# I

# Revolutions in the International Monetary System

# 2

## On the Map: Making Surveillance Work

Surveillance, a central pillar of IMF activities and responsibilities in the modern era, is not an easy concept to grasp. Jacob A. Frenkel, a former Economic Counsellor at the Fund, has called it "a terrible word [that] . . . gives the impression of a policeman chasing criminals [or] . . . that somebody is looking after somebody, typically in a patronizing way." Surveillance, in his view, "should give way to concepts of cooperation, partnership, and consultation; of bringing on board the rest of the world's considerations." (Boughton and Lateef, 1995, pp. 238–39.) In practice, surveillance has encapsulated all of the above notions, but at its best it has been motivated by and has itself promoted a spirit of international cooperation.[1]

Surveillance was a latecomer to the Fund's lexicon. The first official use of the term came in the final report of the Committee of Twenty, issued in June 1974: "Fund consultation and surveillance regarding the adjustment process will take place at two levels, the Executive Board and the Council. . . ."[2] Four years later, the concept was enshrined in the Second Amendment to the Fund's Articles of Agreement: ". . . the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies" (Article IV, Section 3(b); for the full text of the Article, see the Appendix to this chapter). Surveillance thus was to comprise both consultations with each member country on exchange rate and macroeoconomic policies and analysis of the functioning of the international

[1]For a political science perspective on the nature of Fund surveillance, see Pauly (1997). Pauly explains the self-interest of states in submitting to surveillance by analyzing the process as an inherently ambiguous but still substantive means for states to cope with the conflict between the political ideal of national sovereignty and the economic ideal of global integration.

[2]"Final Report and Outline of Reform of the Committee of Twenty"; de Vries (1985), Vol. 3, pp. 165–96. The quoted passage is from paragraph 5 of the report, p. 168. The Committee of Twenty was the committee of IMF governors established in 1972 to negotiate reforms in the international monetary system. The Council mentioned in this passage was not established, and the role envisaged for that body was played by the Interim Committee. The term "surveillance" had long been used informally and internally at the Fund to describe the (largely futile) effort to assert a significant role for the institution in previewing proposals to change par values under the Bretton Woods system. James (1995), which provides a general history of the development of surveillance at the Fund, cites a 1964 report by the Group of Ten as the "first use of the term in discussions about the international economy" (p. 767).

monetary system and of the policy requirements for achieving a stable system of exchange rates.

It is clear from the record of the deliberations on the Second Amendment in the mid-1970s that the Fund's governors did not agree on the precise meaning of "firm surveillance" and even that the phrase was introduced as a substitute for agreement on a more precise reform of the exchange rate system. Those (notably U.S. officials) who sought a flexible system in which exchange rates could adjust freely in response to market forces saw surveillance as a means of discouraging countries from manipulating exchange rates in opposition to market pressures. Those (notably French officials) who sought greater stability in exchange rates saw it as a means of encouraging countries to adopt economic policies that would ensure such stability. Both sides recognized that the principles and procedures of surveillance would have to be worked out gradually through experience.[3]

The original purpose of surveillance was to ensure that each member country complied with its new obligations after the Second Amendment. Those obligations included notably "to collaborate with the Fund and with other members in order to assure orderly exchange arrangements and to promote a stable system of exchange rates" (Article IV, Section 1). Later, additional objectives for surveillance would be identified, and by the late 1990s the Fund was being asked to use surveillance to identify economies where financial crises might occur and to report to the membership and to the general public on the soundness of each economy and of each country's economic policies. In the 1980s, public dissemination of the findings from Article IV consultations was not generally seen as desirable, because of concerns that it could compromise the forthrightness and effectiveness of the confidential discussions.

Until the Jamaica accords of January 1976, when the Interim Committee agreed on the text of the amended Articles, the goal of the discussions on surveillance was to define a new way of stabilizing exchange rates without the central anchors of gold and a stable U.S. dollar.[4] After that effort failed, the goal became to implement Fund surveillance in a firm and effective manner so as to ensure that exchange rates would reflect underlying or "fundamental" economic conditions. Few if any countries, however, were prepared to be subjected to surveillance in that

[3]The basic reference on the negotiations is de Vries (1985), Parts Two (on the Committee of Twenty) and Eight (on the amendments to the Articles). Also see Chapter 4, pp. 190–91, below; James (1996), Chapters 9 and 10; and the papers by Boughton and James in *Comité pour l'Histoire Économique et Financière* (1998).

[4]This point was stated most clearly in the final report of the Committee of Twenty (June 1974): "The main features of the international monetary reform will include . . . better functioning of the exchange rate mechanism, with the exchange regime based on stable but adjustable par values and with floating rates recognized as providing a useful technique *in particular situations*" (emphasis added). The Jamaica communiqué (January 1976) tacitly acknowledged that floating would play a more pervasive role, and it concluded that stability would derive from underlying conditions, not from the form of the system: "The new system [of exchange arrangements] recognizes an *objective* of stability and relates it to achievement of greater underlying stability in economic and financial factors" (emphasis again added). See de Vries (1985), Vol. 3, pp. 167 and 227, respectively.

strong sense. The 1980s therefore became a decade of experimentation, in which the staff and management of the Fund constantly probed and prodded to see how far they could go in persuading countries to respond positively to Fund analysis and advice.

This chapter recounts the various efforts by the Fund in the period through 1989 to put some flesh on the bones of Article IV. It was not an easy task either to develop the right advice or to reach effective agreements, and the efforts often were not successful. Although the limitations to surveillance were easy to identify, the solutions frequently required political commitments that—usually for very good reasons—countries were not prepared to make. By the mid-1990s, partly because of the success of the "silent revolution" and partly because of the galvanizing influence of the 1994–95 financial crisis in Mexico, the world's economic policymakers were more prepared to subject themselves to a code of conduct and to quantifiable standards. The adoption of a series of "declarations" on desirable policy standards by the Interim Committee in 1993–96, the gradual opening up of surveillance conclusions to public scrutiny, the acceptance by many countries from all regions of the world to a Fund-established standard for the dissemination of economic data, the intensification of the Executive Board's direct scrutiny of countries' exchange rate policies: all made Fund surveillance a more effective process.

The backbone of surveillance after the Second Amendment was to be a regular cycle of consultations with each member country. The Fund was already holding consultations with members, originally (starting in 1952) under authority of Article XIV, the article that enabled members to maintain certain exchange restrictions temporarily, provided that they agreed to consult regularly with the Fund "as to their further retention." For the first decade, annual consultations were held only with members still operating under the transitional provisions. Starting in 1961, the Fund also held regular consultations with countries that were not under Article XIV, but on a strictly voluntary basis and with no formal conclusions by the Executive Board.[5] The intent of the new Article IV adopted in 1978 was to formalize, extend, and strengthen that process and to aim it at the goal of stabilizing the exchange rate system. (For more on exchange restrictions and Article XIV, see the section in this chapter on Reducing Exchange Restrictions.)

Although the Fund was not given any special powers to enforce its policy advice to nonborrowing countries, it did have a measure of influence in the international community. If surveillance was to have any substance, the Fund would have to develop that influence: through the power of persuasion (Fund management and staff to country authorities), through peer pressure (country to country in the forum of the Fund), and through publicity (Fund to the public). The relative merit

[5]The Executive Board enacted a decision on June 1, 1960, providing for voluntary consultations with countries that had accepted the obligations of Article VIII. The first such consultation was held in August 1961, with the United Kingdom. See Horsefield (1969), Vol. 1, pp. 479–82; Vol. 2, pp. 246–48; and Vol. 3, pp. 260–61.

of each of these channels was always the subject of much debate. Was publicity appropriate, or would it conflict with and even nullify the benefits of persuasion and peer pressure? Did surveillance mean that the IMF was expected to be a financial Interpol, seeking out and punishing errant behavior, or should its role be more that of a faithful confidant of those entrusted with implementing macroeconomic policies around the world? Even among IMF staff, those questions did not yield uniform answers.[6]

Aside from the general problem of how to make surveillance consultations effective, an important concern for the Fund in designing a strategy for surveillance was to make it evenhanded for all member countries: large and small, surplus and deficit, floaters and peggers. That last dimension was especially troublesome. After the collapse of the par value exchange rate system in the early 1970s, countries around the world adopted a wide variety of exchange arrangements. What defined the system, of course, was the decision of the largest countries—the United States, Japan, and Germany—to let their exchange rates float vis-à-vis one another. For those countries, the implicit primary task of Fund surveillance was to evaluate whether their macroeconomic policies were unstable or unsustainable to the point that they might detract from the stability of the exchange rate system. Many smaller countries chose to peg their exchange rates to a single currency or to a currency basket, or to manage exchange rate policy so as to maintain a degree of stability vis-à-vis a currency or basket. For that group of countries, the implicit task of surveillance was to determine whether macroeconomic and exchange rate policies were consistent. Since this latter task was more well defined, a major challenge was to ensure that the "floaters" were also held up to appropriate standards of conduct.

A further complication in the conduct of surveillance was the lack of an agreed objective for exchange rate policy that could apply to a broad range of countries. During the 1980s, the debate often was framed as follows: Was the exchange rate to be an instrument for external adjustment, a nominal anchor for financial stability, or a real anchor for maintaining international competitiveness? Both inside the Fund and more widely, views on how best to define and rank such goals varied between countries and over time. Although a degree of eclecticism and flexibility was no doubt necessary, the absence of an objective model or framework inevitably led to arbitrary judgments and prolonged disputes.

These issues are the subject of the present chapter. The first section examines the attempts made to strengthen the principles of surveillance during the first decade of experience under the Second Amendment. The second section takes a closer look at the issues that complicated the Fund's task of assessing countries' exchange rate policies. The chapter concludes with a review of the evolution of the practice of surveillance, including the use of special consultations in response to specific problems.

[6]For a general discussion of these issues, see the papers in Boughton and Lateef (1995), Chapter 11.

## Implementing Article IV: The Principles of Surveillance

As soon as the language for the new Article IV had been accepted *ad referendum* at the January 1976 meeting of the Interim Committee in Jamaica, the Fund's Executive Board set out to devise a set of principles and procedures for implementing surveillance. After much debate, a formal decision was adopted on April 29, 1977.[7] But because the differences in view that had made the amendment itself difficult to pass had not disappeared after Jamaica, the language in the implementing decision was scarcely more concrete than the language in the Articles. The core of the decision was a set of five "principles" for identifying cases that "might indicate the need for discussion with a member," aside from the scheduled consultations. The first indicator was "protracted large-scale and one-way intervention in exchange markets." Countries were expected to intervene when necessary to counter disorderly market conditions, but not to the point where they might be seen as avoiding a needed exchange rate adjustment. The second, third, and fourth indicators related to excessive external borrowing or lending, exchange restrictions or incentives, or the adoption of domestic economic policies "that provide abnormal encouragement or discouragement to capital flows," provided that such actions were undertaken "for balance of payments purposes." And the fifth indicator was a portmanteau: "behavior of the exchange rate that appears unrelated to fundamentals."

All these principles or indicators eventually gave the Fund headaches. Protracted one-way intervention was neither controversial as an indicator nor especially difficult to identify, but its impact was decidedly asymmetric because it did not apply to the large industrial countries or other countries with floating rates. The limiting phrase "for balance of payments purposes" provided a virtually ironclad defense against any criticism, since economic policies could always be justified on domestic grounds. For example, although Executive Directors often criticized the policy strategy that produced large current account surpluses for Japan, the Japanese authorities consistently defended the practice. In their view, the strategy was dictated by a domestic need for large current net national saving to prepare for the decline that would inevitably follow the expected rise in the average age of the Japanese population in the 21st century. (See Chapter 3.) Moreover, it was very difficult to detect when capital flows were "abnormal." That judgment, which is equivalent to determining whether the current account surplus or deficit is abnormal, required making arbitrary assumptions and thus was useful more for analytical than for practical surveillance purposes.

The indicator that applied most directly to the large industrial countries was the last one: exchange rate movements unrelated to "fundamentals." That criterion was difficult to assess, because the idea of "fundamentals" was so elastic. For example, when a shift in the U.S. policy mix toward fiscal expansion and monetary

[7]The approved principles and procedures are reproduced in the Appendix to this chapter. For a review of the debate in 1977, see de Vries (1985), pp. 837–49.

contraction led to a sharp appreciation in the U.S. dollar in the first half of the 1980s, the appreciation could be judged inconsistent with fundamental underlying conditions only by first judging that this mix of policies was inconsistent with the fundamentals. U.S. officials argued (again, see Chapter 3) that their policy stance was an appropriate and necessary response to the inflationary pressures of the preceding years. Nonetheless, the Fund was able to base surveillance in that case on the argument that lax fiscal policy was unsustainable and thus could not be treated as an underlying fundamental condition.

The Executive Directors who adopted the 1977 surveillance decision recognized that these principles were quite weak and might have to be changed eventually once enough experience had been gained to produce a consensus on a means of improving them. Accordingly, they included a provision that the principles should be reviewed at least biennially. But the problems that made the original principles difficult to apply also made it difficult to reach agreement on strengthening them. In the first three reviews (1980, 1982, and 1984),[8] no formal proposals were made to amend the principles. By 1986, however, the recognition was growing that the principles were out of sync both with economic realities and with the evolving practice of Fund surveillance.

In 1986 and again in 1987, the staff—in an effort spearheaded by Andrew Crockett, Deputy Director of the Research Department—suggested that the principles should be changed, on several grounds. First, the distinction between policy actions taken "for balance of payments purposes" and those taken for domestic purposes was neither meaningful nor helpful. Second, the causes of fluctuations in exchange rates had turned out to be quite different from what had been thought in the 1970s. Although price stability had been largely restored, exchange rates had continued to show wide and persistent fluctuations, mainly because countries had adopted divergent mixes of monetary and fiscal policies. Third, the role of official intervention in affecting exchange rates had turned out to be much smaller than expected. Consequently, the staff concluded that the "current principles for the guidance of members' exchange rate policies do not, by themselves, provide sufficient guidance to generate medium-term exchange rate stability."[9]

The conclusion that the surveillance principles were flawed was an easy one to reach, but agreement on a revised list remained elusive. The staff offered several suggestions for either giving the Fund a more specific role in overseeing exchange rate policies or significantly extending the meaning of "exchange rate policies" beyond the narrow concept embodied in the 1977 decision. First, the Fund could encourage countries to establish target or reference zones for their exchange rates. Second, the Fund could encourage countries to set limits on shifts in the mix of

[8]The 1977 decision did not specify an initial date from which the biennial review cycle would ensue. In January 1979 the Managing Director suggested, and the Executive Board agreed, that the cycle should begin with the date on which the Second Amendment became effective: April 1, 1978. The first review was therefore to be concluded by April 1, 1980. "Revised Text of Decision," EBD/79/18, Rev. 1 (January 22, 1979).

[9]"Surveillance Over Exchange Rate Policies—Biennial Review of 1977 Document," SM/86/3 (January 10, 1986), p. 15.

monetary and fiscal policies so as to foster sustainability of exchange rates. Third, the Fund could ask members to set medium-term targets—or at least to make projections—for key economic variables and to discuss developments in those variables in consultations with the Fund.

When the Executive Board first discussed these suggestions in February 1986, Directors expressed considerable interest but limited enthusiasm. The one proposal that drew widespread support was the one that made the smallest departure from existing practice: strengthening the use of quantitative indicators as the basis for surveillance discussions. Support for that proposal—as discussed in more depth below—continued to build over the next year and was enshrined in the Interim Committee communiqué of April 1987 (Para. 3):

> Committee members considered that actual policies should be looked at against an evolution of economic variables that could be considered desirable and sustainable. They encouraged the Executive Board to examine the ways in which the existing principles and procedures of Fund surveillance could be updated to incorporate the use of indicators. . . .

In response, the Board took the unusual step of scheduling a special review of the principles of surveillance in July 1987, several months before the regular biennial review. When the time came for a concrete decision, however, support for change suddenly evaporated. The Fund was already cautiously expanding the use of quantitative indicators in surveillance, and Directors took the quite practical view that it could continue to do so without amending the surveillance principles. Thus the one real opportunity to strengthen the principles was allowed to pass.[10]

The source of the Board's reluctance to amend the surveillance principles was clear. Both the Articles of Agreement and the 1977 surveillance decision were crafted so as not to impose obligations on member countries to conduct domestic macroeconomic policies in a particular way, other than the general obligation to cooperate with the Fund in the conduct of surveillance. Specifically, Article IV of the Articles of Agreement distinguishes between "exchange rate policies" in a narrow sense and the broader set of economic policies that affect exchange rates. The article enjoins the Fund to practice "firm surveillance" over the narrower range of international policies (section 3(b) of the article) and to "oversee" the effects of the broader range of policies on the international monetary system (section 3(a)). The principles listed in the 1977 decision apply only to the narrow concept, which accounts for the language that circumscribes coverage to policies undertaken "for

[10]See the minutes of EBM/87/105–106 (July 22, 1987) and EBM/87/107 (July 23, 1987). The only amendments to the original Board decision in the 1980s concerned procedures rather than principles. For the first decade of surveillance, the Board agreed to review the implementation of surveillance annually and the principles biennially. At the conclusion of the 1988 review, it was agreed that henceforth both aspects would be reviewed only biennially. "Amendment and Review of Document Entitled 'Surveillance Over Exchange Rate Policies' Attached to Decision No. 5392-(77/63), Adopted April 29, 1977, As Amended," SM/88/39, Sup. 2 (April 20, 1988). The principles were later amended, in April 1995, with the addition of a sixth criterion for assessing potential problems related to "unsustainable [international] flows of private capital" (see *Annual Report 1995*, p. 202). Also see footnote 58, p. 95.

balance of payments purposes." Applying that distinction is inherently illogical and has little practical effect "in the field," because the dominant influence on exchange rates is domestic macroeconomic policy, but to modify it would substantially expand the scope of the Fund's authority.

At the July 1987 discussion, the U.S. Director, Charles H. Dallara, asked rhetorically, "Can anyone imagine a U.S. Article IV consultation that does not cover fiscal policy?"[11] Although the Fund certainly did offer strenuous and often effective advice on fiscal policy through those consultations, the unspoken corollary was (and remains), "Can anyone imagine the IMF dictating fiscal policy to the United States?"

## Assessing Exchange Rate Levels and Policies

The central difficulty in conducting surveillance over countries' exchange rate policies is the absence of a generally accepted goal or standard for those policies. There is no generally accepted economic model that determines whether it is better for a country to float, fix, or manage its exchange rate or how to relate exchange rate policy unambiguously to one or more of several macroeconomic goals. This lacuna in the conduct of surveillance was manifest in three major issues during the 1980s. Was it feasible or desirable for the Fund to treat countries evenhandedly despite the presence of a wide variety of exchange arrangements? Was floating inherently preferable to fixing the exchange rate? What, if anything, should be the role of the exchange rate as a policy instrument or indicator?

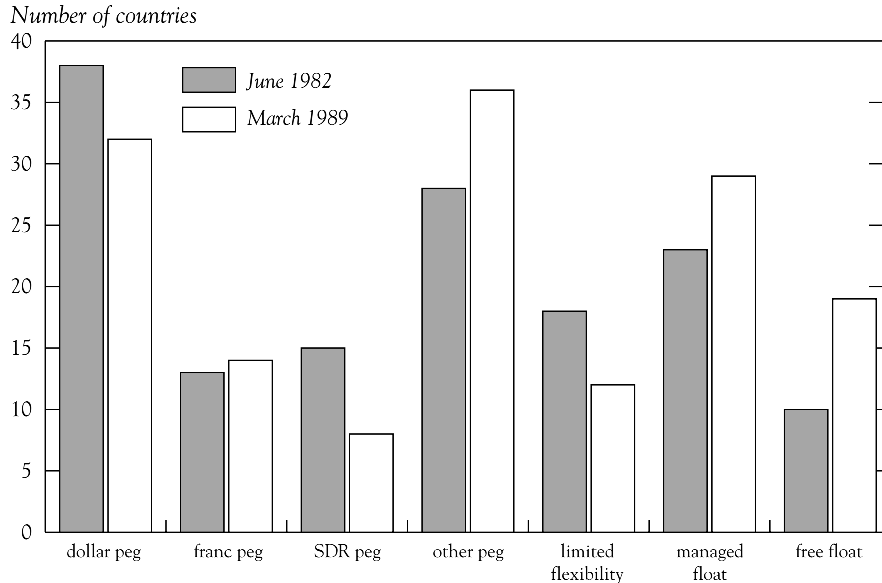
### Variety in Exchange Arrangements

The par value system of exchange rates that was established at Bretton Woods in 1944 sought to establish uniformity as well as stability in exchange arrangements. Stripped of its complexities, that system had two basic elements: the United States established the value of the U.S. dollar in terms of gold, and all other member countries established par values for their exchange rates in terms of the dollar. In stark contrast, the replacement system that was established in Jamaica in 1976 acknowledged that the monetary role of gold had ended, that the U.S. dollar could no longer serve as the sole reserve currency, and that countries should be free to adopt whatever exchange regime was best suited to their own circumstances. Nonetheless, the most popular regime by far—the choice of 38 of the Fund's 146 member countries in 1982—was still pegging to the U.S. dollar (see Figure 2.1). An additional 56 countries pegged to other currencies or to a currency basket, while only 10 countries were classified as having independently floating rates. The remainder were classified as having varying degrees of flexibility.[12] The

[11]Minutes of EBM/87/105 (July 22, 1987), p. 25.

