INTERNATIONAL MONETARY FUND

IMF POLICY PAPER

June 2019

REVIEW OF THE FUND'S POLICY ON MULTIPLE CURRENCY PRACTICES: INITIAL CONSIDERATIONS

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its February 1, 2019 consideration of the staff reports.
- The **Staff Report**, "*Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations*," prepared by IMF staff and completed on August 1, 2018 for the Executive Board's consideration on February 1, 2019.
- The **Staff Report**, "*Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations—Historical Development and Legal Framework of the MCP Policy,"* prepared by IMF staff and completed on August 1, 2018 for the Executive Board's consideration on February 1, 2019 (Background Paper I).
- The **Staff Report**, "*Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations—Economic Context and Experiences,"* prepared by IMF staff and completed on August 1, 2018 for the Executive Board's consideration on February 1, 2019 (Background Paper II).
- The **Staff Report**, "*Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations—Methodology to Assess Multiple Currency Practices*," prepared by IMF staff and completed on August 1, 2018 for the Executive Board's consideration on February 1, 2019 (Background Paper III).

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INTERNATIONAL MONETARY FUND
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IMF Executive Board Reviews Multiple Currency Practices Policy and Considers Reforms

On February 1, 2019, the Executive Board of the International Monetary Fund (IMF) discussed a paper reviewing the Fund's policy on multiple currency practices (MCPs) and considered staff's initial proposals for reform. By limiting the circumstances in which Fund members may introduce and maintain multiple exchange rates, the MCP policy aims to promote orderly exchange arrangements and a stable system of exchange rates. As one of the original provisions of the Fund's Articles of Agreement, the prohibition of MCPs was part of a larger effort to eliminate restrictions on current international payments and transfers in the post-war era, as well as earlier distortive practices.

MCPs can arise from exchange transactions. An MCP occurs if action by a member's authorities results in an exchange transaction on the member's territory taking place at an exchange rate spread that does not reflect normal commercial realities. For spot transactions, the current policy establishes a uniform permissible spread of up to 2 percent for all countries; for non-spot transactions, the permissible spread is not quantified but it should not exceed the normal commercial costs and risks of the transaction vis-à-vis spot transactions. Over time, the purview of the policy has broadened to capture not only actions that give rise to actual exchange rate spreads in access of the permissible thresholds, but also those that have the potential to do so.

Under the current policy, Fund members are prohibited from engaging in MCPs, unless they are maintained under the transitional arrangements of Article XIV upon joining the Fund or are temporarily approved by the Fund's Executive Board. Such approval is for periods of 12 months and can be granted where the MCP is maintained for either balance of payments (BOP) or non-BOP reasons.

The last time the MCP policy was extensively reviewed was 1981, after the abandonment of fixed exchange rates under the par value system. Meanwhile, significant changes have occurred in foreign exchange markets, that provide an opportunity to review the policy: greater experience with flexible exchange rates, substantial deepening and standardization, development of hedging products, and substantial improvements in data availability. Several operational challenges have also arisen in the implementation of the policy.

To modernize the policy and better align it with other Fund policies, the paper discussed by the Board presented some initial considerations for reform. These considerations relate to what actions should be covered under the policy, how an MCP should be defined, and when MCPs should be approved. Staff will shortly, based on guidance received from the Executive Board, present a proposed new MCP policy to the Executive Board.

Executive Board Assessment[1]

Executive Directors welcomed the opportunity to review the policy on multiple currency practices (MCP). They noted that, since it was last reviewed in 1981, foreign exchange markets have undergone significant changes and some operational issues have arisen in the implementation of the policy. They agreed that these developments warrant a consideration of reforms to the MCP policy, with a view to maintaining its relevance, effectiveness, and traction with members.

Directors agreed that there remain economic and legal reasons to retain the MCP policy as a cornerstone of the Fund's legal and policy framework for exchange rates. They observed that MCPs can be distortionary, create unfair competitive advantage among countries, and hamper trade and investment. Directors noted that, while the existing MCP policy has served the Fund well, some important aspects of the policy have increasingly complicated its implementation in today's realities.

Directors broadly supported the majority of the reform proposals. As a general principle, they concurred that for the policy to be effective, it needs to be based on rules that reflect market realities in member countries, can be applied consistently across the Fund's membership, and are simple and easily understood by stakeholders. Directors also stressed that any revisions to the policy should seek to ensure that the Fund's legal and policy framework continues to facilitate the development of stable foreign exchange systems that are free of restrictions on payments and transfers for current international transactions. A number of Directors also attached importance to refocusing the MCP policy on measures that are deemed material. Overall, Directors considered that the core principle of the current policy—that official action should not cause unreasonable deviations in foreign exchange spreads compared to normal commercial costs and risks—remains appropriate.

Directors agreed that the scope of official action should be clarified to focus primarily on action that segments foreign exchange markets. They broadly concurred that certain practices

[1] An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

currently captured by the MCP policy should be excluded in the future, notably foreign exchange auctions that conform to best practice, illegal parallel markets, and the use of official exchange rates based on the market exchange rates of the previous day. A number of Directors stressed that removing illegal parallel markets from the MCP analysis should be complemented with reasonable efforts by country authorities to eliminate such markets and a stronger emphasis on exchange restrictions in Fund surveillance.

Directors endorsed the proposal to eliminate the practice of finding MCPs due to potentiality. They concurred that an MCP should only arise if official action resulted in an actual exchange rate spread on the member's territory exceeding the permissible margin. This would refocus the policy on economically more meaningful developments and promote a more constructive dialogue with the membership. In a similar vein, Directors supported excluding broken cross-rates, which have almost disappeared, from the remit of the policy.

Most Directors maintained the view that MCPs applying solely to the capital account are not considered a breach of obligation under Article VIII, Section 3 and are not subject to Fund approval. They saw merit in clarifying the specific linkages of the MCP policy and the Institutional View (IV) on the liberalization and management of capital flows as set out in the paper. In particular, they agreed that where MCPs also constitute capital flow management measures, they should be assessed under the IV. Such an assessment would, however, remain within the confines of policy advice without changing the rights and obligations of member countries under the Articles of Agreement. Some Directors were supportive of, or open to considering, the inclusion of MCPs on capital account transactions within the scope of the Fund's jurisdiction under Article VIII, Section 3, noting the materiality and distortionary effects of such MCPs.

With regard to the permissible spreads for spot transactions, Directors welcomed staff's proposal to replace the current fixed two-percent rule with a country-specific market-based norm that would apply uniformly across the membership. They noted that the range between the most depreciated and most appreciated exchange rates in the wholesale market on a given day would be an appropriate benchmark that is sensitive to the level of market development and market conditions in each member country. Most Directors also agreed that a two-percent tolerance margin around the mid-point of this range would help avoid capturing insignificant deviations from the market norm, although a few Directors would have preferred a higher margin. Directors also supported the proposal to treat non-spot transactions in an analogous manner, using the methodologies proposed by staff. In terms of implementation, most Directors supported retaining the notion that a single breach should constitute an MCP, while a number of Directors called for some flexibility based on materiality considerations.

Many Directors endorsed the proposal to remove the possibility of temporary approval of MCPs maintained for non-balance of payments (BOP) reasons, thereby more closely aligning the policies for approval of MCPs and exchange restrictions. Many other Directors considered that member countries should be allowed to maintain MCPs for non-BOP purposes in certain situations. A number of Directors saw merit in reviewing the policy on exchange restrictions in light of the proposed changes to the MCP policy, with a few Directors noting an opportunity to also revisit the Board decision on payment restrictions imposed for security reasons.

Directors considered the case for developing a formal remedial framework for unapproved MCPs. Most Directors favored preserving the current cooperative approach, under which the Fund, through its surveillance, program conditionality, and technical assistance, would encourage member countries to eliminate such measures. Some of these Directors saw scope for more transparent reporting in respect of unapproved MCPs. While a few Directors would be willing to consider a remedial framework for prolonged cases of MCPs, some others called for further analysis on the need for, and the modalities of, a remedial framework.

Going forward, Directors supported putting in place transitional arrangements to provide adequate time for member countries to adjust their policies, after which the revised MCP policy would become operational. Directors looked forward to further consultation and a formal proposal for reform that incorporates their views, followed by a guidance note for staff with implementation details. They would also welcome periodic reviews of the new MCP policy and its implementation in the future.

INTERNATIONAL MONETARY FUND

August 1, 2018

REVIEW OF THE FUND'S POLICY ON MULTIPLE CURRENCY PRACTICES: INITIAL CONSIDERATIONS

EXECUTIVE SUMMARY

This paper reviews the Fund's policy on multiple currency practices (MCPs). The policy is a cornerstone of the Fund's legal and policy framework for exchange rates. The policy has not been reviewed extensively since 1981. Significant changes in foreign exchange (FX) markets—including greater experience with flexible exchange rates, substantial deepening and standardization, and the development of hedging products—provide an opportunity for the Fund to conduct a sweeping review of the policy. Additionally, the review would allow the Fund to address operational issues that have arisen in the implementation of the policy.

There remain strong economic and legal reasons to retain a policy on MCPs. While MCPs have been approved by the Fund in particular circumstances, broader use remains objectionable because MCPs can be distortionary, create unfair competitive advantage among countries, and hamper trade. The core principle of the current policy remains appropriate, namely that "official action" should not cause unreasonable deviations in FX spreads compared to normal commercial costs and risks.

The over-arching aim of the review is to make the policy and its application more effective. The objective is to adjust the policy so that it does not discourage good practices established in FX markets and is better aligned with the Fund's other policies, while ensuring that it continues to address policy actions that are objectionable. Any changes would be designed to make the MCP policy more relevant and understandable.

Based on this review, the paper proposes initial considerations for reforming features of the policy that have created challenges. These are summarized in the table at the end of this summary, and include:

- **Clarifying the concept of "official action" to focus on measures that segment FX markets.** This would exclude certain practices from the coverage of the MCP policy, such as FX auctions designed in accordance with best practice, illegal parallel markets, and the use of official exchange rates based on the market exchange rate of the previous day. Exchange taxes would remain under the purview of the MCP policy.

- **Eliminating potentiality.** An MCP would only arise if official action resulted in an *actual* exchange rate spread on the member's territory that exceeded the permissible margin. This would re-focus the policy on economically more meaningful developments, and promote a more constructive dialogue with the membership.

- **Updating the threshold for permissible FX spreads.** The two-percent rule for permissible spreads for spot FX transactions would be replaced with a country-specific market-based norm, including a tolerance margin, that would apply uniformly across the membership. This would provide a more accurate standard to use in determining whether exchange rate spreads are commercially reasonable. An analogous treatment would be applied for non-spot transactions.

- **Adjusting approval policies.** Policies for approval of MCPs and exchange restrictions could be better aligned. In particular, approval of MCPs for non-BOP reasons, which has become rare over time, would be removed. Approval would only be granted if the MCP is maintained for BOP reasons, is temporary, and does not give the member an unfair competitive advantage over other members or discriminate among members.

- **Reviewing links with capital transactions.** Staff's longstanding position has been that the MCP policy also applies to capital transactions. However, the IMF Board has historically not endorsed this interpretation of the Fund's jurisdiction. This paper revisits the debate. In the event the Board retains its view, it clarifies the link between the MCP policy and the Institutional View (IV).

- **Considering merits of a remedial framework.** It would be possible for the Fund to establish a framework under which members in breach of their obligations under the MCP policy would be subject to escalating remedial measures, although the merits of introducing such a framework would need to be carefully weighed.

Next Steps. The Executive Board will have an opportunity to discuss the paper initially during an informal staff level briefing covering technical aspects and then a formal meeting. Based on the guidance from this meeting, a formal proposal for reform, with draft decisions, will be presented to the Board. Following the adoption of the new policy, a guidance note for staff would be issued with details on how to implement it.

Challenge	Current Treatment	Proposed Reform
"Official action" is applied too broadly		
• Captures spreads even if there is no "market segmentation"	MCPs include actions that do not segment markets	These practices will no longer be considered official action giving rise to MCPs: (i) FX auctions (including multi-price auctions) that conform to best practice, (ii) illegal parallel markets, and (iii) (1-day) lagged official exchange rates. Exchange taxes would remain under the purview of the policy
• "Potentiality" captures practices that are not distortionary	Actions that *could* lead to impermissible spread can give rise to MCPs	MCPs will only be found if impermissible spread actually emerges
"Two-percent" rule no longer reflects market realities	Spread of more than 2 percent between buying and selling rates for spot exchange transactions gives rise to MCP	Spread that exceeds the higher of the country-specific market-based norm or a tolerance margin will give rise to MCP
Treatment of non-spot FX transactions is unclear	Spread relative to spot rates that exceeds what is justified by the normal commercial costs and risks for non-spot transactions (not specified)	Spread relative to similar non-spot transactions that exceeds the higher of the country-specific market-based norm or a tolerance margin will give rise to MCP
Broken cross-rates are no longer common	Broken cross-rates constitute MCPs	Broken cross-rates will no longer constitute MCPs
Approval policies for MCPs are misaligned with those for exchange restrictions	MCPs can be approved for both BOP and non-BOP reasons; exchange restrictions only for BOP reasons	MCPs will no longer be approved for non-BOP reasons; approval criteria for BOP reasons remain unchanged
Link with capital transactions needs clarification	MCPs on capital transactions do not represent breach of obligations and do not need approval	Staff will re-assert longstanding view that MCPs on capital transactions should also be part of policy; if Board retains its current view, will clarify that, where MCPs constitute CFMs, they will also be assessed under the IV

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INTRODUCTION

1. **This paper reviews the Fund's policy on multiple currency practices (MCPs) and proposes some initial considerations for reform**, as requested by Executive Directors. The policy has not been comprehensively reviewed since 1981.

2. **The MCP policy is a cornerstone of the legal and policy framework for the Fund's jurisdiction over exchange rates.** The term "multiple currency practice" is a misnomer. It is not concerned with the maintenance of more than one *currency* on a member's territory, but with the maintenance of multiple *exchange rates* on a member's territory. The obligation of member countries to refrain from engaging in MCPs is an original provision of the Articles. It has promoted the objective of maintaining orderly exchange arrangements and unified exchange rates.

3. **However, the policy is outdated.** The current framework was put in place after the formal abolition of the par value system and the entry into force of the Second Amendment of the Articles in 1978, and has remained virtually unchanged since. While the original policy was closely tied to the operation of the par value system, the post-1978 framework sought to adapt the MCP policy to a new world of floating exchange rates. This framework has, in many ways, served the Fund well, notably by acting as an important deterrent of distortionary practices in exchange systems. However, significant changes in FX markets—including greater experience with flexible exchange rates, substantial deepening and standardization, and the development of hedging products—call for a sweeping review of the policy. In addition, the policy has proven increasingly complex and difficult to apply, with implications for policy implementation and traction with members.

4. **The central message of this paper is that a legal and policy framework for MCPs remains essential for the Fund's operations, but the current policy needs revision.** This paper proposes reforms to bring the policy in line with good practices established in FX markets and with the Fund's other policies, while ensuring that it addresses policy actions that are objectionable. These reforms leverage the experience with flexible exchange rates accumulated since the Second Amendment to help identify exchange measures that are most likely to be economically meaningful and distortive. In addition, they harness improvements in data availability in the last decades, which allow the identification of MCPs to be more market-determined.

5. **The paper is organized as follows.** It begins by describing what MCPs are and what measures can give rise to them (Section I), followed by an explanation of why an MCP policy is needed (Section II), and a discussion of experience with the policy since the last comprehensive review (Section III). The paper then presents the main challenges with the implementation of the MCP policy, together with preliminary options for reform (Section IV). The paper ends with issues for discussion (Section V). This paper does not propose any decisions for adoption by the Executive Board. Such decisions will be presented in a subsequent paper, after views of the Executive Board on the preliminary options in this paper have been received.

WHAT IS AN MCP?

6. The Fund's Articles prohibit members from engaging in MCPs in certain circumstances but do not define the term.[1] They allow the Executive Board, through interpretation and by decision, to give content to the term through the MCP policy.[2] While the content of the policy can be modified to reflect changing realities, the Fund cannot decide not to apply it. Given that the Articles prohibit members from engaging in MCPs, unless otherwise authorized therein, the Fund must apply this provision and enforce compliance with this obligation by its members.[3]

7. Under the current policy, the following conditions must be met for an MCP to arise:

- *Action by the authorities ("official action")*. An MCP must result from action by the authorities. It may occur directly, where the authorities themselves engage in exchange transactions that exceed the permissible spreads under the policy, or where the authorities take action (e.g., an FX regulation) that causes impermissible spreads to arise from exchange transactions engaged in by market participants – in particular, where the authorities create separate or "segmented" FX markets on their territory in which the rates at which exchange transactions are conducted by participants in the two markets exceed the permissible spreads. Official action can also involve cases where the authorities impose a cost on FX transactions (e.g., an exchange tax) that causes permissible spreads to be exceeded. Official action may also take more subtle forms, such as informal guidance or moral suasion to influence the exchange rate.

- *The official action must relate to an "exchange transaction"* i.e., purchase or sale of the member's currency against a foreign currency. In assessing exchange rates, the Fund examines the *effective rate of exchange*. This includes not only the nominal exchange rate, but also any additional costs or subsidies that have been imposed by official action and are so closely related to the transaction that they should be considered as part of the effective exchange rate.

- *The exchange transaction must take place on the member's territory*. This includes not only the member's metropolitan territory, but also any other territories of the member.

- *The official action, of itself, must give rise to a spread in exchange rates beyond what is considered "commercially reasonable", as specified in the MCP policy*. Specifically, in the case of spot transactions, the action must give rise to a spread of more than two percent between any buying

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[1] Background paper I provides more details on the historical and legal development of the MCP policy discussed in this section.

[2] In this paper, the MCP policy refers to the framework developed to support the obligation contained in Article VIII, Section 3 of the IMF's Articles of Agreement. The current MCP policy is based on Decision No. 6790-(81/43) ("1981 Decision"), adopted by the Executive Board on March 20, 1981, as amended.

[3] Elimination of the concept of an MCP would require an amendment to the Articles of Agreement.

rate and selling rates on the member's territory (the "two percent" rule).[4] For non-spot transactions (e.g., forwards), the official action must give rise to deviations between buying and selling rates for these other transactions against spot transactions, beyond what is representative of the additional costs and exchange risks for these other transactions (although this is not explicitly quantified) compared with spot transactions. An MCP also arises where official action results in "broken cross-rates", i.e., midpoint spot exchange rates for other members' currencies against its own currency differing by more than one percent from the midpoint spot exchange rates for these currencies in their principal markets and persisting for more than one week.

8. Two aspects of the policy's application are noteworthy. First, while the "two percent rule" was originally presented as a proxy for "commercial reasonableness", in effect the rule has been applied as a "*de minimis*" standard, i.e., official action that of itself leads to spreads of less than two percent is not prohibited under the policy. Second, while the 1981 Decision underlying the current policy defines MCPs as exchange rate spreads that actually exceed the applicable thresholds, over time application of the policy has evolved to include official action that could *potentially* give rise to such spreads, even if they have not emerged in practice (i.e., "potentiality"), unless there is a mechanism in place to keep the spread within the permissible range.[5] Box 1 provides examples of exchange measures that typically give rise to an MCP.

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[4] Members with more than one official currency are required to comply with the obligation not to engage in MCPs with respect to each currency.

[5] The concept of potentiality can be traced to the application of the requirement that Fund members notify the Fund of any changes to their exchange arrangements under Article IV, Section 2, and the requirement that they seek prior approval of the Fund before introducing measures which give rise to MCPs (*Implementation of the Second Amendment – Notification of Exchange Arrangements under Article IV, Section 2*, November 28, 1977). In cases where it was not clear whether a measure would indeed give rise to a spread in excess of 2 percent, members were advised to seek prior approval of the potential MCP which would exist if the spread did exceed two percent. Since the early 1980s, this practice has been interpreted to mean that where there was the potential for a spread in excess of two percent to arise, an MCP would exist unless there was a mechanism to prevent such a spread from arising.

Box 1. Exchange Measures that Give Rise to MCPs

While not exhaustive, the list below describes measures that are typically considered to give rise to MCPs under the current policy.

Different rates for different transactions. The authorities set different exchange rates for different categories of transactions which result in spreads of more than two percent between these rates, or against market rates. This will occur, for example, when the authorities set an *official exchange rate for governmental transactions* (e.g., servicing external debt, other government operations) which differs by more than two percent from prevailing market rates or other official rates. An MCP will also arise when members impose *surrender requirements*, whereby certain market participants (e.g., exporters) must sell their FX proceeds at a special rate which differs by more than two percent from the market rate or other official rates.

Dual or multiple FX markets. The authorities establish separate exchange markets and the rates at which exchange transactions are conducted by participants in the two markets exceed the permissible spreads.

Exchange taxes. A tax payable on exchange transactions is closely enough related to the exchange of currencies to be considered part of the effective exchange rate by increasing the cost of the exchange transaction.[1] If such costs imposed by the authorities exceed two percent, an MCP will arise.

Bilateral payments agreements (BPAs). The authorities have an agreement under which two central banks settle current transactions (e.g., imports and exports) between the two countries on pre-defined dates at specific exchange rates, and the exchange rates used in the agreement differ by more than two percent from those prevailing in the FX markets.

Exchange guarantee schemes. The authorities put in place a scheme to cover exchange risks of certain market participants (e.g., exporters). Depending on the features of the scheme, the compensation for exchange losses is considered to be part of the effective exchange rate that can give rise to an MCP.[2]

FX auctions. The authorities allocate FX outside the auction at a different exchange rate than the auction rate, or the auction rate differs from the market exchange rate, and these rates differ by more than two percent. In addition, a multi-price auction also gives rise to an MCP if the rates at which successful bidders are sold FX at the same auction differ by more than two percent.

Import deposit requirements. The authorities require an import deposit to be made before a letter of credit is opened or FX purchased. If the interest rate on the deposits is lower than the prevailing market interest rate, this is considered an additional cost of the FX transaction that can give rise to an MCP.

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[1]The Fund has long recognized that exchange taxes fall within the Fund's jurisdiction under Article VIII, Sections 2(a) and 3. See *Statement to Members transmitting Fund's Decisions on Multiple Currency Practices*, Appendix to Decision No. 237-2, adopted December 18, 1947; and *Legal Aspects of Multiple Currency Practices under Second Amendment* (May 15, 1979). See also Background paper I.

[2]A system for covering exchange risks managed by a member or its fiscal agencies does not give rise to an MCP if it is self-financed, i.e., if the premia paid by the beneficiaries of the system are sufficient to cover the cost of operating the system.

9. An MCP is a breach of obligation under the Articles and may result in the imposition of sanctions.[6] However, members are permitted to maintain MCPs under the following conditions:

- Transitional arrangements: Article XIV, Section 2 allows members to maintain those MCPs that were in effect on the date the country became a member, without the need for Fund approval.[7] The member is expected to eliminate these measures over time as its balance of payments (BOP) improves.

- Approval: MCPs that are not covered under the transitional arrangements mentioned above may be maintained temporarily with Fund approval. The Fund may grant approval if they are introduced or maintained for BOP reasons, are temporary, and do not give the member an unfair competitive advantage over other members or discriminate among members. Approval may also be granted for MCPs that are maintained primarily for non-BOP reasons, if these MCPs do not materially impede the member's BOP adjustment, do not harm the interests of other members, and do not discriminate among members. Approval for MCPs is generally granted for one year, to allow regular review by the Executive Board in the context of Article IV consultations.

10. MCPs have implications for the observance of conditionality under Fund arrangements. Since 1980, Extended Fund Facility and Stand-by Arrangements have included a standard continuous performance criterion that prohibits the introduction or modification of MCPs during the period of the arrangement, which has since been extended to other Fund arrangements and non-financing instruments. The introduction or modification of an MCP during Fund arrangements requires a waiver for nonobservance for financial resources to be disbursed.

11. The MCP policy is closely related to both Article IV and the Fund's policy on exchange restrictions under Article VIII, Section 2(a):

- *Article IV* allows members substantial freedom in choosing their exchange arrangements but subjects them to certain obligations in the conduct of their exchange rate policies. In particular, Article IV, Section 1 requires members to collaborate with the Fund and other members to ensure orderly exchange arrangements and promote a stable system of exchange rates, and to refrain from manipulating exchange rates in order to prevent BOP adjustment, or to gain an unfair competitive advantage over other members. In implementing their exchange rate policies under Article IV, members are prohibited from engaging in MCPs.

- *The Fund's exchange restrictions policy* prohibits members from imposing, without Fund approval, restrictions on the making of payments or transfers for current international transactions. Exchange measures imposed by members frequently give rise to both MCPs and exchange restrictions. The logic behind this approach relates to the cost of FX. MCPs typically involve circumstances where some market participants are given access to FX at a more favorable rate than others. The additional cost borne by other market participants may be considered by the

[6] As specified in Article XXVI, Section 2. See Section IV(F) for additional information.

[7] This provision applies to members that have not accepted the obligations of Article VIII, Sections 2, 3, and 4.

Fund as an impediment to their access to FX for current payments and, therefore, an "exchange restriction". However, the MCP policy is broader in at least one important respect: an MCP can arise from any purchase or sale of FX that relates to either the making (i.e., outflow) or receipt (i.e., inflow) of a current international payment, while the policy on exchange restrictions deals only with restrictions on outward payments and transfers for current international transactions.[8]

12. MCPs are also relevant under other legal frameworks, such as the World Trade Organization (WTO). MCPs arising from export subsidies or exchange taxes are generally prohibited under the WTO legal framework. However, if an MCP is maintained by a country in accordance with its obligations under the IMF Articles of Agreement, i.e., it is temporarily approved by the Fund under Article VIII or maintained under the transitional arrangements of Article XIV, it would not be subject to discipline under the WTO legal framework.[9]

WHY DOES THE FUND NEED AN MCP POLICY?

13. The prohibition of MCPs was part of a larger effort by the Fund to eliminate restrictions on current international payments and transfers after the destructive trade wars of the 1930s.[10] During this period, which saw a variety of distortive trade barriers followed by waves of retaliatory tariffs, countries frequently established different rates of exchange for selected commodities to stimulate exports and suppress imports. To preserve scarce supplies of FX, countries also concluded BPAs with each other using exchange rates that did not reflect market conditions. These measures disrupted trade, increased economic difficulties, and stimulated destructive spillovers and retaliatory measures between countries.

14. MCPs have historically been used for two main purposes. First, as an attempt to mitigate BOP pressures. Second, to achieve non-BOP objectives—such as revenue mobilization or allocation of resources to specific entities or sectors—without having to resort to more direct methods of taxation or subsidies. As MCPs can, in some cases, be adopted by executive order or central bank regulation, they have often been used instead of other measures that require legislation.

15. In the short term, MCPs have had partial success in stabilizing the BOP position. MCPs that increase effective import prices relative to export prices should, in theory, improve trade and current account balances. In practice, there have been examples where countries used MCPs to temporarily mitigate BOP pressures, including those associated with capital flow volatility. MCPs have also at least temporarily helped to reduce pressure to tighten monetary policy while protecting the BOP during financial distress, where there may be a destabilizing transmission of external shocks to

[8] The wording of Article VIII, Section 2(a) is explicit in this regard: stating only that members may not impose restrictions on the "making of payments and transfers;" it does not apply to receipts. For a discussion of the key elements of Article VIII, Section 2(a), see Background paper I.

[9] For more details see Background paper I.

[10] Background paper II provides more details on the economic impact and context of MCPs discussed in this section.

domestic activity. In some cases, MCPs have improved the revenue-raising powers of the government in the short term.

16. However, MCPs are typically not the most effective or efficient means of achieving these objectives. They do not address fundamental reasons leading to BOP imbalances and only delay the impact of BOP pressures. When used for non-BOP purposes, MCPs tend to introduce unintended inefficiency in resource allocation and are less transparent than direct taxes or subsidies provided through the budget. MCPs can also invite rent-seeking behavior from interest groups pressing for favorable treatment.

17. Moreover, MCPs distort relative prices and domestic resource allocation, particularly over the medium and long term. A review of the literature and country case studies suggests that MCPs have had adverse effects in the medium and long term, especially where these systems become a more permanent part of a country's exchange arrangement. MCPs have brought about expenditure reduction through implicit taxation, as well as expenditure switching through explicit changes in relative prices. For instance, an exchange rate spread that acts as a tax on exports and a subsidy on basic imports can undermine a country's exports and encourage the growth of inefficient import-substituting industries, resulting in resource misallocation and a loss of economic growth and job creation. MCPs have generally been associated with lower GDP growth, higher inflation, and lower trade volumes. Country experiences also confirm that MCPs can distort the current account because of asymmetric effects on imports and exports. Figure 1 depicts some correlations between the use of MCPs and macroeconomic performance across member countries that have faced crises. However, given that countries that use MCPs tend to be in generally challenging macroeconomic situations, it is difficult to establish causality between MCPs and macroeconomic performance.

18. In addition, MCPs may be considered a discriminatory trade practice.[11] By acting *de facto* as a differentiated tariff, MCPs can create unfair competitive advantage, hamper international trade, and generate retaliatory measures. Some MCPs, such as taxes on the purchase of FX for the remittance of profits, may also deter foreign investment. The experience of the 1930s is a stark reminder of how such exchange measures can contribute to the destabilization of world trade and global prosperity, especially if used by a significant portion of the membership.

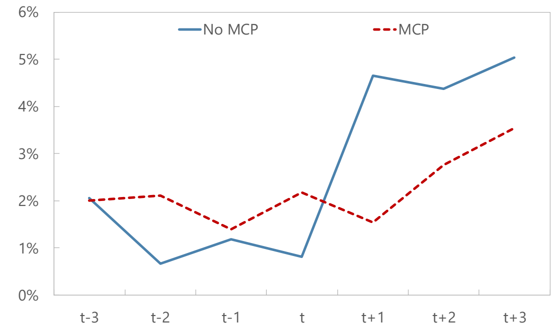
19. The MCP policy provides a strong deterrent against the emergence of distortive exchange practices. As the next section indicates, the policy has contributed to a substantial decline in MCPs over the last few decades, especially among large countries. In its absence, there would be less protection against a re-emergence of exchange practices that undermine trade and investment, which is a particularly salient risk in the current global environment.

[11] The literature draws conceptual parallels between the effects of MCPs and those of direct and indirect tax/subsidy policies (Fleming (1974) and Dornbusch (1986)).

Figure 1. MCP and Macroeconomic Performance Before and After Crisis, 1980–2015

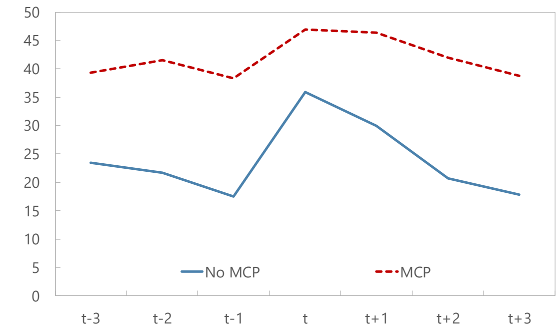
While countries with MCPs have a lower output loss, post-crisis recovery is much slower and smaller.

GDP growth
(In percent)



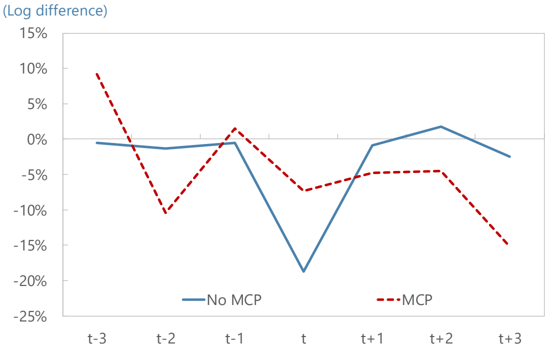
Countries with MCPs tend to have higher inflation throughout the period.

CPI inflation
(In percent)



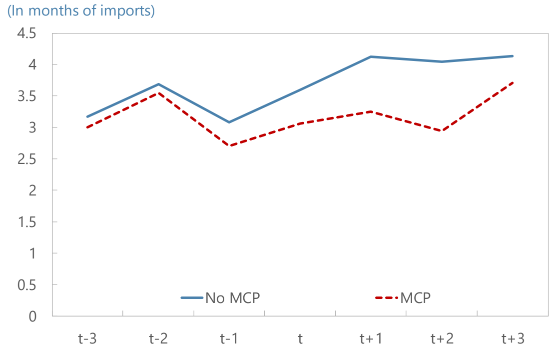
Devaluation is postponed in countries with MCPs…

Change in REER
(Log difference)



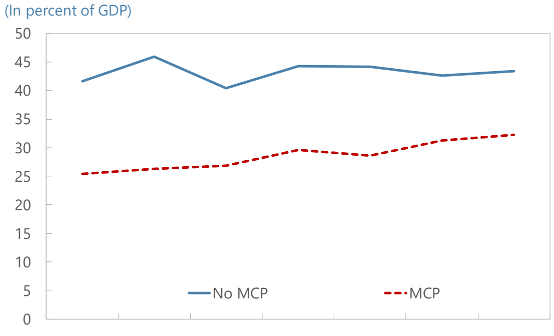
…but the recovery in international reserves is slower.

International reserves
(In months of imports)



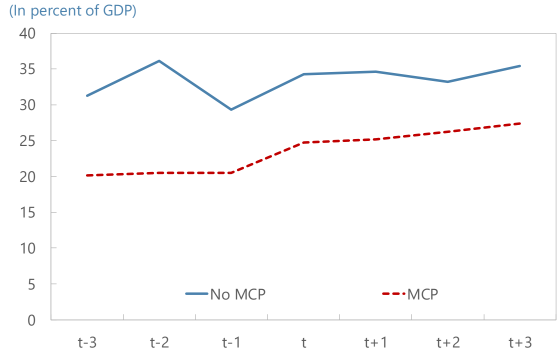
Countries with MCPs tend to be less open…

Imports
(In percent of GDP)



…but the evolution of trade variables over time is similar.

Exports
(In percent of GDP)



Sources: WEO, IFS, BOP, INS, and AREAER databases, IMF staff reports, and IMF staff estimation.

Notes: The charts plot simple averages over countries of selected macroeconomic variables from three-years before a crisis to three-years after the crisis. Advanced economies are excluded. The crisis dates are based on Laeven and Valencia (2012). "MCP" and "No MCP" refers to countries that did and did not have actual MCPs around the crisis, respectively. There are about 60 "No MCP" and 50 "MCP" crisis episodes. The actual number of observations differs across variables due to data availability constraints. Outliers in inflation are winsorized at 1 percent.

HOW HAS THE MCP POLICY WORKED IN PRACTICE?

20. MCPs were a frequent feature of members' FX systems in the early history of the Fund, but their use dropped significantly through the early 1980s. In the mid-1950s, about two-thirds of members maintained MCPs, often for non-BOP purposes such as protecting domestic industry, developing export industries, or collecting tax revenues. Significant progress toward reducing reliance on MCPs was made by the latter half of the 1950s and 1960s, against the background of improved international trade and payment conditions, and exchange reforms in key jurisdictions. By the early 1980s, only about 30 percent of the membership maintained MCPs. Reliance on MCPs among emerging and developing countries (EMDCs) temporarily increased in the early 1980s, with about a third maintaining them in 1986, fueled by widespread BOP difficulties, but declined thereafter (Figure 2).

21. This downward trend has generally continued over the past three decades.[12] Many EMDCs gradually opened up their economies and liberalized their exchange systems in the 1990s and early-2000s. While the first half of the 1990s saw a sharp rise in the number of countries with MCPs, this was largely attributable to the admission of the former Soviet Union and socialist bloc countries into the Fund, a number of which had highly restrictive exchange systems. Many of these MCPs were subsequently eliminated. After the global financial crisis, there was a small uptick in MCPs, in part reflecting BOP difficulties and FX shortages. At end-2017, 45 MCPs were in place in 28 member countries, down from 102 MCPs in 55 countries in 1986 (Table 1). Among those countries with MCPs, the average number of MCPs ranges between 1 and 2.

22. In recent years, MCPs have generally been confined to lower-middle and low-income countries, particularly in Africa and Middle-eastern regions. Accordingly, the share of countries with MCPs in international trade has declined from about 12 percent in 1982 to about four percent in 2016. The decline is even more evident among EMDCs (Figure 2).

23. The composition of MCPs has also changed since the Fund's early years. The use of the FX system to discriminate against certain transactions (e.g., through exchange subsidies, guarantees) has declined, as has the use of taxes on the conversion of FX. Other types of MCPs—such as those arising from margin requirements, unremunerated advance import deposit requirements and BPAs—have also decreased in the last three decades, while broken cross-rates have virtually disappeared. On the other hand, the share of MCPs arising from parallel markets has increased (9 MCPs as of end-2017). These tend to be highly distortionary, as such MCPs typically arise due to FX shortages and rationing in the official market.

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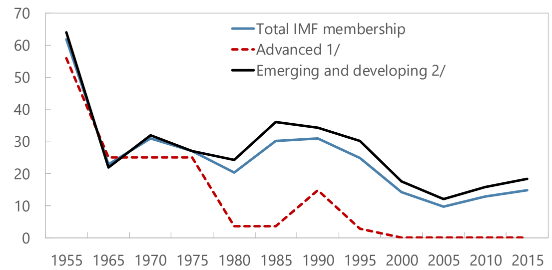
[12] This decline coincided with an increase in acceptance by members of the obligations of Article VIII, Sections 2(a), 3 and 4.

