

**Review of the 1977 Decision—Proposal for a New Decision
Companion Paper**

**Excerpts from the Companion Paper: Material Explicitly Endorsed by the Executive
Board that Provides Guidance on Applying the 2007 Surveillance Decision
June 21, 2007**

External stability

*With paragraph 6 explicitly endorsed as providing the definition of fundamental
exchange rate misalignment*

3. **A balance of payments position consistent with external stability is one in which both** (i) the underlying current account is broadly in line with its equilibrium (which, as discussed below, is equivalent to there being no fundamental exchange rate misalignment), and (ii) the capital and financial account does not create risks of abrupt shifts in capital flows. While the balance of payments refers to “flows,” the assessment of these flows must take into account the existing stocks, and, in particular, the economy’s net external asset position (NEAP) and the level and structure (e.g., composition by instrument or holder, maturity, currency denomination) of gross assets and liabilities. The next two sections examine the current account and the capital and financial account in turn, while a third section further clarifies the concept of external stability.

The underlying current account and fundamental exchange rate misalignment

4. **External stability requires the underlying current account to be broadly in equilibrium:**

- *The underlying current account is in equilibrium when the country’s NEAP is evolving in a manner consistent with the economy’s structure and fundamentals. Otherwise, the NEAP evolves in a way that creates a risk of abrupt reversal and thus of disruptive adjustments in exchange rates.¹ In general, the equilibrium evolution of the NEAP is expected to be consistent with the present and expected values of such fundamentals as productivity differentials, the terms of trade, permanent shifts in factor endowments, demographics, and world interest rates.² Of course, the equilibrium evolution of the NEAP is a matter of considerable judgment, especially in light of the recent trend toward financial globalization.*

¹ See paragraph 9 below on the unsustainability over time of NEAPs that are evolving inappropriately.

² The initial position of the NEAP is also important. If it is low because of earlier negative shocks, it may be appropriate for a country to run temporarily stronger current account balances. In general, the equilibrium evolution of the NEAP is not one in which the NEAP is necessarily constant.

- *The underlying current account is the current account stripped of temporary factors, such as cyclical fluctuations, temporary shocks, and adjustment lags.*³ If the actual current account deviates from the equilibrium current account due to temporary factors, the NEAP will evolve *for a while* in a way inconsistent with the economy's structure and fundamentals, but this will not necessarily create risks of abrupt reversal.⁴ The underlying current account is thus the one consistent with a zero output gap.^{5 6}

5. **The underlying current account may deviate from equilibrium for various reasons.** Exchange rate policies may be keeping the exchange rate at a level where, in the absence of an output gap, it yields too large a current account deficit or surplus. Or the same exchange rate result may come about because of market imperfections or persistent expectational errors on the part of the private sector, such as overoptimistic assessments of future productivity growth. Alternatively, a current account disequilibrium may also stem from domestic policies that tend to lead to excessive accumulation of assets or liabilities. Unsustainable fiscal policy is an obvious example.

6. **When the underlying current account differs from the equilibrium current account, the exchange rate is “fundamentally misaligned.”**⁷ In these circumstances, the exchange rate is not at its equilibrium level—the one required to generate an equilibrium current account, in the absence of an output gap—be it because of exchange rate policies, market imperfections, or unsustainable domestic policies. The exchange rate of interest here is the one that affects the current account, hence the *real effective* exchange rate,⁸ and its equilibrium level will also depend on factors affecting the relationship between the exchange rate and the equilibrium current account (such as trade restrictions). Of course, in practice an

³ Including lags in the current account with respect to previous exchange rate movements.

⁴ These temporary factors are assumed to offset each other over time, so that any temporary accumulation of assets does not affect the long-term position of the NEAP.

⁵ In low-income countries, defining an output gap and an associated underlying current account is likely to be challenging because cyclical fluctuations are typically less important than structural changes. The judgment required is similar, however, to the commonly-made judgment whether aggregate demand is consistent with the economy's “absorptive capacity.”

⁶ Since the assessment should be conducted in a multilateral setting, the underlying current account should also be calculated assuming other countries have no output gap.

⁷ An exchange rate will be misaligned in a manner that is not “fundamental” when the *actual* current account differs from the equilibrium current account. Such misalignment may thus include a cyclical component.

⁸ Of course, the concept of misalignment could equally be cast in terms of the exchange rate at a *particular point in time* and measured in nominal terms—that is, *given* the relevant price levels. To form a view on misalignment through time, however, it is clearly necessary to account for the evolution of price levels.

exchange rate would only be judged to be fundamentally misaligned if the misalignment was found to be significant.