[12]Prior to 1982, the Fund's classification scheme was less detailed and did not distinguish between independent floating and various intermediate schemes. When the first data were published in *International Financial Statistics* in 1979, 42 countries had pegged their currencies to the

**Figure 2.1. Exchange Rate Arrangements, 1982 and 1989**




rest of the decade saw some move toward greater flexibility, but the general pattern persisted.

A consequence of this diversity was the difficulty of applying the principles of surveillance evenhandedly to all member countries. If a country that pegged its exchange rate decided to devalue its currency, it was required to notify the Fund and was subject to scrutiny. If a country with a floating rate allowed market forces to depreciate its currency without interference, no notification was required and no scrutiny would follow except in the normal cycle of Article IV consultations. The basis for this distinction was the expectation that market forces would push a currency toward equilibrium, whereas official action could constitute manipulation for a competitive advantage. When experience proved that currencies could float far off track without any official intervention, the wisdom of treating these situations differently was naturally called into question. Year after year, Executive Directors and other officials representing countries with managed exchange rates complained about what they perceived as deferential treatment to countries with floating rates. Jón Sigurdsson (Iceland) put the point succinctly in 1982:

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U.S. dollar, and 52 countries had adopted other pegging arrangements. The data in Figure 2.1 are derived from tables for a single date each year: June 30 through 1987, and March 31 thereafter. See the Fund's Annual Reports for summary tables of arrangements in effect for each of those years, and the *Annual Report on Exchange Arrangements and Exchange Restrictions* for detailed descriptions for each member country. For a review of trends in exchange rate arrangements in the 1980s, see Quirk and others (1987), Chapter 2. Throughout the 1980s, one member country—Cambodia—did not notify the Fund of its exchange arrangements (see Chapter 19).

> The Board must be careful not to weight its surveillance procedures against a member that takes a precise step in one direction at one time [i.e., a devaluation], compared with another member that accomplishes an adjustment of the same—or greater—magnitude by means of gradual changes over time—be these administered or brought about through so-called free floating.[13]

The staff and management broadly accepted that argument and tried to alleviate the asymmetry by strengthening surveillance over countries with floating rates—such as the proposals discussed in the preceding section. The limited success of that effort was attributable in part to its inherent difficulty and in part to the size and economic power of the countries with floating rates at that time.

A special challenge arose in dealing with regional exchange rate arrangements such as those in Europe, Africa, and the Caribbean.[14] Several European countries established the European common margins arrangements (commonly known as the "snake") in 1972, which was modified and extended in March 1979 to form the "exchange rate mechanism" (ERM) of the European Monetary System (EMS). That mechanism required frequent exchange rate adjustments, especially during the first several years while the seven participating countries gradually brought their macroeconomic policies into closer alignment. (See Ungerer, Evans, and Nyberg, 1983.) In Africa, two groups of countries in the central and western regions maintained a common currency firmly linked to the French franc. Known collectively as the CFA franc zone, those countries eschewed exchange rate policy in favor of trying to discipline monetary and fiscal policies in line with those prevailing in France (see Chapter 13, p. 579). In the Caribbean region, eight countries adopted a common currency, the Eastern Caribbean dollar, which was pegged to the U.S. dollar. However, in contrast to the CFA franc zone's relationship to France, the Caribbean currency arrangement was not supported by the United States.

In conducting surveillance in these and similar cases, the Fund found itself holding separate discussions with each participating country while trying to develop a comprehensive analysis of the policy requirements for maintaining stability in the context of the multicountry constraints. The anomaly was that although the raison d'être for surveillance was the oversight of exchange rate policies, the Fund did not have a mandate to discuss those policies at the regional level at which decisions were taken and implemented.[15]

[13]Minutes of EBM/82/135 (October 13, 1982), p. 11.

[14]For the Fund's views on regional trading arrangements, see Chapter 20.

[15]An exception was initially made for the Belgo-Luxembourg Economic Union. Because the Luxembourg franc was tied to the Belgian franc through a currency union, Luxembourg subordinated its monetary and exchange rate policy to its much larger partner, Belgium. Furthermore, Luxembourg consistently maintained sound fiscal policies and avoided external imbalances and therefore had little need for surveillance in the traditional sense. Through 1982, the Fund accordingly adopted a minimalist but effectively regional approach. The staff conducting the Belgian consultations would spend a day in Luxembourg and would include a brief report on the Luxembourg economy in the Belgian report. The Board would then discuss the two economies simultaneously. In October 1982, Jacques J. Polak (Executive Director for the Netherlands; formerly head of the Fund's Research Department) suggested that it would be helpful to have a separate consultation for Luxembourg, so that the Fund could regularly review and learn from the

This complication is illustrated most clearly by the Fund's relationships with the member countries of the EMS. As discussed in Chapter 20, European countries had aimed since the late 1940s to avoid becoming too dependent on the Fund and to develop their own institutions that both reflected and promoted the high degree of intra-European economic interdependency. The EMS was a continuation of a series of institutions established in that spirit. The role of the Fund vis-à-vis the EMS was therefore more analytical and reactive than operational and would not be regarded as constituting regional surveillance. This limitation became of even greater operational significance at the end of the 1990s, when the inauguration of the euro as a regional European currency and of the European Central Bank (ECB) as a regional monetary authority forced the Fund to reexamine the nature of surveillance in such cases.

Several key senior staff and many non-European Executive Directors initially reacted skeptically and warily when the formation of the EMS was first announced in 1978.[16] However, the Managing Director, Jacques de Larosière, reacted more positively and emphasized the importance of establishing good working relations with what he believed would be a major force for stability in international economic relations.[17]

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"well-managed" Luxembourg economy; minutes of EBM/82/133 (October 8, 1982), p. 15. (Polak was also aware that elevating the status of the consultations with Luxembourg would help soothe feelings in the wake of the February 1982 unilateral decision by Belgium, without consulting Luxembourg officials, to devalue the Belgian—and therefore the Luxembourg—franc.) Separate consultations were held from then on.

[16]Jacques Polak, then Economic Counsellor and Director of Research, argued in July 1978 that "the danger lies . . . in an arrangement which brings about a much tighter pegging of rates than divergences in domestic policies will permit. . . . [T]he Fund might quickly find itself involved with several" EMS participants. The Director of the European Department, L. Alan Whittome, suggested to the Managing Director a few days later that it was "very obvious that as a minimum we are going to be faced with formidable difficulties in the fields of exchange rate surveillance and conditional lending." When the Executive Board first discussed the embryonic system in December 1978, Byanti Kharmawan (Indonesia) recalled that "in the past the Fund had found it difficult to persuade some European countries to follow its advice," and he warned that "the problem would probably be exacerbated when individual participants were backed up by the powerful EMS bloc." In contrast, the Director of the Exchange and Trade Relations Department, Ernest Sturc, argued in September that "the scheme should be welcomed." Memorandums to the Managing Director from Polak (July 27, 1978), Whittome (August 4, 1978), and Sturc (September 7, 1978); and minutes of IS/78/13 (December 21, 1978), p. 21. All in IMF/CF (S 1817.1 "European Monetary System, 1978"). Also see Polak (1980), which discusses the importance of developing cooperative arrangements under which EMS members would be expected to make use of Fund as well as European resources in case of balance of payments difficulties.

[17]James (1996), p. 303, attributes the Managing Director's enthusiasm to personal persuasion by the President of the European Commission, Roy Jenkins, at a meeting in mid-December 1978. As early as September, however, de Larosière informed European leaders that "the Fund was ready to welcome wholeheartedly an arrangement which would contribute to international monetary stability," as long as the system was flexible and did not isolate its members from the Fund or the world economy. Memorandum for Files by R.G. Ware (Personal Assistant to the Managing Director), September 13, 1978, on the Managing Director's trip to Europe, September 8–12; in IMF/RD Managing Director file "BIS—Basle, September 1978" (Accession 84/21, Box 4, Section 168). Also see minutes of IS/78/13 (December 21, 1978), p. 22.

The Executive Board regularly reviewed the exchange rate policies of EMS members in the framework of Article IV consultations with individual countries, but that forum was obviously limited in scope. The EMS also was a regular topic in the World Economic Outlook (WEO) exercise. On several occasions from 1979 on, the staff prepared analyses for the Executive Board on the operation of the system, notably at times of major realignments.[18] On only two occasions, however—in April 1983 and in February 1989—did the Board meet to discuss the situation. The first instance was motivated by an exchange crisis that centered on a speculative attack on the French franc and culminated in the seventh realignment of EMS currency parities in four years (and the first to involve all eight[19] participating currencies). The Board, like the staff, viewed the realignment positively but expressed caution that the system would remain subject to strains and possibly to crises until its members achieved a higher degree of policy coordination. The second Board discussion was motivated by the increasing momentum toward full economic integration of the European Community (EC) that was manifest in 1989. Directors again agreed with the staff in painting a broadly positive picture: in the first decade of operation, the EMS had succeeded in creating a "zone of monetary stability" in Europe and had begun to show real progress in converging toward sustainable economic policies and performance.[20] A decade later, the Fund would respond even more positively to the introduction of the euro and the ECB and would move more aggressively to accommodate the practice of surveillance to the new realities.

In dealing with currency unions such as the CFA franc zone in Africa or the Eastern Caribbean dollar area, the Fund followed a broadly laissez-faire path in the 1980s. At the beginning of the decade, several Executive Directors from industrial countries prodded the staff into analyzing the viability of these arrangements, especially those of the franc zone. The resulting study, which was directed by Rattan J. Bhatia (Deputy Director of the African Department), drew generally benign conclusions. Specifically, the constraint against using the exchange rate as a policy instrument was judged as not having prevented countries from undertaking timely and effective adjustment when required, relative to nonparticipants facing

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[18]Five of those studies were published in the Fund's series of Occasional Papers: Ungerer, Evans, and Nyberg (1983); Ungerer and others (1986); Guitián, Russo, and Tullio (1988); Folkerts-Landau and Mathieson (1989); and Ungerer and others (1990).

[19]The number refers to the currencies for which central rates were established, regardless of the degree of commitment to maintain them. At the time, 10 countries were members of the EMS, but only eight participated in the exchange arrangements, and 2 of those (Belgium and Luxembourg) maintained their own currency union. Thus there were, in effect, only seven independent currencies that were fully in the system. A notional central rate was assigned to the pound sterling, but the United Kingdom did not commit to maintain its exchange rates within fixed margins until October 1990. Greece joined the EMS in January 1981, but without a central rate, as did Spain and Portugal five years later. Spain began participating in the exchange arrangements in June 1989.

[20]See "European Monetary System—Realignment of Exchange Rates," SM/83/57 (April 1, 1983) and minutes of EBM/83/61 (April 15, 1983); and "The European Monetary System in the Context of the Integration of European Financial Markets," SM/89/3 (January 6, 1989) and minutes of EBM/89/9–10 (February 1, 1989).

similar circumstances. Directors who had called for the study expressed disappointment in it, but the Board as a whole did not take a position and did not consider the matter further at a regional level until 1990.[21]

In conducting Article IV consultations with members of currency unions, the staff usually chose not to call their participation into question, even when some members were experiencing much more severe economic problems than others. (In practice, this issue did not arise with regard to the Caribbean group.) If circumstances required external adjustment, the staff normally advised changes in monetary, fiscal, or other domestic policies aimed at strengthening international competitiveness. The major exception in the 1980s concerned Côte d'Ivoire, the largest country in the CFA franc zone. In concluding the 1987 consultations, the Executive Board expressed fears that Côte d'Ivoire's adjustment problem was so severe that it could not be tackled properly through restrictive domestic policies alone. Several Directors argued that "consideration of an exchange rate adjustment should not be precluded."[22] It would take several more years, but that urging finally took root when the CFA members jointly devalued the franc in January 1994.

A related complexity arose in dealing with countries that had no national currency and therefore no exchange rate policy. In the 1980s, only a few small countries chose that option. Panama used the U.S. dollar as its principal currency, Liberia used the U.S. dollar in the first part of the decade until the authorities lost control of the economy, and Kiribati (which joined the Fund in 1986) used the Australian dollar. That type of regime is an extreme variant of pegging, with the important additional constraint that the stock of domestic currency is limited by the country's net receipts of foreign exchange. Fiscal policy becomes the main macroeconomic instrument, but it is partially constrained because of the absence of monetary financing.

In conducting surveillance with these countries, the Fund took the view that as long as fiscal policies were sustainable, it would not question the choice of currency regime. As it happened, Kiribati's policies were unproblematic, Panama's policies were sound until a political upheaval occurred in 1987, and Liberia's political and fiscal weaknesses were abundantly evident throughout the decade. Through the Article IV consultations, the Fund urged Liberia both to strengthen its fiscal position and to adopt a more realistic currency and exchange regime.[23]

[21]See "Currency Unions," SM/82/183 (August 31, 1982), and minutes of Executive Board Seminar 83/1 (May 4, 1983). Directors who expressed disappointment that the study had not been more critical included notably Michael Casey (Alternate—Ireland), Richard D. Erb (United States), Tom de Vries (Alternate—Netherlands), and Peter Kohnert (Temporary Alternate—Germany). Also see Bhatia (1985), which is based in part on that study, and McLenaghan, Nsouli, and Riechel (1982), which was prepared as a form of technical assistance for the countries in the franc zone and did not occasion a discussion by the Executive Board. For the subsequent study, see "A Review of the CFA Franc Arrangements," SM/90/136 (July 9, 1990), and minutes of Executive Board Seminar 90/6 (November 5, 1990).

[22]Minutes of EBM/87/172 (December 15, 1987), p. 33. Also see the review of Fund lending to Côte d'Ivoire in Chapter 13.

[23]See, for example, the Chairman's summing up of the 1986 consultation; minutes of EBM/86/156 (September 15, 1986), pp. 15–16.

Liberia and Panama eventually fell into arrears to the Fund, but in the latter case the absence of a national currency was never an issue (see Chapter 16).

### Assessments of the International Monetary System

From the earliest days after the collapse of the Bretton Woods par value system in 1973, the staff of the IMF sought a strategy for stabilizing exchange rates within a floating-rate framework. That search, however, was more fruitful on the theoretical than on the empirical level. Largely because the precise measurement of equilibrium exchange rates for the major countries was elusive, surveillance over the international monetary system remained based primarily on broad assessments of whether rates were over- or undervalued.

In 1974 the staff proposed a set of "guidelines" to the Executive Board under which countries would have been encouraged to intervene in exchange markets to stabilize rates within a "normal zone" agreed with the Fund. That proposal was watered down during the final negotiations, and the guidelines adopted in June 1974 called for the Fund to determine "medium-term norms" for effective exchange rates, defined as the rates that are expected to equilibrate the "underlying" balance of payments, and to encourage countries with floating rates to take actions as needed to keep their rates within reasonable bounds around the norm. Even that version, however, generated concerns among officials of countries adopting floating rates. The Board was never able to agree on a plan for implementing the guidelines, and the strategy embodied in the 1977 surveillance decision effectively abandoned the concept of quantified norms for floating rates.[24]

By the end of the 1970s, the conventional wisdom at the Fund was that the floating-rate system was working reasonably well, though it might work a little better if countries could adopt policies that were better aimed at preventing misalignments.[25] The initial wariness about the potential dangers of floating never really receded, and the dollar crisis of November 1978 served as a stark reminder. Nonetheless, once that crisis was passed, the Fund's concerns were muted for a couple of years.

The view began to change markedly in the spring of 1981, when exchange rates among the key currencies appeared to be moving in ways contrary to expectation and away from levels that the Fund staff and management considered appropriate.[26]

[24]The staff proposals and the 1974 guidelines are described in de Vries (1985), Vol. 1, pp. 297–302, and Vol. 3, pp. 487–91. The "underlying balance of payments" was defined as the "overall balance in the absence of cyclical and other short-term factors affecting the balance of payments" (ibid., p. 490).

[25]"Over the last decade, exchange rate movements have contributed to required adjustments in the current account, but this contribution was subject to a number of limitations. . . . The appropriate use of exchange rate policies to help in correcting excessive payments imbalances differs according to the prevailing world economic situation and the circumstances of the country concerned." *Annual Report 1980*, p. 50. For an early and influential expression of acceptance of the necessity of living with floating rates, see Emminger (1977).

[26]The debate over how closely the major currencies should be controlled related primarily to the U.S. dollar, the Japanese yen, and the deutsche mark. Except for the Canadian dollar and at times the pound sterling, the currencies of the other G-10 countries were all managed to some degree within the framework of the EMS.

As monetary and fiscal policies shifted in divergent directions in several of the largest countries, exchange rates were much more strongly under the influence of financial forces than of the balance of trade. De Larosière soon became convinced that the system that he had once helped design was no longer working. At a meeting of the Surveillance Committee (see below, pp. 103) in March 1981, he lamented to his senior advisors that over the previous year "almost everything had been going wrong with exchange rates." The next day, he asked the Research Department to prepare a thorough study on the behavior of exchange rates for the key currencies:

> Until late last year it seemed defensible to assert that the behaviour of exchange rates under the floating regime had been relatively satisfactory, leaving aside two currencies—sterling and the yen. It may still be true that the underlying trend in the major currencies has contributed to the adjustment process. Nevertheless the magnitude and speed of the swings in key exchange rates in recent months must raise a number of questions.[27]

The staff shared the view that there were "a number of questions," but they were less convinced that any useful answers were waiting to be discovered. Even if—as seemed increasingly likely—market activity could not be relied upon to push exchange rates toward equilibrium, could official intervention guided by economic analysis and measurement produce a better outcome?

On a practical level, the first question to be tackled was how to define equilibrium. The prevailing view in the economics profession was that an equilibrium exchange rate was one that established purchasing power parity (PPP); i.e., one that equilibrated prices of traded goods between countries. But to many of those in the Fund who were attempting to estimate empirical relationships among the key currencies, the influence of PPP on exchange rates appeared to be quite weak. Financial variables such as interest rate differentials (driven by differences in the mix of macroeconomic policies) were more important than PPP in the short run, and the structural determinants of the balance of payments were more important in the long run.[28] In addition, the PPP approach could yield a wide range of estimates for equilibrium exchange rates, depending on which index one used to compare price levels.[29]

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[27]Memorandum from the Managing Director to William C. Hood, Economic Counsellor and Director of Research (March 20, 1981); IMF CF (S 490). The "going wrong" quotation is from a March 19, 1981, file memorandum by C. Maxwell Watson (Personal Assistant to the Managing Director); ibid.

[28]For reviews of the empirical and theoretical limitations of PPP-based models, see Isard (1987) and Boughton (1988).

[29]In 1986, when the U.S. dollar was retreating from a severe overvaluation, two seminars presented by prominent academic economists at the Fund's Research Department illustrated the extent of this problem. John Bilson, of the University of Chicago, concluded on the basis of a PPP model using consumer prices that the dollar was already undervalued relative to the Japanese yen; his estimate of the equilibrium rate was around 240 yen per dollar, compared with the then-prevailing rate of 180. A few weeks later, Paul Krugman, of the Massachusetts Institute of Technology, presented estimates based on the prices of manufactured goods that the equilibrium rate was "below 140," and therefore that the ongoing depreciation of the dollar had "a considerable way to go."

As noted above, the 1974 "guidelines for the management of floating exchange rates" had referred to the "underlying" balance of payments as the criterion for equilibrium, by which was meant the external balance that would emerge after cyclical and other short-term forces stabilized and worked their way through the economy. By the 1980s, it was becoming ever clearer that the underlying-balance approach was empirically more meaningful than PPP as a basis for evaluation.

The Fund's underlying-balance approach was set out in a staff paper that was discussed by the Executive Board at a seminar in January 1984 and was later published as an Occasional Paper (Artus and Knight, 1984).[30] That study concluded that estimating "sustainable" or equilibrium exchange rates was inherently difficult and that the proposed methodology could "only be expected to yield an approximate range for the sustainable exchange rate of each member country, rather than a precise level."[31] Although the calculations discussed by Artus and Knight did yield such estimates, the paper did not include them, either as points or ranges. Besides their caution about appearing to be too precise, the staff were quite sensitive to the notion that if their estimates became known, they could influence short-term pressures on the actual pattern of rates in the markets.