Figure 2. Incidence of MCPs in Fund Membership

MCPs have become less common over time….

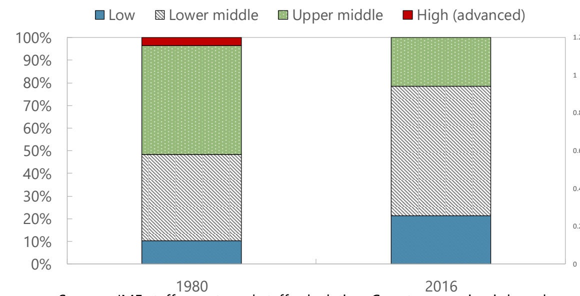
Incidence of MCPs in Fund Membership, 1955-2015
(In percent of respective country group)



Sources: IMF (1984) and IMF staff estimates based on staff reports.
Notes: Country grouping is based on WEO as of end-2016 for 1980-2015.
1/ Corresponds to "Industrial countries" between 1955 and 1975.
2/ Corresponds to "Developing countries" between 1955 and 1975.

…with recent MCPs mainly concentrated among LIDCs.

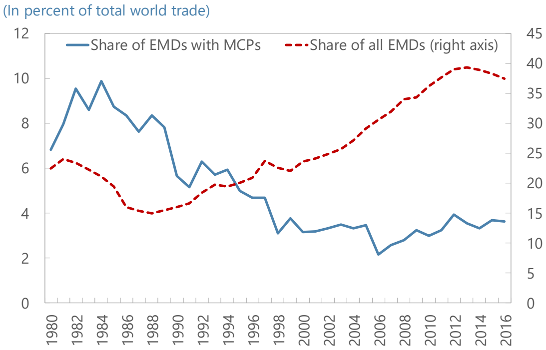
Countries with MCPs, by income level
(In percent of countries maintaining MCPs in respective year)



Sources: IMF staff reports and staff calculation. Country grouping is based on World Bank as of 2016, with an exception that "upper middle" group includes high income emerging market economies based on WEO grouping.

As MCPs have become less prevalent, the share of EMDCs with MCPs represent a decreasing share of world trade….

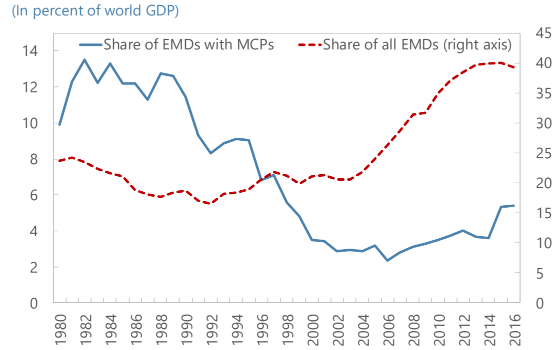
Share in World Trade of EMDCs
(In percent of total world trade)



Sources: WEO, IMF staff calculation.

…and world GDP, despite the growing share of EMDCs in world trade and GDP.

Share in World GDP of EMDCs
(In percent of world GDP)



Sources: WEO, IMF staff calculation.

24. **Increasingly, MCPs have been found on the basis of potentiality**. About one third of recent MCP findings have fallen in this category. This increase in potentiality-based MCPs accounts for much of the rise in the total number of MCPs in the last decade. The two most frequent potentiality-based MCPs arise from FX multi-price auctions and the lagged calculation of official exchange rates, i.e. where the authorities calculate the exchange rate used for governmental transactions based on previous days' market exchange rates.

25. **While some MCPs have been quickly eliminated, others have been more permanent features of members' exchange systems** (Figure 3). On average, MCPs have lasted for about 4.4

years, with more than 20 percent of MCPs eliminated within a year of their identification.[13] Certain types of MCPs, by their design, have taken longer to eliminate—for example, exchange taxes (which represent the largest group of MCPs lasting more than 10 years), exchange rate guarantee schemes, and BPAs.

Table 1. List of MCPs, as of end-2017

Type of MCPs	Num of countries	Country names (years since initial finding)
Different rates for different transactions	13	Armenia (3), Burundi (12), Ghana (6), Guinea (13), Iran (3)**, Kyrgyz (7), Maldives (2), Mongolia (9), Nigeria (1), Papua New Guinea (2), Sudan (5), Trinidad and Tobago (2), Ukraine (6)
Spread with parallel market	9	Eritrea (15), Iran (4)**, Iraq (5), Maldives (9), Nigeria (2), South Sudan (4)***, Sudan (5), Syria (14), Venezuela (14)
FX auctions (multiple price)	5	Angola (11), Honduras (2)**, Jamaica (1)**, Mongolia (9), Myanmar (5)**
FX auctions (spread with the market rate)	3	Angola (2), Honduras (2)**, Ukraine (3)
Exchange taxes	4	Angola (11), Brazil (3), Eritrea (10), Ukraine (6)
Import deposit requirements	3	Pakistan (1)*, Sudan (11), Syria (34)
Exchange guarantee schemes	1	Tunisia (30)
Bilateral payments agreements	1	Congo, DR (15)
Other	6	Eritrea (13), Iran (15)**, Mauritius (1)**, Papua New Guinea (2), Trinidad and Tobago (2), Uzbekistan (8)
Total	45	

Sources: AREAER database.
Notes: 45 MCPs were identified in 28-member countries based on the latest Article IV staff reports issued before end-2017. "Other" includes MCPs arising from buy/sell spreads, exchange subsidies, and non-interest bearing blocked accounts. A number in parenthesis following a country name indicates duration of the MCP since its initial finding, as of December 2017. A country name that is underlined indicates that the finding is based on potentiality. "*" and "**" indicate that the measure is approved for BOP reasons and non-BOP reasons, respectively. "***" indicates that the measure is maintained under Article XIV.

26. The Fund has only sparingly approved MCPs. Only a third of MCPs were approved for at least one year during their existence (Figure 3). Among a total of 506 MCPs reported in staff reports since 1980, only 108 measures (21 percent) were approved, 79 measures (16 percent) were approved only for a part of their duration, while 285 measures (56 percent) were never approved, and the rest did not require approval by the IMF (e.g., MCPs maintained under Article XIV). Approvals for non-

[13] The average duration is relatively long because of a few MCPs that lasted for a long time (e.g. among the current MCPs, 2 have been in place for more than 25 years). IMF staff reports do not necessarily mention MCPs that were introduced and removed between two consecutive staff reports, so the actual number of MCPs that were eliminated shortly after their introduction may be larger.

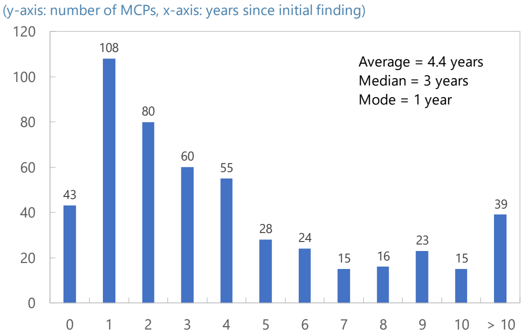
BOP reasons accounted for less than 10 percent historically but became more common recently for potentiality-based MCPs. In the majority of cases, approval was not granted because the MCP was not considered temporary. More than a half of parallel market MCPs and MCPs from different rates for different transactions were not approved, while MCPs from multi-price auctions, which were typically based on potentiality, were more readily approved.

Figure 3. Duration and Approval of MCPs

Most MCPs are eliminated within 2-3 years, but there are some exceptions.

Duration of MCPs, 1980-2016

(y-axis: number of MCPs, x-axis: years since initial finding)

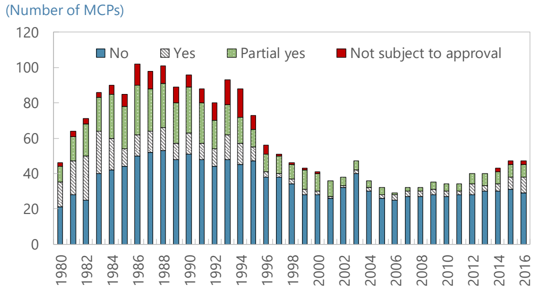


Sources: IMF staff reports and staff calculation

About a third of MCPs were approved.

MCPs by approval status

(Number of MCPs)



Sources: IMF staff reports and staff calculations.
Notes: "Partial yes" refers to MCPs that were approved for a partial duration. MCPs "not subject to approval" include Article XIV MCPs and MCPs solely related to capital transactions.

REVISITING THE MCP POLICY: KEY CHALLENGES AND PRELIMINARY PROPOSALS FOR REFORM

27. This section discusses the principal challenges arising from the current MCP policy and proposes possible approaches to address them. While the MCP policy has acted as an important deterrent of distortionary practices in members' exchange systems, it has also increasingly captured measures that, on consideration, should not be treated as the result of official action, or that involve relatively minimal deviations in exchange rates with little harm to the economy. In addition, a lack of clarity on some important aspects of the policy has complicated implementation. Any revision of the policy should seek to ensure that the Fund's legal and policy framework continues to meet the objective of facilitating the development of FX systems that promote a stable system of exchange rates, are free of restrictions on payments and transfers for current international transactions, and are based on unitary exchange rates. For such a policy to be effective, it needs to be based on rules that reflect market realities in member countries, can be applied uniformly across the Fund's membership, and are simple and easily understood by stakeholders.

A. Clarifying the Concept of Official Action and its Application

28. The concept of official action is a core element of the MCP policy. As discussed in Section I, an MCP must result from action by the authorities that, of itself, gives rise to impermissible spreads. However, the Fund has never fully clarified the scope of the concept of official action. As a result, the concept has evolved over time through its application, but this has resulted in an excessively broad interpretation in some cases.

29. Under the current policy, official action can conceptually be divided into three categories:

- The authorities directly engage in FX transactions that give rise to a multiplicity of exchange rates that exceed the permissible spread under the MCP policy. This is the case where (i) the authorities engage in exchange transactions at the same time using different exchange rates (e.g., for oil imports or imports of luxury goods) and the deviation between these exchange rates or the market exchange rate exceeds permissible spreads, or (ii) the spread between the buying and selling rates the authorities offer, or between any of those rates and other rates in the market exceed permissible spreads (for spot transactions, where the spread exceeds two percent). In the latter cases, an MCP will arise whether or not there is segmentation – that is, where the rate is only available for a limited group of market participants or for a limited range of purposes. Where segmentation does arise, the authorities' actions effectively result in discrimination against particular market participants or particular purposes.

- The authorities do not engage in FX transactions themselves but take action (e.g., an FX regulation) to require or bring about a multiplicity of exchange rates in the exchange transactions of other parties that exceed the permissible spread under the MCP policy. In this case, although the authorities are not participating directly in an exchange transaction, they are taking action that causes a multiplicity of exchange rates to arise in the exchange transactions of other market participants. This is typically the case where the authorities establish separate FX markets subject to different rules and sources of FX (i.e., market segmentation), and spreads between the two markets emerge or where their actions otherwise lead to spreads between buying and selling rates in excess of permissible margins.

- The authorities directly impose costs on FX transactions that lead to exchange rates exceeding the permissible spread under the MCP policy. Some types of official action are so directly related to the exchange transaction as to become a part of the effective rate. An example of such kind of official action is a tax payable on exchange transactions. The imposition of exchange taxes increases the spread between buying and selling rates and if the tax applies only to certain types of exchange transactions, it may also cause market segmentation.

30. This taxonomy has provided a useful framework for the analysis of MCPs but it gives rise to two challenges. First, it is too broad in some respects. Second, even where the scope of the framework is appropriate, it has been applied too broadly by the Fund. The first challenge relates to the Fund's analysis of cases where the authorities directly purchase or sell FX in the market (including

FX auctions). The second challenge relates to the treatment of parallel markets and the "potentiality" rule. Each of these cases is described below.

FX Auctions and Official FX Intervention

31. The concept of official action involving direct FX purchases and sales by the authorities is too broad. Under the current policy the authorities can be found to be engaging in an MCP when they offer FX to the market at rates beyond permissible margins even in the absence of market segmentation. However, this approach would not appear appropriate: where the authorities offer exchange rates that exceed permissible margins to the entire market for all purposes, the consequent purchases or sales of FX and the resulting exchange rates are attributable entirely to economic choices freely made by the market participants because they can choose to deal with counterparties other than the authorities. Accordingly, where the authorities directly purchase or sell FX, an MCP should only arise where there is segmentation – i.e., where the relevant exchange rate is offered to a limited group of market participants or for a limited set of purposes. In such circumstances, any emerging multiplicity of rates cannot be attributed to market participants' economic choices because not all of them are given access to a specific rate to meet legitimate demand for FX. Rather, the multiplicity will be the result of limitations on the availability of FX that the authorities have imposed. This analysis is of particular importance for the Fund's jurisprudence on FX auctions.

32. Both single and multi-price exchange auctions have been found to give rise to MCPs. In contrast to a single price auction where FX is bought from/sold to all auction participants at the same price, FX in multi-price auctions is simultaneously bought/sold at rates that reflect the bids submitted by participants. Where auction rules allow successful bids to deviate from each other by more than two percent, the multi-price auction has been considered to give rise to an MCP due to the simultaneous settlement of FX transactions by the authorities at rates that exceed the permissible margin under the MCP policy. This will be the case even if all market participants are allowed to participate in the auction. In the case of both single and multi-price auctions, an additional MCP may arise from the deviation of more than two percent between the auction rate(s) and prevailing market rates outside the auction.

33. This approach has placed members making use of these auctions in breach of obligation, even where the auction is serving legitimate market purposes. Well-designed FX auctions are often used as a form of official intervention in the FX market, and are commonly accepted as a transparent mechanism to provide FX to intermediaries, as well as an effective means of facilitating price discovery and market development. Finding a practice that is common and well-accepted in FX markets to be inconsistent with members' obligations under the Articles (unless it is temporarily approved) creates reputational risks for the Fund, and tension with national authorities.

Possible Solution

34. Applying the analysis set out above, an FX auction (including a multi-price auction) would not give rise to an MCP in the absence of segmentation. While the authorities may be selling FX to successful bidders at different rates at the same time, or at different exchange rates than prevailing in the market, an MCP would not arise as long as the authorities allow all market participants, either directly or through intermediaries, to access the auction. In such circumstances, any multiplicity of rates would result only from economic choices made by the participants in the auction. Market segmentation would only exist where the authorities restrict access to the auction only to certain market participants or for certain FX transactions.[14]

35. Reliance on this approach would be consistent with the Fund's current approach to other types of FX intervention under the MCP policy. As intervention typically involves the authorities offering to purchase or sell foreign currency on one side of the market at a particular rate to all market participants or by accepting offers from market participants, it does not give rise to an MCP as long as the offer is open to all market participants either directly or indirectly through market makers. However, where such transactions are conducted in a manner that makes foreign currency available at a particular rate only to/from certain selected market participants, or for specific purposes, an MCP may arise, as it involves a form of market segmentation caused by official action where FX is made available to a select group or for select purposes.

Parallel Markets

36. The treatment of parallel markets under the MCP policy is unclear and gives rise to implementation challenges. Parallel markets generally emerge in two situations: (i) to service illegal transactions only (e.g., drug sales); and/or (ii) because FX demand for certain legitimate transactions is not being met in the legal market. The second case typically involves situations where the authorities impose exchange restrictions on the availability of FX in legal markets (thereby forcing certain market participants to obtain FX in the parallel market), or actively send market participants to the parallel market to meet demand that cannot be met in the legal market. Parallel markets should not be confused with dual markets. Whereas the first deals with an illegal market, the latter involves two or more separate legal markets, sometimes in different territories of the member.

37. Conceptually it is difficult to treat the spreads arising in illegal parallel markets as the result of official action, given that the authorities themselves have prohibited transactions from taking place in that market. While clearly no MCP arises where the market has only been

[14] The operation of the auction would need to be designed in accordance with best practices to avoid any form of segmentation. As participation in such auctions is typically limited to intermediaries in the country's wholesale FX market, the auction would need to: (i) grant access to all such intermediaries so that they can all make purchases for themselves and on behalf of their clients.; (ii) ensure that the bid exchange rate submitted by participants is the only criterion used to determine whether the bid or the offer will be selected to buy or sell FX; and (iii) not set constraints on the range or level of the exchange rates that can be submitted, as this may segment the auction from the rest of the FX market. Such auctions would not result in MCPs even if the difference between the auction rate(s) and the market rate exceed permissible margins.

used to meet FX demand for illegal transactions, it has been more difficult for the Fund to determine whether an MCP arises when a parallel market is used to meet legitimate demands for FX that the authorities are not meeting in the legal market. The challenge for the MCP policy has been to articulate a clear standard as to when it is appropriate to attribute spreads between the official and parallel market to official action.

38. The current treatment is the result of practices developed in the course of the policy's implementation. Staff's assessment in such cases has relied on concepts like "toleration", "relegating" or "channeling". The first concept refers to situations where the parallel market is merely tolerated by the authorities, and is thus not considered to arise due to official action. The other concepts have been used interchangeably to refer to situations where the authorities are somehow encouraging or relying on the parallel market to satisfy legitimate needs for FX. Given that, in some cases, it is difficult to ascertain whether the authorities are merely tolerating or relying on the parallel market, staff's assessment has also examined whether the authorities are actively "cracking-down" on the parallel market (i.e., prosecuting illegal FX dealers). These various tests have all proven difficult to apply. Greater clarity regarding whether and how to apply the MCP policy to parallel markets will reduce the potential for inconsistent treatment of members and lower friction with authorities, who often object to being held accountable for exchange transactions that take place in markets they legally prohibit.

Possible Solution

39. Applying the conceptual framework for official action described above, it would appear appropriate to exclude parallel markets from the MCP analysis whenever they are legally prohibited, because the exchange rates that emerge within them are not the result of official action. Exchange rates in such parallel markets should not be attributed to official action, given the illegal nature of such markets. Instead, such cases could be dealt with under the Fund's policy on exchange restrictions.[15] Spreads between parallel market and legal market rates often arise because access to FX in the formal market is restricted or limited in some way (e.g., rationing and/or prioritization), and market participants have to rely on the parallel market to meet legitimate demands for FX.[16] The Fund's jurisdictional analysis in such cases could focus on the authorities' action in the formal market to restrict the availability of FX, rather than the resulting spread in the

[15] As the exchange restrictions policy only focuses on outward payments and transfers, this approach would not cover exchange practices that relate to inward payments and transfers, such as the requirement for exporters to surrender FX proceeds at an off-market rate. However, to the extent that there are legal FX markets in the country (e.g., interbank market), the surrender requirement at an off-market exchange rate could still be captured under the MCP policy.

[16] In some cases, a parallel market arises due to other restrictions in the official market, i.e., the authorities establish an exchange rate that does not clear the market, while limiting the freedom of banks to adjust the exchange rates at which they deal with their customers and/or limiting supply of FX to the market through official FX intervention.

parallel market.[17] Thus, while such cases would no longer give rise to an MCP, they would still be considered an exchange restriction.[18]

Potentiality

40. The concept of potentiality is a significant source of difficulty. As discussed in Section I, the policy has evolved to find MCPs to arise not only from actual spreads that result from official action, but also from *potential* spreads. Potentiality has been particularly relevant in the context of FX auctions. Even if deviations between the auction rate and the market rate or among the winning bids do not exceed two percent, the possibility that spreads exceeding the permissible margin may emerge leads to an MCP finding, unless there is a mechanism in place to prevent such spreads from emerging. Potentiality has also been relevant in some cases involving official exchange rates, where an MCP has been found unless there is a mechanism to prevent spreads of more than two percent from arising between official and prevailing market rates.

41. Potentiality raises a number of issues. While it has facilitated policy application in some ways,[19] the concept itself is not well grounded in the 1981 Decision, and has been difficult to explain to national authorities who are found to maintain MCPs even when excessive spreads have not actually emerged. Moreover, MCP findings based on potentiality may lead to the adoption of sub-optimal economic solutions. For instance, the adoption of rules to limit deviations between winning bids in multi-price auctions may undermine the price discovery function of the auction, and may have an adverse impact on market development.

Possible Solution

42. It is difficult to reconcile the concept of potentiality with the kind of official action that the MCP policy aims to capture. If one accepts the proposition that the MCP policy should capture a multiplicity of exchange rates arising from official action, it becomes difficult to justify how a member's official action is relevant to the MCP policy unless it causes an actual multiplicity of exchange rates. Given the challenges described above, it would appear appropriate to eliminate potentiality. Under this approach, an MCP would only arise if official action resulted in an actual FX spread emerging on the member's territory that exceeded the permissible threshold under the policy. Focusing on official action that results in actual FX spreads would capture the economically meaningful effect of

[17] Even in the presence of significant spreads in the parallel market, in some cases it may not be easy to find evidence of the exchange restriction(s) in the formal market. Often, access to FX in the formal market is determined through moral suasion, as opposed to FX regulations. However, this does not prevent the Fund from making a finding of an exchange restriction. In such cases, staff would typically interview market participants to find evidence of moral suasion. External payment arrears could also provide evidence of exchange restrictions.

[18] Countries with financial account restrictions can have parallel markets for financial account transactions, but under the proposed approach these would not be considered MCPs as long as the transactions in the parallel market are illegal, even if the Fund's jurisdiction under the MCP policy is extended to cover capital transactions.

[19] Reliance on potentiality minimizes the need for staff to continuously monitor spreads in FX markets to determine whether MCPs have arisen.

official action, and facilitate a more coherent application of the policy. A proposed framework for finding and eliminating MCPs under this approach is presented in Box 2.

Box 2. Finding and Eliminating MCPs Based on Actual Spreads

An MCP would arise whenever official action results in an actual FX spread beyond what is permitted under the policy. Upon confirmation that a single deviation from the permissible spread resulted from official action, an MCP would be found.[1]

An MCP could be eliminated as follows:

- As under the current policy, an MCP would be considered eliminated when the authorities remove the official action that gave rise to the MCP – for example, through the abolition of an off-market official exchange rate. To the extent that elimination of the official action may take time, approval of the MCP could be granted during the period in which the necessary steps are being taken.
- Where the authorities choose to keep the relevant official action in place, in certain circumstances the MCP could still be considered eliminated if the authorities take credible measures to ensure that such action will not, in the future, give rise to spreads that fall outside of permissible margins. If an impermissible spread arose again in future, a new MCP would be found.
- Given that in some cases an actual deviation might occur but not reemerge, a new possibility for eliminating the MCP could be considered. Where the authorities do not take any action to eliminate the MCP, it could still be considered eliminated if the member demonstrates over a specified "observation period" (e.g., 12 months) after the emergence of the spread that an impermissible spread had not recurred. The MCP would remain in place during the observation period and would be noted in Article IV staff reports. The reemergence of an impermissible spread during this period would "reset the clock", and the observation period would start again. This would allow the Fund to be satisfied that the relevant official action is no longer giving rise to impermissible spreads before the MCP is considered eliminated.

[1]Staff considered an alternative approach whereby an MCP would only arise if the permissible spread were exceeded for a certain number of consecutive days, or within a defined period, but this approach would leave important gaps in the framework. While such a system would ensure that brief and periodic deviations would not give rise to an MCP, it may fail to capture potentially significant deviations that occur sporadically, such as large official exchange transactions that do not take place on a daily basis, e.g., periodic government purchases of commodities at a special exchange rate, BPAs that settle on a periodic basis, exchange rate guarantee schemes, and regular, yet intermittent, exchange auctions where FX is earmarked to certain sectors and/or participants.

B. Revisiting Permissible Spreads

43. The two percent rule as currently formulated is an anachronism. The justification for the two percent rule in 1981 was based on a survey of actual transaction costs in twelve FX markets.[20] It was felt at the time that the two percent rule would strike a pragmatic balance between the need to

[20] New York, London, Frankfurt and nine markets in Africa, Latin America, and the Middle East. See *Operational Aspects of Multiple Currency Practices Under the Second Amendment*, June 13, 1979.

take account of the variety of differences in member countries' exchange transaction costs, and the need for precision.[21]

44. Reliance on the two percent rule creates a number of difficulties. First, the rule does not reflect market realities of individual members. Empirical analysis suggests that the reasonable cost of doing exchange business in most markets for spot transactions is significantly less than two percent but, in some cases, may be more. Second, market circumstances could lead, even in well-functioning markets where the spread is below two percent, to a temporary increase in spreads beyond two percent. Third, the comparison of exchange rates under the rule has not always been clear, e.g., whether the comparison should be made using rates prevailing in the market at the exact same time, or the closing rate of the day.

45. The test for assessing deviations between "spot" and "other transactions" has also proven difficult to apply. The two percent rule applies only to comparisons of exchange rates for spot telegraphic transfer transactions, while a less precise standard of "commercial reasonableness" is used for other spot and non-spot transactions (e.g., forwards). This standard is conceptually problematic, as the comparison is made between the exchange rates for spot transactions and for non-spot transactions. More logically, the comparison should be made between exchange rates for similar non-spot transactions, where official action should not cause these rates to deviate beyond permissible margins. In addition, the absence of clear criteria for the assessment of whether spreads with other transactions are attributable to "additional costs and exchange risks" for these transactions makes application challenging.

Possible Solution

46. To address these challenges, the permissible spread could continue to be based on the principle of "commercial reasonableness", but the current rules could be updated in light of developments in FX markets. Staff has considered different alternatives for replacing the two percent rule, and suggests replacing it with a market-based formula that would be applied uniformly across the membership.[22] Under this approach, the market rates within a member's principal exchange market

[21] While staff recognized that two percent could be too generous for industrialized economies (or too stringent for less developed markets), it was also felt that attempting to quantify reasonable spreads for spot transactions on a case by case basis for each country would pose significant operational challenges at the time.

[22] Staff also considered two other options: (i) updating the two-percent rule in light of current market data (either uniformly or on a country-specific basis), and (ii) focusing on deviations in exchange rates only where they are considered "macrocritical". However, simply updating the two percent rule based on a new market survey would not really address problems with the application of a universal numerical threshold, and the equitable administration of a country-specific fixed permissible spread for each member would also give rise to serious problems. Finally, introducing a concept of macrocriticality into the MCP policy would not appear to be feasible. It would be challenging to operationalize such a concept in a manner consistent with uniformity of treatment, given that a measure may be considered to have macrocritical implications for one member, but not another member, and for the same member in one year but not in another. The degree of subjectivity involved in this assessment could expose the Fund to discord with members, undermining the effectiveness of the policy.

would be used to determine a permissible range of exchange rates for the member that would change on a daily basis.[23] Although the range would be different for each country, this approach would be consistent with the principle of uniformity of treatment, as the results would be determined on the basis of the same methodology, applied consistently across the membership.

47. Developments in FX markets now allow the adoption of such a market-based formula. In the late 1970s, staff had to interview FX traders by phone to seek their assessment on the reasonable bid and ask spreads for particular markets over the previous 12 months. With this method, only 36 currencies could be included in the 1979 review. The adoption of a market-based norm is now possible because (i) market exchange rates that are independently computed based on standardized methodologies are now available for most IMF members; and (ii) FX markets across the Fund's membership have deepened considerably since the latest review in 1984. Today, exchange rate benchmarks, including bid/ask, high/low and open/close rates, both on intraday and closing basis, are prepared and published daily by professional international benchmark administrators for all but five IMF members.[24] In addition, there is now a high degree of standardization of practices across FX markets across the Fund's membership that has greatly increased the comparability of FX benchmarks across members.

48. Staff suggest using Thomson Reuters DataStream as the primary source of information for market rates, as it has the most extensive coverage of the membership.[25] For the MCP assessment, data representative of the wholesale market can be obtained in a standardized way from international benchmark administrators. For the 14 members for which data are not available through Thomson Reuters DataStream, data would be sourced from Bloomberg. Both companies provide accurate data in real time, and their methodologies are subject to independent assessment of their compliance with the international standard for the computation of international benchmarks of the International Organization of Securities Commission, thereby ensuring the integrity of data.[26] The robustness of the approach is enhanced by the availability of data from multiple sources that are equally reliable. In certain cases, alternative data sources could be used, as further described in Background paper III.

[23] The market rate is the inter-dealer market for spot and non-spot transactions respectively. Based on global financial market standards for settlement date, staff differentiates between spot (settled at up to 2 days) and non-spot (settled at more than 2 days) transactions as the price formation differs in these two markets. Any rate arising from official action in the spot market will be assessed with reference to the interdealer spot market, and any rate arising from official action in the non-spot market would be assessed with reference to the interdealer non-spot market rate, or a calculated non-spot rate if the former is not available. See Background paper III for further details.

[24] Iran, South Sudan, Sudan, Syria, and Tajikistan. Information for all countries except Syria could be obtained by staff from other sources.

[25] Reuters also provides information for many countries on transaction rates rather than quotes.

[26] The principles for the computation of benchmark aim at limiting opportunities for manipulation. The benchmark provider ensures that the collected rates are validated based on pre-established robustness checks, outlier rules, and expert judgment. Suspicious contributions are discarded.

49. The range between the highest and lowest exchange rates (H/L) in the wholesale market of members on a given day could be considered as an appropriate benchmark for a market-based norm that reflects commercial reasonableness. The high (H) is the most depreciated exchange in the respective FX market during the trading day while the low (L) is the most appreciated one. Thus, the H/L indicates the "market boundaries" or range of exchange rates traded during a given day. As such, as the H/L increases in exceptional market circumstances, no MCP would arise as long as the exchange rate arising from official action remains with the H/L range on a given day. Staff consider the H/L to be a superior replacement to the uniform two percent rule for all members for the purposes of determining a benchmark for reasonable commercial spreads in the market. As described below, an MCP would occur if an exchange rate arising from official action falls outside the H/L range of market rates or a fixed margin on either side of the mid-point of this range, whichever is larger. The margin represents a tolerance buffer to avoid capturing relatively minor deviations from the market norm.

50. The revised policy would assess the existence of an MCP in three steps:[27]

- First, staff would ascertain whether an exchange rate has arisen from official action.
- Second, staff would check whether the rate arising from official action is within the market-determined exchange rate range (H/L) of the day. If it is within the range, it would not constitute an MCP.[28] If the exchange rate is beyond the H/L range, staff would proceed to the third step.
- Third, to avoid capturing insignificant deviations, a tolerance margin (in addition to the H/L) or "buffer" would apply. This margin could be defined as a percentage of the average of the H/L (i.e., the midpoint of the H/L) for a particular day, and could be added on either side of the midpoint. As a result, no MCP would arise when the exchange rate resulting from official action remained within the margin, even if it is outside of the H/L range (see Box 3). A single deviation from the norm as a result of official action would be considered an MCP, as under the current policy.

This three-step methodology could, in principle, be applied to all the exchange measures that typically give rise to MCPs. However, in certain limited cases some adjustments seem to be appropriate, as discussed in Box 4.

[27] A more detailed discussion of the methodology and its application is included in Background paper III.

[28] While the bid/ask was an option that staff explored, staff prefers the H/L because the published bid and ask rates are an average of rates and do not define a maximum limit for deviations during the day. Staff hired a foreign exchange market expert who interviewed FX market participants and confirmed that the H/L norm was considered as the most representative of the market rates.

Box 3. Assessing the Existence of an MCP

The exchange rate must satisfy the following conditions:

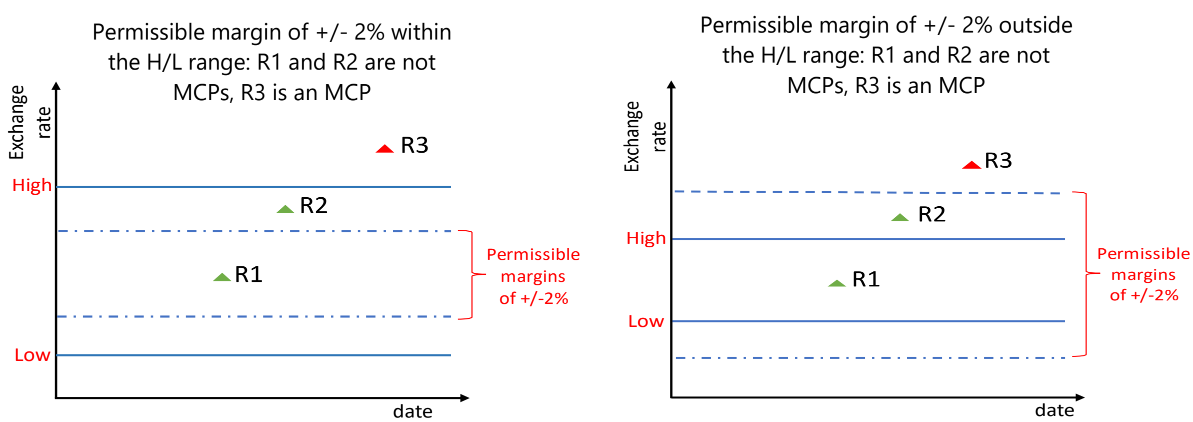
$$\text{Min}\{\text{LOW} ; M_{H/L} - 2\%\} \quad \leq \text{R} \leq \text{Max}\{\text{HIGH} ; M_{H/L} + 2\%\}$$

Where:

- R is the exchange rate arising from official action
- HIGH is the intraday high, i.e. the most depreciated exchange rate of the day;
- LOW is the intraday low, i.e. the most appreciated exchange rate of the day, and
- $\mathrm{M}_{\mathrm{H/L}} = \frac{\mathrm{HIGH+LOW}}{2}$

If the exchange rate falls outside of the range defined above, an MCP would be found.

Assessment of exchange rates set by official actions (R1, R2 and R3) under the revised policy



51. **Staff considers +/-2 percent an appropriate tolerance margin for permissible deviations from the market norm.** Staff studied the distribution of the H/L and deviations between the average of the H/L and available official rates in the membership to gauge the level below which one could consider a deviation as insignificant (Figure 4). Typical distribution thresholds for tail events would be reached for a two percent margin (95 percent of the deviations are less than two percent). The margin would help to ensure that the policy focuses on egregious cases involving significantly large spreads arising from official action. Figure 4 also indicates the distribution of the bid-ask spread and the H/L relative to the two percent in the membership.

52. **The proposed margin would differ from the two percent rule under the current MCP policy in two important respects.** First, the two percent rule was originally endorsed as a proxy for commercial reasonableness. Under the new methodology, this would now be represented by the country-specific H/L range. Second, while the current two percent rule applies to spreads resulting from official action between buy and sell rates (buy/sell), between buying rates (buy/buy), and between selling rates (sell/sell), the proposed margin would compare both buying and selling rates caused by official action with the H/L midpoint rate. In practical terms, in cases where the H/L is relatively wide this would allow spreads larger than two percent between buying and selling rates (buy/sell).

Box 4. Exchange Taxes and Lagged Calculation of Official Exchange Rates

Exchange taxes

In the case of exchange taxes, the application of the methodology requires some adjustment. First, since the official action (tax) may affect all exchange rates and as such the H/L as well, it may be difficult to compare the exchange rate resulting from official action with market rates. Second, using a country-specific H/L as a measure of permissible exchange taxes may result in a wide range of tax rates that would be deemed acceptable under the MCP policy. Third, even negligible taxes could cause market rates situated near the boundaries of the H/L or the +/- 2 percent margin to trigger MCP findings.

Historically the MCP policy has allowed members to impose minor taxes on exchange transactions without giving rise to an MCP.[1] Under the current policy, exchange taxes will not give rise to MCPs if they are equal to or less than two percent. Provided that this flexibility to impose minor taxes without giving rise to MCPs is still considered appropriate, an approach could be considered in the case of exchange taxes, where the tax could be deemed to be levied on the midpoint of the H/L, and compared with the +/- 2 percent permissible margin. In practice, assuming no other governmental costs imposed on exchange transactions, this would imply that exchange taxes up to two percent would not be considered MCPs.[2] This approach would allow countries that have built the two percent in their exchange regimes to continue using this practice.

Use of official exchange rates with lagged calculation

While the elimination of potentiality should greatly reduce the number of MCPs arising from the use of official exchange rates that are calculated with a lag, these rates could still give rise to MCPs despite the authorities' best efforts to align the official rates with market exchange rates. Official exchange rates are occasionally calculated based on market exchange rates of the previous day.[3] In times of high volatility in the FX market, the divergence of official rates from contemporaneous market rates may randomly exceed the threshold permitted under the MCP policy. To minimize MCP findings in such cases, it is proposed that exchange rates used by the authorities for certain official transactions which are based on market exchange rates with a maximum of one-day lag would not give rise to an MCP. The official rate would need to be computed as a weighted average of transaction exchange rates between wholesale intermediaries, or between intermediaries and their clients.

