

Is the IMF's Role in Exchange Rate Policy Advice Well Defined and Understood?

Legal Framework and Practical Guidance

9. The IMF's unique role in exchange rate surveillance derives from formal obligations on both the IMF itself and on member countries; participation in the exercise is not voluntary. The IMF's Articles of Agreement and the 1977 Surveillance Decision spell out (1) the obligations of member countries for the conduct of their domestic and exchange rate policies; and (2) the role of the IMF Executive Board in exercising firm surveillance over the exchange rate policies of members, as well as for overseeing the international monetary system to ensure its effective operation.¹ Members' obligations focus on the pursuit of domestic economic and financial policies that promote growth and stability at home, and on the avoidance of external instability that may adversely affect other members. Member countries are also obliged to provide certain data to the IMF for effective surveillance of their policies. The IMF's role in providing exchange rate policy advice is based on a set of formal obligations and is therefore quite distinct from providing a demand-driven service, such as technical assistance.² In fulfillment of its surveillance responsibilities, the IMF's Executive Board conducts Article IV consultations with each member country, typically once a year or every two years, based on staff reports that summarize recent developments and discussions with the national authorities. In addition, broad developments in exchange rates are reviewed periodically by the Board, for example, through discussions of the IMF's *World Economic Outlook (WEO)* and of exchange rate and financial market developments.

10. Practical guidance to staff has evolved over time, in the context of both the regular Executive Board reviews of surveillance and operational guidance set

by management.³ Guidance refers both to broad principle (e.g., that exchange rate issues are to be "considered candidly throughout the membership") as well as to substance. It is well established, for instance, that exchange rate advice cannot be considered in isolation from other macroeconomic policies, and hence that the assessment of exchange rate, monetary, fiscal, and financial sector policies should be integrated. Guidance is provided on priorities to be addressed in surveillance, including external sustainability, vulnerability to balance of payments crises, and international spillovers of policies in large economies. The Board has also provided specific guidance on analysis and coverage. In 2004, for example, it stressed the need for "clear identification of the de facto exchange rate regime in staff reports;⁴ more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and a thorough and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues."⁵

11. Yet, many aspects of what staff are supposed to do remain unspecified. For example, while (following the 1978 amendment to the IMF Articles of Agreement) members choose their exchange rate regimes,⁶ staff are obliged to assess them. But there is no clear guidance to staff on the criteria to be used for making such assessments. Staff are also required to assess exchange rate levels, but the generality of the guidance allows for much variation in practice. Some question

³See, for example, IMF (2005).

⁴Countries' de facto exchange rate arrangements may differ from their officially announced, or de jure, exchange rate regimes. The IMF's de facto classification scheme (managed by the Monetary and Capital Markets Department (MCM)) ranks exchange rate arrangements on the basis of their degree of flexibility and the existence of formal or informal commitments to exchange rate paths.

⁵See IMF (2004a).

⁶More accurately, members are free (with a couple of exceptions) to choose their exchange arrangements. They are obliged (under Article IV) to notify the Executive Board promptly of changes in arrangements, but staff report that many countries no longer formally do so.

¹See Background Documents 1 and 2 and IMF (2006b) for more detail. For a description of the global public good elements of this structure, see Camdessus (1999).

²Technical assistance is provided upon request of a member country and the reports are normally not seen by the Executive Board.

whether a levels assessment is required when a country has a freely floating exchange rate; and others are concerned lest estimates of misalignment be interpreted as anything more than inputs to discussions on policy. Similarly, while there has been some analysis of intervention policies, staff receive little specific guidance on how to advise authorities on the appropriateness or effectiveness of intervention strategies. (For instance, the definition of several key “pointers,” referred to in the 1977 Decision, has neither been explained in practical terms nor tested in any meaningful way.) In forming judgments on exchange rate issues, staff have relied on their own knowledge as well as on cross-country studies and analytical papers (e.g., Schadler and others (1993) and those discussed by the Executive Board since 1999⁷). However, with the lack of professional consensus, including on issues of assessing regime choice and of exchange rate levels, it would have been particularly useful (if challenging) to distill analytical guidance Fund-wide that would at the same time respect country circumstances.⁸ Finally—and of relevance to a key theme of this report—management has put little emphasis on how staff should conduct the dialogue with authorities to maximize its effectiveness.

