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January 10, 1986

To: Members of the Executive Board

From: The Secretary

Subject: Surveillance over Exchange Rate Policies - Biennial Review of 1977 Document

Attached for consideration by the Executive Directors is the paper on surveillance over exchange rate policies - biennial review of 1977 document.

This paper, together with the paper on surveillance over exchange rate policies - annual review of surveillance and review of proposals for changes in procedures (SM/86/4, 1/10/86) has been scheduled for Executive Board discussion on Wednesday, February 19, 1986.

Mr. Crockett (ext. 8982) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Surveillance Over Exchange Rate Policies--Biennial Review of 1977 Document

Prepared by the Research Department and the Exchange and Trade Relations Department

(In consultation with other Departments)

Approved by Wm. C. Hood and C. David Finch

January 10, 1986

Contents

Surveillance Over Exchange Rate Policies--
Biennial Review of 1977 Document

I. Introduction

The decision adopting the document "Surveillance Over Exchange Rate Policies" (Decision No. 5392-(77/63), April 29, 1977) provides for a review of the document every two years. The document itself acknowledges that the principles and procedures it sets forth "are not necessarily comprehensive and are subject to reconsideration in the light of experience." The present paper constitutes the basis for the biennial review of the surveillance principles. It also serves to review and discuss the proposals made in the reports of the Group of 10 and the Group of 24 that would involve changes to the text of the 1977 document. A companion paper 1/ considers those proposals in the G-10 and G-24 reports that affect the implementation of surveillance without necessarily requiring changes in the text of the 1977 document.

The Second Amendment, which introduced the provisions on surveillance, became effective on April 1, 1978, and the first biennial review of the surveillance document was therefore scheduled to take place not later than April 1, 1980. There have thus far been three reviews of the document (in 1980, 1982, and 1984). There have also been reviews of the implementation of surveillance on seven occasions, three of which coincided with the above-mentioned reviews of the basic document.

The reviews that have taken place have resulted in a number of modifications in the way in which the Fund's surveillance activities are conducted, including the adoption, in 1979, of a "Supplemental Surveillance Procedure" intended to facilitate discussion of exchange rate developments considered to be important or to have important effects on other members. The basic document "Surveillance Over Exchange Rate Policies" has not been amended as a result of any of the three reviews that have taken place, despite the expectation at the time the Decision was adopted that the principles and procedures would be subject to reconsideration in the light of experience.

The fact that the Surveillance document has not been changed does not, of course, reflect a feeling of satisfaction with the way in which surveillance has operated. In fact, the annual and biennial reviews have revealed widespread concern that the objectives of Fund surveillance are not being fully met. However, Directors have generally felt that the source of the problem lies not so much with the principles and procedures

1/ "Surveillance over Exchange Rate Policies--Annual Review of Surveillance and Review of Proposals for Changes in Procedures," SM/86/4, 1/10/86. See also "Surveillance over Exchange Rate Policies--Annual Review: Background Material." (To be issued.)

themselves as with the willingness of members, individually and collectively, to carry them into effect. It has been considered that the language of the 1977 Decision is sufficiently widely drawn to permit the Fund to express views on the whole range of policies affecting international economic developments. At the same time, it has been feared that greater specificity in prescribing policies would meet with disagreement and might not be in accordance with the requirement of the Articles of Agreement that... . "these Principles shall respect the domestic social and political policies of members, and in applying these principles, the Fund shall pay due regard to the circumstances of members." 1/

For several reasons, the current review of the Surveillance document is an opportune occasion for a more thorough-going reappraisal of the basic principles of surveillance than has taken place in earlier reviews. In the first place, concerns about exchange rate variability have, if anything, intensified in the period since the last review. Exchange rate variability has been a more troubling feature of international economic relationships than was expected at the time the Decision was adopted. This applies both to short-run exchange rate volatility and, more particularly, to longer-term exchange rate swings. Second, it is clear that management of the debt difficulties facing developing countries can be hampered by inappropriate policies affecting exchange rates or unpredictable exchange market developments. This applies both to exchange rate policies of heavily indebted countries themselves, and to exchange rate developments among their industrial country trading partners. These latter can have major implications for the real cost of servicing debt, as well as for the strength of protectionist sentiment.

A third reason for reconsidering the surveillance document is the attention given to the functioning of the exchange rate system and the subject of surveillance in the recent reports of the G-10 and the G-24. Both of these reports devote considerable attention to the subject of surveillance, and make recommendations for improvements. The G-10 report notes that surveillance has not been as effective as desirable in bringing about needed policy changes. The appropriate response to these shortcomings is felt to lie in a strengthening of existing mechanisms for encouraging better policies rather than in major changes in the institutional structure for surveillance itself. Nevertheless, the report invites the Board to review the 1977 and 1979 decisions with a view to facilitating greater use of supplementary surveillance procedures, and makes a number of other suggestions that could involve changes in the text of the 1977 document. In addition, some deputies from G-10 countries expressed interest in exploring the technical aspects of target zone proposals. More generally, it is for consideration whether changes in the underlying surveillance document could play a constructive role in contributing to the objectives set out in the G-10 report.

1/ Article IV, Section 3(b).

The report of the G-24 goes further than that of the G-10 in suggesting changes to the existing mechanisms of surveillance, and contains several proposals that would require changes in the language of the surveillance document. Paragraph 77 of the G-24 report states that "Surveillance...should be explicitly recognized as surveillance of the international adjustment process." Paragraph 66 proposes the use of "target zones" for exchange rates as a means for achieving greater exchange rate stability, and paragraph 68 puts forward the concept of exchange rate misalignment as a criterion or trigger for multilateral consultations. All these proposals would require changes in the 1977 Decision and supporting document to give them effect.

The plan of the rest of the paper is as follows: Section II sets out the background to the 1977 Decision, indicating the prevailing view of international economic interactions at the time that decision was adopted, and the perceived scope and limitations of the surveillance mechanism. (As part of this background, this section also covers earlier experience with the "Guidelines for Floating" which were adopted in 1974 and effectively lapsed with the adoption of the 1977 Decision.) Section III of the paper considers developments in the nine years or so since the Surveillance document was adopted. The purpose of this is to identify those aspects of the world economy that have differed from the evolution that was foreseen in 1977, and to consider the implications of these differences for the content and role of exchange rate surveillance. Section IV considers ways in which the existing surveillance document might be changed in the light of the preceding analysis. It does not propose specific language, but rather attempts to consider the issues raised in giving effect to some of the proposals that have been made concerning the exchange rate system. This section also considers those procedural suggestions that would involve changing the language of the 1977 decision. Lastly, Section V discusses the future organization of work on the issues raised in this paper. It considers the nature of the guidance that might be sought from the Interim Committee on the major substantive issues involved, and the means by which such guidance could be used to make further progress toward a revised decision. The Appendix to the present paper reproduces the 1977 Decision, and the supplemental procedure introduced in 1979.

II. Background to the 1977 Document

1. The 1974 "Guidelines for Floating"

During the period of the par value system, the Fund had frequently expressed views on members' economic policies in general, and on the effectiveness of their adjustment policies in particular. A body of experience had been accumulated concerning how to define what constituted a "fundamental disequilibrium" that would justify exchange rate action. However, little attention had been devoted to developing a code for economic policy-making that would be applicable in circumstances where most major currencies were floating. The need for such a code became apparent during 1973-74, when it grew clear that flexible rates among major currencies would probably endure for a considerable period.

