IMF Exchange Rate Policy Advice

Overview

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. The overriding question addressed by this evaluation is whether, over the 1999–2005 period, the IMF fulfilled this core responsibility. The main finding is that the IMF was simply not as effective as it needs to be in both its analysis and advice, and in its dialogue with member countries.

The reasons for the IMF's failing to fully meet its core responsibility are many and complex. Among these reasons are a lack of understanding of the role of the IMF in exchange rate surveillance; a failure by member countries to understand and commit to their obligations to exchange rate surveillance; a strong sense among some member countries of a lack of evenhandedness in surveillance; a failure by management and the Executive Board to provide adequate direction and incentives for high-quality analysis and advice on exchange rate issues; and the absence of an effective dialogue between the IMF and many—though certainly not all—of its member countries.

The evidence supporting this conclusion, along with other key findings, is set out in this report. To assess the quality of the IMF's analysis and advice and the effectiveness of its policy dialogue with the authorities, the evaluation reviewed documents for the last two Article IV consultations for the entire membership through 2005, undertook a review of internal and Executive Board documents for 30 selected economies over the full review period, surveyed IMF staff and country authorities, and held a series of interviews with government officials, market participants, academics, IMF Executive Directors or their Alternates, and IMF staff.

The evaluation report presents a detailed set of recommendations, which, if acted upon, could go a long way in improving the quality and effectiveness of exchange rate surveillance by the IMF. Implementation of these recommendations will require the full commitment and support of IMF staff, management, the Executive Board, and the authorities of member countries. Without that, it is difficult to see how sustained improvements can be made.

In this context, it is important to note that, in preparing the evaluation, the IEO found numerous examples of good analysis and dedicated, highly qualified staff teams. It is this very human capital that can form the base on which progress can be achieved.

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).

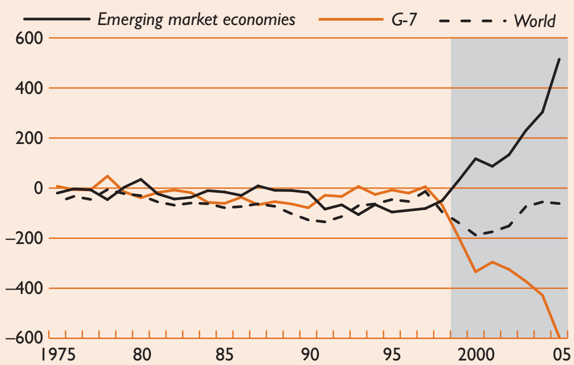
Box 1.1. The Global Context

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.

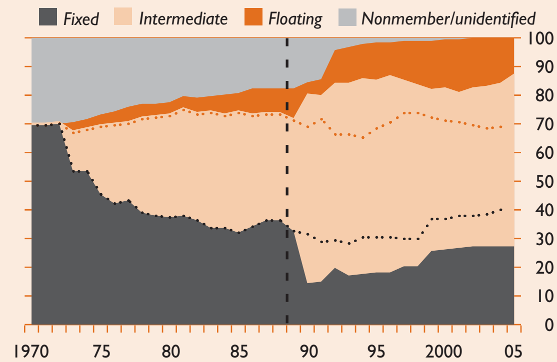
Against this backdrop, the evaluation period was characterized by growing U.S. current account deficits that were no longer offset by corresponding surpluses in other advanced economies, but increasingly instead by surpluses in the emerging markets—particularly in Asia and among the major oil producers (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

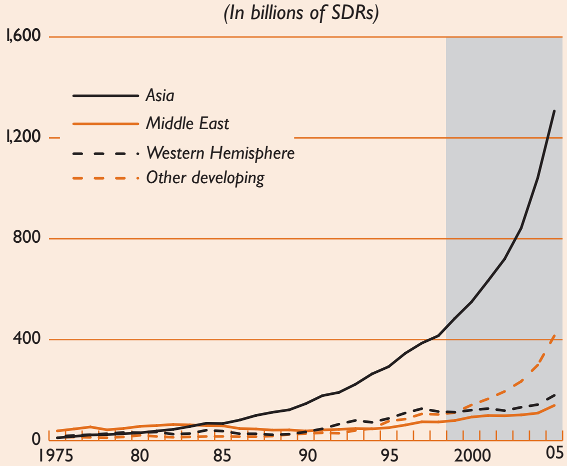
A. Current Account Balances, 1975–2005
(In billions of U.S. dollars)



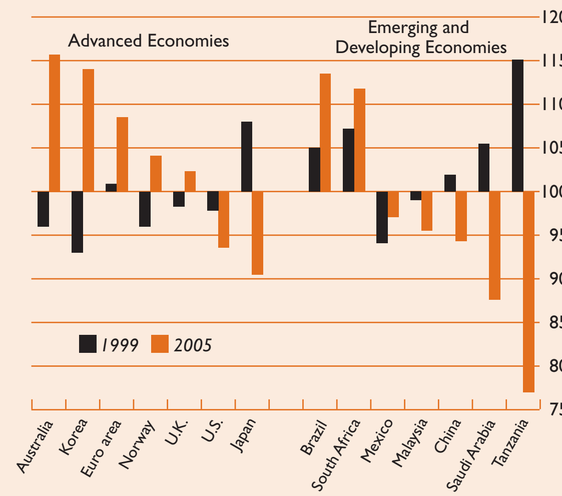
B. Distribution of Exchange Rate Regimes, All Members, 1970–2005[1]



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



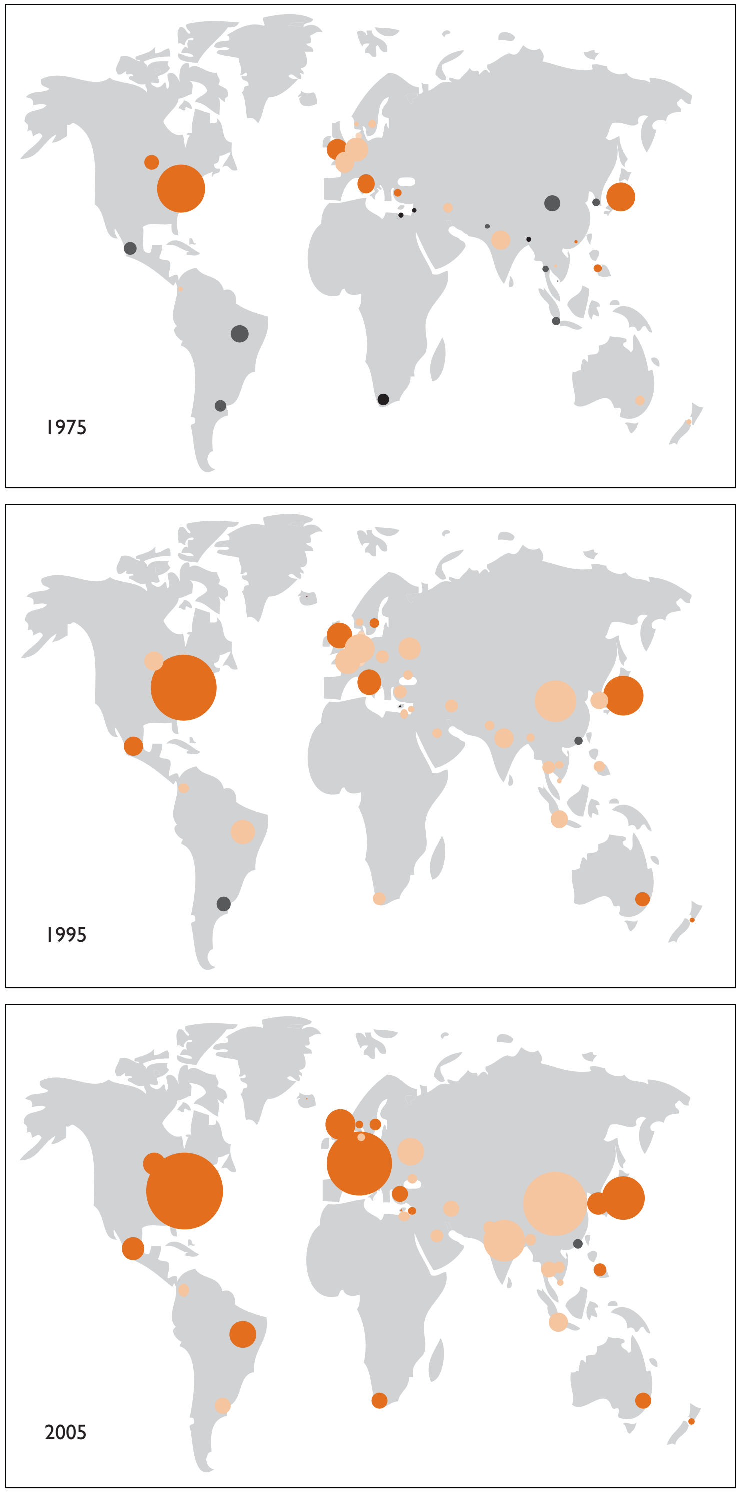
D. Real Effective Exchange Rates for Selected Economies, 1999–2005
(In percent of period average)



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.

CHAPTER

2 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

[1]See 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).

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

[3]See, for example, IMF (2005).

[4]Countries' 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.

[5]See IMF (2004a).

[6]More 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.

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 1999[7]). 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-

[7]Important 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).

[8]In 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.

[9]This 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.

[10]See 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

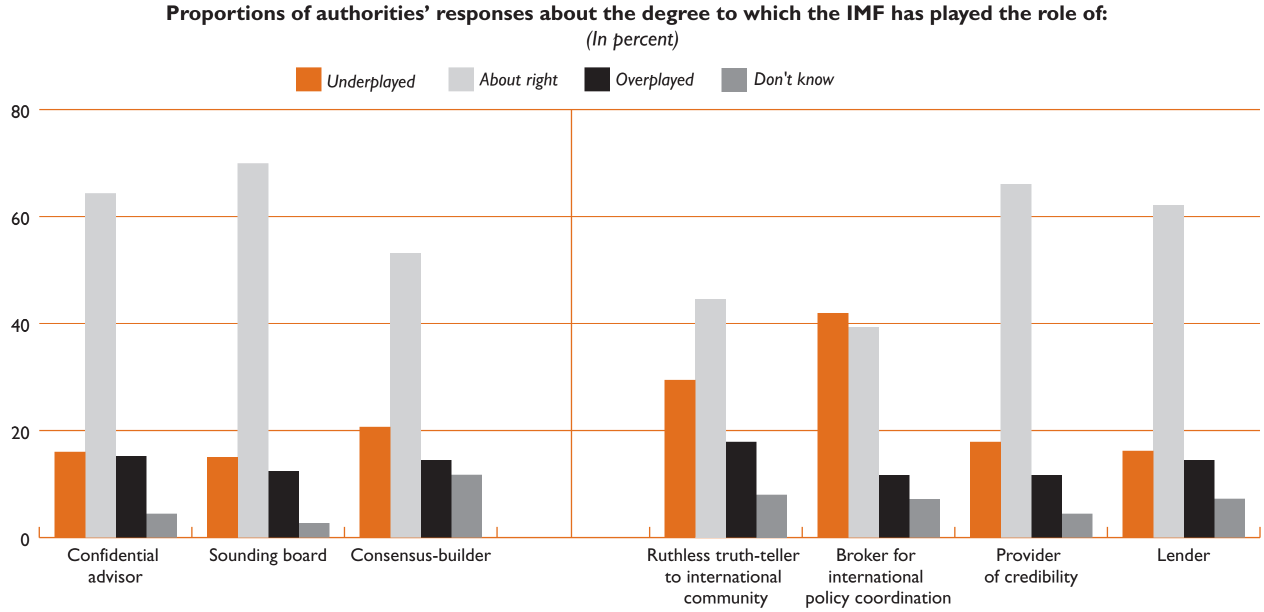
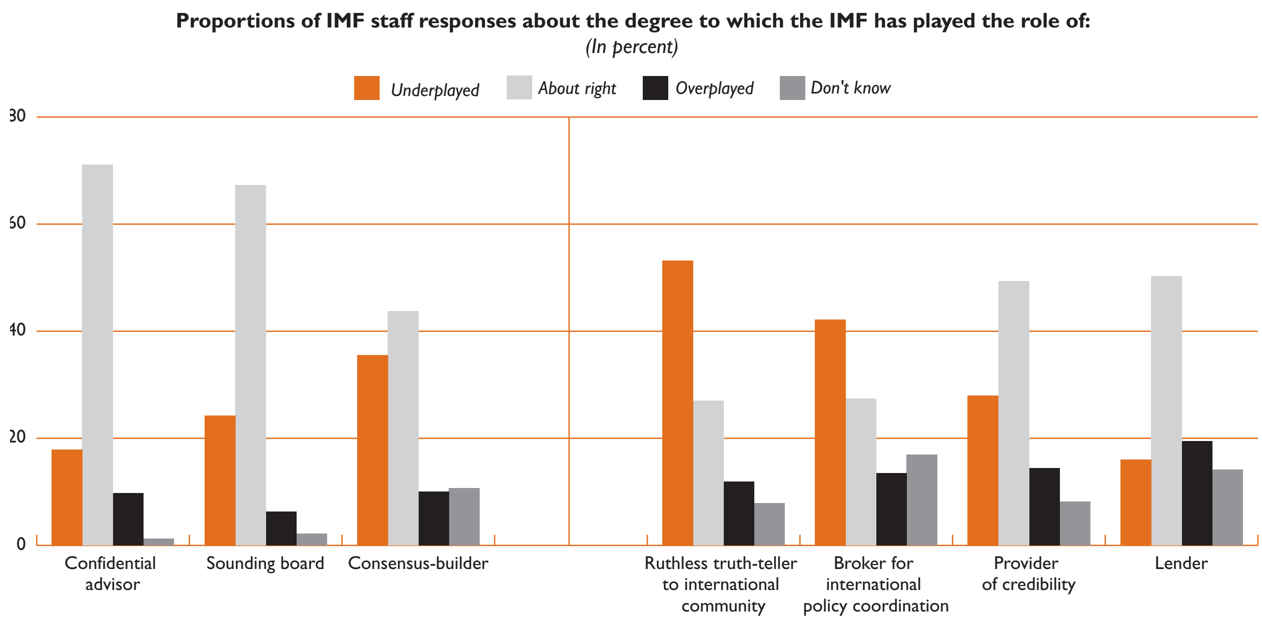


