

## **Appendix 2: Report to Congress on IMF Bilateral and Multilateral Surveillance over Members' Policies**

The Supplemental Appropriations Act, 2009 requires Treasury to (1) report on ways in which the IMF's surveillance function under Article IV could be enhanced and made more effective in terms of avoiding currency manipulation; (2) report on the feasibility and usefulness of publishing the IMF's internal calculations of indicative exchange rates; and (3) provide recommendations on the steps that the IMF can take to promote global financial stability and conduct effective multilateral surveillance.<sup>1</sup>

### **Background on IMF Surveillance**

The IMF was founded in 1944 against the backdrop of the destructive mercantilist economic policies of the 1930s, including highly protectionist trade policies and beggar-thy-neighbor competitive exchange rate depreciations. From the start, exchange rate issues were at the core of the Fund's fundamental responsibilities in the international monetary system.

IMF member countries have the right to select an exchange rate regime of their choosing but also an obligation not to manipulate their exchange rate for the purposes of preventing effective balance of payments adjustment or gaining an unfair competitive advantage in international trade. The IMF is charged with overseeing the international monetary system to ensure its effective operation and monitoring each member's compliance with its policy obligations. This involves both bilateral and multilateral surveillance of exchange rates.

Obligations over **bilateral** surveillance were operationalized in the landmark 1977 Executive Board *Decision on Surveillance of Members' Exchange Rate Policies*. In fulfillment of its surveillance responsibilities, the IMF's Executive Board conducts Article IV consultations with each member country, typically once a year. IMF Management, or a country, may delay the Article IV consultation for a reasonable period. During the Article IV process, an IMF staff team meets a country's economic officials at the technical, senior policy, and typically the Ministerial/Central Bank Governor level. IMF staff views are then set forth in a staff report that summarizes economic developments and prospects, as well as discussions with the national authorities. The staff report is discussed by the IMF Executive Board. Publication of both the summary of the IMF Executive Board meeting and the staff paper are voluntary but presumed, though the country in question has the right to delete "market sensitive" information, and may decline to permit publication altogether.

The key instruments of the IMF's **multilateral** surveillance are two semi-annual publications produced by the Fund – the *World Economic Outlook* (WEO) and *Global Financial Stability Report* (GFSR). The WEO presents IMF staff analyses of global economic developments during the near and medium term. The GFSR focuses on current conditions in global financial markets, highlighting issues that could pose a risk to financial market stability. In addition, broad developments in multilateral exchange rates are reviewed periodically by the Executive Board, e.g., through discussions of the WEO and the GFSR and of exchange rate and financial market developments.

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<sup>1</sup> Title XIV, Section 1403(c) of the Supplemental Appropriations Act, 2009 (P.L.111-32).

## **Improving IMF Bilateral Exchange Rate Surveillance**

In June 2007, the IMF Executive Board adopted a new *Decision on Bilateral Surveillance over Members' Policies*, replacing the 1977 *Decision on Surveillance over Exchange Rate Policies* as the guiding document on surveillance. The new decision was strongly backed by the U.S. Treasury Department in an effort to refocus the Fund on its core mandate.<sup>2</sup> In addition to formalizing the *de facto* coverage of fiscal, monetary, and financial sector policies in the conduct of bilateral surveillance, the new IMF surveillance framework reaffirmed the central role of exchange rate work in the Fund's daily life.

The 2007 Decision restored exchange rate surveillance's position at the core of the IMF's mandate. Since the Decision, IMF surveillance of exchange rates has improved in both breadth and quality. The IMF's Independent Evaluation Office found only 63 percent of Article IV reports from 1995-2005 included a clear assessment of the exchange rate's value in relation to economic fundamentals.<sup>3</sup> In contrast, the 2008 Triennial Surveillance Review found that that number had risen to 92 percent after the Decision.<sup>4</sup> Selected issues papers accompanying Article IV staff reports have been increasingly devoted to exchange rate issues and the sophistication of exchange rate assessments has improved, as econometric assessments of the exchange rate's equilibrium value have become more common.