In spite of its caution, the Artus-Knight study marked a peak in the staff's confidence about estimating equilibrium exchange rates for the major countries. The view expressed there was that "the Fund *must* reach judgments about the appropriateness of the exchange rates of all of its members [i.e., including the large countries with floating rates] in a consistent manner, while watching for possible conflicts among those members" (p. 30; emphasis added). Almost simultaneously, however, Goldstein (1984) argued for an even more cautious approach in evaluating the functioning of floating rates among the major currencies. He concluded that floating might exacerbate "inflation differentials" but that it had enabled these countries to adjust to the massive macroeconomic shocks of the 1970s,

[30]The analysis in that study was an extension of the technique that had been pioneered by the staff in conjunction with the preparations for the Smithsonian meeting of the G-10 countries in December 1971, at which agreement was reached on a new set of exchange rate parities after the United States ended convertibility of the dollar into gold (see Chapter 5, under "Multilateral Exchange Rate Model"). Although conceptually linked to the "underlying balance of payments" mentioned in the 1974 guidelines, its empirical application was related to the current account rather than the overall balance of payments. That is, the equilibrium real effective exchange rate was defined as the rate that would make a country's underlying current account balance equal to its normal or sustainable net capital flow. The underlying-balance approach is also closely related to the portfolio-balance approach to explaining movements in real exchange rates, as pioneered by Fund staff economists Pentti Kouri and Michael Porter in the early 1970s (see Kouri and Porter, 1974).

[31]Occasionally the staff attitude became even more ambivalent, to the point of implying that one could reasonably make judgments about whether exchange rates were under- or overvalued even though one did not have a quantified view about what the right range of rates might be. For example, at the Executive Board seminar on the Artus-Knight study, William C. Hood (Economic Counsellor and Director of Research) summarized the view of both the staff and a number of Executive Directors as being "that it was easier to make a judgment about the direction in which an exchange rate in disequilibrium should move than to judge the appropriate level for an exchange rate." Minutes of Executive Board Seminar 84/2 (January 30, 1984), p. 24.

which had made it especially difficult to detect what the equilibrium levels were. "Indeed, in such an environment managed floating may well have been the *only* system that could have functioned continuously" (p. 45; original emphasis). That judgment received widespread support from Executive Directors when they discussed both the Artus-Knight and Goldstein papers in the January 1984 seminar.[32]

Internally, for a few years after those studies appeared, the Research Department regularly produced estimates of equilibrium rates, which were circulated solely for the information of management. Over the next few years, the staff became increasingly skeptical of the value of these estimates, and by 1987 the practice was quietly abandoned for the time being. (It came into vogue again in the second half of the 1990s.) Separately, beginning about 1987 (shortly after Jacob Frenkel became Economic Counsellor and Director of Research), the Research Department conducted several evaluations of proposals for "target zones" or other partial moves back toward greater fixity of rates among the key currencies.[33] Those evaluations yielded generally negative conclusions. In Frenkel's view (see his 1996 paper), the major countries had an unavoidable need to pursue independent monetary and fiscal policies, which made fixing or targeting exchange rates impracticable.

The Executive Board also got involved in the analysis of exchange rate developments in 1987. When the U.S. dollar suddenly started dropping in value in January, the Executive Directors for India and Italy (Arjun Sengupta and Salvatore Zecchini) called for a discussion of the situation by the Board. Zecchini observed that when major currencies started moving sharply, "it was embarrassing to have to say [to outsiders] that the Fund did not have an opinion on the subject."[34] Although some other Directors and the staff expressed concerns that the Fund might be drawn into reacting to short-term fluctuations that were inherently unpredictable, the Board agreed to begin holding informal discussions of market developments on a roughly quarterly schedule. Those discussions then became an increasingly important analytical tool in the Fund's surveillance of the functioning of the international monetary system.[35]

A persistent question about floating rates was whether volatility (as opposed to sustained misalignment) of exchange rates was a problem that should concern the Fund. Short-run volatility among the key currencies was a highly visible phenomenon in the early 1980s, and it was frequently raised as a policy issue by Executive

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[32]See minutes of Executive Board Seminar 84/1–2 (January 30, 1984).

[33]Those proposals arose out of studies commissioned by both the G-10 industrial countries and the Group of Twenty-Four (G-24) developing countries in 1985, buttressed by the advocacy of a group of economists at the Washington-based Institute for International Economics. See Chapter 4 and Frenkel and Goldstein (1986).

[34]See minutes of EBM/87/8 (January 14, 1987), p. 48.

[35]See minutes of EBM/87/8 and 87/9 (January 14, 1987). From 1987 through 1992, the Board's discussions were in informal session under the heading of "Exchange Rates—Recent Developments" or simply "Exchange Rate Developments" and were normally confined to the currencies of Group of Seven (G-7) industrial countries. Beginning in 1993, the breadth of the discussion was widened, and the sessions were retitled "World Economic and Market Developments."

Directors during Article IV consultations with the major countries and in discussions on the world economic outlook. Few on the staff, however, were convinced that it was a serious problem, and for the most part the debate in the Fund concentrated on longer-term issues.[36]

### Policy Role of the Exchange Rate

As noted above (p. 74), a general complication in the conduct of surveillance in the 1980s was the absence of a universally agreed objective for exchange rate policy. The Fund frequently advised countries in this period to adjust their nominal exchange rates to a level consistent with the country's price level relative to prices in other countries, so as to promote a sustainable external payments balance. Unfortunately, that principle often conflicted with other objectives that were important to the country's authorities.

Perhaps the most frequently proffered advice to countries—almost a symbol of the role of the Fund in some parts of the world—was to devalue the currency to compensate for an excess of domestic over world price inflation and thereby to restore the international competitiveness of the country's export industries. To try to keep the rate of domestic inflation from rising by enough to wipe out the gain in competitiveness or to destabilize economic activity, devaluation advice was always coupled with advice to exercise greater discipline over monetary and fiscal policies. The Fund also occasionally recommended devaluation to countries that had no inflation problem but that had developed troublesome current account deficits owing to external forces, such as a collapse in the world market for the country's principal exports. The key to success in those cases was to *retain* control over financial policies following a needed devaluation, which inevitably would bring losses in real incomes to a large part of the working population.

The converse also applied, but it came into play much less often. If a country had relatively low inflation and a fixed exchange rate, or undertook a devaluation without a prior loss in competitiveness, it could gain a competitive advantage over other countries. To forestall a series of competing devaluations (or other types of what are generally known as "beggar thy neighbor" policies),[37] the Fund might advise the country to revalue its exchange rate upward. Such cases, although a driving concern at Bretton Woods in 1944, occurred only rarely in the post–Bretton Woods era. On a few occasions, the Fund conveyed concerns that key currencies such as the U.S. dollar or the Japanese yen were undervalued (see Chapter 3), and

[36] For a succinct statement of the Fund position on exchange rate volatility, see *Annual Report 1982*, pp. 42–45. Staff studies on the subject included notably IMF Research Department (1984)—which was authored by Crockett—and Gotur (1985). Most empirical studies of industrial countries (surveyed in those papers) concurred that short-term volatility had only small real effects. Exceptionally, Kenen and Rodrik (1986) found more significance. Studies of the effects of volatility on trade in developing countries, however, typically found more sizable effects. See, for example, Caballero and Corbo (1989) and Grobar (1993).

[37] The term is attributable to Joan Robinson, whose original phrasing (see Robinson, 1937) was "beggar my neighbor."

in a very few cases the Fund investigated complaints that smaller countries might be deliberately undervaluing their currencies (see the discussions below on Sweden and Korea). Those exceptions aside, the Fund's preferred term for its advocacy—"exchange rate flexibility"—became in effect a euphemism for devaluation and maintenance of a competitive rate.[38]

Countries that resisted using the exchange rate as an instrument for adjustment usually did so for one or more of several reasons, only one of which was clearly bad. The obviously bad reason was that the exchange rate serves political as well as economic ends. Politicians all over the world and all over the political spectrum have equated a "strong" exchange rate (i.e., an overvalued currency) with a strong economy. That confusion—which in the early 1980s afflicted the Reagan administration in the United States just as much as the López-Portillo government in Mexico—has prevented many a government from acting rationally in the face of a deteriorating ability to compete in world markets.

A second and more legitimate reason for resistance was concern over the contractionary effects of large exchange rate changes on business solvency, the government's fiscal position, and consumer demand. Firms that rely heavily on external borrowing or on imported inputs are likely to suffer from devaluation and might not be able to absorb the cost. In many countries, the government also benefits fiscally from a strong currency and may be vulnerable to the increased costs resulting from devaluation. As businesses, consumers, and the government all retrench in the face of rising costs of imports and external debt service, economic activity might contract severely. In theory, these negative factors could be more than offset by the benefits to export sectors, but in practice the stimulus to exports might be slow to materialize or even virtually nonexistent.

Third, a substantial margin of error always surrounds measurements of the equilibrium level of the exchange rate. As noted above, the rate that equilibrates price levels between countries (the PPP rate) might vary substantially depending on the choice of price index or base period, and the PPP rate might be quite different from the rate that would equilibrate the balance of payments. It therefore was always easy for recalcitrant policymakers to insist—not without justification—either that the current rate was within acceptable bounds or that neither they nor the Fund had a better rate to suggest than the one produced by the market (again see the discussion below on Sweden).

A fourth reason, which took on increasing importance during the 1980s, was that many countries found it useful to treat the exchange rate as a "nominal anchor" for expected prices. A widespread difficulty with the use of the exchange rate as an instrument of adjustment is that devaluation can help perpetuate the inflation for which it is trying to compensate. Devaluation or depreciation directly raises the prices of imported goods and services, and businesses and workers are bound to try to bid up prices and wages in an effort to compensate. If a government

[38]For an inside review of the Fund's advice on exchange rate policy to developing countries in the mid-1980s, and for a pro-floating and pro-adjustment perspective, see Quirk and others (1987).

has experienced trouble stabilizing prices because of a limited ability to control monetary, fiscal, and incomes policies, then fixing the exchange rate may provide a viable alternative, albeit only if the strategy succeeds in breaking the inflationary psychology and enabling stable macro policies. Devaluation would threaten the credibility of an economic strategy based on an exchange rate anchor, and stable "exit strategies" for introducing a different anchoring regime have proved difficult to manage.[39]

Finally, countries resisted adjusting the exchange rate because they valued a fixed rate as a means of stimulating trade within a region. Because the empirical assessment of whether a particular group of countries is an optimum or natural area for a common currency or a set of fixed exchange rates is inherently slippery, disputes are bound to arise and persist. This type of debate was especially important in the Fund's relationships with European countries in the 1980s. Although the Fund staff and management generally acknowledged the value of fixed exchange rates for stimulating trade, they also were mindful of the dangers of adhering to fixed rates in the face of major divergences in economic policies or differences in economic conditions.

The Fund's approach to evaluating exchange rate policies evolved during the first decade of experience with Article IV surveillance, with a broad trend toward a greater sympathy with the stabilizing and trade-promoting virtues of fixed exchange rates.[40] That trend, however, was often obscured by differences in emphasis between countries and between regions. It is perhaps more easily discerned in the Fund's advice to countries that were using (or were seeking to use) Fund resources than in surveillance-only discussions, since explicit advice was seldom given on the exchange rate in the latter context. Moreover, the Fund often took quite different attitudes on exchange rate policy for developing and industrial countries. That dichotomy principally reflected the much greater importance of private financial markets in industrial countries during the 1980s. Where exchange rates were influenced as much by financial as by trade considerations, the assessment of equilibrium became more difficult, the ability of the authorities to control rates became more limited, and the risk increased that the Fund might destabilize market behavior if its criticism of a country's rate became publicized. In many developing countries, in contrast, both trade and finance were more controlled, and the main issue was not whether, but toward what end, the authorities were going to aim exchange rate policy.

While the Fund was shifting in the mid-1980s to a more skeptical view on targeting exchange rates in industrial countries, it was also developing a more balanced view on how developing countries should manage their exchange rate poli-

[39]Edwards (1998) examines two case studies—Chile in 1982 and Mexico in 1994—when the failure of the exchange rate anchor to reduce inflation contributed to the onset of a financial crisis. Eichengreen and others (1998) and Eichengreen (1999) discuss the difficulties of devising viable exit strategies.

[40]For a longer-term review of this evolution, see Polak (1995).

cies. Up to that time, the Fund had almost universally recommended devaluation to countries that were having trouble remaining competitive in international markets (see Chapter 13 and Johnson and others, 1985). As the limitations of that strategy became increasingly apparent, the staff's initial response was to encourage developing countries to adopt floating exchange rates. A staff study prepared in 1986–87 (Quirk and others, 1987) concluded that the 15 developing countries that had adopted floating rate regimes in the preceding few years were generally experiencing satisfactory results. However, the study (which was not discussed by the Executive Board) cautioned that successful floating required a sound institutional structure and the maintenance of sound macroeconomic policies and might not be universally applicable. As it happened, the popularity of floating was beginning to wane a bit around the same time as the study appeared. By 1989, only 12 developing countries still maintained independently floating rates.[41]

When the floating-rate option also appeared to be of limited applicability, the Fund shifted somewhat to a more eclectic approach that at least paid lip service to the values of exchange rate stability in developing countries. A Research Department review (Aghevli, Khan, and Montiel, 1991) concluded that what mattered most for economic performance was for countries to establish discipline and credibility in the conduct of fiscal and monetary policies. If they could do so while letting the exchange rate float, fine; otherwise, fixing the exchange rate could be a means toward that end. (Also see Aghevli and Montiel, 1996.) Nonetheless, a separate review prepared at the same time in the Exchange and Trade Relations Department (ETR) revealed that in Article IV consultations concluded in 1987 or 1988, the staff had reported favorably on exchange rate policies two-thirds of the time when the rate was "flexible" and just one-third of the time when the rate was fixed.[42]

One positive influence on staff thinking about the stabilizing role of exchange rate policy, as Polak (1991, 1995) has stressed, was the example of the EMS. After 11 realignments in the system's first 8 years, European leaders committed themselves in September 1987 to a set of reforms (known as the Basel-Nyborg agreement) aimed both at bringing about greater discipline and convergence in domestic policies and at strengthening institutional arrangements so as to reduce the need for exchange rate adjustments (see Ungerer and others, 1990, pp. 8–9). By the end of the decade, it appeared that the strategy was working: neither policy differences nor inflation differentials had vanished, but Europe was undergoing a gradual convergence toward low inflation and strong economic growth without the disruption of periodic currency

[41]The 1990s brought a resurgence of floating. In March 1995, the Fund classified 36 developing countries as having independently floating rates, along with 11 industrial countries and 12 countries in transition from central planning. To some extent, though, this resurgence was more apparent than real. The increase included many countries that managed their exchange rates without specifying a target value.

[42]"Review of Exchange Rate Policy Assessments in Recent Article IV Consultations," SM/90/200 (October 18, 1990), Tables 2 and 4.

crises.[43] Similarly, the largest industrial countries achieved a measure of exchange rate stability through the policy coordination exercise that culminated in the Louvre accord of February 1987 (see Chapter 4). In both cases, such stability was widely viewed as a contributor to improved economic performance. Set against those observations, however, was the rapidly deteriorating performance in some of the larger countries participating in the CFA franc zone in western and central Africa. As the world economy lurched toward the 1990s, about all that could be said with confidence about exchange rate policy was that no single model would work for all countries or even for a few countries in all circumstances.

## Establishing Effective Procedures

The new Article IV that was agreed upon in 1976 required the Fund to "oversee the compliance of each member [country] with its obligations" to "assure orderly exchange arrangements and to promote a stable system of exchange rates." The procedures for doing so were left to be worked out by the Executive Board, which responded by setting out five general practices in its basic 1977 decision:

1. Members are required to notify the Fund of any changes in their exchange arrangements, such as changes in pegs, intervention policies, etc.
2. Periodic (normally annual) consultations are to be held under the provisions of Article IV.
3. The Board is to periodically review "broad developments in exchange rates," principally in the context of the WEO.
4. The Managing Director is to maintain close contacts with members regarding exchange arrangements and policies.
5. The Managing Director may initiate special consultation discussions with members under specified conditions.

The 1977 decision also specified that these procedures were to be reviewed annually in the light of experience. In contrast to the difficulty of trying to update the principles, the Board did periodically fine-tune its procedures throughout the 1980s. There were five branches to those efforts: attempts to strengthen the conduct of Article IV consultations, attempts to set standards for countries to live up to, attempts to assess performance of individual countries in a broader context, attempts to give greater publicity to the Fund's findings, and attempts to focus attention on the most serious problem cases.[44]

[43]For an example of the Fund's positive reaction, see the *World Economic Outlook* (IMF, 1990), pp. 43–44.

[44]In addition to the changes discussed here, the Fund introduced procedures for "enhanced surveillance" in 1985 (see Chapters 9 and 10). That practice was developed as a means of supporting countries' efforts to obtain or maintain loans from other creditors in cases where the countries preferred not to enter into a stand-by arrangement with the Fund or to use Fund resources.

### Conduct of Article IV Consultations

On the surface, the Fund conducted consultations under the new Article IV in much the same manner as the old Article VIII or XIV consultations. A "mission" team of (usually) four or five economists, normally headed by someone with the rank of Division Chief or above (generally higher for the largest countries), would spend around two weeks in the country's capital city. During that time, the team would meet daily with senior officials from the finance ministry, the central bank, and other government agencies; and occasionally (especially after the mid-1980s) with representatives of "civil society," such as employers and labor unions. Prior to the mission, the team would prepare by drafting a detailed list of questions to be sent ahead of time to the authorities, by updating the database as much as possible, and by conducting research on specific issues. Missions would typically conclude in a meeting with the minister of finance and other senior officials, at which the staff would present its assessment of the country's policies and economic outlook. Returning to headquarters, the mission chief would immediately submit a confidential "back-to-office" report to the Managing Director. The mission team would then prepare two documents for circulation to the Executive Board: a staff report, summarizing the main policy issues, reviewing the work of the mission, and concluding with the staff assessment; and a background paper on "recent economic developments" (called the RED). The Board would then hold a formal meeting to conclude the consultation, no later than three months after the return of the mission except in exceptional circumstances.

The one real procedural innovation after the Second Amendment was that the Board meeting was to end with a formal "summing up" by the Managing Director of the views expressed by Executive Directors, which would then be sent to the authorities.[45] Previously, Board meetings on Article XIV consultations concluded with a formal decision that included a brief summary of the consensus view of Directors on the country's policies and performance. Article VIII consultations, being voluntary, did not require any formal conclusions, although occasionally the Managing Director did undertake to summarize the discussion to convey the Fund's views to the authorities.[46] The innovation of the formal summing up, which was unique to the Fund, turned out to have more than just procedural importance:

[45]The text of the original proposal for the summing up, which was approved by the Executive Board on March 20, 1978, is reproduced in the Appendix to this chapter.

[46]A good example occurred in July 1977, while the United Kingdom was implementing an adjustment program supported by a Fund stand-by arrangement. The Managing Director, H. Johannes Witteveen, closed the Board discussion of the Article VIII consultation by complimenting the authorities for what they had achieved so far but urging further action to contain inflation, which he suggested was "a precondition for the resumption of a more satisfactory growth pattern." He concluded by observing that the U.K. experience "showed how difficult it was for an economy that had strayed far from the path of balanced growth to return to it," and by calling for "patience and perseverance." (See minutes of EBM/77/103 (July 15, 1977), p. 12.) Although these remarks reflected views expressed by Executive Directors, they were made informally and personally by the Managing Director in his capacity as Chairman of the Executive Board.

it enabled the Fund as an institution to draw conclusions about a country's policies without having to negotiate and take a legal decision.[47] The summing up included references to positions taken by individual or groups of Executive Directors, and it did not necessarily even refer to a majority or predominant view. In most cases, however, it expressed clear conclusions on behalf of the international community and sent a clear message to the authorities as to the effects of their policies on the rest of the world. By the 1990s, the summing up also served as the basis for the Fund's public reports on surveillance discussions.

The challenge for the Fund was to focus the consultation process as clearly as possible on the economic policy issues that were most relevant to the international community. The central issue was always the same: are the country's macroeconomic policies oriented toward sustainable growth and consistent with its exchange rate policy?—or, if the exchange rate policy was one of laissez-faire: are macroeconomic policies sustainable and consistent with a stable system of exchange rates? With that question in mind, staff reports reviewed the policy stance and the overall performance of the economy, assessed the outlook for both, and offered recommendations for how policies might be improved. Paradoxically, owing to the sensitivity of the exchange rate as a topic for discussion—more specifically, the fear that an assessment that the exchange rate was overvalued might cause a run on the currency if it became publicly known—staff reports rarely discussed the sustainability of exchange rate policy directly. Instead, the staff discussed whether monetary and fiscal policies were consistent with exchange rate policy. If overly expansionary policies had made the exchange rate overvalued, the option of devaluing might be implied but was seldom stated openly.