Figure 2.2. Staff's Views on Different Roles the IMF Has Played in the Area of Exchange Rate Policy

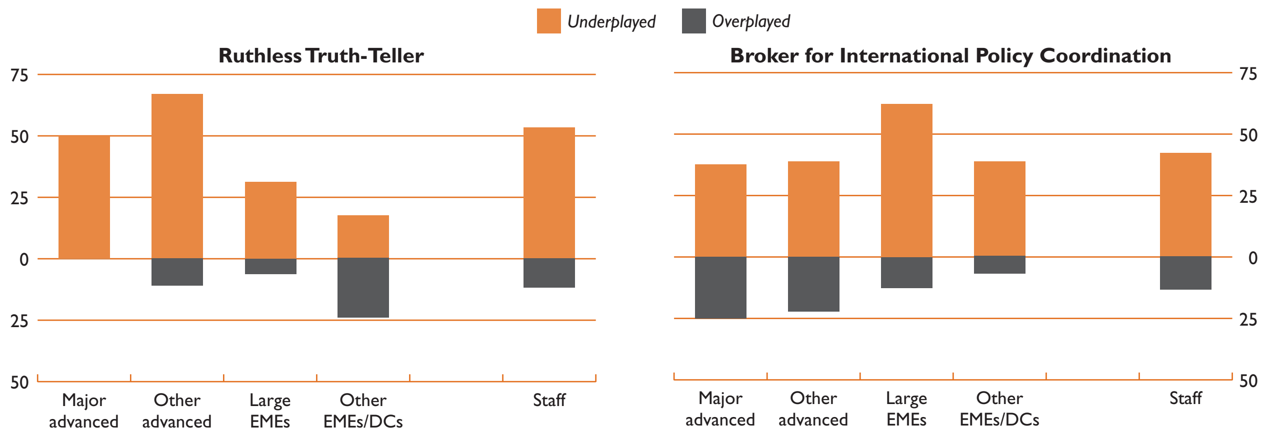


ing major exchange rate decisions taken by member countries, especially in the advanced and large emerging market economies. While the problem was by no means universal, the IMF was too often considered by authorities to have provided little value added. Of those country authorities who reported having 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

Proportions of authorities' and IMF staff's responses about the degree to which the IMF has either overplayed or underplayed the role of:[1]

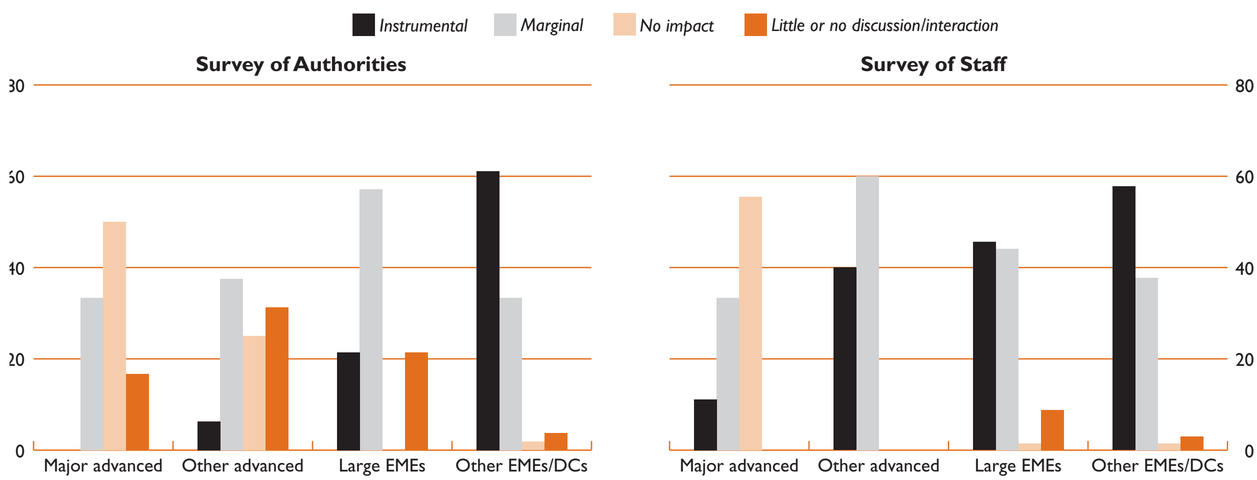
(In percent)



[1]Responses indicating that the roles were played "about right" are not displayed.

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 countries. 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.

CHAPTER

3 What Has Been the Quality of IMF Analysis and Advice?

18. There is a disconnect between the perceptions of staff and of the authorities regarding the quality of IMF exchange rate analysis and assessment—particularly in respect of advice to major advanced and large emerging market economies. While two-thirds of all staff respondents considered that the IMF's exchange rate policy advice had improved or significantly improved over the period covered by the evaluation (since about 1999), country authorities overall were less convinced. Just over half of authorities' survey respondents saw improvement. Responses grouped by type of country revealed a more differentiated, and—taken with the observations of impact noted above—more worrisome pattern (see Figure 3.1). In particular:

- Within the group of *large emerging market economies*, appreciation for the quality of the IMF's advice was significantly weaker: about 70 percent of respondents from the authorities reported that the quality of policy advice was unchanged or worse than a few years ago. By contrast, 70 percent of responses from staff working on these economies considered IMF advice to have improved or significantly improved. Notably, these economies had received much attention over the period (involving crisis prevention and resolution efforts in some). In part, the authorities' responses may reflect discontent with the implementation of IMF surveillance in general, and the very challenging policy environment that they face, for which there were no easy answers. Certainly the quality of the IMF's advice cannot be judged simply by how popular it is. Nonetheless, in the IEO's opinion, the authorities' views were validated by examples they provided of how the advice could have been improved.

- A mixed message could be taken from the *advanced economies*, the majority of whose respondents reported no change (in the case of major advanced economies) or improved quality (in the case of other advanced economies), but also for the most part said that IMF views had little or no bearing on their decisions.

- The most appreciative of the IMF's efforts were the authorities in 60 percent of *other emerging market and developing economies*, whose perceptions of improved quality, as well as of impact, matched those of the staff. However, only limited comfort should be drawn from this result. The authorities in these countries, many of whom saw IMF advice as instrumental in the context of IMF-supported programs, also indicated several areas in which the quality of advice could be improved significantly. Moreover, with the prospect of fewer IMF-supported programs, greater analytical capacity in many countries and further European integration, the challenges for the IMF to remain relevant in these economies will increase too.

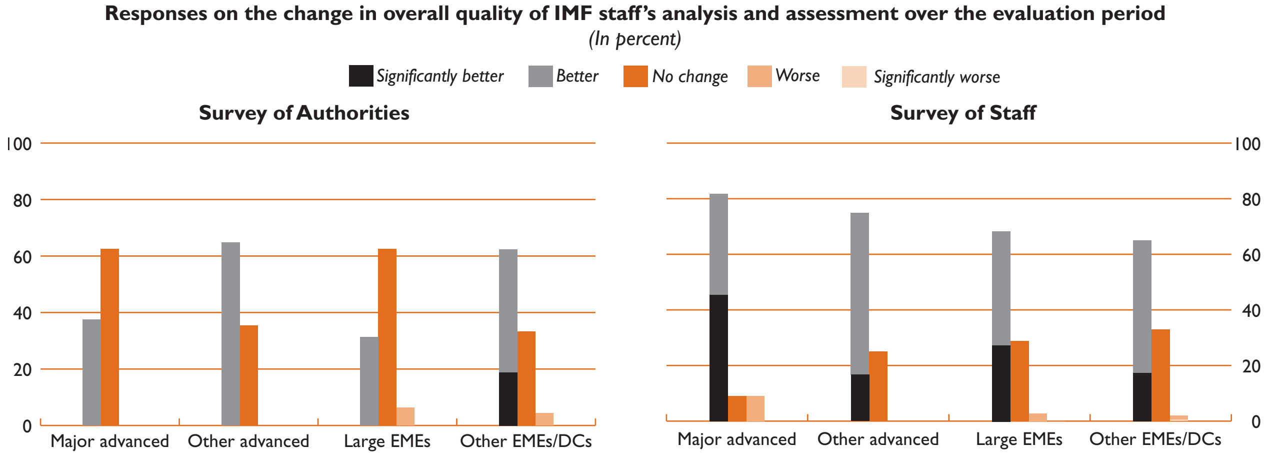
All in all, the results were indicative of a gap between the existing quality of advice and that which would be found useful by many authorities, especially in advanced and emerging market economies. Interviews with country authorities gave credence to this finding. While some officials stressed that the quality of analysis was excellent, and clearly valued, others (and not just those who may have disagreed with the advice given) were quite blunt in saying that it fell short of what would have been appropriate and helpful.

19. What could explain these different perceptions? The evaluation found several aspects in which the quality of exchange rate advice had improved, but also examples of why it had failed to persuade. It focused on eight elements of quality, including aspects of advice and its analytical basis for which some guidance had been given to staff.[1]

- Coverage of exchange rate issues, including linkages with other policy areas (see the section "Coverage of Exchange Rate Issues").

[1]See Chapter 2 and Background Documents 1 and 2 for more detail. As noted, the specific guidance to staff on how to go about exchange-rate-related surveillance is surprisingly limited—at least relative to the centrality of exchange rate policy issues to the IMF's responsibilities.

Figure 3.1. Perceived Change in the Overall Quality of IMF Staff's Exchange Rate Analysis and Assessment



- A description of the exchange arrangement has been a standard requirement throughout, but, in addition, from 2004, staff have been required to "accurately identify and describe the de facto exchange rate regime" in place (see the section "Regime Identification").
- A description of intervention policies and practices is necessary to describe and assess exchange rate policy (see the section "Intervention and Related Policies").
- The requirement for staff to "give a candid assessment of the impact of deficiencies in the timeliness and/or quality of data provided to the IMF on the staff's ability to conduct effective surveillance," from the 1997 BSR was taken up in subsequent Board meetings, including on the IMF's reserves template, and in a 2005 guidance note on data provision for surveillance purposes (see the section "Data Requirements").
- An assessment of the exchange rate level is required, according to the Board guidance, from the 2000 BSR (see the section "Analysis of the Level of Exchange Rates").[2]
- An assessment of the exchange rate regime is to be made in all cases, guidance also dating from 2000 (see the section "Advice on Exchange Rate Regimes").
- The integration of multilateral and regional perspectives (see the section "Multilateral and Regional Perspectives").
- The consistency and evenhandedness with which advice was provided (see the section "Consistency and Evenhandedness of Advice").

Coverage of Exchange Rate Issues

20. Strikingly, in a number of cases, substantive discussions with the IMF did not cover important exchange rate topics that were live issues for the country at the time. Some authorities perceived that in discussions with the IMF certain exchange rate issues received less focus than in internal debates (Figure 3.2). The failure to cover topics comprehensively was reflected in gaps or limited discussion in staff reports submitted to the Executive Board (though, on occasion, the lack of a substantive exchange of views with the authorities would be difficult to discern from reading the staff report and should have been flagged more clearly). Examples arose in a wide variety of circumstances and, for instance, in at least 5 of the 30 economies whose experience was reviewed in-depth (China, Korea, Mexico, Saudi Arabia, and the United Kingdom), there had been no meaningful two-way discussions on certain exchange rate issues for at least part of the period under review, or their treatment in staff reports was pro forma (lacking detail or much analytical content).[3] In

[2]The 2002 Operational Guidance note (IMF, 2002) specified that "all Article IV consultation discussions and reports should include . . . a forthright assessment of the exchange rate level."

[3]In the case of China (in 2001–02), substantive engagement with the authorities was lacking on the specifics of exchange rate regime options identified by IMF staff. In the case of Korea (in 2003–04), Article IV discussions did not satisfactorily cover the authorities' intervention policy and its consistency with the announced exchange rate policy. In the case of Mexico (in 2002–04), the staff did not assess the exchange rate level despite the fact that competitiveness was a live issue; in contrast, staff in the same period pursued with the authorities other contentious exchange-rate-related issues. In Saudi Arabia (2003–05), pronounced shifts in the terms of trade did not

some cases, IMF staff did not deal in a substantive way with possibly contentious issues (such as assessments of the appropriateness of a country's exchange rate level, regime choice, or limits to accumulating international reserves). Staff interviewed by IEO explained that the reasons for not being more forthright on such issues included not only judgments on the relative importance of issues, but also the desire to preserve the IMF's relationship with the country in question, and insufficient support from management or the Executive Board—an observation that is supported by the staff survey. In other cases, policy constraints and market or political sensitivities meant that the authorities were either hesitant or unwilling to discuss certain issues.

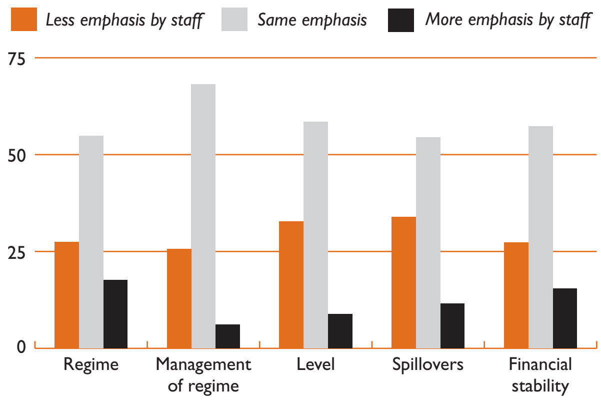
21. That said, in several countries, there was much *more* to IMF advice than met the eye in staff reports. In those cases, the exchange rate discussions were much more intense than suggested by Article IV staff reports. For example, detailed discussions on regime choice took place, with little or no documentation in staff reports or related selected issues papers. Staff activities in these cases ranged from informal workshops to confidential staff notes and meetings, extending over several years in some cases, with the authorities and staff exploring a variety of alternative policy options in the process. The staff received praise for this work, but it could only have been accomplished on the understanding that it not be divulged to the Executive Board. While it is reassuring that this work was carried out in some countries and was highly appreciated, the lack of reporting to the Executive Board of substantive issues in the context of Article IV consultations, which is not a new issue, does raise issues of accountability as well as the appropriate bounds of confidentiality.

