1. This background document presents a summary of major findings from the IEO’s in-depth review of IMF exchange rate surveillance in 30 economies, which was designed to supplement the full review of documents for all countries. As explained below, the 30 economies were selected on the basis of a set of economic indicators as well as consultations with various stakeholders (Table A5.1).

**Design and Implementation**

2. The selection of the economies involved a three-stage process. First, the evaluation team selected the euro area, Japan, and the United States for their systemic importance and the West African Economic and Monetary Union (WAEMU) as the largest of the regional monetary unions among the developing countries.

3. Second, the team considered additional economies from a list of 78 economic areas that met two or more of the following criteria, which were thought to identify cases where exchange rate issues might be particularly relevant:

   - Largest multiperiod current account imbalance, both in percent of GDP and U.S. dollars, during 1999–2005 (measured on the basis of rolling, two-year averages);
   - Percentage change in and coefficient of variation for the real effective exchange rate during 1999–2005;
   - Change in foreign exchange reserves over 1999–2005, in percentage terms and in relation to the M2 money stock at end-1998;
   - Average trade openness, measured as the sum of exports and imports divided by GDP, during 1999–2005;
   - Exchange rate regime change (based on the IMF Monetary and Capital Markets Department’s de facto classification of exchange arrangements); and
   - De facto dollarization (countries with a score of 10 or more on IMF staff’s composite dollarization index).

4. Third, the team consulted with IMF staff, members of the Executive Board, and other stakeholders to see if there were additional country cases that could provide significant insights into how the IMF conducts exchange rate surveillance. In finalizing the list of economies for the in-depth review, the evaluation team sought diversity in terms of geography, experience with regime change, and program or technical assistance relationships with the IMF (see Annex A5.1 for the summary descriptive statistics for these economies).

5. The 30 economies selected for review can conveniently be grouped on the basis of type of country or exchange rate regime (Table A5.2).

6. To give a thorough and consistent treatment to each of the economies, a detailed set of questions was prepared, for which answers were based on all relevant documents for the 1999–2005 period, including communications with the authorities and internal memorandums or analytical documents on issues related to exchange rate policies. Because of the deliberate selection process (and the greater weight of advanced economies and larger emerging market countries in the sample), the evaluation team designed the questions in such a way as to allow a consistency check with the full review. This allowed the team to draw any generalizations from the findings with greater confidence.

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2The country groups follow the IMF’s World Economic Outlook, except that “Other emerging market and developing economies” are further broken down by size.

3Some of these questions, along with coded answers, are reproduced in Annex A5.1.

4As a simple illustration, coverage of exchange rate issues in staff reports was higher, on average, for the 30 sample economies than for the entire IMF membership (see Background Document 4).
Main Findings

7. The primary objective of the exercise was to identify issues and trends that cut across the 30 economies. In identifying these issues and trends, the review focused on a variety of broad quality dimensions, some of which are summarized below.

Coverage of exchange rate issues

8. For emerging market and developing countries, the analysis focused mainly on competitiveness considerations, while for advanced economies the coverage tended to be richer, with some prominence given to developments in global capital markets and their capital account implications. Exchange rate policy advice per se was given only in 60 percent of the cases reviewed, with half of the remaining cases involving advanced economies with flexible exchange rate regimes.

9. In several countries, exchange rate discussions between staff and the authorities were much more intense than suggested by the Article IV reports. For example, detailed discussions on the exchange rate regime took place with little or no documentation in Article IV staff reports or related selected issues papers. Staff activities in these cases ranged from informal workshops to confidential staff notes and meetings with the authorities and staff exploring a variety of alternative policy options in the process.

10. At the other extreme, hard policy constraints and market or political sensitivities have meant that the authorities in some countries were either hesitant or unwilling to discuss certain policy issues. IMF staff, in turn, have sometimes been unwilling to deal in a substantive way with possibly contentious issues (e.g., exchange rate level, regime choice, or intervention policy), partly in order to preserve the IMF’s cooperative relationship with the member country concerned. As a result, certain exchange-rate-related issues remained effectively “off the table,” or their treatment appeared to be pro forma with no true engagement—at least for a certain period of time. The review finds that these factors applied for at least five economies, though for different reasons and under different circumstances.

