UPDATE 2-IMF softens currency surveillance rules

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(Adds details, quotes by spokeswoman, analyst)

By Lesley Wroughton

WASHINGTON, June 30 (Reuters) - In a major about-face, the International Monetary Fund on Tuesday revised the way it monitors foreign exchange rates of member countries, acknowledging that its efforts to label currencies had backfired.

In a staff report, the IMF said it would no longer use the specific phrase "fundamental misalignment" in its assessment of exchange rates that it decided to use since 2007 to pressure countries to alter foreign exchange policies.

"The attempt to apply exchange rate-related 'labels'-- for instance, the use of specific terminology such as fundamental misalignment -- has proved an impediment to effective implementing of the decision," the IMF said.

The revision appears aimed at easing tensions with China, which opposed the 2007 changes and pushed back at the Fund's prodding over its exchange rate.

Beijing saw the decision as part of a U.S. ploy to enlist the Fund in its campaign for a stronger yuan and delayed the completion of the IMF's annual assessment of China's economy.

While China is not the only country to object to the 2007 decision on exchange rate surveillance, it is by far the most important.

The staff report also said that because of a shift in policy, it would no longer hold ad-hoc consultations with countries whose currencies are misaligned and causing problems for other nations.

It said its attempts to determine whether foreign exchange policies were "fundamentally misaligned" undercut the candor of discussions with countries and undermined the Fund's monitoring role and damaged its credibility.

IMF spokeswoman Caroline Atkinson said the 2007 decision helped to sharpen the focus of the IMF's surveillance and improved the quality of its exchange rate analysis.

"A change in the way we implement the decision does not change the decision itself," Atkinson said.

"We believe that the revised guidance will promote deeper analysis and candid discussion on exchange rate policies with countries and at our executive more effectively than labeling," she added.

IMF Managing Director Dominique Strauss-Kahn has preferred to use the term "significantly undervalued" when speaking of the Chinese currency and urged Beijing to structure the economy toward relying more on internal rather than external demand.

The new Obama administration has also sought a new tone for dealing with China. Unlike his predecessor, new Treasury Secretary Timothy Geithner has refused to call the yuan undervalued, keeping the issue on the burner without letting it boil into a disputed item.

Eswar Prasad, a professor at Cornell University and former IMF official, said the 2007 decision by the IMF on currency surveillance created enormous ill will among major emerging market economies.

"Given that the IMF has become reliant on these economies to participate in the increase in its resource base, I think they have felt an essential need to bring the emerging markets back on board," Prasad said, speaking by phone from Beijing.

"I wouldn't characterize it as a quid pro quo, but there is a strong element of a tie-in between the emerging markets, especially China, agreeing to contribute to the IMF's resource pool and a weakening of what was seen as a very contentious approach to exchange rate surveillance," he added.

China, Russia and Brazil have announced in recent weeks they intend to contribute to IMF resources as part of an agreement by Group of 20 member nations in April to boost the Fund's capital by $500 billion, as more countries turn to it for emergency loans to cope with the global crisis.

The move is also part of rising emerging powers' efforts to play a larger role in global financial institutions.

Prasad said the revision changed the emphasis the IMF puts on exchange rates in the overall surveillance process.

"It does appear we will go back to a system where the exchange rate is one of the many elements that is part of the assessment process and is not given any special emphasis," he said.

(Reporting by Lesley Wroughton; Editing by Dan Grebler, Bernard Orr)