22. Although exchange rate issues cannot sensibly be considered in isolation from domestic policy settings, evidence was mixed on how well the discussion of exchange rate issues was integrated with that of other relevant policy areas. In the surveys, both the authorities and staff agreed that coverage of linkages in discussions was good overall. However, a sizable minority of the authorities' responses (35 percent) suggested room for improvement, an assessment in line with other sources of evidence. In the desk reviews:

- Integration with monetary and fiscal policies was found to be good, with structural policies also well integrated for most countries. Discussions in staff reports were characterized by a focus on the consistency of these policies with the exchange rate regime and the external environment.[4]

Figure 3.2. Survey of Authorities: Relative Emphasis Given by the Authorities and Staff, by Policy Issue

Authorities' responses about the relative emphasis given to exchange rate issues in internal discussions compared to those with IMF staff
(In percent)



- Coverage and integration of financial sector and financial stability issues has improved over time—and significantly so in the context of countries' Financial Sector Assessment Program (FSAP) exercises and related technical assistance missions.[5] The in-depth review of 30 economies found that FSAPs benefited the integration of financial sector and stability issues into staff analysis. At the same time, about 40 percent of the surveyed staff saw analysis of financial stability issues as well as better analytical tools (e.g., balance sheet analysis) as areas where improvements could still be made.[6]
- Global and regional spillovers were an area that, despite recent improvements, remained infrequently covered. Guidance from the 1997 BSR called for staff to incorporate spillover effects by focusing "on the international as well as the domestic implications" of the policies of regionally or systemically

trigger assessments of exchange rate levels. In the United Kingdom (2000–03), there was no substantive discussion on the issue of euro adoption, including on the merits and implementation of the so-called "five tests," until after the authorities had made their decision.

[4]Among the 191 economies examined, there were only 25 cases in which the two most recent staff reports were judged not to have explicitly linked exchange rate discussions to these other policy areas. In all of these 25, the exchange rate was either not regarded as a live policy issue or exchange rate issues were treated in selected issues papers, with part of the discussion of linkages covered there. See Background Documents 4 and 5 for more detail.

[5]This finding is consistent with the IEO's recent report on the topic; see IEO (2006b). Given the importance of FSAPs for the integration of financial sector and stability issues, the improvement in quality may be partially driven by the fact that, among the 30 economies reviewed in-depth, 24 (80 percent) had completed an FSAP.

[6]In the broader area of country vulnerabilities, the degree of integration of the IMF's internal "vulnerabilities exercise" into staff's surveillance activities was also found to be good overall.

important member countries.[7] Progress was made particularly in the treatment of international ramifications of U.S. policies, reflected in numerous staff papers using a variety of multicountry simulation models. For other country cases, however, progress was much less pronounced—an issue that is taken up in more detail in the section "Multilateral and Regional Perspectives."

Regime Identification

23. A review of the most recent staff reports across the IMF membership suggested that classifications by staff of de facto exchange rate regimes were not always obvious or unambiguous; moreover, tensions between de jure and de facto classifications have remained unresolved throughout the entire period covered by this evaluation. In 12 cases (6 percent of the IMF membership), there appeared to be inconsistencies between MCM's classification of the de facto regime and the descriptions provided in either the body of the Article IV staff report or its annex on IMF relations.[8] In at least 3 of the cases from the in-depth review of 30 economies, the staff's classification of the de facto regime conveyed, at least temporarily, a misleading impression of the regime in place, reflecting in part the continuing tensions between authorities' de jure classification and the de facto classification based on staff judgment, for which consensus did not exist.[9]

Intervention and Related Policies

24. Analysis of intervention and related policies has been lacking in various ways. Coverage of intervention policies in staff reports was found to be incomplete, in at least 5 cases (with floating or managed floating regimes) from the in-depth desk review of 30 economies (euro area, Japan, Korea, Norway, and Singapore) reflecting, to different degrees, a more general lack of attention. This included insufficient analysis of past intervention episodes (including their effectiveness) for otherwise floating exchange rate regimes; missing assessments of whether intervention activities had been in line with the authorities' stated intentions; and incomplete analysis of the effects of changes (beyond the narrow definition of reserves) in the net foreign assets of government agencies or government-sponsored enterprises (see Box 3.1), whether for balance of payments or other purposes. Aspects of intervention policies that received almost no staff attention were intervention tactics, that is, the specifics of how intervention is implemented and the extent to which such practice is consistent with the stated intervention goals, and the "exit problems" involved in withdrawing from large-scale intervention activity.[10] Staff in general did not consider the effects of intervention activities (including those conducted in the context of fixed exchange rate regimes) on the countries whose currencies were used for intervention—or on the currencies of third countries.[11]

25. Staff have generally supported a country's accumulation of reserves for precautionary purposes, but not for purposes of maintaining competitiveness (see Box 3.2). About half of the sample of 30 economies covered in the in-depth desk review accumulated significant reserves in 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 considerations (in countries with large natural resources or aid flows); and (3) concerns about competitiveness and export/industrial performance. IMF staff have generally endorsed the accumulation of reserves on precautionary grounds and in countries with large natural resource endowments. But they have advised against accumulating reserves aimed at containing the appreciation of the exchange rate in the event of strained competitiveness (including in low-income countries, when international reserves had reached a more prudent level). Because explicit analysis of an adequate level of precautionary reserves (linked to the exchange rate regime, nature of shocks, and country conditions; see Table 3.1) is often absent, assessments of the appropriateness of such policy measures have remained highly judgmental.[12]

[7]The Crow Report and the IEO evaluation of multilateral surveillance reiterated the need. See Crow, Arriazu, and Thygesen (1999) and IEO (2006c).

[8]See Background Document 4 for more detail.

[9]Besides the de facto classification used by MFD/MCM, there are several different classification schemes proposed by researchers. Correlations across different schemes are virtually as low as the correlation for any one of the de facto classification schemes with the de jure classification. This casts doubt on the idea that there exists an unambiguous de facto classification (see Bénassy-Quéré, Coeuré, and Mignon, 2006; and Frankel, 2004).

[10]Examples include the practice of covert interventions, an arrangement that is typically seen as limiting the effectiveness of intervention through the signaling channel.

[11]During the Executive Board meetings in 2005, comments by Executive Directors on the lack of such assessments remained unanswered by staff and management; and in its desk reviews, the IEO identified only two possible examples of staff analysis of intervention-related spillovers. Implications of Asian intervention policies were analyzed in a 2004 selected issues paper for the euro area, which looked at different scenarios for global rebalancing on the basis of a three-country version of the IMF's GEM DSGE model, arguing that asset-market-based adjustments could have adverse effects on the euro area if these were to rely largely on the euro. In addition, possible regional spillover effects from yen depreciation in the context of antideflationary policies had been analyzed on the basis of simulation models in 1999/2000. This analysis, however, was not updated in the context of the interventions in 2003–04.

[12]More recent papers have given some emphasis to the upper band of reserves accumulation. See IMF (2004b), whereas earlier studies focused on precautionary motives (IMF, 2001).

Box 3.1. IMF Surveillance of Intervention Policies

Foreign exchange market intervention is an important topic for exchange rate surveillance, with the 1977 Surveillance Decision—in outlining "Principles for the Guidance of Members' Exchange Rate Policies"—placing a strong emphasis on members' activities in this area. Yet, the evaluation found that intervention policies are insufficiently covered in the IMF's surveillance of members' exchange rate policies. In practice, Article IV staff reports and internal documents rarely describe the nature of intervention activities in any detail and few of them analyze such issues as the effectiveness of such activities, optimal levels of reserves, or intervention tactics and implementation. This is despite the existing academic literature on some of these issues, which could have provided guidance for staff in conducting such analysis.[1] An exception is the analysis of the quasifiscal costs of countries' intervention activities, which are a more or less standard feature of staff assessments in countries with pronounced foreign exchange interventions.

A key aspect of staff's treatment of intervention policies is a narrow focus on the use and accumulation of international reserves, which tends to disregard economically very similar activities outside the traditional boundaries of intervention policies, such as those associated with government-controlled investment funds and their investment policies. Being fiscally induced, such activities differ from "traditional" sterilized or nonsterilized interventions. However, to the extent that these activities are targeted at—or are otherwise expected to affect—the real exchange rate, an assessment of that country's intervention policy against its stated rationale should be complemented by taking explicitly into account the impact of those government-controlled funds on capital flows.[2] This, in turn, will require relatively detailed information on countries' public sector net foreign assets—data that are not currently available to staff for all countries.

In some cases, the staff may have to judge whether a particular intervention policy is appropriate or not. While the 1977 Surveillance Decision suggests certain developments that "might indicate the need for discussion with a member,"[3] the evaluation finds that these "pointers" seldom guide the staff's internal assessments of intervention policies, while being largely absent from any material submitted for discussion by the Board. But quite apart from any guidelines that would help define the legal issues, what is lacking is practical guidance on what would and would not constitute sensible and appropriate activity, in different circumstances and with different purposes, that could form the basis of a cooperative discussion.

The staff, in coming to an informed position, should have an estimate of the equilibrium real exchange rate in order to assess if intervention broadly defined (i.e., practiced through reserve movements, fiscal, or other means and motivated for balance of payments, fiscal, or other reasons) is keeping the exchange rate low or high, and forming policy advice on the basis of that assessment. Although there is no universally accepted methodology for assessing the exchange rate level, the staff could choose the concept of equilibrium exchange rate that, in their judgment, best suits the task at hand,[4] and then supplement this analysis with an assessment of other quantitative and qualitative indicators. However, equilibrium exchange rate models are infrequently used in staff analysis in any case, and not typically in connection with discussion of intervention policies (see the section "Analysis of the Level of Exchange Rates").

[1]See, for example, Boyer (1978) on "optimal intervention," Williamson (1973) and Ben-Bassat and Gottlieb (1992) on "optimal reserves," and Edison (1993) on the "effectiveness of interventions." Recent examples of IMF work in the area are IMF (2004b) and Ishii and others (2006).

[2]The same applies to official borrowing or lending and capital controls, as highlighted in the Surveillance Decision. The use of this broader concept is not intended to question the traditional distinctions based on the motivation of policies. For example, in this context, the Executive Board noted that "[m]onetary or interest rate policies adopted for demand management purposes or other policies adopted for purposes other than balance of payments purposes would not be regarded as action to influence the exchange rate." See IMF (1974) and Crockett and Goldstein (1987).

[3]See "Principles of IMF Surveillance over Exchange Rate Policies," paragraph 2.

[4]See Background Paper 3 for more information on these models and their key assumptions.

26. In general, IMF staff have been reluctant to consider the use of intervention, including in the context of money or inflation targets, beyond the building of precautionary reserves.[13] During the evaluation period, many economies experienced large inflows of aid, private capital, or natural resource revenues, which have put upward pressure on their real exchange rates. Staff's reluctance to support the idea of intervention in these cases appears to be based on the assumption that the path of real appreciation would be identical, whether induced by a nominal exchange rate appreciation, or by an intervention-spurred increase in money and prices. However, this assumption is open to challenge. With underdeveloped capital markets, or underemployed resources, there are plausible reasons why this assumption may not hold, especially in the short run. Authorities' concerns about the potential harm to the export sector from excessive nominal exchange rate appreciation may be warranted and should therefore be discussed on their

[13]See Ho and McCauley (2003) for an analysis of the use of intervention in the context of money or inflation targets.

Box 3.2. Views on Reserves Accumulation, 2000–05: Selected Cases

Many in the IEO's sample of 30 economies accumulated significant reserves during the evaluation period. This box summarizes the experiences of seven such countries and the corresponding views of IMF staff and the Executive Board. In general, the IMF supported the accumulation of reserves for precautionary motives and in resource-rich cases, but did not on competitiveness grounds.

Continued support of reserves accumulation

Brazil. The authorities explained the accumulation of reserves, pursued in the context of a flexible exchange rate regime, in terms of reducing external vulnerabilities. Staff generally supported the authorities' argument, but cautioned against the perception that they were defending a particular exchange rate level. The Board supported the vulnerability-reducing motive of reserves accumulation.

Norway. Norway maintains an inflation targeting framework and its central bank does not intervene in foreign exchange markets. Its natural resource wealth is managed through a petroleum fund that was set up to mitigate Dutch disease effects and for intergenerational equity, with oil and gas resources expected to be depleted over the medium term. Staff and the Board consistently supported the use of the government fund to sterilize the macroeconomic impact of oil revenues and called for a consistent rules-based fiscal policy to minimize appreciation pressure.

Shift to limiting reserves accumulation

Korea. Initially, the rationale for intervention was to rebuild reserves after the currency crisis and to moderate appreciation, but from about 2001 it also began to include the need to limit volatility. As early as 2000, IMF staff saw Korea's level of reserves as adequate and argued that intervention should only be undertaken in disorderly market conditions. From 2003, staff increasingly argued for greater exchange rate flexibility, with broad Executive Board support.

Peru. The authorities' rationale for reserves accumulation shifted from vulnerability concerns associated with economic shocks and high dollarization to competitiveness and price stability concerns. IMF staff were supportive of higher reserves until about 2004, when they began to argue for limiting the reserves buildup and for allowing greater flexibility of the exchange rate (because of inconsistency with the stated exchange regime, sterilization costs, and their view that competitiveness was not a concern). The Executive Board broadly supported the precautionary buildup of reserves and argued also for greater exchange flexibility, with more divided views on the latter in recent years.

