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GRAY/07/1943
Revised: 6/15/07

June 14, 2007

Statement by Mr. Sadun and Mr. Cipollone on the
Review of the 1977 Decision—Proposal for a New Decision
(Preliminary)
Executive Board Meeting 07/51
June 15, 2007

Overview

We would like to congratulate the staff for their excellent work in outlining a new Decision and providing, with the companion paper, detailed definitions for the new concepts introduced in the Decision. We also appreciated their efforts to incorporate with an open and flexible mind the most valuable suggestions that emerged from previous discussions.

The ultimate objectives of this exercise are to promote a more effective peer review by the Board, to hone the dialogue between staff and national authorities, and to ensure that surveillance remains evenhanded across the membership and focused on the most relevant issues without introducing new obligations. While surveillance will be anchored to the key notion of external stability, its focus will be on the domestic policies that underpin external stability.

The adoption of the Decision is an important starting point but is not the end of the story. We need to find the best way to make both staff and authorities familiar with this new framework in order to ensure its coherent and comprehensive implementation. In other words, we should make certain that this new Decision does not, like the previous one, become yet another paper forgotten by most of the actors responsible for its implementation.

We support the overall structure of the Decision, which clarifies the staff's responsibilities vis-à-vis those of the membership. We also agree with the remarks made by Mr. von Stenglin and Mr. Haupt. We will concentrate our comments on a few key areas: the scope of the Decision, the treatment of currency-union members, and the modalities and new principles of exchange rates.

1. Scope of Surveillance: *external stability is the centerpiece of surveillance*

The new focus on external stability, defined as a balance of payments position that "does not, and is not likely to, give rise to a disruptive exchange rate adjustment," well reflects the overall spirit of Art. IV, which calls for a close collaboration among the membership to promote orderly conditions necessary for financial and economic stability at the global level.

Most of the time, policies directed at the achievement of domestic objectives are also conducive to external stability. However, there could be situations in which the linkages between domestic and external stabilities might be weaker or the "transmission" lags longer than projected or experienced in the past, and we would appreciate if the staff could provide further clarification in this regard.

In paragraph 14 of the companion paper, the staff addresses some possible conflicts. While we welcome the idea that external stability is a "cyclically-adjusted" concept, cases of inconsistency between domestic and external stability might emerge. However, in the "rare" event of inconsistency, identifying an alternative policy mix that will increase the contribution to external stability without weakening the domestic equilibrium is always desirable. This is also in line with the main purpose of the Fund's surveillance, aimed at identifying the most suitable policy solutions to pursue domestic equilibrium while ensuring that the current and foreseen external balance remains sound and sustainable.

2. The fundamental exchange rate misalignment*: the new yardstick*

Fundamental exchange rate misalignments are the main yardstick proposed by staff to check the "health" of members' external stability. The exchange rate misalignments play an important role in identifying potential risks and represent a powerful early-warning tool to flag them. Nevertheless, the serious weaknesses of the available techniques cannot be ignored, both in terms of estimating the equilibrium exchange rate as well as assessing the degree of the misalignment.

While the exchange rate misalignment analysis should become a key tool in the surveillance framework, a mechanical interpretation of its findings should be avoided. This is particularly important when deviations from equilibrium (real) exchange rate levels do not necessarily require immediate action on the nominal exchange rate. On the contrary, such deviations might call for changes or for accelerating the implementation of domestic policies to reverse any structural imbalances that have a bearing on the exchange rate.

Domestic policy plays a central role in the overall surveillance exercise, the primary objective of which is to look into fiscal and monetary polices, as well as into issues of a structural nature, to the extent they are crucial to address structural misalignments. This concept is flagged in paragraph 5 of the Decision, and the new wording captures the sequencing and priority of the Fund's surveillance.