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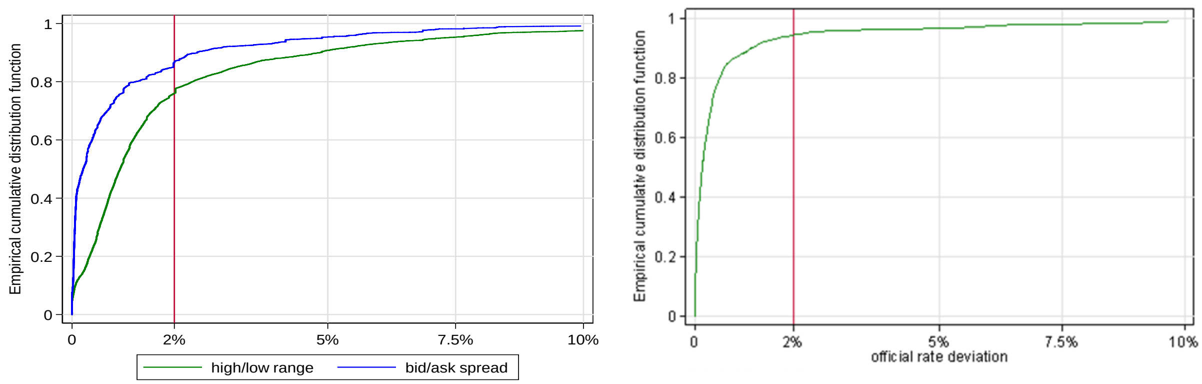
[1]According to *Operational Aspects of Multiple Currency Practices under the Second Amendment* (June 13, 1979), it was felt that a two percent spread would accommodate minor taxes on exchange transactions "*without jeopardizing an orderly system of exchange rates*."

[2]While exchange taxes below two percent do not currently give rise to MCPs, and would not give rise to MCPs under the approach set forth in Box 4, in a few cases the Fund has found an exchange restriction to arise when the exchange tax targets the making of payments and transfers for current international transactions. Due to the absence of a *de minimis* rule for exchange restrictions, this has resulted in findings of exchange restrictions even for negligible exchange taxes below two percent. However, it would not appear appropriate to allow a member to impose a two percent exchange tax under the MCP policy, and at the same time consider such tax, or a substantially similar tax (which may not be considered an MCP), to be an exchange restriction. Indeed, when the two percent rule was initially proposed in 1979, it was felt that minor taxes of up to two percent "*would have no serious effect on world commerce*", and that *"national authorities should continue to have freedom to employ them as they wished without reference to the Executive Board*" (Minutes of Executive Board Meeting, October 26, 1979, p. 36). The Second Amendment papers (*Operational Aspects of Multiple Currency Practices under the second Amendment*, June 13, 1979; *Legal Aspects of Multiple Currency Practices under the Second Amendment*, May 15, 1979; and *Review of the Fund's Policy on Multiple Currency Practices*, February 5, 1981) suggest that the treatment of exchange taxes under the policies on MCPs and exchange restrictions should be harmonized. Thus, it would appear important to address this inconsistency and clarify that, under a revised MCP policy, if an exchange tax does not give rise to an MCP, it would also not give rise to an exchange restriction.

[3]See Background Paper III.

Figure 4. Distribution of the High/Low Spreads and Deviation, April to October 2017



Source: Bloomberg, Reuters

Note: In the right chart, the official rate deviation is defined as the official rate minus the mid of the H/L.

53. The comparison of non-spot transactions would also be based on a market-specific formula for such transactions. The comparison would apply to transactions of the same nature (e.g., non-spot vs non-spot), as opposed to the current policy, which compares spot versus other transactions.[29] While the coverage of FX market data for non-spot transactions is not as broad as that available for spot transactions, staff can use alternative data sources. For a detailed discussion of how the market-specific formula would apply to non-spot transactions, see Box 5 and Background paper III.

[29] As discussed in Background paper III, while banknote transactions have historically been treated as non-spot transactions under the MCP policy, they would be treated as spot transactions under the new methodology.

Box 5. Assessing MCPs for Non-Spot Transactions

Official action may give rise to MCPs by resulting in segmentation with respect to exchange rates for transactions that are settled more than two days later. These exchange rates may include forwards, FX swaps and options.[1] The assessment of whether these exchange rates give rise to an MCP would follow the same methodology as the one applied to spot exchange rates (see Box 3):

- **Forwards**
  An MCP would arise whenever the forward exchange rate is not within either the H/L of the market forward rates for the same maturity or the additional buffer, i.e., +/-2 percent of the mid of the H/L ($M_{H/L}$) due to official action at the inception of the contract.
- **Swaps**
  In a typical swap transaction, the forward leg would be assessed as a forward exchange rate while the spot leg would be assessed like spot exchange rates.
- **Options**
  Options, if exercised, will be assessed based on comparison with market transactions of similar terms at inception. The effective exchange rate of the contract (i.e., the strike rate plus the option premium) should not deviate from the exchange rate of comparable market determined options by more than the permissible margin.

Data availability. Interdealer forward rates and option quoted prices are available for 76 and 20 traded currencies, respectively.[2] When interdealer rates are not available from the benchmark providers (Reuters and Bloomberg), staff can use other exchange rate data which are representative of the market, as described in Background paper III. If no such alternative data are available, the methodology would rely on theoretical rates as a reference. Bloomberg and Reuters provide a calculator for computing theoretical forward exchange rates and option prices.

Due to evolving trends in FX market sophistication, assessment of non-spot transactions may become more frequent under the new policy. There might be circumstances in which market related information on prices may be difficult to obtain or assessing non-spot exchange rates may be complex. Thus, further refinement of the methodology and guidance may be needed after more experience with assessing non-spot transactions is gained.

The assessment using theoretical prices would be as follows:

$$T - 2\% \leq \mathrm{R} \leq T + 2\%$$

where

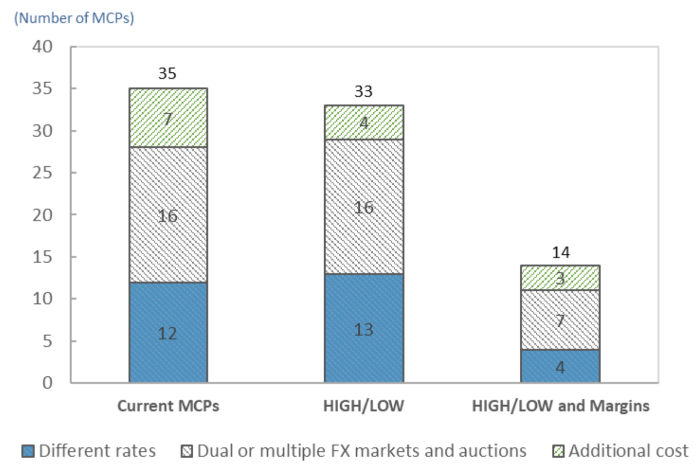
- R is the official rate arising from official action settling at more than T+2;
- and T is the exchange rate calculated using a theoretical model.

[1] Options—giving the right to an exchange transaction at or by a specified date, at a pre-determined exchange rate—are rarely assessed under the current MCP policy. Exchange rate guarantee schemes are akin to forwards or options and would be treated in a similar manner. Self-financing exchange rate guarantee schemes will continue not to give rise to an MCP.

[2] FX option prices from contributors are available against USD for EUR, JPY, GBP, CHF, AUD, CAD, NOK, SEK, HKD, NZD, PLN, CNY, INR, ISL, MXN, RUB, ZAR, SGD, THB, and TRY.

54. The proposed new methodology would address some of the key challenges of the current policy. Upgrading the current two percent rule and applying it to actual FX spreads would allow the policy to be refocused on economically meaningful measures. The testing of the new methodology, combined with a refined application of the concept of official action, presented in Background paper III indicates that it would lead to fewer but better targeted MCP findings. Figure 5 illustrates preliminary results of applying the revised policy.[30] The H/L norm, in combination with the proposed changes in the definition of official action under the new policy, would reduce the number of findings to 33. The number of MCPs would decrease to 14 with the addition of the +/-2 percent tolerance margin.

Figure 5. New Methodology: Illustrative Results*



Source: IMF staff estimates.

* The first column includes 35 of the 45 MCP that existed in 2017, out of which 18 are based on potentiality. The 10 MCPs that are not presented in the figure arose from practices that could not be tested due to the absence of data. The second column indicates the number and composition of MCPs of the same type included in the first column based on whether the exchange rate is outside the H/L. The third column indicates the number of MCPs, where the exchange rate is outside both the H/L and the +/-2 percent tolerance margin from the mid of the H/L.

C. Eliminating Broken Cross-Rates Provisions

55. Developments in international FX markets over the last decades challenge the rationale for covering broken cross-rates under the MCP policy. While broken cross-rates were widespread in the early days of the MCP policy, with the increased convertibility of currencies, reliance on such practices has practically disappeared. Recent MCP findings due to broken cross rates typically relate to infrequent adjustments in official exchange rates in relation to less commonly used currencies prescribed for some transactions.

[30] The results are based on data for the period April to October 2017.

Possible Solution

56. Consideration could be given to the elimination of the provisions on broken cross-rates from the MCP policy. In staff's view, they are no longer economically relevant at this juncture. As such, it seems desirable to do away with the relevant provisions of the MCP policy. If conditions were to change and such practices were to re-emerge, they could be brought under the MCP policy again.

D. Aligning Approval Policies

57. While MCPs can be approved for both BOP and non-BOP reasons, exchange restrictions can only be approved if they are maintained for BOP reasons. This means that a measure that is maintained for non-BOP reasons and is found to give rise to both an MCP and an exchange restriction can be approved as an MCP, but not as an exchange restriction. In these circumstances, operational difficulties arise.

Possible Solution

58. The MCP approval policy could be more closely aligned with the approval policy for exchange restrictions. The possibility of granting approval of MCPs for non-BOP reasons was originally put in place to allow some members (e.g., developing countries with weak institutional capacity) to use the FX system to pursue policy goals unrelated to BOP adjustments or the operation of their FX system (e.g., to collect revenue). In recent years, such cases have been rare and the policy would no longer appear necessary. Accordingly, the policies for approval of a member's retention of MCPs and exchange restrictions would be more closely aligned, and thus, approval would only be granted if the relevant measure is introduced or maintained for BOP reasons. Approval of a member's retention of MCPs would continue to require that the relevant measures are temporary, and do not give the member an unfair competitive advantage over other members, or discriminate among members.[31]

E. Reconsidering Links with Capital Transactions and the Institutional View

59. MCPs can apply both to current and capital transactions. This dual nature of MCPs raises two issues: (i) the treatment of MCPs applicable solely to capital transactions under the MCP policy; and (ii) the relationship between the MCP policy and the Institutional View on the liberalization and management of capital flows (Institutional View, or "IV"). The first issue has been a subject of long-standing discussion in the Fund; the second is a recent development.

[31] However, the two approval policies would still not be identical, as it would be possible to approve a measure that gives the member an unfair competitive advantage over other members as an exchange restriction but not an MCP. According to Decision No. 1034-(60/27), June 1, 1960, the Fund will grant approval of exchange restrictions imposed for balance of payments reasons "only where it is satisfied that the measures are necessary and that their use will be temporary while the member is seeking to eliminate the need for them."

60. Since the early days of the Fund, Management has taken a more encompassing view of the applicability of the MCP policy to capital transactions than has the Executive Board. While acknowledging that members are generally free to regulate international capital movements,[32] staff has long taken the position that Article VIII, Section 3 prohibits members, without Fund approval, from engaging in MCPs that relate solely to capital transactions.[33] This matter has been brought for discussion on more than one occasion, most recently in 1985, but the Board has not endorsed staff's position. As such, while staff identifies MCPs applicable to capital transactions in Article IV consultation reports, no finding of a breach of obligation is made and they are not subject to Fund approval.[34]

61. Separately, further clarification on the relationship between the MCP policy and the Institutional View may be warranted. The IV, adopted in 2012, articulates the Fund's view on members' policies to liberalize and manage capital flows. It provides a framework for consistent assessments and advice on liberalizing the financial account and managing capital flows—without changing the rights and obligations of members under the Articles of Agreement, or other bilateral or multilateral treaties. Unlike the Fund's policies on MCPs, which define the scope and content of members' obligations under the Articles, the IV has the status of policy advice. While the IV takes note of a potential overlap with Article VIII, Sections 2 and 3, additional guidance on the relationship between those policies would appear warranted.

Possible Solution

62. It remains staff's view that MCPs applicable solely to capital transactions fall under the Fund's jurisdiction. In staff's view, the MCP policy must be understood in light of the purpose of the Fund to "promote exchange stability" and "maintain orderly exchange arrangements among members";[35] as well as members' general obligations regarding exchange arrangements under Article IV. Staff's view, based on the review of the legislative history of the relevant provisions under the Articles, is that members' obligations under Article VIII, Section 3 are general in nature, and not specifically limited to current transactions or even to international payments and transfers. The Fund's jurisdiction over MCPs applicable solely to capital transactions is therefore not limited by the members' right to exercise any controls that are necessary to regulate international capital movements. While recognizing the position of the Executive Board on this issue, staff would reiterate their view to the Board for consideration. If the Board were to endorse this view, staff will conduct

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[32] This freedom is specifically recognized in Article VI, Section 3.

[33] *Controls on Capital Transfers*, February 8, 1956. Under Article XXX(d), payments for some transactions that are considered capital from an economic perspective are considered payments for current transactions, including: (i) payments of moderate amounts for amortization of loans or for depreciation of direct investments, (ii) moderate remittances for family living expenses, and (iii) normal short-term banking and credit facilities.

[34] The Chairman's Summing Up at the Conclusion of the Discussion on Multiple Currency Practices Applicable Solely to Capital Transactions, February 25, 1985; and Minutes of Executive Board Meeting, February 13, 1985.

[35] Article I(iii).

additional work to propose an appropriate framework, including to avoid inconsistencies between the approval policy for MCPs applicable solely to the capital account and the IV.

63. Assuming no change in the position of the Executive Board, staff would suggest the following specific clarifications on the linkages with the IV:

(i) reiterating that the IV does not alter the Fund's jurisdiction or policies under Article VIII, Section 2(a) and 3;[36]

(ii) measures that give rise to MCPs and exchange restrictions and which are also considered CFMs will, in addition to Article VIII, be assessed under the IV in Fund surveillance;[37] and

(iii) with respect to the transactions that are registered in the financial account of the balance of payments but considered current under the definition of current payments and transactions under the Articles,[38] MCPs or exchange restrictions that are temporarily approved under Article VIII would be considered appropriate under the IV for the approval period.

F. Considering a Remedial Framework

64. The Fund does not have a specific remedial framework for dealing with breaches of obligation under the policies on MCPs or exchange restrictions. While a member that has been found in breach of obligation can be subject to sanctions (i.e., declaration of ineligibility to use the general resources of the Fund, suspension of voting and related rights, compulsory withdrawal), historically the Fund has not applied them. Instead, the Fund has followed a cooperative approach, encouraging members that introduce/maintain unapproved MCPs or exchange restrictions to eliminate these measures through surveillance, programs and technical assistance. However, some Directors have raised concerns about the effectiveness of the current approach, and whether there is a need to develop a specific remedial framework to address cases of such unapproved measures and provide incentives for member countries to remove exchange measures subject to Fund jurisdiction.

[36] The IV provides that, "as the Articles define "payments for current transactions" to include certain items that, from an economic perspective, are capital in nature, CFMs that restrict the making of payment and transfers for any of these transactions would continue to be subject to the Fund's Article VIII jurisdiction and prior approval. See *The Liberalization and Management of Capital Flows – An Institutional View*, November 14, 2012 (para. 62).

[37] In bilateral surveillance, capital flow policies are required to be assessed by the Fund under the Integrated Surveillance Decision (ISD) where a judgement is made that those policies are having a significant impact on a member's domestic or BOP stability. Capital flow policies will also be assessed in multilateral surveillance if spillovers from those policies are considered to significantly influence the effective operation of the international monetary system.

[38] As defined in Article XXX(d).

Possible Solution

65. Consideration could be given to establishing a remedial framework to address cases of unapproved MCPs or exchange restrictions. While the design of such a remedial framework is outside the scope of this paper, in principle it would be possible for the Fund to establish a policy framework under which members in breach of their obligations respecting MCPs or exchange restrictions would be subject to escalating remedial measures such as a declaration of censure or noncooperation (similar to the procedure for breaches of obligation under Article VIII, Section 5) culminating in the imposition of sanctions. This remedial framework could also address cases of long-standing MCPs or exchange restrictions maintained under Article XIV, where the Fund considers that the member is ready to eliminate them.[39]

66. The pros and cons of establishing a remedial framework to address cases of unapproved MCPs or exchange restrictions need to be carefully considered. The possible revisions to the MCP policy discussed in this section seek to focus the application of the policy on practices that are objectionable. Under such a revised approach, it may appear appropriate for the Fund to have a remedial framework for dealing with such practices. On the other hand, from a policy perspective it may be desirable to retain a cooperative approach. While urging the elimination of unapproved MCPs, the Fund and member countries could continue to cooperate on the elimination of MCPs via surveillance and TA, as well as monitoring of exchange measures via standard conditionality in Fund arrangements. Finally, as mentioned in Section I, the introduction of MCPs or exchange restrictions during a Fund-supported program requires a waiver for nonobservance of the relevant performance criterion for financial resources to be disbursed.

G. Operational Issues

67. If the MCP policy were to be reformed in line with the options discussed in this section, the following operational issues would have to be considered:

- *To ensure effective implementation of the revised policy, guidance would have to be provided to members on their obligation to provide data on exchange rates to the Fund.* While Article VIII, Section 5 provides that members are required to furnish to the Fund information on "buying and selling rates for foreign currencies", no further guidance is provided on the modalities for providing this information to the Fund (e.g., it is unclear whether these modalities are covered by any general understandings with members on data provision under Article VIII, Section 5).

[39] Article XIV, Section 3 provides: "The Fund may, if it deems such action necessary in exceptional circumstances, make representations to the member that conditions are favorable for the withdrawal of any particular restriction, or for the general abandonment of restrictions, inconsistent with the provisions of any other articles of this Agreement. The member shall be given a suitable time to reply to such representations. If the Fund finds that the member persists in maintaining restrictions which are inconsistent with the purposes of the Fund, the member shall be subject to Article XXVI, Section 2(a)".

- *As the new methodology would be based on data compiled by third parties, issues such as reliability, integrity, and continuity of data would have to be carefully considered.* The new system may also have implications in terms of budget and staff resources. For the new policy to be effectively applied, Area Departments would need to have access to FX data for each member.[40]

- *Management would need to issue a guidance note on application of the MCP policy, which would be published.* The guidance note would describe in detail the most common types of MCPs and procedures for finding, eliminating and approving MCPs. More specifically, guidance could be provided on issues including the overlap between MCPs and exchange restrictions, in what circumstances auctions would give rise to MCPs, and criteria for approval, including better guidance on how to assess the temporariness of a measure. This guidance would increase the transparency of the MCP policy for staff and the membership, and help ensure that policies are uniformly understood and consistently applied.

H. Transitional Arrangements

68. As part of any new policy, transitional arrangements would be put in place to avoid unnecessary disruptions, in particular with respect to countries that may be adversely affected by the new framework. A transitional period could be envisaged to provide time for members to adjust their policies, after which the revised MCP policy would become operational. Staff will review the revised MCP policy within a period of 5 years, once sufficient experience with its application has been accumulated.

[40] Market data is available through the Fund's subscription to Thomson Reuters DataStream and Bloomberg. The current subscription of the Fund through IMF Library (CFS) covers sufficient licenses to Thomson Reuters DataStream and Bloomberg. These licenses are accessible to various users throughout the IMF in area departments and other functional areas. There is a budget proposal approved to add licenses during the coming fiscal year, whereby almost all research officers in country teams would have access to the required market data. The current service agreement provides both close of day and intraday data for exchange rates covering bid/ask, mid-rates, and intraday H/L.

ISSUES FOR DISCUSSION

- Do Directors agree that MCPs can lead to domestic distortions and externalities, and that the Fund needs a policy to address them?
- Do Directors concur that developments in FX markets and operational issues with the implementation of the current policy warrant a reconsideration of the MCP policy?
- Do Directors support the revisions to the MCP policy proposed by staff?
- Do Directors agree that MCPs applying solely to the capital account should fall under the Fund's jurisdiction?
- Do Directors see the need for developing a remedial framework for MCPs?

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INTERNATIONAL MONETARY FUND

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REVIEW OF THE FUND'S POLICY ON MULTIPLE CURRENCY PRACTICES: INITIAL CONSIDERATIONS—HISTORICAL DEVELOPMENT AND LEGAL FRAMEWORK OF THE MCP POLICY—BACKGROUND PAPER I

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CONTENTS

INTRODUCTION

1. **This paper, which accompanies the paper on the "Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations" (the "Main Paper") examines the historical development and legal underpinnings of the Fund's MCP policy.** It considers the development of the concept of an MCP under the par value system and its evolution thereafter (Section I); the linkages between Article VIII, Section 3 and other provisions of the Articles (Section II), Fund policies on approval of MCPs (Section III); and the implications of the maintenance of unapproved MCPs under Article VIII or those grandfathered under Article XIV (Section IV). The paper then looks at the treatment of MCPs solely applicable to capital transactions (Section V). Finally, Section VI considers the interaction between the Fund's MCP policy and the WTO.

2. **The concern of the drafters of the Fund's Articles in 1944 over multiple exchange rate systems was prompted by the damaging effect of exchange practices that proliferated during the inter-war period.** In the 1930s it became a common practice for countries to establish different rates of exchange for different commodities to stimulate their exports by making them cheaper in foreign markets, while at the same time, making the import of similar or other goods expensive in the domestic market and hence uncompetitive. It was also common for countries to conclude bilateral trade and payments agreements through which increased imports were exchanged for increased exports.[1]

3. **Multiple exchange rates were typically used in the period to protect bilateral trade relationships.** These arrangements usually contemplated fixed rates of exchange below the official rates and provided that balances which originated in payments for exports would be used to pay for imports from the other partner country, thus creating a fragmented international trade and payments system. Other mechanisms frequently used involved the direct rationing of foreign exchange by making it only available for payments of goods or commodities declared essential or priority, while others would be met only if there was a surplus of exchange.

4. **The widespread use of such arrangements was a key concern of the drafters of the Articles of Agreement.** The experience of the 1930s showed the damaging effect of such exchange measures for world trade and global prosperity. Therefore, when the White Plan for the creation of a "United Nations Stabilization Fund" (which later became the IMF) was proposed, it specifically listed as one of the objectives of the Fund the elimination of "*multiple currency practices and bilateral clearing arrangements*".[2] White's proposal was ultimately reflected in the Articles of Agreement under Article VIII, Section 3.

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[1] Elizalde, Hector, *The International Monetary Fund and Current Account Convertibility*, In: IMF, Current Developments in Monetary and Financial Law, vol. 4, Washington, D.C.: IMF, 2005.

[2] The White Plan justified this objective as follows: "The developments during the last twenty years of multiple currency devices and bilateral clearing arrangements served to disrupt trade, increase economic difficulties in some countries, and stimulate the worst kind of competitive practices among countries seeking to increase their foreign markets or protect the foreign markets they already have. These practices frequently arise from difficulties which are subject to mitigation by an appropriately handled stabilization fund. An international stabilization fund with ample resources and broad powers could do much to eliminate the justification for resorting to trade practices that are an

(Continued)

HISTORICAL DEVELOPMENT OF FUND POLICY ON MULTIPLE CURRENCY PRACTICES

5. Article VIII, Section 3 of the Fund's Articles prohibits members from engaging in MCPs, unless otherwise authorized under the Articles. Specifically, under Article VIII, Section 3 members and their fiscal agents must not engage in discriminatory currency arrangements or MCPs unless they are approved by the Fund or maintained under Article XIV, Section 2.[3] This provision is closely tied to Article VIII, Section 2(a), which prohibits members, unless authorized under the Articles, from imposing restrictions on payments and transfers for current international transactions. These two provisions, along with Article IV, provide the foundation for the orderly exchange arrangements that are key objectives of the IMF.

6. While the Articles prohibit members from engaging in "multiple currency practices", they do not define the meaning of this term. As such, the Executive Board has the power to give this term content by Board decisions. The Executive Board has exercised this power and has, over the decades, developed the concept of an MCP and adapted it to the changing economic realities.

MCP Policy Before the Second Amendment

7. Prior to the Second Amendment of the Articles, the Fund was at the center of a system of fixed exchange rates, that provided the bedrock of the Fund's MCP policy. Under the Bretton Woods system, administered by the Fund, the value of the US dollar was fixed at $35 per ounce of gold, and the values of all other currencies were fixed in relation to the US dollar. Under the original Article IV, Section 3, Fund members were required to ensure that exchange rates for spot exchange transactions taking place within their territories did not differ by more than one percent of either side of the par value. Moreover, the par value of a member's currency could only be modified in consultation with the Fund.

8. In the early years of the Fund, the definition of an MCP was intrinsically linked to the par value system. An MCP was defined as any effective buying or selling rate that deviated on either side of the margins prescribed by Article IV (i.e., more than one percent from parity). No action by the member was necessary – to the extent that exchange transactions were taking place at rates outside of the one percent margins around parity, a member could be found to be engaging in

obstacle to a high level of foreign trade for all countries." See IMF, *The International Monetary Fund 1945-1965, Twenty Years of International Monetary Cooperation*, Volume III: Documents, Washington, DC, 1969, p. 47.

[3] The concept of "discriminatory currency arrangements" is distinct from the concept of multiple currency practices. However, in the past, the Fund has never found it necessary to attempt a legal definition of discriminatory currency arrangements. The concepts of MCP and exchange restriction have been considered sufficiently broad to cover the issues that have arisen under the provisions of Article VIII, Sections 2(a) and 3. See *Legal Aspects of Article VIII and Article XIV*, November 18, 1959, pp. 43-46.

an MCP even if it had taken no positive step to cause the deviation and even if it was not a party to the exchange transactions themselves. Mere toleration of the impermissible spreads was sufficient.[4]

9. Early Fund discussions revolved around the definition of the term "multiple currency practice". During 1947 the Fund took the first steps to articulate the general basis of a policy on MCPs. On January 24, 1947, the Board recognized that, since exchange stabilization was a primary purpose of the Fund, the Fund should seek to eliminate MCPs within its membership, particularly those which could lead to exchange fluctuations and depreciation.[5] On February 5, 1947, the Board decided that MCPs, when applied to current international transactions, constituted a type of restriction on payments and transfers for current international transactions.[6]

10. In light of the increasing number of questions raised by members with respect to the Fund's jurisdiction over MCPs, an *ad hoc* Committee of the Board on Spreads and Multiple Currency Practices was established. The Committee was mandated to make recommendations as to the application of Article IV, Section 3, Article VIII, Section 3, and Article XIV, Sections 2-4, and the procedure to be followed in respect to particular cases. The final report of the Committee was discussed in August 1947, and its recommendations were reflected in a policy memorandum that, upon Board approval, was sent to all members (1947 Memorandum).[7] The memorandum set out the first definition of an MCP and articulated several general principles with regard to the Fund's jurisdiction over MCPs that have underpinned the Fund's MCP policy ever since (see Box 1).

11. The development of the MCP policy continued during the 1950-60s. The key milestones included:

- ***First review of the MCP policy***, as articulated in the 1947 Memorandum, was conducted in 1957.[8] The review was prompted by the desire to make further progress toward the elimination of MCPs which remained fairly wide spread at the time.[9] The conclusion of the review was reflected in Executive Board Decision No. 649-(57/33), which emphasized that "*unification of the exchange rates in multiple rate systems is a basic objective of the Fund*", and that "*complex multiple rate systems damage the economies of countries maintaining them and harm other countries*". Furthermore, it was stated that the Fund wished to intensify collaboration with members to assist in the simplification and elimination of complex multiple rate systems, including through technical assistance in the preparation of programs and measures directed toward exchange simplification.[10]

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[4] *Legal Aspects of Multiple Currency Practices under Second Amendment*, May 15, 1979, p. 11 ("The Legal Aspects Paper").

[5] *Multiple Currency Practices*, January 13, 1947.

[6] *Multiple Exchange Rates*, February 5, 1947.

[7] Decision No. 237-2, adopted December 18, 1947.

[8] *Review of Fund Policies on Multiple Currency Practices*, January 10, 1957.

[9] MCPs continued to be used by 38 of the Fund's 60 members. *Id.*

[10] Decision No. 649-(57/33), adopted June 26, 1957.

- ***Adoption of approval policies.*** On June 1, 1960, the Executive Board adopted Decision No. 1034-(60/27) that articulated the Fund's policy on approval of MCPs. The decision identified two key principles: First, if members proposed to maintain or introduce measures which required approval under Article VIII for balance of payments reasons, the Fund would grant approval only if satisfied that the measures were necessary and that their use would be temporary while the member was seeking to eliminate the need for them.[11] Second, as regards measures requiring approval under Article VIII and maintained or introduced for non-balance of payments reasons, the Fund believed that the use of exchange systems for non-balance of payments reasons should be avoided to the greatest possible extent, and was prepared to consider with members the ways and means of achieving the elimination of such measures as soon as possible.

Box 1. The 1947 Memorandum

The 1947 Memorandum recognized MCPs as systems of multiple rates and exchange restrictions. In line with earlier Board discussions, the memorandum recognized that MCPs often had a restrictive nature. In particular, the memorandum noted that MCPs, "*besides being in most cases restrictive practices, also constitute systems of exchange rates*", and that MCPs often represented "*both systems of exchange rates and restrictions on payments and transfers for current international transactions*". Thus, since the beginning, Fund policy has recognized that Article VIII, Section 2(a), which deals with exchange restrictions, and Article VIII, Section 3, which deals with MCPs, are closely related, both seeking to eliminate restrictive exchange measures.

The 1947 memorandum also recognized an intrinsic relationship between Article VIII, Section 3, and Article IV, Section 4(a), focusing on exchange rate stability. Article IV of the original Articles of Agreement dealt with "Par Values of Currencies", and its Section 4 referred to members' "Obligations Regarding Exchange Stability". The 1947 Memorandum underscored the relationship between MCP and exchange stability, noting that *"since exchange stability depends on effective rates, the general purposes of the Fund and the members' undertakings of Article IV, Section 4(a) 'to collaborate with the Fund to promote exchange stability, to maintain orderly exchange arrangements with other members, and to avoid competitive exchange alterations' are fundamental considerations in an interpretation of the rights and obligations of members under (…) Article VIII, Section 3*".

The 1947 Memorandum articulated the first MCP definition. In line with the recognition that exchange stability was a "fundamental consideration" in the interpretation of MCPs, the 1947 Memorandum concluded that an effective buying or selling rate which differed from parity by more than one percent constituted an MCP. Therefore, the 1947 Memorandum linked the MCP definition to the parity margins of one percent prescribed in Article IV, Section 3(i). Despite subsequent reviews of the MCP policy, the basic concept of an MCP set forth in the 1947 Memorandum would remain essentially unchanged for the next three decades.

The 1947 Memorandum also articulated for the first time the Fund's jurisdiction over exchange taxes. According to the 1947 Memorandum, "*When a tax affects an obligation undertaken by the members of the Fund, the relationship between the tax and the obligation is of direct concern to the Fund and subject to its jurisdiction. Whenever exchange taxes are used to modify par values, create multiple currency practices, or introduce restrictive exchange controls, they are subject to the Fund's jurisdiction. The Fund has authority to deal with these exchange matters irrespective of the official device or procedure involved*."[1]

[1] *Statement to Members transmitting Fund's Decisions on Multiple Currency Practices*, Appendix to Decision No. 237-2, adopted December 18, 1947.

[11] These criteria continue to guide approval by the Fund of exchange restrictions under Article VIII, Section 2(a). See also Section IV.D of the Main Paper.

12. The abolition of the par value system in 1971 prompted a number of significant changes in the international monetary system, and the MCP policy. The announcement by the United States in August 1971 that it would no longer convert official holdings of U.S. dollars from members into gold or other reserve assets, made it difficult for members to observe the margins set out in the Articles. This led to an attempt to reestablish fixed relationships among all currencies, comparable to those of a par value system, but with wider margins for exchange transactions than those permitted under the Articles, substituting par values with more informal "central rates" (the so-called "Smithsonian Agreement"). The Fund reflected this system of wider margins and central rates in Executive Board Decision No. 3463-(71/126), adopted on December 18, 1971. As those changes were unfolding, the Fund also had to adapt the MCP definition and policy accordingly, as reflected in several decisions of the Executive Board adopted over that period (see Box 2). More significantly, these changes affected members' obligations under Article IV. Members were no longer required to maintain fixed exchange rates, nor were they expected to continue to police the behavior of private market actors by ensuring that all exchange transactions took place within the permissible margins.

Box 2. Developments During 1971–1978

The adoption of a temporary regime of wider margins was not intended to liberalize the Fund's policy on MCPs. Despite the changes, members would continue to be obligated to obtain the Fund's approval whenever this was required under the Articles.[1] However, as the wider margins sat outside of the margins then provided for in Article IV, this meant that there needed to be a change to the Fund's concept of an MCP as the previous definition was based on the relationship between Article VIII, Section 3 and Article IV. As such, the cumulative margin of permissible spreads (of +/- 1 percent around the fixed parity) under the par value system was replaced with an absolute limit of 2 percent between buying-selling rates, as reflected in Decision No. 3463-(71/126), adopted December 18, 1971.

Decision No. 3463 dealt with three specific situations which could give rise to MCPs. First, the Executive Board was concerned that members should not take advantage of the wider margins to institute excessive spreads. As such, a maximum spread of two percent between the buying and selling rates (buy-sell spread) for spot exchange transactions was permitted. These margins were initially suggested based on the prevailing practice under the Bretton Woods period, and was ultimately adopted in Paragraph 5(i) of the decision. Second, members would not be empowered to establish at will differentials between buying rates (buy-buy spread), or between selling rates (sell-sell spread), for spot exchange transactions (Paragraph 5(ii)(1)). They would also not be allowed to establish a relationship among the buying rates, or among the selling rates, for the currencies of other members (broken-cross rates), that the Fund regarded as inconsistent with *"promotion of exchange stability, the maintenance of orderly exchange arrangements with other members, and the avoidance of competitive exchange alterations"* (Paragraph 5(ii)(2)). The decision, however, refrained from setting a maximum spread for the differentials covered under Paragraph 5(ii), indicating that this would be analyzed on a case by case basis.

Practical difficulties in its application soon prompted calls for an amendment of Decision No. 3463. Uncertainty about the scope of Paragraph 5(ii) raised questions from the membership. The absence of an explicit cap for differentials in Paragraph 5(ii) was perceived by some as a permission for members to establish differentials above two percent. Therefore, four months after its adoption an amendment was proposed to apply the two percent rule not only to spreads between buying and selling rates (buy-sell spread), but also to differences between buying (buy-buy spread) or between selling rates (sell-sell spread).[2] The amendment resulted in Decision No. 4083-(73/104), adopted November 7, 1973, which prohibited "*a difference in excess of 2 per cent between any two buying or any two selling rates for spot exchange*

Box 2. Developments During 1971–1978 (concluded)

transactions between its currency and the currencies of other members; or a spread in excess of 2 per cent between a buying and a selling rate for spot exchange transactions between its currency and the currency of another member."

[1] *Statement by Managing Director on Exchange Practices*, August 27, 1971.

[2] "Under the new text the two percent limit, which under the present text is expressly applicable only to spreads between buying and selling rates for exchange transactions between a member's currency and the currency of another member, would apply also to the cases referred to in paragraph 5(ii)(1) and (2). It will be recalled that under the existing text of paragraph 5 the determination of the permissible difference was to be made by the Fund. In the light of operational experience, it is felt that the maximum difference should be fixed at two percent also for these cases and this is now made the rule under the amended provision." See *Amendment of Decision on Central Rates and Wider Margins and Decision on Adjustment of Fund's Holdings of Currencies*, April 25, 1972, p. 3.

Legal and Operational Aspects of MCPs under the Second Amendment

13. The formal abolition of the par value system took place through the Second Amendment to the Fund's Articles in 1978 and prompted the Fund to reconsider the MCP definition. The Second Amendment resulted in fundamental changes to members' obligations under Article IV: members were now allowed to freely choose their exchange arrangements and, in particular, could allow the exchange rates of their currencies to float against other currencies. At the same time, members had an obligation to conduct their exchange rate and other economic and financial policies in accordance with their obligations under Article IV, Section 1. In addition, they were obliged to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. The margins of +/- 1 percent around parity, formerly contained in Article IV, Section 3(i), however, had been removed. As such, the previous basis for the MCP definition—these fixed margins—was eliminated and this required a reconsideration of how an MCP should be defined. During the period 1979-1981, in the course of three staff reports[12] and four Board meetings,[13] the Fund considered how its then-existing MCP policy would be reformulated in a post-Second Amendment world.

14. A key change in the post-Second Amendment concept of an MCP relates to the concept of official action. Before the Second Amendment a member could be found to be engaging in an MCP even though the member and its fiscal agencies had not taken any positive action to give rise to a spread in exchange rates produce the multiplicity of rates. This was the case even if the authorities were not themselves contracting parties to exchange transactions (i.e., a member's toleration of an exchange practice was considered to be "action" by the member that amounted to engaging in the practice). Under the post-Second Amendment MCP policy, the mere existence of multiple effective exchange rates within the territory of a member would be insufficient to give rise to an MCP. Rather, the authorities, or their fiscal agencies, would need to act positively in

[12] *Operational Aspects of Multiple Currency Practices*, June 13, 1979 ("The Operational Aspects Paper"); The Legal Aspects Paper; and *Review of the Fund's Policy on Multiple Currency Practices*, February 5, 1981; collectively referred to as "Second Amendment Papers".