Perceptions of Country Authorities and IMF Staff

12. Survey evidence suggests that the IMF's role is not clear. There is inadequate appreciation of the formal role of the IMF, and the rights and obligations of membership that underlie its exchange rate policy advice. At a practical level, the IMF is often characterized as having various roles to play. Perceptions about the extent to which the IMF has under- or overplayed these roles differed across country groups,⁹ and between IMF staff and country authorities, reflecting different expectations of what the

IMF is supposed to do, as well as different perceptions about what it is doing. Such differences make it difficult for the IMF to discharge its responsibilities effectively. Further, in some cases staff were of the view that if they carried out some aspects of what they considered to be their surveillance responsibilities, they would not be supported by management and the Executive Board.

- In the context of their own countries, about two-thirds of the authorities' respondents felt that the IMF had appropriately played roles as a *confidential advisor* to the authorities and as a *sounding board/intellectual partner* for discussing authorities' exchange rate policy views (Figure 2.1). About half considered that a role for the IMF as a *consensus builder among domestic policymakers* was played as much as it should have been. In all three roles, authorities from large emerging market economies were more likely to sense missed opportunities (i.e., roles were underplayed) than were those from other countries. Staff were a little less confident than the authorities that the three roles had been played to the right degree, with sizable minorities seeing each role as being underplayed (Figure 2.2).
- The IMF's more global responsibilities were often perceived to be underplayed, particularly in being a *ruthless truth-teller to the international community* and a *broker for international policy coordination*. While it is difficult to draw a fine line between functions that mostly benefit individual countries and those that mostly benefit the international community, the truth-teller and broker roles carry a larger element of global public goods character; and the authorities' responses suggest that the IMF has not been doing as much as they would expect in either of these roles (Figure 2.1). A view that the IMF was insufficiently playing its truth-teller role, in particular, was much more pronounced among advanced economies, with emerging market and developing economies seeing the broker role as underplayed (Figure 2.3). Some two-fifths of staff, in turn, felt that the IMF had underplayed both its truth-teller and broker roles (Figure 2.2). Finally, although most staff and authorities agreed that the IMF's role had been about right as a *provider of credibility* (e.g., in capital markets or to the donor community) and as a *lender in the event of adverse contingencies*, respondents from the large emerging economies saw some missed opportunities in both cases, while major advanced economies generally perceived the IMF's role as a lender as being overplayed.¹⁰

