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To: Members of the Executive Board

From: The Acting Secretary

Subject: The Organization and Substance of IMF Surveillance

At the meeting of the G-10 Deputies on November 17, 1983, the Fund was asked to prepare papers to serve as background material for the next meeting of the G-10 Deputies. The first such paper, describing the surveillance activities of the Fund, is now being circulated for the information of the Executive Directors before being transmitted to the G-10 Secretariat.

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INTERNATIONAL MONETARY FUND

The Organization and Substance of IMF Surveillance

Prepared by the Staff

January 5, 1984

This report describes the surveillance activities of the Fund both in the broad sense of overseeing the functioning of the international monetary system, and in the narrower sense of exercising surveillance over the exchange rate policies of its members. The report makes particular reference to issues relevant to the main industrial countries. Section I outlines the general framework within which surveillance is exercised and describes the recent evolution and current status of the Fund's work in this area, noting the need for comprehensive assessments and the diversity of channels through which surveillance activities proceed. Section II considers some of the broad policy issues that arise in the context of surveillance.

I. The Organization of IMF Surveillance

The Second Amendment to the Articles of Agreement, which entered into force on April 1, 1978, requires that the Fund "shall oversee the international monetary system in order to ensure its effective operation." 1/ Furthermore, while the Articles give Fund members the right to maintain the exchange arrangements of their choice, members are obliged to "collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates." 2/

Experience in the early years following the generalized floating of the major currencies in 1973 had clearly indicated that both policy changes and exogenous developments could exert very pronounced effects on exchange rates and payments balances, implying a high degree of interdependence both among the industrial countries themselves and between industrial countries and the developing world. It is this interdependence that provided the basic rationale for including, in the amended Article IV, the requirement that "the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies." 3/ These principles were enunciated in the document

1/ Articles of Agreement of the International Monetary Fund. Article IV, Section 3.
2/ Articles of Agreement, Article IV Section 1.
3/ Articles of Agreement. Article IV, Section 3(b).

entitled "Surveillance Over Exchange Rate Policies" that was adopted by the Fund's Executive Board in 1977. 1/

The document noted that surveillance over exchange rates is a complex process involving a multiplicity of factors and interests, so that appraisal of a member's policies needed to be carried out within a framework that took into account the particular features of the member's circumstances. In addition, the document explicitly recognized that the adopted principles and procedures were not necessarily comprehensive and were subject to reconsideration in the light of experience. To this end, it was decided that the principles of surveillance would be reviewed biennially and that the implementation would be reviewed every year. 2/ The Fund's experience thus far suggests that the principles continue to give adequate guidance for the exercise of surveillance. Thus, no changes have been made in the text of the principles since their adoption in 1977. The procedures of Fund surveillance, however, have evolved significantly in several respects in the light of experience with their implementation.

Owing to the broad scope of the Fund's responsibility for the stability of the international monetary system, its appraisal of a member's exchange rate policies must be based on an evaluation of its balance of payments developments within the framework of a comprehensive analysis of its economic situation and its policy strategy. An assessment is made of the appropriateness of the member's policies with respect both to the sustainability of its external position and to the effects on other member countries. The latter aspect is, of course, particularly relevant in the case of the main industrial countries. However, the Fund endeavors to exercise surveillance in a consistent and symmetric manner, both at the multilateral level and at the level of each individual member country, regardless of the size of the country or of the exchange arrangements to which that country adheres.

1. Multilateral surveillance

The World Economic Outlook, which is generally discussed by the Executive Board at least twice each year, provides a comprehensive framework for the review of the world economy and the exchange rate system, and thus for surveillance over the exchange rate policies of individual members. A further review of the World Economic Outlook is normally conducted by the Interim Committee at its spring and fall meetings. The staff analyses underlying these discussions emphasize the stance of economic policies in those countries that exert an important influence on the international monetary system and, in recent years, have increasingly stressed a medium-term approach. In this context, the staff regularly prepares studies setting out broad scenarios for the world economy over a

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1/ Decision No. 5392-(77/63), adopted on April 29, 1977. The principles entered into legal force simultaneously with the Second Amendment to the Articles of Agreement on April 18, 1978.

2/ The next biennial review is to be completed before April 1, 1984.

period of 3 to 4 years. These scenarios are not regarded as forecasts; rather, they serve to illustrate how the international economic situation might develop over the medium term under alternative assumptions.

In addition, special studies that have been prepared by the staff on particular surveillance topics--such as exchange rate policies in industrial or developing countries, or external debt servicing problems--are discussed by the Executive Board from time to time. These special studies and the regular analyses contained in the World Economic Outlook and the Annual Report combine to provide a basis for the assessment of policy developments in the major industrial countries and the interactions among them. This approach allows a special focus to be placed on policy aims or actions of one or more countries that may clash or harmonize with those of others, thereby providing an opportunity for an exchange of views among Executive Directors and an important framework for the Fund's exercise of its responsibility for surveillance over members' exchange rate policies.