Despite these improvements, the IMF's bilateral exchange rate surveillance still needs to improve in its candor, consistency, and transparency. In terms of candor, the 2008 Triennial Surveillance Review noted that a large portion of IMF exchange rate assessments completed since the 2007 Decision conclude that the exchange rate is broadly in line with fundamentals, even when large current account imbalances exist. IMF staff are too quick to explain current account imbalances as a result of temporary factors and 1 in 5 IMF Mission Chiefs cited the "need to preserve quality relationships with the authorities" as a challenge to full treatment of exchange rate issues. Taken together, this suggests IMF bilateral surveillance is biased towards accommodation of large external imbalances, as opposed to adjustment. With IMF staff facing strong pressure from country authorities to avoid conclusions of over or undervaluation of the exchange rate, improving the candor of IMF exchange rate surveillance requires providing IMF staff with counterbalancing institutional incentives for frank assessments. In particular, the IMF must explore methods to make both staff and management more accountable for their surveillance conclusions. Two possible methods are either ex-post assessments of bilateral surveillance conclusions or peer review of exchange rate assessment conclusions (i.e. the assessments would be 'refereed').

In terms of consistency, the IMF needs to deepen the integration between multilateral and bilateral surveillance and devote more consideration in Article IVs to the external implications of a member's policies. The IMF has increasingly incorporated some treatment of the external implications of members' policies (including exchange rate policies) into bilateral surveillance of systemically important countries. However, the IMF's bilateral surveillance of members at times

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<sup>2</sup> See, for example, remarks by Under Secretary for International Affairs Tim Adams at the American Enterprise Institute Seminar, "Working with the IMF to Strengthen Exchange Rate Surveillance," February 2, 2006.

<sup>3</sup> Independent Evaluation Office of the International Monetary Fund, "An IEO Evaluation of IMF Exchange Rate Policy Advice, 1999-2005," 2007.

<sup>4</sup> International Monetary Fund, "2008 Triennial Surveillance Report – Overview Paper," September 2, 2008.

continues to condone policies (such as reserve re-accumulation beyond commonly accepted benchmarks) that seem inconsistent with the risks highlighted in the IMF's multilateral surveillance. Discussion of external and internal spillovers is rare in surveillance of less systemically important countries, even though these countries as an aggregate can also influence the global system. Improving the consistency of surveillance requires better use of multilateral surveillance analysis in the WEO and GFSR as inputs into bilateral surveillance. Strengthening cooperation between the country teams for interdependent economies (for example, by rotating staff) might also help increase the focus on cross-border spillovers.

Finally, the transparency of the IMF's exchange rate assessments must increase. The most important transparency measure is to continue to encourage IMF members, particularly systemically important countries to consent to timely Article IV reviews and the publication of their Article IV staff reports. Among the G-20 economies for example, two have not held an Article IV consultation with IMF staff in the past two years (Argentina and Turkey) and four more did not consent to publication of the staff reports from their most recent Article IVs (China, Brazil, Indonesia, and Saudi Arabia).

The transparency of the analysis behind the IMF's exchange rate assessment conclusions also is lacking in some cases. The 2008 Triennial Surveillance Review found that 22 percent of staff reports in the 50-country sample did not include clear presentations of the methodologies used in the exchange rate assessment. In some cases, the IMF simply states its conclusion that a currency is in line with its equilibrium, without providing supporting rationale. In other cases, the IMF presents the results of quantitative equilibrium exchange rate exercises without providing analysis and support for the conclusions. IMF staff could better document their exchange rate assessment analysis, in either the Article IV report itself or in accompanying documents.

