

INTERNATIONAL MONETARY FUND

Article VIII Acceptance by IMF Members: Recent Trends and Implications for the Fund

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I. INTRODUCTION¹

1. **The Fund’s legal framework provides the basis to actively promote the liberalization of member countries’ current accounts.** The Articles of Agreement set out legal obligations which effectively promote the free convertibility of members’ currencies for payments and transfers for current international transactions.
2. **The last detailed discussion of countries’ acceptance of the obligations of Article VIII, Sections 2, 3, and 4 (hereinafter referred to as “Article VIII obligations”) took place within the framework of the 1992 biennial review of the Fund’s surveillance policy.**² At that time, the Board “agreed that many members have availed themselves of Article XIV for too long and should take appropriate steps to remove remaining restrictions. Therefore, the staff will intensify its efforts to encourage countries to accept the obligations of Article VIII, especially in those long-standing cases where there are no restrictions subject to Articles VIII or XIV.”
3. **Overall, the goals set out in the 1992 report have been met, and substantial progress in this area has been made.** 165 out of 184 members have now notified the Fund that they have accepted Article VIII obligations and no longer avail themselves of the transitional provisions of Article XIV; 95 of such acceptances were notified between 1992 and 2005. Notification of the acceptance of Article VIII obligations, often a byproduct of underlying economic changes, reflects a Fund member’s efforts to liberalize its legal framework and administrative practices in the area of foreign exchange regulation. Most countries that have notified acceptance of Article VIII obligations have also significantly simplified their exchange control regimes. Some countries have liberalized controls on capital movements partly in view of their positive experience with removing restrictions on current international payments and transfers.
4. **Trends in macroeconomic variables presented in Section IV appear to suggest that, in general, the acceptance of Article VIII obligations has been associated with a number of benefits in member countries.** Parallel market spreads, exchange rate volatility, inflation, and interest rates have tapered off. Capital inflows and international reserves have increased, and fiscal balances have improved as countries have proceeded to accept Article VIII obligations.
5. **While important progress has been made, more can be done to improve compliance with Article VIII obligations and continue to move forward with current account liberalization.** Not all members have yet notified their acceptance of Article VIII obligations, and some have availed themselves of the transitional arrangements of

¹ Prepared by a MFD-LEG staff team under the supervision of Ross Leckow and Udaibir S. Das.

² Subsequently, IMF, 2002, *Biennial Review of the Implementation of the Fund’s Surveillance and of the 1977 Surveillance Decision: Framework and Conduct of Surveillance in 2000-01*, provided detailed updated information, as have the series of IMF papers *Exchange Rate Arrangements and Currency Convertibility: Developments and Issues* (1999) and *Exchange Arrangements and Foreign Exchange Markets: Developments and Issues* (2003), available at www.imf.org.

Article XIV for over 40 years. In addition, some members impose exchange restrictions or multiple currency practices (MCPs) without Fund approval. A concerted staff effort is needed to press for the removal of unapproved exchange restrictions and MCP's and to ensure that new changes to members' exchange control regimes are consistent with Article VIII obligations and macroeconomic considerations. Moreover, growing demand for technical assistance in the foreign exchange area provides opportunities for expanding the Fund's involvement in streamlining members' exchange control regimes. There is also significant scope to improve the compilation of information on members' exchange systems and to further the understanding of the economic implications of existing exchange restrictions and MCPs.

6. **This paper reports on the work undertaken in this area since the 1992 review and seeks to encourage further progress in current account liberalization among the membership.** Section II provides an overview of the legal framework; Section III studies recent trends in members' acceptance of Article VIII obligations, and analyzes the factors underlying these trends; Section IV outlines the possible economic (and financial) benefits of current account liberalization for Fund members; finally, Section V lays out the implications for surveillance, the enforcement of compliance with Article VIII obligations and technical assistance.

II. LEGAL FRAMEWORK

7. **A key purpose of the Fund is to “assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions, which hamper the growth of world trade.”**³ In furtherance of this purpose, Article VIII establishes certain obligations that members must observe with respect to exchange restrictions, MCPs, and discriminatory currency arrangements (hereinafter collectively referred to as “exchange measures”).⁴

8. **Article VIII, Section 2(a) prohibits members, subject to certain exceptions, from imposing exchange restrictions or, as they are referred to in Article VIII, Section 2(a), “restrictions on the making of payments and transfers for current international transactions.”** The guiding principle in ascertaining whether a measure is an exchange restriction under Article VIII, Section 2(a) is “whether it involves a direct governmental limitation on the availability or use of exchange as such.”⁵ An exchange restriction will arise when a member restricts the making of payments or transfers for current international transactions, or subjects such payments and transfers to “undue delays.” Payments for current transactions are defined in Article XXX (d) as “payments which are not for the purpose of transferring capital.” They include payments on the current account (e.g., relating to trade,

³ Article I(iv) of the IMF's Articles of Agreement.

