INTERNATIONAL MONETARY FUND

The 2007 Surveillance Decision: Revised Operational Guidance

Prepared by the Strategy, Policy, and Review and the Legal Departments

In consultation with other Departments

Approved by Reza Moghadam and Sean Hagan

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1. **The adoption of the 2007 Decision on Bilateral Surveillance was a landmark for the Fund.** Unlike its predecessor, which was focused exclusively on exchange rate policies, the Decision mapped out the full scope of surveillance, including domestic policies. It set out external stability as the organizing principle for surveillance, and was thus expected to promote focus on issues central to the Fund's mandate, including monetary, fiscal, and financial sector policies and increased attention to exchange rate issues. Surveillance under the Decision was intended to promote candor through clear assessments of the economic situation, outlook, and vulnerabilities of members and clear policy recommendations in pursuit of domestic and external stability.

2. **Implementation of the Decision appears to be broadly achieving its objectives, but suffered one major setback.** The 2008 Triennial Surveillance Review (TSR) found that the focus of surveillance has sharpened significantly and that the coverage and quality of analysis of exchange rate issues has improved.[1] However, the attempt to apply exchange rate-related "labels"—for instance, the use of specific terminology such as "fundamental misalignment," as called for by the Interim Guidance for the 2007 Decision—has proved an impediment to effective implementation of the Decision. The TSR noted widespread concerns about cross-country consistency in exchange rate analysis, and that undue importance should not be attached to precise calculations, given the inherent methodological and data limitations. In addition, there were indications that the attempt to apply labels may

[1] See IMF Executive Board Reviews the Fund's Surveillance, Public Information Notice (PIN) No. 08/133, 10/11/08. See also Robert Lavigne and Garima Vasishta (2009), *Assessing Implementation of the IMF's 2007 Surveillance Decision,* Bank of Canada/Banque du Canada Discussion Paper 2009-6, which comes to similar conclusions.

even have *weakened* the candor of some assessments. Moreover, difficulties in implementing this aspect of the Decision have been the main reason why Article IV consultations with a few members have fallen far behind schedule. These extensive delays have resulted in *less* focus by the Fund on members' exchange rate policies in key cases. In those cases, and in putting together a multilateral picture of the world economy, this has undermined Fund surveillance, running counter to the objectives of the 2007 Decision and damaging the Fund's credibility.

3. **The difficulties are at least twofold**:

- First, as noted in the TSR, a "fear of labeling" may itself have weakened the candor of some assessments and contributed to delaying pending consultations. Members for which "labels" have been considered have engaged in intense discussions with staff on this issue, to the point where attention has been distracted from the broader issues of macroeconomic policies. This experience highlights the challenge involved, for a cooperative institution like the Fund, in making specific findings about the exchange rate of members' currencies while also maintaining effective dialogue and persuasion—which the Decision itself recognizes as key pillars of surveillance.

- More fundamentally, there is an inherent tension between applying "labels" and the uncertainty that surrounds exchange rate analysis. Uncertainty is particularly great when it comes to attributing outcomes to exchange rate policies or other policies, since it is always the policy mix that matters. Because of the paramount importance of treating members evenhandedly, these uncertainties typically—and appropriately—have resulted in a judgment of "reasonable doubt" prevailing in practice. Moreover, the mere consideration of labels tends to encourage a search for pinpoint accuracy—which, in discussing the TSR, many Directors emphasized should not be taken too far. Searching for accuracy is not only costly but can in some cases detract from the real objective of Fund analysis, namely to better understand the policy mix and the economy's vulnerabilities. Tellingly, the TSR found that integration of the exchange rate analysis into the broader assessment of external stability and macroeconomic policies was a key area for improvement.

4. **The Fund needs a durable solution to this problem and a way of implementing the Decision that fosters more, rather than less, effective surveillance.** The Decision provides a sound framework to focus surveillance on its core tasks. However, it needs to be applied in a manner that strengthens the Fund's capacity to engage in effective dialogue and persuasion with members whose exchange rate policies raise concerns and to foster sound policies that promote the stability of the system. The candor in assessment sought by the Decision can, and should, primarily be delivered through clear policy recommendations.