The "Guidelines for the Management of Floating Exchange Rates" were adopted on June 13, 1974. 1/ They were based on an analytical view of the world in which:

(i) it was considered possible to make an operationally meaningful distinction between policies being used for balance of payments purposes, and policies being used for other purposes;

(ii) balance of payments equilibrium could be defined as a situation in which the current account surplus or deficit was equal to "normal" capital flows plus reserve accumulation;

(iii) "normal" capital flows could be identified on the basis of slow-moving historical trends;

(iv) current account flows were a fairly predictable function of relative prices and the relative cyclical position of the countries concerned; and

(v) short-term capital (or "hot money") was considered liable to move in an unpredictable way in response to speculative or interest rate factors.

In this view of the world, three types of dangers were perceived to be important. First, the volatility of short-term capital was thought likely to give rise to undesirable short-term fluctuations in exchange rates. (A related fear was that in the absence of short-term stabilizing speculation, individual large current account transactions might themselves introduce instability into day-to-day rates.) A second fear was that short-term swings in a country's balance of payments (e.g., for seasonal reasons) might lead to unnecessary exchange rate shifts unless "buffered" by reserve changes. And a third fear was that longer lasting swings in the current account position (caused, for example, by cyclical factors) might give rise to exchange rate movements that would have to be reversed at some future date. This could be particularly damaging if weakness in the domestic economy led to a strengthening of the current account and if, as was widely believed at the time, a strengthening of

1/ Executive Board Decision No. 4232-(74/67), 6/13/74.

the current account tended to push up the exchange rate. Such exchange rate appreciation would tend to further unbalance relative cyclical positions.

The "Guidelines for Floating" addressed each of these three concerns. The first guideline stated that members should intervene to prevent or moderate short-term (day-to-day and week-to-week) fluctuations in rates. The second guideline permitted members to act ("through intervention or otherwise") to moderate month-to-month and quarter-to-quarter movements. The third guideline dealt with target zones. If countries wished to establish target zones, or exchange rate "norms", for their currencies, they could do so, but would have to consult with the Fund. If a country did not establish a target zone, the Fund itself could find that its rate had moved outside the "range of reasonable estimates of the medium term norm for that rate." It could then encourage the member to either permit the rate to move back toward the range, or to take action to moderate further divergence from the range. A member would not be asked to resist strong market pressure, and it was accepted that "on occasion, the market view [of an exchange rate] may be more realistic than the official view..." 1/

The central focus of the policy actions discussed in the guidelines was the exchange market. The "Commentary" that accompanied the guidelines gave the following definition of exchange rate policies.

> "'Action to influence an exchange rate' includes, besides exchange market intervention, other policies that exercise a temporary effect on the balance of payments and hence on the exchange rate, and that have been adopted for that purpose. Such policies may take the form of official forward exchange market intervention, official borrowing, or lending, capital restrictions, separate capital exchange markets, various types of fiscal intervention, and also monetary or interest rate policies. Monetary or interest rate policies adopted for demand management purposes or other policies adopted for purposes other than balance of payments purposes would not be regarded as action to influence the exchange rate."

The "Guidelines for Floating" did not contain specific procedures for monitoring, or for the exercise of surveillance. During the course of 1974-75 various proposals for the implementation of surveillance were developed but these did not lead to a formal decision by the Board, and by early 1976, the guidelines were effectively superseded by the agreement in principle reached in Jamaica on a revised Article IV. For much of the period during which the Guidelines were in effect, the major countries provided reserves information that permitted a judgment to be reached as

1/ See SM/74/75, Supplement 1, 6/21/74.

to whether intervention was moderating month-to-month or quarter-to-quarter movements in rates. Confidential information was also provided to show how intervention was used to counteract short-term volatility. Concerning the third guideline, however, no country with a floating exchange rate chose to consult with the Fund concerning a medium-term target zone, nor did the Fund use its powers to find that a country's rate had moved outside the range of reasonable estimates of a medium-term norm. Nevertheless, the staff did make regular calculations of the underlying balance of payments position of the major countries with floating rates, and provided qualitative assessments of the direction and broad magnitude of the exchange rate changes needed to restore equilibrium.

2. The 1977 document

As just noted, the effort to improve the implementation of the 1974 guidelines was effectively suspended in January 1976, with agreement in principle on a new Article IV at the Jamaica meeting of the Interim Committee. This agreement emphasized the central importance of stable domestic policies in providing the basis for a stable international monetary system. 1/ Thus, the obligations placed on members in the amended Article IV gave emphasis to the need to foster orderly underlying economic and financial conditions, and to direct policies toward the objective of fostering orderly economic growth with reasonable price stability. Members' obligations with respect to exchange policies were to "avoid manipulating exchange rates or the international monetary system" and to "follow exchange policies compatible" with their other obligations. The amended Articles left to the Executive Board the working out of "specific principles for the guidance of all members with respect to those policies."

a. The global economic environment in 1977

The Executive Board began consideration of principles for the guidance of members' exchange rate policies shortly after the agreement reached at Jamaica. At that time, three years had elapsed since the end of fixed rates and the adoption of floating by most major currencies. These three years had been characterized by: a major international recession; a four-fold increase in oil prices; a major shift in payments balances on current account; a surge of inflation; and a considerable degree of variability in exchange rate relationships.

Of particular note was the extreme variability of inflation, both across countries and over time. In 1975, for example, the average rate of increase in the GNP deflator of the seven largest industrial countries

1/ See IMF Survey, January 19, 1976.

was 10 1/2 percent, with a range running from about 7 percent in Germany to 28 percent in the United Kingdom. Within countries, changes in inflation performance were also dramatic. In Japan, for example, inflation touched 26 1/2 percent (at an annual rate) in the first half of 1975, but had fallen back to 6 percent by the first half of the following year. In the United Kingdom, inflation fell from some 32 percent in the first half of 1975 to 12 1/2 percent in the first half of 1976.

Also noteworthy were the sharp shifts in balance of payments positions that accompanied the substantial changes that were taking place in the international economic environment. The U.S. current account was in small surplus in 1973 and 1974, then moved into record surplus in 1975, before shifting back toward deficit in 1976. Japan, by contrast, was in substantial deficit on its current account in 1974 before swinging strongly back into surplus in 1976.

Reflecting these developments, exchange rates also moved substantially. The U.S. dollar depreciated by 13 percent in the first seven months of 1973 then recovered by 12 percent in the ensuing six months. The currencies of countries affected by high inflation rates (especially the pound sterling and the Italian lira) exhibited a general tendency to depreciate through most of the early years of the floating period. The countries with relatively good inflation performances throughout this period (e.g., Germany and Switzerland) showed a general tendency to appreciate, though with interruptions of one or two quarters. The Japanese yen, after having appreciated up to early 1974, then fell sharply as price increases in Japan accelerated.

b. The lessons of the early experience with floating

It is not easy to characterize the lessons which policy makers in 1976 felt had been learned from the early experience with floating. Nevertheless, certain conclusions having relevance for the design of surveillance principles seem possible. Four are of particular importance.

First, it was recognized that it had become considerably more difficult to estimate the underlying current account balances associated with a particular pattern of exchange rates. This was partly because there was more uncertainty about what constituted "normal" cyclical positions. It had become difficult to interpret indices of capital utilization, since part of the capital stock had been rendered obsolete by the increase in energy prices. Moreover, traditional notions of full employment had become unrealistic as a guide to normal employment levels over a standard business cycle. A further difficulty in estimating underlying current account balances was created by the sharp movements that had occurred in terms of trade and relative costs. Since these factors affected current account positions with uncertain and distributed lags, and since they had fluctuated substantially during the previous several years, it was difficult to estimate the relevant elasticities for the medium and longer run.

Second, it was recognized that normal capital flows had become considerably harder to estimate. With the significant increase in the balance of payments surpluses of oil countries, the disposition of capital flows in the world economy became much more dependent on the portfolio allocation decisions of the major oil-exporting countries. Not only that, prospective capital flows depended to a substantial extent on how, and how quickly, the surpluses of oil exporters would be absorbed in higher imports. With this uncertainty about the prospective level of "normal" capital flows for the major industrial countries, the current account position that was associated with overall equilibrium was also uncertain.