The management of the Fund also participates in various multilateral meetings of the major industrial countries. The Managing Director regularly attends meetings of the Group of Ten ministers and governors and presents the Fund's views on economic developments from the perspective of its role in multilateral surveillance. At the 1982 Economic Summit meeting, the seven participating countries undertook "to strengthen their cooperation with the Fund in its surveillance work and to develop this cooperation on a multilateral basis, taking into account particularly the currencies constituting the SDR." 1/ One channel by which this has been accomplished is through regular meetings of ministers of the Group of Five and the participation of the Managing Director in these meetings. On these occasions, the Managing Director has reviewed recent developments, particularly with regard to financial and exchange rate policies. The Managing Director has stressed the need for policy cooperation among major industrial countries in order to achieve convergence of economic performances, particularly as regards a moderation of inflation rates, and to foster developments in exchange rates that are consistent with underlying economic conditions. He has also sought to focus attention on the policies that would assist in achieving convergence and stability over the medium term. More broadly, in the context of these meetings, the Managing Director has stressed the need for major countries, in framing their domestic policies, to give weight to the exchange rate implications of their decisions.

2. Surveillance over individual countries

The principal channel for surveillance at the level of the individual country is the Article IV consultation. This consultation provides a regular occasion for the systematic review of the member's economic and

1/ Versailles Communiqué. June, 1982.

financial policies, with particular focus on exchange rate policies and the way these affect, and are affected by, economic policies and developments in the rest of the world. The opportunities provided by the consultation for the expression of the Fund's views include meetings with the authorities of a country in the course of a consultation, final statements by the mission to the country's authorities and the ensuing discussion, staff reports on the consultation, and the Managing Director's summing up of the Board discussion of the consultation report. Ultimately, the efficacy of Fund surveillance depends in a major way on the frequency, regularity and content of its Article IV consultations with member countries.

An annual frequency is normally maintained for members, such as major industrial countries, whose economies have a substantial impact on other countries. A yearly cycle is also maintained in the case of countries that are undertaking Fund-supported adjustment programs, or for which there are substantial doubts about the medium-term viability of the balance of payments. For other members, longer cycles may be specified, but the period between successive consultations in no case is to exceed two years. To help ensure the observance of these cycles, the Executive Board recently agreed to specify, at the conclusion of each consultation, a date by which it was expected that the succeeding consultation would be completed.

In order to ensure the comprehensiveness and relevance of Article IV consultations, the analytical content of staff reports has been steadily adapted to changing circumstances. For example, the Fund has recently extended its efforts to provide a forward-looking analysis of external debt developments of each member that is consistent with the global picture provided by the World Economic Outlook. Increased emphasis has also been placed on the analysis of protectionist tendencies, particularly for the major industrial countries.

While Article IV consultations provide regular opportunities for a comprehensive assessment of a member's exchange rate policies, the Fund also monitors changes in exchange rates as they occur. Members are required to notify the Fund promptly of changes in their exchange arrangements. Such notifications cover all exchange rate changes for members whose currencies are pegged, as well as large discrete changes for other currencies. As the notification procedure does not provide a basis for monitoring the continuous changes in exchange rates of floating currencies, which may be (or again may in some circumstances not be) small on any given day but may cumulate to a large magnitude over a number of months, it has recently been supplemented by a system that regularly reviews developments in real effective exchange rates for all members. Under this system, which was adopted on an experimental basis at the time of the March 1983 surveillance review, a quarterly report reviewing developments in real effective exchange rates is provided to the Executive Board. For any individual member that has experienced large changes (presently set at 10 percent) in its real effective exchange rate since the last time the Board had an opportunity to discuss its exchange rate policies, moreover, an "information notice" advises the Board of that fact.

Thus, in most cases, changes in exchange rates or exchange rate policies are discussed with members through regular Article IV consultations or through discussions on the use of Fund resources, but a variety of procedures are available for special discussions involving management and staff, and, in many cases, the Executive Board. The policies of major industrial countries are discussed at frequent intervals during special staff visits and by the Executive Board in the context of the World Economic Outlook exercise. In addition, supplemental or ad hoc consultations may be held with a member country if the Managing Director determines that movements in the exchange rate for its currency or changes in its exchange rate arrangements might not be in accord with the principles of surveillance, or might have important effects on other members. In such circumstances the importance of ensuring confidentiality is, if anything, even more crucial than it is in the case of Article IV consultations. Indeed, the need for such meetings between the Managing Director and the country concerned to be both informal and confidential is explicitly recognized in the principles and procedures of surveillance, which also confer upon him a relatively wide degree of discretion in communicating the substance of these discussions to the Executive Board. 1/ It is recognized that this need to preserve confidentiality presents a difficult problem since, in certain cases, it may tend to erode the effectiveness of surveillance to the extent that it limits the scope for exerting an influence on a member country's actions. At the same time, however, the preservation of such confidentiality is crucial, both because it serves to assure the Fund's access to economic information essential to its analyses, and because it provides the foundation for full and frank discussions with national authorities regarding the general economic situation and their specific policy responses.