⁴ Article VIII, Section 3 also prohibits members from engaging in discriminatory currency arrangements subject to some qualifications. The Fund has not defined “discriminatory currency arrangements” in detail. The concepts of exchange restrictions and multiple currency practices have been sufficiently broad to cover the issues that have arisen under the provisions of Article VIII, Sections 2(a) and 3.

⁵ See “Article VIII and Article XIV,” Decision No. 1034-(60/27), adopted June 1, 1960.

services, interest, and income) and a few items that, from an economic perspective, are capital in nature (e.g., payments of moderate amount for amortization of loans or for depreciation of direct investments).

9. **Article VIII, Section 3 prohibits members, subject to certain exceptions, from engaging in MCPs or discriminatory currency arrangements.** In this regard, the Fund has determined that “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.”⁶ An MCP will, in particular, arise from action by a member that, of itself, gives rise to a spread of more than 2 percent between buying and selling rates for spot exchange transactions on its territory.⁷

10. **A member that imposes exchange measures in a manner that is inconsistent with its obligations under Article VIII will be in breach of its obligations under the Articles and subject to the imposition of sanctions by the Fund under Article XXVI.** These sanctions comprise a declaration of ineligibility to use the Fund’s general resources, the suspension of voting and certain related rights, and compulsory withdrawal. These sanctions have not been applied to members for a breach of Article VIII, Section 2(a) or 3.

11. **There are two key circumstances in which a member may apply exchange measures in a manner that is consistent with its obligations under Article VIII:** (i) where the measures are approved by the Fund; and (ii) where they are maintained under Article XIV, Section 2 of the Fund’s Articles. Each of these circumstances is discussed below.⁸

12. **Exchange measures may be legally imposed under Article VIII with the prior approval of the Fund (i.e., the Executive Board).** Generally, approval of an exchange measure is granted by a decision of the Executive Board when the Board is satisfied that the measure: (i) is imposed for balance of payments reasons; (ii) is applied in a manner that does not discriminate between Fund members; and (iii) is temporary in the sense that there is a

⁶ See “Policy on Multiple Currency Practices,” Decision No. 6790-(81/43), adopted March 20, 1981, as amended.

⁷ Article VIII, Section 4 establishes certain obligations with respect to the convertibility of officially-held balances. With the development of interbank foreign exchange markets, these obligations are, at present, of limited operational relevance.

⁸ Moreover, the obligations of Article VIII, Section 2(a) are subject to the provisions of Article VII, Section 3 which allow the Fund to declare the currency of a member to be “scarce.” This latter provision has never been applied in practice.

clear timetable for its removal. Approval is granted for a specified period.⁹ However, a different procedure applies for restrictions imposed for security reasons.¹⁰

13. **Exchange measures may be legally maintained or adapted to changing circumstances under Article XIV, Section 2.** When joining the Fund, a member may avail itself of the transitional arrangements of Article XIV, Section 2. This provision permits a member to maintain and adapt to changing circumstances the exchange measures that were in place on its date of membership without the need for Fund approval.¹¹ However, even for members that avail themselves of the transitional arrangements of Article XIV, Section 2, new exchange measures are subject to Article VIII and may only be imposed with Fund approval.¹²

14. **Under the Fund's Articles, a member may formally notify the Fund of its acceptance of Article VIII obligations.** Such formal notification has certain legal consequences. A member is subject to the obligations of Article VIII, Sections 2, 3, and 4 as soon as it becomes a member of the Fund; no formal acceptance of these obligations is necessary. The only legal consequence of a member's notification of the acceptance of Article VIII obligations is that the member can no longer rely on Article XIV, Section 2 to maintain or adapt the exchange measures it had in place on its date of membership. Once it notifies the Fund of its acceptance of the Article VIII obligations, it loses the right to rely on Article XIV, Section 2 forever.

15. **The Fund has stated that, before members notify the Fund of their acceptance of Article VIII obligations, it would be desirable that, as far as possible, they eliminate measures requiring Fund approval and satisfy themselves that they are not likely to need recourse to such measures in the foreseeable future.**¹³ While, legally, a member may

⁹ See "Discrimination for Balance of Payments Reasons," Decision No. 955-(59/45), adopted October 23, 1959; "Article VIII and Article XIV," Decision No. 1034-(60/27), adopted June 1, 1960; "Payments Arrears," Decision No. 3153-(70/95), adopted October 26, 1970; and, "Policy on Multiple Currency Practices," Decision No. 6790-(81/43), adopted March 20, 1981, as amended.