Third, the role of expectations in influencing exchange market developments was increasingly apparent. These expectations related both to factors that affected the current account directly, and to developments that could have a more general effect on overall economic performance. Movements in oil prices, for example, could affect currency relationships among industrial countries depending on the relative extent to which such price changes were expected to affect their payments positions. And shifts in inflation prospects resulting, say, from wage bargaining agreements, could affect exchange rates before showing up in actual cost differentials.

Fourth, the early experience with floating appeared to be consistent with the view that relative price performance (both actual and prospective) was perhaps the most important single determinant of exchange rate developments, at least over the medium term. The countries with the best price performance (Germany and Switzerland) had consistently appreciating rates; those with the worst price performance (Italy and the United Kingdom) had experienced depreciation; and the country with the most volatile inflation (Japan) had appreciated during the period when its performance was better than average and had depreciated when its inflation rate rose above the average. (It should be noted, however, that there were also substantial movements in exchange rates that could not be related to price developments.)

c. Implications for surveillance

If the above lessons were indeed those that could be drawn from the initial experience with a regime of floating rates, they carried the following implications for the design of surveillance principles: first, it would be hard, if not impossible, to base exchange rate principles on the concept of an agreed equilibrium exchange rate; second, instability in exchange rates was the result of instability in the surrounding economic environment; third, a major source of instability in the surrounding environment was high and volatile inflation.

For these reasons, neither the amended Article IV nor the surveillance document adopted subsequently, makes any reference to the concept of "normal" or equilibrium exchange rates. The basic philosophy of the amended Article IV is that members should follow stable domestic policies that will contribute to "orderly" economic growth and reasonable price stability. Members are not expected to take specific actions with regard to exchange rate policies, but rather to avoid manipulation and to follow policies compatible with the other undertakings of Article IV. The expectation was that the restoration of stability in the domestic economies of member countries would be the main requirement for restoring better stability in the international exchange rate system more generally.

The amended Article IV provided, in Section 3(b), for the Executive Board to adopt "specific principles for the guidance of all members" with respect to their exchange rate policies. However, the "specific principles" contained in the surveillance document go little farther than the text of the Article itself. They provide for intervention to counter "disorderly" market conditions, and enjoin countries to take account in intervention of the interests of the country issuing the intervention currency, but otherwise simply repeat the obligation to avoid manipulation.

The fact that the main principle of exchange rate policies is the need to "avoid manipulation" carries two implications that are worthy of note. The first is that, in the absence of manipulation, the pursuit of the other obligations of Article IV (namely the fostering of orderly underlying economic and financial conditions) is expected to lead to a broadly satisfactory outcome for the exchange rate. The second is that some guidance is needed to recognize manipulation.

Identifying "manipulation" occupied a considerable part of the time devoted by the Executive Board to the formulation of the Surveillance document. It was recognized early on that a wide range of economic policies affected exchange rates. However, as an early staff paper noted, 1/ some limitation was needed on those policies that would be considered "exchange rate policies" if the necessary focus was to be provided for the Fund's surveillance activities. Therefore, attention was directed to policies that had a rather direct impact on conditions in the foreign exchange market. (Other policies would be reviewed by the Fund under its obligation to "oversee" members' compliance with their obligations to foster orderly underlying conditions rather than as an aspect of surveillance over exchange rate policies per se).

1/ "Surveillance of Members' Exchange Arrangements Under the Amended Draft Article IV: A Discussion Paper," SM/76/176, 7/30/76.

It was also recognized at an early stage that policy actions that might constitute manipulation under one set of circumstances would not necessarily have a similar connotation under other circumstances. Early drafts of the surveillance document carried the implication that certain actions--e.g., prolonged one-way intervention, excessive borrowing or lending or abnormal current or capital controls--would be considered prima facie evidence of manipulation. Eventually, however, it was agreed that such developments should be no more than "pointers", to be taken into account by the Managing Director in reaching a judgment on whether the possibility of a need for discussion with a member existed. It was also agreed that in addition to the specific "pointers" that could indicate the need for discussion with a member, any behavior of the exchange rate that appeared to be unrelated to underlying economic and financial conditions could also create the basis for supplementary consultation.

In brief, the conclusion was that, while manipulation could not be defined in the abstract, it could be identified in specific cases. It was therefore envisaged that, with the accumulation of a body of experience, it would become clearer, both to the Fund and to its member countries, what constituted manipulation. This approach dictated the structure of the document that was eventually adopted. Since it was not possible to develop "specific principles for the guidance of members" that went much beyond the language of the Articles, an indication was needed as to how such guidance would evolve over time. Thus in the document the principles for the guidance of members, which are rather general, are accompanied by principles for the guidance of the Fund, which attempt to illustrate circumstances in which a dialogue about the appropriateness of exchange rate policies should occur. There is then a section on procedures which specifies how that dialogue should be conducted and concluded.

III. The Working of the Exchange Rate System Since 1977

1. The changing nature of the issues facing policymakers

The main issues that have arisen in the working of the exchange rate system over the past nine years have differed somewhat from those that were foreseen at the time the surveillance document was adopted. First, manipulation of the kind envisaged in the document has not been a serious problem. Second, although much greater price stability has been restored among the major countries, shifts in exchange rates have been substantial. Third, capital flows have proved to be larger and more volatile than could have been foreseen in 1977. And lastly, the procedure that provides for additional or special consultations (procedure V) has never been invoked, so that no "case law" has been built up that could help make members' obligations in the field of exchange rate policies more specific. Each of these features warrants some elaboration:

-Exchange rate manipulation. For much of the period since 1977, although exchange rates were certainly strongly influenced by divergences in policy mix, major industrial countries did not seek to affect conditions in the foreign exchange market directly, other than in the context of the EMS. This choice reflected a number of factors, including the belief that market forces would be effective in bringing about an appropriate exchange rate, a recognition that the resources at the disposal of private market participants were much larger than those of the authorities, the view that sterilized intervention would have only a transitory influence on market conditions, and the belief that unsterilized intervention would require an undesirable loss of control over domestic monetary conditions. Nevertheless, intervention has been felt to be useful in certain circumstances, particularly when the authorities have believed a particular pattern of rates to be sustained by artificial factors and to be unrelated to fundamental factors. Concerted intervention has occurred on a number of occasions since 1977, including November 1978, September 1984, February 1985, and most recently in the past few months following the September 1985 G-V meeting in New York. On these occasions, the intervention, being coordinated (or at least agreed) among the countries directly involved, has not involved policy conflicts and has been felt to be useful in influencing exchange rates in an appropriate direction. The substance of the new policies has been communicated to the Fund by the members concerned.

-Inflation and exchange rates. The period since the mid 1970s has also witnessed a considerable reduction in inflationary pressures in industrial countries, and a narrowing in the dispersion of inflation rates about their mean level. In 1974-76, inflation had averaged 10 percent in the industrial countries as a group, with a standard deviation of 4 1/2 percentage points about this rate. By 1984-85, the average inflation rate had fallen below 4 percent with a standard deviation of less than 3 percentage points. The convergence of inflation rates toward a lower level did not, however, bring about the expected reduction in exchange rate variability, whether exchange rate movements are measured in the short or longer term. Quarter-to-quarter movements in key exchange rate relationships were considerably greater in 1984-85 than they had been in 1975-76. Medium-term exchange rate swings have also had greater amplitude. This is particularly evident for the U.S. dollar, whose real effective exchange rate (measured as a quarterly average) fluctuated within a range of 10 percent during 1974-76, but moved by more than 50 percent during the four years to the first quarter of 1985. There have also been striking movements in the exchange rates of other major currencies. The real effective rate of the Japanese yen, for example, fell by over 25 percent between late 1978 and early 1980, and the deutschemark depreciated by a similar amount over the five years to early 1985. In both cases, the exchange rate movements were significantly larger than those that occurred in the first four years of floating.

