DOCUMENT OF INTERNATIONAL MONETARY FUND
AND NOT FOR PUBLIC USE

FOR AGENDA

SM/85/19

January 16, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Multiple Currency Practices Applicable Solely to Capital Transactions

Attached for consideration by the Executive Directors is a paper on multiple currency practices applicable solely to capital transactions, which will be brought to the agenda for discussion on a date to be announced.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Multiple Currency Practices Applicable Solely to Capital Transactions

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

(In consultation with the Area and Research Departments)

Approved by C. David Finch and George P. Nicoletopoulos

January 15, 1985

I. Introduction

The Fund's experience with multiple exchange rate regimes was recently reviewed on the basis of two staff papers, 1/ at Executive Board meetings EBM/84/60, 4/18/84 and EBM/84/61, 4/19/84. At the conclusion of the latter meeting the Acting Chairman noted that: "... the sense of the meeting was that the Board should re-examine the issue of the Fund's jurisdiction under Article VIII, Section 3 over multiple currency practices applicable solely to capital transactions. For this re-examination the staff will prepare a paper that will review the past considerations of this issue and present its further views."

The legal analysis which is set forth in Section II of this memorandum concludes that the Fund had jurisdiction over such practices under the previous Articles and continues to have jurisdiction under the present Articles. The legal arguments that provide the basis for this conclusion refute the proposition that the Fund's approval jurisdiction over multiple currency practices does not apply to rates for capital transactions because this would limit the member's right under Article VI, Section 3 to exercise any controls that are necessary to regulate international capital movements. Since the beginning of the Fund, the staff has always held to the view that Article VIII, Section 3 is general in its formulation and does not confine the Fund's approval jurisdiction to multiple currency practices applying to current payments and transfers, and Article VI, Section 3, which speaks of "controls", was not intended to introduce an exception with respect to rates for capital transfers. For this, and

1/ "Review of Experience with Multiple Exchange Rate Regimes" (SM/84/64, 3/19/84, Correction 1), and "Review of Multiple Exchange Rate Regimes-Background Information" (SM/84/65, 3/20/84, Corrections 1 and 2).

other reasons, the decisions of the Fund relating to multiple currency practices have not been making an exception for multiple currency practices applying to capital transactions, although the Executive Board has not yet settled the issue expressis verbis. The procedure followed with respect to multiple currency practices relating solely to capital movements has been to identify these practices but to refrain from making recommendations regarding their approval and expressing a position on whether the practices constitute a violation of an obligation under the Articles.

A description of the types of actual practice maintained by Fund members that are applicable solely to capital transactions and a summary of their economic consequences--drawing on the recent review--is presented in Section III. Section IV contains the conclusions.

II. Multiple Currency Practices Applicable Solely to Capital Transactions--Legal Analysis

1. The current Fund position with respect to the jurisdiction of the Fund over multiple currency practices that apply solely to capital transactions can be summarized as follows: the Executive Board has not yet taken a view on the question of Fund jurisdiction over multiple exchange rates applicable solely to capital transfers, but the view of the staff, which it has expressed on several occasions, is that multiple currency practices established for the control of capital transfers require prior approval by the Fund under Article VIII, Section 3. 1/

2. The legislative history of the relevant provisions under the original Articles was carefully searched. It contains no suggestion that the general provisions with respect to par values and rates were subject to an exception for the control of capital transactions. Rather, there are implications to the contrary in statements that, as rates have international effects, they would have to be the subject of international consultation.

3. The scope of the Fund's jurisdiction over multiple currency practices was the subject of examination during 1946 and 1947 by the Executive Board Committee on Spreads and Multiple Currency Practices, in various staff memoranda, and by the Executive Board. The conclusions of this examination were laid down in a letter to members and an accompanying statement agreed by the Executive Board on December 18, 1947. 2/ This

---

1/ "Review of Experience with Multiple Exchange Rate Regimes," SM/84/64, page 17.
2/ Decision No. 237-2, Selected Decisions, Tenth Issue, page 247.

communication contained the following general principles regarding the jurisdiction of the Fund:

> "Multiple currency practices, besides being in most cases restrictive practices, also constitute systems of exchange rates. Since exchange stability depends on effective rates, the general purposes of the Fund and the members' undertakings of Article IV, Section 4(a) 1/ 'to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations' are fundamental considerations in an interpretation of the rights and obligations of members under Article XIV, Section 2 or Article VIII, Section 3, to maintain, introduce, or adapt multiple currency practices...."

