CHAPTER

I

Introduction and Context

1. Exchange rate policy advice is critical to the IMF's purpose.[1] The IMF is charged by its Articles of Agreement and a landmark 1977 Executive Board Decision to exercise surveillance over the international monetary system and members' exchange rate policies.[2] The subject remains a high priority: the latest review by the Executive Board, in 2004, established a greater focus on exchange rate issues as one of the monitorable goals for the period ahead;[3] and the Managing Director's Medium-Term Strategy in 2005 highlighted the need to strengthen the IMF's capacity to assess exchange rate levels in a multilateral framework, while calling for a review of the 1977 Decision.[4]

2. Yet for years the IMF's work on exchange rates has been criticized and problems have persisted. The Executive Board's own reviews of exchange rate surveillance have repeatedly pointed to shortcomings, and called for a strengthening of the effectiveness of the IMF's exchange-rate-related analysis and advice.[5] Clear and candid treatment of exchange rate issues has remained a challenge, and attention to the multilateral perspective and analysis of spillovers has been found wanting. Some outside critics argue that the IMF falls short of meeting "its most fundamental responsibility,"[6] in particular by failing to persuade surplus countries to adjust. Others accuse it of a different type of asymmetry: approaching the advanced economies with kid gloves, but being heavy-handed with other countries. Meanwhile, there is no consensus, either within or outside the institution, on the appropriate exchange rate policies for countries in particular circumstances. For example, some observers criticize the IMF for being too quick to advocate floating exchange rates, while others do so for being too slow to advise exit from pegged or tightly managed exchange rate regimes.[7]

3. The period under review (1999–2005) was characterized by marked shifts in the global economic context and widespread debate about exchange rate issues, with many implications for the IMF's exchange rate policy advice:

- The most dramatic development was the emergence of China and, to a lesser extent, other large developing economies and oil producers as significant players in a more globalized monetary and financial system (see Box 1.1 and Figure 1.1).
- The adoption of the euro in 1999 (initially by 11, now 13 countries) marked a major stage in the realignment of world currencies, with the euro floating freely—as are the four other currencies of the G-7—and emerging as a global reserve currency.
- In the wake of the Asian and other financial crises, many emerging market economies adopted more flexible exchange rate regimes while still managing to replenish their reserves. Once reserves had been built to prudent levels, those countries with renewed capital inflows faced a policy dilemma. With an eye on what others were doing, they had to decide how to pursue more flexible exchange rate regimes while continuing to emphasize growth, including through policies affecting saving-investment decisions as well as foreign exchange intervention.

[1]For this evaluation, exchange rate policy advice is defined broadly to include any IMF advice on exchange-rate-related issues, especially regime choice and management, competitiveness and currency misalignment, and measures directed at resolving external imbalances. Although much of the focus is placed on bilateral surveillance, the evaluation also refers to other vehicles through which advice is provided, including multilateral surveillance, IMF-supported programs, and technical assistance.

[2]For details, see Background Document 1 and IMF (2006c).

[3]See IMF (2004a).

[4]See IMF (2006a). For a recent internal assessment by IMF staff of exchange rate surveillance in 30 systemically important countries, see IMF (2006d).

[5]The implementation of surveillance, for which principles and procedures were set out in the 1977 Decision, is reviewed periodically. During the period relevant for this evaluation, the Executive Board has conducted Biennial Surveillance Reviews (BSRs) in 1997, 2000, 2002, and 2004; see Chapter 2. In addition, the Whittome Report (Whittome, 1995) and the Crow Report (Crow, Arriazu, and Thygesen, 1999) were highly critical of certain aspects of surveillance.

[6]See Goldstein and Mussa (2005). From different perspectives, see, for example, Bhalla (2004) and Adams (2005).

[7]See, for example, the criticism of the advice related to exit from Argentina's convertibility regime, as reported in IEO (2004).