-Capital flows. One of the reasons for these unexpectedly wide movements in key exchange rates is to be found in the growing importance of divergences in economic policy mix in creating incentives for capital flows. While it has been recognized for some time that the foreign exchange market should be viewed largely as an asset market, it was generally felt that the determinants of market participants' willingness to hold assets in different currencies would be affected by many of the same factors that influenced the evolution of current account positions. It has become clear, however, that the volume of internationally mobile capital is sufficient to finance current account imbalances that are considerably larger and more prolonged than was earlier considered possible.

-Use of supplementary consultations. The fact that "manipulation" has rarely occurred, at least in the restrictive sense envisaged in the surveillance document, has meant that the specific provisions for supplemental consultations have not been invoked. 1/ The realization that it would be difficult for the Managing Director to initiate special discussions under the surveillance decision, because it would be interpreted as overt disagreement with a member's policies, gave rise to the 1979 decision on supplemental surveillance procedures. These were intended to provide a neutral basis for discussions, by permitting consultations to take place following any exchange rate development that "may be important or may have important effects on other members." 2/

2. Weaknesses in the working of the exchange rate system

The features of the international economic environment described above have led to three kinds of development that are of concern from the point of view of the international exchange rate system. First, short-term exchange rate volatility among major currencies has created a climate of uncertainty that is felt to impede the balanced expansion of trade and investment. Second, medium-term exchange rate swings of these currencies have been associated with a balance of payments structure that cannot be considered sustainable in a longer-term context. And third, many countries with fixed exchange rates developed unsustainable current account deficits, financed by excessive borrowing from commercial sources. Such overborrowing culminated in the debt crisis when access to capital inflows was curtailed. These concerns may be considered in turn.

Short-term exchange rate volatility became much larger after the advent of generalized floating and, contrary to some expectations, has not shown any tendency to diminish with the passage of time. The average

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1/ A special mission was sent to Sweden after the 1982 devaluation of the Swedish Krone, but it was decided not to use the powers of the surveillance decision as the basis for the mission.

2/ Decision No. 6026-(79-13), 1/22/79. (See Appendix.)

of daily changes in the rates of five major currencies against the U.S. dollar, which had been well under 0.1 percent during the decade of the 1960s, averaged 0.3 percent during 1974-76, and was 0.5 percent in 1983-85. A similar picture emerges when monthly rates are considered. Average movements in monthly average exchange rates were around 0.1 percent in the 1960s, 1.6 percent in 1974-76, and 2.4 percent in 1983-85. However, while this volatility undoubtedly introduces an additional degree of uncertainty into the finance of international trade, neither a priori reasoning nor empirical evidence suggests that the effects of short-term exchange rate movements on the volume of international trade have been substantial. Well-developed forward markets exist for short-term maturities in all major currencies, and the cost of purchasing forward cover in these markets (measured as the spread between bid and offer prices) remains small. It is true that forward markets are less available for the currencies of developing countries, but this cannot be attributed mainly to the volatility of rates among major currencies. With relatively few exceptions, empirical studies on the effects of short-term exchange rate volatility on trade have concluded that there is little evidence to support the contention that such effects are of major importance. 1/

The same cannot be said of the longer-lasting swings in exchange rates that have also characterized the floating rate period. Such exchange rate movements, unlike the short-term volatility discussed above, last long enough to affect resource allocation decisions. They give rise to shifts in profitability that can induce major reallocation of resources between traded and nontraded goods industries. The prospect of such profitability shifts can reduce the attractiveness of capital formation (particularly in longer-lived assets). When relative costs do change, unemployment can result, as well as the other costs involved in transferring resources to new activities. Moreover, when unemployment appears to be due to the capricious behavior of the foreign exchange market, it can more easily generate pressures for protectionism. Lastly, when large exchange rate movements are associated with the buildup of unsustainable current account imbalances, uncertainty is created about when and how the eventual reversal of these imbalances will be brought about.

The third concern about the functioning of the exchange rate system relates not to variability of exchange rates in industrial countries but to the way in which developing countries have been able to use excessive

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1/ See, IMF, "Exchange Rate Volatility and World Trade," Research Department, July 1984; Akhtar, M.A., and R.S. Hilton, "Exchange Rate Uncertainties and International Trade"; Research Paper No. 8403, Federal Reserve Bank of New York, May 1984; Gotur, Padma, "Effects of Exchange Rate Volatility on Trade: Some Further Evidence," IMF Staff Papers, September 1985, pp. 475-512.

external borrowing to delay needed balance of payments adjustment. The size of resulting imbalances financed through reliance on unsustainable capital inflows in the period leading up to 1982 meant that the loss of creditworthiness that occurred in that year had more severe consequences for the economies concerned than need otherwise have been the case. The responsibility for the crisis that emerged in 1982 must be shared by countries which over-borrowed, creditors which over-lent, and the institutional arrangements that permitted such developments to occur. In the three years 1979-81, the group of countries which later experienced debt-servicing difficulties increased their borrowing from commercial banks at an average annual rate of 24 percent. In 1984-85, their net borrowing grew at a rate of only 2 percent, and would have shrunk by a substantial amount had it not been for major packages of concerted lending under rescheduling arrangements. With the benefit of hindsight, it is possible to see that these countries were enabled to maintain unsustainable exchange rate and current account positions through excessive official borrowing--even though such borrowing was not specifically undertaken for balance of payments purposes.

3. Implications for surveillance principles

The foregoing discussion carries a number of important implications for the design of principles for the conduct of members' exchange rate policies. Six seem particularly worthy of note.

a. The absence of manipulation is a necessary, but not a sufficient, condition for the emergence of a satisfactory underlying balance of payments position. There have been few if any instances where major countries have for balance of payments purposes adopted policies that could reasonably be said to hamper the working of the adjustment process. Yet there has been considerable volatility in exchange rates, and currency values have moved to levels that are unsustainable in the longer run.

b. The restoration of domestic price stability is not in itself sufficient to restore exchange rate stability. This result is contrary to a number of expectations that were entertained at the time the surveillance document was adopted. At that time, the high level of inflation, and the prevailing uncertainty about future price trends, were considered to be the major factors behind the unexpected degree of exchange rate variability in the early years of floating. In recent years, however, the average rate of inflation has fallen dramatically, and the dispersion of price increases has narrowed, but the amplitude of exchange rate swings has increased.

c. The principal determinants of medium-term exchange rate swings in industrial countries are fluctuations in domestic saving/investment balances. These induce capital flows which in turn give rise to exchange rate movements and generate the shift in current account positions that is the counterpart of the change in domestic saving/investment balances. Thus, if it is desired to diminish the amplitude of exchange rate movements, actions must be taken to stabilize saving/investment balances.

d. Government policies, and in particular the mix of monetary and fiscal policy, are a major determinant of shifts in national saving and investment levels. At the same time, the effectiveness of policy in promoting a conducive environment for saving and investment in the private sector can also be important. These policies have not thus far been framed with exchange rate objectives in mind, but exchange rate considerations would need to become more important if exchange rate stability is accorded greater priority as a policy objective.

e. The current principles for the guidance of members' exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability. Since the choice of policy mix through which members seek to create "orderly domestic economic and financial conditions" is left to the individual member, it is possible for divergent choices to lead to undesired exchange rate patterns. The procedures that exist for policy mixes to be discussed are useful but fall short of being a mechanism for effective reconciliation of policy objectives.

f. The role of intervention in exchange rate management is a limited one. Experience has led the major countries to the conclusion that sterilized intervention cannot have a major or lasting impact on the exchange rate determined by fundamental economic factors. 1/ It is recognized, however, that intervention can play a helpful role on occasions where market exchange rates appear to have diverged from the pattern implied by economic fundamentals, or when the authorities wish to communicate to the market their determination to pursue a particular policy course with respect to fundamentals.