5. **To this end, within the framework of the Decision, management intends to revise the guidance to staff on implementation**. Specifically, the guidance would be revised to eliminate the requirement to use specific terms such as "fundamental misalignment" and to make a number of other changes that will acknowledge the large degree of judgment required in the analysis and, in practice, reserve findings on the nonobservance of a Principle for the most egregious cases. Consequently, management also intends to withdraw its statement of August 4, 2008 on the use of ad hoc consultations, which, contrary to expectations, did not help bring to conclusion long-delayed consultations. These changes will facilitate more effective surveillance.

6. **At the same time, the progress made in exchange rate analysis over the last 18 months needs to be safeguarded and extended.** The analytical requirements of the Decision will remain in place, with Frequently Asked Questions (FAQs) continuing to provide guidance to apply the conceptual framework of the Decision; ongoing initiatives on training, knowledge dissemination, and methodological work will continue; and analysis of exchange rates and external stability risks will of course remain one of the surveillance priorities for 2008-11, with the next TSR in 2011 monitoring the progress made.[2]

7. **Staff has prepared a revised Interim Guidance Note and revised FAQs.** Attachment I shows the revised Interim Guidance Note. Attachment II shows the revised FAQs. The guidance has been streamlined, as experience has shown that seeking to specify every step in the process merely opens up new questions, and it is more helpful to explain more clearly the central concepts at stake.

8. **The revisions**:

- *Emphasize the importance of good exchange rate analysis and clear assessments, but also that the ultimate objective is to gain economic and policy insight.* The intention is to avoid resources being invested into analytical refinements that create a false sense of precision in staff's assessments and crowd out from staff reports other relevant material, particularly in cases where there is no great cause for concern on the exchange rate front.

- *Remove the requirement to use specific terms such as "fundamental misalignment*," while still calling for a clear and candid discussion—using plain economics terms—of the exchange rate and the full range of policies that affect external stability.

- *Recognize the uncertainty involved in attributing outcomes to exchange rate policies as opposed to other policies,* as a result of which cases where a member would be deemed to be in nonobservance of Principle D, in particular, are likely to be very rare.

[2] Surveillance Priorities for the International Monetary Fund (October 2008).

- *Allow the assessment of exchange rate policies to take into account the authorities' intentions.* In assessing the exchange rate, the underlying current account would still be calculated using current exchange rate policies, as the goal remains to evaluate whether the *prevailing* level of the real effective exchange rate is under- or overvalued. However, the revised FAQs also allow established exchange rate policies (i.e., policies announced and—to the best judgment of the team—likely to be implemented) to inform judgments about external stability and the assessment of observance of the Principles.[3]

- *Simplify the treatment of transitional factors in the exchange rate assessment.* In cases where net external assets are considered to be in transition from one equilibrium to another, the original FAQs considered the equilibrium current account to be one consistent with this transition. The revision instead uses the *medium-term* equilibrium current account, and asks staff to be clear when any under- or overvaluation found in this analysis is the result of transitional factors.[4] The different parsing of this issue allows the first step in the assessment to parallel more closely the methodologies of the Consultative Group on Exchange Rates, simplifying the discussion.

- *Distinguish more clearly between the broad economic assessment and formal, legally required jurisdictional findings under Article IV.* The FAQs are confined to issues key to the economic assessment. An appendix provides guidance on the legal modalities for finding a member in nonobservance of a Principle.

- *Streamlining the language* to make it less heavy-handed and to explain more clearly the central concepts.

- *Remove references to the use of ad hoc consultations*, which will continue to be guided by the provisions of paragraph 20 of the Decision but no longer by the Managing Director's statement of August 4, 2008.

9. **Management intends to issue the new Interim Guidance Note and FAQs following the present consultation with Executive Directors.** The goal is to finalize the revised Surveillance Guidance Note without further delay.

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[3] The Companion Paper to the Decision (June 2007) does not provide an exhaustive list of the factors considered to be temporary in the evaluation of external stability, and thus leaves open the possibility of taking account of future exchange rate policies. In practice, the underlying current account at established *domestic* policies and *current* exchange rates is essential to form a view on the current exchange rate, but in a second step, which is the basis for judgments about external stability concerns, staff would also take into account established exchange rate policies.

[4] Because such under- or overvaluation is temporary, it would not be a basis for being concerned about external stability or the observance of the Principles.