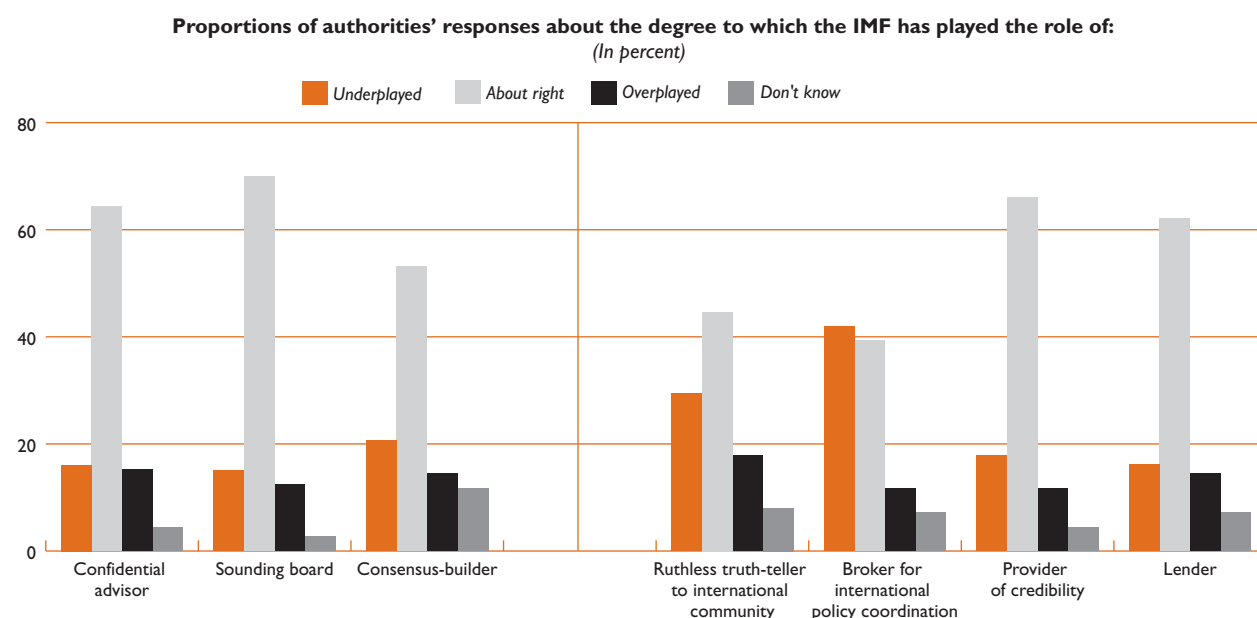
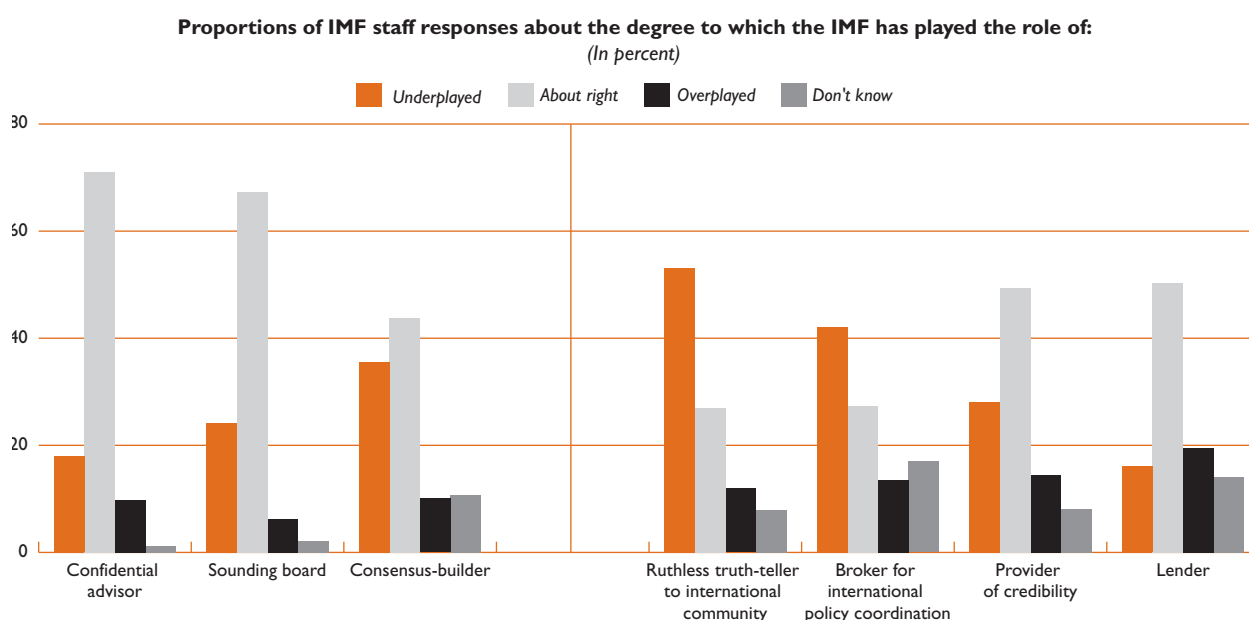
13. In this light, compelling evidence of a problem for the IMF came from interviews and survey perceptions of the institution's impact, or lack of it, in shap-

⁷Important discussions over the period covered by the evaluation included those on Mussa and others (2000), IMF (2001), Rogoff and others (2004), IMF (2004b), and IMF (2004c).