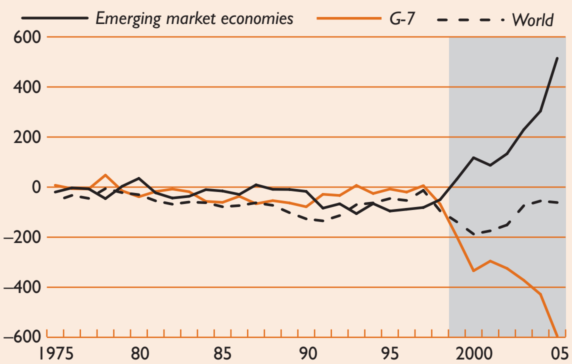
Box 1.1. The Global Context

Developments over 1999–2005 reflected the broader trend of financial globalization. There was phenomenal growth in cross-border transactions in bonds and equities, which—starting from a low base of less than 10 percent of GDP for even the most advanced countries in the 1980s—rose to more than 100 percent of GDP for many countries by 2005. Foreign exchange markets expanded apace, with daily average turnover rising from $200 billion in the mid-1980s to about $1.9 trillion in 2004. A key implication of these changes was the ability to finance larger current account imbalances over longer periods, but also the increased vulnerability to capital account fluctuations and shocks. At the same time, growing stocks of foreign assets and liabilities increased the relevance of valuation effects, giving rise to important balance sheet interlinkages and international spillovers.

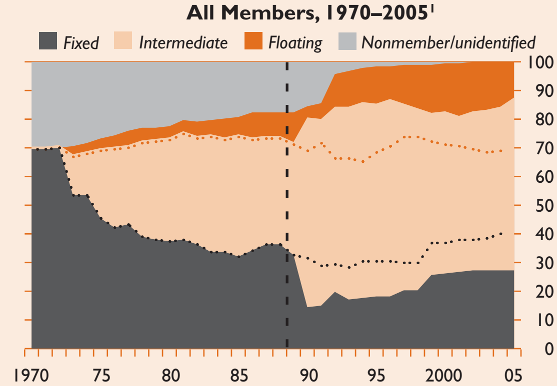
Against this backdrop, the evaluation period was characterized by growing U.S. current account deficits that were no longer offset by corresponding surpluses in other advanced economies, but increasingly instead by surpluses in the emerging markets—particularly in Asia and among the major oil producers (Figure A). Given the continuing predominance of more managed exchange rate regimes outside the advanced economies (Figure B), regional surpluses have been mirrored by increasing international reserves (Figure C). Observed real effective exchange rate movements over this period raised questions about the extent to which they have reflected—either too much or too little—underlying developments in fundamentals (Figure D).

Key Developments over the Evaluation Period

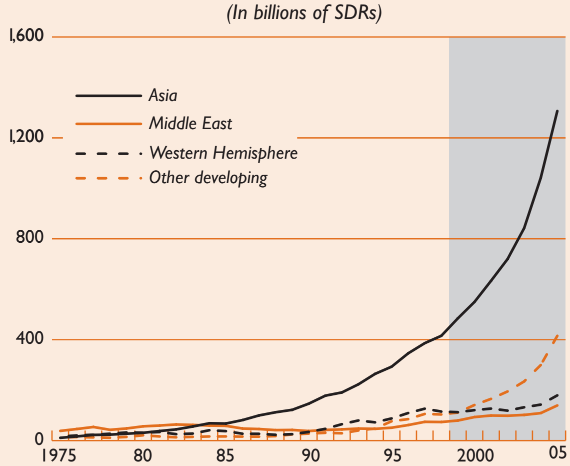
A. Current Account Balances, 1975–2005
(In billions of U.S. dollars)



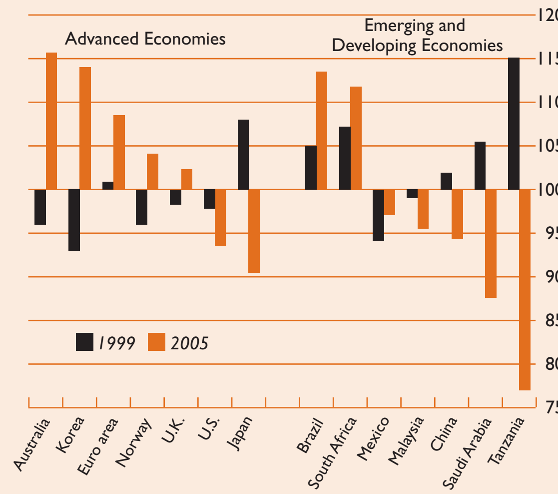
B. Distribution of Exchange Rate Regimes, All Members, 1970–2005[1]