Russia. Staff initially supported the authorities' aim to limit the pace of real appreciation, arguing that a fairly stable exchange rate was a reasonable compromise between nominal appreciation pressures in the face of capital inflows, concerns that too rapid an appreciation would jeopardize output recovery, and uncertainty surrounding the recovery in money demand. This view included the assessment that continued intervention would seem appropriate. Among staff, however, doubts were expressed about the consistency of such advice with the objective of reducing inflation. Eventually, changing views on the persistence of strong terms of trade gains led to repeated advice in 2002–03 to scale back intervention and avoid further delays in allowing increased exchange rate flexibility. While the Board's views developed broadly along with those of the staff, some Directors remained supportive of the authorities' preference for targeting both inflation and the exchange rate in the face of real appreciation pressures.

South Africa. The authorities initially built up reserves in order to unwind the net open foreign position from past interventions. Once the net open foreign position was closed, staff supported the authorities' early stance to increase reserves, especially against the background of gradual capital account liberalization; by 2005, however, staff began to argue that reserves were adequate. The Board broadly supported the evolving views of the staff.

Tanzania. The authorities' stance on reserves accumulation stemmed from competitiveness concerns linked to external resource flows. They continued to build reserves by using only a portion of aid receipts to limit the monetary impact of increased government spending. From 2002, the staff did not see a problem with the level of the exchange rate and called for a greater absorption of foreign assistance. The Board, while supporting the buildup of reserves early on to create a buffer, endorsed the staff position and suggested structural reforms to ease competitiveness concerns.

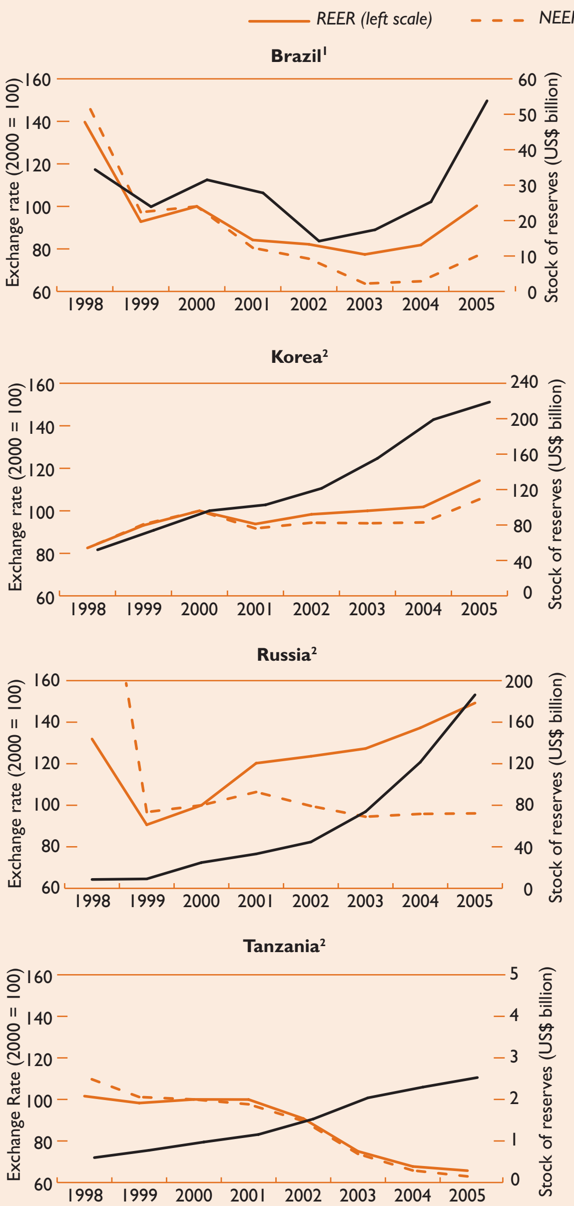
merits.[14] Further analysis should be worthwhile to draw out the different implications for policy advice, depending on the source of the inflow—whether aid, private capital, or income from natural resource exports.

[14]See, for example, Caballero and Lorenzoni (2006).

Data Requirements

27. Serious data problems appeared to have hampered effective surveillance. Staff reported that data problems impaired their ability to conduct exchange rate analysis and provide advice in 37 percent of coun-

Exchange Rate and International Reserves, 1998–2005



Sources: IMF, *World Economic Outlook* and Information Notice System.
[1]Program definition of net international reserves.
[2]Gross international reserves.

tries. In 23 percent of countries, authorities were unwilling to provide relevant data. In part, lack of reliable intervention data, as well as related information (e.g., on intervention tactics and the investment policies of government-controlled asset management vehicles), seems to have limited the staff's ability to properly assess intervention activities. Data have also remained incomplete on international reserves and authorities' intervention and reserves management activities (see Box 3.3). In some cases, the full scale of countries' reserves holdings, and broader concepts of government-controlled net foreign assets, raised difficult

Table 3.1. Coverage of Optimal Reserves Levels in Article IV Issues Papers, 2001–05[1]

Economy	Issues Paper	Year	Nature of Analysis	Concerned with High/Low Reserves
Angola	International Reserve Adequacy in Angola	2003	Explicit	Low
Bulgaria	External Sustainability and Vulnerability	2004	Implicit	Low
Central African Economic and Monetary Community	Reserve Adequacy in a Currency Union	2005	Explicit	High/Low
Chile	Chile's Holdings of Foreign Reserves	2004	Explicit	High
Haiti	Reserve Adequacy in Haiti	2005	Explicit	Low
Kazakhstan	An Assessment of External Vulnerability	2001	Implicit	Low
Korea	Foreign Exchange Crises, Money Demand, and International Reserves	2001	Implicit	Low
Libya	Oil Fund for Saving and Stabilization—Reform Options for Libya	2003	Implicit	High
Lithuania	Current Account Sustainability	2005	Implicit	Low
Malaysia	Malaysia's Resilience to Unanticipated Shocks: Initial Results	2002	Implicit	Low
Mauritania	Managing Oil Wealth	2005	Implicit	High
Mexico	Reserve Adequacy in Mexico	2003	Explicit	High
Namibia	International Reserves and Investment Decisions by Institutional Investors	2004	Implicit	Low
Norway	The Norwegian Government Petroleum Fund and the Dutch Disease	2005	Implicit	High
Slovak Republic	Slovakia's Current Account Deficit: Why So Large and Is It Sustainable?	2002	Implicit	Low
South Africa	The Case for Building International Reserves	2004	Explicit	High/Low
Tunisia	Assessing Reserves Adequacy	2004	Explicit	High/Low
Ukraine	External Risks and Opportunities	2005	Implicit	Low
West African Economic and Monetary Union	The Adequacy, Sources and Costs of International Reserves in the WAEMU	2005	Explicit	High/Low

[1]Based on a desk review of exchange-rate-related issues papers for the entire IMF membership.

issues. Also, several of the big reserves holders do not disclose the currency composition of their reserves—for lack of participation in both the Composition of Foreign Exchange Reserves (COFER) database and the Special Data Dissemination Standard (SDDS).[15]

28. At the same time, staff appear to have been hesitant to pursue such data issues more forcefully. Because by definition official intervention always involves a counterparty, often a correspondent bank handling the actual trades, some information is bound to exist in the market that can be—and, on occasion, has been—sought out by staff. More generally, however, although staff are required to certify that data are adequate for effective surveillance, the evidence from the staff survey raises questions as to why the certification is granted so often. For staff to take a stronger stand when authorities are unwilling to share the critical information needed for surveillance, however, requires support by senior management and the Board, which—according to the staff survey and interviews—was perceived as lacking.

[15]Absence of such information on currency composition of reserves will complicate any analysis of reserves-management-related risks of disorderly exchange rate adjustment. This is one of the key multilateral risk factors highlighted in recent Article IV reports for the United States and a number of other major economies (see Box 3.4). COFER is a database maintained by the IMF's Statistics Department that keeps end-of-period quarterly data on the currency composition of official foreign exchange reserves, defined as monetary authorities' claims on nonresidents in the form of foreign banknotes, bank deposits, treasury bills, short- and long-term government securities, and other claims usable in the event of balance of payments needs. COFER data are currently reported on a voluntary basis by 119 countries; individual country data are strictly confidential and disseminated, including within the IMF, only in aggregated form for three country groupings. The SDDS was established to guide IMF members in the provision of their economic and financial data to the public, including data on foreign exchange positions. Subscription is voluntary, but carries a commitment by a subscribing member to observe the standard and to provide certain information to the IMF about its practices in disseminating economic and financial data; to date, there have been 64 subscriptions to the standard.

Box 3.3. Data Issues in IMF Exchange Rate Surveillance

Data shortcomings seem to have impaired the surveillance of a significant proportion of IMF members in recent years. The IEO found that staff reported material problems with data availability and quality in 90 of 191 economies in the two most recent Article IV consultations through 2005. Likewise, of the 115 countries for which country-specific information was identified by the IEO survey of IMF staff, 42 appeared to have had problems with availability or quality of data that—in the staff's view—had impaired their ability to conduct exchange rate analysis.[1] More than 40 percent of staff surveyed by the IEO also identified the availability of data as an area where significant improvement could be made that would raise the overall quality of exchange-rate-related analysis.

The causes of data shortcomings differ across countries. In some cases, such as those that have undergone transition or civil unrest, authorities themselves have not had the data. In other cases, authorities collect but seem to be unwilling to share important pieces of relevant information, such as records of intervention activity, material components of foreign exchange reserves, or unconventional intervention measures that are likely to affect exchange rates. Such data are not always essential for high-quality surveillance, but the IEO found that in about a quarter of cases IMF staff appeared to be conducting discussions from a position of informational disadvantage.[2] Under such circumstances, it is difficult to see how staff advice could be effective.

Data problems do not always relate to reserves. In the case of Greece, for example, knowledge of the extent of shortcomings in fiscal data, which were not apparent to the IMF at the time, would have affected surveillance discussions in the run up to the country's adoption of the euro in 2001. Staff responses to the IEO survey suggest that the authorities were unwilling to share critical information in several of those 30 economies that the IEO had selected for in-depth study. The desk review came across one case where underreporting of transactions had significantly affected that country's international reserves and was not fully apparent from staff reports submitted for discussion at the Executive Board. In two other cases, reserves-related data issues were reported to the Board. In all three cases, the respective problems have subsequently been addressed.

[1]Specifically, IMF staff working on 42 countries agreed or strongly agreed with the statement that "for [country name, as specified], the availability and quality of data has *impaired staff's ability* (italics in original) to conduct exchange rate analysis and provide related advice."

[2]In 26 out of 115 country cases, IMF staff agreed or strongly agreed with the statement that the authorities were "*unwilling* (italics in original) to share some critical data/information needed for exchange rate analysis and related advice." In a similar number of cases, staff judged the authorities as technically not capable of furnishing critical data.

Analysis of the Level of Exchange Rates

29. While efforts have been made to enhance the analytical basis of staff assessments of exchange rate levels, "forthright assessments" have not been provided in all cases.[16] While some description of exchange rate levels is contained in virtually every Article IV report, the in-depth review of IMF documents for the sample of 30 economies finds 5 cases with little or no analysis of exchange rate levels over part of the 1999–2005 period. China and Saudi Arabia are very different examples of countries for which the IEO found that a "forthright" assessment had not been made—in part because of analytical difficulties, but seemingly also because staff did not discuss with authorities and report what were potentially contentious levels-related issues.[17]

30. The use of sophisticated methodologies in the IMF's analysis of exchange rate levels has increased, but is still limited and documentation could have been significantly better. For example, in 2005 there were only 25 cases for which one or more such techniques were used (see Table 3.2).[18] In general, staff could have explained better how they reached their assessments of levels. At times, the choice of methodology appeared arbitrary, casting doubts on the results and their usefulness.[19] In selecting methodologies, more attention should have been given to the particular strengths and weaknesses of individual approaches, and to how these relate to the circumstances of the

[16]While there is no clear-cut definition of what "forthright" assessments are supposed to entail, the IEO's review made the judgment that the following reasons would constitute failure to make such assessment: (1) absence of any analysis in situations where external developments strongly suggest that equilibrium exchange rate levels may have changed; (2) failure to bring all relevant information to bear in coming to a conclusion.

[17]In the case of Saudi Arabia, exchange rate levels were consistently not analyzed in Article IV reports, despite pronounced, possibly long-lasting, terms of trade changes and repeated calls—in the internal review process—for more analysis. In China, by contrast, exchange rate levels were analyzed using a variety of methodologies: however, some traditional indicators of exchange rate misalignment were not brought to bear on the issue until 2005, clouding the overall assessment of renminbi levels.

[18]Important analytical contributions were made, for example, in the case of the United Kingdom (2001), the West African Economic and Monetary Union (WAEMU) (2004–05), as well as in a selected issues paper on China (2003, later published in the IMF Occasional Paper series).

[19]See Background Documents 3 and 5 for detail.

Table 3.2. Staff Use of Analytical Methods for Exchange Rate Level Assessments, 2000–05[1]

Year	Number of Countries	Instances of Staff Use: PPP/adjusted PPP	Macroeconomic balance/CGER	FEER/BEER	Other
2000	14	1	10	2	1
2001	17	1	15	1	2
2002	23	6	14	4	1
2003	18	11	9	3	1
2004	26	8	9	10	4
2005	25	12	9	8	7

[1]See Background Document 3 for a description of the various methodologies and more detail on staff use.

economy in question and existing measures of competitiveness. So, while the staff's work on exchange rate levels may have become more sophisticated, its impact on the quality of the resulting assessments and advice is difficult to establish. Also, given the large "error margins" inherent in all methodologies of equilibrium exchange rate determination, staff have generally been hesitant to attach much emphasis to model-based exchange rate assessments. The IMF's Consultative Group on Exchange Rate Issues (CGER) approach, for example, is met by staff with a degree of skepticism, with only 40 percent of the surveyed staff who had worked on relevant countries finding it very useful.[20] However, in its review of country cases, the IEO saw scope for more developing countries to have benefited from greater quantitative analysis of exchange rate levels and competitiveness. A prerequisite would be to have more and better data, including on costs, so that the link between assessments of competitiveness and of exchange rate levels, in periods of structural change, can be improved.