IV. Possible Changes in the Surveillance Document

1. The objectives of surveillance in current circumstances

The fundamental objective of the Fund's activities in the field of surveillance remains the efficient operation of the international monetary system. This purpose is stated clearly at the outset of Article IV:

1/ See "Report of the Working Group on Exchange Market Intervention" (chaired by P. Jurgensen), January, 1983.

> ".... the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth...."

The language of Article IV goes on to state that a principal objective is the development of orderly underlying conditions, and requires members to collaborate with the Fund and other members to assure orderly exchange arrangements and promote a stable system of exchange rates. All these purposes remain equally valid in today's circumstances, as do the objectives of promoting economic growth and reasonable price stability and avoiding harmful manipulation of exchange rates.

Nevertheless, it can be argued that the individual pursuit of these objectives by member countries has not been as successful as could be hoped in promoting "a framework that facilitates the exchange of goods, services and capital among countries, and that sustains sound economic growth," and has been unsuccessful in promoting a stable system of exchange rates. Exchange rate variability has created damaging uncertainties, and wide fluctuations in flows of funds between countries have required costly reallocation of resources. Moreover, the weakness of the surveillance mechanism and the way capital flows have operated helped to precipitate the debt servicing crisis from which the world economy is still recovering.

It is widely agreed that the correction of these deficiencies in the functioning of the international monetary system should be an important objective of policy. Efforts in this direction can follow two approaches (which are not mutually exclusive): (i) the guidance given to members and to the Fund itself through decisions of the Executive Board can be amended; and (ii) the manner in which guidance is implemented can be improved. Since it has been argued in this paper (and also on the occasion of previous reviews of the surveillance document) that the principles set forth in the document remain valid, any amendment to the existing language would presumably be in the direction of clarifying, extending, or making more specific the guidance given to members with respect to their exchange rate policies. Amendments could also be made so as to indicate more precisely circumstances in which the Fund would be expected to invoke the consultation procedures provided for in the document. These possibilities, which would require a change in the Executive Board's 1977 decision, are examined in the remaining part of this Section. Changes in procedures for the implementation of surveillance can to some extent be considered separately from the specific guidance given to members, and are discussed in the companion paper SM/86/4.

2. Main features of the document

Before proceeding to a discussion of the changes in the Surveillance document that could be suggested by the proposals made in the G-10 and G-24 reports, it is useful to have a clear idea of the structure and scope of the 1977 decision. The document itself contains four sections. The first, entitled "General Principles", defines the limits of the document: it underlines its objective to deal only with the topic of exchange rate policies. The second section of the document provides principles for the guidance of members. The third section sets forth principles to guide the Fund in its exercise of surveillance over members' exchange rate policies. And the fourth section provides for certain procedures to be followed, pertaining both to multilateral and to bilateral review of exchange rate policies. In addition to the provisions contained in the document, an Executive Board decision of 1979 provides for supplemental surveillance procedures, and the periodic reviews of the implementation of surveillance have led to a number of developments in practice.

3. General principles

The section of the document entitled "General Principles" defines the scope of the document as a whole. It limits the coverage of the principles and procedures to exchange rate policies, thus excluding domestic economic policies (regarding which the Fund also has oversight responsibilities under Article IV, Section 3(a)). It is recognized that there is a close relationship between domestic and international economic policies, although the language of the document does not indicate how this relationship should be taken account of by the Fund in the exercise of its surveillance responsibilities.

The key issue in connection with the General Principles is whether the surveillance that the Fund is called on to exercise over exchange rate policies should involve examination of members' compliance with the obligations covered in Section 1 of Article IV, regarding the objective of fostering stable economic and financial conditions and a monetary system that does not tend to produce erratic disruptions. The justification for such an extension would be the increasing recognition that exchange rate movements that cause international concern are more often the unintended result of divergences and inadequacies in domestic policies rather than the deliberate consequences of policies aimed at influencing conditions in the foreign exchange market. It is clear from Article IV, Section 1, that members have obligations in the field of domestic economic policies, in particular, the obligation of seeking to promote stability by fostering orderly underlying economic and financial conditions. Under Article IV, Section 3(a), the Fund has a duty to oversee the international monetary system in order to ensure its effective operation, and to oversee the compliance of each member with its obligations under Section 1. Of course, the Articles do not give the Fund powers of surveillance in areas where members' policies do not affect the interest of other members. Judgment is therefore necessary in deciding where the line should be drawn. Nevertheless, the experience of recent years is abundantly clear: domestic policies and their international interaction do have an impact on exchange rates and on the stability of the system. To be effective, surveillance must be extended to all policies having such effects.

4. Principles for the guidance of members' exchange rate policies

The section "Principles for the Guidance of Members' Exchange Rates Policies" contains three principles. Two relate to short-term intervention to counter disorderly market conditions and, being uncontroversial, are not considered further here. The other guidance provided is a repetition of the obligation, in Article IV, to avoid manipulation of 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. The rather general nature of this language has the advantage of flexibility, since it permits judgment to be exercised according to the circumstances of individual cases. It has the drawback, however, of providing relatively little concrete guidance, and permitting conflicting interpretations. As events have shown, such guidance has not in practice prevented the emergence of exchange rate swings that have created international concerns. If it were felt desirable to introduce more specific guidance, the possible approaches would fall under three main headings:

a. Members could be encouraged to establish limits to the zone of fluctuations for their currency, and to undertake certain actions, or at least to consult, as the value of their currency moved outside the zone.

b. Members could be encouraged to establish limits on the development of certain domestic policy variables which, together with guidance covering intervention in the foreign exchange market, would be presumed to help establish a "sustainable" exchange rate.

c. The kind of behavior that constitutes manipulation, and that is therefore proscribed, could be more precisely and meaningfully defined. Such a definition would presumably extend beyond actions narrowly directed at the exchange market.

If none of these approaches were to meet with favor, a fourth approach would be to retain the present rather general guidelines, and to focus on procedural mechanisms for improving policy formulation and coordination.

Each of the suggestions just noted can be found, explicitly or implicitly, in either the G-10 or the G-24 Report. The G-24 Report favors target zones for the major currencies on the grounds that it would help achieve the objective of exchange rate stability and sustainable levels of payments balances. The G-10 Report, by contrast, opposes the establishment of a target zone system (with some Deputies dissenting). The principal reasons given are that it would prove extremely difficult in practice to reach a consensus on the range of desirable exchange rates, that market behavior that was inconsistent with zones would add to instability, and that the constraints imposed by zones on domestic policies might undermine efforts to pursue sound and stable policies in the medium term.

The theoretical and practical aspects of the target zone proposal are discussed in some detail in the staff's paper on that subject (SM/86/4). The adoption of some variant of this proposal as the basis for the operation of the exchange rate system would have clear implications for the principles and implementation of Fund surveillance over exchange rate policies. Among the issues that would need to be decided are the following: (i) Should the adoption of target zones be mandatory or optional? (Mandatory target zones would of course require amendment of the Articles, since the existing Articles give members freedom, subject to certain limitations, to maintain exchange arrangements of their choice); (ii) In what forum would a multilateral grid of rates or zones for the largest currencies be decided?; (iii) How wide should target zones be? (iv) What procedures should be applied for changing target zones? (v) What undertakings 1/ would countries make with respect to zones? (Should they undertake to act to prevent their currencies moving outside the zone or simply to consult with respect to the reasons for the departure?) (vi) Should target zones be publicly announced or rather used as a basis for confidential discussions among the countries concerned?