Over time, structural economic issues—which had always been included in Article IV consultations—took on increasing importance in staff reports. Part of the impetus came from a growing recognition of the widespread need for structural reform to combat chronically high unemployment and sluggish growth, in industrial as well as developing countries. Further stimulus came from the Fund's growing involvement with centrally planned or state-controlled economies: new members or representatives such as the People's Republics of Angola, China, Hungary, Mozambique, and Poland; and older members such as Romania and

[47]The role of the summing up and the procedures for conveying Executive Directors' views to the authorities were agreed upon during the first Article IV consultation with a major industrial country: at the Executive Board meeting on the United Kingdom in July 1978 (see Chapter 3). At that time, Joseph Gold (General Counsel) explained that the summing up had the same legal effect as a formal Board decision, although its language was more flexible. On procedures, the Board agreed that the Secretary (rather than the Managing Director) would formally send the summing up to the authorities of the country concerned. (See minutes of EBM/78/102 (July 6, 1978).) It was understood that Executive Directors would normally also send it to the authorities of other member countries as part of their normal reports on Fund activities. Although the Board did not approve each summing up by taking a formal Decision, Executive Directors implicitly approved the text by not asking for a discussion of it when it was circulated internally. (See "Establishment of Document Series for Summings Up Concerning Surveillance," SUR/83/1 (July 19, 1983).)

Yugoslavia.[48] The staff recognized that exchange rate policy had only an indirect influence on the balance of payments in planned economies, because of the high degree of state control over both domestic prices and the quantities of traded goods. Surveillance over planned economies, in this view, therefore required surveillance over the macroeconomic implications of the country's economic plan, in addition to the usual indicators of economic policies and performance.

When the Executive Board discussed the matter in a June 1982 seminar, Tse Chun Chang (China) argued for a more fundamental rethinking of surveillance in dealing with planned economies. Unless the Fund dispensed altogether with the notion of profit maximization as a "decisive factor in the allocation of resources" and recognized the importance of national goals regarding equality of income distribution and the avoidance of both inflation and unemployment, it could not hope to understand the reluctance of these countries to adopt measures that promote economic efficiency but that also threaten these essential goals. Jacques Polak (whose constituency included both Romania and Yugoslavia) noted the "almost inevitable" ambivalence of the staff's views, which aimed to be evenhanded while encouraging countries to adopt more market-oriented regimes. Most important, he noted that whereas "the Fund did have a model for the market economies, there was no equivalent theory of the economic functioning of centrally planned economies." The view was pervasive that the Fund's (and the economic profession's) knowledge about the workings of planned economies was weak, and Polak's call for an "ad hoc" and "modest" approach to the task was widely endorsed around the table.[49]

The international debt crisis of 1982 provided a second impetus for the Fund to devote more attention to structural issues; in this case, through the use of medium-term (i.e., longer than the Fund's usual 18- to 24-month forecast horizon) scenarios for heavily indebted countries. At an April 1983 meeting on Fund policies in dealing with the debt crisis, the Board directed the staff to begin collecting more detailed debt statistics, to provide technical assistance to countries on the collection and compilation of debt data, to do more analyses of the global debt outlook, and to produce scenarios on the medium-term outlook for external debt in regular Article IV consultations.[50] In a particularly clear example, the 1985 staff report on Chile included a table projecting (correctly) that Chile's total external debt-

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[48]China was represented in the Fund by the People's Republic from April 1980. The Hungarian People's Republic joined in May 1982, the People's Republic of Mozambique in September 1984, the Polish People's Republic in June 1986, and the People's Republic of Angola in September 1989. The Socialist Federal Republic of Yugoslavia was an original member of the Fund until the country ceased to exist in December 1992. The Socialist Republic of Romania joined in December 1972. For further information, see Chapter 19.

[49]Minutes of Seminars 82/3 and 82/4 (June 25, 1982), pp. 4 (Zhang) and 10–11 (Polak). Modesty may have prevented Polak from pointing out that he had played a seminal role in the development of the Fund's model of market economies. For a review of that development and Polak's role in it, see Chapter 13, p. 559, and Frenkel, Goldstein, and Khan (1991).

[50]Minutes of EBM/83/58 (April 6, 1983), pp. 33–35. The detailed staff proposal for preparing medium-term debt scenarios is in "Fund Policies and External Debt Servicing Problems," SM/83/45 (March 8, 1983), pp. 15–19.

service payments would steadily decline as a percentage of export receipts from nearly 50 percent in 1984 to just 26 percent by 1990.[51] Once the staff began developing the policy implications of those scenarios—which quickly became a standard feature of discussions with heavily indebted countries—it was inevitably drawn into analyses of structural problems affecting the levels of domestic saving and investment.

A third impetus came from the growing concern over the widespread resort to protectionist trade policies. Trade liberalization was the task of the General Agreement on Tariffs and Trade (GATT) and thus was not really the Fund's turf. In practice, though, it was often difficult to separate exchange rate policies from trade policies, since countries could always substitute between them to gain competitive advantage. When exchange rates began to display persistent swings and misalignments in the early 1980s, both industrial and developing countries reacted by raising a wide variety of tariffs and other barriers to trade. To monitor and discourage such practices, the Executive Board used the occasion of the 1983 review of surveillance to direct the staff to devote more attention to trade policies in Article IV reports.[52] Tables of major trade restrictions and discussions of changes in them then became a regular feature of staff reports. For example, the staff report for the 1984 consultation with France included a section describing France's use of trade restrictions to protect employment opportunities in certain sectors, and the RED included a detailed appendix on the subject. After explaining the authorities' position on the issue, the staff report concluded that "there remained considerable scope in France—as elsewhere—to dismantle trade restrictions of whatever type and coverage."[53]

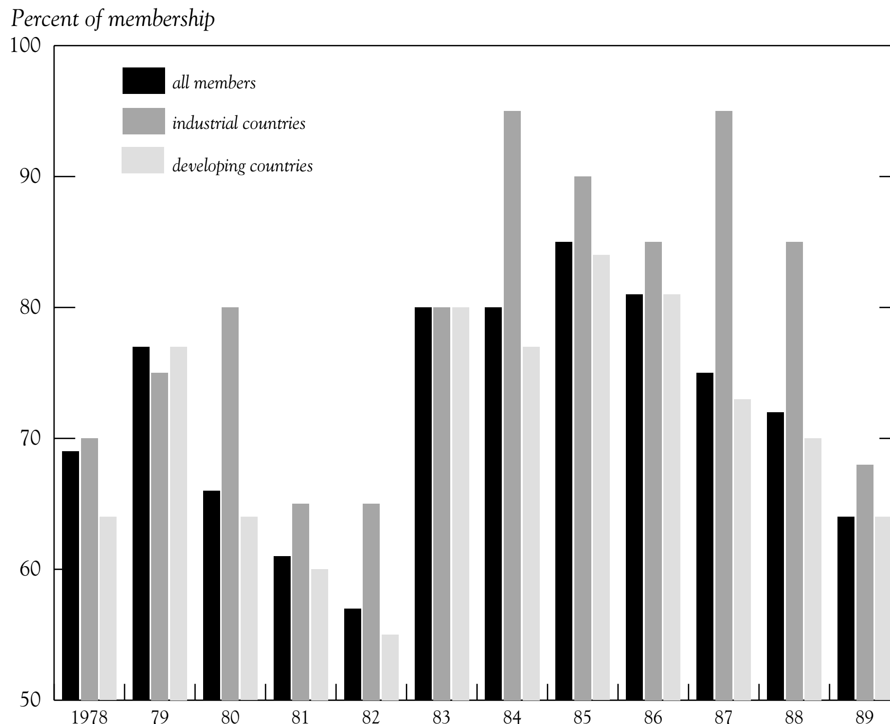
Beyond those changes that related specifically to the content of Article IV consultations, the Fund's concerns and appetite for information continually expanded throughout the 1980s. In 1984, as World Bank lending became increasingly complementary to the Fund's, summaries of countries' relations with the Bank began appearing in Article IV reports. Discussions of the adequacy of countries' statistical data also took on more prominence around that time. And in the second half of the decade, staff reports or background papers increasingly included analyses of issues such as the extent of poverty and other issues arising from disparities in the distribution of income; structural distortions arising from controls on labor, goods, and financial markets; and the environmental impacts of macroeconomic policies. Overall, the Board welcomed those innovations but also (with a degree of inconsistency) insisted that emphasis and focus be kept on exchange rate policies and the balance of payments.

[51]"Chile—Staff Report for the 1985 Article IV Consultation and Request for an Extended Arrangement," EBS/85/122, Sup. 1 (July 12, 1985), pp. 10 and 22.

[52]Minutes of EBM/83/54–55 (March 28, 1983). Trade policies were regularly reviewed in the WEO exercise, beginning in 1978. Also see Chapter 20, on relations between the Fund and the GATT.

[53]"France—Staff Report for the 1984 Article IV Consultation," SM/84/109 (May 15, 1984), p. 19. The RED discussion is "France—Recent Economic Developments," SM/84/123 (May 29, 1984), Appendix II.

**Figure 2.2. Coverage of Article IV Consultations, 1978–89**




## Frequency of Consultations

Although the goal of the Fund was to hold consultations annually with every member, this was not realistic. There was not enough time in the year for the Executive Board to review and discuss developments in every member country, and there were not enough staff to hold the consultations and write the reports. Moreover, circumstances such as elections, parliamentary budget cycles, civil unrest or war, and natural disasters often conspired to prevent discussions from taking place as scheduled. And finally, in numerous cases, authorities put off the Fund's efforts to hold consultations in order to prevent an embarrassing airing of the state of the country's economy. Nonetheless, over the first 12 years of surveillance, the Fund managed to complete consultations for an average of 72 percent of the membership each year (Figure 2.2).

The low point in the evolution of surveillance came in the early 1980s, when many countries had ready access to commercial bank loans and saw little need for frequent contacts with the IMF. After an initial flourish in 1978–79, the frequency of consultations dropped sharply: in 1982, meetings were held with barely over half the Fund's 146 member countries. There was a general problem of lack of continuity, in that the Fund was out of date in its awareness of economic developments in a large portion of its member countries. Even more seriously, the backlogged cases included some countries where major debt-servicing difficulties were devel-

oping. When the Executive Board met to discuss the Mexican economy in June 1982, it was doing so for the first time in 27 months (for the background, see Chapter 7, pp. 282–86). E. Walter Robichek (Director of the Western Hemisphere Department) had raised a warning to management in October 1981 that the Fund should undertake a more intensive monitoring—more often than annual consultations—with the three largest countries in Latin America (Brazil, Mexico, and Argentina), owing to their international importance and potential for macroeconomic imbalances.[54] Not until after the debt crisis hit in August 1982 was the Fund galvanized into action.

One person who was most disturbed by the gaps that had crept into the surveillance procedures was de Larosière. If the Fund could ensure that it would have regular contacts with and fruitful oversight of most of the membership on at least an annual basis, then in his judgment, the Fund would be much less likely to get caught off guard as it had been when the debt crisis struck. For the 1983 review of surveillance procedures, the staff prepared recommendations for improving the scheduling of consultations: adhering more strictly to the criteria for specifying annual consultations, setting an outer limit of 24 months between consultations for all members, setting dates at the conclusion of each consultation by which the next one should be held, and tightening the circumstances under which delays would be accepted.

The only real issue was that last point. Countries had frequently asked for delays on the grounds that they were revising policies or preparing budgets or getting ready for elections. As the staff paper for the 1983 surveillance review noted, a "strong case can be made that it is precisely at such times that Article IV consultations can be most constructive . . . particularly in countries that are experiencing a serious deterioration in their situation. Not infrequently, the member eventually has had to seek use of Fund resources on an emergency basis without the benefit of a recent consultation." Several Directors were no more enthusiastic about the idea than if they had been told they should go to the dentist more regularly rather than waiting until their toothache became intense, but no serious objections were raised.[55]

As is evident from Figure 2.2, the new guidelines made a big difference. Annual coverage rose from 57 percent in 1982 to 80 percent or more in each of the next four years.[56] Most important, the number of countries with which no

[54]Memorandum from Walter Robichek to William C. Hood, for circulation to the Surveillance Committee (October 9, 1981); in IMF/RD Managing Director file "Correspondence and Memoranda—1981" (Accession 87/27, Box 11, Section 535).

[55]"Annual Review of the Implementation of Surveillance," SM/83/43 (March 1, 1983), p. 17, and minutes of EBM/83/54–55 (March 28, 1983).

[56]Notwithstanding the pressures on the work program of the staff and the Executive Board, the Fund also accommodated the desire of the authorities in the Netherlands to have separate consultations for the Netherlands Antilles. Although a territory within the Kingdom of the Netherlands and not an independent member of the Fund, the Antilles maintained its own currency and its own exchange rate policy (the currency, the Netherlands Antillean guilder, was pegged to the U.S. dollar). The Fund began holding consultations with the Antilles under Article VIII in 1969 and under Article IV in 1978. When Aruba (formerly part of the Antilles) became a separate territory within the Kingdom in 1986, the Fund began holding Article IV consultations with it also.

consultation had been held for two years or more dropped from a peak of 19 in 1982 to 4 in 1984. By that time, the problem of surveillance being avoided at countries' requests had been almost eliminated.[57]

By 1986, the improved regularity of consultations was causing the balance of concerns to shift back to the burdens on the Fund's resources, especially on the time of Executive Directors and the staff. As it happened, in the mid-1980s demands on the Fund were high enough that regular consultation cycles longer than a year could be specified for only a limited set of countries without weakening the effectiveness of surveillance. A large and growing number of countries had stand-by or other borrowing arrangements with the Fund, and many also maintained exchange restrictions that were temporarily approved by the Fund in accordance with Article XIV of the Articles of Agreement. That group had to be kept on an annual cycle whatever their macroeconomic situation, because Article XIV requires countries to consult annually with the Fund on the retention of restrictions, with a view toward their eventual elimination (see below, p. 120).[58]

To reduce time spent on routine consultations, Hans Lundström (Executive Director from Sweden) suggested in July 1986 that the Fund establish a "bicyclic" consultation procedure under which the staff would hold discussions with the authorities every year, but without a concluding Board meeting in the odd years. Staff in area departments and in ETR generally responded favorably to this prospect, but de Larosière declared himself to be "rather reserved." Nonetheless, he judged that this was essentially a matter for the Board to decide, especially

[57]"Surveillance Over Exchange Rate Policies—Annual Review—Background Material," SM/86/4, Sup. 1 (January 28, 1986), p. 3 and Table 1. Three of the four backlogged cases resulted from security problems. The Fund had had no contacts with a succession of revolutionary and outlaw governments of Democratic Kampuchea (Cambodia) since October 1973. Consultations with Iraq and the Islamic Republic of Iran were suspended because the two countries were at war. Only in the fourth case, Cape Verde, was the delay attributable to reluctance of the government to receive a mission from the Fund.

[58]The legal constraint is explained in "Periodicity and Form of Article XIV Consultations," SM/87/30 (February 4, 1987). In March 1987, the Executive Board approved a technical amendment to the 1977 decision, by which the Fund could revert to the practice of holding separate consultations under Article XIV in cases where the Article IV consultation cycle was longer than one year. See the minutes of EBM/87/38–39 (March 4, 1987); "Periodicity and Form of Article XIV Consultations—Amendment of Document Entitled 'Surveillance Over Exchange Rate Policies' Attached to Decision No. 5392-(77/63), Adopted April 29, 1977," SM/87/30, Sup. 1 (March 30, 1987); and Decision No. 8564-(87/59), adopted April 1, 1987 (reproduced in the Appendix to this chapter). The following year, a procedure was introduced whereby the Board could indicate the completion of an Article XIV consultation on a lapse-of-time basis, based on a brief report by the staff. See "Annual Review of the Implementation of Surveillance," SM/87/29 (February 4, 1987), pp. 24–25. That procedure was first invoked for Libya in December 1988 and was used twice in 1989 (for Trinidad and Tobago and for Malta). On Libya, see Decision 9054-(89/1), adopted December 30, 1988, on the basis of the staff paper, "Socialist People's Libyan Arab Jamahiriya—Staff Report for the 1988 Article XIV Consultation," SM/88/281 (December 27, 1988).

since it had a large potential impact on the Board's own workload, and he instructed the staff to prepare a specific proposal.[59]

The Board approved Lundström's bicycle plan in general terms in March 1987 and, with some technical modifications, implemented it beginning that summer.[60] With this new procedure, 12-month cycles were to be retained for the 20 largest countries, for 4 others deemed to be "regionally important," for all countries with Fund-supported programs in place or under discussion (58 countries, initially), and for another 5 countries that had requested to be on an annual cycle. For 14 countries that did not fit into any of the categories requiring annual cycles, the staff proposed 18- or 24-month intervals. That left approximately 50 countries that were potentially eligible for the bicycle. In about half those cases, however, the staff responsible for conducting consultations with the country expressed concerns about the sustainability of the country's balance of payments or external debt-servicing capability, or about the country's maintenance of severe restrictions on international trade or payments. Twelve-month cycles were recommended for those cases, and the bicycle was proposed for just 25 countries.

In view of all the constraints imposed, it is perhaps not surprising that the bicycle was a failure. As long as only 25 countries were affected, and only half of those would be scheduled for an interim consultation in any given year, not much scope existed for reducing anyone's workload. Only 3 consultations were concluded on an interim basis in 1987, 11 in 1988 (the first full year of experience), and 15 in 1989. The pace never did pick up significantly, and the procedure was abandoned just a few years later, in 1993.

A reader of this account would be excused for dismissing the story of the bicycle as of little interest or importance, but it does contain a lesson about the culture of the Fund in the 1980s. No matter what gloss might have been applied, the countries on the bicycle were perceived to be less important for the institution. Is it

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[59]Memorandums from Hans Lundström to Alexandre Kafka (Brazil), Dean of the Executive Board (July 10, 1986); and from C. David Finch (Director of ETR) to the Acting Managing Director (August 18, 1986), with pencilled comments from the Managing Director (September 8); both in IMF/CF (S 420.3, "Article IV Consultations (Second Amendment) 1982–1986").

[60]Ironically for a technical proposal aimed at streamlining Board procedures, Executive Directors spent nearly 2½ days of formal meetings over a period of four months hammering out an agreement. A large part of the difficulty was deciding whether the Board should have any involvement in the interim consultations. In the end, it was decided that interim staff reports would be sent to Executive Directors for information only, so that the Board would have no responsibility. The alternatives were to have the Board (substantively) approve the report on a lapse-of-time basis or (procedurally) approve the completion of the interim consultation on that basis. See "Annual Review of the Implementation of Surveillance," SM/87/29 (February 4, 1987); minutes of EBM/87/38–39 (March 4, 1987); "Consultation Procedures—Initiation of the Bicyclic Procedure and Proposed Changes in Cycles for Article IV Consultations," SM/87/117 (May 20, 1987), Sup. 1 (June 5, 1987), and Sup. 2 (June 24, 1987); minutes of EBM/87/84–85 (June 8, 1987); "Article IV Consultations—Options for Simplified Interim Procedures," SM/87/139 (June 23, 1987); and minutes of EBM/87/100 (July 8, 1987). The procedure was modified in February 1991 to give Executive Directors a lapse-of-time opportunity to request a Board discussion of an interim report.

then surprising that there was a general reluctance on all sides to put countries on it? What official would want to acknowledge that his or her country was unimportant, and what staff member would want to acknowledge that he or she was working on an unimportant country?

### Setting Performance Standards

The most glaring gap in the design of Fund surveillance was that no agreed standard existed by which to judge a country's performance. The staff could evaluate the internal consistency of a country's policies and (especially in the WEO exercise) the consistency of policies among countries. But the Fund was on slippery ground when it tried to form judgments about whether policies or performance overall were up to par, simply because par had never been defined. From the beginning, several attempts were made to alleviate this problem by establishing general criteria to make surveillance as concrete as the Fund's financial programming exercises for borrowing countries.

The first effort to establish a standard of performance began at the Annual Meetings in Belgrade, in October 1979. The governor in the Fund for the United States, Treasury Secretary G. William Miller, proposed that the IMF should be able to challenge a country with a persistent balance of payments problem to devise a plan for reducing it, regardless of whether the country needed the financial resources of the Fund. Under this proposal for "greater symmetry" in surveillance, "any nation with an exceptionally large payments imbalance—deficit or surplus—must submit for IMF [i.e., Executive Board] review an analysis showing how it proposes to deal with that imbalance." (IMF, *Summary Proceedings*, 1979, p. 116) Miller's deputy for international affairs, Anthony Solomon, and the U.S. Executive Director, Sam Y. Cross, then pressed their colleagues from other countries in the Group of Five (G-5) to endorse the idea, without initial success.