Advice on Exchange Rate Regimes

31. Assessments of countries' exchange rate regimes are a standard feature of Article IV reports, usually taking the form of a statement noting that the regime in place has served the country well. When advice *was* given over the evaluation period, it tended to be in the direction of more flexible exchange rates. In particular, based on the last two staff reports through 2005, IMF staff were found to have advised countries to adjust their exchange rate regimes (including monetary frameworks) in 63 cases. In 51 of these, they advised in favor of more exchange rate flexibility, which was linked to a proposed switch to inflation targeting in 8 cases. For the 30 economies reviewed over the 1999–2005 period, explicit regime advice was given in 12 cases, mostly in the direction of enhanced flexibility.[21] Although such advice may not be unreasonable, particularly in a medium- or long-term context, greater flexibility may not always be desirable, and a particular view should not be taken for granted. What is striking is:

- the frequent lack of formal, country-specific analysis backing such advice, which is likely to have limited the Executive Board's ability to judge the merit of staff's advice on a case-by-case basis; and
- the lack of a Board-endorsed view since 1999 that this is indeed the right strategic direction for the IMF to be taking.[22] The lively debates over exchange rate advice have taken place in other fora, in informal discussion, and in individual country cases.

32. Over the evaluation period, advice in favor of flexibility was not always backed up by formal analysis.[23] While it is difficult in practice to separate cleanly the logic and timing of advice on regimes from advice pertaining to misalignments, recent IMF advice on exchange rate policy has mostly been couched in terms of calls for greater exchange rate flexibility. Formal analyses of exchange rate levels were used for only 25 of the 63 economies to which recent regime advice was given, and regime suitability was analyzed in only 10 cases (Table 3.3). This pattern is consistent with the observation, from the IEO's sample of 30 economies, that analysis of regime choice was often of a

[20]Isard and others (2001) listed a number of caveats on the reliability of estimates.

[21]In the survey of authorities, a majority of the respondents saw the IMF favoring particular regimes over others, with opinions roughly split on whether the IMF's approach had paid sufficient attention to intermediate regimes. See Background Document 6.

[22]See Background Document 2 for more information.

[23]Some analysis may have been provided over earlier consultation cycles. A review of selected issues papers (2001–05) for the 63 countries that have received advice on their exchange rate regimes finds 17 cases (27 percent) for which no paper on exchange rate issues was available. Another 28 countries (44 percent) had only one such issues paper over the period. Most of these papers were conceptual in nature or focused on only a subset of the issues at hand.

Table 3.3. Exchange Rate Regime Advice and Its Analytical Basis[1]

Nature of Staff Advice	Number of Cases[2]	Regime Sustainability or Suitability Analyzed[3]	Formal Exchange Rate Level Analysis[4]	Currency Deemed Over- (Under-) Valued by Staff
More flexibility	51	7	20	11 (10)
Less flexibility	1	1	0	0 (0)
Implementation; management of existing regime	24	4	11	2 (6)
Number of economies with advice[5]	63	10	25	11 (11)
No specific advice given	128	14	38	8 (4)
Total number of economies	191	24	63	19 (15)

[1]As recorded in the IEO desk review of the two most recent staff reports through 2005.
[2]Advice has been given to 63 economies overall (in 13 cases, advice on flexibility and management of the regime was given simultaneously), of which 2 were advanced economies, 10 were large emerging market economies, and 51 were other emerging market and developing economies.
[3]Based on tools such as optimum currency area criteria and analysis of economic shocks.
[4]Analysis of exchange rate level explicitly involved tools other than interpretation of REER charts.
[5]Net of double counting.

largely conceptual nature, appeared to be influenced by concerns about exchange rate levels, and tended to lag—rather than lead—the IMF's general direction of advice.[24] In addition, in a few of the sample economies, IMF staff and management also pressed the authorities to move quickly, usually against their preference for a more gradual approach, and failed to fully appreciate country-specific factors, especially—but not always—in a program context.[25] This finding was supported by survey evidence, particularly among the large emerging market economies and in interviews. The IMF was acting against the background of the lack of clear-cut guidance from the academic literature on regime choice, which has tended to discuss regime decisions in the context of a limited number of economic characteristics, but without developing operational tools to aid practical choice.[26] Whatever the reasons, the IMF may have overemphasized the benefits of a rapid move to more flexible exchange rate regimes, while insufficiently appreciating country-specific obstacles to implementation and other reasons why country authorities may prefer to remain—or remain longer—with a more managed exchange rate system.

33. A key problem was the lack of appreciation on the part of staff and management for the challenges posed by implementation. In the words of one senior official—expressing a sentiment shared by others—"the more complex or country-specific the [implementation] issue, the less useful the IMF's advice.'' Some 40 percent of the authorities' survey responses indicated that attention to implementation issues could be improved. This view was particularly pronounced within the group of large emerging market economies and among those authorities that had received advice on their exchange rate or monetary policy regimes during the last two consultation cycles. (Among the latter, 60 percent would have liked to see broad advice being developed into concrete advice on issues of implementation.)[27] Interviews suggested that technical obstacles to the implementation of more flexible exchange rates tended to be underestimated by staff, who were perceived by the authorities as having insufficient technical expertise or practical experience. Technical assistance (TA), to the extent it was provided, was in general valued by both staff and the

[24]This applies—to different degrees—to the cases of Malaysia, Morocco, and Ukraine.

[25]Specifically, in the case of Ukraine in 2004, attempts were made to make enhanced exchange rate flexibility a prior action for the completion of a program review—later toned down to a "demonstrable shift" in exchange rate flexibility as an important element in completing the review. This was despite a lack of compelling analytical work in support of an urgent regime adjustment and despite disagreement by the authorities. A similar attempt at leveraging the program context was made in the case of Egypt in 2002, with regard to possible access to IMF resources under the Compensatory Financing Facility (CFF), a purchase that never materialized. While staff had made a case for urgent action, the authorities' state of readiness and management's use of pressure in the CFF context appeared questionable. The desire to use apparent windows of opportunity in less than perfect conditions has to be set against the risks to credibility if the strategy does not work.

[26]The IMF, for its part, has been late to develop such approaches. However, though very different in terms of methodologies, recent work by Husain (2006)—first applied in the context of Morocco, and later used for countries such as the former Yugoslav Republic of Macedonia, Serbia, and Ukraine—and Schadler and others (2005)—on the adoption of the euro in Central Europe—can be considered valuable contributions.

[27]Within the same group, staff's follow-up activities were judged—according to 45 percent of the respondents—to have either no or only marginal influence on implementation, which contrasts with staff's much more favorable assessments and suggests that provision of practical assistance was falling short in the view of the authorities.

authorities as being an important component of IMF advice.[28]

34. In individual cases, demands for urgent action and insufficient attention to detail led to unintended outcomes that reflected badly on the advice given. In the case of Egypt, in January 2003, both staff and the authorities had not given sufficient attention to ascertain that the microeconomic preconditions for successful floating (e.g., a functioning foreign exchange interbank market and a monetary policy framework) had been put in place. The IMF had provided technical assistance in advance, but there was no careful checking of whether the recommendations had been implemented. In the event, the flotation attempt was aborted in the wake of unfavorable market dynamics. These were triggered by pent-up demand for foreign exchange and open positions on bank balance sheets (which had been identified in the earlier technical assistance, in broad terms, as potential sources of risks), as well as a lack of sustained support from other policies. In the case of Ukraine, in 2005, an undue sense of urgency conveyed by the IMF's policy advice complicated communications with the authorities to an extent that policy actions were taken without proper preparation.[29] Reasons for staff to advocate a "rush to more flexibility," either at the level of implementation (as in Egypt) or more generally (as in Ukraine), could have included substantive concerns, for example, that the economy was open to even greater risks of substantial shock if adjustments were delayed and that no other policy option were available to cope with these risks. However, in the cases mentioned above, such risks did not appear great; or at least, evidence was not presented to support going ahead without having the "first best" groundwork in place. It appears, therefore, that, in these cases, one of the abiding lessons from the Asian crises was being applied too readily.

Multilateral and Regional Perspectives

35. Despite increased attention to global imbalances and capital flows in recent years, multilateral considerations did not feature prominently in most bilateral discussions. Multilateral aspects were explicitly referred to in one-sixth of the recent staff reports covered by the desk review of the full IMF membership, while regional aspects were referred to in about a third (Table 3.4).[30] In the desk reviews, however, depth has often been found lacking, with references to multilateral developments not fully integrated into the staff report or supported by formal analysis. It is also the case that multilateral considerations have been heavily dominated by concerns about global current account imbalances, while regional considerations tended to focus on economic conditions in major regional trading partners. Scant attention, however, was being given to other issues, such as financial market and balance sheet spillovers, as reflected by the relatively limited analysis of exchange-rate-related issues in the IMF's multilateral surveillance that have been relevant for bilateral surveillance (see Table 3.5),[31] and the failure in bilateral surveillance to pick up financial market issues that may have affected several countries at once.

36. In particular, coverage often lacked depth even in cases for which regional or multilateral issues would be expected to be important. This has included limited coverage of potential regional spillovers emanating from such economies as the euro area, Brazil, or Russia.[32] Moreover, bilateral and multilateral surveillance have focused unevenly on common factors underpinning exchange rate developments and associated policy responses. For example, while attention was given to self-insurance motives and the accumulation of reserves across a large number of countries from the late 1990s, discussions of the abundant global liquidity in later years (and the possibility of its being temporary in nature) were not translated—in bilateral or multilateral surveillance—into analysis of common patterns across countries of those intervention policies that seek to contain exchange rate appreciation pressures to help preserve competitiveness. Consistent with this, some 45 percent of the respondents to the IEO's survey of country authorities found that IMF staff had rarely

[28]In interviews, the IEO was alerted to a case in which the findings of an exchange-rate-related TA mission may have been turned into program conditionality with undue urgency. While a more detailed assessment was deemed beyond the scope of this evaluation, the IEO screened IMF documents for the last two Article IV cycles (up to 2005) for country cases with program conditionality on exchange rate issues, identifying 10 such cases. By tracing the history of these program conditionalities, however, the IEO's opinion was that most of these had clearly not been driven by the results of preceding TA missions and/or did not have an unrealistic timetable.

[29]The April 2005 decision for an ad hoc step realignment of the exchange rate, which was ill-received by unprepared markets, was taken in the immediate aftermath of a meeting between IMF management and a senior country official, at which the IMF had reemphasized the need for more exchange rate flexibility.

[30]Mention of multilateral policy issues was limited relative to the overall size of the IMF membership, but corresponded closely with the weight of such factors as country size and systemic importance. The 31 staff reports found to contain some discussion of multilateral issues, such as global imbalances and international capital market spillovers, include those for the euro area, most individual G-7 countries, and a number of non-G-7 economies and international trading centers. Most of the remaining economies experienced sizable multiyear current account imbalances over the period 1999–2005.

[31]This evidence backs up the findings in an earlier IEO study of the uneven integration of bilateral and multilateral surveillance (see IEO, 2006c). See also Background Document 6, paragraph 20 and paragraph 35 (Figure A6.25).

[32]See Background Document 4. In this context, the newly instituted *Regional Economic Outlooks* through 2005 did not seem to have been used to provide such analysis (and in the case of Russia, would need to cross over the IMF's departmental boundaries).

Table 3.4. Coverage of Multilateral and Regional Issues, by Country Group[1]

Issue	Major Advanced	Other Advanced	Large Emerging	Other Emerging/Developing
Multilateral				
Resolution of global imbalances	7	7	3	0
Global capital markets	2	1	6	5
Regional				
Spillovers from trading partners/competitors	1	2	6	22
Other regional spillovers	1	2	4	16
Memorandum item:				
Number of economies in group	8	21	20	142

[1]Based on the last two Article IV reports through 2005.

Table 3.5. Selected Coverage of Exchange Rate Issues in the *World Economic Outlook*, 2000–05

Title	Date	Coverage
How will global imbalances adjust?	9/2005	Appendix
Learning to float: experience of emerging market countries in the early 1990s	9/2004	Chapter
How did Chile, India, and Brazil learn to float?	9/2004	Box
Foreign exchange market development and intervention	9/2004	Box
The effects of a falling dollar	4/2004	Box
How concerned should developing countries be about G-3 exchange rate volatility?	9/2003	Chapter
Reserves and short-term debt	9/2003	Box
Are foreign exchange reserves in Asia too high?	9/2003	Chapter
How have external deficits adjusted in the past?	9/2002	Box
Market expectations of exchange rate movements	9/2002	Box
Weakness in Japan, global imbalances, and the outlook	3/2002	Appendix
How did September 11 affect exchange rate expectations?	12/2001	Box
What is driving the weakness of the euro and the strength of the dollar?	5/2001	Chapter
The weakness of the Australian and New Zealand currencies	5/2001	Box
Convergence and real exchange rate appreciation in EU accession countries	10/2000	Box
Why is the euro so undervalued?	10/2000	Box
The pros and cons of dollarization	5/2000	Box

Source: IMF, *World Economic Outlook*.

identified, or sufficiently integrated into their analysis, spillovers affecting their countries. The authorities were roughly split on whether or not spillovers emanating from their countries had been sufficiently integrated. In both cases, dissatisfaction was felt particularly among the large emerging market economies (Figure 3.3).[33]

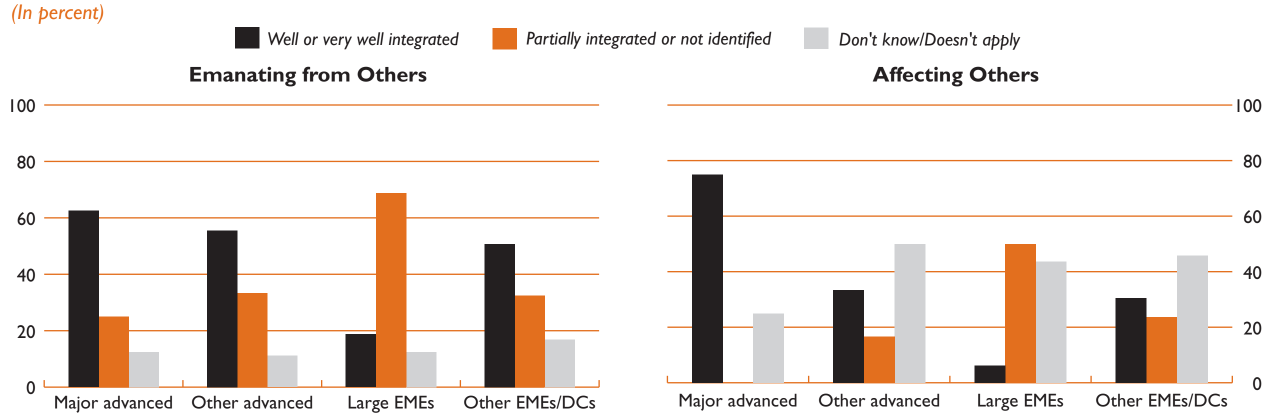
[33]Across all respondents, 39 percent agreed that the quality of their interaction with staff would have benefited from a better integration of multilateral perspectives. While only 19 percent of staff agreed with this assessment of past discussions, about 40 percent of the same respondents said that the analytical framework for the discussion of multilateral issues was lacking and that the IMF's multilateral surveillance tools had not provided them with relevant inputs. Looking forward, 42 percent of staff saw scope for improvement of IMF analysis of policy spillovers, while 47 percent said the same about integration of bilateral and multilateral surveillance.