These jurisdictional principles do not distinguish between multiple rates for current transactions and multiple rates applying solely to capital transactions. Rather, they deal with multiple currency practices as such, irrespective of whether these practices apply to current or capital payments.

4. In the years preceding the 1959 move to convertibility by a number of members the Fund made a detailed examination of the legal principles of the Articles regarding exchange practices, including problems connected with the maintenance of multiple rates. SM/56/15, entitled "Controls on Capital Transfers", reiterated the position that "One type of capital control measure can be singled out, as falling in any case under the Fund's approving jurisdiction. Any regulations maintained in order to allow capital transfers through a free market and involving multiple currency practices ... are subject to the Fund's standards and procedures for multiple currency practices." 2/

After considering the question the Executive Directors asked the Committee on Interpretation of the Executive Board to examine the legal aspects of the issue, particularly with respect to the conclusion that "Some types of capital control measures fall clearly under the Fund's approving jurisdiction either because the member engages in multiple currency practices or in discriminatory currency arrangements, or because the capital controls exercise an adverse effect on current payments." 3/ The Committee concluded that the use of discriminatory currency arrangements for control of capital movements does not require

---

1/ Refers to the Articles of Agreement in effect before the Second Amendment.
2/ SM/56/15, page 4.
3/ EBM/56/24, page 7.

the approval of the Fund, and the Executive Board subsequently confirmed that view. 1/ The Committee did not complete its consideration with regard to the Fund's jurisdiction over multiple currency practices applying solely to capital transactions. Its report stated that:

> "The Committee has not fully examined the question whether multiple currency practices solely designed to control capital movements would require the prior approval of the Fund under Article VIII, Section 3. The question is of a somewhat complex nature as it involves the relationship between Article VIII, Section 3 and the provisions of the Fund Agreement with regard to rates. However, it was the opinion of the Committee that, in the experience of the Fund, the application of differential rates to capital movements in the form of either a fixed rate or a free market generally embraced some current transactions and that in these cases at least members must seek prior approval of the Fund.
>
> The Committee therefore proposes to keep this aspect of the problem under consideration...." 2/

The Committee has not studied the matter since that time.

5. The exemption of exchange restrictions on capital transfers and currency discrimination regarding capital transfers from the Fund's approval jurisdiction, 3/ does not justify any conclusion with respect to multiple currency practices applying solely to capital transfers. The legal basis for the distinction between exchange restrictions and discriminatory currency arrangements on the one hand, and multiple currency practices on the other hand, which was the subject of a study in 1955, 4/ must be explained in terms of the relationship between Article VIII, Sections 2(a) and 3, and Article VI, Section 3. 5/ The first clause of Article VI, Section 3, "Members may exercise such controls as are necessary to regulate international capital movements", might give the impression, if read out of context, that members undertook no

---

1/ "Report No. 7 - Controls on Capital Transfers", EBD/56/71,(July 11, 1956), and Executive Board Decision No. 541-(56/39) (Selected Decisions, Tenth Issue, page 116).

2/ EBD/56/71, page 3.

3/ Decision No. 541-(56/39), July 25, 1956, Selected Decisions, Tenth Issue, page 116. See also 1957 Annual Report, page 127.

4/ "Legal Aspects of Regulations of International Capital Movements", SM/55/74, November 17, 1955.

5/ See Appendix I, Note 1, of this memorandum.

obligations with regard to the kinds of exchange measures used to regulate their capital movements. Under this reading of Article VI, Section 3, that provision could constitute an "authorization" for members to engage in multiple currency practices without approval of the Fund if such practices were applied to capital movements. The result of this view would be to remove such practices from the approval jurisdiction of the Fund because Article VIII, Section 3 proscribes the use of multiple currency practices without Fund approval "except as authorized under this Agreement". However, this view was not found acceptable because the "controls" referred to in Article VI, Section 3 cannot be understood to mean rates. Rather, they are the types of exchange measures that fall under the purview of Article VIII, Section 2(a) ("restrictions on the making of payments and transfers") and, therefore, Article VI, Section 3 does not contain an "authorization" within the meaning of Article VIII, Section 3 for members to engage in multiple currency practices affecting only capital movements without approval of the Fund.