[13] *Multiple Currency Practices – Legal and Operational Aspects*, October 26, 1979; and *Multiple Currency Practices – Review of Policy*, March 6, 1981.

such a way as to give rise to a spread between the buying and selling rates for foreign exchange transactions within the member's territory.

15. The Second Amendment Papers continued to recognize relationships between Article IV and Article VIII, Section 3, as well as between Article VIII, Sections 2(a) and 3. The link between Article IV and Article VIII, Section 3, under the par value system, had been direct, and while maintained under the Second Amendment, was now more indirect given that Article IV no longer prescribed parity and permissible margins, which margins underpinned the Fund's definition of an MCP. Thus, no longer would a breach of a member's obligation under Article IV lead to an automatic breach of Article VIII, Section 3, as had previously been the case. In relation to the links between Section 2(a) and Section 3 of Articles VIII, the 1947 Memorandum recognized this initial link by emphasizing that MCPs, in most cases, represented both "*systems of exchange rates and restrictions*". Under the Second Amendment Papers, this common thread was explicitly maintained through reference to the fact that members should not interfere with the freedom of the market and should not, through administrative measures, increase the commercial costs of FX transactions.[14]

16. The Second Amendment Papers also continued to emphasize the relevance of exchange markets in determining permissible spreads for purposes of the MCP policy. The Second Amendment Papers recalled that the original margins of one percent in the pre-Second Amendment period "*were based, in large part, on what the drafters of the original Articles thought should be the limits, under normal market conditions, of the movement of an exchange rate from parity within a gold exchange standard, that is, the limits set in practice by the "gold points"*".[15] In line with the early development of the policy, the Second Amendment Papers proposed that "*the content of the concept of MCPs must be determined by reference to the normal practices in exchange markets*. *Certain spreads or differential rates in exchange transactions engaged in by a member or its fiscal agencies can be regarded as MCPs if they are not consistent with the normal practices of exchange markets*."[16] However, after the Second Amendment this required the setting of a general standard for considering *which* deviations from the normal practices of exchange markets across the membership would give rise to an MCP.

17. "Commercial reasonableness" became the underlying principle of the new MCP definition. The Second Amendment Papers considered what differentials between exchange rates should be considered an MCP. It was proposed that the new basis for determining what constitutes an MCP would be the standard of "commercial reasonableness", i.e., reasonable differences between buying and selling rates for exchange transactions attributable to normal commercial costs would not be considered an MCP. Consideration was given to whether "commercial reasonableness"

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[14] *"A member should not interfere with the freedom of the market without the approval of the Fund. A member should not prevent or hinder access to the market and it should not distort the rates that normally would prevail there*"; and "*a member should not by administrative decision add to the normal commercial costs of engaging in an exchange transaction*". See [The Legal Aspects Paper](), p. 21.

[15] Ibidem.

[16] Idem, p. 22.

should be judged on a country-by-country basis, or whether a more uniform approach was appropriate. The country-by-country approach was considered, but was ultimately rejected as not feasible at the time.[17]

18. A new definition was proposed in an attempt to strike a balance between the need to take account of the variety of different costs for exchange member countries', and the need for precision. It was proposed that the Fund would adopt a quantitative standard, as a proxy for "commercial reasonableness", for core exchange transactions at the time (i.e., spot telegraphic transfers) on the basis of which exchange rates for other transactions are derived. Based on a survey on costs of exchange transactions in selected FX markets, a two percent threshold was proposed. For other transactions, spreads should not exceed the normal commercial costs and risks of engaging in these transactions, vis-à-vis spot telegraphic transfer transactions. In terms of which exchange rate differentials should be captured, it was understood that the MCP policy should continue to capture the spread between the buying and selling rate, and also spreads between buying or between selling rates.[18]

19. The two percent threshold was established as a pragmatic solution. While the 1979 paper observed that the historical maximum permissible spread of two percent between buying and selling rates for spot transactions was "far in excess" of actual spreads in major markets (where spreads rarely exceeded 0.1 percent for interbank spot transactions in major currencies), it recommended that the Fund retain the two percent standard "to accommodate the diversity of practices in the markets of other members". It was also acknowledged at the time that the two percent threshold would allow minor taxes or charges on exchange transactions without jeopardizing an orderly system of exchange rates.[19] As discussed in 1979, "*the two percent figure seemed to provide a minimum degree of freedom for a country to act as it wished. It was thought that it would be over fastidious for the Executive Board to worry about stamp taxes and similar small items affecting the cost of exchange transactions that would technically involve the creation of a multiple rate by official action, but in such a minor degree that the Fund ought not to be concerned*".[20]

20. Impermissible spreads would also need to have been caused directly by official action. During the 1979 Board meetings, there was extensive discussion as to the interaction between the concept of official action, and the permissible margin which had been proposed. This discussion hinged on two options: if the official action *of itself* would have to be in excess of two percent for

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[17] Staff explained the difficulties with that approach as follows: "*…the question arises whether it is sufficient to base a new definition wholly on a standard of reasonableness which is left unquantified as between countries and which would be qualified only in reference to the transactions costs within the exchange market of a given country. Such an approach would not be appropriate. It would involve the Fund in the difficult exercise of attempting to judge the commercial reasonableness of the costs attached to exchange transactions in member countries. Therefore, the equitable administration of such a definition would raise serious problems*". See The Operational Aspects Paper, p. 7.

[18] "The differences between a buying and a selling rate, between selling rates, or between buying rates, that would exist without governmental action that sets or results in other rates or prevents the spread from narrowing should continue to be the legal criteria for determining whether a multiple currency practice exists". See The Legal Aspects Paper, p. 21.

[19] The Operational Aspects Paper, p. 8.

[20] *Multiple Currency Practices – Legal and Operational Aspects*, October 26, 1979, p. 36.

spot transactions for an MCP to arise, or whether *any* official action causing the spread between spot transactions to go above two percent would result in an MCP. Ultimately it was decided that an MCP (for spot transactions) should only arise if the entire two percent spread was attributable to official action, on the basis that this would be the simplest way to administer the policy. This means that the actual spread between two spot exchange rates may be significantly higher than 2 percent depending on market conditions without giving rise to an MCP, as long as the part of the spread which is the result of official action did not exceed 2 percent. This interpretation effectively turned the 2 percent threshold into a *de minimis* rule.

21. The proposals discussed in the period from 1979 to 1981 were reflected in Decision No. 6790-(81/43), adopted on March 20, 1981. According to Decision No. 6790, official action should not cause exchange rate spreads and cross rate quotations to differ unreasonably from those that arise from the normal commercial costs and risks of exchange transactions. Exchange spreads arising without official action would not give rise to an MCP. In particular, Decision No. 6790 prohibits:

- Official action that of itself gives rise to a spread of more than two percent between buying and selling rates for *spot* exchange transactions between the member's currency and any other member's currency;
- Official action causing deviations between the buying and selling rates for *spot* transactions and for *other* transactions, unless they represent the additional costs and exchange risks for these *other* transactions; and
- Official action which results in midpoint spot exchange rates of other members' currencies against its own currency in a relationship which differs by more than one percent from the midpoint spot exchange rates for these currencies in their principal markets, if the one percent differentials persist for more than one week (broken cross-rates).

22. While the Executive Board has made only one change to the MCP policy since the adoption of Decision No. 6790-(81/43), there have been several developments with respect to its application in practice.[21] Most significantly, since the early days of the policy in the 1980s, it has been applied in such a way as to find MCPs whenever an official action creates a situation where a spread of more than two percent *may* arise, even if such a deviation has not actually emerged in practice, unless the authorities have in place a mechanism which prevents such spreads from arising. As discussed in the Main Paper, this "potentiality" concept has given rise to a number of MCP findings over the last several decades, particularly in the context of multi-price FX auctions and lagged calculation of official exchange rates.[22]

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[21] One minor change occurred in 1998 to allow a longer approval period "where the practice is maintained only for existing arrangements and for a specified period of time". This change will be discussed in more detail below (see Section III, Fund Policy on Approval of MCPs).

[22] The concept of potentiality can be traced to the application of the requirement that Fund members notify the Fund of any changes to their exchange arrangements under Article IV, Section 2, and the requirement that Fund members

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RELATIONSHIP BETWEEN ARTICLE VIII, SECTION 3 AND OTHER PROVISIONS OF THE ARTICLES

23. As noted above, Article VIII, Section 3 is linked to several other provisions of the Articles. These include Article VIII, Section 2(a) on exchange restrictions; Article IV, which governs exchange rate policies and surveillance; and Article XIV, which outlines the transitional provisions for members who join the Fund with MCPs or exchange restrictions in place. It is also linked to the underlying purposes of the Fund, set out in Article I (the promotion of exchange stability and orderly exchange arrangements in Article I(iii), and the elimination of exchange restrictions which hamper growth of world trade (Article I(iv)).

Multiple Currency Practices and Exchange Restrictions

24. Exchange restrictions and MCPs are distinct legal concepts under the Articles of Agreement, covered under Article VIII, Sections 2(a) and 3, respectively. While Article VIII, Section 3 prevents members from engaging in MCPs, Article VIII, Section 2(a) prohibits them from imposing restrictions on the making of payments or transfers for current international transactions, unless authorized under the Articles. An overview of the key elements of Article VIII, Section 2(a) is presented in Box 3.

Box 3. Exchange Restrictions Under Article VIII, Section 2(a)

Article VIII, Section 2(a) prohibits members from imposing restrictions on the making of payments and transfers for current international transactions. The key aspects of the provision are explained below:

Article VIII, Section 2(a) prohibits restrictions on the "making" of payments and transfers. The prohibition applies to member whose traders are on the paying side, as distinguished from the member whose traders are on the receiving side of payments. By implication, the obligation only extends to outward payments and transfers and hence does not extend to restrictions on inward receipts.

Meaning of "restriction" under Article VIII, Section 2(a). In order to clarify the meaning of Article VIII, Section 2(a), the Executive Board of the Fund has decided that: "[t]he guiding principle in ascertaining whether a measure is a restriction on payments and transfers for current transactions under Article VIII, Section 2, is whether it involves a direct governmental limitation on the availability or use of exchange as such."[1] Examples of exchange measures that can give rise to exchange restrictions include, but are not limited to, imposition of priority lists for access to foreign exchange, imposition of absolute limits on the amount of foreign exchange that can be purchased (e.g. allowances), and exchange taxes; in all cases when they impede or increase the costs of the making of current international payments and transfers.

Article VIII, Section 2(a) refers to "payments and transfers". Exchange restrictions are only those measures that interfere with payments and transfers for current international transactions. Thus, it does not preclude a member from prohibiting certain import transactions. If, for example, a country prohibits the import of certain luxury items and includes a provision in its exchange control laws prohibiting the use of foreign exchange to

seek prior approval of the Fund before introducing measures which give rise to MCPs. In cases where it was not clear whether a measure would indeed give rise to a spread in excess of two percent, members were advised to seek prior approval of the potential MCP which would exist if the spread did exceed two percent. Since the early 1980s, this practice has been interpreted to mean that where there was the potential for a spread in excess of two percent to arise, an MCP would exist unless there was a mechanism to prevent such a spread from arising.

Box 3. Exchange Restrictions Under Article VIII, Section 2(a) (concluded)

pay for prohibited imports, that would not be a restrictive measure within the scope of Article VIII, Section 2(a).

Payments for "current" transactions are defined in Article XXX(d) of the Fund's Articles. Payments for current transactions means payments that are not for the purpose of transferring capital and include payments relating to trade, services, interest on loans and income. The illustration of current transactions within the Fund's Articles also includes several other items that may be characterized as capital from an economic or financial reporting perspective. For example, payments of moderate amounts for amortization of loans or for depreciation of direct investment are treated as payments for current transactions.

The current transactions to which Article VIII, Section 2(a) applies are "international". The normal meaning of this word is between countries. For instance, current transactions between a metropolitan territory and one of its subordinate territories where separate currencies are involved are not considered "international" for purposes of Article VIII, Section 2(a). However, transactions between the subordinate territory of one member and other members are "international" within the reasoning of the provision, and restrictions on payments and transfers for current transactions between persons in these territories come within the rule of Article VIII, Section 2(a).[2]

Article VIII, Section 2(a) is directed at restrictions that are "imposed" by a member. Exchange restrictions that do not result from governmental acts are not subject to the Fund's jurisdiction because the members of the Fund are not responsible for them. The imposition of a restriction by a member may take the form of a law or regulation, but a restriction may also arise from the administrative practice of a member even in the absence of an explicit regulation. Thus, administrative practices which result in undue delays in the availability or use of foreign exchange for the making of payments and transfers for current international transactions may give rise to exchange restrictions within the meaning of Article VIII, Section 2(a).

[1] Decision No. 1034-(60/27), adopted June 1, 1960.
[2] Legal Aspects of Article VIII and XIV, November 18, 1959, p. 25 and Decision No. 1034-(60/27), adopted June 1, 1960.

25. Exchange measures imposed by members frequently give rise to both MCPs under Article VIII, Section 3 and exchange restrictions under Article VIII, Section 2(a). As explained in the Main Paper, the logic behind this approach relates to the cost of FX. MCPs typically involve circumstances where some market participants are given access to FX at a rate that is more favorable than that accorded to other market participants. The additional cost borne by these other market participants may be considered by the Fund as an impediment to their access to FX for current payments and, therefore, an "exchange restriction". Similarly, where an additional cost is imposed on all market participants by official action (i.e., an exchange tax in excess of 2 percent), such measure may be both an MCP and an exchange restriction.

Multiple Currency Practices Maintained Under Article XIV

26. The Articles of Agreement include transitional arrangements under Article XIV for members to maintain MCPs or exchange restrictions in place at the time at which they join the Fund.[23] A member availing itself of Article XIV may maintain those MCPs or exchange

[23] The provision authorizes a member that avails itself of such transitional arrangements to "maintain and adapt to changing circumstances the restrictions on payments and transfers for current international transactions that were in effect on the date on which it became a member". For purposes of Article XIV, the reference to "restrictions" includes (Continued)

restrictions that were in effect on the date on which it became a member, and consult with the Fund annually with respect to their removal (See Box 4).[24] Any measures put in place by the authorities after the member joins the Fund are not protected by Article XIV, Section 2 and will give rise to a breach of Article VIII, Section 3, unless approved by the Fund.[25]

27. Members maintaining MCPs under Article XIV can be called upon to remove such measures in exceptional circumstances. While Article XIV, Section 2 provides that members who maintain exchange measures under the transitional provisions of Article XIV are expected to withdraw such measures as soon as they are satisfied that they will be able, in the absence of these measures, to settle their balance of payments in a manner which will not duly encumber their access to the Fund's general resources, the Fund may, in exceptional circumstances, make representations to a member that the circumstances are ripe for the removal of such measures.[26] In this regard, the Fund is expected to provide the member with suitable time to respond to such representations. Persistent failure to remove such measures may lead to the member being declared ineligible to use the general resources of the Fund under Article XXVI, Section 2(a).

28. The Fund has historically adopted a collaborative approach and has used a range of tools to facilitate removal by members of measures maintained under Article XIV, including MCPs.[27] These tools included Fund-supported programs, surveillance and technical assistance (TA). Given that MCPs, even those maintained under Article XIV, are generally undesirable policies, Fund-supported programs have, in certain cases, included structural conditionality requiring members either to accept the obligations of Article VIII, Section 2, 3 and 4,[28] or to remove specific exchange measures maintained under Article XIV. This is in line with Article V, Section 3(a) which directs that the use of the Fund's resources should assist a member to resolves its balance of payments difficulties in a manner consistent with the purposes of the Fund. The Fund has also addressed these measures in its surveillance and provided TA to members to facilitate exchange system reforms and acceptance by members of obligations under Article VIII.

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both exchange restrictions and MCPs, because Article VIII, Section 3 states that if a member is engaging in multiple currency practices on the date when it joins the Fund, the member concerned must consult with the Fund as to their progress removal "unless they are maintained or imposed under Article XIV, Section 2, in which case the provisions of Section 3 of that Article shall apply."

[24] The following countries still rely on the transitional arrangements under Article XIV as of the date of this paper: Afghanistan, Angola, Bhutan, Bosnia and Herzegovina, Burundi, Eritrea, Ethiopia, Iraq, Liberia, Maldives, Myanmar, Nigeria, Sao Tome and Principe, Somalia, Syrian Arab Republic and Turkmenistan. However, many of these countries no longer maintain any MCPs or exchange restrictions under Article XIV.

[25] Such measures would also be subject to the provisions of Article VIII, Section 2(a).

[26] Article XIV, Section 3. The Fund has not articulated criteria for making such representations to members.

[27] Decision No. 1034-(60/27), adopted June 1, 1960, stated that the Fund "… *is prepared to consider with members the ways and means of achieving elimination of such measures as soon as possible*."

[28] Acceptance of Article VIII, Section 2, 3, and 4, as a practical matter, encourages the removal of all measures maintained by the member under Article XIV.

Multiple Currency Practices and Surveillance

29. Article VIII, Section 3 and Article IV are also closely related. Under Article IV, Fund members undertake to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates, and to observe several, specific obligations with respect to its domestic economic, financial and exchange rate policies.[29] For its part, the Fund is required to exercise surveillance over each member's policies. Article VIII, Section 3 is designed to help further that goal. To assist surveillance, both the Integrated Surveillance Decision ("ISD") and its predecessors have recognized several indicators which may suggest the need for additional consultations between the Fund and a member in order to ensure that the member is in compliance with its Article IV obligations. While the obligations under Article VIII, Section 3 are "in addition" to members' obligations under Article IV, both provisions deal with members' exchange rate policies. The Second Amendment eliminated the explicit link between the two articles with respect to permissible spreads (see above) but close links remain. In particular:

- While members have the freedom to determine their exchange rate arrangements, this does not permit members to engage in MCPs.[30]
- If substantial spreads arise in the market but do not give rise to MCPs (e.g., because they do not arise as a result of official action), the Fund may call on a member to consult with it under the obligation to collaborate with the Fund under Article IV.[31]
- MCPs may be considered in assessing indicators that may signal the need for additional discussion of compliance with the Principles for the Guidance of Members' Policies under the ISD.
- The approval criteria for MCPs echo the provision of Article IV, Section 1(iii) that prohibits members from manipulating exchange rates to gain an unfair competitive advantage over other members.

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[29] Under Article IV, Section 1, Fund members 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 Article IV.

[30] The Legal Aspects Paper, p. 26.

[31] Before the Second Amendment, on several occasions the Fund relied on the members' obligation to collaborate set forth in Article IV to either call on or recommend to members that they take certain actions or refrain from taking actions in order to achieve the objectives set forth in this provision. See *Article IV of the Fund's Articles of Agreement – An Overview of the Legal Framework*, June 28, 2006, pp. 9-11.

30. In principle, both MCPs and exchange restrictions must be covered in Article IV consultations.[32] In light of the importance of MCPs and exchange restrictions for surveillance, as part of the Article IV consultation staff must determine whether a member has introduced or continues to maintain MCPs or exchange restrictions that require Fund approval or under Article XIV. MCPs and exchange restrictions are required to be identified in the staff report, and the staff appraisal should make a recommendation concerning Board approval. Staff should inform members that failure to notify and seek Fund approval would be a breach of their obligation under the Articles.[33]

Box 4. Consultations Under Article IV, Article VIII, and Article XIV

Consultations under Articles IV, VIII and XIV: The Integrated Surveillance Decision (ISD) provides that, in principle, consultations under Article IV shall include the regular consultations under Article VIII and Article XIV, and shall take place annually.[1] During an Article VIII consultation, the Fund assesses any measures (i.e., exchange restrictions and MCPs) maintained by the member which are subject to IMF approval under Article VIII, Sections 2 and 3, and may decide to approve such measures. Under Article XIV, members are required to consult annually as to the further retention of any measures maintained under this article (i.e., those restrictions or MCPs that were in effect on the date it became a member of the Fund). This requirement ceases once the member no longer maintains such measures.

The modalities for concluding these consultations differ, as follows:

- *Article IV*: Article IV consultations are typically concluded by way of a summing up, rather than a formal Board decision.
- *Article VIII*: Where approval of an exchange restriction or MCP is not being sought, no formal Board decision is taken. The Board makes a finding of an exchange restriction or MCP in the summing up when it endorses the conclusions of staff set forth in the staff appraisal. Where staff recommends approval of measures subject to Article VIII, and the Board agrees, a formal Board decision is taken.
- *Article XIV*: A formal Board decision is required to conclude the consultation.

[1] Decision No. 15203-(12/72), adopted July 18, 2012, as amended.

[32] The Integrated Surveillance Decision provides that "[i]n principle, the consultations under Article IV shall comprehend the regular consultations under Articles VIII and XIV, and shall take place annually." See Decision No. 15203-(12/72), adopted July 18, 2012, and *Guidance Note for Surveillance Under Article IV Consultations*, March 20, 2015, p. 35.

[33] Further, under Article VIII, Section 5, each member has an obligation to provide to the Fund national data on: (i) buying and selling rates for foreign currencies, and (ii) exchange controls, i.e., a comprehensive statement of exchange controls in effect at the time of assuming membership in the Fund and details of subsequent changes as they occur.

FUND POLICY ON APPROVAL OF MULTIPLE CURRENCY PRACTICES

31. **While the Fund has consistently discouraged members from using MCPs, it may temporarily approve MCPs if certain criteria are met.**[34] The Fund is prepared to grant approval for MCPs introduced or maintained for balance of payments if the measures are temporary and are being applied while the member is endeavoring to eliminate its balance of payments problems, and provided they do not give the member an unfair competitive advantage over other members[35] or discriminate among members. With respect to MCPs imposed for non-balance of payments reasons, approval may be granted if the practices do not materially impede the member's BOP adjustment, do not harm the interest of other members, and do not discriminate among members.[36] As the approval policy for exchange restrictions does not allow for approval for non-balance of payments reasons, if an exchange measure gives rise both to an MCP and an exchange restriction, such measure currently can only be approved if it is introduced or maintained for balance of payments reasons.[37]

32. **Approval for MCPs is generally granted for a one-year period, to provide for regular review by the Executive Board in the context of Article IV consultations.** In 1998 a minor amendment was proposed to Decision No. 6790 to allow longer approval periods on a case-by-case basis, when the authorities have decided to discontinue the practice, but legal commitments have already been made and must be carried out. This would be the case where the authorities have, for example, formally eliminated a foreign exchange guarantee scheme but there remain outstanding commitments which had been made under such scheme. Therefore, paragraph 5 of Decision No. 6790 was amended to allow a longer approval period "where the practice is maintained only for existing arrangements and for a specified period of time". This is the only amendment to Decision No. 6790 since 1981.

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[34] For example, a 1984 review of experience with multiple exchange rate regimes reiterated that members' reliance on multiple exchange rate regimes was not a desirable policy option, and where such regimes were in existence, concrete plans should be put in place for the elimination of these schemes (see *Review of Experience with Multiple Exchange Rates* March 19, 1984 and March 20, 1984). The review further indicated that previous experience with multiple rate regimes indicated that these regimes had been used as a substitute for or to postpone necessary policy adjustment. Such regimes also tended to be accompanied by quantitative FX restrictions and undermined confidence in the member's economic policies.

[35] This criterion echoes the prohibition to manipulate exchange rates set forth in Article IV, Section 1(iii).

[36] Decision No. 6790-(81/43), adopted March 20, 1981, as amended.

[37] Other approval criteria are also not identical. See Section IV.D of the Main Paper.

IMPLICATIONS OF IMPOSITION OF MCPs

33. An unapproved MCP is a breach of a member's obligations under the Articles and therefore could lead to the imposition of sanctions under Article XXVI, Section 2(a), which sets out possible the legal consequences of a breach of obligation (i.e., ultimately, compulsory withdrawal). In practice, many Fund members have maintained MCPs which would have required approval by the Fund, and have either not requested temporary approval for such MCPs, or the Fund has not approved their maintenance. This places them in breach of their obligations under the Articles. While it would be possible for the Fund to establish a policy framework under which members in breach of their obligations respecting MCPs (or exchange restrictions) would be subject to escalating remedial measures such as a declaration of censure or noncooperation (similar to the procedure for breaches of obligation under Article VIII, Section 5),[38] to date the Fund has opted for a collaborative approach and has refrained from applying the sanctions available under Article XXVI, Section 2(a) in such cases.[39] Indeed, Management has not to date issued a "complaint" to the Executive Board, the first step in applying sanctions under Article XXVI, Section 2(a), alleging that a member has breached its obligations in respect to Article VIII, Section 3.[40]

34. Additionally, MCPs can have implications for observance of conditionality under Fund arrangements. Since 1980, Fund arrangements have included a standard continuous performance criterion that prohibits the introduction or modification of MCPs during the period of the arrangement, which has since been extended to other Fund arrangements and non-financing instruments.[41] The introduction or modification of an MCP during a Fund arrangement blocks a member's right to make purchases or request a disbursement in the absence of a waiver of non-observance by the Executive Board.

[38] The Decision on Strengthening the Effectiveness of Article VIII, Section 5 (Decision No. 13183-(04/10), adopted January 30, 2004, as amended), introduced an escalating series of steps to be followed in the event of non-compliance with Article VIII, Section 5. To date, two members have been subject to the escalating sanctions provided for under this Decision.

[39] The Fund decided early in its history to take a collaborative approach to dealing with members with MCPs. Ten years after the Fund articulated its first definition of an MCP, over half of the membership maintained MCPs, due to the continued reliance on multiple rate systems. The Fund decided to intensify collaboration with members to assist in the simplification and elimination of multiple rate systems, including in the form of technical assistance in the preparation of programs and measures directed toward exchange simplification. To further support the collaborative approach, in 1960, the Fund adopted its policy on approval of MCPs, which allowed MCPs to be approved for both balance of payments and non-balance of payments reasons. See *Review of Fund Policies on Multiple Currency Practices*, January 10, 1957, noting that MCPs continued to be used by 38 of the Fund's 60 members; and Decision No. 649-(57/33), adopted June 26, 1957.

[40] Rule K-1 of the IMF's Rules and Regulations. Under Rule H-2 of the IMF's Rules and Regulations, it would, however, be open for another member to bring a complaint against a member alleging a breach of the latter's obligations under the Articles.

[41] See *Form of Stand-by and Extended Arrangements*, May 13, 1980, as updated by Decision No. 10464 (-(93/130), adopted September 13, 1993. The same performance criterion is included in Extended Credit Facility and Stand-by Credit Facility arrangements under the Poverty Reduction and Growth Trust, as well as the Policy Coordination Instrument and Policy Support Instrument and arrangements under the Precautionary and Liquidity Line.

MCPs AND CAPITAL TRANSACTIONS

35. Article VIII, Section 3 prohibits members from maintaining unapproved MCPs, but does not specify whether this obligation applies only to current transactions or to capital transactions as well. In contrast, Article VIII, Section 2 prohibits members from imposing, without Fund approval, restrictions on payments and transfers for current international transactions (as defined in Article XXX(d)), Article VIII, Section 3 does not specify the range of transactions which fall within its ambit. As MCPs may apply both to current and capital transactions, the lack of specificity in the Articles has been the source of a long-standing discussion in the Fund, with staff and the Board historically differing in their views.

36. Since the early days of the Fund, staff has taken the position that Article VIII, Section 3 prohibits members, unless authorized under the Articles, from engaging in discriminatory currency arrangements and multiple currency practices that relate solely to capital transactions. A key issue in this regard is the relationship between Article VIII, Section 3 and Article VI, Section 3, which allows members, with few limitations, to "exercise such controls as necessary to regulate international capital movements."[42] Staff's position, first articulated in 1955,[43] was based on the view that member's obligations under Article VIII, Section 3 form part of their obligations concerning exchange rates, exchange stability, and promoting orderly exchange arrangements, as spelt out in Article IV. As these obligations were considered fundamental to the Articles and as members' obligations under Article IV are not limited only to policies related to current transactions, the scope of these obligations should not be circumscribed by Article VIII, Section 3. Finally, a distinction between current and capital transactions is not always easily identifiable, given that under Article XXX(d), several transactions which would be considered "capital transactions" are considered current for the Fund's purposes.

37. Staff's position has not been shared by the Executive Board, which has discussed this matter on several occasions. In 1956, staff's position was discussed and ultimately rejected by the Committee on Interpretation.[44] With respect to discriminatory currency arrangements, the Committee considered that Article VI, Section 3 authorizes members to engage in such arrangements related solely to capital transactions whenever such arrangements "may reasonably be needed". With respect to MCPs related solely to capital transactions, the Committee was unable to reach a conclusion: while not concluding that Article VIII, Section 3 "authorized" members to engage in MCPs applicable solely to capital transactions, the Committee noted that the issue was "complex" in that it involved the "relationship" between Article VIII, Section 3 and "the provisions of

[42] Those limitations are that controls over capital movements cannot be exercised "in a manner which will restrict payments for current transactions or which will unduly delay transfers of funds in settlement of commitments, except as provided in Article VII, Section 3(b) and in Article XIV, Section 2".

[43] *Legal Aspects of Regulations of International Capital Movements*, November 17, 1955; and *Controls on Capital Transfers*, February 8, 1956.

[44] *Capital Movements – Legal Aspects of Fund's Jurisdiction Under the Articles*, February 21, 1997, Supplement 3, p. 9.

the Fund Agreement with regard to rates"[45] and proposed to "keep this aspect of the problem under consideration". The issue was later discussed in 1979 during the discussion of the changes to the MCP policy post-Second Amendment. At the time, staff maintained their earlier views and noted that "the changes in Article IV made by the Second Amendment should not be taken to justify the argument that Article VI, Section 3 authorizes the use of multiple currency practices to control capital movements without the approval of the Fund under Article VIII, Section 3".[46] The Fund considered MCPs applicable solely to capital transactions again in two sets of Board meetings in 1984 and 1985, but no consensus emerged.[47] As a result, while staff identifies MCPs applicable to capital transactions in Article IV consultation reports, no finding of a breach of obligation is made and they are not subject to Fund approval.[48]

38. In the latter half of the 1990s, the Executive Board discussed an amendment to the Articles of Agreement that would have transformed the Fund's formal role in capital account liberalization and capital account issues in general. The amendment contemplated two fundamental changes. First, the Fund would be endowed with the explicit purpose to promote the liberalization of capital movements. Second, the Fund would assume jurisdiction over the capital account, establishing as a general rule that member countries would be prohibited from imposing restrictions or MCPs on certain types of international capital movements without the approval of the IMF. However, after the advent of the Asian crisis in 1997, support for the proposal waned and the amendment to the Articles failed to materialize.[49]

39. In 2012 the Fund adopted its Institutional View on liberalization and management of capital flows. The institutional view (IV) does not change the rights and obligations of members under the Fund's Articles and as such has the status of policy advice. It does, however, acknowledge a potential overlap with Article VIII, Sections 2 and 3. In this regard, the IV provides that it does not alter the Fund's jurisdiction or policies under Article VIII, Section 2(a) and 3.[50] Beyond this statement, the IV did not expressly consider the Fund's jurisdiction over MCPs related solely to capital transactions.

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[45] *Report No. 7 – Controls on Capital Transfers*, EBD/56/71, July 11, 1956, p.3.

[46] The Legal Aspects Paper, p. 25.

[47] *Review of Experience with Multiple Exchange Rate Regimes*, March 19, 1984; and *Multiple Currency Practices Applicable Solely to Capital Transactions*, January, 16, 1985.

[48] *The Chairman's Summing Up at the Conclusion of the Discussion on Multiple Currency Practices Applicable Solely to Capital Transactions*, February 25, 1985; and *Executive Board Minutes of the Discussion on Multiple Currency Practices Applicable Solely to Capital Transactions*, February 13, 1985.

[49] *Capital Account Convertibility and the Role of the Fund - Review of Experience and Consideration of a Possible Amendment of the Articles*, February 5, 1997; and *Capital Movements - Legal Aspects of Fund Jurisdiction Under the Articles*, February 21, 1997.

[50] The IV provides that, "as the Articles define "payments for current transactions" to include certain items that, from an economic perspective, are capital in nature, CFMs that restrict the making of payment and transfers for any of these transactions would continue to be subject to the Fund's Article VIII jurisdiction and prior approval. See *The Liberalization and Management of Capital Flows – An Institutional View*, Revision 1, para. 62.

MCPs AND THE WTO FRAMEWORK

40. As discussed in the Main Paper, the prohibition of MCPs in the Fund's Articles was to address wide-spread harmful exchange and trade practices during the pre-Second World War period. As MCPs may be considered a discriminatory trade practice, the concept of an MCP is relevant under the legal framework of the World Trade Organization (WTO). MCPs arising from export subsidies or exchange taxes are generally prohibited under the WTO legal framework. However, MCPs maintained by countries in accordance with their obligations under the IMF Articles of Agreement, i.e., that are temporarily approved by the Fund under Article VIII or maintained under the transitional arrangements of Article XIV, are not subject to discipline under the WTO legal framework.

41. To avoid inconsistent treatment of measures that may fall within the jurisdictions of both the Fund and the WTO, the WTO defers to the Fund's determination on the consistency of such measures with the Fund's Articles. In this regard, the two key legal instruments of the WTO legal framework – the General Agreement on Trade in Goods (GATT) and the General Agreement on Trade in Services (GATS) --provide that:

- Under GATT Article XV, 9(a), the use of "exchange controls or exchange restrictions" in accordance with the Fund's Articles does not violate the GATT. The term "exchange controls or exchange restrictions" is understood by the WTO to extend to MCPs as a form of what they consider to be an exchange restriction. Thus, GATT Article XV, 9(a) safeguards the use of MCPs by Fund members that are in accordance with the Fund's Articles. GATT Article XVI (Ad Article XVI) indicates that the prohibition of export subsidies does not preclude a country's use of "multiple rates of exchange in accordance with" the Fund's Articles. GATT Article VIII (Ad Article VIII) also provides that the prohibition of exchange taxes or fees does not preclude the use of "multiple currency exchange fees for balance of payments reasons" if maintained in a manner consistent with the Fund's Articles.

- Under GATS Article XI, paragraph 2, nothing in the GATS can "affect the rights and obligations" of Fund members under the Fund's Articles, including the use of exchange actions which are "in conformity" with the Fund's Articles. The "rights" of members are understood as the rights to impose or maintain all exchange measures, including MCPs, that are consistent with the Fund's Articles. Thus, GATS Article XI ensures that the use of MCPs which have been approved by the Fund would be consistent with the member's obligations under the GATS.[51]

42. Historically, there has been close cooperation between the Fund and the WTO on matters of mutual interest. This cooperation is enshrined in the 1996 Cooperation Agreement, which calls for the Fund and the WTO to cooperate in the discharge of their respective mandates

[51] According to Article XI a WTO member "shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions" except under WTO provisions to safeguard the country's balance of payments (GATS Article XII) or "at the request of the Fund" (Article VI, Section 1 of the Fund's Articles).

and to consult with each other with a view to achieving greater coherence in global economic policymaking.

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REVIEW OF THE FUND'S POLICY ON MULTIPLE CURRENCY PRACTICES: INITIAL CONSIDERATIONS—ECONOMIC CONTEXT AND EXPERIENCES—BACKGROUND PAPER II

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REVIEW OF LITERATURE AND COUNTRY CASES: 1925–1983[1]

This chapter describes the corrective and distortive effects of multiple currency practices (MCPs) using country case studies. MCPs have been used for two main purposes: (i) stabilization of short-term BOP pressures; and (ii) revenue mobilization or resource allocation. While MCPs have had partial success in the short term in stabilizing the BOP position and capital flows, they have been associated with adverse effects in the medium to long term, especially where these systems have become a long-lasting aspect of the country's exchange arrangement. Since MCPs can affect relative prices, they also have the potential to adversely affect other countries through trade and investment channels.

A. MCPs in Literature and Country Case Studies: 1925–1983

1. This chapter describes the corrective and distortive effects of MCPs using selected country case studies over the period 1925–83.[2] The literature has traditionally taken a "first-best" approach on the issue, and denounced all distortions as having negative effects. The chapter intends to take a "second-best" approach, and evaluate how MCPs may have helped to correct market imperfections as well as whether they have exacerbated or led to other distortions—both in the short term and long term. In addition, the appropriateness of MCPs in correcting market imperfections could depend on persistency of external shocks.

2. MCPs implemented in a range of middle income countries with differing degrees of trade and financial openness are studied.[3] Table 1 summarizes the findings of MCP episodes in previous studies that we have examined. Specifically, the country case studies covered by our literature survey are: Argentina (1981 and 1982), Costa Rica (1980–83), Cuba (1925–50s), Honduras (late 1930s–50), Indonesia (1950s and 1960s), Jamaica (1977–80), Mexico (1982), the Philippines (1951–65), Romania (late 1970s–80), Turkey (late 1970s-80), and Venezuela (early 1960s). In our survey, we have focused on selected countries that have been found by the academic literature and past IMF papers to have used systems of multiple exchange rates for current transactions. Not all of these countries have necessarily been identified by the IMF as having had a multiple currency practice.

[1] Prepared by Tamon Asonuma, Swarnali Ahmed Hannan, Callum Jones, Suman Basu (all RES) and Silvia Sgherri (SPR).

[2] MCPs became less prevalent after the 1980s due to both increased flexibility of exchange rates and increased capital mobility and there is limited additional studies in the literature since then.