¹⁰ See "Payments Restrictions for Security Reasons: Fund Jurisdiction," Decision No. 144-(52/51), adopted August 14, 1952. More specifically, a member should normally notify the Fund before imposing such measures. The notifications are immediately circulated to the Board. The member may assume that the Fund has no objection unless the Fund informs the member otherwise within 30 days of the notification. The Fund's approval of an exchange restriction pursuant to Decision No. 144-(52/51) is granted for an unlimited period of time.

¹¹ To take advantage of the transitional arrangements of Article XIV, Section 2, a member must notify the Fund of its intention to do so when it becomes a member. Multiple currency practices, when applied to current international transactions, constitute a type of restriction for the purposes of Article XIV, Section 2. See "Statement to Members Transmitting Fund's Decisions on Multiple Currency Practices," Decision No. 237-2, adopted December 18, 1947, para. II.B.1.

¹² Under Article XIV, Section 3, members are required to consult annually with the Fund as to the further retention of the measures maintained under Article XIV, Section 2; furthermore, the Fund may, under exceptional circumstances, make representations to a member that conditions are favorable for the general or partial abandonment of these restrictions.

¹³ See "Article VIII and Article XIV," Decision No. 1034-(60/27), adopted June 1, 1960.

notify acceptance of these obligations at any time, Fund staff recommends that such notification be made only after the member has, as far as possible, eliminated all exchange measures requiring Fund approval, and has satisfied itself that it is not likely to need recourse to such measures in the foreseeable future.

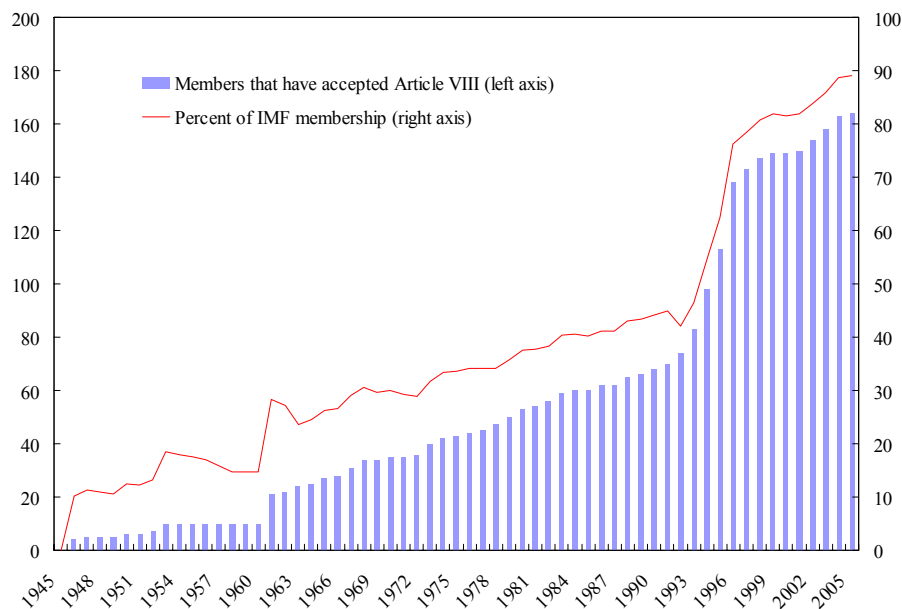
16. **It is important to distinguish between the acceptances of Article VIII obligations and the maintenance of an exchange system free of exchange measures.** As noted above, there have been cases in which members have notified their acceptance of Article VIII obligations while maintaining exchange measures or have imposed them after such notification, even where such imposition is inconsistent with Article VIII obligations. Conversely, a member may eliminate all such measures without notifying the Fund that it has accepted Article VIII obligations. Country practice in this area is discussed below.

III. ACCEPTANCE OF ARTICLE VIII OBLIGATIONS

A. Trends

17. **When the 1992 biennial review was discussed by the Board, 74 member countries had notified the Fund of their acceptance of Article VIII obligations.** Of those which had not, 68 had been Fund members for more than 20 years, while 39 members actually did not maintain any restrictions under Article XIV, of which the Fund was aware.

Figure 1. IMF Member Countries Accepting Article VIII Obligations, 1945–2005



Note: As of end-December 2005.

Source: AREAER database.

18. **Since then, the proportion of Fund member countries that have notified the Fund of their acceptance of Article VIII obligations has increased sharply, but a**

number of countries have not yet done so and have availed themselves of Article XIV for an extended period. The proportion of countries that have notified their acceptance of Article VIII obligations rose from less than 50 percent in 1993 to almost 90 percent in 2005 (Figure 1), with a particularly large number of countries (64) notifying their acceptance between 1993 and 1996. After gradually declining, this number increased again, with seven countries notifying acceptance during 2004–2005. At present, 19 members (holding less than five percent of Fund quotas) have not yet notified the Fund of their acceptance of Article VIII obligations.¹⁴ Of these, at least half have been Fund members for more than 40 years. Four countries do not maintain any exchange measures under Article XIV but are reluctant to notify the Fund that they accept Article VIII obligations.