ATTACHMENT I

INTERNATIONAL MONETARY FUND

Implementing the 2007 Surveillance Decision
Revised Interim Guidance Note

Prepared by the Strategy, Policy, and Review and the Legal Departments

In consultation with other Departments

Approved by Reza Moghadam and Sean Hagan

June 22, 2009

1. This note replaces the interim guidance on implementing the 2007 Surveillance Decision issued on June 28, 2007 (SM/07/228), focusing on the coverage of discussions with the authorities and staff reports, and is complemented by the Frequently Asked Questions on the 2007 Surveillance Decision (FAQs). It complements the existing Surveillance Guidance Note (SGN) and will be integrated into the upcoming revision of the SGN. Missions are strongly encouraged to read the Decision, Summing Up, supporting Board documents, and the FAQs on the Decision, which are all available on SPR's website under "Surveillance Decision."

2. The 2007 Decision establishes ***the following expectations*** for the coverage of discussions with the authorities and of staff reports. [1]

3. Consistent with the requirements of the Decision, these expectation focus on an assessment of the economic situation of the member; an assessment of all the member's relevant domestic policies including in all cases fiscal, monetary, and financial sector policies, to examine whether they are promoting domestic stability; and an assessment of the member's exchange rate policies to examine whether they are promoting external stability.

[1] Similar expectations would apply to summings up, as it is the Board that conducts the assessment under surveillance.

A. General

- A discussion of policies—both domestic policies and exchange rate policies—through the prism of external stability as the central focus of surveillance;
- An assessment of whether policies are promoting external stability, and to the extent they are not, a discussion of recommended adjustments;
- An evaluation of developments in the balance of payments;
- Frank and open dialogue, candor, evenhandedness, due regard to country circumstances (including implementation capacity and the authorities' objectives aside from external stability), attention to inward and outward spillovers (including drawing on multilateral surveillance as relevant), and a medium-term perspective (including a discussion of medium-term objectives and planned policies, including possible policy responses to the most relevant contingencies).

B. External stability

- A clear assessment of the current account and the exchange rate level;
- A clear assessment of risks arising from the capital and financial account, including from the composition of inflows and balance sheet mismatches.

C. Domestic policies

- An assessment of whether domestic policies are promoting domestic stability, and to the extent they are not, a discussion of recommended adjustments;
- An examination in this context of monetary, fiscal, and financial sector policies (both their macroeconomic and macroeconomically relevant structural aspects);
- An examination of domestic policies other than fiscal, monetary, and financial sector policies only to the extent that they significantly influence external stability, and, in particular, an examination of policies to promote high levels of potential growth only in those cases where this significantly influences prospects for domestic and external stability. In cases where the link of these policies to domestic and external stability is not self-evident, it needs to be explained (not just stated). In cases where it is self-evident, no statement about linkage is needed.

D. Exchange rate policies

- Where there are concerns, a discussion of how the member's exchange rate policies may need to be adjusted, in the context of the overall policy mix. The Principles in the Decision provide guidance to members for the conduct of their exchange rate policies and to the Fund in conducting surveillance over these policies;

- Should a Principle not be observed—which is expected to be rare—a statement to this effect in the staff appraisal, referring to either a named Principle or its content, and in the case of Principle A including a statement of the staff's view that the member is in breach of obligation under Article IV, Section 1 (iii);

- If one of the indicators in paragraph 15 of the Decision is present, a discussion of this fact and its implications. The discussion does not need to make reference to "indicator [x] in the 2007 Decision" or use the specific wording in the Decision, but does need to be clear on the concepts being discussed.

Frequently Asked Questions on the 2007 Surveillance Decision (FAQs)

These FAQs are aimed at helping staff deal with common operational issues in applying the concepts of external stability and the Principles for the Guidance of Members' Exchange Rate Policies in the 2007 Surveillance Decision. They complement the interim surveillance guidance note. While the primary focus of these FAQs is on exchange rate assessment and how it fits into the overall examination of policies, this should not by any means be read to deny the importance in bilateral surveillance of an assessment of monetary, fiscal, financial sector, and other relevant domestic policies.

Q1. What does the 2007 Decision ask staff to do and how do exchange rates fit in?

The 2007 Surveillance Decision requires staff to assess whether the policies pursued by a member are contributing to external stability. This would include *all* policies including, but not limited to, monetary, fiscal, financial sector and exchange rate policies. The goal is, as it has always been, to provide economic and policy insight, advise a country of potential risks and recommended policy adjustments, foster discussion, and ensure that both the staff's and authorities' views are reported carefully and candidly.