This conclusion was based on the following legal considerations. Article VIII, Section 2(a) obligates members to refrain from the imposition of restrictions on the making of payments and transfers for current transactions. Article VIII, Section 3 is neither limited to the <u>making</u> of payments, since it applies also to the <u>receipt</u> of payments, nor limited to payments for current transactions. These differences demonstrate that a substantive distinction in the scope of the two provisions was intended. The obligations undertaken under Article VIII, Section 3 apply to arrangements which may affect the making and the receipt of payments for both current and capital transactions.

Additional reasons for this view were based on the then existing provisions governing the par value system, under which members assumed obligations with respect to the maintenance of rates for their currency within narrow margins around parities based on par values and undertook to collaborate in the promotion of exchange stability and orderly exchange arrangements (Article IV). These were fundamental and overriding obligations, unaffected by Article VI, Section 3.

6. The relation between Article VI, Section 3 and Article VIII Section 3 was next discussed in "Legal Aspects of Article VIII and Article XIV" (SM/59/73, November 18, 1959 at pages 40-43). That memorandum recalled that the question of the Fund's approval jurisdiction with respect to multiple currency practices was not settled by the decision that had been adopted regarding discriminatory currency arrangements. While in the case of discriminatory currency arrangements it was necessary to reconcile only Article VIII, Section 3 and Article VI, Section 3, in the case of multiple currency practices the provisions of Article IV on par values, rates of exchange and exchange stability entered the picture.

In view of these provisions, Article VI, Section 3 did not remove multiple currency practices applying exclusively to capital from the jurisdiction of the Fund under Article VIII, Section 3. The par value and rate provisions were general in scope and made no distinction between capital and current transactions.

The memorandum also pointed out that the problem was of the same legal character as the one that had arisen in connection with the necessity for approval by the Fund of all changes in multiple currency practices that were restrictions subject to Article XIV, Section 2. The Fund had decided that the approval of the Fund was necessary for these actions notwithstanding the broad language of Article XIV, Section 2 authorizing adaptation of restrictions.

7. The par value, exchange rate, and exchange stability provisions of the original Articles, which had not been modified by the First Amendment, were changed by the Second Amendment after a period in which exchange arrangements were governed by the Decisions on "Central Rates and Wider Margins". Both these decisions dealt with multiple currency practices in a manner consistent with the legal position referred to above, as they made no jurisdictional distinction between multiple rates for current and for capital payments and transfers. 1/

Article VIII, Section 3 of the Second Amendment differs from the formerly existing provision in two ways: (a) the proscription of multiple rates applies only to rates that are engaged in, or caused by, a member or one of its fiscal agencies, and (b) the new provision makes it clear that multiple currency practices may exist of rates inside or outside margins under Article IV. The new aspects of the provision were explained in Chapter C, Section 8 of the Commentary on the Second Amendment:

> "In view of the greater width of margins, it has been made clear that the Fund's jurisdiction over multiple currency practices and discriminatory currency arrangements applies to rates within or outside margins observed by members under Article IV or prescribed by or under Schedule C, paragraph 5 (Article VIII, Section 3). The Fund will be able to develop a body of principles on what practices are to be regarded as multiple currency practices or discriminatory arrangements, subject to the practices authorized by the provisions of the Articles. This is the way in which these concepts have been applied under the present Articles." 2/

1/ Decision No. 3463-(71/126), paragraph 5 and Decision No. 4083-(73/104), paragraph 5. (Selected Decisions, Eighth Issue, pages 14 and 18).

2/ Proposed Second Amendment to the Articles of Agreement of the International Monetary Fund: A Report by the Executive Directors to the Board of Governors, Part II, Chapter C, Section 8.

Again, the new provision and the Commentary are couched in general terms and make no distinctions in respect of current and capital transactions.

8. The legal aspects of multiple currency practices under the new provisions of the Second Amendment on exchange arrangements were examined in SM/79/127, which reiterated the conclusion that exchange rates for capital transfers are included in the reference to multiple currency practices in Article VIII, Section 3. 1/

This study examined the proposition that the absence of a par value system might be viewed as derogating from the reasoning on which the staff's view had been founded under the pre-Second Amendment Articles. Thus, it might be argued that when members are free to choose exchange arrangements under which the exchange rate for their currencies is floating, the assertion that a separate rate for particular transactions would undermine the stability of the rate was less persuasive. The study rejected this argument, taking the view that the changes in Article IV did not justify the view that Article VI, Section 3 authorizes the use of multiple currency practices to control capital movements without the approval of the Fund under Article VIII, Section 3. As explained on page 26 of the study:

> "The provisions of Article IV continue to support the view that the exchange arrangements that were envisaged were based on the assumption of a unitary rate whatever the exchange arrangements a member might choose to apply. It has been explained in the present paper that the ability of a member to apply exchange arrangements of its choice does not authorize the choice of multiple currency practices because these practices are inconsistent with the purposes of the Fund expressed in Article I(iii) and Article I(iv). There is no evidence that there was an intention at any time to qualify these purposes in relation to exchange rates for capital transfers." 2/

9. The same considerations underly the Fund's policy with respect to multiple currency practices outlined in Decision No. 6790-(81/43), 3/ which provides that there exists a multiple currency practice when official action causes a spread of more than 2 per cent between buying and selling rates for spot exchange transactions between a member's currency and another member's currency (paragraph 1.a.(i)). Broken cross rates are defined in an analogous manner, as rates for which the

---

1/ "Legal Aspects of Multiple Currency Practices Under Second Amendment," SM/79/127 (May 15, 1979), discussed at EBM/79/164 and 165.
2/ Ibid., p. 26. Other relevant passages from this memorandum are reproduced in Note 2 in Appendix I.
3/ Adopted March 20, 1981 (Selected Decisions, Tenth Issue, page 257).

spread between midpoint spot exchange rates differs by more than 1 per cent from certain other rates (paragraph 1.b.). These principles are general in scope, making no distinction between rates applying to current and capital payments and transfers.

10. The most recent review of the problem by the Executive Board took place in April 1984 (EBM/84/160 and 161), on the basis of SM/84/64, entitled "Review of Experience with Multiple Exchange Rate Regimes" (March 19, 1984), as mentioned in Section I above. The memorandum noted:

> "There is no disagreement that Article VIII gives the Fund jurisdiction over multiple exchange rates affecting payments and transfers for current international transactions, which are defined by Article XXX to include, inter alia, 'normal short-term banking and credit facilities' as well as 'payments of moderate amounts for amortization of loans or for depreciation of direct investments.' However, the Executive Board has not yet taken a view on the question of Fund jurisdiction over multiple exchange rates that affect solely medium- and long-term capital transfers and payments." (p. 17)

The paper also raised the issue of the consistency of treatment of the latter practices in the exercise of Fund surveillance over exchange rate policies and in the exercise of its jurisdiction, and suggested that the Executive Board re-examine the issue of Fund jurisdiction over the practices in question.

11. The examination of the relationship between Article VI, Section 3 and Article VIII, Section 3, and the determination of the scope of its approval jurisdiction are not the only contexts in which the Fund has concerned itself with separate rates for capital transfers. Both the Guidelines for the Management of Floating Exchange Rates, which were adopted in 1974, and the Guidelines on Surveillance over Exchange Rate Policies which were adopted on April 29, 1977 and that are in effect at the present time, illustrate the Fund's concern with multiple rates for capital transfers in formulating its position regarding the kind of exchange rate policies that members are to follow. Prior to the Second Amendment floating exchange rates constituted regimes which the Fund had no authority to sanction. The Guidelines for the Management of Floating Exchange Rates (Decision No. 4232-(74/67), June 13, 1974, <u>Selected Decisions</u>, Eighth Issue, page 21) had their legal basis in the then existing Article IV, Section 4(a) which required members to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements, and to avoid competitive exchange alterations. Certain of the terms used in the Guidelines were defined in a Commentary,(<u>Ibid</u>. p. 27), which explained that:

> "(iii) '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 exchange rates, and that have been adopted for that purpose. Such policies may take the form of official forward exchange market intervention, official foreign borrowing or lending, capital restrictions, separate capital exchange markets...."

12. In connection with the formulation of the present principles on Surveillance over Exchange Rate Policies, (Decision No. 5392-(77/63), Selected Decisions, Tenth Issue, page 10) the question arose whether the application of capital controls or the flows that occur in the absence of capital controls can properly be an indication of the need for consultation under Article IV. The staff made the following statement at EBM/77/10 (January 19, 1977):

"One has to look at all aspects of the situation and all provisions of the Articles. With respect to the aspects of the situation, it should be borne in mind that a rate affected by capital transfers also affects current transactions. If the exchange system is not unitary, the situation is one in which the Fund should look at the exchange arrangements for that reason." (p.9)

The staff also explained that the explicit reference to capital in the introductory clause of the new Article IV 1/ would provide ample authority for the Fund to consider that what happens with respect to capital can have its impact on the exchange rate and can be justification for consultation. If a member's choice of policies leads to or tends to lead to an external disequilibrium in its own position or in the position of other members, the Fund had a legitimate and legal concern.