19. **A number of countries that have already notified the Fund of their acceptance of Article VIII obligations have continued to maintain existing or introduced new exchange measures.** A review of the staff reports for recent Article IV consultations with these members indicates that, presently, 18 members that have so notified the Fund maintain unapproved exchange measures that would not appear to be imposed for reasons solely related to national or international security.¹⁵ Another 5 members that have accepted Article VIII obligations maintain approved exchange measures. The countries currently maintaining exchange measures hold about 10 percent of Fund quotas and represent a similar share of world GDP and world trade, which together with the share of countries availing themselves of Article XIV amounts to almost 20 percent of world trade.

20. **These exchange measures are mainly of three types:** (i) limits on payments for invisible transactions (i.e., travel, medical, and educational allowances); (ii) limits on transfers from nonresident accounts; and (iii) foreign exchange budget allocation systems. Some of the exchange measures are evidenced by the existence of nonsovereign external payments arrears. Existing MCPs arise mainly from the use of special exchange rates for official transactions and the imposition of foreign exchange taxes and subsidies. The reasons generally given by countries maintaining exchange measures are discussed more fully in Section IVB.

21. **A number of members have, in the past five years, introduced exchange controls in the context of recent international initiatives to combat terrorist-financing and money-laundering.** Some of these controls give rise to exchange restrictions that should be notified to the Fund pursuant to the procedures described in Decision No. 144-(52/51).¹⁶ The number of countries maintaining such restrictions has increased from 69 (37 percent of total reporting countries) in 2000 to 104 (54.5 percent of total reporting countries) in 2005.

¹⁴ In terms of their economic significance, they hold a negligible share of world GDP and a less than 10 percent share of world trade.

¹⁵ This number excludes any members that have not yet notified the Fund of their acceptance of Article VIII obligations and that have exchange restrictions or MCPs that are subject to Fund approval that have not been approved.

¹⁶ See footnote 9 above.

However, there would appear to be scope for improving the reporting of such measures to the Fund. There is evidence to suggest that not all such restrictions have been notified to the Fund.¹⁷

B. Underlying Factors

22. **The Fund's effort to encourage member countries to eliminate existing exchange restrictions and MCPs and accept Article VIII obligations has been an important factor behind the increase in acceptance since 1992.** This effort was based on the assessment, reflected in the 1992 biennial surveillance review, that global economic circumstances allowed for the more rapid development of functioning market economies. Drawing upon the Fund's legal framework, staff has promoted current account convertibility through Article IV consultations, technical assistance, program conditionality, and analytical work. Fund publications, especially the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), have also played a useful role.

23. **Other factors were related to trade liberalization or regional efforts.** These included: (i) WTO-member practices to negotiate the elimination of exchange measures subject to Fund jurisdiction with countries seeking to join the WTO; (ii) EU requirements that countries planning accession liberalize their rules governing international payments and transfers; and (iii) other bilateral and regional agreements (e.g., NAFTA) requiring current account convertibility on transactions covered by the agreements.

24. **Above all, the global environment that fostered free markets during the 1990s, manifested itself in broader liberalization trends that presaged more open exchange systems and markets, institution building, and divestment of state holdings.** Based on country experiences, an important domestic factor behind the liberalization trend was the emerging private sector, which generally had an interest in dismantling unnecessary controls. Furthermore, some countries were encouraged to pursue current account convertibility by the recognition of the inefficiencies of maintaining exchange measures and by the need for greater exchange rate flexibility to restore balance of payments viability.

IV. ELIMINATION OF RESTRICTIONS AND MULTIPLE CURRENCY PRACTICES

A. Macroeconomic Implications

25. **The negative economic effects of these exchange measures are historically well-recognized.** The trade stifling effects of such measures were particularly acute when it became common practice for many countries in the 1930s to introduce multiple exchange

¹⁷ In this regard, there are specific restrictions imposed for security reasons that are cited in the 2005 Annual Report on Exchange Arrangements and Exchange Restrictions that have not been notified to the Fund; it needs to be confirmed whether such measures do, in fact, remain in place. Based on a review of the information in the AREAER, out of 104 countries that would appear to maintain such security-related restrictions, only 88 countries have notified the Fund pursuant to Executive Board Decision No. 144-(52/51).

rates to stimulate exports and discourage imports and to engage in bilateral trade and payments agreements.¹⁸