With the urging of de Larosière, the U.S. initiative was included in a set of staff proposals in the first biennial review of the implementation of surveillance.[61] The staff envisaged that the Managing Director would be responsible for deciding whether a particular surplus or deficit was "large," based on staff analyses and preliminary confidential discussions with the country's authorities. The proposal was, however, put forward with some trepidation, because the staff who were involved (principally from ETR) were not convinced of its practicality. The difficulty, as they saw it, was that large imbalances were not necessarily undesirable. Notably, at the time (end-1979), external surpluses were concentrated in the major oil-exporting countries; given the price of oil, the challenge was not so much to reduce those surpluses as to ensure the orderly financing of the corresponding deficits in oil-importing countries. If those surpluses were excluded, then implementing

[61]"Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies," SM/79/292 (December 21, 1979), pp. 7–8.

the U.S. proposal would detract from, rather than enhance, the symmetry of Fund surveillance.[62]

The Executive Board showed quite a bit of interest in the idea, but Directors raised several questions about how it would work in practice. Were countries to be required to submit a quantified official statement of policy intentions, equivalent to the Letter of Intent required of countries borrowing from the Fund? If so, the willingness of countries to cooperate with the Fund might be compromised. Was the imbalance to be measured by the current account or by the overall balance of payments? Directors representing countries with ready access to international capital markets preferred the latter, and conversely. Was "large" to be defined in terms of the national economy or world trade? Directors representing smaller countries were naturally prepared to insist on a test of international significance. Were surplus and deficit countries to be treated equally? If not, it was not clear what the proposal added to current practice.[63]

A modified and more specific proposal was submitted to the Board a few months later. In this version, the Managing Director would be called upon to form a preliminary judgment whether a country had an external imbalance that was "large" in relation to the national economy, in the sense that it reflected underlying macroeconomic problems. Considerable discretion was to be given to the Managing Director in determining how the Fund should respond to such an assessment. Although the staff and management expected this modification to allay many of the concerns that Executive Directors had raised in February, it had the opposite effect. Led by Joaquín Muns (Spain) and Byanti Kharmawan (Indonesia), Directors representing most developing and some smaller industrial countries objected that the proposal would impose "onerous" burdens and would attempt to replace "persuasion" with "prescription" as the foundation of surveillance. Mahsoun B. Jalal (Saudi Arabia) cautioned his colleagues by quoting an Arab proverb: "If you want to be obeyed, ask for the possible and not for the impossible." Although a clear majority favored accepting the proposal, de Larosière was more impressed by the intensity of the opposition than by the numerical superiority of the support and therefore declined to approve it: "it is not desirable to have twelve Executive Directors overrule nine on a matter of this nature; for the success of the surveillance process depends completely on sustaining confidence and trust in relations."[64] The proposal was never revived.

A second major effort to establish general performance standards was made in the context of discussions of "quantitative indicators" for surveillance, starting in 1985. The idea of using a standard set of uniform, quantitative, and objective in-

[62]C. David Finch, "Review of Surveillance: Aide Memoire," memorandum to the Managing Director (February 5, 1980), in IMF/CF (S 490 "Surveillance Over Exchange Rate Policies, June 1978–December 1980").

[63]Minutes of EBM/80/19–20 (February 6, 1980).

[64]Chairman's summing up, minutes of EBM/80/89 (June 11, 1980), p. 32. The "onerous" quotation is from Muns, p. 3, and "prescriptions" is from Kharmawan, p. 18. The quotation from Jalal is on p. 24.

dicators to assess the economic performance of countries was not a new idea in the mid-1980s. It had been an elusive goal ever since the collapse of the par value exchange rate system in the early 1970s. In November 1972, the U.S. deputies to the Committee of Twenty, Paul A. Volcker and J. Dewey Daane, proposed that countries should be required to undertake adjustment whenever their reserve balances moved outside predefined boundaries. Subsequent discussion of that proposal focused in part on whether the set of "objective indicators" should be broadened beyond reserve levels to include the fundamental determinants of reserve adequacy. When it became clear that defining an acceptable reserve target was an extremely complicated and controversial task, the whole effort was abandoned (see de Vries, 1985, pp. 165–76). The general idea of using a broad set of objective indicators as an analytical tool was revived by the Fund staff in 1985 as a means of strengthening the role of the Fund in the G-5 multilateral surveillance exercise (see Chapter 4). In 1986, the use of uniform indicators in the WEO was enhanced along similar lines (Chapter 5).

A parallel effort was made to find a role that objective indicators might play in strengthening the process of Article IV consultations with member countries. In February 1986, as part of a push for setting what eventually were called "monitoring zones" as the basis for assessing macroeconomic performance, Charles Dallara (United States) asked the staff "to explore the feasibility of . . . notional ranges for the outcome in such policy areas as growth, employment, inflation, and the external current account." Dallara suggested that "any substantial deviations from the notional range of outcomes in a country in any one of those policy areas could be a basis for considering the need to hold discussions with the member."[65] That idea was discussed further in a series of Board meetings in 1986 and the first months of 1987, by which time it appeared that a consensus was building in favor of rewriting the basic surveillance decision or at least supplementing it with a new decision covering the role of objective indicators.

Accordingly, in June 1987, the staff offered some specific proposals for giving objective indicators a central role in Article IV surveillance. Instead of continuing to be guided by criteria that had not been helpful, such as whether countries were pursuing, "for balance of payments purposes, . . . monetary and other domestic financial policies that provide abnormal encouragement or discouragement to [international] capital flows," Fund surveillance would be based in part on an evaluation of specific indicators. Under this proposal, the Fund would establish a set of indicators for a country's policies and macroeconomic performance and would determine a range of "desirable and sustainable" values for each indicator. A significant divergence of actual developments from that reference path would trigger consideration of whether special discussions with the country were warranted. To formalize such an approach, the staff suggested that the 1977 surveillance decision be amended by replacing the original five criteria for assessing the "need for discussion with" a member country by a single reference to the signaling role of an

[65]Minutes of EBM/86/30 (February 19, 1986), pp. 46–47.

agreed set of indicators, and by adding an obligation for members to furnish data on the indicators to the Fund. The Executive Board, however, was almost unanimous in its reluctance to introduce new formal procedures without first gaining experience through informal experimentation.[66] The proposal for monitoring zones thus got caught in a catch-22: no single country wanted to volunteer to be the subject of more intense scrutiny and pressure, while the Board as a whole was unwilling to jump into uncharted waters. No one was able to find an intermediate path, and this proposal also died.

Closely related to the quantitative indicators idea was the dream that the Fund could agree on a qualitative *global* strategy for assessing the policies and performance of member countries. In 1979, U.S. Treasury Secretary Miller suggested that "one possibility" for "bolder action" to strengthen surveillance "would be for the Fund to assess the performance of individual countries against an agreed global strategy for growth, adjustment, and price stability" (IMF, *Summary Proceedings*, 1979, p. 116). The staff paper for the first biennial surveillance review included a more modest version of the proposal, in which the seven largest industrial countries would each give the Fund a quantified policy strategy. The Fund would then assess the global implications of the implied aggregate strategy in the WEO and would assess actual performance against the implied standard in Article IV consultations. The time, however, was not yet ripe for even that level of commitment, and in February 1980 the Board—notwithstanding Cross's support—expressed considerable doubts whether the goal was practical.[67]

On a rather more mundane level, the Board did agree in 1980 that in principle it would be helpful to bunch the consultations with the G-7 countries as close together as possible, so that those countries could be considered in relation to one another and discussed in a consistent manner. If all of the major countries could be asked to discuss their economic outlook and their intended policy course at the same time, then perhaps something akin to a global strategy might emerge spontaneously. Unfortunately, neither the staff nor the Executive Board had the resources to take all seven countries in one bite. Instead, three countries were to be bunched before the spring WEO and the other four before the fall round. Brief staff visits were to be made to the countries in the latter group to obtain current data and policy intentions prior to the spring WEO. That general strategy was followed throughout the 1980s.

The requirements for agreeing on a global strategy were discussed further during the 1982 biennial review. The U.S. Executive Director, then Richard D. Erb, took a dimmer view than his predecessor, noting that "the Fund clearly did not possess" either the requisite analytical framework or the political power to impose

[66]See "The Use of Indicators in Surveillance—Review of the 1977 Decision on Surveillance Over Exchange Rate Policies," EBS/87/136 (June 24, 1987), pp. 7–11, and the Chairman's summing up in the minutes of EBM/87/107 (July 23, 1987), p. 6.

[67]See "Review of the Implementation of the Fund's Surveillance Over Members' Exchange Rate Policies," SM/79/292 (December 21, 1979), pp. 8–9; and the minutes of EBM/80/19–20 (February 6, 1980).

it on sovereign countries even if it had one. Notably, neither within the staff nor among Executive Directors was there a general agreement or understanding on the role of the exchange rate as a policy instrument or on the effectiveness of different exchange rate regimes. Without such agreement, there could be no global strategy.[68]

After 1982, the global strategy lay dormant for about a decade before being revived in the early 1990s in the context of the silent revolution. By that time, the proposed strategy was no longer confined to the appropriate conduct of exchange rate policy, but was broadened to cover the whole panoply of policies affecting macroeconomic stability and economic liberalization. The Interim Committee endorsed a general strategy in 1993 and then adopted a more comprehensive strategy at its meeting in Madrid in October 1994, in what became known as the Madrid Declaration (see *Annual Report 1995*, pp. 207–8).

### Publicity

How much publicity should be given to the Fund's consultations with member countries? This has always been a delicate question, on which opinions shifted very gradually during the 1980s and then more dramatically several years later.

When the Fund began conducting surveillance under Article IV in 1978, the secrecy of the process was taken for granted (see de Vries, 1985, p. 850). The Fund would be asking the authorities of member countries to provide sensitive information about how they were conducting exchange rate policies, the staff were expected to prepare candid assessments of the consistency and sustainability of those policies, and both the staff reports and the summing up of the Executive Board discussion would be circulated on a timely basis to all member governments. To make those documents available to a wider audience, it was judged, could create economic and political problems for the authorities and could compromise their willingness to be forthright. Even when the Board decided in 1980 to add a section on surveillance to its Annual Report, it did so on the proviso that "there should be no publication of information on individual countries."[69]

With experience came a trickle of minor exceptions.[70] By the early 1980s, a scattering of countries began releasing the staff's preliminary appraisal to the press shortly after the conclusion of discussions with the staff mission. (Although the staff report was a document of the Fund, the preliminary appraisal delivered to the authorities at the conclusion of the mission was the property of the member country.) Beginning in 1984, countries under "enhanced surveillance" (see Chapters 9 and 10) were permitted to release the staff report to their private sector creditors,

[68]See the minutes of EBM/82/31–32 (March 17, 1982) and the Chairman's summing up in the attachment to "Review of the Document 'Surveillance Over Exchange Rate Policies' and Annual Review of the Implementaton of Surveillance," EBD/82/89 (April 13, 1982), p. 1.

[69]Chairman's summing up, minutes of EBM/80/20 (February 6, 1980), p. 40.

[70]A related issue, discussed in Chapter 5, was whether to publish the WEO documents. Publication was approved in 1980.

on a strictly confidential basis. (Since it was in the banks' own interest to keep the information to themselves, the confidentiality rule was generally obeyed.) Beginning in 1986, the Fund's *Annual Report* included a summary of the conclusions of the consultations with each of the G-7 countries, based on the summing up of the Board discussion. In 1988, the Fund began publishing—only for those countries that agreed—the indexes of nominal and real effective exchange rates that were the focus of surveillance discussions on exchange rate policy.

The basic principle of confidentiality of the staff report was not seriously questioned in the 1980s, but the background (RED) papers were occasionally treated more liberally. In a few cases, background studies for an RED would be circulated as Working Papers and published under the author's name as independent research papers. An early example was a study of the impact of North Sea oil on the U.K. economy, which was prepared as part of the 1980 consultation with the United Kingdom and later published in *Staff Papers* (Bond and Knöbl, 1982).[71] In 1989, the Fund broke precedent by publishing a revised version of the RED for the 1988 consultation with Germany (Lipschitz and others, 1989). These tentative steps culminated in a decision in 1994 to publish REDs and other background papers on a more regular basis, unless the authorities of a country objected.[72]

## Handling Problem Cases

A central dilemma—perhaps *the* central dilemma—in devising effective procedures for surveillance was how to reconcile the need for evenhandedness with the desirability of devoting as much attention as possible to countries with serious economic problems and to countries whose policies have major impacts on their neighbors or on the world economy. How could surveillance be effective if the Fund treated all countries the same?

The Fund received a mandate to focus especially on problem cases, very shortly after the Second Amendment to the Articles came into force. At the end of April 1978, the Interim Committee responded to concerns about exchange rate misalignments, especially the collapse of the U.S. dollar, by noting "with approval . . . that particular attention will be focused on those cases in which there are ques-

[71]A summary of the main findings of the study was included in the RED: "United Kingdom—Recent Economic Developments," SM/81/30 (February 5, 1981), Appendix I.

[72]See *Annual Report 1995*, p. 39. In 1992, the Fund began publishing REDs for the new member countries that had been part of the former Soviet Union or were in transition from central planning, under the series heading of *Economic Reviews*. On an exceptional basis in the early 1990s, papers derived from consultations with Germany and the United States were published as Lipschitz and McDonald (1990) and Horiguchi and others (1992), respectively. In addition, the coverage of policy issues from consultations in the *Annual Report* was greatly expanded, from 3 pages on 7 countries in 1986 to 60 pages on 40 countries in 1997. The Fund then began issuing "Press Information Notices" (PINs; later redubbed "Public Information Notices") on many consultations, derived primarily from the summing up. Those notices were published separately, and the extended treatment in the *Annual Report* was dropped.

tions about whether the exchange rate policies of members are consistent with the agreed exchange rate principles."[73] Immediately afterward, Managing Director Johannes Witteveen established a secret internal Surveillance Committee (chaired by the Managing Director and including the Deputy Managing Director and the Directors of the area departments, ETR, and Research) to identify and discuss problem countries. The Surveillance Committee first met on June 1, 1978 (the only meeting chaired by Witteveen, who was succeeded as Managing Director by de Larosière later that month). Thereafter, it met two to four times a year throughout most of de Larosière's tenure at the Fund.

Jacques Polak—supported by most other participants including the Managing Director—argued forcefully at the early meetings of the Surveillance Committee, and in associated memorandums, that the Fund—and the Managing Director in particular—should take an active role in identifying and discussing with member countries cases where exchange rate movements were causing problems. But the Committee struggled with the question of how best to carry out this type of surveillance: through supplemental or ad hoc consultations, or merely through regularly scheduled but especially intensive Article IV consultations?

During its first couple of years, the Surveillance Committee identified several problem cases, mostly related to developing and small industrial countries. This led to some intensification of discussions of the exchange rate in the regular consultations, but not to much more. Perhaps the most notable effect was the handling of Denmark and Belgium, both of which were singled out by the Surveillance Committee in March 1980 as countries with an overvalued exchange rate. Besides having the staff raise the matter with the authorities during the scheduled Article IV consultations, de Larosière approved the idea of going public by mentioning the Fund's concerns in the WEO—which was to be published for the first time that spring. Although the language was typically circumspect, the evaluation of the exchange rate was unusually blunt:

> Prominent among [countries with severe adjustment problems] are *Belgium* and *Denmark*. . . . In both of these countries, there have been sizable increases in interest rates and other restrictive monetary measures designed to support the exchange rate, but in recent months intervention in the exchange markets has been required nonetheless (*WEO*, May 1980, p. 51).

Otherwise, the problem cases identified by the Surveillance Committee were usually handled routinely. Over time, the committee turned its attention ever more to the economies of the major industrial countries, and it became primarily a means of coordinating the analysis of the European, Asian, and Western Hemisphere Departments on those countries. By 1986, it had outlived its usefulness, and for a time it ceased to meet. (A new Surveillance Committee was formed in the 1990s, as part of a broad effort to strengthen surveillance.)

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[73]Interim Committee communiqué, April 30, 1978, para. 4; in de Vries (1985), Vol. 3, p. 236. For background, see de Vries (1985), pp. 854–57.

### *1977 Decision on Ad Hoc Consultations*

What the Interim Committee endorsed in the communiqué quoted above was a provision in the Executive Board's 1977 surveillance decision for ad hoc consultations at the initiative of the Managing Director. In addition to the scheduled consultations that were to be held with every member country, the 1977 decision enabled the Managing Director to initiate a confidential discussion with a country, and report on it to the Board, if he "considers that a member's exchange rate policies may not be in accord with the exchange rate principles" of Article IV.[74] In practice, despite the care that went into drafting that language and the explicit endorsement it received from the Interim Committee, this specific procedure was never invoked.

The staff and the Managing Director were eager to hold ad hoc consultations, to test and demonstrate the effectiveness of Fund surveillance. After discussions of several possible cases during the summer of 1978, they decided to try to tackle a small country first. At the beginning of September 1978, a newly elected government in Iceland announced that it was devaluing the exchange rate by 15 percent as an emergency measure. The Fund staff immediately prepared a paper on the background to the devaluation, which was placed on the agenda of the Executive Board for September 8 with the intention that the Board would decide whether to hold a formal consultation on the matter. The staff did not dispute the need for the devaluation, but they felt that the need for tighter financial policies and other supporting measures should be taken up by the Fund at an early date.[75]

When the meeting opened, the Executive Director speaking for Iceland, Frede Hollensen (Denmark), objected strenuously. Hollensen did not object in principle to the idea of the Fund discussing the devaluation of the Icelandic króna, but he argued that it was neither proper nor acceptable for the Fund to pick on Iceland while it effectively ignored the similarly large fluctuations in currency values of the major countries with floating rates. C. David Finch (Deputy Director, ETR) responded for the staff that the circumstances in this case were unique in the period since the Second Amendment had come into force. Although it was true that the Japanese yen and the U.S. dollar had shown substantial movement in the past few months, and both countries had implemented policy actions to affect the exchange rate, those developments were viewed by the staff as having occurred within the framework of an unchanged exchange rate policy. The Fund had dealt with other significant discrete changes in rates (by Jamaica, Peru, Ghana, and Nepal) through normally scheduled consultations with the member country. The Board, however, was not

[74]The Fund also had in place a procedure, initiated in 1970 and formalized in 1973, for conducting special consultations with member countries as background for the WEO. See de Vries (1985), pp. 276–79.

[75]Iceland's exchange crisis followed from a severe loss of international competitiveness for the main export industry, fishing. Exchange markets were closed on August 28, and the government that took office on September 1 informed the Fund on September 4 that it would reopen the markets on September 6 at the new exchange rate. "Iceland—Exchange System," EBS/78/501 (September 7, 1978).

convinced. Not a single Director spoke in favor of holding a substantive discussion of the Iceland case, and the matter was dropped from further consideration.[76]

A few months later, in response to an emergency package of policies announced by the U.S. authorities to reverse the rapid depreciation of the dollar, the Fund held a special consultation with the United States (see Chapter 3). In that case, the staff decided not to invoke the 1977 ad hoc procedure, and the consultation was treated instead as a "special consultation"—the first of its kind—under the general authority of the new Article IV.[77] In summing up that experience, the Managing Director noted that

> this was the first occasion on which the Board has undertaken special surveillance of the exchange rate and of the underlying policies of a major member country. This has been carried out with the active cooperation of the United States. This kind of surveillance should always be conducted whenever situations develop in major countries that have an important bearing on the economies of other countries.[78]

### *1979 Decision on Supplemental Consultations*

In January 1979, the Executive Board formalized that approach by adopting a separate "supplemental surveillance procedure" instructing the Managing Director to initiate an ad hoc consultation with a member whenever he "considers that a modification in a member's exchange arrangements or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members, whatever the member's exchange arrangements may be." An unusual feature of that decision was the accompanying statement by the Managing Director explaining its context, which was to be considered as having the same legal effect as if it had been part of the decision.[79] That statement (reproduced in the Appendix to this chapter) made it clear that "lack of movement" in an exchange rate could trigger such a discussion just as well as movement, if the level of the rate had become inappropriate to a country's circumstances. Further, the statement noted that the phrasing of the decision covered both importance to the member (which would be relevant for small countries) and importance to other members (which would be relevant for larger countries).

The 1979 decision on supplemental consultations was thus intended to ensure evenhandedness and to remove the stigma associated with the 1977 decision. Although it was explicitly framed as a "supplement" to the 1977 decision (which remained on the books), it effectively superseded it. Under the new procedure, the Managing Director was not required to submit a formal report on a discussion to the Executive Board, but he "may report to the Executive Board or informally ad-

[76]Minutes of EBM/78/136 (September 8, 1978).

[77]Later, the question of whether a supplemental consultation should be held with the United States (under the 1979 decision discussed below) was considered by the staff and management on several occasions, always without result.

[78]Minutes of EBM/78/198 (December 13, 1978), p. 20.

[79]On the role of the Managing Director's statement, see the minutes of EBM/79/13 (January 22, 1979), especially the statement by the General Counsel, Joseph Gold.

vise the Executive Directors," and a formal report and discussion might follow from such informal soundings.

The new procedure did not turn out to be much easier to apply than its unfortunate predecessor. During its first year, it produced only two hesitant actions. First, in January the government of South Africa announced that it was abandoning the practice of fixing the exchange rate on a daily basis, that it intended to move toward a unified exchange regime, and that henceforth it would let the market determine the rate subject to intervention by the central bank. In response, a staff team visited South Africa in February to discuss the implications with the authorities. The mission concluded that the policy shift was appropriate and welcome. A report on the matter was circulated to Executive Directors in April, but no one felt that a Board meeting was needed.[80] Second, in May the exchange value of the Japanese yen began to weaken markedly. Ernest Sturc (Director of ETR) suggested to the Managing Director that he initiate a supplemental consultation with Japan. De Larosière flew to Tokyo to meet with the Finance Minister and the Governor of the Bank of Japan, but no further action was taken for several months. When the yen weakened further in March 1980, the Surveillance Committee recommended a supplemental consultation. A staff visit was held, but again no Board discussion followed (see Chapter 3).