This is indeed the position expressed in the Fund's decision setting forth "The Principles of Fund Surveillance over Exchange Rate Policies," which contains the following passage:

"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:

....
(iii) ....

(b) the introduction or substantial modification for balance of payments purposes of restrictions on, or incentives for, the inflow or outflow of capital;

1/ "Recognizing that the essential purpose of the international monetary system is to provide a framework that facilitates the exchange of goods, services, and capital among countries ..."

(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." 1/

As was noted in the 1984 review paper (SM/84/64, p. 18), acceptance of "the argument that the intention of the Articles of Agreement was that the Fund have approval authority over these multiple currency practices [applicable to capital transactions] would contribute to policy consistency in this area."

13. Article VI, Section 3, as all provisions of the Articles of Agreement, must be understood and applied in accordance with the purposes of the Fund. One of the principal purposes of the Fund is to "promote exchange stability" and to "maintain orderly exchange arrangements among members" 2/ The Second Amendment, which replaced the par value provisions of the original Articles with a system based on freedom of choice of exchange arrangements subject to a code of behavior, also imposed on members general obligations regarding exchange arrangements. 3/ The authority of members after the Second Amendment to exercise controls over capital transfers under Article VI, Section 3 needs to be understood in light of the Fund's purposes and the general obligations of members regarding exchange arrangements.

The obligations of members under Article IV, Section 1 are not limited to economic and financial policies with respect to payments and transfers for current international transactions. On the contrary, these obligations relate to all economic and financial policies and practices because they are relevant to orderly exchange arrangements and a stable system of exchange rates. For that reason, the proposition that under Article VI, Section 3 a member would be able to maintain multiple rates to regulate international capital movements would need to be reconciled with the obligations of members under Article IV, Section 1 to foster orderly underlying financial conditions, and to follow exchange policies compatible with these obligations. The relationship of these practices to members' adjustment policies is examined in the following section.

1/ Selected Decisions, Tenth Issue, page 10.
2/ Article I(iii).
3/ Article IV, Section 1.

III. Members' Recourse to Multiple Rates for Capital Transactions

The main issue addressed in this paper concerns the scope of the Fund's authority over multiple currency practices. As such, the issue is mainly jurisdictional in nature. So far, legal considerations have been advanced in support of the conclusion that the jurisdiction of the Fund extends to multiple currency practices regardless of the particular characteristics of the transactions to which they are applied. Those legal considerations have also an economic counterpart. Sustained use of multiple exchange rates introduces distortions in an economy and thus, it hampers resource allocation, including the allocation of savings. This proposition, which is generally recognized, obtains independently of the particular types of transactions which are conducted at the various rates of exchange.

The economic arguments relating to multiple exchange rates, including those discussed in the present paper, were broadly surveyed in SM/84/64, "Review of Experience with Multiple Exchange Rate Regimes " (3/19/84) and reviewed at the Executive Board in April 1984. A general conclusion drawn at that time was that:

> "Experience shows that multiple rate systems are costly in terms of efficiency in resource allocation between sectors and products, they are burdensome to administer, and they have not proven conducive to medium-term balance of payments adjustment" (SM/84/64, p. 25).

On the particular subject of a separate exchange rate for capital transactions, that report pointed out that the main reason for its establishment had been the desirability of the insulation of the domestic economy from the influence of capital movements. However, the paper noted (on page 10) that the survey of such practices had indicated that in general they "did not provide an effective shield against the impact of capital movements" and that in the majority of instances "a sharp divergence prevailed or arose between the rate in the free market and the official rate and raised doubts on the continued viability of the latter."

The experience of the Fund membership in this regard is that few industrial countries have maintained multiple currency practices and even fewer have applied separate exchange rates to transactions clearly distinguished as of a capital versus current nature. Several practices involving both capital and current transactions in a number of industrial countries were reviewed on the occasion of EBM/84/60 and EBM/84/61. 1/ Over the past

1/ Belgium and Luxembourg, 1950 to present; France, 1972-73; Italy, 1972-73; and Netherlands ("O-guilder" market, 1972-74). See SM/84/64, p. 19 and SM/84/65, pp. 30-34. As in those two papers, the coverage in this section relates to practices maintained by industrial countries in the period 1970-83, and by developing countries as of end-1983.

decade and a half, four industrial country members have also at some time maintained practices solely applicable to international capital transactions. The practices are the separate exchange markets maintained by France and the United Kingdom, taxes applied by Germany, and a noninterest-bearing deposit requirement by Italy. Only those in France and Italy remain in effect.