[3] We include Romania (late 1970s–80) as a representative country with limited trade and financial openness.

B. Why and How Have Countries Imposed MCPs?

3. MCPs are generally imposed to mitigate BOP pressures and/or capital flow volatility (de la Torre and Ize 2013; IMF 1984a; Kiguel and O'Connell 1994).[4,5] Typically, an MCP is introduced in countries hit by a large negative external shock. These countries were also typically facing underlying vulnerabilities, including expansionary fiscal policies and/or rapid domestic credit expansion under a fixed exchange rate regime. The deterioration in the terms of trade and surge in the demand for foreign assets triggered by financial repression and/or unsustainable macroeconomic policies placed substantial pressures on exchange rates, in some cases leading to a substantial depreciation of the exchange rate. Jamaica in 1977–80 and Venezuela in early 1960s are representative episodes of MCPs having been imposed following deterioration in the terms of trade (IMF 1984b; Woodley 1964).[6]

4. MCPs have also been imposed to achieve revenue mobilization or special resource allocation objectives (IMF 1984a; Sherwood 1956). Countries have often used multiple exchange rates when the problem of finding sources of revenue to finance rapidly-increasing government expenditure is acute (e.g. Cuba, the Philippines and Venezuela).[7] The use of multiple rates is preferred over taxation for two main reasons. First, the administration of multiple rates is easier when compared to the administrative difficulties of direct taxation (export and import taxes) particularly when state capacity is weak (Fleming 1974; Dornbusch 1986). Second, revenue collection through multiple rates can be sizable, especially in the near term. In addition, MCPs are used for special resource allocation purposes in order to promote specific categories of FX receipts or to curb certain FX expenditure.

5. Exchange taxes, export taxes/subsidies, and import surcharges have also given rise to MCPs. Honduras introduced a tax on all FX purchases, while the Philippines introduced it on FX sales (Vinelli 1951; Sherwood 1956). Similarly, Nicaragua implemented two surcharges, one on semi-essential and the other on nonessential imports (Sherwood 1956). Meanwhile, Indonesia introduced a tax on the basic rate, export taxes/subsidies, and import surcharges—together with export inducement certificates and FX entitlements (Kanesa-Thasan 1966).

6. Market structure and segmentation due to exchange controls can help explain the emergence and persistence of multiple exchange rates. IMF (1984b) finds that market

[4] Lizondo (1987) shows theoretically that a once-and-for-all devaluation of the official exchange rate, without any accompanying policy changes, has only a transitory effect on the differential between the free and the official exchange rates and on the balance of payments. On the contrary, an increase in the rate of crawl of the official exchange rate is shown to have permanent effects on the both the differential between the exchange rates and the balance of payments.

[5] MCPs are also adopted in response to the volatility of capital flows or one-way pressure on the capital account, particularly during periods of exchange rate volatility.

[6] IMF (1984a) finds that episodes in Costa Rica, Dominican Republic, and El Salvador also fall in this category.

[7] The tax revenue obtained from MCPs was 4.6, 20.5, and 5.2 percent of total revenue in Cuba, the Philippines, and Venezuela, respectively, over the years 1951–54.

segmentation due to exchange controls resulted in multiple exchange rates in Argentina, Jamaica, Mexico, Romania and Turkey in late 1970s and early 1980s. For instance, the exchange market in Jamaica was split in to a "basic" market for essential import payments, government transactions, and most transactions of the bauxite-exporting sector, and a second market where all other transactions were conducted at a depreciated rate. The same market development pattern was witnessed in Cuba and Venezuela in pre-WWII periods (de la Torre and Ize 2013; Woodley 1994).

C. Near-term Corrective Effects of MCPs

7. MCPs had some success in the short term in stabilizing the BOP position and capital flows. As Dornbusch (1986) describes, theoretically, MCPs that increase effective import prices relative to export prices, ceteris paribus, should lead to improved trade and current account balances, primarily through a reduction in imports.[8] As an example, Costa Rica experienced a sharp decline in import volumes and stable export volumes (Figure 1) after it further tightened the restrictiveness of its trade and exchange rate system with a number of measures including MCPs between 1980–83 (IMF 1984b). In the case of Venezuela in the early 1960s, acute BOP difficulties were mitigated at least temporarily under MCPs and exchange controls (Woodley 1964). In a similar vein, MCPs used in Mexico in 1982 successfully insulated the economy from the impact of unsustainable capital flows (including sudden stops and reversal) and prevented further capital flight (IMF 1984a, 1984b).

8. In doing so, MCPs helped manage the trade-off between inflation and unemployment as part of the macroeconomic adjustment. MCPs can at best partially insulate domestic prices from foreign shocks in the short term (Ghei and Kiguel 1992).[9] At least temporarily, MCPs in Argentina and Mexico in 1981–82 and Venezuela in the early 1960s successfully reduced the pressure to tighten monetary policy in an environment of financial distress while protecting the BOP by mitigating the transmission of external shocks to domestic prices. The countries examined, thus, appear to have had more control over domestic inflation, largely avoided a sharp drop in real wages, and were better able to stabilize output.

9. In some cases, MCPs improved the revenue-raising powers of the government. Even when the exchange tax or exchange spread is very small, multiple rates are, in general, not a small source of revenue. This, in turn, results in sizable revenue collection in comparison with revenue from other individual tax sources.

[8] Sherwood (1956) also notes that the exchange tax imposed in the Philippines in 1952 helped to restrain the effective demand for imports, which was noted as an important consideration of the authorities during a time of BOP difficulties.

[9] Ghei and Kiguel (1992) mentions that parallel FX market can also provide insulation—though limited—in the short term.

D. Distortive Effects of MCPs

10. The imposition of MCPs may hurt long-term growth. IMF (1984b) compares the macroeconomic developments of a group of non-oil developing countries with MCPs to that without such practices during the period 1979–82. It finds that real output growth was lower in three out of the four years and inflation was higher in all four years in countries with MCPs. Both export and import volumes were lower for the MCPs group, leading to a lower ratio of the current account deficit to exports of goods and services.

11. One reason for this finding is the distortive effect of MCPs on the export sector. Dornbusch (1986) outlines how an MCP can cause expenditure reducing effects through the implicit taxation associated with multiple exchange rates. Simultaneously, MCPs can also cause expenditure switching effects through the explicit changes in relative prices. Therefore, the exchange rate spread, by acting as a tax on exports and a subsidy on basic imports, can undermine a country's exporting industries as well as import-substituting industries affected by the subsidy on imports.[10] This results in resource misallocation, and a loss of economic growth and job creation. Representative episodes of these distortions include Argentina and Mexico in the early 1980s and Venezuela in the early 1960s (Kiguel and O'Connell 1994; Woodley 1964).

12. In addition, MCPs may incentivize socially-inefficient activities. The exchange rate spread can give rise to a wedge between private and social interests, resulting in socially destructive rent seeking activities (de la Torre and Ize 2013). Furthermore, the complete segmentation of exchange rates cannot be implemented in practice, with different rates giving opportunities for illegal leakage, weakening the effectiveness of dual exchange rates partly due to the over-invoicing of imports and under-invoicing of exports (Fan 2004).

13. The use of MCPs to raise tax revenue generates a negative incidence on domestic consumers. Sherwood (1956) emphasizes that the incidence of the tax would fall not only on importers but also on domestic consumers through higher prices. The tax might have been transferred to domestic consumers in the form of reduced receipt amount, since foreign investors may respond negatively to the tax on the remittance of profits abroad.

14. Countries have faced difficulties in removing MCPs, potentially delaying needed macroeconomic adjustment. Venezuela in the early 1960s was a prominent case where the MCP was maintained over prolonged periods and necessary fiscal and monetary adjustments were not implemented (Kiguel and O'Connell 1994). Similarly, MCPs in Cuba and in the Philippines became important sources of general revenue and it was consequently difficult to abolish the tax in the

[10] MCPs could be designed in a such way that they may exclude intermediate goods which, in turn, affect export and FX-generating sectors.

absence of clear alternative revenue sources (Sherwood 1956).[11,12] In line with this, the 1984 IMF review of experiences documented that multiple rates had in many cases become a long-lasting device for the postponement of necessary policy adjustments, rather than a transitional arrangement:[13]

- **These systems have often become a long-lasting aspect of members' exchange arrangements.** In the bulk of instances, multiple rates were seen as temporary, but their elimination proved difficult and in the case of a number of members, they were maintained over an extended period of time. For example, from 1970 to 1983, 12 members had multiple exchange rates continuously, and for a total of 61 members maintaining explicit MCPs at some time over this period, the average duration for which they were in existence was five years.[14]

- **MCPs have been implemented using complex mechanisms subject to numerous modifications.** Dual FX markets used to delay an exchange rate adjustment require either direct intervention in the second market or manipulation of the markets through administrative means, and experience pointed to associated shortcomings. Generally, the requirement to surrender FX at the official rate was rarely effective enough to prevent FX holders from profiting at the market rate.[15] In these cases, as well as in others[16], either the rate in the second market was pegged, or the system was modified in other ways. In general, this occurred only after a substantial amount of official FX had been used to support the rate in the second market, further stimulating capital outflows. Some countries introduced administrative exchange allocations when the rate in the free market depreciated significantly relative to the official rate (e.g., Argentina, 1981 and 1982). Partial free market mechanisms have also on occasion tended to contribute to capital outflows, as excessive exchange rate instability developed in the second market.[17] In some instances, the failure of partial free markets to achieve the objectives sought by the authorities led to their rapid dismissal (Argentina, 1981 and 1982; Costa Rica, 1980).

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[11] Cuba implemented a 0.25 percent tax on most money sales in 1925, gradually increasing it to 2 percent by 1943, and levied on most sales of FX and exports of securities. In 1956, the receipts from this tax contributed about 5 percent of general government revenue.

[12] Exchange tax in the Philippines was initially intended in 1951 to be a temporary two-year measure, but was extended at various times, and by 1954 it raised about 20 percent of the total revenue.

[13] The review examined the historical importance of multiple exchange rates, discussed the main reasons adduced by members that resorted to multiple exchange rate systems in recent years and described the outcome of these systems (*Review of Experience with Multiple Exchange Rate Regimes*, March 19, 1984; and *Review of Multiple Exchange Rate Regimes – Background Information*, March 20, 1984).

[14] See *Review of Experience with Multiple Exchange Rate Regimes*, March 19, 1984.

[15] Examples are the Dominican Republic (under-invoicing of minor exports), Sierra Leone, Somalia (leakages associated with inflows of private remittances), and Sudan.

[16] For example, Costa Rica between 1976 and 1980; Ecuador between 1981-82; and Sudan, 1982.

[17] For example, Argentina between 1981 and 1982; Costa Rica between 1980-82; and Ecuador between 1981-82.

- **Frequent changes to the system generated significant uncertainty.** On occasion, rather than undertaking a depreciation of the official exchange rate, a second exchange market was established. This temporary exchange market was set up with the intention of adjusting the official exchange rate toward the exchange rate in the second market, either directly or through shifts of transactions from one market to the other, or both. This strategy has often resulted in a more appropriate average exchange rate—from that standpoint, it helped the exchange rate system perform a more effective role in the adjustment process. However, when the shift of transactions involved unduly frequent changes or when the adjustments in the official exchange rate were perceived to be insufficient, the strategy proved counterproductive for exporters and importers.[18] Expectations were formed regarding exchange rate changes which tended to disrupt foreign trade, as the anticipation of a more depreciated exchange rate in the future encouraged exporters to withhold shipments and repatriation of receipts, and incentivized importers to stockpile and over-invoice imported goods. These speculative trade activities exerted added pressures on official international reserves.

E. Cross-Border Spillovers

15. MCPs also have the potential to adversely affect other countries via trade and investment channels. MCPs may be implemented to differentiate among trade partners and transfer additional payment burden, i.e. tax incidence to non-preferred partners. This may distort trade between the imposing countries and non-selected trade partners and generate retaliatory measures if used in a persistent fashion. The Romanian experience in the late 1970s–80, where a number of implicit rates were applicable to different transactions, is a representative case (IMF 1984b). In a similar vein, MCPs negatively influence investment: in the Philippines, a tax on the remittance of profits abroad was paid by foreign investors and potentially deterred foreign investment (Sherwood 1956).

16. In this context, the literature draws broad conceptual parallels between the effects of MCPs and those of direct and indirect tax/subsidy policies. Reviewing MCPs for commercial transactions across countries from the 1960s, Dornbusch (1986) notes that MCPs change the relative prices of exports and imports, with the economic consequences comparable to tax and subsidy policies that change relative prices in the same way. Furthermore, Fleming (1974) notes that taxes and subsidies on capital transactions, if enforced by exchange controls, would resemble MCPs in potential effectiveness.[19]

[18] For example, in Costa Rica, several stabilization plans were initiated over the 1980s, but uncertainties surrounding exchange rate determination under a dual market system probably contributed to exacerbate domestic inflationary expectations and pressures. See also the examples of Romania and Sudan.

[19] Fleming (1974) also notes that taxes and subsidies on capital transactions would be far less flexible than MCPs and would therefore be less effective in mitigating short-term BOP imbalances.

F. Balancing Corrective and Distortive Effects of MCPs

17. In summary, the review of the literature on MCPs and the experience with their operation seem to concur that these practices are likely to have partial success in the short term but negative effects in the long term. They have had partial success in the short term in stabilizing the BOP position and capital flows, as their insulation of domestic prices from foreign shocks has not been fully undone by the market. However, they have also been associated with adverse effects in some instances and have had a deleterious impact on long term growth in nearly all the cases where they have been imposed in a persistent manner. They also have the potential to adversely affect other countries via the trade and investment channels. As such, the Fund should continue to discourage members from using MCPs, but there could be instances where those practices would be accepted, on a temporary basis, as a partial step in the process of undertaking the required exchange rate adjustment or to complete the necessary market development process. The desirability of avoiding reliance on multiple exchange rates or of establishing concrete plans for their elimination where they already existed should also be reiterated.

Figure 1. Costa Rica MCP (1980–83)

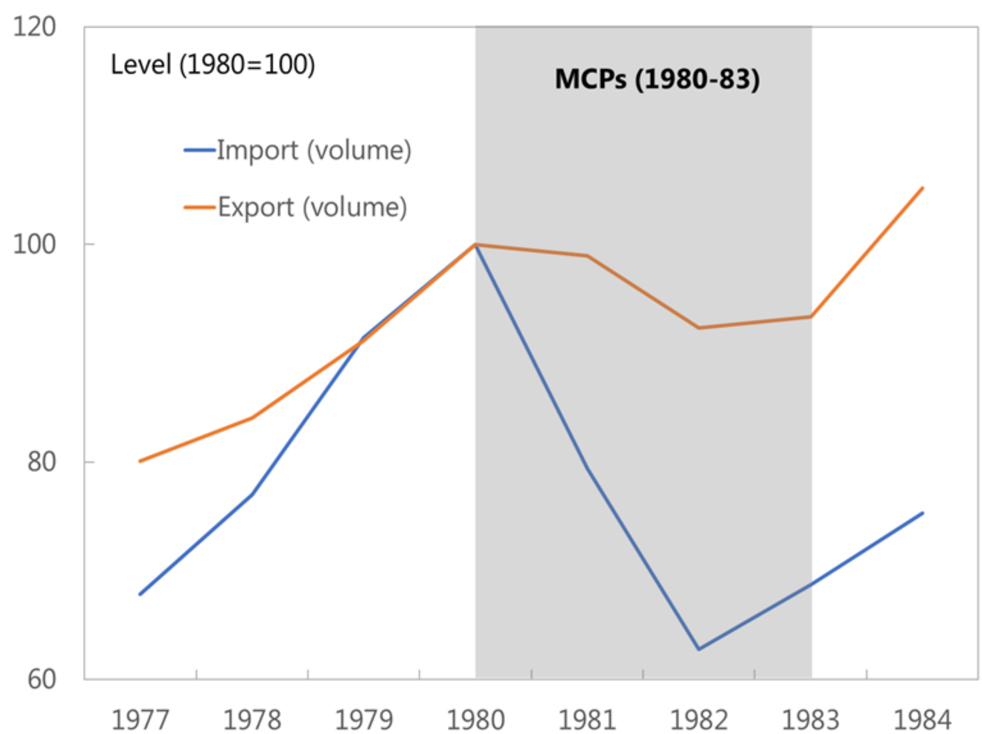


Table 1. MCP Episodes: Selected Country Case Studies

	Time Period Considered	Market Inefficiencies / Policy Actions	Policy Purposes / Rationales	Distortions in the Domestic Economy
Argentina	1981 and 1982	Market segmentation: a commercial market for trade transactions, a financial market, and other markets for specific transactions	Mitigating BOP pressure / avoiding speculative capital outflows	(i) Resource misallocation, (ii) undermining market confidence, (iii) amplifying uncertainties engendered by financial and other policies, (iv) substantial net capital outflow
Costa Rica	1980-83	Import surcharges together with restrictions on imports, including outright import prohibitions and requiring import deposits in advance	Mitigating BOP pressure	(i) Change in relative price of exports and imports, (ii) strengthening of balance of payments
Cuba	1925-50s	Up to 2 percent tax on exchange sales and securities exports	Raising revenue	(i) Change in relative price of exports and imports, (ii) relatively small strengthening of balance of payments, (iii) reduction in foreign investment
Honduras	Late 1930s-50	Tax on all purchases of foreign exchange	Specific resource allocation purposes (permitting exporters to retain exchange)	(i) Only a small fraction of total exchange receipts traded due to an increase in illegal trading
Indonesia	1950s and 1960s	Fixed exchange rate component (including the basic rate, export taxes/subsidies, and import surcharges) and a variable component (including export inducement certificates and foreign exchange entitlements)	Anti-inflationary purposes / insulating essential good imports from the depreciation in the import rates	(i) Distortions in domestic production and distribution, including failure of realizing the full potential of export-import sectors, (ii) a significant increase in foreign exchange in black market, (iii) less equal real income distribution due to increased black market activity, (iv) decline in export earnings
Jamaica	1977-80	Market segmentation: a "basic" market for essential import payments, government transactions, and most transactions of the bauxite-exporting sector and a second market for all other transactions	Mitigating BOP pressure	(i) Resource misallocation and distortions in growth, (ii) postponement of the necessary macroeconomic adjustment
Mexico	1982	Market segmentation: one exchange market with the preferential rate for servicing of external debt, priority imports, exports of petroleum, and the net borrowing operations of the public sector and one market with free market rates for all other transactions	Mitigating BOP pressure / avoiding speculative capital outflows (including preventing the subsidization of further capital flight)	(i) Resource misallocation and distortions in growth, (ii) postponement of the necessary macroeconomic adjustment
Philippines	1951-65	Exchange tax of 10-17 percent levied on the peso value of sales of foreign exchange	Raising revenue / market structure purpose (monitoring the demand for imports)	(i) Protective effects on specific industries, (ii) deterrent to exports which contain imported materials, (iii) tax incidence on importers and pass-through on consumption prices, (iv) deterrent to foreign investment
Romania	Late 1970s-80	Market segmentation: a number of implicit rates were applicable to different transactions (exchange transactions, non-exchange transactions)	Trade partner differentiation / insulating domestic prices from foreign shocks	(i) Resource misallocation and distortions in growth, (ii) deterrent to productions which contain large imported materials, (iii) deterrent to foreign investment
Turkey	Late 1970s-80	Market segmentation: multiplicity of exchange rates resulting from broken cross rates, from the imposition of premia or levies on various exchange transactions and from exchange retention schemes	Special resource allocation purpose (permitting exporters to retain exchange and receive tax rebates, allowing importers to receive stamp duties and facilitating remittances)	(i) Resource misallocation and distortions in growth, (ii) postponement of the necessary macroeconomic adjustment
Venezuela	Early 1960s	Market segmentation: two free exchange markets, with one separated from the other by restrictions on the quantities that commercial banks could sell for certain items	Mitigating BOP pressure (continued decline of foreign exchange reserves)	(i) Distortions in oil companies' operations, (ii) certain exchange transactions conducted in the stock market, instead of banks

Sources: de la Torre and Ize (2013) for Cuba; IMF (1984b) for Argentina, Jamaica, Mexico, Romania and Turkey; Kanesa-Thasan (1966) for Indonesia; Kiguel and O'Connell (1994) for Argentina, Mexico and Turkey; Sherwood (1956) for the Philippines; Vinelli (1951) for Honduras; Woodley (1964) for Venezuela.

RECENT EXPERIENCE WITH MCPs: 1980–2017[20]

This chapter discusses experience with the Fund's MCP policy since the last comprehensive review in 1981, including the frequency and evolution of MCPs, their characteristics and main economic drivers, and their treatment under the Fund's approval policy.

A. Evolution of MCPs and Macro Drivers

18. Multiple currency practices (MCPs)[21] were a frequent feature of exchange systems in the early history of the Fund, but their use dropped significantly by the early 1980s. In the latter half of the 1950s and 1960s, as international trade and payment conditions improved, considerable progress had been made toward reducing the incidence of MCPs. After the abolishment of the par value system, the incidence of MCPs increased moderately in the mid-1970s, primarily for balance of payment reasons. In the early 1980s, about 30 percent of Fund members maintained MCPs.

19. MCPs resurged in the early 1980s among emerging and developing countries (EMDCs), against the background of widespread balance of payment (BOP) difficulties. In the aftermath of the second oil shock in 1979, the global economy was hit by recession at the beginning of the 1980s. Tight monetary policy in advanced economies to rein in inflation affected the global economy and led to higher debt payment burdens for EMDCs that had borrowed in foreign currency to finance elevated oil imports in the 1970s. In addition, sharp appreciation of the U.S. dollar (about 50 percent between 1979 and 1985), reflecting high interest rates, put further pressure on the BOP of EMDCs that had used the U.S. dollar as their nominal anchor. Eventually, many EMDCs suffered from debt crises in the early 1980s, and resorted to MCPs. Correspondingly, the incidence of new MCPs during this period was concentrated among EMDCs, in particular in Latin America, while the reliance on multiple exchange rates continuously declined among advanced economies (Figures 2 and 3). The incidence of MCPs peaked in 1986, with about a third of EMDCs maintaining MCPs. As the global economy recovered toward the mid-1980s and the U.S. dollar depreciated after the Plaza Accord in 1984, MCPs started to decline.

20. Developments in the number of countries with MCPs in the 1990s and early 2000s reflect a global liberalization trend. Many EMDCs gradually opened up their markets and liberalized their exchange systems, particularly in Europe owing to regional integration efforts. A

[20] Prepared by Chikako Baba (MCM). The construction of the MCP database was assisted by Svetlana Popova (MCM) and Amanda Kosonen (external expert).

[21] There is no established database on MCPs before 2005, when the AREAER database started to include the information on "restrictions and/or multiple currency practices" as reported in the last IMF staff report issued by December 31 of the respective year. The information on multiple currency practices for 1980-2005 was collected from IMF staff reports by reviewing all reports that contained the term "multiple currency practice(s)". The information on MCPs is based on the last IMF staff report issued to the IMF Executive Board by December 31 of the respective year. Therefore, the first year of an MCP in the data corresponds to the first year of identification (rather than the actual introduction of the measure), and the year of elimination corresponds to the first year that the elimination was reported in an IMF staff report.

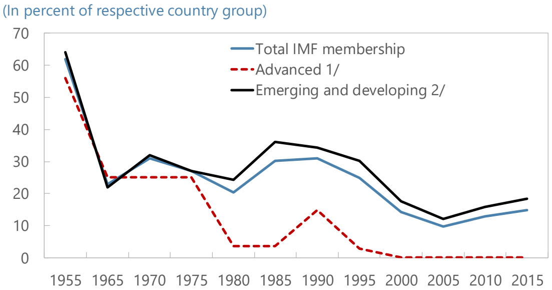
sharp rise in the number of countries with MCPs in the first half of the 1990s reflected the expansion of IMF membership; 25 new members joined the IMF by 1993, following the collapse of the communist bloc in 1989. Many of these MCPs were eliminated gradually in the 1990s. Advanced economies stopped using MCPs by 2000, and many EMDCs eliminated MCPs and accepted Article VIII obligations in the late 1990s. The share of countries with MCPs in international trade declined from about 12 percent in 1982 to about 4 percent by 2017. The decline is more evident among EMDCs, with the share of countries with MCPs falling from 40 percent to 10 percent of EMDC trade during the same period. Likewise, countries with MCPs represent an increasingly smaller share of world GDP. Between 1982 and 2017, their share dropped from 14 percent to 5 percent of world GDP and from 56 percent to 13 percent of EMDC GDP.

Figure 2. Incidence of MCPs in Fund Membership

MCPs have become less common over time….

Incidence of MCPs in Fund Membership, 1955-2015

(In percent of respective country group)

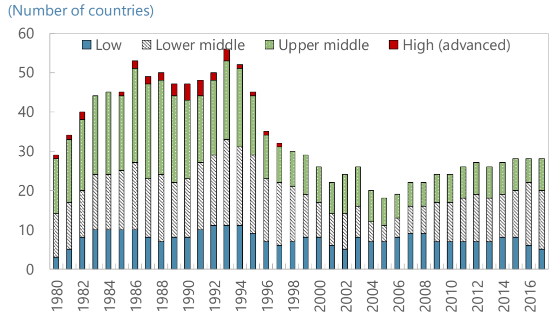


Sources: IMF (1984) and IMF staff estimates based on staff reports.
Notes: Country grouping is based on WEO as of end-2016 for 1980-2015.
1/ Corresponds to "Industrial countries" between 1955 and 1975.
2/ Corresponds to "Developing countries" between 1955 and 1975.

…with recent MCPs mainly concentrated among LIDCs.

Countries with MCPs, by income level

(Number of countries)

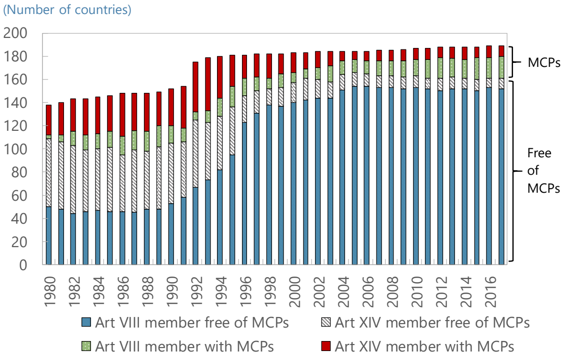


Sources: IMF staff reports and staff calculation. Country grouping is based on World Bank as of 2016, with an exception that "upper middle" group includes high income emerging market economies based on WEO groups.

Members with MCPs represent a smaller fraction of the membership than in the 1980s and 1990s.

IMF membership and MCPs

(Number of countries)

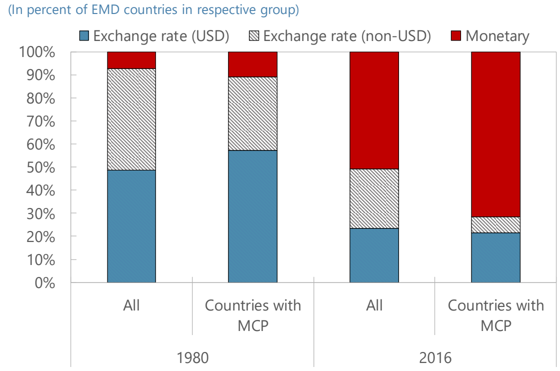


Sources: IMF staff report and staff calculation

In the past, countries with MCPs tended to have less flexible exchange rates.

Nominal anchor for EMDCs

(In percent of EMD countries in respective group)

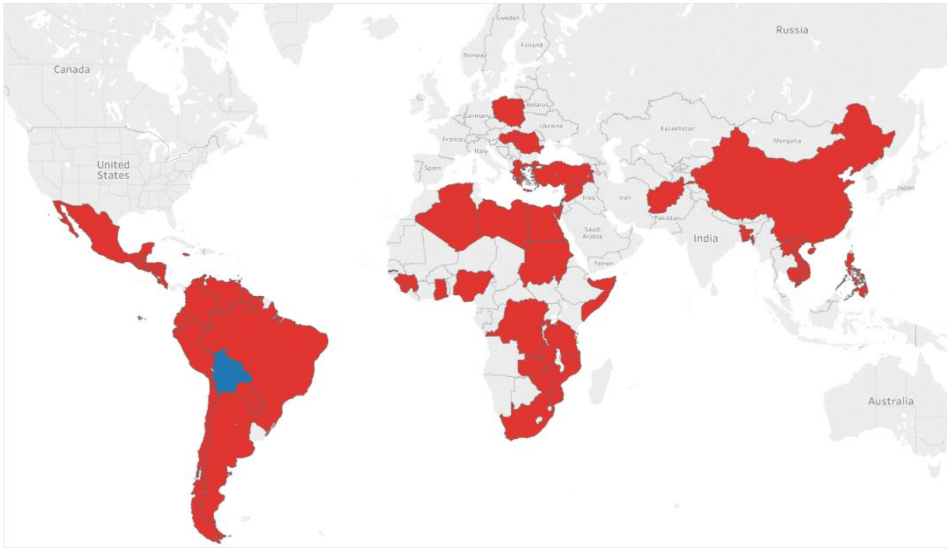


Sources: IMF staff reports, AREAER database, staff calculations.

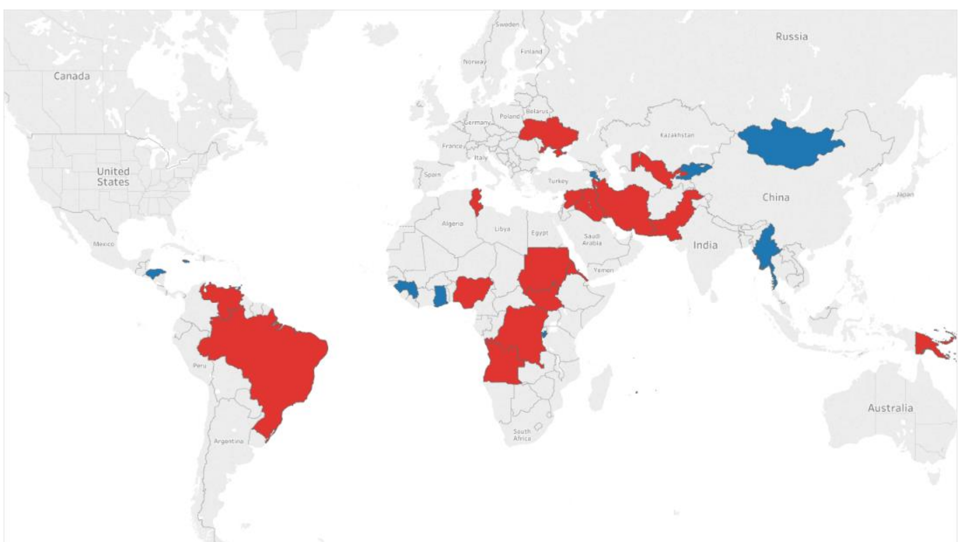
Figure 3. Incidence of Multiple Currency Practices by Region

MCPs were concentrated in Latin America in the 1980s, but have since gravitated toward Africa and the Middle East.

Countries with MCPs in 1986



Countries with MCPs in 2017



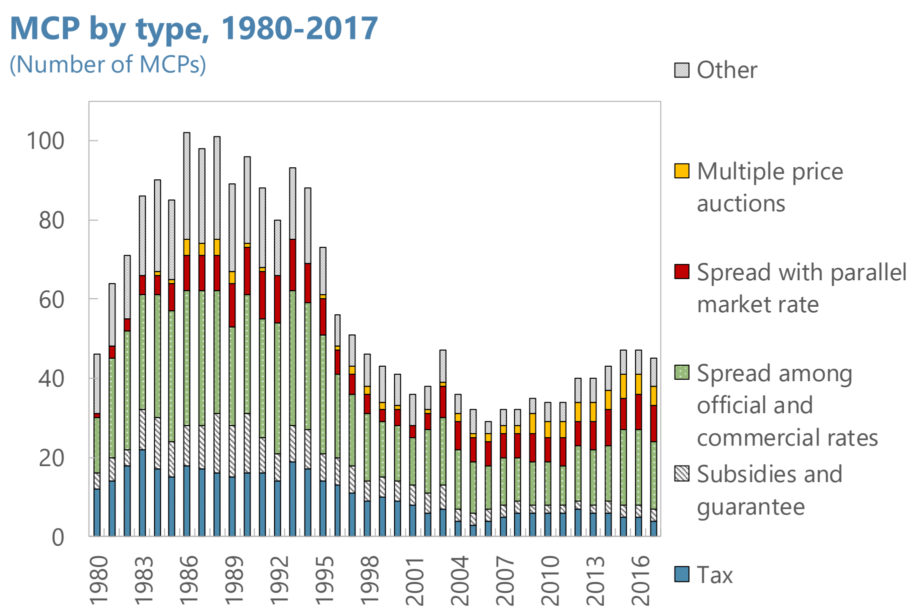
Source: IMF staff reports and staff calculation.
Notes: Countries in red maintained actual MCPs, while countries in blue maintained only potentiality-based MCPs. The findings are based on the latest Article IV staff reports issued before end-2017.

21. Since the Global Financial Crisis (GFC), the number of countries maintaining MCPs increased marginally. At the end of 2017, there were 45 MCPs maintained by 28 countries. Recent MCPs have been found mostly in lower-middle and low-income countries, in particular in Africa and Middle-eastern regions. Some countries introduced MCPs as a result of BOP difficulties and foreign exchange shortages, but many MCPs (in particular potentiality-based MCPs) arose in efforts to move toward a more liberalized FX market. Typical examples are MCPs arising from FX auctions and the computation of official exchange rates under a floating exchange rate regime. Reflecting these, MCPs have become more prevalent among countries with more flexible exchange rate arrangements.

B. Characteristics and Frequency of MCPs

22. The evolution in the number of MCPs roughly follows the number of countries maintaining MCPs. The total number of MCPs declined from its peak of 102 in 1986 to a trough of 29 in 2006, while it has been on a rise recently (Figure 4). Countries that are found to maintain MCPs usually maintain more than one, with the average number of MCPs per country ranging between 1 and 2.

Figure 4. Type of MCPs



Sources: IMF staff reports and staff calculation.
Notes: "Other" includes, among others, MCPs from a BPA, margin requirement, and broken-cross rates.

23. The composition of MCPs has changed since the 1980s. The use of the foreign exchange system to discriminate against certain transactions (e.g., subsidies, tax, guarantees) has declined. At the same time, the share of MCPs arising from the spread between the formal and the parallel markets has remained sizeable (9 MCPs as of end-2017). MCPs have been found increasingly on the basis of "potentiality" i.e., due to the lack of a mechanism to keep the spreads among different market segments within a two percent range, without necessarily observing *de facto* spreads among the effective rates (Figure 5). Recently, the share of such MCP findings represent about one third of total MCP findings.

24. Potentiality-based MCPs arising from lagged calculation of official rates represent a sizable share of recent MCP findings (10 out of 13 MCPs related to official transaction rates). An MCP arises when the authorities use an official exchange rate that is calculated based on the previous day's market transactions for official transactions, thus creating the potential for a deviation of two percent or more between the official and market exchange rates. Often, the use of lagged official exchange rates reflects the lack of capacity to calculate the market average exchange rate on a real-time basis.

25. Another type of potentiality-based MCP that has recently become common arises from multiple price auctions. Official multiple price FX auctions give rise to an MCP unless there is a mechanism in place which ensures that exchange rates of accepted bids do not deviate by more than 2 percent. Countries typically operate auctions to distribute FX among market participants when FX supply is concentrated or accrues to the authorities and the interbank market is shallow; a multiple price format is often used to promote responsive bidding behavior and facilitate price-discovery. MCPs arising from multiple price auctions were rare before 2000. Examples of MCPs from multiple price auctions in the 1980s included those found in Jamaica, Bolivia, Chile, and Ghana. Recently, multiple price auctions have been used more widely, in part reflecting the efforts to introduce a currency price mechanism in countries with less developed FX markets. Since 2000, a total of 15 countries have been found to maintain MCPs from multiple price auctions due to the potential spread among winning bids (Angola, Burundi, Egypt, Guinea, Honduras, Hungary, Jamaica, Mongolia, Mozambique, Myanmar, Nigeria, Sierra Leone, Uganda, Ukraine and Zimbabwe).

26. The use of taxes on the conversion or transfer of FX as well as subsidies and guarantees for BOP and non-BOP reasons has been declining.

- *Tax*: Of 67 MCPs arising from exchange taxes in the last 35 years, about a third target invisible transactions, such as foreign exchange for travel and profit remittances. Many of these taxes were introduced for fiscal reasons and/or maintained at the time when the country joined the IMF, while some countries also introduced such taxes to address BOP difficulties. About half of tax-related MCPs target trade transactions (import or export), often introduced in the context of BOP pressures. Examples include taxes on FX proceeds from exports, and taxes on purchase of FX for import transactions to dampen demand for FX. MCPs arising from taxes targeting trade transactions were often eliminated along with trade liberalization, or replaced by a trade tariff. Some taxes introduced for fiscal reasons were similarly eliminated as the capacity for tax collection improved.