By then it was clear that the only way the Fund could hope to have special consultations become an effective part of surveillance was to make them less special and more routine. For the Board's 1980 review of surveillance, the staff proposed that supplemental consultations be employed with some regularity in cases where problems might exist or even be latent. That proposal was endorsed in principle, but Executive Directors again expressed concerns about the negative connotations that might be attached to such consultations. The Managing Director tried to reassure them by stressing that there should be "no formality" and "no stigma."[81] In practice, although the 1979 procedure was officially neutral, it did not escape being seen as stigmatic, and it was invoked only rarely. Several times throughout the 1980s, the Managing Director initiated informal discussions with members outside the usual cycle of Article IV consultations, but only twice did those talks lead to formal special consultations: with Sweden in 1982 and with Korea in 1987. Those cases are discussed below.

### *Information Notice System*

Since the staff was reluctant to initiate special consultations after the 1978 rebuff on Iceland, the procedure could be used only when one country or a group of countries brought a complaint against another. What was needed was a more regular means of reporting potential problem cases to the Board, so that Directors could indicate in a more neutral framework whether they wished to hold a discussion on a country. During the supplemental consultation with Sweden in Decem-

[80]See "South Africa—Exchange System," EBS/79/220 (April 16, 1979).
[81]Minutes of EBM/80/20 (February 6, 1980), p. 41.

ber 1982, Polak suggested that the staff should develop a regular and quantitative procedure for initiating Board discussions of significant changes in exchange rate policies. That led to the establishment of the Information Notice System the following year.

The heart of the Information Notice System was a detailed database on real effective exchange rates that the staff had developed over a period of years.[82] By 1983, the data covered all but about 30 of the Fund's 146 member countries.[83] For countries with substantial exports of manufactured goods, effective changes were calculated using weights that reflected the country's overall competitiveness, rather than just its bilateral trading relationships as in most earlier estimates.[84] For the larger industrial countries, comparisons were based on unit labor costs, which the staff viewed as the most reliable measure of underlying costs. For developing and smaller industrial countries, where cost data were more limited, consumer price indexes were used instead. By plotting these data over enough years, one could get a prima facie indication of whether a country had been gaining or losing international competitiveness for its exports.

The Achilles' heel of the system was the lack of an unambiguous measure of the right level of competitiveness: of a clear way to judge whether a change in the index was moving the country toward, away from, or along an appropriate path. When working in detail on a single country, the staff usually looked for a period in the not-too-distant past when the country's balance of payments was in a comfortable position. A substantial appreciation of the real effective exchange rate since then would be considered a signal of a possible problem.[85] That methodology was too unwieldy for a system to be applied uniformly to the whole membership, so the Fund had to devise a rather arbitrary substitute. Since the point of the exercise was to help determine whether a special discussion should be held between the normally scheduled consultations, the obvious solution was to focus on large changes (in either direction) since the last time the Executive Board had discussed the country's economy.

The Executive Board agreed to establish the Information Notice System during the annual review of surveillance in March 1983. At de Larosière's suggestion, it

[82]Economists use the term "real exchange rate" in two distinct senses, reflecting the type of interaction that is being stressed (see Kenen, 1985, pp. 636–37): the real exchange rate is either the ratio of traded to untraded goods prices, or the product of the nominal exchange rate and the ratio of domestic to foreign prices. By either measure, a rise (appreciation) in the real exchange rate signals a loss of international competitiveness. The latter measure is the one commonly used at the IMF, both in policy discussions and in publications such as the *World Economic Outlook* and *International Financial Statistics*.

[83]The main limitation was that a number of countries did not compute monthly or even quarterly price indexes. In 1986, the system was made virtually universal by interpolating price data where necessary.

[84]The methodology was derived from the Fund's Multilateral Exchange Rate Model (MERM), which is discussed in Chapter 5. For details, see Zanello and Desruelle (1997).

[85]For a brief review of the issues, see Artus and Knight (1984), pp. 6–8. For a later detailed review of the difficulties of assessing the equilibrium behavior of exchange rates, see MacDonald (1995).

was agreed that the threshold for issuing a notice to the Board should be a 10 percent change in the real effective exchange rate since the last Board discussion (or over the previous 12 months, if the Board had not held a discussion in that time span). There was no particular rationale for that number, except that it was expected to produce a manageable number of notices. To round out the procedure, the Board also agreed to a suggestion from Polak that the staff prepare a quarterly report showing longer-run changes in the indexes for all countries.[86]

Like every other attempt to focus surveillance effectively on problem cases, the Information Notice System was a failure. During seven years starting in 1983, the staff issued 152 separate notices of large changes in real effective exchange rates (excluding notices issued as part of a more general staff report), covering 67 different countries. Not one of those notices ever led to a special Board discussion, and the whole system of individual country notices was disbanded at the conclusion of the 1990 biennial review of surveillance procedures.

Because the staff remained reluctant to flag specific problem cases, the country notices typically just reported the change and summarized the country's macroeconomic situation without drawing conclusions on whether the reported change might be good or bad. The arbitrary base period (normally the date of the last Board discussion of the country) added to the difficulty of interpretation. Furthermore, an unexpected complication arose. As it happened, the frequency of large changes was affected heavily by the behavior of the key reserve currencies, which occasionally led to a large number of irrelevant notices being issued. For example, 41 separate Information Notice System notices were issued in 1986—mostly for small countries—owing largely to the sharp depreciation of the U.S. dollar rather than to the country's own policies or economic conditions. In fact, it turned out to be more difficult for large countries to be the subject of a notice, partly because of the greater frequency of consultations but also because of the greater diversity of their trading relationships. (A small effective depreciation of the dollar might well cause a much larger effective depreciation of a small-country currency pegged to it.)[87]

### Supplemental Consultations

The Fund held only two supplemental consultations under Article IV during the 11 years covered in this History, and none in the following decade. In each case, the Fund reached a cautious compromise and conveyed a muted criticism to the member country. For all its limitations, the process had an important strength, in that the Fund served as an objective referee in disputes between countries and diffused what had been quite heated political pressures. This cooling-off procedure helped economic policies to evolve gradually in the right direction.

[86]Minutes of EBM/83/54–55 (March 28, 1983).

[87]Over the seven years of the full-fledged Information Notice System, three separate notices were issued on the U.S. dollar (in 1985, 1986, and 1988), two on the pound sterling (in 1985 and 1987), one on Japan (in 1990), and none on the other G-10 countries. The largest number of notices (eight) was for the Nicaraguan córdoba, which was linked to the U.S. dollar.

***Sweden***

The first supplemental consultation was in response to a 16 percent devaluation of the Swedish krona in October 1982. Most observers agreed that a devaluation was needed, but the staff judged that the size was much larger than warranted.

Sweden, in contrast to many other countries with relatively high inflation, did not fear devaluation. Swedish officials especially recalled the benefits of the devaluation of the krona by just over 30 percent against the U.S. dollar in 1949, at a time when Swedish exports had become seriously overpriced in world markets.[88] During the global currency turmoil of 1971–73, the krona generally appreciated slightly against the dollar but depreciated against other European currencies, after which the government decided to try to stabilize the currency by fixing the exchange rate within the narrow margins of the European "snake" arrangements. That experiment, however, lasted just four years, until Sweden's first non-Socialist government since 1932 bailed out of the snake with a 10 percent effective devaluation in August 1977.[89] The krona then was pegged to a basket of 15 currencies that was weighted by trade shares except that the U.S. dollar was assigned a higher weight. Thus when the Fund began conducting "firm surveillance" in 1979, the krona was temporarily at a comfortable level. The underlying position, however, was troubled by a continuing inconsistency between the stable exchange rate and the high rate of Swedish inflation.[90]

Sweden's economic difficulties accumulated again to the boiling point by the beginning of 1981. The coalition government barely weathered an exchange crisis without a devaluation in January by tightening both fiscal and monetary policies, but the coalition fell apart a few months later in the midst of rising unemployment and other strains on the economy. A Fund mission—headed by Hans O. Schmitt, Senior Advisor in the European Department—arrived in Stockholm in late August to conduct the regular Article IV consultation. Schmitt advised the authorities that they would have difficulty reversing the 8 percent loss that Sweden had undergone in international competitiveness since 1973 without a "significant devaluation" or a large cut in social security contributions or in other compensation to employees: cuts that would have been anathema (and probably politically fatal) to the government.

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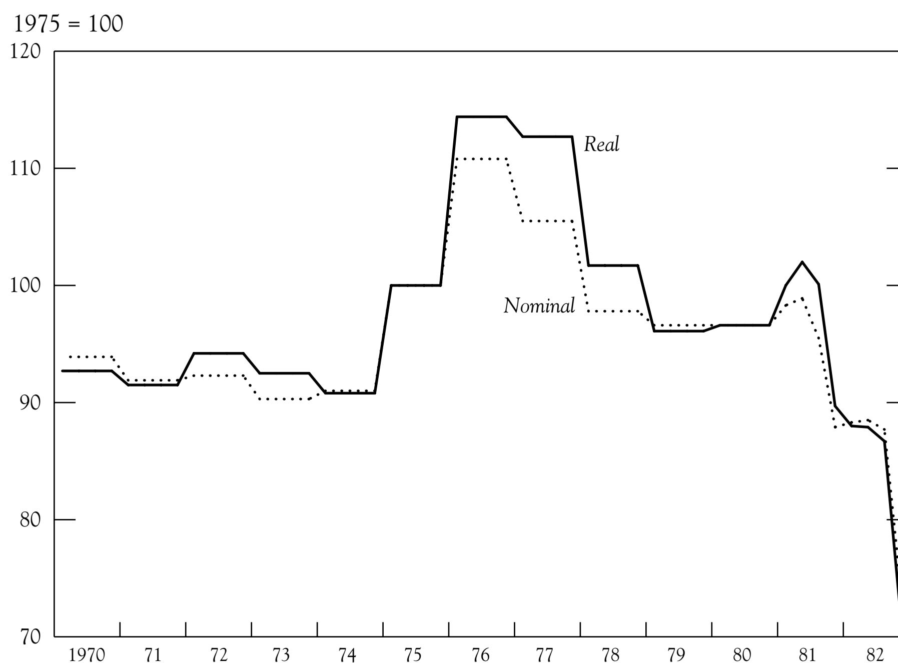
[88]For the Fund staff's analysis of the 1949 devaluation (at which time Sweden was not yet a member of the Fund), see Rolf Evenson, "Note on Sweden's New Exchange Rate," Staff Memorandum No. 399, October 12, 1949; IMF/CF (C/Sweden/430, "Exchange Rates"). The devaluation against the dollar was by the same percentage as that of the pound sterling and a number of other currencies shortly beforehand, so the effective devaluation would have been much smaller. Nonetheless, it was cited as a prototype by the architect of the 1982 devaluation; see Feldt (1991), p. 59.

[89]Exchange rate changes beginning in the 1970s are measured in effective terms and thus are not commensurate with the 1949 devaluation. This brief summary also omits numerous smaller exchange rate adjustments.

[90]For the six years through 1982, consumer prices in Sweden rose at an average annual rate of 10½ percent, and in total by about 20 percent relative to the average for all industrial countries.

**Figure 2.3. Sweden: Effective Exchange Rate, 1970–82**




Schmitt's advice on behalf of the IMF was very much in line with the views of the authorities. Ten days later, on September 14, 1981, the central bank (the Riksbank) devalued the krona by 10 percent against the basket, the first devaluation since the peg was established four years earlier.[91] Both the staff and the Executive Board judged this devaluation to be an appropriate response to circumstances, noted that it should fully offset the fall in competitiveness of the previous eight years (Figure 2.3),[92] and urged the authorities to implement supporting domestic measures aimed at restructuring the economy.[93]

Parliamentary elections in September 1982 returned the Social Democrats to power, led by Prime Minister Olof Palme.[94] During the three-week transition after

[91]At that time, the Riksbank had legal responsibility for exchange rate policy. The governor and the governing board were chosen by parliament, and the bank's policies were expected to be consistent with those of the government. In most cases (including this one), the initiative for a change in the rate was taken by the governor.

[92]The "real exchange rate" in Figure 2.3 is an index of unit labor costs relative to partner countries, adjusted for changes in exchange rates. Fourteen partner countries are included, weighted by importance for competitiveness; the weights reflect both bilateral trade and indirect competition, as in the MERM. This was the primary index used by the Fund staff at the time.

[93]The staff conclusions are in "Sweden—Staff Report for the 1981 Article IV Consultation," SM/81/201 (October 27, 1981), p. 11. For the Chairman's summing up of the Executive Board meeting, see the minutes of EBM/81/144 (November 18, 1981), pp. 15–16.

[94]Palme had been prime minister from 1969 to 1976, the last in a continuous succession of Social Democrats who had governed Sweden for 44 years.

the elections, Palme's Minister of Finance, Kjell-Olof Feldt, devised a plan to devalue the krona by 20 percent against the basket. He persuaded a reluctant central bank governor (Lars Wohlin) to go along with the plan, but he then ran into a buzzsaw of opposition from abroad.

The morning before the new government was to take office, on October 7, all of the other Nordic finance ministers and central bank governors (i.e., those from Denmark, Finland, and Norway) met secretly with Feldt at Arlanda Airport just outside Stockholm. Their reaction to the proposal was uniformly and strongly negative, but Feldt argued that it was necessary to strengthen the competitiveness of Swedish industry. The only alternative, in his view, would be a ruinous increase in domestic interest rates.[95] To regain credibility and stabilize the rate after the devaluation, Feldt was considering tying the krona to the deutsche mark. When he informed the president of the Deutsche Bundesbank, Karl-Otto Pöhl, of his intentions later in the day, Pöhl also reacted quite negatively on the grounds that Sweden's macroeconomic policies were not consistent with those of Germany. Pöhl managed to dissuade Feldt from the linkage to the deutsche mark but could not convince him to keep the devaluation within single digits. Finally, near midnight in Stockholm, Feldt reached de Larosière by telephone. The Managing Director also tried unsuccessfully to convince Feldt to reduce the magnitude of the devaluation and to back it up with a sharp increase in interest rates.

The only effect of all of this criticism on October 7 was to persuade the new government to reduce slightly the size of the planned devaluation. The next day, Palme took office and promptly announced a 16 percent devaluation against the basket.[96]

Even before the devaluation, Schmitt's staff team had concluded that the most that could be justified by lost international competitiveness was a devaluation of 4 to 5 percent. That technical finding coincided with political judgments across Europe, which made a confrontation in the Fund all but inevitable. When Jón Sigurdsson (Iceland), the Executive Director speaking for Sweden, informed the Board of the authorities' action that same day, Gerhard Laske (Germany) immediately asked for the matter to be placed on the Board's agenda. Laske was supported by Christopher Taylor (Alternate—United Kingdom), who suggested that a supplemental consultation might be the appropriate vehicle, and by all of the other European Directors and Dallara. Despite Sigurdsson's plea on behalf of Sweden to wait for more information to be made available, a preliminary discussion on procedures was scheduled to be held the following week.[97]

[95]Feldt (1991), pp. 57–77, describes this meeting and other elements of the preparations for devaluation. Additional information here is from background interviews and internal IMF memorandums. For what was known in the Fund at the time, see the memorandum from L. Alan Whittome to the Managing Director (October 12, 1982), in IMF/RD Managing Director file "Sweden, 1982" (Accession 85/33, Box 2, Section 376); also see the statement by Gerhard Laske at EBM/82/133 (October 8, 1982), p. 37.

[96]The exchange regime involved maintaining the value of the krona against an index, which was defined at 100 for the period from August 1977 to September 1981. The 1981 devaluation raised the index to 111, and the 1982 devaluation set it at 132.

[97]Minutes of EBM/82/133 (October 8, 1982).

On October 13, the Board took up the formal question of whether to hold a special consultation and, if so, under what authority: the 1979 "supplemental surveillance procedure" or the more stigmatic 1977 decision. Sigurdsson again issued a strong protest, not only because he believed the devaluation to be warranted but because it appeared that the Fund was singling Sweden out for undue scrutiny. Several other Directors, however, suggested that the devaluation was unjustified and was aimed at gaining Sweden an unfair competitive advantage over its trading partners; in effect, that it was a "beggar my neighbor" policy that could lead to a dangerous spiral of competitive devaluations. Sigurdsson himself was awkwardly placed by the situation, as he also represented two of the countries that were most adversely affected and were pushing the Fund to act: Denmark and Norway. His two-part intervention, arguing against and then for intervention by the Fund, was regarded around the table as a remarkable tour de force, but the second half must have been the more persuasive: the Board agreed to hold a special consultation under authority of the 1979 decision.[98]

The Swedish authorities clearly would have preferred that there be no special consultation, but it did present them with an opportunity. Given that several of their main trading partners were upset enough to be contemplating retaliatory or offsetting measures, cooperation with the Fund might help deflect criticism and forestall retaliation.[99] Schmitt and three other staff economists spent a week meeting with officials in Stockholm in early November, at the end of which they reiterated the gist of the conclusions that they had reached earlier. They agreed that Sweden faced a "structural" current account deficit (i.e., one that was too large to have resulted from business-cycle factors alone) and that a devaluation was an appropriate means of reducing it. "However, in the view of the staff, a devaluation of a lesser amount than that undertaken should have been ample to serve the purpose, especially given the devaluation of last year."[100] Although the staff team estimated that a devaluation of no more than 5 percent would have restored sustainability to the external accounts, they decided not to go too far out on a limb and instead cited a range of 5–10 percent—still well below the actual figure of 16 percent—as justifiable.

A critical issue for the Fund was the relationship between the exchange rate and the whole range of Sweden's other economic policies. If "other obstacles to competition from abroad," such as export credit subsidies, were eliminated, then "the possible adverse effects on other countries [could] be mitigated," the staff report

[98]The formal decision read, "The Executive Board, acting under Article IV and Decision No. 6026-(79/13), adopted January 22, 1979, invited the Managing Director to conduct special consultations with Sweden." Decision No. 7225-(82/135), adopted October 13, 1982; minutes of EBM/82/135 (October 13, 1982), p. 29.

[99]Finland devalued the markka by 10 percent in effective terms in two steps, immediately before and after the Swedish action. Norway had already devalued the krone by around 6 percent in August and September and took no action at this time. Denmark did not change its exchange rate.

[100]"Sweden—Staff Report for the 1982 Special Consultation Under Article IV with Sweden," EBS/82/222 (December 3, 1982), p. 11.

concluded.[101] Since the authorities seemed willing to take such action, Schmitt suggested to the minister of finance, Kjell-Olof Feldt, that he write a letter to the Managing Director detailing a strategy to carry out specific supporting measures. Feldt eventually agreed to do so, on the condition that it be a personal letter. The Managing Director could (and did) quote from the letter at the Board meeting, but could not circulate it; otherwise, it might be interpreted as equivalent to a Letter of Intent and exploited by opposition parties.

The Board met in restricted session on December 22 to conclude the special consultation and found in favor of the staff view: "it was considered that, on the whole, the size of the . . . devaluation was not justified by the underlying competitive devaluation and that a lesser move would have been appropriate."[102] It was an uneasy meeting. Several Directors were uncomfortable with the whole idea of the Fund making judgments about appropriate exchange rate adjustments, since so much uncertainty was involved. Since no one was prepared to argue against the legitimacy of devaluation as a policy tool for countries with large external deficits, Directors found themselves arguing more from instinct than from evidence. And there was a general discomfort with the circumstances that made it easier for the Fund to deal with discrete exchange rate adjustments than with the misalignment of floating rates, especially since this lack of symmetry served in some measure to give the major countries a free ride. Even so, at the end of the day, most of those involved felt that the conclusion was the right one and that the Fund had played a helpful role both in defusing a volatile situation by serving as an objective referee and in defining the right course for further policy action by Sweden.