II. The Substance of IMF Surveillance

Within the broad, virtually continuous process of Fund surveillance, there are two main stages in dealing with questions that arise concerning a member's policies. The object in the first is to identify the exchange rate developments and policies affecting exchange rates that may hinder international adjustment or, more broadly, the functioning of the international monetary system. The object in the second is to determine the

1/ Executive Board Decision No. 5392 (77/63) (adopted April 29, 1977); and Decision No. 6026 (79/13) (adopted January 22, 1979).

specific policy measures required to deal with the problems. At both stages of the process, the Fund must form a tentative view and then through a process of consultation and persuasion seek to arrive at a common understanding with the authorities of the country or countries involved. This may at times be difficult because of the complexity of the economic processes at work behind exchange rate developments, and because important domestic considerations of an economic, social, and political nature bear on the views of national authorities on these surveillance matters.

1. The identification of problems

There are cases where it is a relatively easy matter to arrive at a view that the policies of a member have implications for international adjustment or the functioning of the international monetary system that require discussion. The 1977 document on surveillance, referred to in the preceding section, lists a number of such cases, including cases where there is protracted large scale intervention in one direction or restrictions on international transactions for balance of payments purposes. In such cases, the need for the Fund to raise the matter with the member concerned is evident.

In many other cases, however, it is a matter of judgment whether specific policies or developments should be viewed with concern by the Fund in the context of its surveillance activities. In particular, it is often difficult to decide when the "behavior of the exchange rate... appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements." 1/ The Fund's judgments on this point are arrived at by considering whether the exchange rate appears to deviate very substantially from a sustainable level. In this context, the term sustainable is given its traditional broad meaning: an exchange rate is viewed as being sustainable if it can be maintained over the medium term and is appropriate from the standpoint of the country in question and the international community as a whole. Of course, the Fund's judgment of a given country's exchange rate must be consistent with its assessment of the set of exchange rates that is appropriate among its members. This consistency aspect is a crucial element of Fund surveillance.

In practice, the issue of the sustainability of the exchange rate is often related to other issues. For example, the Fund must take into account the overall policy strategies of its members. When pegging is used by a member as a source of domestic discipline, a judgment must be made as to how far the member can go in using the exchange rate for domestic rather than external purposes. In forming this view, account must be taken of two opposite considerations. If the member devalues as

1/ Decision No. 5392-(77/63), section 2(v).

soon as the worsening in competitiveness starts to hurt the open sector of its economy seriously, the announced exchange rate policy will soon lose its credibility and its disciplinary value. If it persists too long in keeping the rate fixed while competitiveness deteriorates, the economy may be badly hurt and the devaluation, when it finally comes, may have to be large and may also have to take place under disorderly conditions. Not only may the country itself suffer, but its trading partners may have a valid source of complaint if, as is likely, their trading relations are disturbed.

Even more fundamentally, it is often very difficult to form a view as to whether specific exchange rate developments among the floating currencies are consistent with changes in underlying economic and financial conditions. This is particularly the case when major structural changes are involved, such as a change in a country's position as energy producer or importer. In some instances, there is no fully satisfactory explanation for exchange rate developments, and therefore no reliable way to decide whether the conditions responsible for these developments should be considered to be part of the underlying conditions. For example, it is difficult to explain fully the large and persistent decline in the "real" effective exchange rate of the U.S. dollar by 30 to 40 percent (depending on the choice of the deflator) from 1969 to 1979, and the equally large rise of that real rate from 1979 to late 1983. The same is true of some of the other large long-run fluctuations experienced by other major currencies over the past fifteen years. Broad factors having to do with the perception of market participants of fundamental changes in the overall policy stances of national authorities, in the circumstances of countries due perhaps to exogenous shocks, and in the relative conditions for safe and profitable investment, are probably involved, but the influence of these factors is difficult to assess and virtually impossible to quantify to any satisfactory degree.

Whenever the circumstances are such that the Fund is led to a tentative view that there is an exchange rate problem in the system, it is of the essence of the first stage of the surveillance process that the Fund discuss its view with the authorities of the country or countries concerned and seek to arrive at a common judgment as to the existence of the problem and its nature. The view as to the nature of the problem underlies the delineation of the policy response that is appropriate.