C. International Reserves, 1975–2005
(In billions of SDRs)



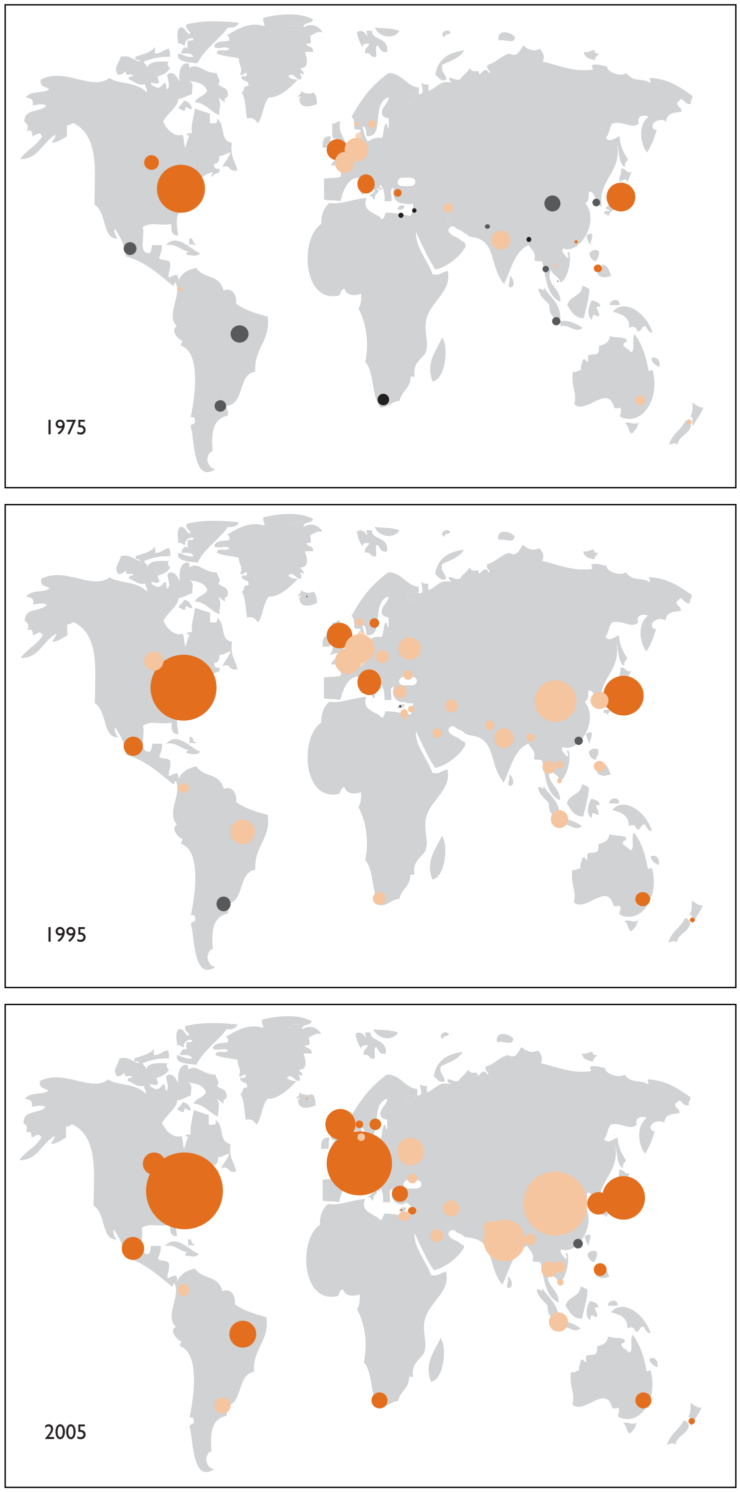
D. Real Effective Exchange Rates for Selected Economies, 1999–2005
(In percent of period average)



Sources: IMF, *World Economic Outlook, International Financial Statistics, Balance of Payments Statistics,* and MFD/MCM data; Ghosh, Gulde, and Wolf (2002); and BIS (2005).

[1]In percent of present IMF membership; from 1989 onward de facto regimes (dotted lines and values up to 1989: de jure); fixed regimes include single currency pegs (up to 1989 only), currency boards, currency unions, and countries without own legal tender; floating regimes include independent floats only.

Figure 1.1. Major Currencies, by Real GDP and Currency Regime, 1975–2005[1]



Sources: World Bank (GDP data); MFD/MCM (de facto regimes); and Ghosh, Gulde, and Wolf, 2002 (de jure regimes).