An example in this context is the IMF's treatment of global imbalances—the key multilateral surveillance issue of the last few years (Box 3.4).

The Consistency and Evenhandedness of Advice

37. The consistency—or evenhandedness—of IMF advice is another important aspect of quality: no clear-cut cases of uneven treatment were identified in the sample of 30 economies, but more could have been done to counter the perceptions of inconsistency, which remain strong. Consistency requires that advice be given across the membership in ways that adjust for different circumstances, while also allowing for

Figure 3.3. Survey of Authorities: Views on the Integration of Spillovers
(In percent)



the fact that a variety of measures can be used to deal with similar challenges.[34] Claims of inconsistency are as difficult to dispel as they are to prove. However, providing better explanations for particular policy advice would reduce the risk of inconsistency, as well as the risk of being accused of it. But care also needs to be taken that similar types of assessments are delivered with similar degrees of analytical detail to preserve an evenhanded approach. Three types of potential inconsistencies or lack of evenhandedness were examined briefly, but they raise questions rather than provide answers.

38. One possible inconsistency arises from the lack of in-depth analysis of countries' intervention policies, which could lead the IMF to treat reserves accumulation—or more broadly, public sector net foreign asset positions—unevenly across countries. For example, would the IMF's view on reserves accumulation in China, or Peru, be different if long-term developments, such as aging or receipts from natural resource exports, were taken into account, with sizable parts of the country's net foreign assets accumulated in a dedicated fund for the benefit of future generations, or with a state-owned holding company? How would these examples compare to the analyses of large, government-controlled net foreign asset positions in other countries; and how and on what basis would the IMF make judgments in such cases?

39. A second possible lack of evenhandedness can arise from an unwillingness to raise sensitive issues with advanced economies, while having less compunction in doing so with other countries. An example from the sample of 30 countries was staff and management's reluctance to raise with the U.K. authorities the issue of exchange rate regime choice while the United Kingdom was deciding whether or not to adopt the euro.[35] Given the significance of euro adoption during the evaluation period, the case of Greece is also of interest. The 1999 Article IV staff report for Greece noted that weaknesses in data "complicated the assessment of economic conditions," but the true extent of these weaknesses and their implications were not unearthed until later years. This raises the question of whether more effective surveillance would have altered the assessment of policies in the period before the adoption of the euro in 2001. When the data problems were later revealed, no report was discussed at the Executive Board on the causes and implications. These examples have done nothing to dispel the notion that advanced countries are treated differently, though by themselves they cannot prove it either.[36] It is particularly important, for both substantive and signaling reasons, that the exchange-rate-related advice to advanced economies (including those in the euro area) is evenhanded and perceived as such.

40. Finally, consistency checks can also be applied to advice given to economies in similar circumstances. One view expressed in Europe, for example, was that, in the context of the launch of the European Economic and Monetary Union, the IMF had shown even less readiness to involve itself in the cases of Italy or Germany than in the case of the United Kingdom. The

[34]Consistency is not to be confused with a "one size fits all" approach, which would give insufficient attention to country circumstances.

[35]In this case, the U.K. authorities had not been keen for the IMF to give its view and—prior to 2003—staff and management obliged, thus missing the opportunity for any influence or discussion. Preliminary work by staff in the context of the 1999 Article IV consultation had set the stage for possible subsequent development of these issues, including on the appropriate exchange rate level at which to join the euro area. In 2003, staff pressed for, and management finally agreed to, a thorough analysis of how the "five tests" had been applied by the authorities, but only after they had announced that the economic case for adopting the euro had not been made.

[36]Evidence from the staff survey is consistent with such a tendency. For example, a somewhat higher percentage of respondents working on advanced economies, than for the overall sample, agreed with the statement that the need to preserve close relationships with the authorities tended to dilute coverage in staff reports.

Box 3.4. The Treatment of Global Imbalances in Bilateral Consultations, 2003–05[1]

Having emerged as a major macroeconomic policy issue at some point in 2002, global imbalances were given prominence in late 2003, with the near-simultaneous publication of the G-7 communiqué in Dubai and an analysis of reserves accumulation in the IMF's *World Economic Outlook* report. Concerns at the time were—and continue to be—driven mainly by the risk of disorderly adjustment and related cross-country spillovers should exchange rate and macroeconomic policies in major surplus and deficit economies fail to facilitate a timely correction of these imbalances.

The IMF was among the early proponents of the "disorderly adjustment" view, with references to global imbalances starting to appear consistently in internal IMF documents and staff reports for a number of Asian countries in 2003 and, beginning in 2005, for other major surplus economies. In 2002, large-scale reserves accumulation had been identified as an issue with potential multilateral implications in internal IMF discussions on China. Earlier, starting in 1999, references to global imbalances and disorderly dollar adjustment had appeared in Article IV reports for the euro area and the United States, though in the context of imbalances between the G-3 economies.

Despite the importance attached to the issue by both IMF staff and management,[2] and the inherent need for coordinated—possibly, IMF-facilitated—policy responses, the integration of multilateral considerations into analysis at the individual country level generally lacked depth. In particular, with policy advice being formulated largely on the basis of cyclical, country-level considerations that would provide "first best" recommendations for the country in isolation, interdependencies between individual country policies and the responses of other countries were not sufficiently integrated into staff analysis. Accordingly, staff recommendations—while consistent with global adjustment over the medium to long term—became increasingly inconsistent with staff's own assessments of the need for and relative urgency of policy responses at the multilateral level.[3]

As a result, scope for active policy coordination—for example, by providing alternative sets of policy recommendations that are explicitly conditional on policy actions taken in other countries—was insufficiently exploited. Despite increasing coverage of the topic in bilateral Article IV consultations and repeated calls by the Executive Board for a "globally coordinated and calibrated policy response" the Board did not "force" a more systematic approach towards the resolution of global imbalances. Finally, following high-profile remarks by certain country officials in the course of 2005, the search for a coordinated policy response was further complicated as the IMF was increasingly seen as reacting to outside pressure; this—according to a number of country officials—lowered the credibility of its policy prescriptions.

[1]See Background Document 5 for more detail.

[2]See, for example, Köhler (2003) and de Rato (2005).

[3]The IMF's views on the size and urgency of any adjustments and on the corresponding risks for disorderly market conditions were not universally shared, even among IMF staff. Internal debate of competing views, however, has remained limited

IEO desk reviews contrasted the IMF's advice to some African countries that have been subject to a surge in foreign exchange receipts from aid and commodity price increases.[37] At the same time, judgments about inconsistencies are very difficult to make in that different approaches can be adopted to tackle similar issues. For example, empirical research[38] finds that both Hong Kong SAR and Singapore suffered similar shocks and real developments, at least at business cycle frequencies, but had different nominal outcomes in that inflation rates were higher and more variable in Hong Kong SAR than in Singapore. While inflation rates are thought to reflect differences in the monetary (and exchange rate) regimes in place, the evidence on the performance of the two economies gives no reason to believe that current regime choices—and related IMF advice, as the IMF has consistently endorsed existing regimes in both places—have been inappropriate. Another example might be the set of varied exchange arrangements for countries in Eastern Europe in the transition to eventual euro adoption. The best way to dispel notions of possible inconsistency is to explain closely the framework under which advice is given.

[37]For Sub-Saharan African countries, such as Rwanda and Tanzania, that have their own currencies, staff have generally advised the authorities to let any real appreciation from aid and commodity exports receipts take place through nominal exchange rate changes. Liquidity expansions associated with increased government spending were to be sterilized through foreign exchange sales and any adverse effects on competitiveness were to be cushioned through structural reforms (although analysis did not consider the time lags involved). For countries in monetary unions, in contrast, the advice has been for a combination of strong fiscal positions, competitiveness-enhancing structural reforms, and cautious monetary policies that would keep a lid on domestic liquidity, and, by limiting the absorption of foreign inflows, could limit or delay adjustment in the real exchange rate. It is unclear whether in these cases the contrasting advice would have implications for the ability to absorb scaled-up aid or higher commodity receipts without adversely affecting the export sectors. One factor to bear in mind in such analysis is that the CFA franc, though in a fixed peg arrangement, has appreciated with the euro. For the WAEMU, the CFA franc had appreciated in real effective terms by about 20 percent from 2000 to 2005.

[38]See Gerlach and Gerlach-Kristen (2006).

Implications

41. What reasons can be given for the evidence of shortcomings in quality with respect to coverage, analysis and advice, and multilateral work (described above)? In part, the existing incentive structure was not ideally geared to producing the best result. Incentives were to manage various established processes for completing consultations, quickly and with little risk, and these may or may not be consistent, either for staff, the Board, or authorities, with fulfilling exchange rate surveillance responsibilities in a best practice way. Adverse incentives ranged from concerns that taking much space (especially with strict limits on Article IV staff report length) to justify and discuss a well-established regime was unwarranted; to concerns not to ruffle feathers, and possibly markets, when there was a genuine issue.

- Instead of being accountable for gaining traction in their discussions with member countries, by providing relevant and forthright assessments, staff saw the maintenance of a smooth relationship with the authorities as a powerful driver. Unless staff feel they will be fully backed up by senior staff and management, and the Board, when taking a respectful but firm stand as needed in discussions, it is not surprising that opportunities for good surveillance are sometimes missed.
- High priority is put on establishing a policy line and then sticking to it. (Examples in the period under review are the trend toward advocating more flexible exchange regimes, and the policies to deal with the perceived problem of global imbalances.) While admirable to a point, this tendency went too far because the IMF did not at the same time also encourage and reward internal questioning and challenging of that line to ensure that it stays ahead of the curve.
- Insufficient reward was given to integrating the best elements of analysis and expertise from both inside and outside the institution. The “silo” problem has been described in other contexts, but on exchange rate advice the contrast is notable between the access to the latest thinking and ongoing research efforts, and to practical experience and expertise, and the apparent difficulty in ensuring that these elements are appropriately and quickly integrated Fund-wide into frontline advice. Of course, when there is little academic consensus on many points, the problem of distilling and establishing operational guidance is more challenging, but management oversight and the right internal structure are therefore all the more critical.

CHAPTER

4 The IMF's Policy Dialogue and the Impact of Its Advice

How Effective Was the IMF's Policy Dialogue with Country Authorities?

42. Policy dialogue between staff and the authorities is a key part of the IMF's surveillance process. It is an input into the formulation of staff views and a channel of transmission of the resulting policy advice to the authorities, as well as of the authorities' views to the Executive Board.[1] While the official IMF view on a country's policies is formulated only after discussion by the Executive Board and then transmitted to the authorities through the summing up of that discussion, staff views as endorsed or altered by management are earlier communicated in-country during policy discussions with the authorities.[2] Significant changes of these positions at the Board level, though possible, are infrequent, limiting the impact of Executive Board views.[3] The effectiveness of the staff's dialogue with the authorities is thus of central importance for—though not synonymous with—the impact of the IMF's surveillance activities (Figure 4.1).

43. The effectiveness of the dialogue between staff and the authorities can be judged by the extent to which it is genuinely two-way, open, and substantive, adds to the understanding on both sides, and—where relevant—surfaces or addresses issues that need to be followed up in a bilateral or multilateral context. Where no immediate action is called for, and both sides essentially agree, the effectiveness of the dialogue with an individual country arises from the periodic focus given by both sides to the issues discussed, and a shared sense of exploring "what's new? what's missing? what if?" Deviations from this ideal could take various forms, including a one-way "lecture" from the IMF (or a perception that this is the case); a lack of sharing/openness by the authorities (of either data or views); set positions presented by both sides in a staid fashion (e.g., with staff unwilling to think outside the box); or simply an implicit mutual pact not to mention the exchange rate or consider contingencies.

44. Evidence from surveys and interviews suggests that, while the dialogue with authorities is considered satisfactory in many cases, there are nonetheless important questions about its effectiveness. Survey responses indicated that the large majority of the authorities generally perceived their discussions as two-way, with staff being seen as both respectful and willing to approach discussions with candor. Similar majorities approved of the frequency of the discussions and their balance between informality, confidentiality, and the reporting requirements to the IMF Executive Board. Staff share these views. Survey responses differed across country groups, with interviews pointing to difficult relationships between staff and the authorities in individual country cases. In interviews, while not all country officials were satisfied with the basis underlying staff advice, most nevertheless appreciated the opportunity to interact, even when the discussions did not change their views.[4] Two factors were mentioned in this context: (1) IMF endorsement of certain policies can support decision making within countries by helping to overcome differences in views among different branches of government; and (2) IMF staff can serve as a "sounding board" for policy views, helping the authorities to challenge their own thinking.[5]

[1]See Background Document 7 for details.

[2]The concluding statement of the mission does not receive input from the Executive Board. In some countries, a media event at the end of the staff visit, at which the concluding statement might be released, takes place up to three months before the Executive Board discusses the staff report and provides the formal IMF view.