***Korea***

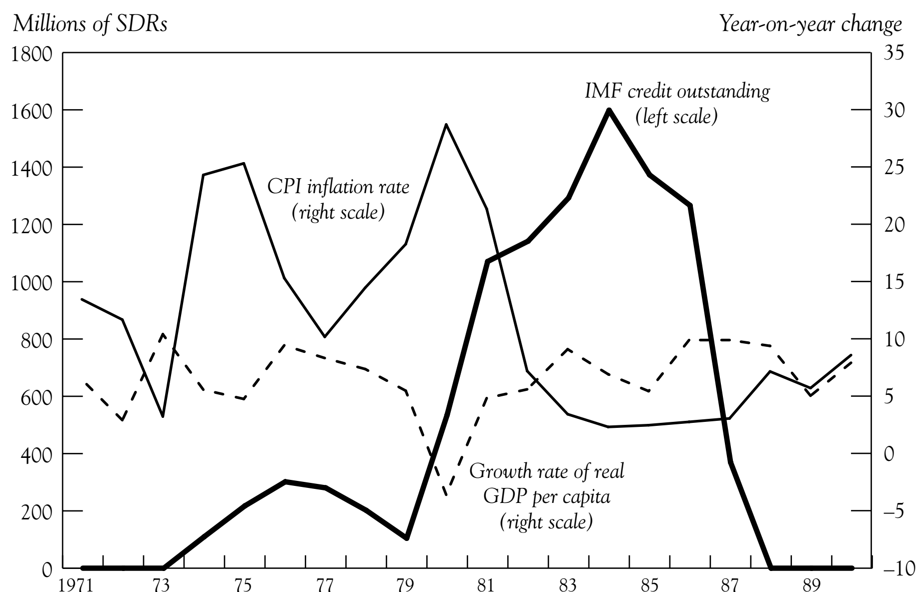
The other special consultation during the 1980s was held with Korea in 1987. As in the Swedish case, the story of this conflict begins with an economic crisis of several years earlier. Korea had experienced rapid development in the 1960s and early 1970s, reflecting the implementation of policies promoting exports, including principally exchange rate and tax policies.[103] Drawings from the Fund's oil facility and the Compensatory Financing Facility (CFF), plus remittances from Koreans who were helping develop the economies of the Middle East states, helped Korea weather the first oil shock in 1973–74. But the industrial policies that had been so successful up to that point led to structural strains and a resurgence of inflation in 1977 and 1978 through overexpansion in petrochemicals and other sectors. These policy errors were aggravated severely in 1979–80 by a series of unrelated exogenous developments: the rapid rise in world oil prices, a severe winter that sharply reduced the rice harvest, and the assassination of President Park Chung Hee in October 1979.

[101]Ibid.

[102]Chairman's summing up, minutes of EBM/82/166 (December 22, 1982), p. 3.

[103]For a review of Korea's adjustment experience through 1984, see Aghevli and Márquez-Ruarte (1985). SaKong (1993) provides an overview of Korean experience with economic development, including relations with the IMF. The structural changes in the Korean economy in the 1980s are examined in Corbo and Suh (1992).

**Figure 2.4. Korea: Growth, Inflation, and IMF Credits, 1971–90**



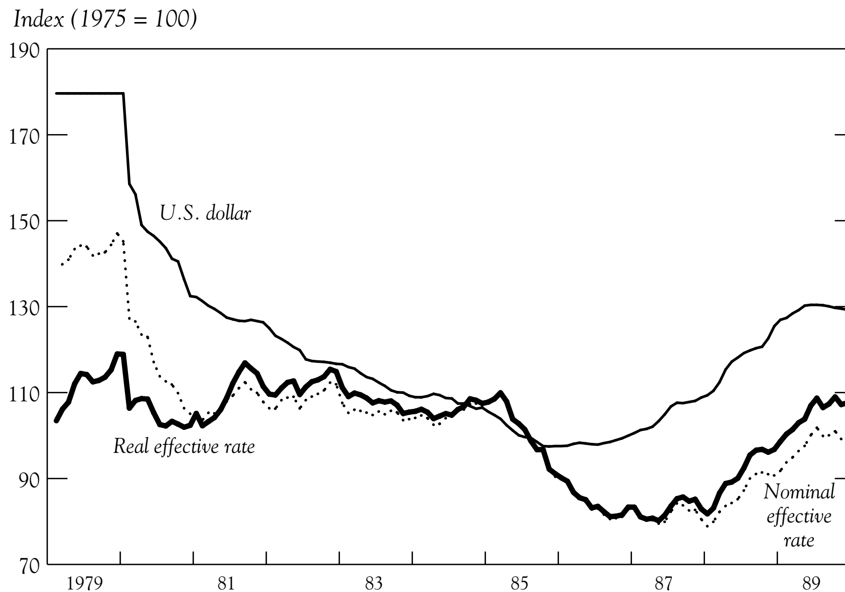

In response to this burgeoning crisis, the Korean authorities initiated a major adjustment program in 1980. The major elements of the program were a large devaluation (17 percent against the U.S. dollar in January 1980), adoption of a more flexible exchange rate regime,[104] a tightening of financial policies, and upward adjustments in domestic energy prices. The Fund supported this program by lending Korea a total of just over SDR 1 billion ($1.3 billion) in 1980–81, under two stand-by arrangements plus compensatory financing for a temporary shortfall in export receipts (Figure 2.4).[105]

By the time the second of these stand-by arrangements expired in 1982, the economy was on the rebound and Korea was regaining some of the international competitiveness that had been lost through inflation. Over the next two years, the exchange rate continued to depreciate sharply against the U.S. dollar. The dollar, however, was quite strong, and most currencies were falling relative to it in 1983–84. The Korean won dropped more than most in 1983 and thus depreciated in effective terms as well, but that trend was reversed in 1984. Overall, from 1981 through 1984, neither the nominal nor the real exchange rate showed much trend (Figure 2.5).

[104]Until January 1980, the Korean won was pegged to the U.S. dollar and was devalued occasionally to offset the inflation differential. Following the devaluation, the authorities managed the exchange rate to maintain competitiveness relative to a basket of currencies.

[105]The first arrangement provided for a loan in eight instalments of SDR 80 million each over two years, beginning in March 1980. The arrangement was enlarged in February 1981 by canceling the initial agreement and replacing it with a 12-month stand-by arrangement with four instalments of SDR 144 million each. The latter arrangement was fully utilized. Korea also borrowed SDR 160 million in July 1980 under the CFF.

**Figure 2.5. Korea: Exchange Rates, 1979–89**



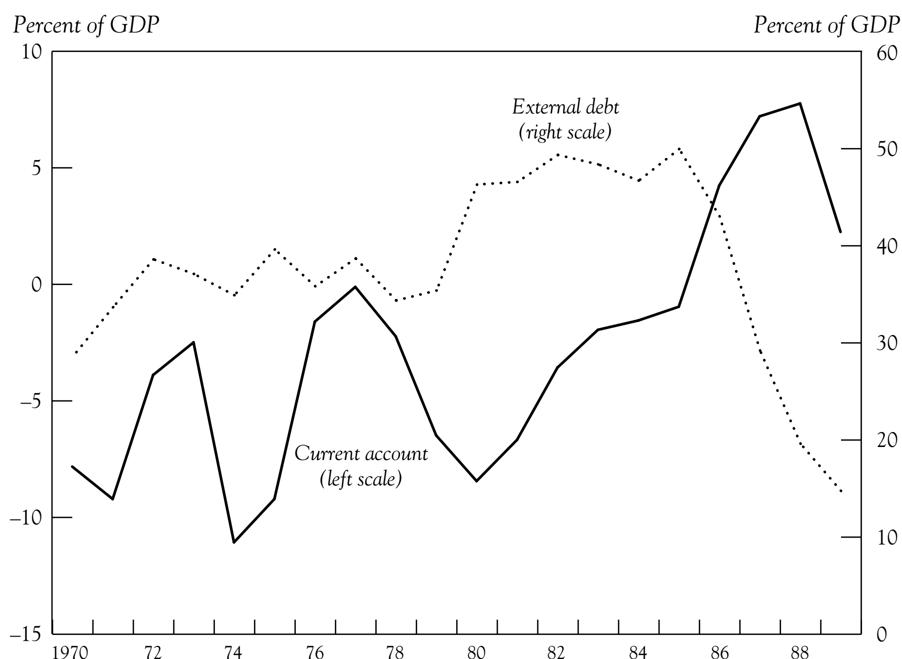

In 1985, when the last of Korea's 16 stand-by arrangements was being negotiated and Seoul was preparing to host the Bank-Fund Annual Meetings, the government was aiming to eliminate the current account deficit by 1987: a remarkable turnaround from the beginning of the decade, when the deficit had exceeded 8 percent of GDP (Figure 2.6). In the event, the target was easily surpassed, and by 1987 Korea recorded a substantial external surplus. This apparently unexpected strengthening reflected both the depreciation of the dollar throughout 1985 and 1986 and more aggressive management of the won exchange rate. By letting the won depreciate slightly against the dollar, the Korean authorities obtained a very substantial overall gain in international competitiveness, as shown in Figure 2.5.

Meanwhile, the U.S. government was becoming increasingly sensitive to bilateral trade imbalances, which were concentrated in Asia.[106] The U.S. Treasury initiated talks with Korean officials during the summer of 1986, but those talks proved fruitless, as the two sides viewed the situation in radically different terms.

The 1986 debate involved three major issues. First, should Korea take advantage of the strengthening external balance to stimulate domestic growth? Second, should the authorities take early action to reduce the current account surplus by allowing the exchange rate to appreciate? Third, should the country liberalize its trade and finance regimes to promote more balanced international relationships over the longer run? The first issue was never elevated to a central role, because both the Korean government and the Fund sensed that Korea was already growing

[106]Concentrated, but not exclusively so. The four largest bilateral surpluses with the United States in 1985 were those of Japan, Germany, Taiwan Province of China, and Korea.

**Figure 2.6. Korea: Current Account Balance and External Debt, 1970–89**




about as rapidly (10 percent a year in real per capita terms; see Figure 2.4) as could be sustained without producing structural imbalances. The memory of the excesses of 1976–78 was still fresh. The other two issues, exchange rate and liberalization policies, were more contentious and became the subject of arduous negotiations between the Korean and U.S. governments—negotiations that the IMF later helped to arbitrate. Curiously, neither issue had been the focus of previous consultations, for either the Fund or the U.S. authorities. As late as July 1985, Dallara was praising Korea's "impressive adjustment efforts" and supporting the Korean position that "high priority had to be given to strengthening the external account."[107] In the following year, however, U.S. officials began to pressure Korea to liberalize several key sectors in U.S.-Korean bilateral trade, such as beef, cigarettes, and intellectual property. This pressure resulted in little immediate policy change, forestalled at least partly because of forthcoming parliamentary elections.

The underlying question was whether the stock of external debt was a real constraint on economic policy. Korea had begun 1986 as the world's fourth largest international debtor, behind only Brazil, Mexico, and Argentina. During the parliamentary election campaign of 1985, the government had been strongly criticized by the opposition for allowing foreign debt to accumulate to that extent. The ruling Democratic Justice Party argued successfully that the debt had enabled Korea to develop its infrastructure and its export capacity, and that Korea had the ability

[107]Minutes of EBM/85/105 (July 12, 1985), p. 17.

not only to service its debt but also to reduce it through the surpluses that productive growth would ultimately bring. Now that a current account surplus was a real possibility, the government acknowledged a responsibility to achieve it and to reduce the stock of debt as rapidly as possible.

Not even the most visionary foresaw the extent and persistence of the shift in Korea's external fortunes, once the improvement was under way. The country's internal changes were reinforced by the collapse in world oil prices, the drop in international interest rates, and the rapid depreciation of the U.S. dollar (forces that became known in Korea as the "three lows"). Consequently, the current account was balanced by mid-1986, showed a surplus of $4.6 billion for the year as a whole, and would rise further to nearly $10 billion in 1987 and $14 billion in 1988. These surpluses enabled Korea to repay nearly $16 billion of its initial stock of $47 billion in foreign debt by the end of 1988, and simultaneously to raise its external assets by $12.7 billion.[108]

The swing to surplus quickly brought forth complaints from the United States, where the authorities were more impressed by the current surpluses—especially the bilateral trade surplus—than by the existing stock of external debt. In their view, the rate of return on capital investment in Korea was high enough to justify maintaining a high debt level. In August 1986, bilateral talks were held between officials of the U.S. Treasury and State Department on the one side, and the Korean finance and foreign ministries on the other. The U.S. officials insisted that the won should be allowed to appreciate against the U.S. dollar by at least 15 percent to be consistent with underlying economic conditions and with the shifts in other exchange rates (mainly the appreciation of the Japanese yen and the Taiwan dollar) that were then under way. When the Korean authorities refused, the Assistant Secretary of the U.S. Treasury, David C. Mulford, offered to go to Seoul to pursue these discussions. The Koreans discouraged him from doing so, fearing that such a visit would be publicized and would make the negotiations that much more difficult. So, over the next several months, discussions on both the exchange rate and the pace of trade liberalization took place in various other arenas: between Treasury Secretary James Baker and Finance Minister In-Yong Chung at meetings in Washington and at the Asian Development Bank in Manila, and between treasury or finance ministry officials and the other country's ambassador. Commerce Secretary Malcolm Baldridge also met with officials in Seoul for bilateral trade talks in April 1987.

During this period of intense behind-the-scene discussions, the IMF staff working on Korea—headed by Hubert Neiss, Deputy Director of the Asian Department—took the position that the emerging external surplus implied that some appreciation of the won would be appropriate. This view was communicated to the Korean authorities on several occasions by the Managing Director. Nevertheless,

[108]The decline in the foreign debt was even greater in relation to the rapidly expanding level of output and exports. As shown in Figure 2.6, the ratio of debt to GDP fell from 50 percent at the end of 1985 to less than 15 percent at the end of 1989. The ratio of debt-service payments to export receipts fell from 27 percent in 1985 to 12 percent in 1989.

the staff avoided suggesting any particular level or pushing for an early decision, and both the Korean authorities and those on the U.S. side came to view the Fund as a neutral and potentially helpful intermediary.

External pressure on Korea was stepped up in February 1987, in the form of a paragraph in the communiqué issued by major industrial countries following the famous Louvre meeting in Paris (see Chapter 4), calling on the "newly industrialized developing economies [to] assume greater responsibility for preserving an open world trading system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals." Although internal discussions in Korea at this time were revealing serious consideration of allowing a more rapid appreciation of the won, the publicity associated with the Louvre communiqué created a political embarrassment for the government and made a smooth policy adjustment more difficult to achieve.[109]

In April 1987, Dallara approached the Managing Director, Michel Camdessus, to request that the Fund hold a supplemental consultation with Korea to discuss competitiveness issues. Because the supplemental consultation procedure had been applied only once before, there was an obvious danger that Korea would raise the same objections as Sweden had five years earlier. However, when Camdessus telephoned Finance Minister Chung, he found a welcome reception. So in early May, the Managing Director notified the Executive Board that he intended to initiate a supplemental consultation with Korea under the 1979 Board decision, "with the full concurrence of the Finance Minister of Korea." Although a number of Executive Directors later came to have second thoughts, no one objected at this time.[110]

The consultation, headed by Neiss, was held in Seoul over a three-week period starting in mid-May. It was a delicate period for the authorities, as a burgeoning pro-democracy movement was attempting (successfully, as it happened) to force the government to hold the first direct presidential election in nearly three decades, and massive demonstrations were turning violent. The consultation, however, was unaffected by the ongoing political turmoil. Based on these meetings, the staff noted that the current account surplus was running well above the official target of $5 billion and concluded that further measures would be needed if the surplus was to be contained within that range. The mission recommended some appreciation of the exchange rate and a further liberalization of import and exchange controls.[111]

When the Executive Board met in restricted session on July 6, 1987, to discuss the staff report, a number of Executive Directors from developing or smaller industrial countries expressed reservations about both the procedure and the staff recommendation on exchange rate policy. This was only the second application

[109]In the Korean view, trade liberalization in Korea required a reduction in U.S. protectionism as well. See SaKong (1988), pp. 14–15.

[110]Minutes of EBM/87/72 (May 8, 1987). For the "second thoughts," see the minutes of EBM/87/97–98 (July 6, 1987).

[111]"Korea—Staff Report for the Supplemental Consultation," EBS/87/134 (June 22, 1987).

of the supplemental surveillance procedure, the first application to a country with a current account surplus, and the first application to a developing country. Questions were raised about whether the Fund had been drawn inappropriately into a bilateral trade dispute, whether it was appropriate for a developing country with a large external debt to try to limit its current external surplus, and whether the supplemental procedure should not be applied first to countries whose policies had global or systemic implications. Broad agreement existed on the need for Korea to liberalize its trading system by reducing controls and opening its markets, but the United States drew little support for its contention that Korea should aim for a current account surplus smaller than $5 billion. Similarly, on the exchange rate, few Directors were prepared to go quite as far as the U.S. chair in calling for a "substantial and prompt reversal" of the won's recent depreciation. Even so, the widespread view on the Board, expressed especially by Directors from the large industrial countries, was that the staff was right in recommending some further appreciation of the Korean currency.[112] The Chairman's summing up on that issue was subjected to an unusual degree of negotiation, even after the meeting. In its final form (approved July 24), the crucial passage read as follows:

> A number of Directors, endorsing further market opening, expressed understanding for the authorities' caution with regard to the appreciation of the won, while not ruling out further action on that front. However, the weight of opinion among Directors was that additional exchange rate appreciation was called for and that exchange rate policy should be used more actively together with an accelerated pace of market opening.[113]

Subsequently, Korea did allow the won to appreciate in effective terms as well as against the dollar, but the current account surplus continued to grow for another year or so, as normally happens in response to exchange rate action. In October 1988, the U.S. administration issued a "Super 301" report to congress (U.S. Treasury, 1988) concluding that Korea was still manipulating the won for an unfair trade advantage.[114] By 1989, however, the Korean surplus was beginning to shrink, the authorities were carrying out further measures to liberalize trade, and the political dispute finally faded away.[115]

[112]Minutes of EBM/87/97–98 (July 6, 1987).

[113]The original version was circulated as "The Acting Chairman's Summing Up at the Conclusion of the Supplemental Consultation with Korea, Executive Board Meeting 87/98—July 6, 1987," SUR/87/64 on July 20, 1987. The revised version was discussed at EBM/87/109 (July 24) and was included in the minutes of EBM/87/98 (July 6), p. 10.

[114]The report was issued pursuant to the requirements of the Omnibus Trade and Competitiveness Act of 1988. Under the popularly named "Super 301" provisions of that Act (which modified and extended Section 301 of the Trade Act of 1974, covering unfair trading practices by other countries), the administration was mandated to take retaliatory actions against countries deemed to be manipulating exchange rates or otherwise pursuing policies aimed at gaining an unfair advantage over the United States in international trade. As a preliminary step, the treasury was required to submit periodic reports to congress identifying such countries.

[115]For a general review of these and subsequent developments, see Lindner (1992).

## Reducing Exchange Restrictions

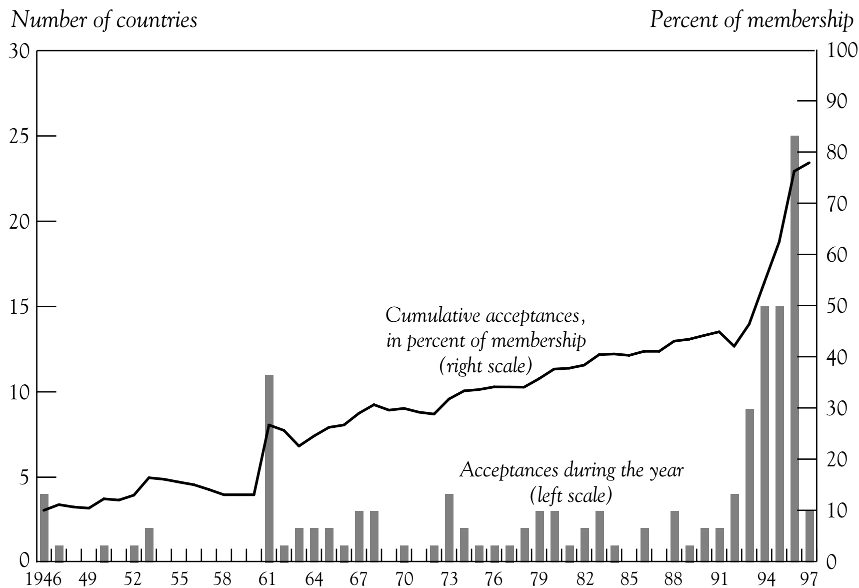
When the Articles of Agreement were drafted in 1944, currency convertibility was a goal that most countries were prepared to approach only gradually. The economic devastation from the Second World War, the long-term disruption of international trade, the pervasive application of exchange controls, and the presence of vast differences in economic power implied that convertibility should come at the end of a possibly lengthy period of recovery. That conclusion was embodied in Article XIV, which permitted countries to maintain existing restrictions on current account transactions so long as they did so with due regard to the "purposes of the Fund" and (after five years of operation by the Fund) agreed to consult with the Fund "as to their further retention." Countries that had been "occupied by the enemy" were also permitted to introduce new restrictions if necessary.[116] To ensure that restrictions were temporary, the Fund was authorized to "make representations" to a member that its restrictions should be abandoned.