[1]Data for 40 currencies are shown; circle sizes represent real GDPs (PPP basis); colors represent exchange rate regimes; black (hard pegs), light orange (other fixed pegs and intermediate regimes), orange (independently floating). Regime classifications are on a de jure (1975), and de facto (1995, 2005) basis.

- For many smaller developing countries, the choice of exchange rate regime and level remained a live issue, in the context of how to maintain macroeconomic stability and deal with incipient real exchange rate appreciation brought about by influxes of aid, investment flows, or receipts from increasingly lucrative natural resource exports.

4. This evaluation aims to shed light on why long-standing problems in exchange rate surveillance, including those identified by staff and the Executive Board, have been so intractable, and to make recommendations. The report has been finalized as the IMF is reviewing the 1977 Surveillance Decision, considering a new "remit" for surveillance, and undertaking a multilateral consultation on global imbalances. The evaluation report does not deal directly with these current discussions, nor with several issues—including on some aspects of the quality of the advice on exchange rate issues—that the IEO will consider pursuing at a later date. It focuses on issues concerning both the substance and procedure of surveillance over exchange rate policies that the evaluation has found, and that need to be addressed in any case. In particular:

- There is a lack of clarity over the roles of the IMF and member countries in exchange rate surveillance, which it would be desirable to resolve. As the discussion proceeds on the various surveillance initiatives, a revalidation of the basic purpose of IMF surveillance would be an important goal.

- There are problems with the IMF's exchange rate surveillance that should be addressed without delay, irrespective of whether or when changes are made to the 1977 Decision. Maintaining moral authority—or the "normative consensus"[8]—on which the IMF's role ultimately depends, requires greater trust and engagement with the membership on how to deal with new challenges.

5. Could the IMF have done a better job in meeting the challenges arising from the developments described above?[9] The short answer is yes. The quality of IMF advice and its supporting analysis may have improved in some ways over the period. However, there was a lack of effective engagement on exchange rate issues in too many cases, whether because of remaining problems of analysis or because of shortcomings in the dialogue with countries.

6. In the IEO's view, a major refocus of efforts is required by all concerned for the IMF to remedy the "effectiveness gap" in its main line of business. Key ingredients would be improvements in the overall quality of the IMF's exchange rate policy analysis and advice, and in the effectiveness of the interactions with country authorities.

7. Though this report focuses deliberately on what is not working well, it should be made clear at the outset that the IEO found many examples of good analysis and dedicated staff teams. This is the base on which further progress can be made.

8. The remainder of this report is structured to follow the logic of a series of evaluation questions.[10] The starting point was to ask whether the role of the IMF in exchange rate policy advice was clearly defined and understood (Chapter 2). Against that backdrop, the IMF's efforts were assessed in turn: how good were aspects of the quality of IMF advice, including on multilateral issues (Chapter 3); and how effective was the dialogue with the authorities, as well as other channels, to maximize the impact of IMF advice (Chapter 4)? The report's findings and recommendations are set out in Chapter 5. Evidence was provided by a review of documents for the last two Article IV consultations (through 2005) for the entire membership, supplemented by a more in-depth review of internal and Executive Board documents and meetings for 30 selected economies over the whole period 1999–2005.[11] To triangulate evidence, especially on effectiveness and impact, the desk reviews were supplemented by interviews with officials from 26 economies as well as market participants and academics, discussions with IMF Executive Directors or their Alternates, interviews with IMF staff, and questionnaire surveys of national authorities and IMF staff.[12]

[8]See Pauly (2006).

[9]The IMF's work on exchange rate issues, both bilaterally with member countries and multilaterally in overseeing the system as a whole, is of course only one of many elements influencing economic outcomes. Of prime importance are national authorities' policies, and the willingness of countries to cooperate with each other, as well as with the IMF. The IMF's role should therefore be seen as aimed at improving the prospects of continued successful outcomes.

[10]For further details, see IEO (2006a) at www.ieo-imf.org/pub/issues.html.

[11]For details of the whole membership review, see Background Document 4; for details of the in-depth review, including the selection process for the 30 economies, see Background Document 5.

[12]Details of the two questionnaire surveys are given in Background Document 6. Survey results presented in the main report and in the background documents are based on data from all responses. When answers from the authorities' and staff surveys are compared, the results were cross-checked based on data only for economies on which there were responses from both authorities and staff, and were found to remain valid.