⁸In the staff survey some 30–40 percent of respondents did not find internal guidance notes or analysis/research from the Policy Development and Review Department (PDR), the Research Department (RES), or the MCM a source of help; and about 75 percent responded that the 1977 Surveillance Decision had not been a source of help; that they did not know whether it had been; or that it had not applied to their work.

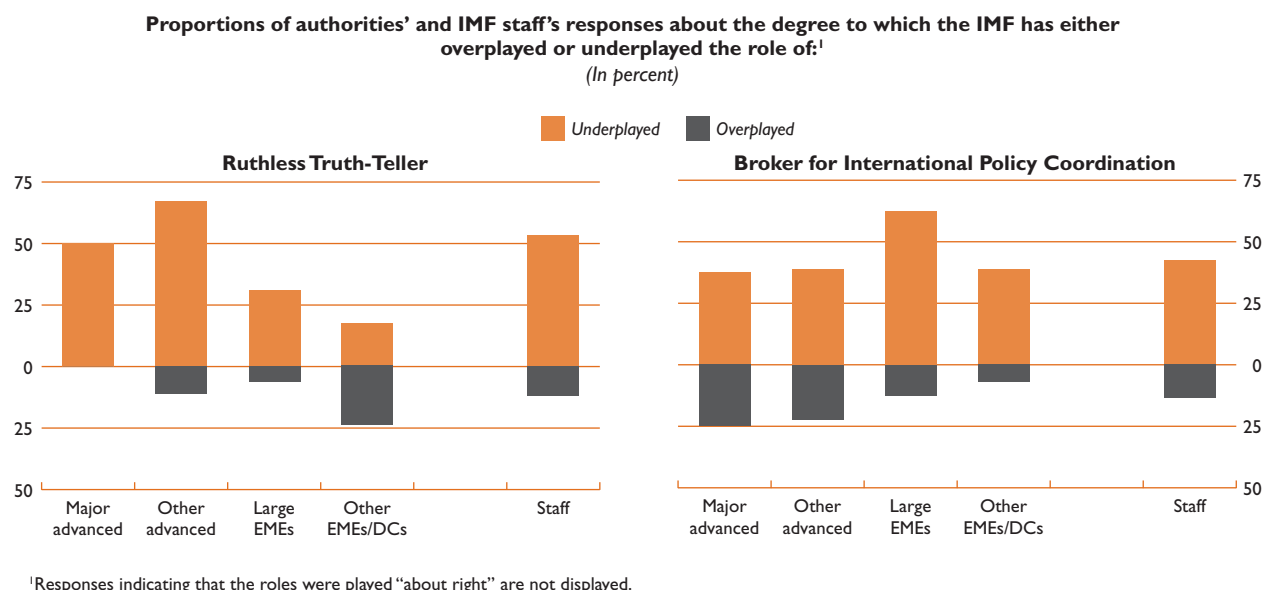
⁹This report classifies economies into four groups: major advanced, other advanced, large emerging market, and other emerging market and developing economies. The list of economies in each group is presented in Background Document 6, Annex A6.2. The categories are from the IMF's *World Economic Outlook (WEO)*, except that here the “other emerging market and developing economies” category is split into two groups, using the size of GDP (more than \$250 billion in 2004 on a purchasing power parity (PPP) basis) as a proxy for systemic importance. Smaller economies of systemic importance, such as major financial trading centers, are covered in the “other advanced economies” category.

¹⁰See Background Document 6, Figure A6.14 for further detail.