The issue of undertakings with respect to target zones raises a further series of questions concerning the nature of the guidance to be given, through surveillance principles, to members and to the Fund. For example, if it were felt that members should act to prevent currencies moving outside target zones (or to limit the extent of such a movement) should the principles for the guidance of members' policies specify the type of policies that can be employed for this purpose? This could be done with varying degrees of precision. At one extreme, there could be an undertaking analogous to that of the Bretton Woods system to intervene in exchange markets to prevent any departure from the established zones. Then, if countries wished to avoid undesired monetary consequences from such interventions, they would have to take steps to ensure that other economic policy instruments were deployed in a manner consistent with the commitment to the exchange rate zone. Alternatively, the guidance given to countries could be somewhat looser, involving either encouragement to take action that would move the currency back inside the zone, or to

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1/ In what follows, the world "undertaking" is used in its general, rather than in its specific legal, sense.

abstain from actions of a kind that would lead to a further departure. Even more loosely, the undertaking could simply be one of consulting with the Fund, which would then raise questions concerning how such consultation would proceed, and how disagreements would be resolved. These questions would have to be dealt with under the section of the surveillance document that deals with procedures (see below).

The possibility of establishing indicators covering domestic policy performance is mentioned in the G-10 Report. This proposal has at its base the view that undesirable exchange rate variability is mainly the result of inappropriate domestic policies, and that any attempt to promote more stable exchange rates should focus directly on national policy formation. There has been relatively little discussion, in either official or academic circles, of what form such "domestic policy-oriented targets" might take. 1/ Questions exist concerning (i) whether such targets should be expressed in terms of policy outcomes or policy instruments; (ii) how wide a range of policy outcomes or instruments should be subject to targets; (iii) how such policies might be quantified; (iii) how agreement could be reached on appropriate targets or zones; and (iv) what action would be called for in the event that the target zones were not adhered to.

Despite the importance of promoting satisfactory and convergent economic performance, there are some practical difficulties in basing surveillance on undertakings with respect to economic outcomes (such as, for example, economic growth or the rate of inflation). Economic outcomes can certainly be influenced by the authorities through the setting of policy instruments, but they are also subject to unexpected exogenous developments. From a practical viewpoint, therefore, there would be advantages in confining domestic economic targets to the setting of policy instruments. The key issue is which instruments should be subject to such control. It seems clear that the aggregate stance of domestic fiscal and monetary policies is an important element in overall economic and financial policies, and therefore should be a part of any such targets that are arrived at. However, it could also be argued that structural policies are important in creating exchange rate movements. Countries that are unsuccessful in removing structural rigidities are likely to experience difficulties in preventing capital outflows, and thus may experience a depreciation in the value of their currency relative to that of countries where superior economic performance tends to attract capital inflows.

When it comes to quantifying domestic macroeconomic policies, the most widely used indicators are some measure of growth in the domestic money supply, and an indicator of the size of the government's fiscal

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1/ For a discussion of these issues, see "Review and Assessment of the System of Floating Exchange Rates," SM/86/5, 1/10/86.

deficit. Judgment would have to be exercised, however, in picking a precise measure for these variables. Most of the large industrial countries use several different measures of the money supply as a means of monitoring the evolution of monetary policy. These measures can move in a somewhat different manner, particularly over short periods. Moreover, the behavior of the demand for money, and thus the appropriate path for the money stock, can be influenced by developments such as financial innovation and changes in the regulatory environment. For these reasons, several major countries have adopted an eclectic approach to the assessment of monetary conditions, involving attention to a variety of financial indicators. With regard to fiscal policy, there is a similar variety of possible indicators. The fiscal deficit or surplus can be measured at the central or general government level, and can be left unadjusted, or adjusted for cyclical factors. There is also the possibility of adjustment for other factors of a systematic nature (e.g., inflation) or of a more ad hoc nature (e.g., large non-recurring transactions). Lastly, other types of fiscal indicator could include the level of government expenditure, and the level and incidence of taxation. The variety of possible measures of the fiscal and monetary stance complicates the task of developing meaningful and comparable indicators of domestic policy stance, but it does not make it impossible, provided adequate flexibility is employed in expressing objectives with respect to these policies. For example, zones rather than specific targets could be established, or undertakings could be expressed in terms of the avoidance of large (or sudden, or disruptive) changes in the chosen measure.

With regard to the issue of how to give operational content to domestic policy undertakings, several possibilities exist. Members could be called upon to set out quantified objectives for monetary and fiscal policies for a given period ahead. This could occur at the time of an Article IV consultation and be subject to review by (or the concurrence of) the Executive Board. Deviations from expressed objectives, as endorsed by the Board, could then be a trigger for a review by the Board of the circumstances in which the deviation had occurred. An alternative would be to express countries' undertakings more loosely as being to avoid sudden disruptive shifts in monetary and fiscal policies, or to formulate such policies so as to promote the efficient working of the adjustment process. The Fund would then have to exercise judgment, during Article IV consultations and at other times, about whether actual policies were consistent with the guidance that had been given.

In assessing what consequences should follow from any departure from the expressed objectives of monetary and fiscal policies, it would have to be recognized that deviations from targets could occur for a variety of reasons. For example, an unexpected shift in velocity could render a previously existing money supply target unrealistic. In the field of fiscal policy, a target for the central government borrowing requirement might be missed because of unexpected weakness (or strength) in economic activity. Given the variety of circumstances which could cause a deviation from domestic policy targets, it would not be wise to prescribe too closely the response called for in such circumstances. One possibility would be to simply provide for consultation with the Fund. This would permit the country concerned to explain its perception of the causes of the developments that had occurred, and other countries to express concerns they might feel; it would not bind the member to any particular course of action. Another possibility would be to call upon the member not to undertake discretionary action that would cause a further deviation of the policy instrument from its target until consultation with (and/or the concurrence of) the Fund had occurred.

Clearly, the development of principles based on guidance with respect to members' domestic policies raises a large number of practical issues that cannot be developed in detail in a short space. In order to adequately explore how such issues could be resolved, it would be necessary to evolve precise language and to discuss in depth the implications of such language. It would not seem fruitful to do this, however, unless Executive Directors gave indications that some likelihood existed that such an approach could provide the basis for useful progress.

The third broad approach, noted above, to changing the "Principles for Guidance of Members' Exchange Rate Policies," is to introduce greater specificity into the description of policies that are to be avoided. This approach had been attempted in the early stages of drafting the 1977 document, when it was suggested that certain kinds of foreign exchange market actions, such as large-scale direct intervention, official borrowing or lending, or the use of controls, could create a presumption that "manipulation" was occurring. 1/ In the event, this approach did not meet with favor, as it was felt that the kinds of actions described could be desirable in certain circumstances and it would not be justified to create any presumption about their appropriateness. It was seen, furthermore, as involving an element of discriminatory treatment, as countries with floating exchange rates were less likely to find themselves intervening in exchange markets than countries with fixed rates.