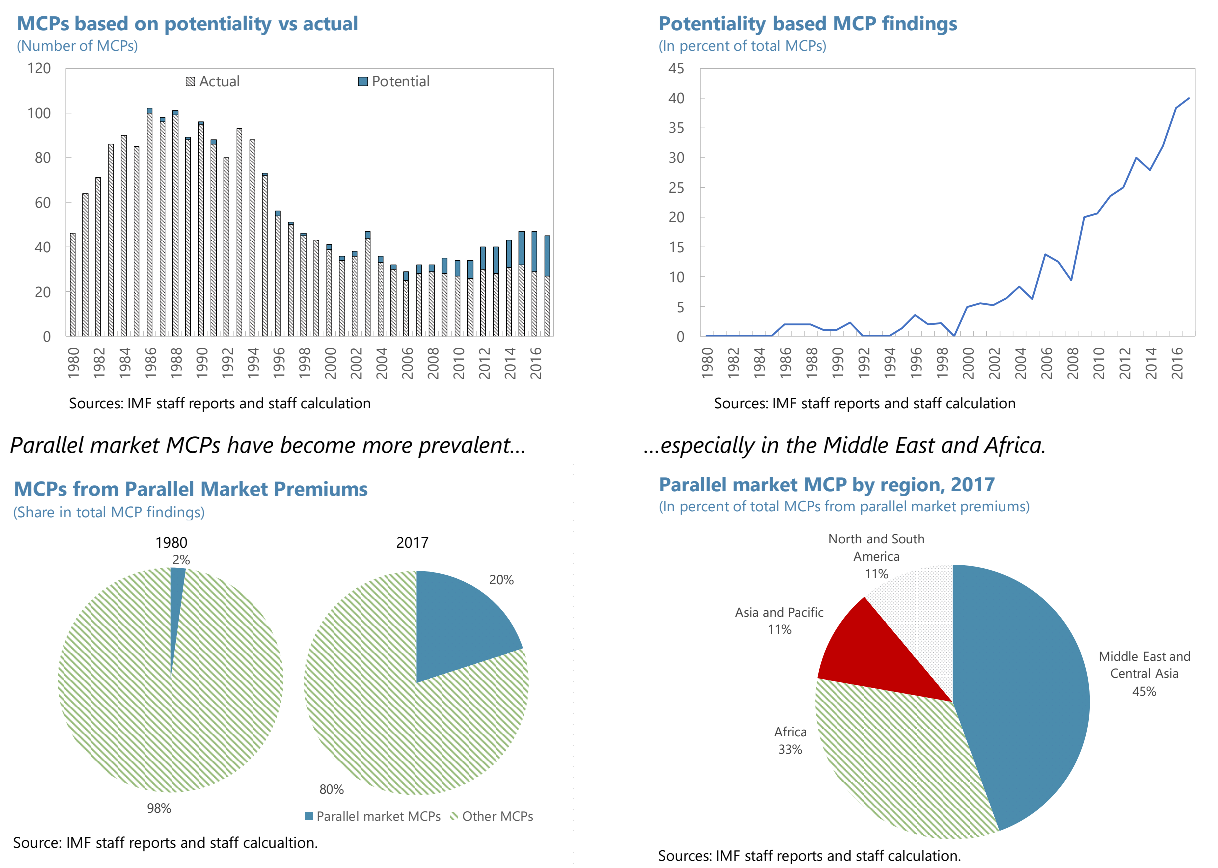
- *Subsidies:* Only one subsidy-related MCP is currently in place, as a result of a legacy of schemes introduced several years ago. Exchange subsidies used to be employed as part of trade policy, with incentives given to non-traditional export sectors to promote exports, often when exchange rates were overvalued. However, the use of such subsidies largely disappeared by 2000, with only a few new MCP findings since (Rwanda, Zimbabwe, Colombia, Iran, and Mauritius[22]).

- *Guarantees*: Exchange rate guarantees are used to reduce FX risks for certain transactions or entities, sometimes following a large devaluation. MCPs from exchange rate guarantees typically disappear naturally as guarantee schemes expire. Currently there is only one such MCP (Tunisia).

- *Preferential exchange rates*: Some countries resorted to preferential exchange rates when faced with BOP pressures. In such cases, different exchange rates were applied to FX purchases for essential and non-essential imports, or for the surrender of (certain) export proceeds.

Figure 5. Composition of MCPs

The composition of MCPs has changed… *…with an increase in "potentiality-based" MCPs*



27. MCPs arising from spreads between official and parallel markets remain sizable.[23] These MCPs frequently arise from the imposition of exchange restrictions in the official market (e.g.

[22] According to the guidelines of the Exchange Rate Support Scheme, no claims under the scheme will be considered after July 16, 2018.

[23] Parallel markets in this context refer to FX markets that are not regulated or closely supervised by the authorities, and can include transactions by FX bureaus or illegal black markets for FX.

FX rationing and/or prioritization). The geographical focus shifted from Latin America, where such MCPs were prevalent in the 1980s and 1990s due to BOP difficulties, to other regions, most notably to countries in Africa with BOP difficulties typically resulting from fiscal expansion at the end of the 1990s. Recently, parallel market premia emerged in several commodity-exporting countries that experienced terms-of-trade shocks. The removal of MCPs arising from parallel market premia often took place in the process of unifying exchange rates supported by an IMF-supported program.

28. Other types of MCPs have significantly decreased in the last three decades.

- **MCPs arising from margin requirements and unremunerated advanced import deposit requirements** had been frequently used for BOP reasons in the 1980s, but hardly any existed in the 1990s and 2000s.

- **MCPs arising from bilateral payment agreements (BPA) have virtually disappeared**. There were 11 MCPs arising from BPA in the period since 1980, with about half adopted by Central and Eastern European countries under the Council of Mutual Economic Assistance (CMEA) agreement. As these countries established currency convertibility, the relevance of BPAs has declined. Currently, there is only one MCP arising from a BPA (Democratic Republic of Congo).

- **Broken cross rates have been rare and are usually unintentional**. While broken cross rates were often used in the early years of the IMF to implement trade policy, there have been only 10 instances of broken cross rates since 1980. Six of them existed historically (before 1980 or pre-existed when a country joined the IMF). Three cases of broken cross rates have been identified since the mid-1990s (Jamaica, Myanmar and Belarus); they typically arise when the authorities update the official rate only infrequently (e.g. monthly) for less commonly used currencies.

29. MCPs applying solely to capital transactions have also been rare. Some countries maintained a dual exchange system for current and capital market transactions, giving rise to MCPs. Dual systems maintained by Belgium until 1982, and South Africa and countries in its currency zone in the 1980s are typical examples. In both cases the MCPs later became subject to approval as some current transactions were also channeled to the capital market in which exchange rates were determined more freely. These episodes indicate administrative difficulties in separating FX markets for capital transactions from current transactions in practice. There were a few other types of MCPs solely related to capital transactions. For example, MCPs with respect to capital transactions arose from fees under the debt-equity conversion program in Philippines (1979-83), from separate exchange rates on the purchase and sale of proceeds by non-residents in India (1983-87), low premia on FX swap arrangements in Argentina (1983-1990), conversion and cancellation of loans covered by exchange rate guarantees in Argentina (late 1980s), tax on some capital remittances in Mauritius (1991-94), and from FX swap schemes in India (2014).[24]

30. The type of MCP adopted is typically determined by their motivation. Countries facing BOP difficulties and foreign exchange shortages tend to create segmented markets, including illegal

[24] The years in parentheses refer to year of issuance of staff reports that contain information on the MCPs.

parallel markets, by allowing only certain priority transactions to take place at a preferential exchange rate. In similar circumstances, other countries resort to taxes or subsidies to provide specific incentives or disincentives for particular exports or imports to improve their current account balance. Exchange taxes and subsidies were also used to help develop certain export sectors in the 1980s, while the use of MCPs for such purposes has been limited recently. In the absence of BOP difficulties, countries under a transition to more flexible exchange rate arrangement tend to introduce multiple price auctions or use lagged official rates, giving rise to relatively less distortionary MCPs.

C. Approval of MCPs

31. Members have generally quickly eliminated newly identified MCPs, but there are some exceptions. MCPs on average last for about 4.4 years, while the median and mode durations are 3 years and 1 year, respectively.[25] More than 20 percent of MCPs were eliminated in a year after they had been identified. Eight percent was eliminated in less than a year; some of the MCPs were eliminated before they were discussed at the IMF board.[26] The average duration is relatively long because of a few MCPs that lasted for a long time (e.g. among the current MCPs, 2 have been in place for more than 25 years).

32. Long-lasting MCPs are explained by various reasons. Taxes represent the largest group among MCPs lasting more than 10 years, suggesting that the authorities often need time to reform the tax framework before eliminating MCPs. It may also indicate the difficulty of giving up the convenience of collecting taxes through the exchange system. MCPs arising from potential spreads owing to lagged official exchange rate calculation may also be difficult to eliminate quickly if the FX markets are not yet well-developed to provide reliable market quotes instantaneously. Elimination of legacy schemes which give rise to MCPs (e.g. guarantee scheme, inoperative BPA) may also take a long time due to the length of the commitment. In some extreme cases, long-lasting MCPs merely reflect delayed assessments by the IMF, especially in countries where regular surveillance was interrupted (e.g. Eritrea, Somalia, Syria). In these cases, MCP findings remain until formal assessments revise them even though underlying measures may have been eliminated.

33. The Executive Board has sparingly approved MCPs, with only about a third of MCPs approved for at least one year during their existence. Among a total of 506 MCPs reported in staff reports since 1980, 108 measures (21 percent) were approved, 79 measures (16 percent) were approved only for a part of their duration, 298 measures (56 percent) were never approved, and the rest did not require approval by the IMF (i.e. MCPs solely related with capital transactions or Article XIV MCPs).

[25] MCP findings are often made with a lag when IMF staff do not have sufficient information to finalize assessments. Hence, the duration of underlying measures that give rise to MCPs can be longer than these years.

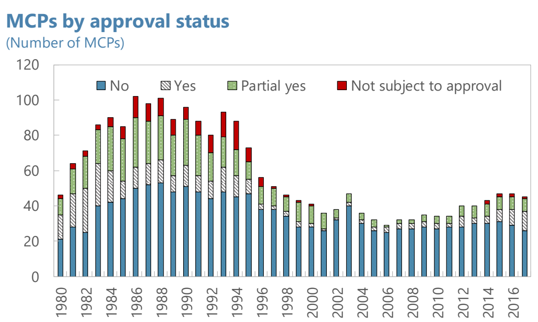
[26] IMF staff reports do not necessarily mention MCPs that were introduced and removed between two consecutive staff reports, so the actual number of MCPs that were eliminated shortly after their introduction may be larger.

34. In the majority of cases, approval was not granted because the MCP was not considered temporary. When IMF staff reports elaborate on the reasons for not recommending the measure for approval, they refer to the lack of a clear time-table for the removal of the MCP in more than 70 percent of cases. MCPs are typically considered temporary when the authorities commit to a timetable for removal. For that reason, it often happens that an MCP is approved in the last few years before elimination even though it was not approved initially. The second most frequent reason for non-approval is that the authorities did not request approval.[27] About 7 percent of MCPs were not approved because they were discriminatory (e.g. BPA).

35. Approved MCPs differ by type, likely reflecting the ease of eliminating the measures and how distortive they are. More than a half of parallel market MCPs and MCPs from rates for official/specific transactions were not approved. However, MCPs from multiple price auctions, which typically were based on potentiality, were more likely to be approved. Measures that usually require more time for preparing for removal (such as tax or guarantee) tend to be approved at a later stage when the authorities can commit to a plan for their removal, even though they were initially not approved.

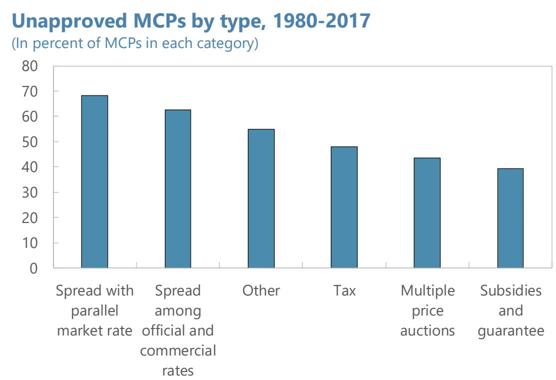
Figure 6. Approval of MCPs

About a third of MCPs were approved....



Sources: IMF staff reports and staff calculations.
Notes: "Partial yes" refers to MCPs that were approved for a partial duration. MCPs "not subject to approval" include Article XIV MCPs and MCPs solely related to capital transactions.

...With MCPs arising from parallel markets and difference between official and/or commercial rates less likely to be approved.



Sources: IMF staff reports and staff calculation.

D. MCPs and Article VIII Acceptance

36. Countries availing themselves of the transitional arrangements of Article XIV are more likely to maintain MCPs, but only a handful of these MCPs are Article XIV MCPs. Of 171 IMF

[27] There are overlaps, because the authorities may not seek approval unless they consider they satisfy conditions for approval (e.g. time-table for removal).

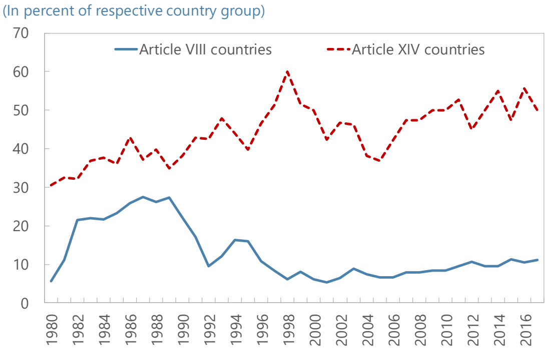
members that have accepted Article VIII status[28] by 2017, 19 (11 percent) maintained MCPs, while 9 out of 18 members with Article XIV status (50 percent) maintain MCPs.[29] Of the MCPs maintained by Article XIV members, only a small fraction is covered by the transitional arrangements of Article XIV. In fact, currently, South Sudan is the only country that maintains an MCP under Article XIV. Article XIV MCPs were more prevalent in the 1980s and 90s, with a sizable rise in the early 1990s when countries of the former communist bloc joined the IMF. Following the elimination of these measures, Article XIV MCPs disappeared by 2000, until South Sudan joined the IMF in 2012 with Article XIV MCPs.

Figure 7. MCPs and Article VIII Acceptance

MCPs are more common among Article XIV countries….

Share of countries with MCPs, by Article VIII status

(In percent of respective country group)

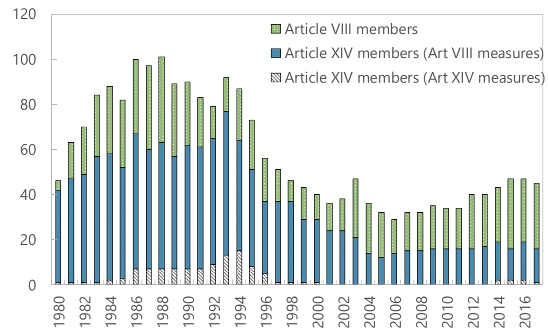


Sources: IMF staff reports and staff calculations.

With most MCPs by Article XIV countries subject to approval under Article VIII

Number of MCPs, by Article VIII status

(Number of MCPs)



Sources: IMF staff reports and staff calculations.

28 Members that chose to avail themselves of the transitional arrangements under Article XIV may maintain and adapt to changing circumstances exchange restrictions and MCPs that they had in place when they joined the Fund. The provision applies only to the measures maintained at the time of membership, and all members are subject to Article VIII obligations with regard to new exchange restrictions and MCPs as soon as they join the Fund; no formal acceptance of these obligations is necessary. Once the member formally notifies the Fund of acceptance of Article VIII obligations, it can no longer rely on Article XIV, Section 2 to maintain or adapt the exchange measures it had in place when it joined the Fund.

29 As of end-2017, the member countries that make use of the transitional arrangements under Article XIV are Afghanistan, Angola, Bhutan, Bosnia and Herzegovina, Burundi, Eritrea, Ethiopia, Iraq, Kosovo, Liberia, Maldives, Myanmar, Nigeria, São Tomé and Príncipe, Somalia, South Sudan, Syria, and Turkmenistan. Kosovo accepted Article VIII obligations in January 2018.

MACROECONOMIC PERFORMANCE OF COUNTRIES WITH MCPs: 1980–2016[30]

A. Introduction

37. MCPs are often associated with poor economic performance, but the evidence is scarce and causality is difficult to establish. Distortions and short-term benefits of MCPs are documented in the literature (see first chapter of this paper). However, it is difficult to establish causality because of strong endogeneity in economic factors related to causes and consequences of MCPs.

38. This chapter empirically investigates causes and consequences of MCPs in the past 30 years. Macroeconomic indicators in countries with MCPs behave differently (see Figure 1 in the main paper). The analysis uses a unique database on MCPs constructed from IMF staff reports from the last 30 years. The data cover 154 IMF member countries (excluding advanced economies)[31] from 1980 to 2016, annually. For countries that joined the IMF at a later time, the data starts from the year of membership. One set of regressions analyzes macroeconomic factors that are associated with the introduction and maintenance of MCPs. Another set of regressions analyzes growth and inflation impacts of maintaining MCPs. Overlap in variables in the two analyses indeed suggest strong endogeneity in causes and consequences of MCPs.

B. Performance Before MCPs

39. The analysis shows that countries introduce and maintain MCPs when faced with macroeconomic concerns (Table 2). Evidence from a logit data model shows that factors contributing to a greater probability of maintaining MCPs include high inflation, a depreciating real exchange rate, lower international reserves, and worsening terms of trade. These are typical characteristics of countries with BOP difficulties, and the finding is in line with the notion that countries resort to MCPs under BOP difficulties. In addition, low trade shares[32] and low income levels are also associated with the introduction of MCPs. These appear to be related to other motivations for introducing MCPs, namely trade promotion and low capacity. On the other hand, the analysis

[30] Prepared by Chikako Baba (MCM).

[31] Advanced economies are excluded because their use of MCPs almost disappeared before the analyzed period. The results are qualitatively similar if advanced economies are included.

[32] Trade openness can affect the likelihood of MCPs in different ways. For MCPs introduced to deal with BOP difficulties, countries with higher trade shares would expect greater policy impact of the measure and hence are more likely to introduce MCPs. On the other hand, MCPs introduced to promote trade are more relevant for countries with lower trade shares. The latter impact appears more relevant for MCPs in the early periods (in the 1970s and 80s), and the regression results showing the relationship between lower trade shares and the probability of MCPs only in the early period are consistent with the view that the motivation for MCPs has shifted over time.

does not find a statistically significant relation between the probability of MCPs and GDP growth or the fiscal balance.[33]

Table 2. Logit Analysis: Causes of MCPs, 1980–2016

	(1)	(2)	(3)	(4)
	All MCPs	All MCPs	Actual MCPs	Actual MCPs
Variables				
Growth	0.869	-2.018	0.577	-1.541
	(0.380)	(-0.840)	(0.290)	(-0.720)
Inflation	0.019 **	0.001	0.017 **	0.005
	(2.480)	(0.100)	(2.370)	(0.380)
Δ Real effective exchange rate	-0.012 *	-0.013	-0.009	-0.010
	(-1.770)	(-1.290)	(-1.300)	(-1.050)
Δ Reserves	-0.038 *	-0.045 *	-0.044 *	-0.045
	(-1.740)	(-1.650)	(-1.850)	(-1.440)
Δ Terms of Trade	-0.698	-0.807	-0.961 **	-0.972 *
	(-1.640)	(-1.400)	(-2.290)	(-1.790)
Trade openness	-0.021 **	-0.012	-0.030 **	-0.024 **
	(-2.520)	(-1.220)	(-3.400)	(-2.080)
Current account balance	0.005	-0.011	0.034 *	0.013
	(0.220)	-(0.530)	(1.750)	(0.620)
GDP per capita	-0.447 **	0.005	-0.641 **	-0.206
	(-2.020)	(0.020)	(-2.540)	(-0.860)
Fiscal balance		2.820		2.218
		(1.040)		(0.860)
Observations	3040	2199	3040	2199
Number of countries	126	117	126	117
Country fixed effect	No	No	No	No

Source: IMF staff estimation.

Note: Logit estimation. Advanced economies are excluded from the regressions. All regressors are lagged. Z-statistics are reported in parentheses. The qualitative results remain the same when country fixed effects and year fixed effects are controlled for. ** p < 0.05; * p < 0.1.

C. Performance with MCPs

40. There is a fundamental endogeneity issue in assessing the impact of MCPs, which requires caution in interpreting the results. The endogeneity originates from the observation that countries with macroeconomic concerns and BOP difficulties tend to resort to MCPs. To minimize

[33] The regressions with the fiscal balance are reported separately because inclusion of this variable significantly reduces the number of observations.

the impact, the analysis uses only lagged variables, and includes all regressors that are found to have a relationship with the causes of MCPs in the previous section.

41. Countries with MCPs tend to experience lower growth and higher inflation (Table 3). Linear regression analysis shows that countries with MCPs experience lower growth and higher inflation. In addition, potentiality-based MCPs do not have a significant impact on growth and inflation. Lower growth after the introduction of MCPs is in line with the observation of slower and smaller post-crisis recovery in GDP for countries with MCPs, while there is no marked difference in pre-crisis performance (see Figure 1 in the main paper). Inflation, on the other hand, is both related to factors leading to MCPs and affected by MCPs after the crisis.

Table 3. Regression Analysis: Macroeconomic Impacts of MCPs, 1980–2016

Variables	(1) Growth	(2) Growth	(3) Inflation	(3) Inflation
MCP actual	-0.006 **	-0.006 **	2.600 **	2.552 **
	(-2.470)	(-2.220)	(3.030)	(3.020)
MCP potential		0.009		-1.581
		(1.340)		(-0.460)
Growth	0.290 **	0.290 **	-0.436	-0.441
	(10.080)	(10.100)	(-0.070)	(-0.070)
Inflation	0.000 **	0.000 **	0.720 **	0.720 **
	(-3.110)	(-3.120)	(18.620)	(18.590)
Δ Real effective exchange rate	-0.005	-0.005	-13.838 **	-13.901 **
	(-0.540)	(-0.510)	(-2.640)	(-2.690)
Δ Reserves	0.002 **	0.002 **	-0.190 **	-0.191 **
	(6.630)	(6.640)	(-2.950)	(-3.000)
Δ Terms of Trade	0.022 **	0.022 **	1.591	1.585
	(2.520)	(2.530)	(0.740)	(0.730)
Trade openness	0.000	0.000	-0.014	-0.014
	(1.350)	(1.290)	(-1.340)	(-1.220)
Current account balance	0.000	0.000	-0.042	-0.044
	(0.220)	(0.290)	(-1.250)	(-1.290)
GDP per capita	-0.007 **	-0.007 **	-0.999 **	-0.984 **
	(-4.510)	(-4.540)	(-3.070)	(-3.060)
Observations	3038	3038	3033	3033
Number of countries	126	126	126	126
Country fixed effect	Yes	Yes	Yes	Yes

Source: IMF staff estimation.

Note: All regressors are lagged. t-statistics are reported in parentheses. ** $p < 0.05$; * $p < 0.1$.

SELECTED RECENT MCPs: INSIGHTS FROM SURVEY OF COUNTRY TEAMS[34]

This chapter summarizes the results of a survey of selected IMF teams covering countries that currently have—or recently had—MCPs. The survey was conducted in January 2018, and reflects information on existing or eliminated MCPs as of that date. The surveyed countries with recent MCPs were Iran, Iraq, Maldives, Nigeria, Papua New Guinea, South Sudan, and Sudan. Surveyed countries with MCPs that had been eliminated were Myanmar[35], Sao Tome and Principe, and Suriname. The responses were qualitative, and based on staff assessments of the economic backdrop, policy options, and domestic and spillover consequences of the MCPs. The responses complement the first chapter of this paper, which covered experiences with systems of multiple exchange rates until 1983.

42. In most of the cases, MCPs were introduced to mitigate BOP pressures (Table 4). The conditions that led to BOP pressures included terms of trade shocks (Nigeria, Sudan, Suriname) and weak macroeconomic policies, such as lack of fiscal discipline and monetary financing (Myanmar, Suriname).

43. The official actions that led to MPCs under the survey usually took the form of limiting the availability of FX. Specific measures included limiting the supply of FX at the official exchange rate to commercial banks (Maldives); allocating FX to priority imports (Papua New Guinea); and setting preferential rates for certain imports (Iran).

44. In staff's assessment, MCPs generally did not address the fundamental reasons leading to the BOP pressures. In general, staff recognized the difficult policy trade-offs and implementation challenges typically faced by countries in these situations. In a few cases, they mentioned specific difficulties in avoiding MCPs, for instance due to international sanctions (Iran), or the need for securing foreign reserves to import socially important goods (Papua New Guinea), Nevertheless, staff often found that alternative policies could have been employed, including:

- *Fiscal consolidation and phasing out of monetary financing* (Iraq, Myanmar, South Sudan).
- *Fiscal and economic reform,* including mobilization of non-oil revenues (South Sudan).
- *Increased exchange rate flexibility* (South Sudan).
- *Targeted subsidies to imports,* instead of allocating FX or setting preferential rates for certain imports (Papua New Guinea, Suriname).

[34] Prepared by Masashi Saito (SPR).

[35] Myanmar maintains one MPC from multiple price auctions, but the survey focuses on those eliminated in 2013.

45. According to staff assessment, MCPs were associated with various forms of domestic distortions and external spillovers, including:

- *Decrease in production.* MCPs contributed to: increased unemployment (Papua New Guinea); heightened volatility in exchange rates (Sao Tome and Principe); increased uncertainty of doing business (South Sudan, Sudan, Suriname); shortages in imports of intermediate goods (Papua New Guinea); a loss of export competitiveness (Iran); lower government revenues (Suriname); and reduced incentives for domestic production when imports were subsidized (Iran).

- *Increase in inflation.* This occurred with depreciations in parallel market exchange rates (Nigeria, Sao Tome and Principe, South Sudan).

- *Expansion of informal economy* (Sudan) and *rent seeking and weakened governance* (South Sudan). MPCs also reduced the authority's capacity to monitor FX transactions (Suriname).

- *Crowding out of bank lending*. Instead, banks tried to make profits from the spread between the official and parallel market rates, with adverse impacts on economic and financial sector development (Iraq). Monetary transmission was also impaired in some countries (Maldives).

- *External spillovers.* MCPs contributed to: lower trade and FDI (Myanmar); higher cost of repatriating investment income from abroad (Iraq) and remittances (South Sudan); reducing capital inflows (South Sudan); and distorting trade (Sudan).

Box 1. Survey Questionnaire

Causes:

- Under which circumstances has the country introduced the MCP(s)?
- Are the MCPs related to restrictions on payments for current or capital transactions?
- Had there been previous episodes of using MCPs in the past 10 years? When and under what circumstances?
- Which factors have been contributing to the appearance of MCPs?
- In the country team's view, was the MCP necessary? If yes, why and for how long?
- In the country team's view, could the MCP have been avoided? If yes, how?

Impact on domestic economy and policy responses:

- In the country team's view, how effective have MCPs been in addressing the issue the authorities aimed to resolve? Why?
- What other policies have been put in place to address the issue the authorities aimed to resolve?
- What kind of distortions have MCPs *per se* caused to the domestic economy?
- Which policies have been put in place to eliminate MCPs?

Externalities:

- What distortions have MCPs caused to trading partners and investors?
- How much extra costs do you estimate MCPs have effectively imposed on the country's external trade and finance? In terms of foregone trade? In terms of foregone flows of capital? In political terms?

Table 4. Recent MCPs: Selected Experiences

	Official actions leading to MCPs	Alternative potential policies	Domestic distortions	Externalities
Iran	Providing FX for certain imports at preferential rates	…	Increases pressure on FX reserves; disincentivizes local production of intermediate goods	Lowers export competitiveness; subsidizes industries importing intermediate goods
Iraq	Limit on FX availability	Fiscal consolidation	Crowds out bank lending; restricts financial sector development	Raises cost to repatriating investment income
Maldives	Rationing of FX at official rate to comercial banks	Support demand for local currency	Weakens monetary policy transmission; limits central bank control of FX market	Limited
Myanmar *(eliminated in 2013)*	Limit on FX availability for both residents and nonresidents	…	Increases transaction costs	Discourages FDI and trade
Nigeria	Limit on FX availability	Exchange rate flexibility	Increase in parallel market spread and distortions in economic decision making, likely contributing to higher inflation and lower economic growth	Extended waiting period for repatriation of FX investments
Papua New Guinea	Rationing of FX at official rate	Free auctions and subsidies for crucial imports	Deepens and extends FX shortage; adverse effects on production and employment	Importers face signficant delays; companies face considerable difficulty in obtaining FX to make dividend payments abroad
Sao Tome and Principe *(eliminated in 2011)*	Rationing of FX	…	Higher exchange rate volatility; higher inflation	…
South Sudan	Limit on FX availability	Exchange rate flexibility; reduce inflation by stopping central bank financing of budget	Disintermediation of FX from formal market; high inflation; dollarization; rent-seeking and weakened governance	Subsidizes imports; raises cost of remittances; increases uncertainty in doing business
Sudan	Limit on FX availability; cash margin requirement for most imports	Macroeconomic adjustment	Increases cost of doing business; weakens governance; damages macro credibility; enlarges informal economy	Distorts trade
Suriname *(eliminated in 2016)*	Providing FX at special rates for certain products and economic agents	Adequate response to terms of trade shocks; targeted subsidies	Creates anti-export bias; undermines government revenues; reduces capacity for monitoring of FX transactions	Increases uncertainty in doing business

Souce: IMF country team surveys.

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INTERNATIONAL MONETARY FUND

August 1, 2018

REVIEW OF THE FUND'S POLICY ON MULTIPLE CURRENCY PRACTICES: INITIAL CONSIDERATIONS—METHODOLOGY TO ASSESS MULTIPLE CURRENCY PRACTICES—BACKGROUND PAPER III

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INTRODUCTION

1. **This background paper describes in more detail the proposed new methodology in the Main paper (Review of the Fund's Policy on Multiple Currency Practices: Initial Considerations) to assess exchange rate deviations that may result in multiple currency practices (MCP).** The current methodology relies, for spot transactions, on a uniform two-percent rule for permissible spreads which does not reflect current market realities and does not provide sufficient guidance on the definition of market exchange rates. The new methodology would retain the principle of commercial reasonableness, i.e., differentials in exchange rates arising from official action would only give rise to an MCP if they exceeded what could be attributed to the normal commercial costs of exchange transactions, but would rely on a market-based, country specific market norm instead of the current uniform two percent threshold. The paper also presents some illustrative preliminary results of the proposed methodology on existing country practices based on available information.

2. **The new methodology is expected to help the MCP policy better reflect market realities.** The introduction of a market-based norm is facilitated by developments in foreign exchange (FX) markets, which have contributed to greater uniformity of market practices across jurisdictions, and the availability of granular market data for most IMF members. Adding a tolerance margin for deviations from the market norm remains important to avoid minor deviations leading to MCP findings.

FOREIGN EXCHANGE MARKETS

A. Market and Pricing

3. **Official action can distort the system of exchange rates that is kept unitary by competition in the foreign exchange market.** Competition between intermediaries both in the wholesale and retail markets reduces the opportunities for arbitrage and keeps rates in both markets together. However, it does not lead to a single rate in the foreign exchange (FX) market as each intermediary and each transaction has a slightly different cost structure; rather, it leads to a range of interrelated rates that move together. This range of rates defines the norm for the market. International standards for exchange rate benchmarks usually provide several rates, such as: (i) the average buying (bid) and selling (ask) rates (thereafter bid/ask); (ii) the intraday high (most depreciated) and low (most appreciated) rates (thereafter H/L); and (iii) the market opening and closing rates. Official action can result in exchange rates that do not reflect the cost structure in the FX market and, thus, deviate from the market norm.

4. Price formation in the FX markets differs depending on the settlement date of the transactions. Based on the global financial market standard for settlement dates,[1] staff distinguish between two types of FX transactions: those that settle at or less than t+2 days (spot) and those that settle at more than t+2 days (non-spot transactions). The settlement date affects price formation in these two markets and, thus, the rates in the two markets cannot be directly compared.

Spot Markets: Transaction Settled at Maximum t+2 days

5. The interdealer (wholesale) market is an important component of FX market pricing. FX intermediaries, such as banks, are generally motivated by profits.[2] They intermediate FX transactions to end users (i.e., the retail market), such as importers and exporters, under a no-loss constraint, and close positions arising from transactions with their clients (risk management) among themselves (i.e., the wholesale market). FX intermediaries also transact in the wholesale market to take advantage of arbitrage opportunities (proprietary trading), thereby keeping the system of exchange rates unitary.

6. In the end-user segment, the pricing of FX transactions depends on their size.

- Large transactions, usually with corporations, are dealt with at the banks' treasury level, as are banks' transactions with other intermediaries, because they create positions for the intermediaries that should be managed without delay in the wholesale market to avoid exposure to exchange rate risk. Thus, these transactions are fully integrated in the pricing of the wholesale market rates due to their impact on banks' FX positions.

- Transactions in smaller amounts, typically with individuals, are managed by banks' customer services at the branch level. Branches are assigned a budget and a schedule of rates for the day by the banks' treasury, which depends on how the treasury plans to manage the exposures arising from small size transactions. The rate of retail transactions is the wholesale rate to which the intermediary's overhead costs and profit margins are added, which depends on competition in the retail segments of the market. Based on the settlement date, under the new methodology, FX transactions involving banknotes would be considered a segment of the spot retail market, which have additional costs related to the handling of banknotes compared to electronic payments.[3]

7. Interdealer market rates define all other spot rates where an interdealer market exists. In the review of the MCP policy that started in 1979 (1979 review)[4], staff considered "spot

[1] The definition of spot transactions can be found in the Model Code of the Association Cambiste Internationale, which is the standard benchmark for global FX and OTC markets. (https://acifma.com/Why-The-Model-Code)

[2] State owned banks may have different motivations.

[3] Under the current policy, banknote transactions are considered "other" (i.e., non-spot) transactions.

[4] See Background Paper I.

telegraphic transfers" as the core exchange transaction from which exchange rates for other transactions are derived in all markets. Staff proposes the interdealer market rates as the core exchange rates for spot transactions for three reasons: (i) this is the "real" market on which the spot rates are formed; (ii) this market can be monitored continuously based on reliable benchmarks; and (iii) official actions are typically reflected in wholesale-type transactions.

Non-spot Markets: Transaction Settled at More Than t+2 days

8. The FX non-spot market provides hedging opportunities vis-à-vis exchange rate risk. This market includes various products such as foreign exchange forwards, swaps and options. It can be considered as a market for future exchange rate transactions for which the exchange rate is locked in advance or guaranteed. Consistent with the treatment of spot transactions, the exchange rates prevailing in the wholesale forward market on the day of the transaction are considered as an adequate proxy for commercial reasonableness for forward transactions.

B. Market Development Since 1979

9. A major development since 1979 is the deepening and increasing sophistication of international FX markets. In 1979, the only data available to staff regarding FX market transaction amounts was the USD 5.3 billion daily turnover on the New York stock exchange. Spot, outright forwards, and swaps represented respectively 55.2 percent, 5.3 percent, and 29.5 percent of the total transaction amount. According to the latest BIS "triennial central bank survey" (Table 1), the average daily turnover in the foreign exchange markets was above USD 5 trillion, more than four times its level in 1995, underscoring the rapid development of FX markets in recent decades.

Table 1. Developments in FX Markets

OTC foreign exchange turnover

Net-net basis,[1] daily averages in April, in billions of US dollars — Table 1

Instrument	2001	2004	2007	2010	2013	**2016**
Foreign exchange instruments	1,239	1,934	3,324	3,971	5,355	**5,088**
Spot transactions	386	631	1,005	1,488	2,046	**1,654**
Outright forwards	130	209	362	475	679	**700**
Foreign exchange swaps	656	954	1,714	1,759	2,239	**2,383**
Currency swaps	7	21	31	43	54	**96**
Options and other products[2]	60	119	212	207	337	**254**
Memo:						
Turnover at April 2016 exchange rates[3]	*1,381*	*1,884*	*3,123*	*3,665*	*4,915*	***5,088***
Exchange-traded derivatives[4]	*12*	*25*	*77*	*145*	*145*	***115***

[1] Adjusted for local and cross-border inter-dealer double-counting (ie "net-net" basis). [2] The category "other FX products" covers highly leveraged transactions and/or trades whose notional amount is variable and where a decomposition into individual plain vanilla components was impractical or impossible. [3] Non-US dollar legs of foreign currency transactions were converted into original currency amounts at average exchange rates for April of each survey year and then reconverted into US dollar amounts at average April 2016 exchange rates. [4] Sources: Euromoney Tradedata; Futures Industry Association; The Options Clearing Corporation; BIS derivatives statistics. Foreign exchange futures and options traded worldwide.

Source: Bank for International Settlements.

10. Liberalization of FX markets since 1979 has reduced the number of countries where an interdealer market does not exist. An interdealer market is necessary to close the positions that arise from intermediaries' transactions with their clients. However, monetary authorities occasionally replace the interdealer market by closing intermediaries' position themselves. In the past, this was associated with regulation impeding interdealer market transactions, such as a full surrender requirement of FX export proceeds to the monetary authorities. Trends in FX market liberalization have supported the emergence of wholesale markets in most members. However, there are still cases where wholesale markets do not exist:

- The country has no separate legal tender, i.e., there is no national currency and another country's currency operates as legal tender (14 members).