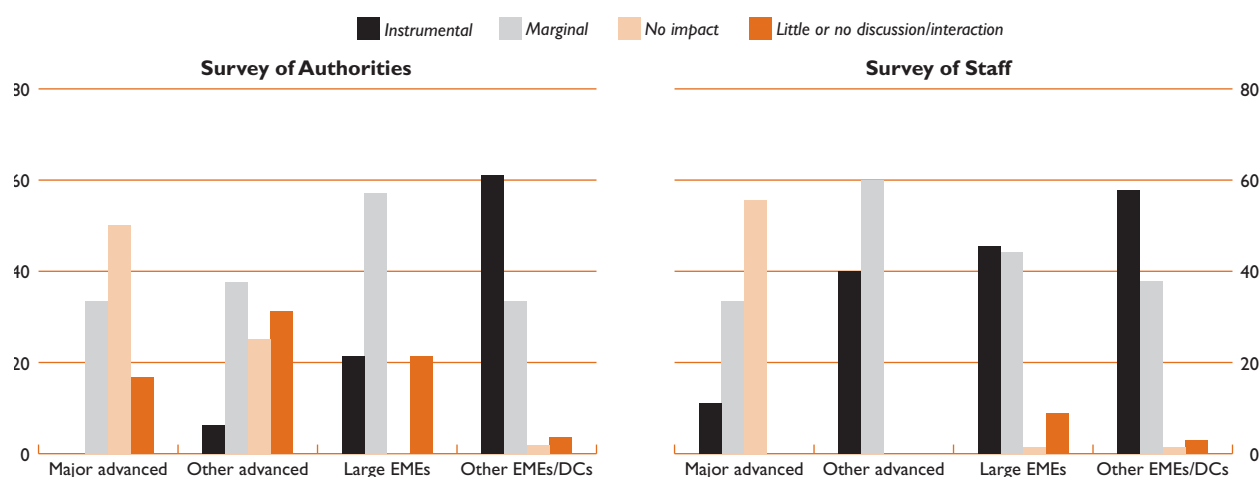
Figure 2.1. Authorities' Views on Different Roles the IMF Has Played in the Area of Exchange Rate Policy**Figure 2.2. Staff's Views on Different Roles the IMF Has Played in the Area of Exchange Rate Policy**

ing major exchange rate decisions taken by member countries, especially in the advanced and large emerging market economies. While the problem was by no means universal, the IMF was too often considered by authorities to have provided little value added. Of those country authorities who reported having taken major policy decisions on exchange rate issues during 1999–2005, 43 percent regarded IMF advice as instrumental,

while 38 percent saw it as marginal, and the remainder saw no impact or no discussion at all. These overall statistics mask some notable differences across country groupings, revealed by both survey and interview evidence (Figure 2.4). The IMF was seen to have only limited impact on a number of key policy decisions in the advanced economies; authorities gave examples of the IMF's lack of engagement in important exchange

Figure 2.3. Views on Selected Roles of the IMF, by Country Group**Figure 2.4. Contribution Made by the IMF to Major Exchange Rate Policy Decisions Taken by Authorities**

(In percent)



rate policy debates, when staff should have expressed a view. In the large emerging market economies, a minority viewed the IMF's role as instrumental and this is an issue of major concern for the IMF if it is to remain engaged substantively with these countries. In the smaller emerging market and developing countries, by contrast, the majority of the respondents regarded IMF involvement as instrumental; in many cases this was coincident with a program relationship.

14. A related observation is that staff may have overestimated their influence on discussions of exchange rate issues in some countries. While the staff had no illusions

over its influence in major advanced economies, and saw its advice—correctly—as being instrumental in many smaller emerging market and developing economies, it often considered itself also to have played key roles in major decisions taken in other advanced and large emerging economies, in sharp contrast to the perception of officials surveyed in many of those economies. This contrast was also apparent from interviews with officials from several countries and with the staff who had worked on the same countries. In all country groups, the authorities reported that they sought advice from sources other than the IMF. Some countries hire consultants and

Box 2.1. Challenges and Tensions in the Roles of the IMF and of Member Countries

The concept of a member being a “good global citizen” is broader than taking account of the consequences for others of its exchange rate policy and exchange rate movements: it also involves ensuring stable growth, while minimizing the risks of financial instability that could lead to cross-border contagion. A verdict on whether countries are acting as good global citizens is always subject to judgment, but the judgment needs to encompass more than the appropriateness of the exchange regime and exchange rate level. In particular, domestic policies, including those affecting financial stability, economic growth and employment, and the level of domestic savings and investment, are integral elements, and are of concern both to the individual member and to other countries.