Integration of exchange rate and other policies

11. An important aspect of IMF analysis of exchange rates concerns the integration of exchange rate policies...

Table A5.2. Features of the 30 Sample Economies

<table>
<thead>
<tr>
<th>Exchange Rate Regime (As of 2005)</th>
<th>Major Advanced Economies</th>
<th>Other Advanced Economies</th>
<th>Other Emerging Market and Developing Economies</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent float</td>
<td>4</td>
<td>4</td>
<td>3 (30)</td>
<td>12</td>
</tr>
<tr>
<td>Managed float</td>
<td>1</td>
<td>1</td>
<td>2 (13)</td>
<td>7</td>
</tr>
<tr>
<td>Other fixed peg</td>
<td>4</td>
<td>2</td>
<td>4 (20)</td>
<td>6</td>
</tr>
<tr>
<td>Currency board</td>
<td>1</td>
<td>2</td>
<td>2 (30)</td>
<td>3</td>
</tr>
<tr>
<td>No separate legal tender</td>
<td>2</td>
<td>2</td>
<td>2 (30)</td>
<td>2</td>
</tr>
<tr>
<td>Total (percent of total)</td>
<td>4 (13)</td>
<td>6 (20)</td>
<td>9 (30)</td>
<td>30 (100)</td>
</tr>
</tbody>
</table>
with measures in other policy areas. For most countries reviewed, integration with monetary and fiscal policies was found to be good overall (e.g., on the monetary policy implications of intervention and sterilization operations, the importance of pass-through effects for inflation and monetary policies, the extent to which exchange rate developments should be factored into monetary policy decision making, and in assessing the effects of debt indexation and fiscal dominance considerations for exchange rate and monetary policies); and, for most countries, there was a good integration of exchange rate policies with structural policies (though with the coverage of mutual implications more vague and less detailed than for other policy areas). Integration was judged to be somewhat lacking relative to financial sector and financial stability issues, though coverage and integration across countries clearly improved over time—and significantly so in the case of those receiving FSAP and related technical assistance missions (e.g., due to better availability of data on financial sector exposures, and a richer knowledge and coverage of institutional detail). This finding is consistent with the IEO’s recent FSAP evaluation.

12. The in-depth review found that the integration of area departments’ advice with the internal interdepartmental “vulnerabilities exercise” was well done. This can in part be explained by the structure of the exercise in which area departments play a key role in coming to the final risk assessment for a given country. Even when the initial model-based exercise signaled that a crisis was improbable (due to strong fundamentals), there were cases where area department staff judgments prevailed—both in the vulnerabilities exercise itself and in bilateral surveillance.

13. An area that, despite recent improvements, remains insufficiently integrated is regional and global spillovers. Although substantial progress was found in the treatment of international ramifications of U.S. policies and of possible regional spillover effects from antideflationary measures in Japan, progress was much less pronounced in the treatment of the policies of other advanced economies. An example of asymmetric treatment is given by the staff reports for the Article IV consultations with the euro area. Although the analysis covered issues such as the implications of a possible disorderly adjustment of the U.S. dollar, there was only limited coverage of the implications of euro area policies for the global economy or individual countries (such as those in Eastern Europe). This was despite exhortations, in the internal review process, to “cover more the Eastern European countries” and to explore “the risks of reversal of the strong capital flows into Eastern Europe” along with any implications of adverse developments in this region for euro area policies. A similar lack of coverage was identified with respect to the regional implications of policies in such countries as Brazil and Russia. In the case of China, the analysis of spillovers focused largely on the regional implications of a possible slowdown in GDP growth, with exchange-rate-related spillovers analyzed only recently—having been mentioned in earlier years.

**Integration of multilateral and regional perspectives into IMF policy advice**

14. Multilateral issues were covered in most bilateral surveillance discussions, but not always in depth. Depth of coverage was found lacking even in countries for which multilateral and regional issues were identified as important. Even when global developments and related concerns were addressed, references to such issues may on occasion have been inserted into the staff reports largely for compliance reasons (e.g., in response to comments received in the internal review process), and not because they had been discussed with the authorities in any material way.

15. The IMF’s treatment of global imbalances is a case in point. Global imbalances were identified in multilateral surveillance as an issue involving non-G-3...
economies as early as 2003, and the topic began to appear consistently in Article IV reports for a number of Asian countries in 2003 and for major oil producers in 2005. Coverage of the issue at the individual country level, however, generally lacked depth; any implications did not appear to have been suitably integrated into staff analysis and thus did not discernibly influence the “policy line” for the countries concerned. Policy linkages across countries were not sufficiently pointed out, with cyclical, country-level considerations dominating the (largely unchanged) advice given at the individual country level. During the period, scope for active policy coordination—for example, by making alternative sets of policy recommendations that are conditional on policy actions taken in other countries—was insufficiently exploited, and the IMF failed to take an institutional stance on how to bring about coordinated policy responses.