[3]A review of Executive Board minutes (EBMs) for the IEO's 30 in-depth sample economies suggests that changes made by the Executive Board to staff positions largely relate to issues of urgency and sequencing, with Directors generally favoring a more cautious approach to implementing exchange-rate-related policy advice.

[4]With regard to discussions between staff and authorities, 70 percent of the country authority respondents indicated that—in areas that had been a focus of policy attention—the authorities and the IMF agreed on the analysis (suggesting either that IMF staff were convinced by the authorities; that IMF advice—to the extent it was given—convinced the authorities; or that the authorities did not need any further convincing to pursue a particular course of action). Staff respondents also reported widespread agreement, but noted a greater level of disagreement on important details such as emphasis, timing, or political feasibility.

[5]See Chapter 2, section on "Perceptions of Country Authorities and IMF Staff" for survey evidence.

Figure 4.1. How IMF Views Connect to Outcomes: A Closer Look

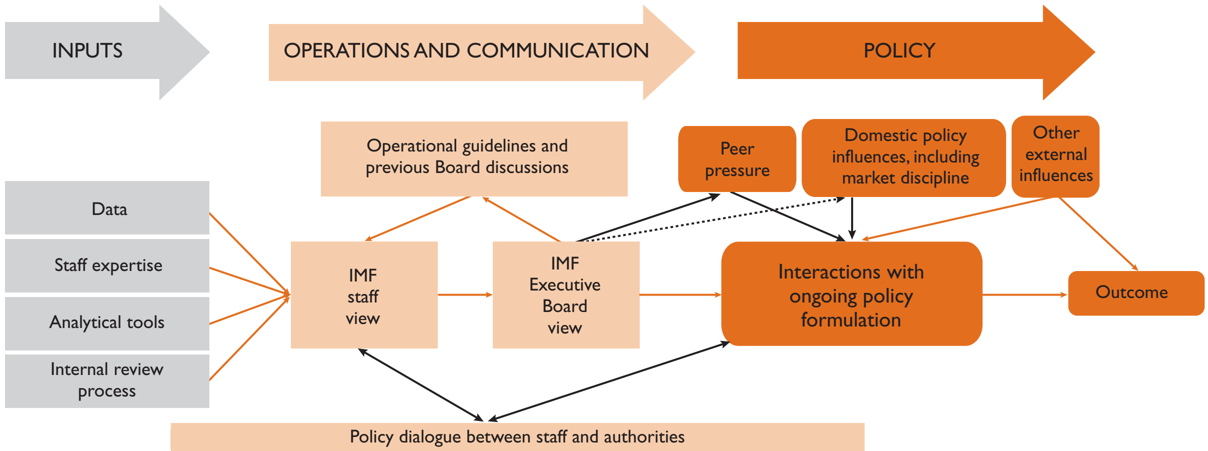


Figure 4.2. Areas of Possible Improvement in IMF Exchange Rate Advice, as Identified by Country Authorities

Proportion of respondents indicating scope for improvement in IMF analysis from country authorities that had agreed/disagreed with IMF advice
(In percent)

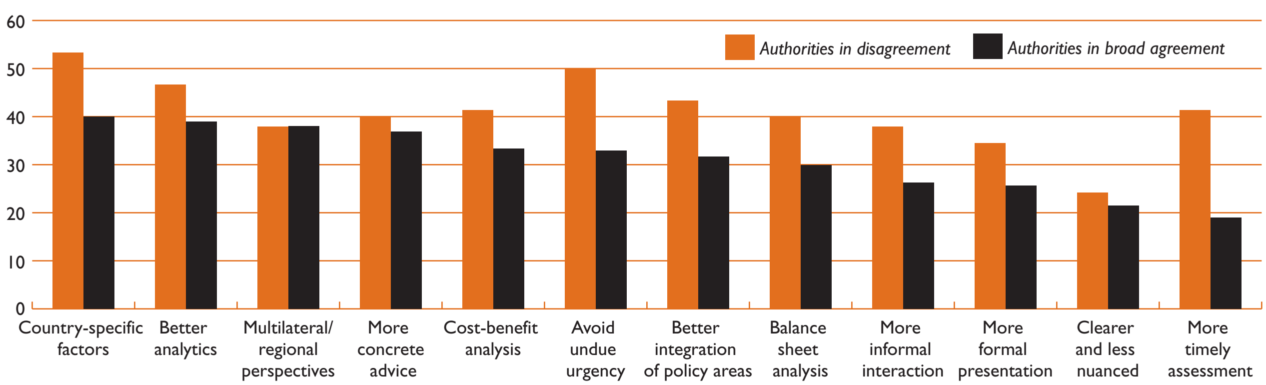


Table 4.1. Survey of Authorities: Limits to IMF Impact

Impact of IMF Advice[1] on Major Decisions	Nature of Discussions Between IMF Staff and the Authorities[2]			
	Restricted	Intermediate	Unrestricted	Total
Instrumental	7 (29)	4 (40)	25 (47)	36 (41)
Marginal	7 (29)	6 (60)	19 (36)	32 (37)
No impact	5 (21)	—	3 (6)	8 (9)
Limited or no discussions with IMF	5 (21)	—	6 (11)	11 (13)
Total	24 (100)	10 (100)	53 (100)	87 (100)

[1]As judged by the authorities.
[2]Number of respondents (percentages in parentheses); based on authorities' answers to the survey questions of whether they had "at times excluded certain sensitive policy issues (e.g., foreign exchange market intervention, choice of exchange rate regime) from substantive discussions with IMF staff," and whether they had "excluded or restrained consideration of certain issues because of concerns about possible dissemination of information."

45. However, while there were few obviously negative experiences, the bigger issue appeared to be the tepid enthusiasm expressed privately in several countries. Outward appearances of respectful and polite to-and-fro therefore concealed the authorities' frustration at a lack of deeper engagement and relevance. Importantly, survey results showed authorities seeking more specific analysis and pointing to other sources of policy advice as useful. These are warning signs that the IMF is seen by some as providing limited value added (and not just in advanced economies, but in other countries too), and that it needs to find a way to reenergize its contribution to members' ongoing policy discussions.

- As regards possible shortcomings on the staff side, country officials mentioned several issues, including the frequent changes in mission chiefs, inadequate knowledge of country-specific background and context, and less technical knowledge of the operational aspects of foreign exchange markets than enjoyed by the authorities themselves—a finding that is supported by survey responses. Officials would have welcomed staff having greater familiarity with the experience of other countries, an aspect in which IMF staff should have been expected to have a comparative advantage. In several economies, officials said they would have welcomed more written material to facilitate internal communication of IMF advice.

- Some authorities admitted to withholding relevant data from the IMF or to excluding sensitive topics from discussion, while staff saw this as a more widespread problem. While the adequacy of data availability is a broader issue that affects analysis, as well as the dialogue (see Box 3.3), it is important to highlight that, in some cases, according to the staff, authorities were unwilling to share relevant data, or excluded certain topics from discussion. These issues are relatively rarely flagged in staff reports, or taken up with management, as forthrightly as appears warranted. Staff appeared reluctant to risk antagonizing the authorities; and the main reason given by the authorities for not sharing data and for avoiding certain issues, was a concern that information would be passed on, either to the Executive Board or through publication.[6]

46. Authorities made suggestions on how IMF exchange-rate-related discussions could be improved. There were some notable differences between the views of surveyed respondents who found themselves in broad agreement with IMF advice, and of those who did not. Reasons for a failure to have impact include, in particular, a lack of attention to country specifics, insufficient analytical underpinnings, and an undue sense of urgency on the part of staff—a finding consistent with the IEO's desk review of 30 countries, particularly in the context of the choice of exchange rate regime (Figure 4.2). The authorities, in turn, have contributed to this state of affairs to the extent that sensitive policy issues have been taken "off the table," as suggested by the correlation between such instances and different degrees of IMF impact on policy decisions made by the authorities (Table 4.1).

47. Some country episodes called for intense involvement of the staff and management in discussions with authorities, both inside and outside the regular Article IV consultation process. The complexity of such interaction varies according to circumstance. For example, a very rapid response by IMF staff and management is required to contribute to advice in the event of exchange market turbulence. During the two most recent episodes of coordinated intervention among G-7 economies (in 1998 and 2000), the IMF did have views, but the extent to which it expressed them differed (see Box 4.1). In other circumstances, by contrast, an effective dialogue with member countries requires a long-term strategic response by IMF staff and management, involving sustained contacts with country authorities outside the regular Article IV consultations, over several years, attuned to the pace and complexity of the decision-making process.

What Are Other Channels of Impact for IMF Advice?

48. There are several channels in addition to the dialogue with authorities through which IMF surveillance may help to influence policy formulation in member countries (see Figure 4.1): (1) a variant of policy dialogue between staff and authorities (discussed above, which is normally thought of in a bilateral context) are efforts at international policy coordination; (2) the influence of the subsequent Executive Board discussion (including peer pressure from other governments based on the account of the discussions between IMF staff and the authorities); and (3) IMF contributions to domestic policy influences, including market perceptions. The relative importance of these channels varies by country and context, but a few general patterns emerge.

49. The influence of the IMF Executive Board discussions differed according to country grouping. Survey respondents representing the smaller emerging market and developing countries agreed by a 6–1 margin that considerations at the level of the IMF's Executive Board had provided an important input into the development of policy, with agreement particularly pronounced among

[6]In interviews, another concern voiced was that information conveyed might be passed to the markets; and relatedly, that some senior staff members have left the IMF and subsequently taken jobs in the private sector—something that reduced the trust the authorities would have in the IMF as confidential advisor.

Box 4.1. Currency Interventions of June 1998 and September 2000

On June 17, 1998, the U.S. and Japanese monetary authorities cooperated in intervening in the foreign exchange markets to support the yen, which had been in an accelerating decline over previous weeks. On September 22, 2000, the European Central Bank (ECB) together with the monetary authorities of the United States, Japan, Canada, and the United Kingdom intervened in the foreign exchange markets to support the euro, which had been in accelerating decline over the preceding weeks, and this intervention was followed in early November by two episodes of unilateral intervention by the ECB. Both episodes of concerted intervention were carried out primarily for signaling purposes and both were moderately successful when judged by subsequent developments.

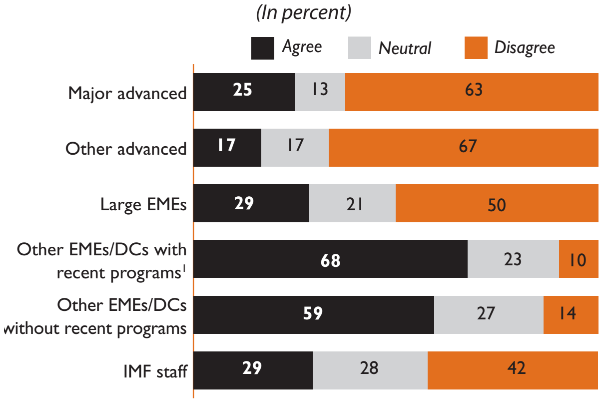
Did the IMF have a view on the relevant exchange rate developments at the time and the possible actions to be taken? Did it communicate these views to the relevant authorities? And did its views have any impact? In both cases the IMF staff did have a view on exchange rate developments and possible policy measures including the (limited) value of intervention; and it had opportunities to communicate this view to the relevant authorities in the course of Article IV discussions, and at G-7 preparatory meetings. Analysis of staff documents and published accounts, and discussions with IMF officials involved at the time suggest rather different answers to the questions about communication and impact in the two cases.

The June 1998 intervention coincided with annual Article IV discussions with the United States and Japan, and staff appear to have taken the opportunity to discuss the option with both, and to encourage action—which at the time was also seen as important to continued recovery from the 1997 Asian crises. Senior management, apparently, had confidential discussions with both the United States and Japan, separate from the Article IV discussions. Board documents did reveal some discussion in the course of the Article IV consultations, though these documents were not circulated to the Board until after the intervention had taken place.

In 2000, IMF staff had the opportunity to discuss the case for and against intervention with ECB and other euro area officials during a mission to examine "Monetary and Exchange Rate Policies of the Euro Area," which took place in late June/early July 2000, and to present any advice in the context of their findings at meetings of euro area ministers and officials in mid-July. It seems that they did not do so, possibly in part because at the time they did not see a strong case for action, and in part because they felt this was a matter for the ECB rather than ministers—even though ministers had in fact discussed the option in May and issued a statement designed to encourage it. By September, following further weakening of the euro, the IMF had reached a clearer view on the value of intervention—the *World Economic Outlook* released in the run up to the September Annual Meetings described the euro as "significantly misaligned"; and at his press conference on September 19, 2000 the IMF Economic Counsellor said, "I think the circumstances in which the major countries would want to use intervention to attempt to influence exchange rates are relatively rare, but they do arise from time to time and one would sort of have to ask if not now, when?" It is clear from subsequent accounts that by that point, following extensive consultations in the G-7 including at a G-7 preparatory meeting on September 13, the decision had been taken to intervene. It is also clear from these accounts that the IMF played no part in these discussions, and was probably unaware of them.

Figure 4.3. Authorities' Views on Policy Inputs Provided by the Executive Board

Proportion of respondents agreeing/disagreeing that the IMF Executive Board had provided important policy inputs
(In percent)



[1]IMF-supported program concurrent with at least one of the last two Article IV consultations through 2005.

those countries that rely on the Board's approval in the context of IMF-supported programs. In contrast, a majority of respondents from the other country groups disagreed that this had been the case—a perception supported by some 40 percent of staff respondents (see Figure 4.3). Interviews with authorities provided further support for skepticism about the direct role of the Executive Board. No direct evidence was found of peer pressure from other authorities as a result of IMF advice.

50. There was some evidence that the Executive Board had indirect influence, which arose, for example, from staff presenting views that are likely to be endorsed by the Executive Board.[7] However, more than 40 percent of staff respondents in the IEO survey

[7]Some support for this view has emerged in interviews with mission chiefs to selected countries, who also described specific cases where Executive Directors for those countries had accompanied missions and helped to resolve disagreements between staff and authorities, in part by communicating to authorities what the sense of the Executive Board was likely to be on the issues of contention.