In France (devise titre market) and the United Kingdom (investment currency market) the foreign exchange transactions subjected to a different exchange rate are those arising from purchases and sales of foreign securities by residents. The arrangement was in effect in the United Kingdom from 1947 to August 1979, and in France from May 1981 to the present day. 1/ The principle underlying both secondary markets has been that a resident buying foreign securities must obtain the foreign exchange from another resident selling foreign securities. A direct consequence of the arrangements is the absence of any net outflow of portfolio investment funds on residents' account, and in both instances the domestic currency has been depreciated in the securities market (Appendix II). A relatively wide discount in the securities market has been sustained in the case of France (a minimum of 13 percent)--by comparison, for example, with the broader-based financial market for the Belgian franc. 2/ A similar measure, although not involving a market determined discount as in the French and U.K. schemes, has been applied by Italy since July 1973 to a broad grouping of foreign investments by residents (direct investments, portfolio investments, financial loans, purchases of real estate, and personal capital movements). The discount involves a 50 percent noninterest-bearing lira counterpart deposit. The requirement was specifically introduced to discourage large outflows of private capital. With effect from December 19, 1983 the implementation of the scheme has been relaxed to admit certain exceptions, including transfers by Italian construction companies operating abroad. A noninterest-bearing deposit requirement (bardepot) on foreign borrowings by residents was in effect in Germany from March 1972 to September 1974. The bardepot was essentially a temporary disincentive designed to ward off inward capital flows responding to disequilibrium between the mark and other major currencies prior to the introduction of generalized exchange rate flexibility. Its rationale was therefore different from that for the other three practices.

Practices presently maintained in developing countries that segment foreign exchange markets precisely on the basis of current and capital transactions are also relatively few. This reflects in part the large number of broader-based practices including some capital transactions and, at a more basic level, the difficulties inherent in maintaining the controls necessary to make the segmentation effective. Four countries in this group (Argentina, Bahamas, Chile, and Mauritius) have practices

---

1/ A similar market division was in effect in France from August 1969 to August 1971.

2/ See SM/84/65, Appendix II, Charts 7A and 7B.

that are identified below as relating solely to capital transactions. In these countries, none of the present practices confined to capital transactions involve market-determined secondary exchange rates designed to insulate against speculative capital movements. The separate exchange market in the Bahamas (investment currency market) has constituted a long-standing incentive for net long-term capital inflows and it was already in effect at the time of Fund membership in 1973. Other practices involve an exchange tax on capital transactions (Mauritius, also in effect at the time of Fund membership in 1968) and, more recently, exchange subsidies applied to foreign currency swaps with the central bank (Argentina and Chile).

The major characteristics of the multiple currency practices applied solely to capital transactions can be summarized in the following manner:

1. In most instances the spreads have been maintained at a more or less steady depreciated rate over extended periods of time, covering several economic cycles, or they varied mainly in response to nonbalance of payments factors or were subject to infrequent discretionary change, all of which have indicated that they have generally played a limited "buffering" role for variations in capital movements. In those instances in which the secondary rate varied in the short run in accordance with market forces, the official rate soon followed suit. This reflected the role that the secondary rate can play either in triggering action on the official rate or as an indicator of the need for greater flexibility in the management of the official market.

2. In most instances, the practices have not taken the form of a separate exchange rate for capital flows in general, but rather for specific components of the capital account, and they have served as an adjunct to quantitative controls on other forms of capital transactions, instead of as an alternative to such controls.

3. With one exception, the practices have led to continuous depreciation of the exchange rate for capital outflows and they may have thus masked medium- and longer-term pressures bearing on the major exchange rate. To this extent, the practices may have accentuated imbalances on current account at times of overall balance of payments difficulties.

4. Effective separation of the exchange markets has been difficult to maintain in practice. Separation requires close control over the underlying transactions as well as over actual payments and receipts, which has proved not only technically difficult but also costly in terms of administrative resources to achieve. The tying up of scarce administrative resources is an important consideration in particular in developing countries. (For a discussion of the difficulties of implementing market separation, see SM/84/65, pp. 31 and 34).