Exchange rate surveillance—analysis of the exchange rate and of exchange rate policies—is thus only one part of surveillance. Nonetheless, it is a crucial part, as the Articles give the Fund a unique responsibility to exercise surveillance over exchange rate policies. The role of the Principles for the guidance of members' exchange rate policies in the Decision is to undergird this analysis. (Additional detail on the Principles is provided in the Appendix.)

Q2. What is external stability?

External stability is a situation where a country's balance of payments position does not, and is not likely to, give rise to disruptive exchange rate movements. Staff should assess whether the country's current account is broadly consistent with equilibrium, whether the capital and financial account or external balance sheet position create risks of abrupt adjustments in exchange rates, and how other factors (including fiscal, monetary, and financial sector policies) are likely to affect the balance of payments in future.

The trigger for disruptive exchange rate movements may come from within the country's own balance of payments or from within that of its partners, and so both deficit and surplus countries can be externally unstable. Whereas an excessive deficit country can suffer an abrupt reversal of capital flows and disruptive exchange rate movements, an excessive surplus country can itself experience a destabilizing capital inflow or contribute to a risk of disruptive exchange rate movements in another country.

The seven indicators mentioned in the Decision provide relevant cues but staff should draw on all available information to make its assessment.

Q3. How should exchange rates be assessed?

Exchange rate surveillance should include an analysis of the current level of the real effective exchange rate, compared to the level that would bring the "underlying" current account in line with the medium-term equilibrium current account. The "underlying" current account is the current account stripped of temporary factors, and assessed on the basis of the current REER and established domestic policies (those in place, as well as policies announced that are, to the best judgment of the team, likely to be implemented). And the equilibrium current account is one that leads the net external asset position (NEAP) to evolve in a manner consistent with the economy's structure and fundamentals, relative to other countries, and subject to a multilateral consistency constraint.

In making this assessment, staff should draw on information contained in the indicators in the Decision as well as other pertinent information, including, if relevant, assessments made by the Consultative Group on Exchange Rates (CGER).

If an under- or overvaluation is considered to be temporary, this should be made clear. This could happen, in particular, in the following cases: (i) if the current level of the REER is affected by temporary factors such as tight monetary policy; (ii) if the economy is considered to be in transition to a new equilibrium NEAP, so that the current account is expected to be temporarily above or below its medium-term equilibrium; and (iii) if the authorities' established exchange rate policies would remove the under- or overvaluation over the medium term.

Q4. What is expected of exchange rate assessments in staff reports?

As regards exchange rate levels, policy notes should include the staff's preliminary assessment, and staff reports a clear analysis and bottom line view, of whether the current account and the exchange rate are broadly in line with equilibrium. The assessment should be fully integrated into the broader assessment of external stability and the overall policy mix, and support clear policy recommendations. When there are no *prima facie* concerns, the discussion can be brief.

In countries with serious data limitations, the assessment may need to be largely qualitative, based upon a discussion of recent and prospective balance of payments developments, debt sustainability analysis (DSA), reserve adequacy, and other factors.

In all cases, information on key assumptions and adjustments should be transparently provided, and the authorities' views and analysis of the issue clearly presented. Moreover, where an indicator described in the Decision is relevant, it should be discussed.

Q5. What is the role of CGER?

The Decision and CGER use the same conceptual framework. Of CGER's three methodologies, the macro-balance (MB) approach and external sustainability (ES) approach (both of which compare the underlying CA with a measure of medium term equilibrium CA) can be most directly related to the framework of the Decision. Especially given the uncertainties involved in establishing an equilibrium CA, CGER's equilibrium real effective exchange rate (EREER) approach (which relates the REER directly to fundamentals) can provide useful complementary information. Where available, CGER results are likely to provide useful input, alongside other information, for assessing exchange rates under the Decision.

Q6. Can a floating exchange rate be under- or overvalued?

Yes. This may happen as a result of domestic policies (e.g., a depreciation induced by large fiscal surpluses), as a result of other countries' policies affecting the exchange rate of the country at issue, or because of market imperfections such as a bubble (which may burst in a disorderly way). Thus, even fully market determined exchange rates can result in disruptive adjustments. As a result, assessments should be applied evenly across members, regardless of the exchange rate regime that is in place.