- Exchange rates are fixed at par or with a very narrow spread between the central banks' FX buying and selling rates (10 members). A meaningful wholesale market is unlikely to emerge in these circumstances.

- The member's FX regulations explicitly or implicitly prohibit interbank transactions. The number of countries having a full surrender requirement to the central bank declined from 22 in 1999 (the first date for which information on surrender requirements is available in the AREAER online database) to 9 in 2016. Similarly, the number of countries with partial surrender requirements to the central bank declined from 44 to 27 during the same period.

11. One issue encountered at the time of the 1979 review was the difference in practices across domestic FX markets. FX market development since 1979 has been accompanied by the standardization of practices across markets that has greatly increased the comparability of FX benchmarks across members, together with technological advancement.

12. Electronic platforms contributed to standardization of transactions and collection of data on market rates. Electronic platforms are the preferred trading channel, with a share above 50 percent for all customer segments, and are available for all instruments and investors across the globe. Spot is the segment with by far the highest fraction of trades conducted electronically, at 64 percent. Due to the practical benefits of electronic execution, such as straight through processing[5], most of the voice trades are, eventually, booked electronically. Some market reports suggest that as much as 95 percent of all spot transactions could, in fact, be electronic.

13. Ascertaining the significance of the banknote segment in the spot market remains a challenge. The 1979 review estimated that the banknote segment amounted to USD 100 million in June 1978 (compared to a 5.3 billion daily turnover for the rest of the market), based on

[5] Straight through processing streamlines the transaction-related processing time. It allows information that has been electronically entered at the trade level to be transferred during multiple points in the settlement process without manually re-entering the same information repeatedly, thus optimizing the settlement process.

information from "New York banknote dealers." Intuitively, staff expected a decline in the relevance of this market segment due to the development of alternative, more convenient, payment methods.

14. Available evidence does not support a definitive conclusion regarding the significance of the banknote segment. There are estimates of the circulation of the euro and the USD outside the euro area and the United States based on banknotes shipments data, but not of market turnover.[6] However, part of the shipment is due to the demand for banknotes as a store of value and, thus, does not necessarily reflect an increase in market turnover. Few countries, usually with a history of important use of FX banknotes in the spot market, publish volumes for this segment. For instance, the volume in one country declined from 2.7 percent of spot transactions in 2003 to 0.5 percent in 2017.

15. While derivatives were not a particular focus of the 1979 review, the development of FX hedging products since 1979 warrants a more detailed discussion in this review. Table 1 shows that all FX derivatives, including forward, swaps, and options experienced a rapid increase in turnover. Foreign exchange swaps account for 47 percent share of the global market, while outright forwards account for 14 percent. FX swaps are mostly traded among intermediaries and used for liquidity management, while forwards are mostly used by end-users.

C. Market Data Availability

16. Availability of wholesale market data based on a standardized methodology increased substantially since 1979. At that time, staff had to interview FX traders by phone to seek their assessment on what was the reasonable bid and ask spreads over the previous 12 months. With this method, only 36 currencies could be included in the 1979 review. Nowadays, standardized exchange rate benchmarks, including bid/ask, high/low, and open/close both on intraday and closing basis, are prepared and published daily by professional international benchmark administrators for all but five IMF members.[7]

17. Staff proposes using Thomson Reuters DataStream as the primary source of information for wholesale exchange rates. For the 14 members, for which data are not available through Thomson Reuters DataStream, data can be sourced from Bloomberg. Both companies prepare reputable, well-known, and widely used international benchmarks for exchange rates. Box 1 describes the methodology used to compute financial benchmarks by Thomson Reuters and Bloomberg.

[6] Estimation of euro currency in circulation outside the euro area, External Statistic Division, European Central Bank, Eurosystem, April 2017. Location of U.S. currency: How much is abroad, Federal Reserve of New York, bulletin, 1997.

[7] Staff conducted a survey of data available at the IMF on (i) interbank market rates; (ii) official rates; and (iii) parallel market rates. It relied on information available to the country teams, including from member countries' authorities. Through the survey, data were made available for four out of the five countries, reducing the list of members with no exchange rate information to one.

18. Both data sources are equally reliable. Both Bloomberg and Thomson Reuters methodologies are subject to independent assessment of their compliance with the international standard for the computation of financial benchmarks of the International Organization of Securities Commissions (IOSCO), thereby ensuring the integrity of data. The ready availability of data from two independent benchmark providers increases the robustness of the proposed methodology.

19. The methodology relies on a predefined order of data sources to limit the risk arising from excessive reliance on a single data source. Data sourcing relies primarily on two independent data providers: Thomson Reuters DataStream is the primary source and Bloomberg is the secondary source. If data become unavailable for a member from the primary source, staff will source data from the secondary source. Both these sources have published independent business continuity plans to ensure uninterrupted services. However, if data for a member from either the primary or the secondary source cannot be used, representative exchange rates from other sources, including from the authorities may be used. Staff will assess the representativeness of exchange rates from such sources based on whether they have been computed in compliance with the IOSCO principles for the computation of financial benchmarks.[8]

20. Anecdotal evidence suggests that the typical difference between wholesale and retail rates is around 70 basis points. There is no standardized benchmark for retail rates, as the focus is on the wholesale segment where price formation takes place. However, central banks publish an average of the intermediaries' FX rates for banknotes for customer information where banknotes play or used to play an important role (Figure 1). The median of the difference between wholesale rates and banknote rates was 70 basis points on March 26, 2018, reflecting overhead costs and the profit margin of intermediaries across countries. Banknote wholesalers contacted during the review indicated that they charge 15 to 20 basis points per 100 USD (30 basis points for higher risk location), leaving the typical profit margin at about 50 basis points.

[8] While there would be a strong presumption for using data from Thomson Reuters DataStream and Bloomberg in the methodology, if data from these sources are not available, or the data that are available appear to be manifestly irregular or inaccurate, staff can use other exchange rate data which are representative of the market. Alternative data sources that could be used by staff would include the following: (i) publicly available independent data source, (ii) publicly available data from the authorities, or (iii) data from the authorities. In all these cases staff would determine whether the data are representative of the market. For non-spot transactions the methodology may also rely on theoretical prices as reference rates, as further described below.

Box. 1. Methodology for the Computation of FX Benchmarks

The World Markets/Reuters (WMR) computes and publishes FX reference benchmarks for 155 currencies. The WMR FX spot benchmarks are currently available for 155 currencies; coverage for forward rates is available for 76 currencies on Thomson Reuters. The WMR has become a de facto standard for foreign exchange (spot, forwards, and Non-Deliverable Forwards) rates and is most widely used in the market, index compilers, and by country authorities. The computation and governance of the benchmark is based on publicly available documentation[1/] and is reviewed against appropriate international FX benchmark regulations and guidance, specifically the principles for the computation of the financial benchmark of the IOSCO.[2/]

The WMR computes and publishes FX reference benchmarks validated through pre-defined robustness checks aimed to limit manipulation. The benchmark provider ensures that the collected rates are validated based on pre-established robustness checks, outlier rules, and expert judgment. Suspicious contributions are discarded. The rates used are the median of the validated contributions from multi-contributor sources. Thomson Reuters undertakes a periodic review of the appropriateness of using specific data suppliers to provide the data for the calculation and validation of the benchmark rates. The review process is intended to, among other things, assist in ensuring that the benchmark rates are: (i) based on reliable and observable market data that reflect the economic realities of a given market, and (ii) themselves reliable representations of the FX market.

The sources of data used for the benchmark, by order of priority and depending on availability, are: (i) actual traded rates; (ii) rates of orders placed in matching order systems; and (iii) banks' quotes. In less liquid markets, the benchmark is predominately based on bid and offer rates, or on prior transactions data.

The primary infrastructure used to source spot exchange rates consists of various FX trading platforms used globally. The information on actual transactions is collected from the platforms of Thomson Reuters Order Matching, EBS, and Currenex. Quotes are collected from Reuters dealing system. Other sources, including central bank spot rates and official fixings, are also used as and when necessary to fill gaps or reach a minimum number of contributions. Data sources are regularly checked for reliability and representativeness. Wherever possible, a multi-contributor source of rates is used in preference to a single contributor unless an "official" fixing is being used.

The methodology is based on the principle that a market in each currency pair represented by the benchmark must genuinely exist, and that the market must be active. The standardized benchmarks, including bid/ask, high/low, and closing both on intraday and closing basis are available. The computation process and validation methodology, however, depend on the liquidity of each market and are grouped in three categories.

- **Trade Currencies:** The top 22 highly liquid currencies referred as *"Trade Currencies."* [3/] The transactional trade and order rates are sourced from liquid platforms, such as Thomson Reuters Order Matching, EBS, and Currenex for validation. The process performs continuous validation, and identifies outliers.

- **Nontrade Currencies**: All other currencies not identified above are assumed as *"Non-trade Currencies."* The primary source of rates will be actual traded rates taken from Thomson Reuters Matching, and EBS, as detailed above, and the secondary source will be the rates on the order matching systems. Commercial bank quotes from Reuters Dealing System will be captured where neither Trades nor Orders are available. Hourly snapshots of quoted rates are taken over fixed periods and medians are calculated.

Box. 1. Methodology for the Computation of FX Benchmarks (concluded)

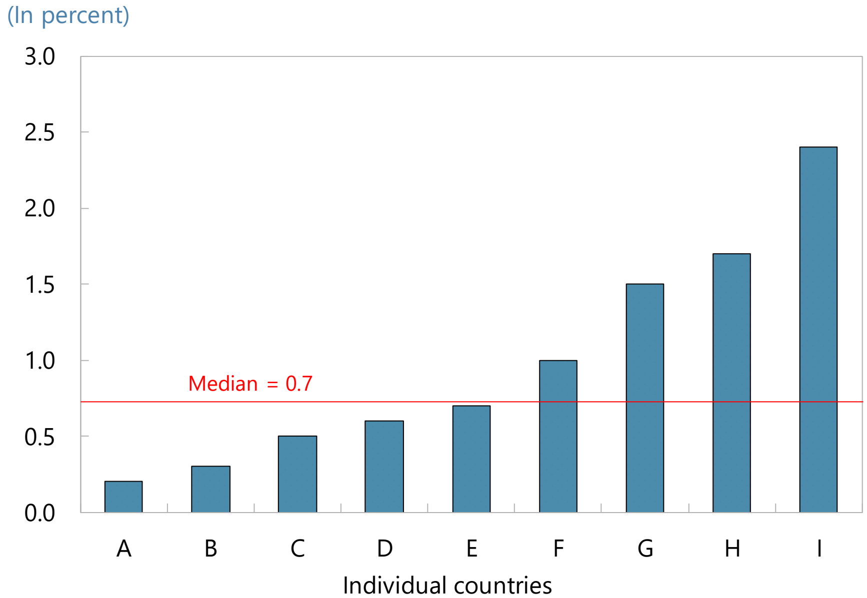
- **Locally-traded Currencies**: The benchmark administrator sources quotes and transacted rates from locally-traded markets, where offshore trading is not permitted. The published spot rates reflect activity in that market's time zone and is for 9 currencies. [4/]

- **CB or Official-fixing Currencies:** These currently include 15 currencies whose rates are sourced from central banks, in the absence of any continuous and reliable availability of wholesale market quotes.[5/] The benchmark administrator reaches out to market contributors, global clients and other counterparts to assess their reliability and representativeness.

The Bloomberg BFIX FX reference rates represent prevailing FX market prices and are published based on Bloomberg Generic Composite (BNG) every 30 minutes. The Bloomberg "BFIX" are FX rates that are half-hourly snapshots of the BGN, using a time-weighted average price ("TWAP"), around the fixing time. The Bloomberg Generic Composite rate (BGN), is a sophisticated pricing algorithm that produces accurate indications of bid and ask quotes that are derived from hundreds of quality sources, including indicative and executable price quotes from money-center and regional banks, broker-dealers, inter-dealer brokers, and trading platforms. However, data are not based on any actual market trades but on indicative rates contributed by market participants.

1/ WM FX Reuters Benchmark: Spot and Forward Rates Methodology Guide. Thomson Reuters is the benchmark administrator for the WM/Reuters Rates and thus has primary responsibility for all aspects of the benchmark determination process.
2/ Thomson Reuters IOSCO Statement of Compliance.
3/ The currencies referred as "Trade Currencies", include AUD, CAD, CHF, CNH, CZK, DKK, EUR, GBP, HKD, HUF, ILS, JPY, MXN, NOK, NZD, PLN, RON, RUB, SEK, SGD, TRY and ZAR. For purposes of the methodology, the data sourced from the benchmark providers for the calculation of the H/L for a member would be based on the relevant time zone of the member.
4/ The currencies are: CNY, IDR, INR, KRW, MYR, PHP, THB, TWD and BRL.
5/ The currencies are: AOA, BOB, BZD, CRC, ETB, HNL, HTG, JMD, KGS, MRO, MVR, NIO, SRD, TTD and VEF.

Figure 1. Deviation Between Banknote and Wholesale Market Exchange Rates
(March 26, 2018)



Source: IMF staff calculations.
Note: Deviation is calculated as follows: (mid of buy and sell banknote rate / mid of H/L)-1, except for one country, where it is (mid of buy and sell banknote rate / mid of electronic transfers)-1.

NEW METHODOLOGY

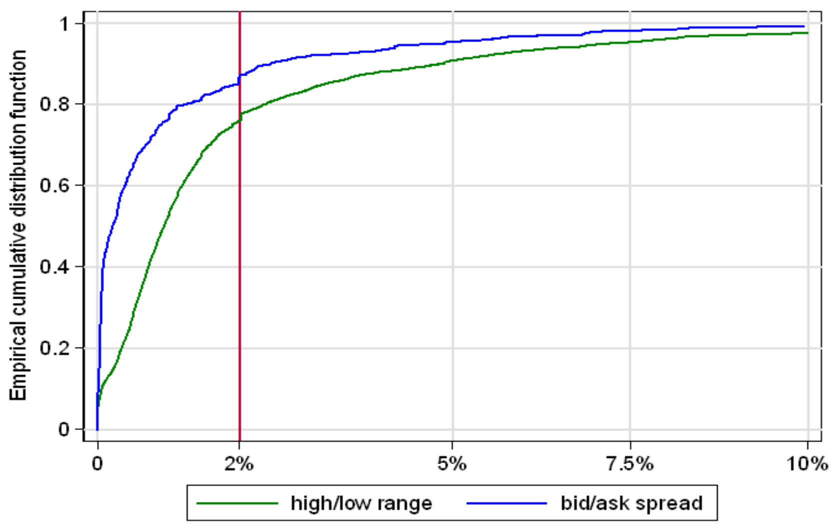
21. Staff proposes replacing the current two percent rule with an indicator that reflects the range of exchange rates traded on a given day. Staff considered, but did not retain, the option to improve the application of the current two percent rule. The challenges with the application could arguably be partly addressed, for example, by choosing the mid of the bid/ask of the day, as a proxy for the market exchange rate to which the two-percent would be applied.[9] These changes would address the current challenges with contemporaneity and the identification

[9] Fundamentally, however, the bid/ask spread is an imperfect benchmark for a market-based norm under the MCP policy. By analogy with the principle that applied to the spread around parities, the 1979 review focused on spread between buying and selling exchange rates, which was understood at the time as the bid/ask spread in the market. However, the buying and selling exchange rates of the par value were single official rates that defined the boundaries of the market while the bid/ask spread represents the average of buying and selling rates in the market and as such do not define market boundaries. In most cases (86 percent), the bid/ask spread is lower than 2 percent with most of the distribution concentrated between 0 and 75 basis points. However, the number of instances in which market spreads exceed 2 percent is far from insignificant. Two circumstances explain higher spreads: (i) less liquid markets in which the cost of doing FX business is higher; and (ii) stressed market conditions (such as large depreciation of the exchange rate), which could happen in liquid as well as less liquid markets.

of the market rate discussed in the Main paper. However, this approach could still result in MCPs arising from more than two-percent differences under stressed market conditions (Figure 2). The introduction of an indicator that reflects market conditions better is, thus, necessary to increase the relevance of the norm in different market circumstances.

Figure 2. Distribution of the Bid/Ask and High/Low Spreads

April—October 2017



Source: Bloomberg, Reuters and IMF staff calculation.

A. Spot Transactions

22. The market indicator that defines the market boundary or maximum deviation between the rates of two transactions in the market is determined by the highest and lowest rates in the market on a given day (H/L). The bid/ask spread provides a country-specific indication of transaction costs for the FX market of each member. However, rates arising from official action may well be outside the bid/ask spread while being in line with the rate of transactions that actually happen in the market, which could lead to "false" findings. As official or reference rates are usually computed at a precise time of the day, they can exceed the bid/ask spread if market rates change after the computation of the reference rate. On the other hand, the H/L adjusts to exchange rate developments during the day, reducing the likelihood of such deviations. Based on the data reviewed by staff, official rates are 3.5 times more likely to deviate from the bid/ask spread than from the H/L range. FX market participants, contacted by the staff, also considered the H/L norm as being most representative of the market rates. Although the H/L range would be different for each country, this approach would be consistent with the principle of uniformity of treatment, as the results would be determined based on the same methodology, applied consistently across the membership.

23. The main limitation of the H/L range is that it can be susceptible to manipulation, but benchmark providers have some built-in safeguards. As the H/L range determines the "market boundaries", manipulation can occur through wash or round-tripping trades [10] that could be used to widen the H/L range for the trading day deliberately, regardless of whether based on traded or on quoted rates. However, benchmark operators have built-in robustness checks as described in Box 1, which provide safeguards against potential manipulation.

24. Staff considers the H/L range of a given market during the trading day as an adequate norm to identify deviations from the market exchange rate. As shown in (1), the requirement is to keep rates arising from official actions (R) in the range of rates defined by the H/L of a given trading day. The High and the Low are both a bid for a counterparty and an ask for another counterparty.

(1) $$LOW \leq R \leq \text{HIGH}$$

R is the exchange rate arising for official action;
HIGH is the highest wholesale exchange rate of the day, i.e., the most depreciated rate of the day;
LOW is the *lowest wholesale exchange rate of the day, i.e., the most appreciated rate of the day*.

25. To avoid capturing insignificant deviations, an additional tolerance margin could be envisaged. While each deviation from the market norm challenges the unity of the system of market exchange rates, staff is of the view that the revised MCP policy should not capture small deviations from the norm as they do not have significant economic consequences. In practical terms, the tolerance margin (*m* in (2) below) on a given day in a given market could be set as a percentage of the mid of the high and low rates ($\mathrm{M}_{H/L}$). An MCP would be found if the exchange rate arising from official action exceeds the H/L and the tolerance margin.

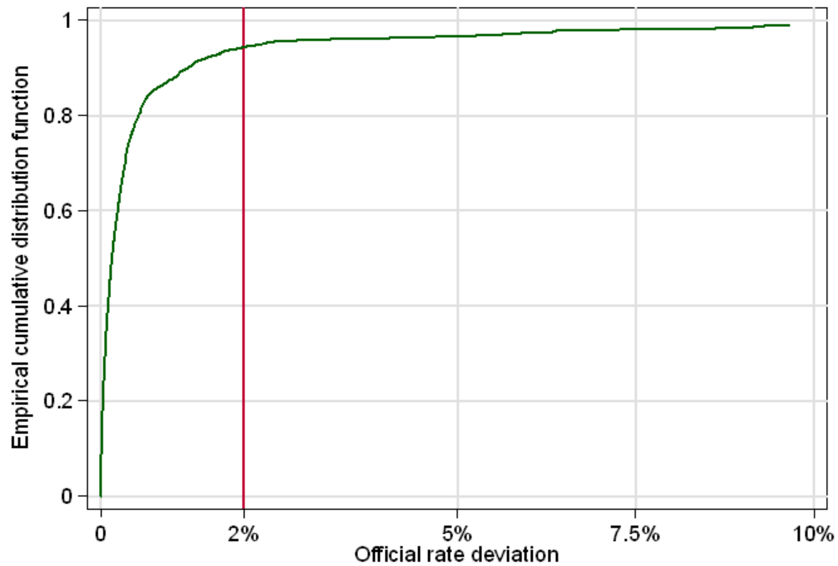
(2) $$\left|\frac{\mathrm{R}-\mathrm{M}_{H/L}}{\mathrm{M}_{H/L}}\right| \leq m\%$$

26. Staff considers a tolerance margin of +/- 2 percent around the mid of the H/L as adequate based on the empirical distribution of official rate deviation from the mid of the H/L ((3) below and Figure 3). Typical distribution threshold for tail events would be reached for +/-2 percent; 95 percent of the deviations are less than 2 percent from the mid of the H/L. In addition, +/- 2 percent minimizes the change in the current policy with respect to members, who have already included it in their policy (e.g. for exchange taxes).

(3) $$\text{Min}\{\text{LOW}\ ;\ M_{H/L} - 2\%\} \leq \text{R} \leq \text{Max}\{\text{HIGH}\ ;\ M_{H/L} + 2\%\}$$

[10] Wash or round-tripping—an attempt to inflate transaction volumes or prices through recurring trades of the same FX between a handful of larger players.

Figure 3. Cumulative Distribution of Official Rate Deviation from the Mid of the H/L
April—October 2017



Sources: Bloomberg, Reuters, and IMF staff calculations.

27. The addition of the tolerance margin would avoid findings due to differences in the cost structure of the spot rates which are compared. As shown in Figure 1, the +/- 2 percent tolerance margin would accommodate the typical spread between the wholesale spot rate and the banknote rate (about 70 basis points) in most cases studied during this review.

28. The tolerance margin would also address the cases in which no independent wholesale market exists. Generally, there would be a negotiated market segment unless the authorities fully intermediate the wholesale markets. In such a case, the monetary authorities capture all FX inflows in the market via surrender requirements or other means, and distribute the proceeds to end-users for the payment of current account and other transactions. In these cases, the wholesale reference rate is the mid-rate between the rate at which the authorities capture FX revenues (buying rate) and the rate at which they redistribute it (selling rate). A typical illustration would be a fixed exchange rate regime with a buying rate and a selling rate and no market outside the central bank. In such circumstances, the new methodology would require that any rates arising from official action remain in the +/- 2 percent tolerance margin from the mid of the official buying and selling rates.

29. A single deviation from the norm because of official action would be considered an MCP. Staff considered the possibility of finding an MCP only if the rate arising from official action deviates from the norm for a minimum number of consecutive occurrences. However, it was considered inappropriate to retain this option because of practices that lead to infrequent breaches of the norm over a longer period (e.g. bilateral payment agreements that have quarterly settlement).

30. Once an official action is identified, deviation from the norm will be monitored on a continuous basis. Once the rate arising from official action is identified, the ready availability of data and the relative ease of applying the methodology will make it possible for staff to monitor the exchange rates continuously to detect deviations promptly. (See Box 2 on the availability of market data through the Fund's subscription to benchmark providers.)

Box 2. Market Data Availability Through DataStream and Bloomberg

Market data is available through the Fund's subscription to Thomson Reuters DataStream and Bloomberg. The current subscription of the Fund through IMF Library (CFS) covers sufficient licenses to Thomson Reuters DataStream and Bloomberg. These licenses are accessible to various users throughout the IMF in area departments and other functional areas. There is a budget proposal approved to add licenses during the coming fiscal year, whereby almost all research officers in country teams would have access to the required market data. The current service agreement provides both close of day and intraday data for exchange rates covering bid/ask, mid-rates, and intraday H/L. The table below details the availability of instruments on FX market data.

Name	Symbol	Type	Source
Exchange Rate - Bid	EB	Time Series	Datastream
Exchange Rate - Middle	ER	Time Series	Datastream
Exchange Rate - Offered	EO	Time Series	Datastream
Exchange Rate, middle unpadded	ER#S	Time Series	Datastream
Default (Not applicable for Advance for Office)	DEFT	Time Series	Datastream
Exchange Rate - Intraday High	EH	Time Series	Datastream
Exchange Rate - Intraday Low	EL	Time Series	Datastream
% Change From Weak Currency	CW	Time Series	Datastream

B. Banknote Transactions

31. Official actions that affect banknote exchange rates are rare. They include the buying and selling of banknotes by the central bank with the public in general or the setting of exchange rates for specific transactions in banknotes (e.g., concessional cash FX rates for specific purposes). Such transactions, cannot be considered FX intervention as the central bank directly trades with the public and not with intermediaries. Central banks that buy and sell banknotes usually operate fixed exchange rate regimes[11] and apply spreads that result in deviations between the banknote and wholesale rates that are lower than the +/-2 percent permissible margins.

[11] This is the case for two central banks and for two regional central banks.

32. Banknote transactions would be treated as spot transactions. As for all spot transactions, the methodology would require that banknote rates resulting from official action remain within the H/L or the permissible margin of the wholesale spot market. The main difference between the exchange rates of banknotes and other spot transactions is due to the additional costs related to the use of banknotes, which result in larger spreads for these transactions. These additional costs usually cannot be quantified and continuously monitored and, thus, applied in the methodology. However, based on information available to staff, the permissible margin of +/-2 percent is expected to provide ample room to absorb the additional costs of banknote transactions. That said, if the authorities can provide representative data on banknote rates in their FX market, such data could be used to apply the methodology. Staff would compare the results of the methodology using the H/L data provided by the benchmark providers and the data on banknote rates provided by the authorities, and the finding would be based on the data that results in the most favorable treatment for the member.

C. Non-Spot Transactions[12]

33. Official actions can affect exchange rates of transactions with maturities longer than spot. Consistent with the proposed methodology on spot transactions, such rates would be considered under the policy if the authorities use them in transactions or require that market participants use them, and if the official action creates market segmentation. Official actions can impact FX derivatives.[13] In addition, official actions can also take the form of exchange guarantee schemes akin to forwards or options, while not explicitly structured as such.[14]

Forwards

34. The market norm for forward exchange rates arising from official action would be the daily H/L of the forward wholesale market. The market norm and the tolerance margin would be applied to the assessment of the exchange rate as in the case of spot transactions. An MCP would arise if the forward rate arising from official action deviated from the H/L of the forward market and the tolerance margin.

35. The primary source of information for these rates is Thomson Reuters DataStream. It provides outright H/L forward rates quoted by interbank market participants for 76 currencies,

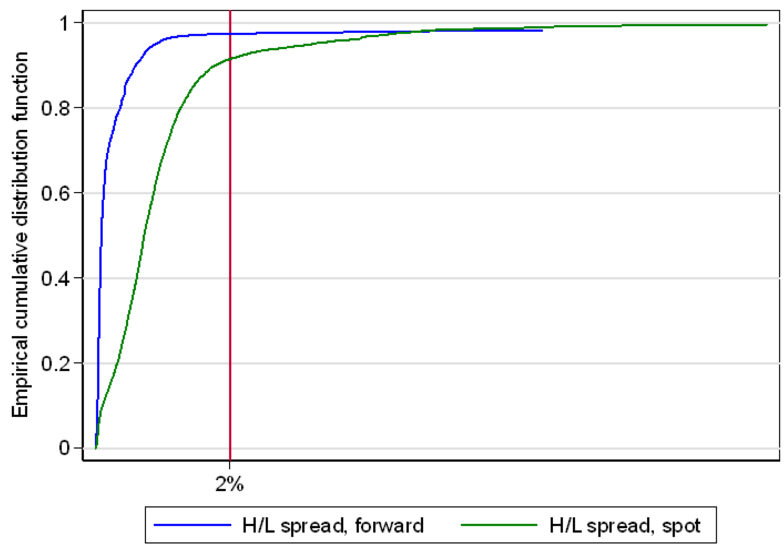
[12] Due to evolving trends in FX market sophistication, assessment of non-spot transactions may become more frequent under the new policy. There might be circumstances in which market related information on prices may be difficult to obtain or assessing non-spot exchange rates may be complex. Thus, further refinement of the methodology and guidance may be needed after more experience with assessing non-spot transactions is gained.

[13] FX forwards are mostly used by end-users to hedge exchange risk and fund FX transactions. FX Swaps are frequently used for liquidity management and funding both in FX and local currency.

[14] FX options allow the holder the right (but not the obligation) to buy or sell FX from the option seller at or by a certain time in the future, for a set price. Two types of exercisable variations are generally offered; ones exercisable at any point before expiration, or ones that can be exercised only at time of expiration date.

where forward markets exist. Three can be sourced from Bloomberg as secondary source. Those forward exchange rates can be monitored continuously. As data come from the most liquid market, 98 percent of the H/L were less than 2 percent in 2017 (Figure 4). In cases where wholesale forward market exchange rates from the benchmark providers cannot be used, forward exchange rate data that are representative of the market from other data sources, including from the authorities, can be used (see also footnote 8). If representative data from alternative sources are not available, staff propose using theoretical prices. The theoretical forward rate is computed by adding the difference between local and foreign interest rate for the maturity of the forward to the spot wholesale market rate.[15] To avoid an MCP, the rates arising from official action should remain in the +/-2 tolerance margin of the theoretical price.

Figure 4. Forward H/L Cumulative Distribution



Source: Thomson Reuters and IMF staff calculations.

36. Market forwards and theoretical prices can be determined for most members with a national currency. Calculated forwards prepared by the benchmark administrators are based on a standardized methodology and the interest rate data available (bank offered rates and government securities rates). Market and calculated forward rates can be monitored on a continuous basis for 178 members. The rest of the members do not have national legal tender.

[15] The intermediaries selling FX to a client at t+>2 immediately borrow local currency at interest rate (i) with a t+>2 maturity and use the proceeds to buy the FX at the spot rate. The FX purchased at (t) is invested in the money market at a remuneration of (i*) until t+>2. The cost for the intermediary, is, thus, the interest rate differential (i-i*), which is passed on to the client with a margin representing the intermediary profit. In practice, forward market exchange rates are often different from what would result from the interest rate differentials.

37. Staff would need to assess whether the domestic interest rate used by the benchmark administrator is the most representative one in the available data. The valuation tools of the benchmark administrators allow replacement of some inputs with other data that may not be publicly available but accessible to the authorities and the country team. Staff may use alternative data sourced from local markets if considered more representative of the actual funding rate in that market for a given maturity.

FX Swaps

38. Exchange rates of FX swaps arising from official action would be assessed with the methodology. Under the proposed methodology, the spot rate would be assessed as any other spot rates, while the forward rate arising from official action—or the implicit forward rate in foreign exchange swaps involving interest exchanges—would be compared with the market forward rate or the theoretical price at same maturity, calculated based on the interest rate differential in the market. The official forward rate arising from the FX swap provided by the authorities should remain in the permissible margin of the calculated forward rate to avoid an MCP.

Options

39. With respect to conditional transactions, the authorities may provide the market with an option to purchase or sell FX at a given rate at or by a future date.[16] The FX option would be exercised if the exchange rate appreciates or depreciates more than a given level, i.e., the strike rate. FX options that are provided to some market participants could give rise to MCPs because they may give a subsidized hedge to some counterparties only, thereby segmenting the market. In contrast, if the option is provided to market participants without segmenting the market (i.e., via a competitive auction meeting the criteria for auctions), the option would be considered as an intervention and, thus, would not be assessed under the MCP policy.

40. The methodology would be implemented only if the option is exercised.[17] The "effective exchange" rate, in the case of a currency option, is the strike price plus the option premium. If the option is exercised at an effective exchange rate that deviates from the equivalent market transaction with similar terms, an MCP would arise. The methodology would examine whether, at the inception of the option, the effective exchange rate of the contract was within the H/L of the effective exchange rates of comparable market options or the tolerance margin of +/- 2 percent from the mid of the H/L. The market effective exchange rate will be obtained from wholesale market transactions with similar terms, when available from benchmark providers. When data from benchmark providers are unavailable, representative exchange rates

[16] Such options can also take the form of exchange rate guarantee schemes.

[17] Staff recognize that the availability of an option to hedge exchange rate risk, in itself provides a value to the beneficiaries, even if the option is not exercised.

from other sources, including from the authorities could be used; in absence of such data, a theoretical price of the option with similar terms will be used.

41. In practice, the assessment of options would have to rely mainly on theoretical prices. Option markets are often not deep and standardized enough to provide relevant price benchmarks. However, both Reuters and Bloomberg[18] provide the possibility to calculate theoretical option prices for a wide range of contracts, including "exotics." The default setting is based on the data available to the benchmark administrator and their assumption regarding expected volatility. The default setting uses the "Black-Scholes formula" for simple contracts—a standard model, widely used in financial markets. Staff propose using Reuters as the default calculator for calculation of theoretical option prices under the methodology, and, if such calculator is not available, Bloomberg's calculator would be used.

42. Staff would assess whether the default parameters used by the theoretical price calculator of benchmark administrators are the most representative for the country. Staff may use alternative data sourced from local markets to change the parameters of the calculation, in particular implied volatility and the local currency interest rate, to obtain option prices. Alternative implied volatility should be based on prices formed in the domestic market that reflect expected exchange rate volatility. Alternative local interest rates should be based on actual cost of funding for the relevant maturities. In the absence of such information, the assessment would be based on the theoretical option price derived from the default setting of the calculator, depending on the type of option.

PRELIMINARY ILLUSTRATIVE RESULTS OF TESTING THE NEW METHODOLOGY

This section presents the preliminary results of the application of the new methodology to spot transactions. The new methodology takes into account the refined application of the concept of official action, as laid out in the Main paper. These tests are based on information currently available to staff and market conditions prevailing at the time when the tests were conducted. These preliminary results are meant to show the potential impact of the proposed changes on existing and possible new MCPs. These preliminary results are merely illustrative. A full jurisdictional analysis, including discussions with the authorities, would be made if and when the new policy enters into effect, before an MCP finding can be made.

[18] Thomson Reuters provides FX Option Calculator as FXOC and Bloomberg provides similar calculator as OVML; both include multiple pricing models depending on the type of option being evaluated.

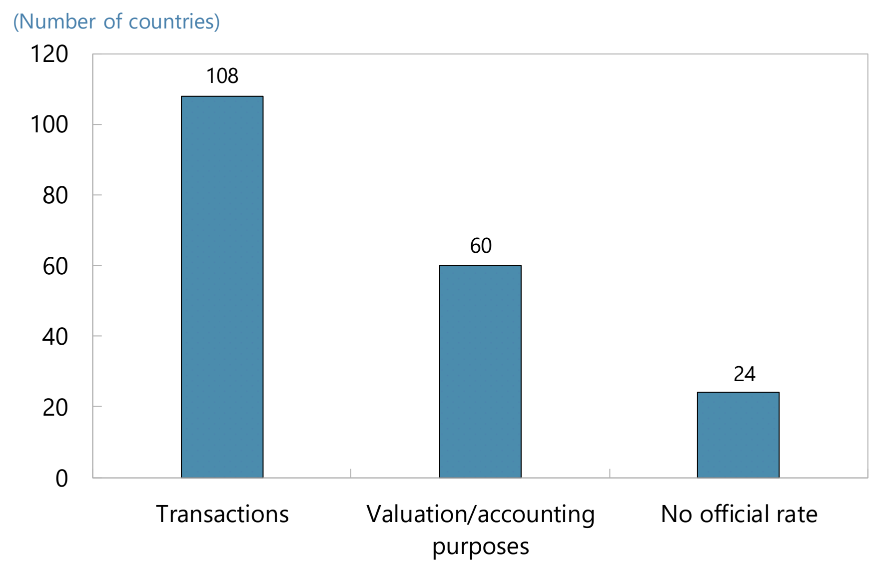
A. Types of Official Actions Analyzed

43. Staff tested the combined effect of the proposed methodology and the refined concept of official action as described in the Main paper on different types of official actions that can result in MCPs.[19] This section presents the results of the tests on the following types of MCPs: (i) official exchange rates; (ii) dual and multiple FX markets; (iii) auctions; and (iv) official actions increasing the cost of foreign exchange transactions (see Appendix I for the main types of MCPs in these categories).

Use of Official Exchange Rate in FX Transactions

44. Official exchange rates are often used in transactions of the authorities.[20] Staff analyzed whether these official exchange rates (often called reference rates) could give rise to MCPs based on the refined concept of official actions and permissible spreads. The analysis considered only those official exchange rates which are used in FX transactions (Figure 5).[21] As a result, staff established that 108 members used an official exchange rate for transactions with FX end-users or foreign exchange intermediaries.

Figure 5. Use of Official Exchange Rates



Sources: 2016 AREAER and survey of country teams. 189 members and 3 territories.

[19] The exercise captured some measures that do not necessarily correspond to the existing MCP findings.

[20] Usually, an average of the market rates—mostly interbank—is used to determine the official exchange rates. The market exchange rates can be actual traded rates or quoted rates. Not every member publishes the methodology for calculating the official rates.

[21] Exchange rates used for accounting and valuation purposes are not covered by the MCP policy in the absence of an exchange transaction in which the official rate would be used.

45. Staff identified 38 members using the exchange rate of the previous days in official transactions, including 5 members calculating official exchange rates with a more than one-day lag. Out of these, 27 members compute their official rates based exclusively on market exchange rates—i.e., they use either a combination of interbank and dealer-client rates or any one of these rates. Five members determine their respective rates based inter alia on the results of FX auctions and the remaining five retain some discretion in the determination of the official rate. Information is unavailable on the lag used by 1 member.