These characteristics need to be viewed against the background of the purposes for which separate markets for capital transactions have been introduced, which were described in SM/84/64 (pp. 10-11). A traditional rationale for dual exchange markets of this nature has been to isolate the economy from cyclical and reversible influences. Such exchange arrangements have been used, inter alia, to give greater stability to the exchange rate for current account transactions. In this context, it may be noted that the existence of a separate market for capital transactions with a freely determined exchange rate was also seen as an alternative to exchange controls. On a more explicitly transitional basis, there was the added reason whereby a second market was established temporarily with the intention of adjusting periodically the official exchange rate with the aim of exchange market unification. The adjustments, made either directly, or through shifts of transactions from one market to the other, or both, often resulted in a more appropriate average exchange rate and thereby helped the exchange rate system perform a more effective role in the adjustment process. On the other hand, when the exchange rate adjustment or shift of transactions was either too small or too frequent, expectations were formed that tended to disrupt foreign trade activities, as the resulting leads and lags added pressures to official international reserves.

In a historical perspective, the argument for dual exchange rates during the Bretton Woods par value system was based on the desirability of buffering the economy from reversible fluctuations in short-term capital flows and economizing the use of official international reserves. When official reserves proved insufficient to cope with such reversible flows, the flexible second rate was seen as obviating the need for an adjustment of the fixed rate that would ultimately be reversed. In this way, trade transactions and the productive base of the economy would not be disrupted unnecessarily by financial shocks. Since the advent of generalized floating, instances have arisen of individual countries which maintain a fixed or heavily managed exchange rate for current transactions, and a floating rate for all or some capital transactions. Here the case for the dual rate system remains essentially the insulation of domestic monetary policy from temporary disturbances transmitted through the capital account; where the disturbances can be identified as temporary and exogenous, and official reserves are inadequate, a dual rate system could be preferable to the alternative of quantitative controls on capital in protecting the economy from the disturbance. In circumstances in which the practice is introduced as a transitional device towards a more appropriate exchange system while other policy adjustments were being made--as with multiple currency practices affecting current transactions--the staff would propose to the Executive Board a recommendation for temporary aproval. These recommendations would be formulated on a case-by-case basis, being based on a careful appraisal of the circumstances of the individual Fund members.

IV. Conclusions

Examination of the legal arguments regarding the scope of the Fund's authority over exchange regimes shows that it is reasonable to conclude that the institution's jurisdiction over multiple currency practices encompasses all such practices and is not limited to those applied only in respect of payments and transfers for current international transactions. There are also sound economic grounds to support the jurisdiction of the Fund over such practices as the distortions they introduce arise regardless of the type of transaction to which they apply.

A survey of the limited instances of such multiple currency practices has shown that there is little evidence that they have served to buffer significantly the domestic economy in general and the current account in particular from financial shocks. Multiple currency practices in most cases are not only restrictive practices, but are also systems of exchange rates, and they must be assessed in the light of the general purpose of the Fund to promote orderly exchange arrangements. Insofar as the practices relating to capital transactions contribute to prolonged avoidance of pressure on the main exchange rate to adjust, they run counter to this general purpose.

It is therefore recommended that the Fund now formally affirm the position that multiple currency practices applying exclusively to capital transactions are subject to Article VIII, Section 3 of the Articles of Agreement in the same way as multiple currency practices applying to payments and transfers for current international transactions.

Affirmation of the Fund's jurisdiction over multiple currency practices applicable solely to capital transactions would ensure greater jurisdictional and policy consistency in the implementation of surveillance over exchange rate policies and of policies relating to the use of Fund resources. Practical consequences of the proposed affirmation would be:

1. Specific information and analysis normally accorded to exchange restrictions and multiple currency practices in staff reports of discussions for Article IV consultations with members would also be provided for the practices under consideration as a basis for the exercise of jurisdiction.

2. In the event that the practices would be maintained on a temporary basis for balance of payments reasons, and were non-discriminatory, the staff appraisal would, as is currently the case, include a reasoned recommendation in appropriate circumstances for their approval by the Fund. Conversely, lack of recommendation of approval for the practice would also be reasoned specifically in the staff's appraisal.

3. The standard performance criterion in stand-by and extended arrangements dealing with introduction of, or modification to, members' exchange practices inconsistent with Article VIII would include the practices under consideration, except as otherwise provided.