3. **Monetary union:** *regional surveillance versus bilateral surveillance*

We welcome the reference to currency unions in paragraph 7 of the new Decision, as well as the implications highlighted for the surveillance of their member countries. We concur with staff that the main responsibility of the currency-union members is to promote their own domestic stability, which in turn fosters stability in the union as a whole. We also agree that in the case of a currency union the risks of disruptive adjustments for a single member of the union do not disappear, although the threshold at which these risks can materialize might be higher than in the absence of a union, considering the absence of intra-union currency risk and the degree of integration of financial markets within the union. The institutional set-ups of the currency unions, for instance the presence of a centralized budget and/or bail-out schemes to absorb imbalances, are essential to assess the aforementioned threshold.

The new drafting of paragraph 7 of the Decision, which already incorporates some important caveats identified by the companion paper, broadly reflects the balance of responsibilities with respect to bilateral surveillance of a currency union member. We concur with staff that the balance of payments pressures at the country level will not disappear and should continue to be assessed at the country level even in the presence of a currency union. Persistent and sizable imbalances of a member's balance of payments might generate spillovers detrimental for both the external stability of the country and that of the whole union as well. Finally, we agree with staff that the principle of proximity might help, at the level of the individual member, to focus the staff's analysis in identifying the most relevant policies for the whole union.

4. **Modalities:** *a multilateral perspective and a forward-looking framework*

The objective of the new Decision is to develop a surveillance model that: a) promotes a shift from a backward- to a forward-looking approach; and b) better links multilateral and bilateral surveillance to assess the nature and the intensity of the spillover effects of domestic policies in the global or regional economy.

We believe that adopting a medium-term policy framework is an essential step to put surveillance in perspective and to help focus the dialogue between staff and authorities on key challenges and on alternative solutions. In the European Union, stability and convergence programs have resulted in a powerful tool for assessing individual members' policy actions, their consequences on the member's economy, and on the union as a whole. We also believe that the PRSP process in low-income countries has been useful in outlining the macroeconomic framework most conducive to the achievement of a country's medium-term objectives. The membership should be completely free to develop the policy framework best-suited to its institutional and current practices. We hope that over time the policy framework will become the centerpiece of surveillance.

Multilateral and bilateral surveillance should interact in a more intense and comprehensive way. Global market integration requires a global view of domestic objectives, not only to preserve external stability but to achieve the domestic objectives themselves. Identifying the possible spillover effects of policy measures is at the core of the assessment of external stability. Growing global trade and the continued expansion of capital flows are making domestic policies more relevant for regional and global stability. Strengthening the regional and global dimension of bilateral surveillance will become the key value added that a global institution like the Fund can—and should—deliver.

5. A new principle: *to go beyond unfair competitive advantages*

The 1977 Decision already includes principles, particularly principle A, aimed at identifying exchange rate manipulation practices, though it focuses mainly on competitive trade advantages. In the current integrated global economy, however, domestic objectives can easily lead to or result in adverse exchange rate dynamics that might undermine both the domestic stability of the member’s economy as well as the member's contribution to external stability. We thus support the inclusion of a new principle to complement principle A, one that provides for assessing the effects of external policies, beyond the intention of gaining unfair competitive advantages.

External stability and external instability are two sides of a coin. However, we agree with staff that external instability bears a stronger sense of urgency not only in terms of the risks to which a member's external position can expose the regional or global economy, but also in terms of the wider range of required policy adjustments.

We concur with staff that structural policies should not be part of new principles, given that their relationship to external instability is either weak or difficult to pinpoint. This approach is perfectly in line with the principle of proximity, which should guide staff in pinpointing, on a case-by-case basis, the most prominent structural issues to strengthen domestic stability while helping restore external balances.

6. Decision and companion paper: *how to give them the same legal status*

We believe that the contents and the detailed explanation of the new concepts are essential to have a comprehensive picture of the Decision and a clear understanding of the responsibility of both staff and authorities with regard to the Fund’s obligation for surveillance. Including the main sections of the companion paper in the Summing Up, as suggested by the staff, will not ensure them the same legal relevance of the Decision itself. Rather, we believe that integrating the companion paper into the Decision, as an annex or commentary, is a more suitable and straightforward option.