Surveillance of intervention policies

16. Coverage of intervention policies in staff reports was found to be insufficient for at least five countries in the sample. Incomplete coverage concerned the past intervention episodes of otherwise floating exchange rate regimes (including an assessment of their effectiveness), as well as a failure to assess whether or not intervention activities had been in line with the authorities’ stated intentions or whether there had been effects for other countries (including for intervention activities conducted in the context of fixed exchange rate regimes). As a result, the staff reports did not always give a clear description of the de facto exchange rate regime, and the IEO identified at least three cases, for which staff’s classification conveyed, at least temporarily, a misleading impression of the regime in place. The problem in these and other cases appears at least partly to have been a reluctance to challenge the views of the authorities.

17. An aspect of intervention policies that has received little, if any, staff attention is intervention tactics, that is, the specifics of how intervention is to be implemented, and the extent to which such practice is consistent with the stated intervention goals such as the smoothing of short-term fluctuations. Examples include the practice of covert interventions—an arrangement that limits the effectiveness of intervention through the signaling channel (though not through the portfolio balance and liquidity channels).

In discussing intervention policies, moreover, staff have narrowly focused on the use and accumulation of international reserves, and tended not to give full attention to economically very similar activities outside the traditional boundaries of intervention policies (e.g., changes in the net foreign asset positions of government agencies or publicly managed investment funds). However, to the extent that these activities are of substantial size and likely (or intended) to affect the real exchange rate, focusing simply on a country’s monetary authorities’ interventions does not allow a clear understanding of the effects of any changes in public sector net foreign asset positions.

18. Advice on the related issue of reserves accumulation has been linked to the underlying rationale for such activities, with staff generally supporting accumulation for precautionary purposes. Accumulation in the context of competitiveness considerations did not usually find staff support, except perhaps in cases such as Russia’s. About half of the 30 sample explicit references were made to “one-sided, protracted intervention” in internal documents, neither of which was followed up with the authorities or referred to in the staff reports.

19. When, for one of these, MCM (then MFD), on the basis of its indicator-based classification approach, suggested that country’s de facto exchange rate regime should be reclassified, the area department staff response included the observation that such a reclassification “would be difficult or impossible for the staff to defend” and “would portray the staff as casting doubt on the veracity of policy statements by officials.”

20. Another reason may be the difficulty in applying criteria in the classification of exchange rate regimes, and the lack of guidance on how to treat episodic events. Correlations across different de facto classification schemes that are virtually as low as the correlation for any one of these with countries’ de jure classifications. See Jeffrey A. Frankel, “Lessons from Exchange Rate Regimes in Emerging Economies,” in Monetary and Financial Integration in East Asia: The Way Ahead, ed. by Asian Development Bank (New York: Palgrave Macmillan, 2004).
economies accumulated significant reserves during
the evaluation period, especially in more recent
years. Their motives included: (1) self-insurance
against disorderly market conditions and volatility;
(2) intergenerational and Dutch disease consider-
ations (in countries with large natural resources or
aid flows); and (3) concerns to maintain international
competitiveness and export/industrial performance.
Because explicit analysis of an adequate level of
precautionary reserves (linked to the exchange rate
regime, nature of shocks, and country conditions) is
not a standard feature of staff reports, assessments
of the appropriateness of such policies have remained
highly judgmental and, at times, contentious—including
among staff and at the Board level.19

Issues of data availability

19. In part, lack of reliable intervention data and
related information seems to have limited the staff’s
ability to properly assess intervention activities. Some
country authorities were unwilling to share informa-
tion that is considered confidential. At the same time,
in some cases, area department staff appear to have
been hesitant to pursue such data issues more force-
fully. The desk review identified one case of repeated
underreporting of off-balance-sheet activities with
a significant impact on the country’s international
reserves that was not fully apparent from staff reports
submitted to the Executive Board. In contrast, in two
other cases, reserves-related data issues had been
reported to the Board and, on both occasions, received
substantial attention during the Board’s discussions.
In all three cases, the respective problems were sub-
sequently addressed.

Analysis of exchange rate levels

20. The sophistication of exchange rate level assess-
ments, as indicated by the use of empirical methods,
was good overall. Although there was no clear change
in sophistication for some two-thirds of the country
cases reviewed, important analytical contributions
were made for economies including China, the United
Kingdom, and WAEMU. The lack of a clear trend in
sophistication was also explained by the strong reli-
ance of staff on CGER estimates for those economies
covered by that exercise, and by the fact that levels
analysis was good at the outset for a substantial part
of the sample. Still, the review found one country
case (Saudi Arabia) in which there was no analyti-
cally based assessment of exchange rate levels over
the entire period (1999–2005), and at least four cases
(Iceland, Korea, Mexico, and Peru) for which little or
no formal analysis—including comprehensive com-
petitiveness assessments—was provided over parts of
the period. The lack of analysis contrasted with the
fact that formal analysis could have given important
inputs into policy formulation.