- For advanced economies (usually with floating exchange rates and developed financial markets), responsibilities extend to considering the impact on other countries of their policies, as well as financial market developments and exchange rate movements; and cooperating with the IMF on appropriate policy or institutional changes.
- For countries that are emerging as major world players, but do not have the floating exchange regime and

financial markets of advanced countries, the dilemmas in meeting responsibilities at home and to the international community can be acute. There is a potential trade-off, for example, between single-mindedly pursuing development goals (sometimes involving attempts to resist real exchange rate appreciation), and acknowledging the contribution of exchange rate movements and/or other policy changes to international adjustment as well as domestic financial stability. The recognition of such dilemmas, and the search for cooperative solutions that minimize the policy trade-offs for individual members, is part of the responsibility of all countries as well as of the IMF.

- For the many countries that remain small players on the world stage, responsibilities include pursuing their domestic goals while, at a minimum, aiming to have an exchange system that is free of current account restrictions and a well-functioning financial sector that will not lead to cross-border instability. The trade-offs between domestic ambition and international consequence are unlikely to be as acute as for larger economies, but they still need to be monitored, including for their regional implications.

seek help from other governments, while several senior officials spoke favorably, for example, of their contacts with the Bank for International Settlements (BIS) and the Organization for Economic Cooperation and Development (OECD), where they appreciated the discussions with peers. Many countries responded that they do not depend principally on the IMF for exchange rate advice, in contrast to the perception of some staff that they do.

Implications

15. What to make of this evidence? At one level, it seems clear that a revalidation of the IMF's role in exchange rate policy advice would be warranted. But, more fundamentally, the underlying problem seems to be one of lack of traction: a failure to be seen to add much value in discussions with some parts of the membership. This failure then leads to less engagement of the membership with the IMF, and a weakened ability for the IMF to undertake its surveillance responsibility. Several factors, including those for which this evaluation provides evidence, suggest that the problem is deep rooted and complex. First, the 1977 Decision was itself controversial, and there was no complete agreement at the time on exactly what the IMF's role should be. Second, despite the pragmatic evolution over the years in the coverage and conduct of surveillance, in recent times the IMF has not been seen as very relevant to the critical debates on exchange rate issues in some member coun-

tries. Third, inevitably, an increasing number of country authorities will be confident of their own ability to analyze exchange rate issues, and will also call on a range of others for complementary advice and expertise. In this environment, it will become more challenging for the IMF to add value and bring the international perspective to bear, and it will therefore find it more difficult to fulfill its surveillance responsibility.

16. The IMF has successfully adapted its surveillance beyond the confines of a legal minimum, based on members' willingness to cooperate with it in meeting new challenges. This is fine—provided that, in practice, the IMF keeps sight of the fundamental purpose of surveillance. Central to this is the requirement for member countries, as well as the IMF itself, to consider the consequence for others of their exchange rate policies and of other policies that affect exchange rates. But what does this mean in practical terms? From the evidence gathered in this evaluation, certain themes can be distilled on the challenges—and tensions—for the roles of the IMF and of member countries (see Box 2.1). Building a greater consensus on these, and similar issues, could have helped to increase the traction of IMF advice over the evaluation period.

17. Can the lack of traction in some countries—the gap in effectiveness between what was and what might have been accomplished—be identified more clearly? The next two chapters of the report concentrate on two elements: the quality of advice in various dimensions, and the effectiveness of the dialogue with authorities.