7. **Although “equilibrium” exchange rates can be defined in various ways, the definition above is the one of prime relevance to Fund surveillance.** It differs from the short-term market equilibrium, and assessments about misalignments are not intended to try to anticipate market outcomes over any specific time horizon. Rather, the goal here is to assess the potential for significant real exchange rate adjustments, that might occur when fundamental forces eventually prevail. Accordingly, the concept of equilibrium exchange rate described above is the one used in best practice Article IV consultations and the one that underlies the work of the Fund’s Consultative Group on Exchange Rates (CGER) (backed up by three different methodologies), which embodies a multilateral consistency constraint and serves as an input for consultation teams.⁹

The role of the capital and financial account

8. **Even if the underlying current account is in equilibrium (and, thus, there is no fundamental exchange rate misalignment), the capital and financial account may be a separate source of external instability:**

- First, the NEAP may be evolving appropriately, and yet the country may be building up, or maintaining, *vulnerable external balance sheet structures*, which could be abruptly unwound. The importance of such structures has been amply demonstrated in the capital account-driven crises of the last decade. The level and structure of gross capital flows is key in this regard—against the background, as noted above, of the level and structure of existing external assets and liabilities.
- Second, even temporary fluctuations in the current account may cause disruptions in the presence of market imperfections leading to *financing constraints*. Inability to finance an excessive current account deficit due to cyclical fluctuations (overheating) or to temporary shocks is thus another possible source of external instability. The level of reserves and access to international capital markets are key factors here.

Three clarifications

9. **The concept of external stability takes account of spillovers across countries, and applies to both surplus and deficit countries.** External instability—the mirror image of external stability—captures instances where a member’s balance of payments creates a risk of disruptive adjustments in exchange rates, where the trigger for such an adjustment may

⁹ Methodology for Current Account and Exchange Rate Assessments (IMF, 2001) (<http://www.imf.org/external/pubs/nft/op/209/index.htm>) discusses econometric methods of estimating the equilibrium exchange rate.

come from within the member's balance of payments or from within that of its partners. A country building up excessive net liabilities clearly becomes vulnerable to disruptions, as it would be regarded to be breaching its intertemporal budget constraint, and would face financing constraints. By contrast, a country building up excessive net assets, inconsistent with the economy's fundamentals, might be able to do so for a long period. However, at least one of its partners is likely to be building up an excessive net liability position, at risk of abrupt reversals.

10. **Although the concept of external stability is anchored in the balance of payments position *today*, this does not mean that surveillance can ignore policies and developments that will only affect the balance of payments position *tomorrow*.** Problems yet to influence the balance of payments—e.g., domestic problems—but that risk leading to external instability are also relevant for surveillance. For example, domestic financial sector weakness might eventually spill over onto the balance of payments when a crisis occurs.

11. **Eliminating external instability does not necessarily mean exchange rates *need to adjust*, but external instability, if not addressed, risks being *reflected in disruptive exchange rate adjustment*.** The definition of external instability should not be read as describing a situation requiring exchange rate adjustment at all times. Rather, it is meant to acknowledge that without remedial action, there is a risk of disruptive adjustment in exchange rates. Consistent with paragraph 5 above, action to promote external stability is not necessarily sought in exchange rate adjustment, but in a range of policies to ensure a balance of payments position consistent with external stability.¹⁰

Indicator (i)—Intervention

41. **The proposed text places particular emphasis on the need to examine sterilization that accompanies protracted large-scale one-way intervention.** Exchange rate intervention *coupled with* sterilization—i.e., mopping up liquidity associated with reserve gains or injecting liquidity to offset reserve losses—prevents domestic prices from adjusting and hence impedes the adjustment of not only the nominal but also the real exchange rate. It therefore warrants special scrutiny.

42. **The explicit mention of sterilization is by no means intended to indicate that sterilization will always be a cause for concern.** Some Directors in February were concerned that such reference would risk surveillance making no allowance for well-justified sterilization such as would, for example, take place in the course of normal reserve buildup

¹⁰ This said, if domestic prices are rigid downward (and inflation is low in other countries), there will be limits to what domestic policies can achieve to make an *overvalued* exchange rate consistent with external stability. In this situation an adjustment in exchange rate policies may be necessary.

or in response to large temporary or cyclical capital inflows.¹¹ The indicator, however, does not call for special scrutiny of all sterilization, but only of sterilization that accompanies protracted large scale one-way intervention. Moreover, in applying it, it is critical to assess whether the sterilized intervention occurs in the presence of a misaligned exchange rate, or whether sterilized intervention aims at preventing market forces from moving the real exchange rate away from its equilibrium, as in the case of speculative capital inflows.¹²

¹¹ Of course, the practical effectiveness and viability of sterilized intervention would depend on the elasticity of capital inflows to interest rate differentials, as well as on its costs.

¹² For example, particular attention should be paid to sterilization of current account surpluses and deficits, rather than of capital account flows, as such sterilization is more likely to point to a misaligned exchange rate.