21. In addition, the review finds that staff did not
always explain well how level assessments were made
and why particular methodologies were preferred over
others; the lack of explanation casts doubts on the
results and their usefulness. In the Article IV reports
for Malaysia, for example, the staff used various meth-
ods over the years to assess the value of the ringgit.
Although use of multiple methods is a welcome devel-
opment, there was often little documentation on the
underlying models, thus making it difficult to judge
the approaches that had been used and why—specific-
ally in 2003/04, when the chosen methodology relied
on deviations from potential output without providing
details on the exact nature and time horizon of the
underlying equilibrium concept. Likewise, in the case
of China, during parts of the 1999–2005 period, the
staff repeatedly analyzed renminbi valuations relying
largely on econometric estimates of various notions
of equilibrium real exchange rates. As noted, while
analytical contributions were made in this context,
the staff did not fully integrate more conventional
indicators of competitiveness (such as data on export
volumes, export market shares, and corporate prof-
itability), as well as the size and pace of reserves
accumulation, current account surpluses, and rapid
productivity growth into its overall analysis of the
exchange rate level.

Advice on exchange rate regimes

22. Explicit regime advice favoring a change or a
significant adjustment was given to 12 economies in
the sample, including China, Korea, Jamaica, Rus-
sia, and Rwanda. Staff advice was almost entirely in

19In the case of Russia, for example, staff advice—after intense
internal discussions—was subject to a major reappraisal in 2002;
a process that started in the context of the 2001 staff report,
which had supported “the authorities’ aim to limit the pace of
the real appreciation of the ruble” by arguing that a fairly stable
exchange rate was a “reasonable compromise between pressures
for nominal appreciation, the authorities’ concern that too rapid an
appreciation would jeopardize output recovery, and uncertainty
surrounding the recovery in money demand.” Internal comments,
however, expressed doubts about the consistency of such advice
with the Board’s Surveillance Decision and with the objective of
reducing inflation. Reactions by area department staff revealed
differences of opinion among staff on the correct policy line,
pointing to Russian concerns about Dutch disease and uncer-
tainties about the ruble’s real effective equilibrium value. In the
wake of large terms of trade changes, staff eventually advised the
central bank in 2003–05 to “subordinate its exchange rate target
to the inflation target, by standing ready to scale back interven-
tions whenever inflation exceeds the charted course” and that
“increased exchange rate flexibility could no longer be delayed
now that fiscal policy is being relaxed if inflationary risks are to
be contained.”
the direction of enhanced flexibility, and 8 cases of advice involved the adoption of inflation targeting—at least over the medium term.\(^\text{20}\) In all but one case, the exchange rate was either fixed or heavily managed, and in the one case of a nominally floating exchange rate system, staff advised less official intervention.

23. A notable feature of staff advice is its highly conceptual orientation, especially in the initial stages of regime advice. In some cases, advice did not go much beyond listing some of the pros and cons of alternative regime options. In addition, advice appeared motivated by cyclical (rather than structural) factors, such as real or perceived exchange rate misalignments and related inflationary or deflationary developments. Country-specific analysis tended to lag—not lead—advice and staff sometimes failed to pursue alternative policy options (e.g., fiscal policy responses, adjustment of an existing currency basket, or currency realignments). As a result, in at least three of the country cases reviewed (Malaysia, Morocco, and Ukraine),\(^\text{21}\) staff advice for greater exchange rate flexibility initially lacked analytical support, with the rationale for otherwise unchanged policy advice changing over time. Adding to these shortcomings was an undue sense of urgency given to staff’s policy advice in two of these cases, which complicated the IMF’s communications with the authorities.