26. **Such exchange measures introduce discernible economic distortions.** Exchange restrictions cause undue delays in obtaining foreign exchange, and result in transactions being shifted to parallel markets where premiums can change rapidly, reaching hundreds of percentage points in extreme cases. Such disparities between parallel market rates distort decisions on consumption, production, and investment and impose heavy welfare costs by distorting import and export prices and introducing implicit taxes and subsidies that vary by type of transaction.¹⁹ Moreover, studies have shown that countries with high parallel exchange rate volatility also exhibit greater price volatility.²⁰

27. **Other possible distortions are more inconspicuous.** Exchange restrictions could encourage rent-seeking behavior and impose government losses associated with enforcement costs and the inability to collect implicit taxes. They could lead to disintermediation and prevent the proper development of financial institutions and markets. They could encourage illegal activity and erode political capital both domestically and abroad.

28. **Correspondingly, the elimination of such exchange measures, often in the context of a member's acceptance of Article VIII obligations, could bring economic benefits.** The removal of restrictions on payments and transfers for current international transactions could reduce parallel market spreads and facilitate trade. The elimination of MCPs could usher in the unification of official exchange markets and introduce a more market-based pricing of foreign exchange. Exchange rates may also exhibit more stability as the foreign exchange market deepens and develops with more transactions being conducted in the official market. The elimination of exchange restrictions could also lead to an increase in the volume of transactions through the banking system, thereby increasing the amount of intermediated funds and providing more accurate information to the authorities about the nature and volume of the flows.²¹ Notably, the acceptance of Article VIII obligations is often seen as a positive signal that commits members' authorities to refrain from resorting to distortionary restrictions in the future. This in turn, could help build overall investor confidence and encourage capital flows.

29. **In practice, it is difficult to establish causality between the acceptance of Article VIII obligations and improved macroeconomic outturns.** On one hand, a country's decision to accept these obligations may be taken long after the elimination of the

¹⁸ See Elizalde (2004).

¹⁹ The Appendix describes a framework for analyzing these distortions.

²⁰ See Montiel et al. (1993).

²¹ Banks are typically subject to reporting requirements concerning transfers made on behalf of their clients. These reports, if adequately designed, can provide timely and useful information to the foreign exchange authorities.

exchange measures. On the other hand, a member may accept these obligations without having eliminated all outstanding measures or may impose new ones after acceptance. Lack of data on the timing of the removal of exchange measures prevents the use of econometric techniques to estimate the impact of this removal on macroeconomic outcomes. Moreover, in some cases exchange measures may be replaced with current account controls that have an equivalent economic impact but may not be subject to Fund approval.²² Finally, removal of exchange measures and acceptance of Article VIII obligations may be accompanied by sound macroeconomic policies in general that contribute to the often observed favorable macroeconomic outcomes after acceptance.