46. The methodology would reduce the number of MCP findings due to official exchange rates. Currently, 12 countries have MCPs arising from the use of official exchange rates that deviate or may deviate from other exchange rates. Based on available information, staff identified thirteen instances in which official rates deviate from the H/L. Among those, four also deviate from the mid of the H/L by more than +/-2 percent and would result in MCPs under the new methodology. This would represent a decrease by two thirds of the number of existing MCPs arising from the use of official exchange rates. None of the current MCPs assessed based on potentiality are captured by the new methodology. The four cases where the official exchange rate is outside the permissible margins emerge from the systematic review of all members' practices.

47. A few official exchange rates calculated with a lag have been excluded from the findings. Of the members using lagged official rates for transactions, twelve members have their official rates outside the H/L range. Out of these twelve cases, six also deviated from the mid of the H/L by more than +/-2 percent. These cases were nonetheless excluded from the results, in line with the proposal not to consider them under the MCP policy if they meet certain criteria (see Box 4 in the Main paper).[22]

Dual and Multiple FX Markets

48. Official action can lead to market segmentation, and give rise to MCPs. While not necessarily targeting specific transactions or economic agents, an official action could impose specific markets by regulation for certain transactions or hinder arbitrage between market segments, which challenges the system of market exchange rates. Staff tested the proposed revisions to the policy on known segmented markets.

49. Parallel markets are not the only case of more than one market in a single jurisdiction. There are few cases where two legal markets coexist due to different trading infrastructures (some transactions are required to take place exclusively on a specific platform). A

[22] Under the proposed revisions to the MCP policy (see Main paper), lagged exchange rates should not lead to MCP findings in the following circumstances: (i) the lagged official exchange rate is computed as a weighted average of transactions between intermediaries and/or between intermediaries and their clients; and (ii) the transactions included in the calculation should have occurred no more than one day before.

further case is where capital controls effectively segment legal FX markets. Exchange rates may differ across segments if arbitrage between the segments is hindered.

50. **Staff has identified 32 members having dual or multiple FX markets.** The number of such markets was determined based on a survey of the country teams and includes dual/multiple markets reported in the 2016 Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), except when the dual rates arise from an auction (results for auctions are presented separately below) or an official rate.

51. **Consistent with the proposal in the Main paper, the methodology was applied to 10 of the 32 dual markets that were either reported as legal or have an undetermined legal status.**[23] The reference used for the H/L and the mid of the H/L was the primary (largest by volume) wholesale spot market. The mid of the H/L in the secondary market was considered as the rate arising from official action (R in Equation 3). In the absence of H/L for the secondary market, the test used an alternative representative rate (usually a single rate).[24]

52. **The application of the methodology and the proposed revisions to the MCP policy capture fewer cases of MCPs due to market segmentation**. There are currently eight MCPs arising from dual or multiple markets (first column of Figure 7). Five out of the 8 MCPs arise from illegal markets and, as such, are excluded in line with the proposed revision to the policy. The systematic review of all countries that report dual or multiple FX markets and for which data is available, including countries currently having no MCP findings, revealed that exchange rates of the secondary markets in five countries are outside the H/L and permissible margins.

Auctions

53. **As proposed in the Main paper, FX auctions (including multi-price auctions) would not be considered under the policy as long as they do not segment the FX market.** Auctions

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[23] In the Main paper, staff propose to exclude illegal parallel markets entirely from the policy and address these cases through the policy on exchange restrictions.

[24] For countries with dual or more markets, except for the primary FX market, data on other market segments are not always readily and/or publicly available. In most cases, either the central bank or the private sector monitor the different segments of the market and prepare representative rates for each of them. The reference rate is usually based on a survey of the operators in the parallel market, which are often FX bureaus. There is typically no standardized methodology to compute these rates, which are often opening or closing rates, or a simple average of the rates reported by the operators. Transactions in the parallel market are sometimes described as "cash" transactions (25 out of 31 reported by country teams) although it could not be confirmed that these markets are purely banknote markets, as "cash" is a term often used to describe spot transactions in the informal market. For the current assessment, in one case, data on the H/L for the dual market was available from the benchmark providers. In the remaining cases data was obtained from country teams, and included opening and/or closing rates, or the midpoint of bid-ask rates, whichever was available and considered representative for the methodology.

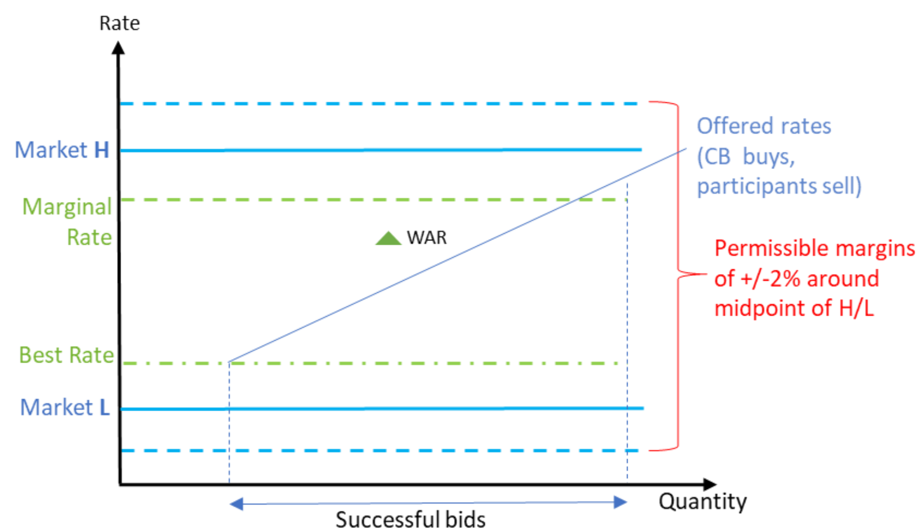
(continued)

that meet certain criteria are not considered as segmenting the market,[25] while auctions that do not meet these criteria, would be assessed as other legal dual markets.

54. **Staff reviewed the auction regulation of 33 members to identify those which are inconsistent with the criteria.**[26] The determination was based on a review of the publicly available information and a survey sent to the country teams (Appendix II). The survey indicates that 19 auctions appear to result in market segmentation by providing FX for specific purposes and only partially based on the price proposed.

55. **The methodology has been applied to auctions that appear to be segmenting the FX market.** The reference used for the H/L and the mid of the H/L, to which the permissible margins are applied, is the spot wholesale market. Considering the bid rates at the auction as reflective of the secondary market (auction), the weighted average rate (WAR) of successful bids represents the rate arising from official action (R). Figure 6 illustrates the integration of the auction rate with the rest of the market rates. In all cases, the auctioneers publish the marginal rate of the auction and the WAR of successful bids.

Figure 6. Auction Rates



Source: IMF staff calculations.

[25] As described in the Main paper, the auction should (i) grant access to all intermediaries in the country's wholesale FX market so that they can all make purchases for themselves and on behalf of their clients; (ii) ensure that the bid exchange rate submitted by participants is the only criterion used to determine whether the bid or the offer to buy or sell FX is selected; and (iii) not set constraints on the range or level of the exchange rates that can be submitted, as this may segment the auction from the rest of the FX market.

[26] Data for 20 of the 33 members operating an auction were obtained from public sources or from country teams. For some auctions, data were not available as the authorities do not publish their auction results and did not share data with staff. For the rest, no auction was organized during the review period.

56. The new methodology, together with the proposed exclusion of auctions that do not segment the market from the definition of official action, reduces the number of cases where the auction exchange rate is beyond the permissible margins. Of the 33 members operating an auction, 19 either do not provide access to all FX intermediaries in the wholesale market or include a criterion for the allotment which is different from the bid rate. Applying the test to those 19 auctions, the number of findings declines from the current 8, all of them based on potentiality, to 2. One finding overlaps with a current MCP.

Official Action Increasing the Cost of the Foreign Exchange Transactions

57. Official actions that increase the cost of FX transactions would continue to be captured under the MCP policy. These include exchange taxes (4 MCPs in 2017), margin requirements, and other types of unremunerated compulsory local currency deposit requirements prior to FX purchases (3 MCPs in 2017). The exchange rate arising from official action is calculated as the deposited local currency augmented by the interest forgone due to the deposit requirement. The application of the methodology consisted of checking whether the effective exchange rate resulting from official action remains in the H/L and the +/-2 tolerance percent margin around the mid of H/L (see Appendix III)

58. The number of cases where official action results in an increased cost of FX transactions exceeding the permissible margins declines to 3 from 7 with the application of the methodology. The two members currently maintaining taxes on FX transactions exceeding 2 percent are captured by the new methodology. Authorities of three other members maintain a compulsory deposit requirement. Official action effectively increased the cost of buying FX beyond the H/L range for two of these members and outside the +/- 2 percent permissible margin for one of them (see Appendix III).

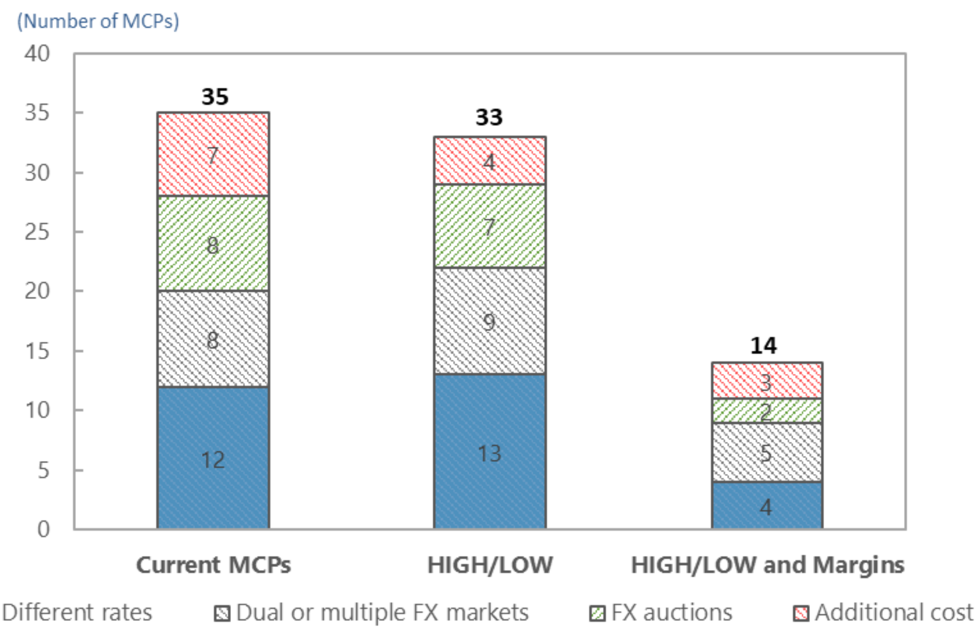
B. Aggregate Results of Applying the Methodology

59. Figure 7 depicts the MCPs as of end-2017 and the preliminary results discussed above.[27] The first column of the chart shows 35 of the 45 MCP findings in 2017, classified into the four MCPs categories described above—i.e., different exchange rates for distinct transactions, dual and multiple FX markets, auctions, and official action increasing the cost of foreign exchange transactions. The 10 MCPs not included on the chart arose mostly from practices that could not be tested during this review due to lack of data. Among the 35 current MCPs, 18 are based on potential rather than actual deviations from the current two-percent rule. The second column illustrates the findings based on the application of the H/L norm only. The third column presents the findings resulting from official actions that are out of the H/L and deviate by more than +/-2 percent from the mid of the H/L.

[27] The results are based on data for the period April to October 2017.

60. The proposed changes to the policy lead to fewer but better targeted findings. The H/L norm, in combination with the proposed changes in the definition of official action under the new policy, would reduce the number of findings to 33 (second column of Figure 7). The number of MCPs would decrease to 14 with the addition of the +/-2 percent tolerance margin (last column of Figure 7). Exchange rates of members with MCPs based on potentiality remained within the permissible margin, while the systematic review of all members flagged a few cases that were not previously identified as MCPs.

Figure 7. Results of the Proposed Revisions of the MCP Policy



Source: IMF staff estimates.

METHODOLOGY TO ASSESS MULTIPLE CURRENCY PRACTICES

Appendix I. Taxonomy of MCPs—Comparative Treatment Under the Current and Proposed New Policy

Taxonomy	Current MCP Policy	Proposed New Policy
Different Exchange Rates for Different Transactions		
Different rates for different transactions, except interventions: Setting by the authorities of different exchange rates applying to distinct categories of transactions (e.g., official transactions, commercial transactions, tourist transactions, etc.).	MCP arises if spread between different buying or selling rates set by the authorities deviates —or has the potential to deviate—by more than 2 percent between the rates themselves (if more than one), or against spot buying or selling market rates. The 2 percent test applies to comparisons of buying (buy/buy), selling (sell/sell) and between buying and selling (buy/sell) rates.	Rate set by the authorities (R) would be measured against wholesale market H/L on a given day or 2 percent from the midpoint of the H/L, whichever is higher. If (R) is within H/L, or 2 percent of the midpoint on either side, no MCP arises. If outside, an MCP arises. Spreads between the different rates set by the authorities, including buy/sell spread, would not be subject to the 2 percent margin. Under the new policy, rates resulting from official action would be compared against the H/L and the midpoint, not against each other. This will allow in practice a deviation of 4 percent or more (if the H/L itself is wider than 4 percent) between them.

Taxonomy	Current MCP Policy	Proposed New Policy
Lagged calculation of official exchange rate: Rates computed based on previous day market transactions and used for official transactions.	An MCP arises if the lagged official rate and the market rate deviate—or has the potential to deviate—by more than 2 percent.	Lagged exchange rates would not lead to MCP in the following circumstances: (i) the official rate for the concerned lagged exchange rate is computed as a weighted average of transactions between intermediaries and/or between intermediaries and their clients; and (ii) the transactions included in the average should have occurred no more than one day ago.
Bilateral payments agreements (BPA): The authorities have an agreement under which two central banks settle current transactions (e.g., imports and exports) between the two countries on pre-defined dates at specific exchange rates.	MCP arises if the "special" exchange rate in the BPA deviates—or has the potential to deviate—by more than 2 percent from spot market rate. No specific guidance in the current policy as to what date should be considered for 2 percent test (e.g., any date, or settlement date specified in the arrangement). In practice, there is less focus on settlement date due to potentiality.	The special rate (R) would be measured against the H/L and the 2 percent tolerance margin at the BPA settlement date.
Exchange rate guarantee schemes: The authorities put in place a scheme to cover exchange risks of certain market participants (e.g., exporters). Depending on the features of the scheme, the compensation for exchange losses is considered to be part of the effective exchange rate because the benefit of the coverage of exchange risk flows directly from exchange losses and, thus, from the exchange transaction in which these losses are realized.	Exchange guarantee schemes can be designed in different ways. As a general matter, a system for covering exchange risks managed by a member or its fiscal agencies does not give rise to an MCP if it is self-financed, i.e., if the premia paid by the beneficiaries of the system are sufficient to cover the exchange risks. In such a case, the system is unlikely to need official subsidies to meet its liabilities. The self-financing character of the system is evaluated in advance, i.e., when the system is set up and the liabilities are incurred (and not when compensation is paid). It is then that it must be determined whether an MCP exists. However, regular assessments need to take place so as to ensure that the system remains self-financed over time so that an MCP would not arise.	Depending on its features, an exchange guarantee scheme could also be assessed under the methodology for non-spot transactions either as a forward or option. Like the current policy, self-financed schemes would not give rise to MCPs.

METHODOLOGY TO ASSESS MULTIPLE CURRENCY PRACTICES

METHODOLOGY TO ASSESS MULTIPLE CURRENCY PRACTICES

Taxonomy	Current MCP Policy	Proposed New Policy
Foreign Exchange Auctions		
Foreign exchange auctions: The authorities allocate FX outside the auction at a different exchange rate than the auction rate, or the auction rate differs from the market exchange rate. In a multi-price auction system the authorities sell FX simultaneously to winning bidders at different rates.	MCP arises if auction exchange rates differ or have the potential to differ by more than 2 percent from the prevailing market exchange rate. In a multi-price auction, an MCP also arises if the winning bid rates deviate—or have the potential to deviate— by more than 2 percent between themselves.	No longer captured under the new policy as long as the auction (i) grants access to all intermediaries in the country's wholesale FX market so that they can all make purchases for themselves and on behalf of their clients.; (ii) ensures that the bid exchange rate submitted by participants is the only criterion used to determine whether the bid for FX will be accepted; and (iii) does not set constraints on the range or level of the exchange rates that can be submitted, as this may segment the auction form the rest of the FX market. Such auctions would not result in MCPs even if the difference between the auction rate(s) and the market rate exceed permissible margins.
		For auctions that do not comply with the above mentioned criteria, the weighted average of the successful bids (in the case of single price auctions the marginal exchange rate) is considered as the rate arising from official action (R). The assessment would check if the R remains in the H/L and the permissible margins, as for other exchange rates arising from official actions. Other types of FX interventions that do not create market segmentation, i.e., are open to all market participants either directly or indirectly through market makers and are not for specific purposes (not earmarked), will continue not to be captured under the MCP policy.

Taxonomy	Current MCP Policy	Proposed New Policy
Dual or Multiple FX Markets		
Dual or multiple FXs markets in a single jurisdiction: The authorities establish separate exchange markets and the rates at which exchange transactions are conducted by participants in the two markets exceed the permissible spreads.	MCP arises if spreads between the rates (i.e., between buying and selling, or buy/buy, or sell/sell rates) in the different markets deviate — or have the potential to deviate—by more than 2 percent.	The rates in each market would no longer be compared directly against each other. Instead, staff would determine which market is the principal exchange market, and which market is the secondary market resulting from official action. The reference used for the H/L and the mid of the H/L, to which the tolerance margin is applied, is the primary (largest) wholesale spot market. The mid of H/L of the secondary market is considered as the rate arising from official action (R). If there is no H/L for the secondary market, which is often the case, the test would use the rate available (usually a single rate). The test would consist of checking whether the R remains in the H/L and the tolerance margin.
Illegal parallel exchange markets: The authorities take official action that results in a spread between the official and the parallel market (e.g., exchange restriction arising from the prohibition to access foreign exchange at the foreign exchange markets for certain imports).	MCP arises if legitimate demand for FX is being channeled/relegated by the authorities to the parallel market. Illegality of parallel market not sufficient to exclude it from the analysis. There has to be evidence that market is not tolerated (i.e. cracking down).	Illegal parallel markets would be excluded from the MCP analysis. Jurisdictional analysis would focus on the exchange restriction imposed in the official market.

METHODOLOGY TO ASSESS MULTIPLE CURRENCY PRACTICES

Taxonomy	Current MCP Policy	Proposed New Policy
Measures that Increase the Cost of FX Transactions		
Import deposit requirements (margin requirement), non-interest-bearing blocked accounts, and non-interest-bearing deposits: The authorities require an import deposit to be made before a letter of credit is opened or FX purchased. If the interest rate on the deposits is lower than the prevailing market interest rate, this is considered an additional cost of the FX transaction.	If the government requires an import deposit to be made before a letter of credit is opened or foreign exchange purchased, the measure is directly connected with the exchange transaction and the cost is considered to be part of the effective exchange rate. Thus, import deposit requirements have been found to give rise to MCPs when the interest paid on the deposit is lower than the market rate, as this is analyzed as an additional cost of the exchange transaction. In practice, due to the application of potentiality, there has been less focus on the computation of the actual effective exchange rate arising from the deposit requirement, and no actual comparison between exchange rates is made.	The rate arising from official action (R) is based on effective exchange rate, calculated as local currency equivalent of the exchange transaction reflecting the cost of the interest forgone. The assessment would check whether the R remains in the H/L and the permissible +/-2 percent margin around the mid of H/L at maturity.
Exchange taxes: A tax payable on exchange transactions is related enough to the exchange of currencies to be considered part of the effective exchange rate by increasing the cost of the exchange transaction.	Exchange taxes above 2 percent give rise to an MCP.	Rate arising from official action (R) would be considered as the mid of the H/L plus the tax. The assessment would check whether the R remains in the permissible +/-2 percent margin around the mid of H/L. In practice, like the current policy, exchange taxes above two percent would give rise to an MCP. If an exchange tax does not give rise to an MCP, it will also not give rise to an exchange restriction.

Appendix II. Applying the Proposed Methodology to Foreign Exchange Auctions

1. **Central banks often organize FX auctions to buy or sell FX with market participants.** The use of auctions is prevalent within the IMF membership: 38 members are reported to operate auctions in 2016, according to the AREAER.

2. **The revised policy proposes to exclude from the MCP policy auctions that do not segment the FX market.** The assessment of auctions under the revised policy would consist of two steps: First, it will be identified if the auction is organized according to the criteria that ensure that the auction does not segment the FX market. This step is based on a review of the auction regulation. Second, for auctions that fail to meet the criteria the quantitative methodology proposed to identify MCPs would be applied.

3. **The rest of the appendix is organized as follows:** (i) it presents the conceptual framework that establishes the relationship between such FX auction and the broader FX market; (ii) proposes criteria to identify auctions organized according to best practices (auction regulation screening); and (iii) discusses the preliminary results of the application of the MCP test for auctions that do not meet the proposed criteria. The presumption is that auctions that fail the screening are auctions that segment the FX market as some FX end-users have a preferential access to FX. These are in fact, allocation systems, for which the term "auctions" is a misnomer.

Conceptual Framework

4. **In the absence of official actions (other than organizing the auction), auction rates are expected to be integrated with the interbank (wholesale) market rates.** At the time of the auction, FX intermediaries are confronted with the choice of participating in the auction or refraining from participation because they expect to find better opportunities in the interbank market. Assuming that the auction is opened only to authorized dealers (i.e., corporations, whose business is to buy and sell FX for a profit as opposed to end users of FX), the rate offered by each participant in the auction should be in line with the rates at which it can re-sell FX to other intermediaries (i.e. the wholesale market) or to its clients (i.e. the retail market). At times, intermediaries may have to close a position at a loss (i.e. bid below the reservation rate), but, on the longer term, intermediaries should not make a loss on FX dealing.

5. Figure II.1 below shows how participants in the auction are expected to bid compared with the market rate.

- The most competitive bid represents the participants' reservation rate. They correspond to the amount of FX that intermediaries absolutely need to buy or sell even at a loss to close a position. This rate should be close to the worst alternative in the market, i.e., the Low if the central bank buys FX and the High if the central bank sells FX.

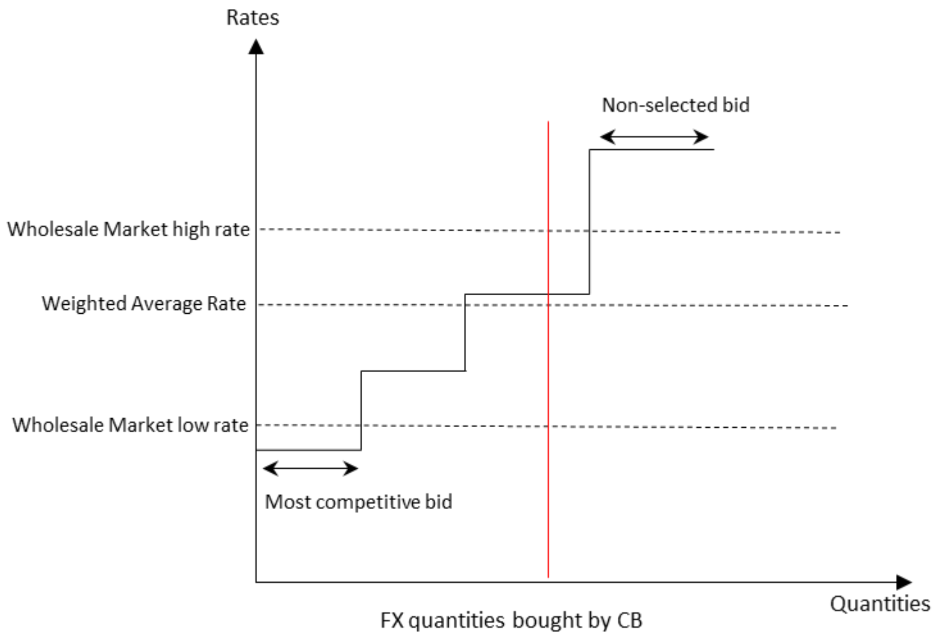
- Then, participants are expected to post bids in line with the average of the market rates (trade bid), which corresponds to what they could trade for a normal profit in the broader market.

- Finally, there may be some opportunistic bids, corresponding to what they are ready to commit while not having the resources available before settlement because their proposed rate is well above the market.

6. This conceptual framework indicates that the marginal rate of the auction should remain in the H/L range. In a well-calibrated auction, the central bank selects bids that correspond to rates ranging from those of the reservation bids (most competitive rates) up to the trade bid rates and reject the opportunistic bids (non-competitive rates), keeping the marginal rate and the auction weighted average rates in between the High and Low rate of the auction day. Deviations could happen in the two following circumstances: (i) the intended allotment is notably less than the position that participants have to close, allowing the central bank to pick only reservation rates and, thus, to overperform the market; and (ii) the central bank has an excessively large allotment objective compared to the position of the market and is forced to pick opportunistic bids, thereby underperforming the market.

7. The relationship between market rate and reservation rate also depends on the depth of the FX market. In the case of a liquid FX market, the reservation rate will be equal to the market rate as banks can sell large volumes of FX in the market at competitive prices. In case of less liquid FX markets, the reservation rate might be lower than the market rate (as shown above). The reason is that a bank might be willing to sell FX at a rate lower than the market rate to sell large quantities, knowing that the sale of large quantities in the market could result in a sharp appreciation of the rate.

Figure II.1 A Stylized Auction for a Central Bank Purchasing Foreign Currency



Source: IMF staff calculations.

Auctions Regulation Screening

8. **To distinguish auctions that do not segment the FX market from other auctions, the proposed policy would consider whether the auction regulations meet two criteria**: (i) access; and (ii) allotment, as explained below:

- *Access*: All intermediaries in the wholesale FX market can participate in the auction which is not open to end-users of FX (i.e., the clients of the intermediaries).

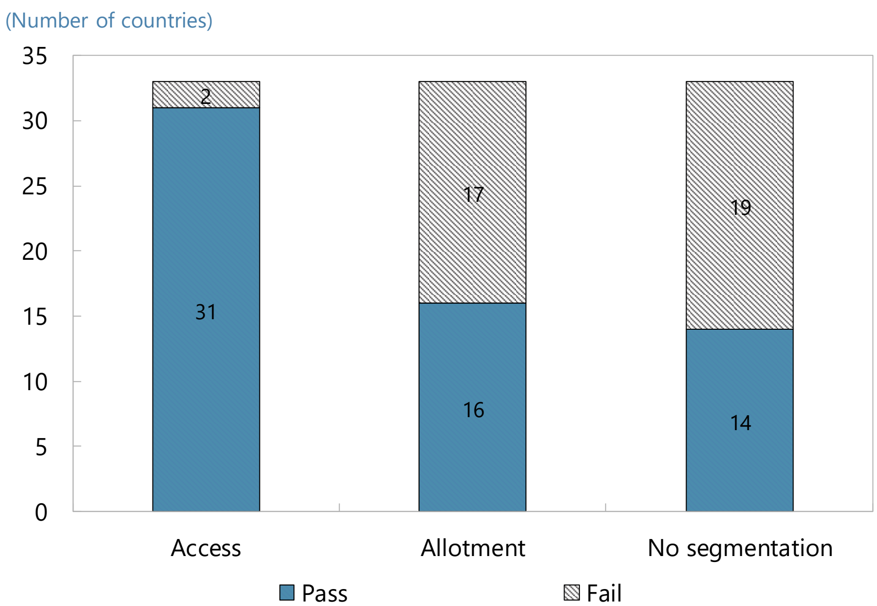
- *Allotment*: The rate is the only criterion to allot the bid at the auction. In practical term, bids are ranked according to the exchange rate offered and FX is awarded to the bids according to their ranking in the limit of the intended allotment with the bids offering the best exchange rates satisfied first. In addition, the authorities do not set constraints on the range or level of exchange rate that can be offered in bids because such restrictions could prevent arbitrage between the interbank wholesale market and the auction, thereby segmenting the market.[1]

9. **The 2 percent limit introduced by some members to avoid that the auction gives rise to an MCP would need to be removed to satisfy the allotment criterion.** This will support the functioning of the FX interbank market and enhance the auction performances.

[1] This however, does not mean that the FX purchased at the auction can be used inconsistently with the general FX regulations.

10. Figure II.2 below shows the results of the preliminary assessment for the 33 countries where auction regulations were available. Among them, 14 had auctions that seem to satisfy the criteria. Information obtained from auction regulations was complemented by staff experience in those countries. Among the 19 auction that did not meet the criteria, 17 failed the allotment criterion, while only two failed the access criterion. None failed both at the same time.

Figure II.2 Preliminary Results of the Auction Regulation Assessment



Sources: IMF staff assessment.

Application of the Methodology

11. Once auctions that are organized according to best practices have been identified based on the analysis of the FX auction regulations, the methodology is applied for those auctions that segment the FX market. This section describes these tests. Figure II.3 presents the preliminary results of the tests applied to the auctions that do not meet either the access or allotment criterion.

12. First, the implementation considers that there is a deviation from the market-based norm (H/L) whenever the weighted average of the successful bid at the auction is not within the high-low range of the interbank market.[2] The weighted average of the

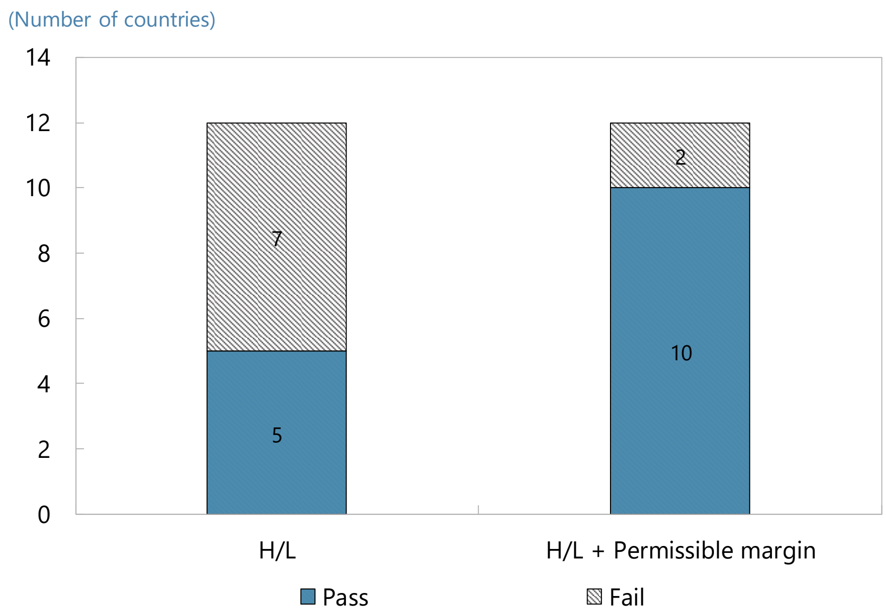
[2] Staff considered using the mid of the successful bids at the auction as the exchange rate arising from official action that would be compared with the H/L of the wholesale market and the permissible margin. However, staff

(continued)

successful bid rates at the auction is considered as reflecting the secondary market that is the auction. A weighted average of the successful bid rates within the high-low range indicates that there is some room for arbitrage between the auctions and the wholesale market.

13. Second, to retain only the most significant breaches of the norm, in cases where the weighted average rate is not within the high/low range, it will be assessed whether the weighted average rate deviates by more than+/- 2 percent from the mid of the FX wholesale market H/L. The country would be considered to have an MCP when this second threshold is exceeded. While six countries have current MCPs arising from FX auctions, the new methodology identifies only two countries where the weighted average exchange rate exceeds both the H/L and the permissible margins.

Figure II.3 Results of the Quantitative Tests



Sources: IMF staff calculations.

is of the view the weighted average exchange rate of the successful bids is a superior representation of the auction results and its relationship with the wholesale FX market. Furthermore, the weighted average of the successful bids is published by the authorities, and thus it is easily accessible for staff, while the mid of the successful bids is generally not published and would require additional information provision by the authorities.

Appendix III. Computation of the Official Exchange Rate for Margin Requirements[1]

1. Margin deposit requirements, if remunerated below market rates due to official action, would be assessed under the MCP policy following the methodology at maturity. Thus, the effective exchange rate of the transaction (R), that includes the forgone interest would be compared with the wholesale spot market H/L and the permissible margin. When the authorities require that margin requirements are remunerated below market rates they raise the all-in cost of buying FX, and change the effective exchange rate that market participants face.

R should be computed in the following way:

$$\text{R}= DC * (i^k - i^g) * \ G * T$$

where,

- DC is the amount of domestic currency required by official action to be deposited to obtain one unit of foreign currency.
- i^k is the annualized domestic currency market interest rate.
- i^g is the annualized rate at which the cash margin is remunerated.
- $(i^k - i^g)$ represents the difference between market rates and the remuneration of the deposit margin.
- G is the margin requirement. G=0.5 means that a market participant wishing to exchange 100 unit of the domestic currency must deposit 50 unit of the domestic currency as cash margin.
- T is the period during which the deposit must be kept. Since interest rates are annualized, it is necessary to adjust the formula for cases where participants will be required to keep the deposit for less than a year.[2] For instance, the participants are required to keep the cash margin for 3 months, T=0.25.

2. For example, the authorities may require banks to provide deposit margins equal to 100 percent of the amount of domestic currency to be exchanged (G=1), up to a year (T=1), for no remuneration ($i^g = 0$), while the market interest rates is 14 percent ($i^k = .14$). The amount of domestic currency (DC) demanded is the market exchange rate.

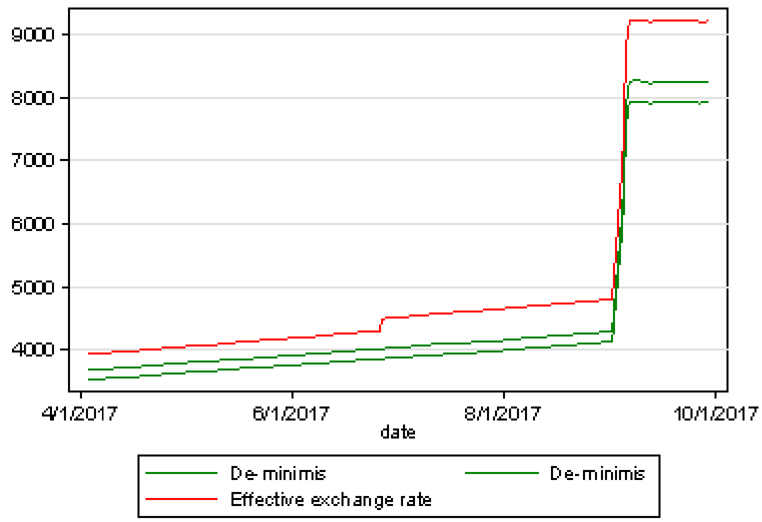
$$\text{R}= \text{M}_{H/L} * (1.14) * \ 1 * 1$$

1 Here the focus is on the case where the cost of acquiring FX is increased as a result of official action. Similar considerations would apply to a case where acquiring FX is subsidized.

2 The maturity of the margin might not be stipulated by the authorities. In this case, staff could use the average duration of margin deposit based on information by market participants or those subject to the margin requirement.

3. This would result in the effective exchange rate to be outside of the High-Low range and to deviate by more than 2 percent from the mid of the H/L (see Figure III.1). Under the proposed policy, an MCP would be found.

Figure III.1 Margin Deposit Requirement 1

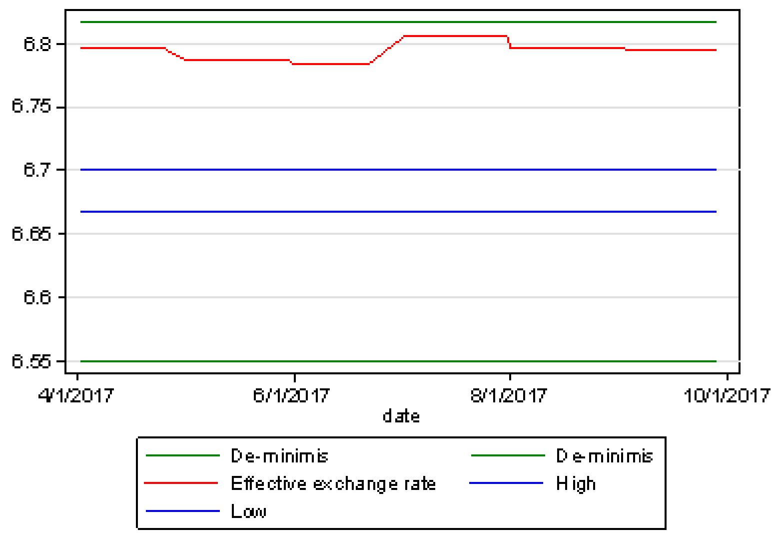


Source: IMF staff calculations.

In another example, banks are required to provide cash margins equal to 50 percent of the amount to exchange (G=0.5), for three months (T=0.25), for no remuneration ($i^g = 0$), while market interest rate is around 13 percent ($i^k = 0.13$).

4. The effective exchange rate at which market participants can transact is outside of the High-Low range but remains within the 2 percent margin. Under the proposed policy no MCP would be found.

Figure III.2 Margin Deposit Requirement II



Source: IMF staff calculations.