Now that more experience has been gained with the operation of the current exchange rate system, it is possible to identify certain types of policy that have led to difficulties in the operation of the adjustment process. For example, divergences in fiscal/monetary mix among major industrial countries have led to patterns of exchange rates and current

1/ "Surveillance of Members' Exchange Rate Policies under the Amended Draft Article IV: A Discussion Paper," SM/76/176, 7/30/76.

account balances that could not be considered sustainable over the longer term. And heavy borrowing by a number of developing countries in the period up to 1982 led to a crisis situation when less favorable prospects for export market growth and the future course of real interest rates caused a reappraisal of creditworthiness. In both cases, problems arose because capital flows were allowed or encouraged to continue to a point where they affected adversely the efficient working of the adjustment process. It would be possible for the "Principles for the Guidance of Members...." to include provisions encouraging countries to avoid policies that led to such results. Such provisions could be couched with varying degrees of specificity. If it were difficult to reach agreement on the precise nature of policy actions to be avoided, it could be provided that members should avoid measures that were inconsistent with the goal of promoting balance of payments adjustment in the medium term. This would require judgments to be reached concerning the type of policies needed for effective adjustment, which could perhaps be adapted from appraisals made during the course of Article IV consultations.

5. Principles of Fund surveillance over exchange rate policies

This section of the document is a list of developments "which might indicate the need for discussion with a member." As noted earlier, the section evolved out of an attempt to develop a list that would create the presumption of manipulation; the hesitant tone of the language eventually agreed reflects the wish of the Board not to create such a presumption in the finally-agreed wording. Nevertheless, the purpose of the section is to give some guidance to the Fund in how to judge whether a member has (or might have) acted inconsistently with the guidance provided in the previous section.

The first such indicator is protracted large-scale exchange market intervention in one direction. The next three indicators are the use, for balance of payments purposes, of current or capital controls, external borrowing and lending, or monetary and other financial policies. The last indicator is "behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions..."

A first issue in relation to the continuing appropriateness of these indicators is whether it remains sufficient to limit the indicators described to actions undertaken "for balance of payments purposes." The section does state, in a later paragraph, that any appraisal by the Fund should take place within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and should recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. Nevertheless, the deletion of the proviso "for balance of payments purposes" from some of the policy developments listed in the section could help broaden the scope of the Fund's responsibility. For example, large-scale official borrowing by heavily indebted countries contributed to the subsequent emergence of the debt crisis, but it could be argued that such borrowing was not specifically undertaken "for balance of payments purposes." Equally, the large capital flows among industrial countries that produced large exchange rate movements resulted from policies that were not primarily oriented to balance of payments objectives. The fact that inappropriate policies are not undertaken specifically for balance of payments purposes does not, of course, prevent the Fund from expressing its views on them during the course of the consultation process.

A second issue relates to the possibility of extending the list of indicators, or making it more precise. Since, as noted above, unsustainable capital flows have been a major source of subsequent difficulties in the international economic system, the emergence of such flows could be used as an additional explicit indicator of the need for special consultations. Other possible additions to the list of indicators would depend, to a considerable extent, on the outcome of decisions with respect to the principles for the guidance of members' policies. The Managing Director should presumably be directed to initiate discussions in circumstances where principles established for members' policies have not been observed.

A final issue covers the degree of judgment to be exercised by the the Managing Director in initiating discussions under the surveillance decision. Since the exchange rate developments listed under the "Principles of Fund Surveillance" are not defined precisely, and in any event are only to be considered as indicators, considerable judgment remains with the Managing Director, although he is required to "[take] into account any views that may have been expressed by other members." One consequence of this is that the formal procedures (see below) for initiating a special consultation under Article IV, Section 3b, have never been invoked (although informal contacts have been held on a number of occasions). A rather more more specific set of guidelines for Fund action would make the surveillance somewhat more automatic.

6. Procedures

Surveillance procedures of different kinds are provided for in the 1977 document, and in subsequent decisions of the Executive Board.

(i) The 1977 document provides for "regular" consultations between the Fund and member countries under Article IV. These consultations are to include both the observance by members of specific principles with respect to exchange rate policies, and obligations under Article IV, Section 1.

(ii) The document provides for the continuation of periodic review of exchange rate developments within the framework of the World Economic Outlook exercise.

(iii) The document provides for special procedures to be invoked if the Managing Director believes, in the interval between Article IV consultations, a member's policies may not be in accord with the exchange rate principles.

(iv) A decision on supplemental surveillance procedures, adopted in January 1979, provides for consultations to take place in certain circumstances where important exchange rate developments have occurred, but no presumption exists that the exchange rate principles have not been observed.

(v) Beginning in 1983 (Decision No. 7374 (83/55), 3/28/83) the staff has provided Quarterly Reports on indicators of real effective exchange rates and has issued "Information Notices" when the real effective exchange rate for an individual currency moves by more than 10 percent from the date of the last consultation.

A number of the procedural proposals made in the G-10 and G-24 reports relate to the way in which the procedures just described are implemented. As such, their adoption would not require any change in the basic surveillance document. These proposals are discussed at more length in the companion paper which reviews the implementation of surveillance (SM/86/4). Other proposals would, however, require changes, either in the text of the procedures section of the 1977 surveillance document, or in the 1979 decision establishing the supplemental surveillance procedure.

Perhaps the key aspect of any modification to existing decisions concerns the degree of discretion the Managing Director is called upon to exercise in invoking specific consultations. It can be argued that such discretion provides for a desirable element of judgment in the assessment of whether a particular exchange rate development requires further investigation. On the other hand, experience suggests that the Managing Director may find it invidious to single out countries for special discussions, and thus special or supplemental consultations at the level of the Executive Board may not take place. The G-10 deputies noted that "it could be helpful if the IMF made greater use of supplemental surveillance procedures" and the G-24 report made a similar suggestion in almost identical language.

The adoption of target zones for exchange rates, or "indicators" for domestic policy variables, would provide an automatic trigger for the review of a member's policies by the Fund. The procedural issues that would arise would be those related to how to proceed once such a review had been set in train. Specifically, should the exercise of "peer pressure" during the review process, as suggested by the G-10, be the main sanction at the disposal of the Fund, or should other steps be envisaged? Additional steps could involve, for example, a finding by the Fund that a member's policies were inconsistent with the guidance given under the surveillance decision.

If target zones or policy indicators were not in existence, other means would have to be sought to trigger a review by the Fund of a member's policies. It might be possible to specify that, when a member's policies departed from those found by the Executive Board to be appropriate on the occasion of the last Article IV consultation, as expressed in the Chairman's summing up, the Managing Director should be required to bring such a departure to the attention of the Executive Board, either through an information notice, or through the tabling of a paper for the agenda. An alternative would be to retain the present system of information notices (perhaps with a different threshold of exchange rate movement) and to provide for more automatic discussion. For example, the staff could be required to make an appraisal in each information notice of whether the exchange rate change described in it was of a kind likely to promote the working of the adjustment process. Where such a statement could not be made on the basis of the information available to the staff, it could be provided that a Board meeting would automatically ensue. Care would need to be taken, however, to avoid a proliferation of meetings on exchange rate developments of marginal significance.

Another aspect in which it might be necessary to modify the existing language of the surveillance decision concerns the role of the World Economic Outlook (WEO) exercise. The desire expressed in both Reports that the WEO should pay more explicit attention to international interactions of policies can be accommodated within the framework of the existing decision. However, if, as suggested by the G-24 report, the WEO is to serve as background for multilateral consultations about a mutually consistent set of objectives and policies for major countries, and if such consultations were to lead to specific objectives being developed for individual member countries, this would constitute a widening of the WEO's current role. Such a widening could be given explicit backing in the procedures section of the surveillance document.

V. Future Program of Work and Issues for Discussion

1. Future program of work

A possible strategy for considering issues related to surveillance would involve three stages:

(i) A discussion of the present paper, together with the accompanying paper on procedures, in the Executive Board, with Executive Directors giving preliminary views on the substantive questions raised.

(ii) A report to the Interim Committee that identified the central issues on which guidance from the Committee was needed.

(iii) On the basis of such guidance, the preparation of draft language that would be considered by the Board in the period leading up to the 1986 Annual Meeting.