### **Publication of IMF CGER Estimates**

Since 1997, the IMF Consultative Group on Exchange Rate issues (CGER) has been conducting biannual exchange rate assessments to determine whether the exchange rate is broadly in line with fundamentals. Over time the methodologies used in the assessments have been revised and the number of currencies included in the assessments has been expanded. Currently CGER covers 27 advanced and emerging market economies with the assessments based on three distinct but complementary methodologies—the macroeconomic balance approach, a reduced form equilibrium real exchange rate approach, and an external sustainability approach.<sup>5</sup>

The results of this exercise are not publicly available, but CGER estimates for a particular currency may be published as part of the bilateral Article IV report. For example, CGER or CGER-type estimates were published for 11 of the G-20 economies in 2009. Three reports refer to the results of the CGER analysis but do not provide estimates. In the 4 cases where the Article IV report was not published, a “Public Information Notice” was released. Each of these provided a qualitative assessment of the real effective exchange rate relative to equilibrium but not data are given. Under current policies, publication of the Article IV staff reports is at the discretion of the member country and each member retains the right to delete market sensitive

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<sup>5</sup> These methodologies are described in “Exchange Rate Assessments: CGER Methodologies,” International Monetary Fund Occasional Paper #261, 2008.

information from a staff report before publishing. Similarly, publication of the CGER analysis would require approval of the member countries whose exchange rates are included in the assessment.

Because the IMF publishes the methodologies used in the CGER assessments it is possible to for researchers to develop similar estimates. An exact replication of the CGER assessments may not be possible as some of the data (notably import and export elasticities for individual economies) are not published and the IMF applies judgment to the results from the three methodologies to develop an overall exchange rate assessment. Nevertheless, researchers in academia, think tanks, and, financial markets use similar data and models produce exchange rate assessments for a range of currencies.

Publication of CGER estimates would increase the transparency of the IMF's exchange rate surveillance, and expose the measures to outside scrutiny which could lead to refinements in methodologies. At this point, however, the CGER assessment does not cover most emerging market currencies. Technical challenges remain to expanding the analysis to commodity dependent economies and to economies undergoing rapid structural change but the IMF has developed methodologies to address some of these challenges. Even if the CGER assessments were published it is important to bear in mind that no precise methodology exists to identify real effective exchange rate misalignments. Nevertheless, models of equilibrium exchange rates can provide useful information especially when various models reach generally similar conclusions in direction and magnitude, (but even when they do not). Further, when model-based results are coupled with other available data composite judgments can be reached.

### **Improving IMF Multilateral Surveillance**

In light of the global economic crisis, the IMF's multilateral surveillance mission has taken on increasing importance. Enhanced multilateral surveillance by the IMF is crucial for both recovery from this crisis and prevention of future economic instability. The IMF's participation in the G-20 mutual assessment mechanism, the new joint IMF and Financial Stability Board (FSB) early warning exercise, and the IMF's role in coordinating exit strategies are important components in this enhanced multilateral surveillance framework.

As part of the Framework for Strong, Sustainable, and Balanced Growth agreed to at the Pittsburgh G-20 Summit, the IMF will play a key advisory role in the G-20 mutual assessment mechanism. The IMF will develop a forward-looking analysis of whether policies pursued by individual G-20 countries are collectively consistent with more sustainable and balanced trajectories for the global economy, and report regularly to both the G-20 and the International Monetary and Financial Committee (IMFC).

The IMF/FSB Early Warning Exercise is intended to identify risks and vulnerabilities across financial institutions, markets, and countries, with particular emphasis on tail risks—defined as low probability- high impact events—that could lead to systemic crisis. The IMF and FSB conducted a dry-run of the EWE during the 2009 Spring Meetings and the first full EWE round was launched during the 2009 Annual Meetings.

Finally, the IMF will play an important role in coordinating exit strategies from extraordinary crisis-related measures. At the Pittsburgh, G-20 Summit leaders tasked the IMF and FSB with assisting Finance Ministers in developing a plan for coordinated exit strategies. The recent IMF WEO highlights the difficulty of coordinating exits. Countries authorities must carefully time exit from accommodative policies so that it is neither premature nor delayed. The optimal timing of exit will vary with country circumstances, which could create cross-border spillovers that will affect the global recovery. Substantive contributions from the IMF to this difficult analytical problem are importantly needed.