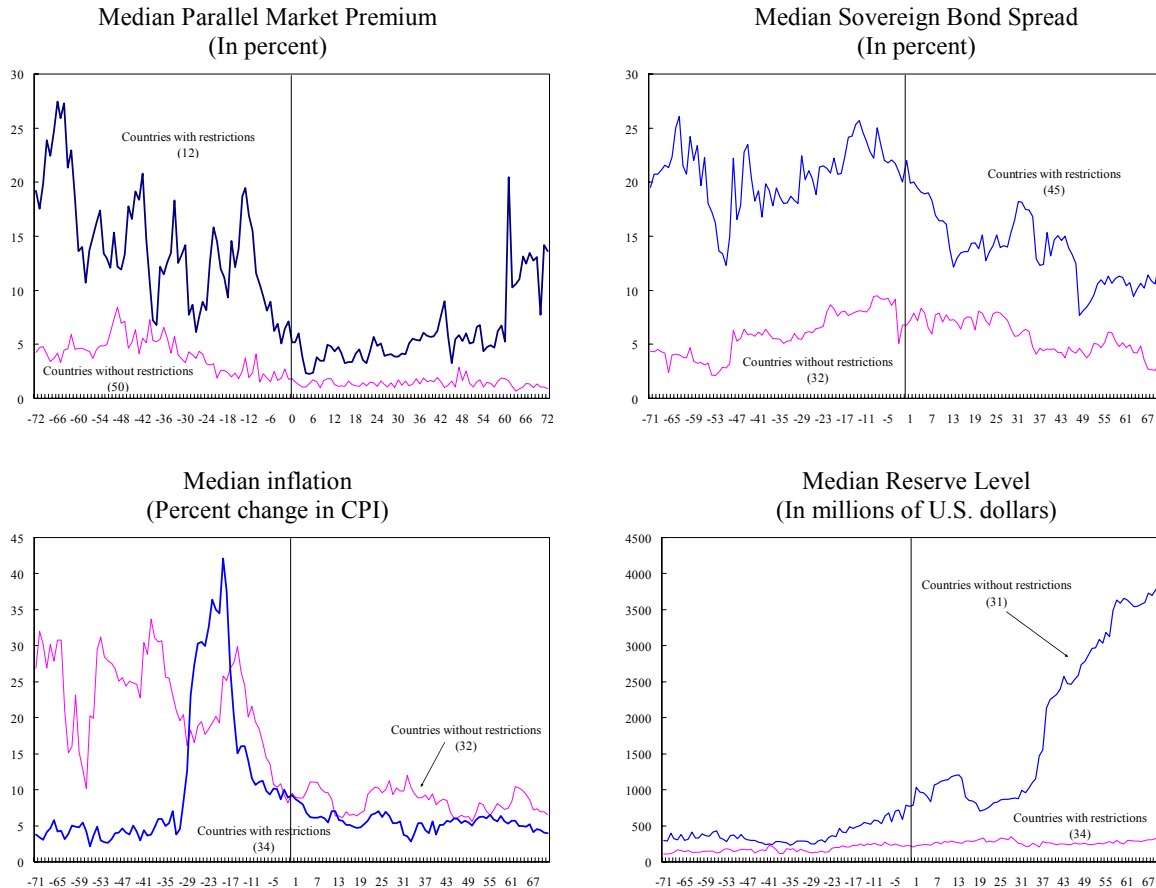
30. **Subject to these qualifications, observed trends in selected macroeconomic variables seem to suggest that Article VIII acceptance has been associated with positive economic developments, particularly with respect to parallel market spreads.** There has been a notable decline in parallel market spreads in the process of countries' acceptance of Article VIII obligations. This observation holds across all regions, across time, and regardless of the exchange rate regime of a country at the time of such acceptance (Figure 2). Moreover, countries that accepted Article VIII obligations after removing all outstanding exchange measures seem to have experienced significantly lower parallel market spreads than countries that retained the measures. This indicates that beneficial outcomes are likely to be related to the elimination of restrictions. On average, the volatility of exchange rates with respect to the U.S. dollar has declined with the acceptance of Article VIII obligations. Similarly, inflation and interest rates have been lower and more stable, although there seems to be no clear correlation with the member's acceptance of Article VIII obligations.²³

31. **There has been no verifiable effect of the trend in the acceptance of Article VIII obligations on international trade since 1992, although individual countries have experienced significant growth in trade in periods after acceptance.** On average, trade has been on an upward trend in most countries as trade reforms have progressed and trade restrictiveness has loosened over time. In many countries, removing trade stifling exchange restrictions has been completed long before the acceptance of Article VIII obligations.

²² More generally, countries may introduce controls on current international transactions in a manner consistent with their Article VIII obligations. These controls may affect trade in goods and services or certain invisibles. For example, some countries replace exchange restrictions with import licensing requirements.

²³ The latter observations may reflect the fact that global inflation and interest rates have been on a downward trend driven by large industrialized economies with low inflation.

Figure 2. IMF Members: Selected Economic Indicators Before and After Acceptance of Article VIII Obligations, 1995–2005



Note: The horizontal axes indicate months before and after acceptance of Article VIII obligations.

Sources: *Pick's Currency Yearbook*; IMF, *International Financial Statistics*, various issues, and *World Economic Outlook*, various issues; and Bloomberg.

32. **Members accepting Article VIII obligations have experienced deterioration in the balance for invisible transactions, but this has been offset by an inflow of capital and improving reserve levels.** Restrictions on payments and transfers associated with invisible transactions, including on remittances of foreign workers' earnings, profits, interest, and dividend payments, have been the most common type of exchange restrictions. Their removal, usually just before the acceptance of Article VIII obligations, has worsened countries' balances on invisible transactions. However, with the removal of restrictions on remittances of profits and other earnings, foreign direct investment may have also surged. The removal of restrictions on invisible transactions has also commonly been associated with a simultaneous opening of the capital account, facilitating capital inflows and a build-up of international reserves.²⁴ As figure 2 shows, countries that removed exchange measures prior

²⁴ Invisible transactions are typically used to circumvent capital controls because their purpose, true value, and date of contract fulfillment are difficult to verify. Hence, since restrictions on invisible transactions are often

(continued)

to or in parallel with the acceptance of Article VIII obligations have been more successful in building up reserves than countries that retained the measures.

33. **Acceptance of Article VIII obligations has also been associated with the elimination of distortionary fiscal practices.** Price distorting MCPs—implicitly taxing export sectors and subsidizing imports of vital items—have been eliminated in the process of accepting Article VIII obligations. In cases where the implicit import subsidies have not been replaced with direct ones, such acceptance has been associated with improved government balances.