(Depending on the complexity of the issues remaining to be resolved after Stages (i) and (ii), Stage (iii) might be more protracted, and might involve the need for further guidance from the Interim Committee.)

2. Issues for discussion

As a guide to Executive Directors in structuring their interventions, this section identifies the broad areas in which it would be useful to have views at the present stage.

(i) General strategy - Does the broad approach to consideration of the topic, as outlined immediately above, seem appropriate?

(ii) "General principles" of surveillance - Would it be desirable to revise the language of this section so that exchange rate surveillance applies clearly to all policies having significant effects on other members, rather than, as at present, only to policies deemed to be "exchange rate policies"?

(iii) Principles for the guidance of members' exchange rate policies - Directors may care to comment on which of the three broad approaches to revising this section offers the best prospect of progress. The three approaches, described in more detail in Section IV above, are

(a) Defining the guidance given to members in terms of seeking to observe some exchange rate target or zone.

(b) Defining guidance in terms of observing quantitative or qualitative objectives for domestic policy instruments.

(c) Defining guidance in terms of actions to be avoided, but introducing more specific language than simply the avoidance of manipulation.

A fourth option would be to leave the guidance to members essentially unchanged, and to focus on other ways of enhancing the implementation of surveillance.

(iv) Principles of Fund surveillance over exchange rate policies - Should the indicators used to trigger consultations extend to policies that are not necessarily adopted "for balance of payments purposes"? Should the list of indicators extend to domestic policies, and should the indicators be made more specific?

(v) Procedures for surveillance - Should the procedures for initiating special or supplemental surveillance consultations be made more automatic and less dependent on the exercise of judgment by the Managing Director?

The above questions are among those that emerge from the analysis presented in this paper. It is recognized, however, that they are not necessarily comprehensive, and that Directors may wish to raise other issues, or use a different framework for discussing the questions involved.

As specified in Decision No. 7645-(84/40) taken March 12, 1984, the biennial review of the document "Surveillance Over Exchange Rate Policies" is to be conducted not later than April 1, 1986. Draft decisions will be proposed for adoption following Board consideration of the present paper and the companion paper on the annual review of the implementation of surveillance. Such decisions are necessary to complete the two concurrent reviews by April 1, 1986. Also, these draft decisions will identify matters for consideration at a later date.

Executive Board Decision No. 5392-(77/63), April 29, 1977

SURVEILLANCE OVER EXCHANGE RATE POLICIES

1. The Executive Board has discussed the implementation of Article IV of the proposed Second Amendment of the Articles of Agreement and has approved the attached document entitled "Surveillance over Exchange Rate Policies." The Fund shall act in accordance with this document when the Second Amendment becomes effective. In the period before that date the Fund shall continue to conduct consultations in accordance with present procedures and decisions.

2. The Fund shall review the document entitled "Surveillance over Exchange Rate Policies" at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

Attachment

Surveillance over Exchange Rate Policies

General Principles

Article IV, Section 3(a) provides that "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article." Article IV, Section 3(b) provides that in order to fulfill its functions under 3(a), "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." Article IV, Section 3(b) also provides that "The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members." In addition, Article IV, Section 3(b) requires that "Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies."

The principles and procedures set out below, which apply to all members whatever their exchange arrangements and whatever their balance of payments position, are adopted by the Fund in order to perform its functions under Section 3(b). They are not necessarily comprehensive and are subject to reconsideration in the light of experience. They do not deal directly with the Fund's responsibilities referred to in Section 3(a), although it is recognized that there is a close relationship between domestic and international economic policies. This relationship is emphasized in Article IV which includes the following provision: "Recognizing . . . that a principal objective [of the international monetary system] is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates."

Principles for the Guidance of Member's Exchange Rate Policies

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 market if necessary to counter disorderly condition 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.

Principles of Fund Surveillance over Exchange Rate Policies

1. The surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop. The functioning of the international adjustment process shall be kept under review by the Executive Board and Interim Committee and the assessment of its operation shall be taken into account in the implementation of the principles set forth below.

2. In its surveillance of the observance by members of the principles set forth above, the Fund shall consider the following developments as among those which might indicate the need for discussion with a member:

(i) protracted large-scale intervention in one direction in the exchange market;

(ii) 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;

(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 domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) 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.

3. The Fund's appraisal of a member's exchange rate policies shall be based on an evaluation of the developments in the member's balance of payments against the background of its reserve position and its external indebtedness. This appraisal shall be made within the framework of a comprehensive analysis of the general economic situation and economic policy strategy of the member, and shall recognize that domestic as well as external policies can contribute to timely adjustment of the balance of payments. The appraisal shall take into account the extent to which the policies of the member, including its exchange rate policies, serve the objectives of the continuing development of the orderly underlying conditions that are necessary for financial stability, the promotion of sustained sound economic growth, and reasonable levels of employment.

Procedures for Surveillance

I. Each member shall notify the Fund in appropriate detail within thirty days after the Second Amendment becomes effective of the exchange arranagements it intends to apply in fulfillment of its obligations under Article IV, Section 1. Each member shall also notify the Fund promptly of any changes in its exchange arrangements.

II. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV. In principle such consultations shall take place annually, and shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1. Not later than three months after the termination of discussions between the member and the staff, the Executive Board shall reach conclusions and thereby complete the consultation under Article IV.

III. Board developments in exchange rates will be reviewed periodically by the Executive Board, inter alia in discussions of the international adjustment process within the framework of the World Economic Outlook. The Fund will continue to conduct special consultations in preparing for these discussions.

IV. The Managing Director shall maintain close contact with members in connection with their exchange arrangements and exchange policies, and will be prepared to discuss on the initiative of a member important changes that it contemplates in its exchange arrangements or its exchange rate policies.

V. If, in the interval between Article IV consultations, the Managing Director, taking into account any views that may have been expressed by other members, considers that a member's exchange rate policies may not be in accord with the exchange rate principles, he shall raise the matter informally and confidentially with the member, and shall conclude promptly whether there is a question of the observance of the principles. If he concludes that there is such a question, he shall initiate and conduct on a confidential basis a discussion with the member under Article IV, Section 3(b). As soon as possible after the completion of such a discussion, and in any event not later than four months after its initiation, the Managing Director shall report to the Executive Board on the results of the discussion. If, however, the Managing Director is satisfied that the principles are being observed, he shall informally advise all Executive Directors, and the staff shall report on the discussion in the context of the next Article IV consultation; but the Managing Director shall not place the matter on the agenda of the Executive Board unless the member requests that this procedure be followed.

VI. The Executive Directors shall review annually the general implementation of the Fund's surveillance over members' exchange rate policies.

SURVEILLANCE PROCEDURES

1. Review The Executive Board has reviewed the procedures relating to the Fund's surveillance over members' exchange rate policies. These procedures, and the procedures for regular consultations under Article IV, will be reviewed again by the Executive Board in December 1979. The Executive Board will review the document "Surveillance over Exchange Rate Policies" at an appropriate time not later than April 1, 1980, as provided for in paragraph 2 of Decision No. 5392-(77/63), adopted April 29, 1977 . . .

2.* . . . .

3. Supplemental surveillance procedure . . . Whenever the Managing Director considers that a modification in a member's exchange arrangement or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members, whatever the member's exchange arrangement may be, he shall initiate informally and confidentially a discussion with the member before the next regular discussion under Article IV. If he considers after this prior discussion that the matter is of importance, he shall initiate and conduct an ad hoc consultation with the member and shall report to the Executive Board, or informally advise the Executive Directors, on the consultation as promptly as the circumstances permit after conclusion of the consultation. This procedure will supplement the proceedings in Executive Board Decision No. 5392-(77/63), adopted April 29, 1977.

Decision No. 6026-(79/13)

January 22, 1979