt to improve the candor of discussion on exchange rate issues, Fund Management has proposed creating a process of "ad hoc consultations" in cases where *management has significant concerns that either (i) a member may not be observing a Principle for the Guidance of Members' Exchange Rate Policies or (ii) a member's exchange rate may be fundamentally misaligned, even if this misalignment does not stem from exchange rate policies (e.g., in cases where a member lets its exchange rate float completely freely).*[20] These ad hoc consultations will normally conclude within six months, may be undertaken at any time, and will provide a framework for enabling the Fund to reach final conclusions on the specific findings under the Decision and whether a country's currency is fundamentally misaligned. The Executive Board must approve an ad hoc consultation before it can be carried out. In addition, the initiation of an ad hoc consultation will be made public.

By employing ad hoc consultations, Fund management hopes to involve the Board early in the consultative process and increase the transparency of exchange rate discussions with member countries. However, given the Fund's reluctance in the past to undertake "special consultations", the challenge before the Fund now is to vigorously use the proposed new "ad hoc consultations" approach to fulfill the IMF's systemic responsibilities and to implement the full extent of the 2007 Decision. Meeting this challenge will be a critical factor in judging the Fund's efforts to modernize and reform itself and to maintain its relevance and legitimacy.

On balance, increased attention to exchange rates in Board discussions and Article IV staff reports along with an increased focus on refining the Fund's analytics, such as the CGER methodology, are all positive steps. These developments, consistent with the 2007 Decision, are helping to strengthen attention to exchange rate issues and enhance the focus of surveillance.

However, the vital task of making tough judgments and increasing candor and clarity on external stability and exchange rate issues has not yet met with the same success. In particular, this task has been impeded by the resistance of some countries fearing stigmatization, uncertainty among Fund staff about how the 2007 Decision is to be applied, and more general concerns in some instances among Management, staff and the Board about broader relationships with countries. The Fund must take further steps to overcome these impediments, succeed in accomplishing this vital task, and fulfill the mission given to it by its founders.

[20] International Monetary Fund "Guidance on Operational Aspects of the 2007 Surveillance Decision," July 11, 2008.

APPENDIX A

Components of the 1977 Decision on Bilateral Surveillance over Members' Policies

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

- A. "A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members."
- B. "A member should intervene in the exchange rate market if necessary to counter disorderly conditions, which may be characterized *inter alia* by disruptive short-term movements in the exchange value of its currency."
- C. "Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene."

Note: Principle A repeats the obligation in Article IV (Section 1.iii), while B and C provide guidance on assessing the consistency of a member's exchange rate policies with its obligations under Article IV.

***Principles of Fund Surveillance over Exchange Rate Policies*:**

- Indicators to be used in gauging whether members are abiding by the PGMs:
    - Protracted large scale intervention in one direction in the exchange market;
    - An unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi official lending, for balance of payments purposes;
    - (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;
    - The pursuit, for balance of payments purposes, of monetary and other domestic policies that provide abnormal encouragement or discouragement to capital flows;
    - Behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements; and
    - Unsustainable flows of private capital

***Procedures for Surveillance*[21]**

[21] James M. Boughton, Silent Revolution: The International Monetary Fund 1979-1989, International Monetary Fund, 2001.

- Members are required to notify the Fund of any changes in their exchange arrangements, such as changes in pegs, intervention policies, etc.
- Periodic (normally annual) consultations are to be held under the provisions of Article IV.
- The Board is to periodically review "broad developments in exchange rates," principally in the context of the *World Economic Outlook* (WEO).
- The Managing Director is to maintain close contacts with members regarding exchange arrangements and policies.
- The Managing Director may initiate special consultation discussions with members under specified conditions.

ANNEX B

CGER Exchange Rate Methodology and Assessments

The current CGER methodology is based on three distinct but complementary approaches to assessing real effective exchange rate misalignment for 27 currencies.[22] The three approaches are: Macroeconomic Balance Approach, Equilibrium Real-Exchange Rate Approach, and External Sustainability. This annex provides a brief explanation of these approaches and how they are combined to provide an overall assessment of misalignment.

Macroeconomic Balance Approach (MB)

The MB approach compares the underlying current account balance with the current account norm. The underlying current account balance is the balance that is expected to occur once cyclical factors have been eliminated. These data are calculated as part of the medium-term forecasts in the IMF's *World Economic Outlook* (WEO). The current account norm is derived from a model estimating the relationship between economic fundamentals thought to affect the current account (fiscal balance, demographics, relative economic growth, net foreign assets, oil prices, economic crises and whether the country is a regional financial center). The model incorporates data for 54 countries over a 30 year period. The estimated relationships are then applied to the medium-term values of these economic variables (from the WEO database) to derive the current account norm for each country. Any difference between the underlying current account balance and the current account norm requires an adjustment of the real effective exchange rate. The extent of the adjustment depends both on the size of the difference and the ease with which a change in the exchange rate affects the current account balance. The less responsive the current account is to the exchange rate the greater the change in the exchange rate required to eliminate any imbalance.

After the estimates of the required adjustments in each of the 27 REER's in the CGER model are made, these are compared and adjustments are made if needed to ensure multilateral consistency.

Equilibrium Real-Exchange Rate Approach (ERER)

The ERER approach compares the current REER with an estimated equilibrium real effective exchange rate. The estimated real exchange rate is based on a model examining the relationship between the real exchange rate and economic fundamentals thought to affect the real exchange rate (net foreign assets, productivity differentials, commodity terms of trade, government consumption, trade restrictions and price controls). The estimated relationships are then applied to the medium-term values of these economic variables to derive the equilibrium real exchange rate for each country. The extent of misalignment of the exchange rate is determined by the difference between the current REER and the estimated equilibrium real effective exchange rate. As in the MB approach, the estimates are adjusted to ensure multilateral consistency.

External Stability Approach (ES)

[22] The three-model approach was implemented by the IMF's Consultative Group on Exchange Rates in 2006. The methodology was also extended to cover major emerging market economies. The CGER methodology is described in detail in: Jaewoo Lee, Gian Maria Milesi-Ferretti, Jonathan Ostry, Alessandro Prati, and Luca Antonio Ricci, "Exchange Rate Assessments: CGER Methodologies," IMF Occasional Paper 261, 2008.

The ES approach determines the current account balance as a percent of GDP that would stabilize a country's net foreign asset position at some benchmark level. This estimate for the current account is compared with the medium-term current account balance as a percent of GDP (from the WEO database). Any difference in the two ratios necessitates an adjustment in the REER. As in the MB approach the extent of the adjustment depends both on the size of the difference in the current account ratios and the ease with which a change in the exchange rate affects the current account balance. Adjustments in the REERs are made to ensure multilateral consistency.

Overall Assessment of Misalignment

In many cases the three approaches provide similar answers. In cases where the results differ the overall assessment may be based on a weighted average of the three approaches. The weight given to each approach may differ across countries reflecting how well each model is thought to apply to a particular country. Given the uncertainty surrounding the estimations, results indicating only small adjustments in the REER are needed are not taken as an indication of misalignment.

Economic Areas Covered by CGER

Advanced Economies: Australia, Canada, Japan, Sweden, Switzerland, United Kingdom, United States, and Euro area. Emerging Market Economies: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Hungary, India, Indonesia, Israel, South Korea, Malaysia, Mexico, Pakistan, Poland, Russia, South Africa, Thailand, and Turkey.