If the Executive Board endorsed the conclusions of this memorandum, the Fund would exercise its approval jurisdiction over all multiple currency practices in all cases, although the Fund could decide to treat multiple currency practices applying solely to capital payments differently from other multiple currency practices in the granting of approval, either by a general decision or in any specific case. Approval would be granted on the basis of the circumstances of the individual members, and on similar criteria as in the case of multiple currency practices affecting current transactions.

Note 1

Article VI, Section 3:

"Controls of capital transfers

Members may exercise such controls as are necessary to regulate international capital movements, but no member may exercise these controls in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b), and in Article XIV, Section 2."

Article VIII, Sections 2 and 3:

"Section 2. Avoidance of restrictions on current payments

(a) Subject to the provisions of Article VII, Section 3(b) and Article XIV, Section 2, no member shall, without the approval of the Fund, impose restrictions on the making of payments and transfers for current international transactions.

....

Section 3. Avoidance of discriminatory currency practices

No member shall engage in, or permit any of its fiscal agencies referred to in Article V, Section 1 to engage in, any discriminatory currency arrangements or multiple currency practices, whether within or outside margins under Article IV or prescribed by or under Schedule C, except as authorized under this Agreement or approved by the Fund. If such arrangements and practices are engaged in at the date when this Agreement enters into force, the member concerned shall consult with the Fund as to their progressive removal unless they are maintained or imposed under Article XIV, Section 2, in which case the provisions of Section 3 of that Article shall apply."

Note 2

SM/79/127, entitled "Legal Aspects of Multiple Currency Practices Under the Second Amendment (May 15, 1979), page 26:

"In addition, Section 1 of Article IV recognizes explicitly an essential purpose of the international monetary system that was not expressed in the original Article I. The new formulation is that 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....' Further, '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.' In particular each member undertakes to '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.'

The 'essential purpose' of the international monetary system recognizes that it is not concerned solely with trade or current international transactions. The purpose is also to provide a framework that 'facilitates the exchange of capital among countries'. While Article IV is not formulated in terms of stable exchange rates, but rather in terms of 'orderly exchange arrangements' and 'a stable system of exchange rates', its provisions give no support to the idea that members are free to apply and to change multiple currency practices unilaterally. Under the terms of Article IV, Section 1(iii), members are to 'avoid manipulating exchange rates ... to prevent balance of payments adjustments or to gain an unfair competitive advantage over other members,' but this obligation is not limited to exchange rates for current international transactions. Similarly, the prohibition against the use of exchange rates to gain unfair competitive advantage is not limited to the exchange of goods and services but applies with equal force under Section 1 of that Article to the exchange of capital."

Table 1. Multiple Currency Practices Applicable Solely to Capital Transactions: Exchange Rate Spreads, 1980-84 1/

(In percent; end of period)

		Bahamas	Chile	France	Italy 2/	Mauritius
1980	1Q	...			5.2	36.00
	2Q	...			5.4	36.00
	3Q	...			5.5	36.00
	4Q	...			5.8	36.00
	Y	20-50			5.5	...
1981	1Q	...			5.9	36.00
	2Q	...			6.3	36.00
	3Q	...		28.90	6.5	45.00
	4Q	...		12.72	6.7	45.00
	Y	21-26		...	6.4	...
1982	1Q	...		20.51	6.8	45.00
	2Q	...		19.03	6.8	45.00
	3Q	...		17.79	6.6	45.00
	4Q	...		23.21	6.6	45.00
	Y	21-26		...	6.7	...
1983	1Q	...		18.70	6.5	45.00
	2Q	...	11.00	23.82	6.1	45.00
	3Q	...	10.00	32.58	6.1	45.00
	4Q	...	8.00	30.30	6.1	45.00
	Y	21-26	...	...	6.1	...
1984	1Q	...	5.60	25.69	5.9	45.00
	2Q	...	5.60	13.35	5.8	45.00
	3Q	...	4.60	12.77	...	45.00

1/ Data provided by national authorities. It is not possible to present in summary form the premia over the official rate associated with the swap arrangements in Argentina, in part because the premia depended on the date the swap arrangement was entered into and the type of transaction covered by the swap arrangement, and the cost of the exchange rate guarantee associated with the swap arrangement has changed over time. By way of example, in July 1982 swap arrangements involving the cancelation of import payment arrears implied a premia in excess of 100 percent; a regular swap arrangement undertaken in July 1982 and unwound at the end of 1982 would have implied a premia over the official exchange rate of 16 percent.

2/ Percent per annum; estimates for Italy are based on average of deposit interest rates.