Q7. What about the capital and financial account?

Even when the current account and exchange rate levels do not raise concerns about external stability, developments on the capital and financial account could give rise to external instability. First, temporary fluctuations in the current account may cause liquidity problems, even if the current account is at a level consistent with medium-term equilibrium. Second, a country's external financing structure may create vulnerabilities which could unwind abruptly. Frequent sources of such vulnerabilities are mismatches in the currency or maturity composition between asset and liability sides of external balance sheets, or reliance on short-term funding. In individual cases, concerns about instability emanating from the capital and financial account may well be much more important than any arising from an under- or overvalued exchange rate.

Appendix: Observance of the Principles on Exchange Rate Policies—Legal Considerations

App. Q1. What is the role of the Principles?

Principles A through D aim to provide guidance to members for the conduct of their exchange rate policies and to the Fund in conducting surveillance over these policies. In applying the Principles, the Fund will pay due regard to the circumstances of members. When concerns arise as to whether a particular member is implementing policies consistent with them, the Fund will always give the member the benefit of any reasonable doubt. Since policies work together to produce outcomes, attribution of outcomes to exchange rate policies will typically be difficult, and, consequently, cases where such attribution can be made beyond any reasonable doubt are expected to be very rare.

App. Q2. In Principles A and D, how are exchange rate policies defined, and how are "floaters" affected?

Exchange rate policies are defined to be intervention policies and certain other policies conducted for the purpose of influencing the balance of payments and hence the exchange rate. Principles A and D are, therefore, not relevant for countries that do not intervene or take other actions aimed at affecting the level of the exchange rate.

App. Q3. When would a member be found in nonobservance of Principle D?

Principle D guards against exchange rate policies that result in external instability. Finding a member in nonobservance of Principle D would require, *beyond any reasonable doubt,* that: (i) there is external instability; (ii) the member has exchange rate policies; and (iii) those exchange rate policies are a significant contributor to external instability.

External instability can be traced either to the current or capital and financial account, or to a combination of the two. On the current account side, external instability takes the form of a "fundamental misalignment," and occurs when (i) there is a misalignment between the prevailing REER and the level that would bring the underlying CA in line with the equilibrium CA, (ii) the misalignment is significant, (iii) the significant misalignment is expected to persist under established exchange rate policies, and (iv) the significant and persistent misalignment is established beyond any reasonable doubt.

Because external instability would normally result from the policy *mix*, it would inevitably be difficult to attribute it unambiguously to exchange rate policies. Instability would be attributed to exchange rate policies to the extent that making the exchange rate sustainable requires domestic policies inconsistent with the objective of domestic stability in Article IV (e.g., "overtightening" and creating deflation). The difficulty of attribution is a key reason why "reasonable doubt" will typically prevail in an analysis of observance of Principle D.

Note that even in a case where the member is in nonobservance of Principle D, it would not necessarily follow that the Fund would recommend changing exchange rate policies, and the Decision explicitly requires the Fund to take into consideration the disruptive impact that excessively rapid adjustment would have on the member's economy.

App. Q4. When would a member be found in nonobservance of Principle A?

Principle A repeats the obligation in the Articles to avoid manipulating exchange rates for the purpose of gaining unfair competitive advantage over other members. An assessment of observance of Principle A is needed, in particular, if a member has failed to observe Principle D because its exchange rate policies result in fundamental misalignment in the form of an undervaluation. The thrust of any analysis of Principle A concerns establishing the authorities' intent. If the intent is to secure a fundamental misalignment in the form of an undervaluation and the purpose of securing such misalignment is to increase net exports, and if the Fund can reach this conclusion beyond any reasonable doubt, then Principle A (and Article IV, Section 1(iii)) has not been observed. The Fund must make an objective assessment as to the intent behind a member's exchange rate policies, based on all available evidence, including consultation with the member. Any representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt.

App. Q5. How should nonobservance of the Principles for the guidance of members be reflected in staff reports?

When a Principle for the guidance of members is not observed, the staff appraisal should state this clearly (either by referencing a named Principle or by referring to the content of a Principle). Nonobservance of Principle A would also give rise to a breach of obligation under Article IV, Section 1(iii) and, if this is the case, the staff appraisal should indicate that.