B. Implications for Countries Maintaining Exchange Measures

34. **According to a survey of desk economists, preventing capital flight, maintaining adequate levels of reserves, and fiscal stability were the main reasons for countries to maintain exchange restrictions and MCPs.**²⁵ Some of the results of the survey are summarized below:

- **Some members impose restrictions to prevent a loss of international reserves through capital flight, but the effectiveness of these measures has been moderate.** Currently, 14 countries (out of the 26 for which responses were received) maintain restrictions with the objective of maintaining adequate levels of reserves. Of these, 11 have pegged exchange rate regimes, which require significant international reserves to be credible. Among the countries struggling with declining foreign reserves, the restrictions were effective in the cases where they were used as an instrument to secure funds for foreign debt repayment. The restrictions appear to be mostly ineffective in the presence of strong pressure on foreign reserves and, generally, in crisis situations.
- **Some countries use exchange measures as fiscal policy instruments, including for revenue enforcement and income redistribution.** Commonly used restrictions are tax certification requirements—permitting the transfer of nonresident income only after payment of all outstanding tax obligations—and multiple exchange rates resulting in MCPs. The latter results in some sectors being indirectly taxed, while others are subsidized. For example, if the military or state-owned enterprises have privileged access to foreign exchange and the private sector is only allowed to purchase foreign exchange at the free market rate, private sector importers could lose competitiveness vis-à-vis enterprises owned by the state.

introduced to fence capital outflows, their elimination is sometimes indistinguishable from the removal of capital controls.

²⁵ These views reflect responses from 26 desk economists out of 33 surveyed. Countries were selected for the survey based on available information regarding the long-term use or retention of exchange measures.

- **Some authorities fear that the removal of such exchange measures could potentially exacerbate their fiscal imbalances.** Cross-country experience shows that such fears are unwarranted since the elimination of any implicit subsidies could bring down the government's (quasi-)fiscal costs.
- **Albeit imprecise, an estimate of the economic significance of the existing exchange measures has emerged from the survey.** Desk economists typically quantify the economic significance of these measures with the share of affected foreign exchange transactions. Based on this type of assessment, twelve desk economists consider that the exchange measures of their assigned countries have a negligible or small economic effect and the impact of their removal should be manageable. Six desk economists consider that the measures are significant as they affect a substantial share of foreign exchange transactions.

V. ISSUES GOING FORWARD

35. **A consistent and sustained effort is needed on the part of the Fund to encourage the continued liberalization of exchange measures by Fund members and to ensure that the provisions of Article VIII are observed.** This focus is dictated by the concerns identified above with regard to the reliance by some members on the transitional arrangements of Article XIV for extended periods, the imposition by some members of exchange measures without Fund approval, and the need to ensure that all security-related restrictions are reported to the Fund on a timely basis.

36. **A key aspect of this effort relates to monitoring members' compliance with their Article VIII obligations and pressing for the removal of unapproved exchange measures.** In the context of the Fund's regular Article IV consultations with members, staff will continue to monitor the introduction of exchange measures subject to Fund jurisdiction, regardless of whether they have been introduced for balance of payments, security, or other reasons. On the basis of the most recently issued Article IV staff reports, there are 29 members that presently impose exchange measures without Fund approval in a manner that is inconsistent with their Article VIII obligations.²⁶ Hence, the Fund must continue to press for compliance by all members with their obligations under the Articles. Moreover, it is important to ensure that any changes which members make to their exchange control regimes are consistent with Article VIII. In particular, members should consult with Fund staff before

²⁶ This number comprises 18 members that have previously notified the Fund of their acceptance of the Article VIII obligations and 11 members that continue to avail themselves of the transitional arrangements of Article XIV, section 2, while maintaining exchange measures which are subject to approval under Article VIII.

introducing such changes and should notify the Fund as soon as possible when imposing restrictions for security reasons.²⁷

37. **In support of this effort, it is important to ensure that the Fund has complete and up-to-date information on members' exchange systems.** Under Article VIII, Section 5, members are required to provide the Fund with information on their exchange controls and official clearing arrangements.²⁸ Recent changes to members' exchange systems are routinely reviewed by the Fund in the context of the Article IV consultation process. The AREAER plays an important role in compiling information on members' exchange systems in a comprehensive and systematic form. To allow the AREAER to continue to play this role, it is essential that the members provide the Fund with the information necessary for this purpose.

38. **Another aspect of this effort relates to the notification of the acceptance of Article VIII obligations by the Fund's remaining members availing themselves of the transitional arrangements of Article XIV.** As the balance of payments position of these members allows, staff will encourage these members to eliminate all exchange measures subject to Fund jurisdiction and to notify their acceptance of Article VIII obligations. Seven countries accepted Article VIII obligations during 2004 and 2005. Three of these members, however, opted to notify their acceptance before their exchange systems had been subject to a comprehensive review.