24. Lack of attention to detail, particularly in terms of implementation, was also an issue. When advising the authorities to allow more exchange rate flexibility, for example, detail was not always provided on why and how exactly this ought to be done—an issue criticized during the 2001 Board discussions on Jamaica. Issues about the exact nature of staff advice to Jamaica reappeared in later years, when the authorities were advised to adopt a “balanced policy mix” of interest rate action and exchange rate flexibility—to account for any impact on inflation, reserves, and debt dynamics—but without much accompanying detail on the specifics of such a strategy. In the case of Egypt, in January 2003, staff and the authorities did not pay enough attention to ascertaining that the microeconomic preconditions for successful floating, such as a functioning interbank market, had been put in place as previously recommended. Indeed, the IMF had provided technical assistance (TA) on two occasions in 2002, but there was no careful checkup of whether the TA recommendations had in fact been implemented. In the event, an attempted flotation of the currency was aborted when pent-up demand for foreign exchange and open positions on bank balance sheets (which at a broad level had been identified as potential risks) coupled with the lack of sustained support from other policies produced unfavorable exchange rate dynamics.
Annex A5.1

Summary Descriptive Statistics for the 30 Sample Economies

1. Do reports identify a current “de facto” exchange rate regime or monetary framework? How?
   - Yes (30)
   - Exchange rate regime: Independent float (12) Managed float/no path (7)
     - Managed float/no path (7)
   - Other fixed peg (6)
     - Currency board (3)
     - Other (8)
   - No separate legal tender (2)
   - Monetary framework: Exchange rate anchor (10) Monetary targeting (4)
     - Monetary targeting (4)
     - Inflation (forecast) targets (8)
     - Other (8)

2. Is there any discussion on (real) exchange rate developments?
   - Yes (30)
   - No (0)

3. Do multilateral analyses feed into country-level assessments?
   - Yes (18)
   - No (12)

4. Do any of the key issues identified by the IMF relate to exchange rate regime or level?
   - Regime only (1)
     - Exchange rate anchor (8)
     - Monetary targeting (2)
   - Level only (6)
     - Inflation (forecast) targets (0)
     - Other (4)
   - Both (21)

5. Did the IMF advise a regime change or adjustment?
   - Yes (12)
     - Exchange rate regime: Independent float (1)
       - Managed float/no path (2)
     - Horizontal band (4)
       - Other fixed peg (3)
       - Other (1)
       - Currency board (1)
       - Monetary framework: Exchange rate anchor (8)
         - Monetary targeting (2)
       - Inflation (forecast) targets (0)
       - Other (1)
       - No (18)

6. Have there been changes to the de facto regime over 1999–2005? What was the old regime?
   - Yes (11)
     - Exchange rate regime: Independent float (1)
       - Managed float/no path (2)
     - Horizontal band (4)
       - Other fixed peg (3)
       - Other (1)
       - Currency board (1)
     - Monetary framework: Exchange rate anchor (8)
       - Monetary targeting (2)
       - Inflation (forecast) targets (0)
       - Other (1)
     - No (19)

7. Is there any formal analysis of regime sustainability or choice?
   - Yes (10)
   - No (20)

8. Have IMF views or advice on the country’s regime changed over the 1999–2005 period?
   - Yes (13)
   - No (17)

9. Over the 1999–2005 period, has the real exchange rate been identified as mis- or correctly aligned? Give direction and scope of analysis for the most recent instance.
   - Yes (27)
     - Direction: Overvalued (7) Correctly aligned (12)
     - Undervalued (8)
     - Scope: Detailed analysis (13) Own results, but no detail (8)
     - “Eyeballing” of charts (10)
   - No (3)

10. Have there been trends or changes over time in the sophistication of analysis?
    - More sophisticated (7)
      - Variation, no clear trend (14)
    - Gotten worse (0)
    - No change (9)

11. Do IMF documents report any level estimates by the authorities or third parties?
    - Yes (10)
    - No (20)

12. Is there any reference to the “pointers”/procedures in the 1977 Surveillance Decision (e.g., reserve accumulation and interventions)?
    - Yes (10)
    - No (20)

13. Is advice on exchange rates sufficiently detailed to be implementable?
    - Yes (18)
      - No advice or no detail (12)
    - No advice or no options (13)

14. If advice (on regime or level) is provided, is there discussion of alternative policy options?
    - Yes (17)
      - No advice or no options (13)

15. At what frequency is formal analysis on level or regime reported?
    - Regularly (11)
      - Occasionally/issues driven (7)
    - Occasionally/issues driven (7)
    - Not at all (6)
    - One-off (6)

16. Is a proposed policy action followed up over various surveillance cycles?
    - Yes (26)
      - No advice or follow-up (4)
    - No advice or follow-up (4)

17. Overall, have recommended policy actions been carried out by the authorities?
    - Yes (16)
      - No advice or not carried out (13)
    - No advice or not carried out (13)

18. Is TA requested or offered in the context of IMF advice on exchange rates?
    - Yes (15)
      - No advice or no TA (15)
    - No advice or no TA (15)

19. For IMF-supported programs, are exchange-rate-related issues part of conditionality?
    - Yes (8)
      - No program or no exchange rate conditions (22)