

## INDEPENDENT EVALUATION OFFICE COMMENTS ON MANAGEMENT AND STAFF RESPONSES TO THE EVALUATION OF INTERNATIONAL RESERVES: IMF CONCERNS AND COUNTRY PERSPECTIVES

Executive Board Meeting  
December 7, 2012

The IEO would like to thank the Managing Director for her statement, and especially her agreement with most of the IEO's recommendations that follow from its analysis. Noting, as the Managing Director also does, that these recommendations are congruent with a number of recent Fund policy positions, the IEO trusts that they will be reflected in the Fund's future surveillance activities.

However, the response by IMF staff misunderstands the main messages of the evaluation. Therefore, rather than responding point by point to staff's interpretation of the IEO's report (Report hereafter), we think it is more constructive to bring the debate back to the central areas of contention, namely the importance of excess reserve accumulation as a threat to the international monetary system (IMS) and the appropriate attention that should be given to the views of country authorities on the issues of reserve accumulation and reserve adequacy.

### Reserves as a threat to the IMS

The Report argues that the IMF's discussion of risks to the IMS from reserve accumulation focused on the symptom of reserve accumulation rather than on the underlying factors driving that accumulation. The IEO is well aware of the IMF's post-crisis work on the IMS, and welcomes its wide-ranging scope. The Report calls for incorporating that often rich body of analysis into its discussion of reserve accumulation.

The Report found that the IMF has not presented a persuasive analysis of why excessive reserves constitute a major problem for the IMS. Nor has it explained how it would identify when a country's or a group of countries' reserves are large enough to pose such a problem. The Report argues that without a clear understanding of the threat of reserves to the IMS, one cannot expect

countries to reduce their reserves, which they see as a critical element of a strategy to insure against shocks. An answer to these fundamental questions is essential for the Fund's success in addressing the alleged problem.

The Report and background papers, which contain more elaborate analysis, indicated that the IMF's concerns about excessive reserve accumulation did not add value to its discussion of global imbalances frequently expressed earlier in the decade. Moreover, rising and more volatile capital flows have also generated concerns in a number of member countries and resulted in higher reserve demand. The Report therefore concluded that policy measures to deal with these concerns should be targeted at the underlying causes of current account imbalances and capital flow volatility, rather than at one of their symptoms.

This point can be illustrated by addressing the staff's assertion that large demand and limited supply of reserve assets constitutes a source of distortion in the IMS. It appears more fruitful to engage the IMF membership on the fundamental policy distortions that lead to large imbalances and excessive capital flow volatility from which the high reserve demand derives, rather than focusing on the excessive reserve accumulation as the source of the distortion in isolation. Yet this was the approach adopted in the papers and speeches the Report was critical of.

### Bilateral Surveillance

The Report noted that surveillance of the largest reserve accumulators was generally appropriate *specifically* because it did not focus on international reserves as such, but on the more fundamental issues involved, thus implicitly recognizing that reserve accumulation was primarily a symptom of deeper structural factors and policies. In other words, the evaluation's positive

assessment of surveillance of the large accumulators is integral to the IEO's critique of the IMF's recent attempts to cast excessive reserve accumulation as a risk to the IMS.

On the other hand, the Report drew attention to several shortcomings in the bilateral surveillance of reserve adequacy in other economies. In particular, a number of these assessments were complacent, pro forma and emphasized a few traditional indicators without taking a broader holistic look at the risks to a country's external and domestic stability.

In this context we take this opportunity to address a misunderstanding by staff of the Report's conclusions regarding the role of peer comparisons in forming judgments about appropriate reserve levels. The response by staff contains an inaccurate characterization of the arguments in the Report which simply stated that for such peer comparisons to be useful they need to pay attention to relevant country-specific circumstances.

The Report also argues that academic research has not provided a solid basis for placing upper limits on reserve levels based on the impact of excessive reserves on the IMS, and that research is unlikely to provide more than approximate guidelines for minimum precautionary reserve levels. Hence, the Report concludes that the reserve adequacy metric which defines upper and lower bounds for precautionary reserves should be adapted to country-specific circumstances and be used as one element in a broad range of indicators that take into account the multiple tradeoffs involved in decisions on reserve accumulation and reserve adequacy.

## Methodology

In its response staff argued that the IMF's rationale for focusing on reserve accumulation and the IMS was neither motivated by a wish to limit the level of reserves held by any country nor to actively pressure countries to reduce existing reserve levels. The IEO welcomes this clarification, but notes that the statement seems at odds with Board documents dealing with this issue, with the perceptions of many of the country authorities interviewed for the evaluation, as well as with the views of some Executive Directors and senior IMF officials who were also interviewed.

With regard to the representativeness of the country sample, the evaluation was based on the experience of 43 economies representing emerging-market and advanced

countries. Given the concern about the relationship between reserves and the IMS that motivated the evaluation, the sample includes most holders of large international reserves, as determined by the absolute size of reserves and the magnitude and speed of reserve accumulation during the evaluation period.

In other words, countries were chosen on the basis of their contribution to the size and growth of global reserves, and not on the basis of their reserve holdings relative to conventional measures of domestic precautionary needs. We believe that this manner of determining the country sample ensures that it is representative for the issue at hand.

## Looking ahead

The global crisis has not ended and the issues highlighted by this evaluation are pertinent to how the IMF formulates policy responses to ensure domestic and international stability. In particular, the findings and recommendations of this evaluation have a bearing on how the IMF conducts external stability assessments for countries and implements the recently adopted Integrated Surveillance Decision.

The IEO finds comfort in the fact that there have been encouraging developments with regard to several recommendations it has made, but notes that more can be done. At the bilateral level, the analysis and advice on reserves could be better integrated with the analysis of financial stability more generally, including, where relevant, in advanced economies. While the response of staff mentions that work has begun in these areas, numerous emerging country officials interviewed for the evaluation felt that much still remains to be done both at the analytical level and in the context of Article IV consultations. Several officials from advanced countries also noted that the Fund has yet to provide an analytical basis for the assessment of reserve adequacy in their countries.

In the context of multilateral surveillance, the precise nature of the externality posed by excessive reserves (as opposed to inadequate reserves mentioned in the response of staff) needs to be clarified if it is to be used as an indicator to be monitored.

The IEO hopes that the analysis, conclusion, and recommendations contained in this report will serve to enhance the work already begun at the Fund on these important issues.