2. The delineation of policy responses

Once an exchange rate development has been identified as a source of concern, the task of deciding what should be done about it begins. In some cases, it is relatively easy to trace the source of the exchange rate development to specific policies that are unwise from both the national and international standpoint. In other cases, however, tracing the specific source of the exchange rate development is a complex task. For example, it is difficult to assess the importance of the relationship between a budget deficit, interest rates, and the exchange rate. From an analytical standpoint, many issues are involved. There is the issue of whether a rise in public sector dissaving in a period of low private demand contributes to sustaining the level of aggregate income and, through that channel, the level of private saving. There is the further issue of whether this offset mechanism can be expected to continue operating once private demand becomes more buoyant, and how far ahead market participants start anticipating a likely clash between the public and private demands for saving. Finally, but without pretending to be exhaustive, there is the issue of whether a large change in the exchange rate can result from the need to have a larger current account deficit or a smaller surplus as a counterpart to the inflow of foreign saving that is induced by the budget deficit. These issues are difficult to settle, but the Fund would not fulfill its responsibilities if it refrained from forming a view on the policies required to remedy exchange rate problems in such cases.

While the task is complex, the process of distinguishing the various issues involved can often go a long way toward reducing existing divergences of views. Thus, it is crucial for the success of surveillance that, whenever the exchange rate implications of certain policies are not well understood, a serious attempt be made at a very early stage to work toward a meeting of minds on the nature of the processes at work. This is why the Fund has endeavored to develop its analysis in this domain in recent years, and why it has sought through publications such as the World Economic Outlook and the Annual Report, through informal contacts between Management and member countries, and through the regular article IV consultations to represent the conclusions of its work to its members.

Furthermore, while it is usually difficult to link specific exchange rate developments to specific policies, it is often possible to identify the broad types of policies that tend to result in undesirable exchange rate developments. For example, divergences in inflationary conditions and in the relative weights of monetary and fiscal restraint in demand management are easily identifiable factors of exchange rate instability. As there is little doubt that low inflation rates are better than high inflation rates, and that a balanced reliance on monetary and fiscal restraint is better than a combination of loose fiscal policy and restrictive monetary policy, it is clear in which direction the convergence should take place. It is these considerations that have led the Fund to stress the need for convergence, in particular among the main industrial countries.

Another aspect of exchange rate determination that is relatively well understood is the tendency for unanticipated changes in monetary policy to result in large, frequently temporary, exchange rate changes. As discussed in the 1983 Annual Report of the Fund, the exchange rate swings of the past four years can partly be attributed to differences in the speed of adjustment of wage and price inflation to reduced rates of monetary growth. As inflation abated less rapidly in the United States than in Japan and in the Federal Republic of Germany, nominal and even real interest rates - that is, the difference between nominal interest rates and estimates of expected rates of inflation - rose more strongly in the United States than in the other two countries as a result of a liquidity squeeze. This change in relative monetary conditions was an important factor contributing to the strength of the U.S. dollar from 1981 to the first half of 1982. To reduce these differences in the speed of adjustment of the inflation rate to the rate of monetary growth is a difficult task. Nevertheless, much can be done to speed up adjustment in countries with persistent inflationary tendencies by following a balanced demand management policy and by reducing rigidities in the goods and labor markets.

While the process of achieving a shared view of the relation between policies and exchange rate developments with the authorities concerned is an important part of the search for a policy solution, it must be recognized that political considerations also play a crucial role. National authorities have important domestic goals and constraints that they feel they have to respect even if the result is inappropriate exchange rate developments. In some cases, there will also be a conflict of objectives among countries, and this will lead to issues of burden sharing and "who does what first." The Fund can play a role of catalyst in the discussion of such issues but here again the role has obvious limits.

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The various considerations raised in this section suggest several conclusions:

(1) Any built-in features of policymaking that conduce automatically to "good" policy decisions will gradually reduce the disparities of conditions and policies that contribute to many of the exchange rate developments that are a source of concern for the international community.

(2) Since history demonstrates that such built-in features are uncommon or inadequate, surveillance becomes a complex problem of analysis and persuasion and its effectiveness largely rests on the hope that competent analysis and a clear identification of the problems will persuade policymakers to take more account of the effects of their decisions on the exchange rates of their partners.

(3) The difficulties of surveillance do not arise only from the fact that countries retain sovereign control over their policies, but from the fact that common understanding as to the policies required in given circumstances is difficult to achieve.

(4) It remains the case, of course, that in some situations, even with a common understanding (whether admitted or not), a national authority may deliberately choose not to take required actions or even to take perverse actions because of what it perceives to be domestic political constraints.