39. **There is a growing demand for technical assistance from the Fund in streamlining existing exchange regimes.** Fund staff has assisted many members that are reforming their exchange systems, and have advised on changes that go beyond the elimination of exchange measures. There is frequently scope for simplifying the legal framework for exchange transactions, which can promote trade and capital inflows by reducing administrative costs, red tape, and generally lowering the thresholds for conducting trade and other current transactions.

40. **Fund staff is planning additional research work on the economic implications of exchange measures.** Three key areas where such research could be warranted are: (i) in the analysis of parallel markets, including their size, reemergence, and economic implications; (ii) in studying the effects of foreign exchange liberalization on macroeconomic developments and trade, controlling for other policies, and focusing on the economic implications of re-imposing measures; and (iii) in studying the economic implications of existing security-related restrictions.

41. **The Fund's present framework to address current account liberalization remains broadly adequate, but firmer implementation and better data are needed.** In

²⁷ Where members maintain measures which are subject to Sections 2(a) and 3 of Article VIII, they are required to consult with the Fund with respect to the further maintenance of such measures pursuant to Decision No. 1034-(60/27), adopted June 1, 1960, para. 3.

²⁸ See Article VIII, Section 5(a)(xi) and (xii).

light of the Fund's resource constraints, the key focus will continue to be on efforts related to monitoring members' compliance with their Article VIII obligations, pressing for the removal of unapproved exchange measures, and helping member countries to establish and operate well-functioning and efficient foreign exchange systems.

Analytical Methods for Estimating the Economic Implications of Exchange Restrictions and MCPs

Exchange restrictions and MCPs tend to increase the cost at which current international transactions are conducted. They create a wedge between the actual exchange rate and an exchange rate that would prevail without their existence. This appendix summarizes the methods that have been used in analyzing the economic implications of exchange restrictions and MCPs.

Models on parallel markets can help assess the costs of restrictions and MCPs that arise from a diversion of transactions from the official to the parallel market. Typically, impact of restrictions or a change in the monetary stance on the parallel market spread is used to demonstrate the extent of the distortions introduced through the functioning of a parallel market. Models analyzing the properties of parallel markets, including the volatility of parallel exchange rates and the potential illegal arbitrage across the parallel markets are summarized by Montiel et al. (1993):

- The real trade approach provides a framework for analyzing the impact of restrictions on the parallel market rate and focuses on the diversion of transactions demand for foreign exchange from the official to the parallel market.
- The monetary approach focuses on the role of expansionary monetary policy in increasing parallel market spreads, and the impact of the latter on incentives to under-invoice permitted trade and transact illegally through the parallel market.
- The portfolio and currency substitution model treats foreign exchange as a financial asset and emphasize the role of asset composition in the determination of the parallel market exchange rate.

However, the analytical approach to assess the economic implications of exchange restrictions and MCPs will need to be tailored according to country-specific conditions. In particular, the analysis would have to take into account the types of restrictions in place, the main factors driving existing exchange rate markets, macroeconomic policies, and the prevailing exchange and capital account regimes (including existing legislation, institutions, and authorities' current practices).

The actual impact of restrictions and MCPs depends also on a number of factors that are not always readily observable. For instance, the distortionary impact of quantitative limits on invisible transactions would depend on whether or not the limits are set high enough to accommodate the actual demand for foreign exchange, on the authorities' enforcement capacity, and on the presence of other exchange controls that could prevent loopholes for evasion. To a certain extent, the volume of transactions in the parallel market would indicate the amount of unmet foreign exchange demand in the system, but parallel market data are seldom readily available, given the illegal nature of these markets. In

addition, the parallel market also provides an avenue for other illegal activities that are unrelated to exchange restrictions and MCPs, so it would be difficult to isolate the transactions brought about only by specific individual measures.

Nevertheless, some attempts have been made to quantify the impact of exchange restrictions and MCPs in selected countries:

- *Standard trade theory* has been used to analyze the welfare cost of maintaining a parallel market. In particular, the welfare losses of the import and export sector took into account the net effects of domestic producers' losses, consumer gains, and government losses due to import subsidies or export surrender requirements.
- *The monetary approach* has been applied to quantify the cost to a central bank of multiple currency practices. Under this framework, the central bank's purchases of foreign exchange from exporters at a more appreciated rate compared to the equilibrium rate and its foreign exchange sales to importers at a less appreciated rate effectively introduced implicit export taxes and import subsidies. The net tax (subsidy) was reflected in the increase (decrease) of the central bank's net foreign assets.
- *A parallel market approach*, supported with econometric analysis, has also been used to estimate the reduction of official exports as a result of depreciation in the official and parallel exchange rates.

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