Although the establishment of the Fund was expected to lead to generalized convertibility within a reasonable time, the transition extended long after the effects of the war had fully dissipated. Initially, most of the Fund's original members took advantage of the transitional provisions. Until the 1960s, only a scattering of countries in North and Central America committed themselves to the avoidance of current account restrictions.[117] Even by the end of 1967, when the First Amend-

[116]Occasionally, countries justified the imposition of exchange restrictions on national security grounds unrelated to commercial trade. The Fund acknowledged in 1952 that although it was "not a suitable forum for discussion of the political and military considerations leading to actions of this kind," it might need to make judgments on whether the imposition of restrictions was motivated solely by such considerations. Members imposing restrictions for security reasons were required to notify the Fund, which would then have 30 days in which to register an objection. See Decision No. 144-(52/51), in Horsefield (1969), Vol. 3, p. 257. During the period covered by this History, three major cases were brought before the Fund, all involving the United States. In the first case, the United States blocked assets of the Iranian government in 1979, in response to the takeover of the U.S. embassy in Tehran and the holding of American hostages there. In January 1986, Libya complained that U.S. sanctions against it—imposed in retaliation for what the United States regarded as Libyan backing of terrorist attacks at the Rome and Vienna airports the previous month—were not justified on security grounds. And in April 1988, the United States froze Panamanian assets in an effort to bring Panama's General Noriega to justice (see Chapter 16). In each case, the Executive Board declined to object to the restrictions. On Iran, see "Communication from Iran" EBS/79/620 (December 7, 1979) and Sups. 1–6 (various dates), and minutes of EBM/79/191 (December 27, 1979). On Libya, see "Communication from the Socialist People's Libyan Arab Jamahiriya," EBS/86/8 (January 15, 1986) and Sup. 1 (January 22, 1986); "Communication from the United States," EBS/86/9 (January 16, 1986); "Communication from Arab Monetary Fund," EBS/86/17 (January 23, 1986); "Notification by the United States of Restrictions Imposed for Security Reasons under Executive Board Decision No. 144 and Complaint by the Socialist People's Libyan Arab Jamahiriya under Rule H-2," EBS/86/21 (January 29, 1986); and minutes of EBM/86/17 (January 31, 1986). On Panama, see "Notification under Executive Board Decision No. 144-(52/51) of Restrictions Relating to Panama," EBD/88/126 (May 9, 1988).

[117]Of the 40 original members of the Fund, only the United States, El Salvador, Mexico, and Panama accepted Article VIII status in 1946. Through 1960, five countries followed suit: Guatemala (1947), Honduras (1950), Canada (1952), the Dominican Republic (1953), and Haiti (1953). Thus at the end of 1960, 9 of 69 members (13 percent) were Article VIII countries. The establishment of currency convertibility in Europe then contributed to a wave of acceptances in the 1960s.

**Figure 2.7. Acceptance of Article VIII Status, 1946–97**




ment was being discussed by the Board, only 31 members (28 percent of the Fund's 110 members) had terminated their recourse to the transition by accepting the obligations of Article VIII (Figure 2.7).[118] Most nonoriginal members, including the large number of newly independent countries, were still claiming recourse to the transitional arrangements of Article XIV.

The Second Amendment (1978) implicitly recognized the generalized and extended recourse to transitional arrangements by dropping all references to the war and retitling Article XIV "transitional arrangements" instead of "transitional period." More substantively, it weakened the distinction between the status of countries accepting the full obligations of Article VIII and those having recourse to the provisions of Article XIV, in two ways. First, acceptance of Article VIII no longer affected the reserve status of a country's currency. Originally, Article VIII status was the criterion for determining whether a currency was defined as convertible and acceptable for use in Fund operations. That linkage was dropped. Second, as noted in the introduction to this chapter, the amendment provided for universal consultations between the Fund and its members, regardless of status. Previously, only countries that still maintained restrictions under the provisions of Article

[118]See de Vries (1976), Vol. 1, p. 571. The transitional arrangements specified in Article XIV relate only to members' acceptance of the obligations of Sections 2 ("avoidance of restrictions on current payments"), 3 ("avoidance of discriminatory currency practices"), and 4 ("convertibility of foreign-held balances") of Article VIII. All members accept the obligations of the other sections of Article VIII. For a complete list of dates (through April 1999) when members accepted the full obligations of Article VIII, see *Annual Report 1999*, pp. 162–63. For an analysis, see Galbis (1996).

XIV were required to consult, although the Fund held consultations with other members on a voluntary basis (see de Vries, 1985, pp. 726–29).

At the beginning of 1979, 47 member countries (34 percent) had accepted Article VIII status; of those, 17 were industrial countries. Of the 37 remaining original members of the Fund, 13 were still availing themselves of the transitional provisions of Article XIV.[119] The Fund adopted a passive attitude toward this division of the membership throughout the period; indeed, throughout its history until the 1990s. As Alan Whittome (Director of ETR) observed during the 1987 review of surveillance procedures, "the acceptance of the obligations of Article VIII had been a matter for the member, with the Executive Board approving the member's decision to change its status once it had been shown to have no restrictions. The Executive Board had not taken a strong position on the termination of the transitional arrangements of Article XIV, either in general or in specific cases."[120]

From 1979 through 1989, 19 additional members moved to Article VIII, bringing the total to 66 (43 percent) Of the new acceptors, four were industrial countries. When Spain accepted Article VIII status on July 15, 1986, all industrial members had moved to that column.[121] A large majority of developing countries, however, remained reluctant to do so.

At least three reasons may be adduced for governments to have been reluctant to let go of the transitional provisions of Article XIV, though none seems persuasive enough to explain the extent of the hesitance. First and most obviously, some countries simply wanted to keep using exchange restrictions. That desire, however, explains relatively little. Many countries that had already eliminated restrictions on current account transactions and that qualified for Article VIII status declined to make the switch. African countries participating in the CFA franc zone were notable examples.[122] Although acceptance of the obligations of Article VIII implies that the country has established convertibility for its currency, it does not automatically follow from convertibility.

Second, countries may have desired to keep open the option of readopting restrictions. Even though such action would be subject to Fund jurisdiction under Article VIII regardless of the member's status, some countries may have been reluctant to be seen as making a public commitment against adopting restrictions. Third—and probably accounting for most cases—countries may have been subject to inertia, not wanting to make a new commitment without some good reason for doing so. As Simmons (2000) has suggested, the most persuasive reason for a country to accept the commitments of Article VIII is to enhance the credibility of its

[119]Original members are defined officially as those that joined the Fund prior to the end of 1946. Of the 40 original members, 3 (Czechoslovakia, Poland, and Cuba) withdrew before the beginning of 1979.

[120]Minutes of EBM/87/39 (March 4, 1987), p. 45.

[121]Portugal accepted Article VIII status in September 1988, when it was still classified as a developing country. In the fall of 1989, Greece and Portugal were reclassified as industrial countries, raising the total in that category to 23. Greece accepted Article VIII status in July 1992.

[122]All 13 members of the CFA franc zone accepted the obligations of Article VIII on June 1, 1996.

economic policies. Only when openness to international finance became a widespread goal for developing countries in the 1990s would the value of Article VIII status become important for a large number of Fund members.

Not until 1993 did the Fund make a major effort to persuade members to accept the obligations of Article VIII, but when it did so, it met with marked success. By the end of 1999, 148 members had done so, bringing the total to 81 percent of the membership.

## Appendix: Principles and Procedures of Surveillance

*The Executive Board approved a set of principles and procedures for surveillance in 1977, in anticipation of the adoption of the amended Article IV of the Articles of Agreement the following year. Reproduced below are the new Article IV, the 1977 document, a description of the summing up procedure adopted in 1978, the decision introducing "ad hoc" consultations in 1979, and amendments to the 1977 decision that were adopted through 1989.*

### Article IV. Obligations Regarding Exchange Arrangements

Section 1. *General obligations of members*

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, and that sustains sound economic growth, and that a principal objective is the continuing development of the orderly underlying conditions that are necessary for financial and economic stability, each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall:

(i) endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability, with due regard to its circumstances;

(ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;

(iii) 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; and

(iv) follow exchange policies compatible with the undertakings under this Section.

Section 2. *General exchange arrangements*

(a) Each member shall notify the Fund, within thirty days after the date of the second amendment of this Agreement, of the exchange arrangements it intends to apply in fulfillment of its obligations under Section 1 of this Article, and shall notify the Fund promptly of any changes in its exchange arrangements.

(b) Under an international monetary system of the kind prevailing on January 1, 1976, exchange arrangements may include (i) the maintenance by a member of a value for its currency in terms of the special drawing right or another denominator, other than gold, selected by the member, or (ii) cooperative arrangements by which members maintain the

value of their currencies in relation to the value of the currency or currencies of other members, or (iii) other exchange arrangements of a member's choice.

(c) To accord with the development of the international monetary system, the Fund, by an eighty-five percent majority of the total voting power, may make provision for general exchange arrangements without limiting the right of members to have exchange arrangements of their choice consistent with the purposes of the Fund and the obligations under Section 1 of this Article.

Section 3. *Surveillance over exchange arrangements*

(a) The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations under Section 1 of this Article.

(b) In order to fulfill its functions under (a) above, the Fund shall exercise firm surveillance over the exchange rate policies of members, and shall adopt specific principles for the guidance of all members with respect to those policies. Each member shall provide the Fund with the information necessary for such surveillance, and, when requested by the Fund, shall consult with it on the member's exchange rate policies. The principles adopted by the Fund shall be consistent with cooperative arrangements by which members maintain the value of their currencies in relation to the value of the currency or currencies of other members, as well as with other exchange arrangements of a member's choice consistent with the purposes of the Fund and Section 1 of this Article. These principles shall respect the domestic social and political policies of members, and in applying these principles the Fund shall pay due regard to the circumstances of members.

Section 4. *Par values*

The Fund may determine, by an eighty-five percent majority of the total voting power, that international economic conditions permit the introduction of a widespread system of exchange arrangements based on stable but adjustable par values. The Fund shall make the determination on the basis of the underlying stability of the world economy, and for this purpose shall take into account price movements and rates of expansion in the economies of members. The determination shall be made in light of the evolution of the international monetary system, with particular reference to sources of liquidity, and, in order to ensure the effective operation of a system of par values, to arrangements under which both members in surplus and members in deficit in their balances of payments take prompt, effective, and symmetrical action to achieve adjustment, as well as to arrangements for intervention and the treatment of imbalances. Upon making such determination, the Fund shall notify members that the provisions of Schedule C apply.

Section 5. *Separate currencies within a member's territories*

(a) Action by a member with respect to its currency under this Article shall be deemed to apply to the separate currencies of all territories in respect of which the member has accepted this Agreement under Article XXXI, Section 2(g) unless the member declares that its action relates either to the metropolitan currency alone, or only to one or more specified separate currencies, or to the metropolitan currency and one or more specified separate currencies.

(b) Action by the Fund under this Article shall be deemed to relate to all currencies of a member referred to in (a) above unless the Fund declares otherwise.

## 1977 Decision on Principles and Procedures

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

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

*Decision No. 5392-(77/63), adopted April 29, 1977*

## Surveillance over Exchange Rate Polices

### *General Principles*

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

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

### *Principles for the Guidance of Members' Exchange Rate Policies*

A. A member shall avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.

B. A member should intervene in the exchange market if necessary to counter disorderly conditions which may be characterized inter alia by disruptive short-term movements in the exchange value of its currency.

C. Members should take into account in their intervention policies the interests of other members, including those of the countries in whose currencies they intervene.

### *Principles of Fund Surveillance over Exchange Rate Policies*

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

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

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

(ii) an unsustainable level of official or quasi-official borrowing, or excessive and prolonged short-term official or quasi-official lending, for balance of payments purposes;

(iii) (a) the introduction, substantial intensification, or prolonged maintenance, for balance of payments purposes, of restrictions on, or incentives for, current transactions or payments or

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

(iv) the pursuit, for balance of payments purposes, of monetary and other domestic financial policies that provide abnormal encouragement or discouragement to capital flows; and

(v) behavior of the exchange rate that appears to be unrelated to underlying economic and financial conditions including factors affecting competitiveness and long-term capital movements.

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

### *Procedures for Surveillance*

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

II. Members shall consult with the Fund regularly under Article IV. The consultations under Article IV shall comprehend the regular consultations under Article VIII and XIV.

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

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

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

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

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

## 1978 Agreement to Conclude Consultations with a "Summing Up"

(excerpted from "Consultation Practices and Procedures," SM/78/67; approved by Executive Directors at EBM/78/36, March 20, 1978)

*. . . III. Executive Board Action to Complete Consultations Under Article IV*

Executive Directors have expressed various views on the question of Executive Board action to conclude annual consultations under Article IV; however, the discussions (at EBM/77/47; 4/7/77) suggested general considerations to be taken into account in clarifying the operational meaning of Executive Board "conclusions", as required by paragraph II of the "Procedures for Surveillance". . . . Such considerations include: (1) the need for uniformity of treatment of members; (2) the recognition that while Executive Board consensus would be desirable, the procedures should be kept flexible so that dissenting views might also be brought to the attention of the authorities of the member concerned; and (3) the expectation that the appraisal in the Staff Reports on consultations under Article IV would focus on the issues involved in respect of members' situations and policies as they relate to the principles and obligations under Article IV as well as Articles VIII and XIV.

Uniformity of treatment of members, in this case, would be satisfied if the Executive Directors were to reach a "conclusion" on the basis of their discussion of the Staff Report on the consultations under Article IV with each member, and if that conclusion were to be an expression of the Executive Directors' views, in each instance, on the staff's appraisal of the member's circumstances and policies as set forth in its report on the consultations under Article IV. In many cases, it would be reasonable to expect that there would be a consensus among Executive Directors to the effect that they generally agreed with the staff's appraisal. However, the procedures should be kept flexible so that dissenting views could be recorded and also be brought to the attention of the authorities of the member concerned. Dissenting views of one or more individual Executive Directors regarding the staff appraisal could be included in the conclusion of the Executive Board.

It is suggested that the Executive Board conclusion take the form of a brief "summing up" by the Managing Director, in his capacity as Chairman of the Exective Board, at the end of the discussion by Executive Directors of the Staff Report on the annual consultation under Article IV. In many cases, this would consist of a short statement by the Managing Director to the effect that Executive Directors generally agreed with the views expressed in the staff appraisal contained in the report on the discussions, perhaps along the following lines:

> "My understanding is that Executive Directors have indicated widespread support for the views expressed in the staff appraisal contained in the report on the [year] consultation discussions with [member].
>
> [In addition my understanding is that Directors are willing to adopt a decision to be taken with respect to [the continued retention of restrictions under Article XIV] [exchange restrictions requiring approval under Article VIII]]."

Of course, if significantly different views had been expressed by Executive Directors, the Chairman's summing up would reflect such reservations. In the cases of relatively few members whose economic situations at the time were considered to be of special importance for the effective functioning of the international monetary system, the Chairman's statement would be somewhat longer and would highlight key points expressed by Directors. In most cases the Chairman would present his summing up of the Executive Board's conclusions directly following consideration of the report on the consultations. However, in some cases, including those mentioned immediately above, the Chairman could delay—until later in the day or the next Board meeting—the presentation of the conclusions so as to allow for the incorporation of differing views or key points expressed by Executive Directors.

## Amendments to the 1977 Decision Adopted During 1979–89

### *A. 1979 Decision on Ad Hoc Consultations*

Managing Director's Statement following EMB/79/13,
(EBD/79/18, Rev. 1, January 22, 1979)

*Surveillance: Ad Hoc Consultations*

The discussion of the Executive Board on Friday, December 22, 1978 of the staff paper "Annual Review of Regular Consultations and Other Issues Related to Article IV" (SM/78/287, 12/11/78) at EBM/78/203 and EBM/78/204 (12/22/78) showed that there was broad agreement on all proposals except those made in Section III of the paper concern-

ing supplemental surveillance procedures. On these procedures, while there was general acceptance of the judgmental approach described in the paper, there was widespread interest in flexible procedures for Executive Board reviews of developments involving the exchange rate policies of individual members between annual consultations. Executive Directors indicated a desire to have staff papers and Executive Board discussions not only when important modifications were made in the exchange policies of members, whatever their exchange arrangements, as proposed in the staff paper, but also when there were important movements of exchange rates even if there had been no modification of policies.

Some Executive Directors also showed an interest in having nonmovement of exchange rates as a possible basis for discussion when such nonmovement deserved examination as part of firm surveillance. To meet these desires, a draft revision of paragraph 3 of the proposed decision was circulated during the afternoon meeting, which took account of these views by adding "behavior of the exchange rate" as a possible basis for a special discussion by the Board. This language could justify discussion not only when there occurred what might be considered an important movement of the exchange rate but also when "behavior" in the form of lack of movement might be considered important because a change in underlying conditions had given, or could give, rise to a serious imbalance.

The proposed decision will authorize the Managing Director to judge whether the "behavior of the exchange rate" justified an ad hoc consultation with the member and, thereafter, a discussion by the Board, or the informal provision of information to Executive Directors.

In order to be properly selective, I would intend to take into account, in initiating the procedures, the importance of the effects on the member or other members of the member's exchange rate arrangements, exchange rate policies, or the behavior of the exchange rate of its currency.

I would also note that in view of the scope of the recent Executive Board discussion, I see no need to have a further discussion of procedural decisions before April 1, 1979, and paragraph 1 of the proposed decision has been revised accordingly.

Finally, there is the question of the review of the document "Surveillance Over Exchange Rate Policies," which is required to be held "at intervals of two years" in accordance with paragraph 2 of Executive Board Decision No. 5392-(77/63). It is not made explicit from what date the two years run, but it would seem clear that they should run from the date when the document became effective, i.e., April 1, 1978. I would propose therefore that it should be understood that the latest date for review would be April 1, 1980. A review can also be held, in accordance with the decision, "at such other times as consideration of it is placed on the agenda of the Executive Board." The discussion of the World Economic Outlook that Directors had on December 13 covered a number of important aspects of the working of the exchange rate system. Directors will no doubt want to return to these matters at a later date but in any case in the context of the 1979 Annual Report. In preparation for this, I have asked the staff to prepare a paper analyzing the opinions expressed by Directors and the issues involved, with a view to a further Board discussion around the middle of the year.

A draft decision taking account of the proposals described above is being circulated to Executive Directors (SM/78/287, Supplement 1) simultaneously with this statement.

In addition, some Executive Directors suggested at EBM/78/203 and EBM/78/204 that, since Executive Board decisions under Article VIII and Article XIV are confined to matters coming within the approval jurisdiction of the Fund, they fail to give due weight to members' adjustment policies and their efforts to reduce reliance on exchange restrictions.

Accordingly, I propose that when such decisions are taken in conjunction with an Article IV consultation, the first paragraph of decisions on consultations under Article VIII or Article XIV would be reworded appropriately, and the staff is preparing a brief paper for this purpose.

On the basis of the foregoing statement, the following decision was adopted by the Executive Board at Meeting 79/13, January 22, 1979:

1. *Review*. The Executive Board has reviewed the procedures relating to the Fund's surveillance over members' exchange rate policies. These procedures, and the procedures for regular consultations under Article IV, will be reviewed again by the Executive Board in December 1979. The Executive Board will review the document "Surveillance over Exchange Rate Policies" at an appropriate time not later than April 1, 1980, as provided for in paragraph 2 of Decision No. 5392-(77/63), adopted April 29, 1977.
2. *Annual consultations*. During the consultation year beginning January 1, 1979, annual consultations as stipulated under Procedure II in SM/77/81 shall be conducted under Article IV, which consultations shall comprehend the consultations under Article VIII and Article XIV, in accordance with the procedures approved by the Executive Board for 1978 consultations and the procedures set out in Section IV, *Article IV Consultations*, in SM/78/287.
3. *Supplemental surveillance procedure pursuant to EBD/79/18, Revision 1 (1/22/79)*. Whenever the Managing Director considers that a modification in a member's exchange arrangements or exchange rate policies or the behavior of the exchange rate of its currency may be important or may have important effects on other members, whatever the member's exchange arrangements may be, he shall initiate informally and confidentially a discussion with the member before the next regular consultation under Article IV. If he considers after this prior discussion that the matter is of importance, he shall initiate and conduct an *ad hoc* consultation with the member and shall report to the Executive Board, or informally advise the Executive Directors, on the consultation as promptly as the circumstances permit after conclusion of the consultation. This procedure will supplement the proceedings in Executive Board Decision No. 5392-(77/63), adopted April 29, 1977.

*Decision No. 6026-(79/13), adopted January 22, 1979*

### B. 1987 Decision to Allow for Separate Consultations under Article XIV

The second and third sentences of Paragraph II of Procedures for Surveillance contained in the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, shall be amended to read as follows:

> "In principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually. They shall include consideration of the observance by members of the principles set forth above as well as of a member's obligations under Article IV, Section 1."

*Decision No. 8564-(87/59), adopted April 1, 1987*

### C. 1988 Decision to Eliminate Annual Procedural Reviews

The first sentence of Paragraph VI of Procedures for Surveillance contained in the document entitled "Surveillance over Exchange Rate Policies" attached to Decision No. 5392-(77/63), adopted April 29, 1977, as amended, shall be amended to read as follows:

The Executive Board shall review the general implementation of the Fund's surveillance over members' exchange rate policies at intervals of two years and at such other times as consideration of it is placed on the agenda of the Executive Board.

*Decision No. 8856-(88/64), adopted April 22, 1988*

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