Box 4.2. IMF Involvement in Selected Episodes of Exchange Rate Policy Coordination

The IEO examined the extent and nature of the IMF's involvement in two major exchange rate events in the early 1990s: the crises in the European Exchange Rate Mechanism (ERM) in 1992–93; and the CFA franc devaluation agreed in January 1994. Examination of internal documents of the time was supplemented by discussion with some of those in the IMF and country officials who were most closely involved with these two episodes.

1992–93 crises in the ERM

Most retrospective analyses of the events of 1992–93 draw similar conclusions. With today's global financial markets, systems of fixed but adjustable exchange rates (short of monetary union) between internationally traded currencies can provide markets with effective one-way bets when under strain. The ERM in 1992–93 suffered major strains resulting from an imbalance in fiscal and monetary policy in Germany, the anchor currency country, following unification. Other ERM countries were forced to hold interest rates higher than warranted by domestic circumstances to defend their central rates. When markets started to doubt the political sustainability of such action, the game was up. In September 1992, sterling and the lira were forced to exit from the arrangement and, at the end of July 1993, the ERM countries were forced to agree to the adoption of widened, 15 percent margins—marking the end of the ERM, as originally set up.

The IMF's role in these events was limited. Staff did not attend any of the critical meetings of the European Monetary Committee or European finance ministers, and were not invited to do so or to offer written advice. The IMF did of course have opportunities to develop its analysis and communicate views and policy suggestions, both in the course of regular Article IV discussions with member countries and through ad hoc management contacts. All the evidence is that the IMF's analysis at the time was partial, missing the financial market dimension, and that such messages as were passed were limited to suggestions about policy actions that would help countries live within the system. Staff did, in 1992, identify the major underlying policy source of strain in the ERM, but they did not appear to recognize the market dynamics creating the fundamental vulnerability of the mechanism until after the forced widening of the ERM bands in 1993. Some confidential high-level messages were passed, notably to the German authorities in the summer of 1993, about policy changes that might ease the underlying tensions, but they were not well received. There was no staff or management discussion with European officials of options for handling crises should they occur.

After the event some useful lessons were drawn for the future. Staff now regularly interacts with key groups of European and euro group officials and ministers. A number of steps were taken to strengthen the IMF's knowledge of and links with private financial markets, and its work on equilibrium exchange rates was beefed up by starting CGER. Management also instituted regular internal meetings of a "Surveillance Committee" (meetings of which continued for the rest of the decade) to discuss global exchange rate developments, and the Board instituted its continuing regular discussions of World Economic and Financial Market Developments.

1994 CFA franc devaluation

From the 1980s, a loss of competitiveness became increasingly evident for the members of the two CFA zones. Some time in 1990 or 1991, IMF staff and management concluded that a substantial devaluation of the CFA franc was needed. There followed three years of quiet diplomacy and persuasion before a 50 percent devaluation was finally announced in January 1994. During this period, while IMF staff and management were extremely active, almost no signal was given to the Board of what was afoot. Several factors led the IMF to adopt this approach. First, it was the IMF's view that the CFA franc zone arrangements had, on balance, served its members well and there was no wish to disband the system—implying a one-off devaluation. Second, it was felt that there would only be one chance to get it right and that the devaluation would therefore have to be substantial. Third, nothing could be achieved without convincing all the member countries and also the French authorities, and the Managing Director judged that this would take time and could be done only in private; and fourth, there was the need to avoid the damaging capital outflows that rumors would induce.

In the event, the negotiations were long and complex with several setbacks before agreement was eventually reached. While some member countries agreed on the need to devalue at an early stage, others, including those with smaller losses of competitiveness, were more reluctant and for a while persuaded their colleagues that adjustment could be achieved with internal measures alone. Governments were also concerned about the impact of a devaluation on living standards, and it was an innovative feature of the IMF-supported programs eventually put in place that they contained measures to protect the poor from the worst impact of devaluation. One advantage of the time lag was that IMF (and World Bank) staff were able to agree to support detailed programs for most members, which were announced very quickly after January 1994. The Managing Director played a key role, both with CFA zone country leaders and in persuading the French authorities and senior politicians. The analytical work that preceded the operation had extended over a long period of time, with the analysis done by the IMF matched by parallel work by the Bank on the "real" economy.

The IMF's role in securing exchange rate policy action in this case was central. The task was exceptionally complex, because of the number of parties involved (13 member countries plus France). One conclusion is that the effective role played by the Managing Director was critical in securing agreement. Another conclusion is that, particularly in the final run-up to devaluation and in the phase after the event, cooperation between the two Bretton Woods institutions, the African governments concerned, and the French government was excellent, and this was an important factor in the success of the operation. A final conclusion is that, in today's circumstances of more open and efficient capital markets, action might well have been forced sooner, with less time for preparation.

felt that the expectation of publication or the need to preserve close relationships with country authorities tended to dilute coverage of exchange rate policy issues in staff reports. These factors suggest that the influence that can reasonably be exercised by the Board is limited. The opportunity for all member countries to express their opinions through the Executive Board on the policies of individual members is a key part of the governance of the IMF. However, evidence that important information is not conveyed to the Board—or not conveyed to the staff, because it might be conveyed to the Board—raises questions about the accountability of staff in these circumstances, as well as effectiveness of the present setup.[8]

51. Use of public channels of IMF influence has also been limited in the case of exchange rate policy advice, for obvious reasons. The IMF's increasing use of public channels to enhance the effectiveness of its surveillance is an important topic, but beyond the scope of this evaluation. Unsurprisingly, many authorities have mixed feelings about the IMF making tactical use of the domestic policy discussion channel to influence exchange rate policy. In countries where the exchange rate is a highly sensitive political issue, authorities may not agree to publication of an Article IV consultation report that delves deeply into exchange rate issues. The option is also available to seek deletions of highly market sensitive information from published Article IV staff reports.[9] While generally welcoming IMF staff analysis of topical exchange rate questions, authorities have often been wary of sparking a public debate that might unsettle markets and reduce authorities' control over the pace and sequencing of reforms. Many authorities nevertheless welcome the opportunity to publicize any IMF endorsement of domestic policies, mindful that endorsement of a country's exchange rate regime or economic policies can enhance policy credibility and facilitate access to capital markets.[10] Other than through this effect, however, the channel linking IMF exchange rate advice to market players appears to be weak—partly because of the IMF's general caution in dealing with market sensitive information.[11]

52. There were no significant examples of exchange rate policy coordination during the period covered by this evaluation;[12] the question is whether the IMF *missed* certain opportunities to have greater impact. Past episodes of (regional) collective action by member countries (see Box 4.2) suggest that IMF contributions to coordinated policy responses have varied greatly, depending on factors including the degree of staff expertise, the extent to which the countries concerned rely on IMF support, and the manner of involvement of the Managing Director (which was clearly a factor in the 1994 CFA franc devaluation). A key question, against this backdrop, is whether the IMF should and could have done more and earlier to facilitate the analysis and resolution of global imbalances. As already noted (Box 3.4), integration of multilateral considerations—and, specifically, concerns about global imbalances—into country-level analysis was often lacking. Partly as a result, messages conveyed to key countries in the course of bilateral consultations were given insufficient emphasis, with limited management follow-up at higher political levels. Scope for more active IMF engagement at an early stage in seeking to promote collective policy action was thus not exploited effectively. This may have contributed to delays in policy action, and it began to hurt credibility as the IMF was subsequently perceived as reacting to outside pressures.

Implications

53. Improvements in the effectiveness of dialogue and other channels to maximize the impact of IMF advice, including policy coordination efforts, require strategic planning and intense management focus. The episodes considered in this evaluation suggest that the following elements are needed: formal planning of strategic focus, both bilaterally, and multilaterally including proactive involvement in the various fora of country officials; assembling the right staff expertise and analysis in advance, and integrating the best advice from inside and outside the IMF; and a clear sense of whom to talk to among the authorities, and how to convey the message most effectively.

[8]One, often overlooked, indirect channel of influence is that staff take note of Board discussions and try to reflect these in *subsequent* discussions with the authorities of the same or another country. Article IV consultations for Japan are a case in point. After complaints by individual Executive Directors in 2003 and 2004, the 2005 staff report did contain an analysis of the intervention episode in 2003/04.

[9]In the majority of country cases reviewed, little or no material change related to exchange rate issues was made to the public versions of recent staff reports by way of deletions and corrections.

[10]Most country authorities' survey respondents agreed that the IMF had appropriately played its role as provider of credibility (see Chapter 2).

[11]Market participants interviewed by the IEO suggested that the IMF has a constructive role to play in causing more and better data to be made public. Strong statements by the IMF were welcomed by some, but views differed on when and under which circumstances IMF views would influence markets.

[12]As noted earlier, the evaluation does not cover the multilateral consultation announced in late 2005.

CHAPTER

5 Findings and Recommendations

Main Finding

54. *In the period reviewed (1999–2005), the IMF was simply not as effective as it needs to be to fulfill its responsibilities for exchange rate surveillance.* This judgment is not meant to detract from the dedicated and hard efforts of staff, nor to fail to recognize the inherent complexity and lack of professional consensus on many of the issues discussed in this report. However, the effectiveness of IMF surveillance in fostering international cooperation depends, ultimately, on the IMF's adeptness in focusing on the key analytical issues of the day (which have shifted radically over time) and in engaging in effective dialogue with its members, individually and collectively. While by no means evident in all countries, this evaluation observed serious shortcomings in both respects that resulted in an "effectiveness gap" in the IMF's main line of business. The reduced traction with advanced economies is in danger of being extended to large emerging market economies, and beyond. Such an evolution is corrosive, breeds cynicism among the staff as well as the members, and builds on perceptions of a lack of evenhandedness. Unless the shortcomings are successfully addressed in the period ahead, and as the number of countries looking elsewhere for policy advice and support continues to grow, there could be serious implications for the ability of the IMF to discharge its responsibilities in the future.

Rules of the Game and Guidance to Staff

Findings

55. *The rules of the game for exchange rate surveillance are unclear, both for the IMF and member countries.* The confusion may reflect to some degree the complex nature of the consensus reached in the 1977 Decision, and the failure subsequently to translate and adapt that understanding into more specific guidance on key points. Yet, the heart of the matter lies with the failure of the IMF to have the appropriate degree of engagement with all of its members. For the staff to do a better job fulfilling its responsibilities, it needs to be both more responsive to members' concerns and more forthright, and it requires the more active support of management and the Executive Board.

56. *Operational guidance for staff is insufficiently clear (or, in some cases, absent).* For example, the requirements to assess exchange rate regimes and levels are not very specific. The evaluation identified two key priorities:

(1) *The stability of the system.* The IMF is charged with responsibility for oversight of the international monetary system, but the last Executive Board review of this topic was in 1999. No recent Board review has therefore assessed whether the stability of the international monetary system is best preserved by the choices of exchange regimes (and exchange rate levels) now made by the membership. Consequently, there is no updated framework that would guide policy advice in individual country contexts. An updated review could have considered, for example, the extent to which large reserve accumulations, among a host of very large shifts in public and private asset positions, affect the workings and stability of the system.

(2) *The use and limits of intervention in intermediate regimes.*

- *Use of intervention.* Emerging market and developing countries have been wrestling with multiple challenges, including how to maintain monetary—or inflation—control in circumstances of large inflows of capital (or aid and natural resource revenues). Allowing a nominal appreciation may facilitate monetary control, but could adversely affect export performance and growth. Insufficient attention has been paid to this trade-off, for example by investigating over what time period intervention—together with other policies, including fiscal measures or changes in capital controls—might modify the assumption that increases in the real exchange rate cannot be resisted.

- *Limits to reserves accumulation* (or, more generally, to the accumulation of public sector net foreign assets). Immediately after the financial crises of the 1990s, guidance was appropriately developed on rebuilding reserves to sensible minima, but insufficient Executive Board guidance was developed on what might constitute reasonable upper bounds, and why.

57. *Management assigned insufficient focus and attention on conducting effective dialogue with authorities.* While staff's discussions with the authorities were generally seen as two-way and were found useful in most cases, a clear message also emerged that authorities in many countries were seeking greater value added.

(1) The effectiveness of the dialogue was hampered in some cases because staff teams did not bring with them sufficient expertise and experience. Financial market and foreign exchange market expertise needed to be complemented by cross-country experience, attuned to country-specific circumstances. Moreover, management did not make sufficiently clear that, in all cases, staff's general advice (e.g., on regime change) should be based on their judgments on the readiness of appropriate implementation capacity, with technical advice to be provided on such aspects, as necessary.

(2) The IMF has not always been well positioned to deliver messages that would add value to the appropriate decision makers. When exchange rate policy is a live issue, it often requires the attention of ministers and government leaders. To be effective in providing advice, the IMF needs to be expert at communicating messages at this highest political level, as well as at the more technical level at which discussions normally take place. Communicating at this level requires skill and the involvement of senior management, a good understanding of decision-making processes, and of where messages need to be given to have impact. Advice has to be presented both orally and in written form in ways that are persuasive to hard-pressed ministers (which means being very brief and very clear).

Recommendations

58. *Clarify the rules of the game for the IMF and its member countries.* As discussions proceed on surveillance policy initiatives, a revalidation of the fundamental purpose of surveillance would be an important goal. Central to this is the requirement on countries, and the IMF, to consider the consequence for others of an individual economy's policies, including exchange rate policies and other measures that affect exchange rates. Since relevance and effectiveness cannot be legislated, however, the key lies in ensuring the trust and willingness of countries to cooperate within whatever legal framework is in place.

59. *Practical policy guidance should be developed on key analytical issues.* This would be based on the latest research and cross-country experience and would help to ensure an evenhanded approach across the membership. Two priorities would be:

(1) *On the stability of the system.* An Executive Board policy review of the stability of the system of exchange regimes and exchange rates should be conducted periodically, taking into account the array of chosen regimes, global liquidity conditions, and other issues. The conclusions would provide an updated framework for guidance in individual country cases.

(2) *On the use and limits of intervention.* As input to developing guidance to staff, given the many circumstances of countries and the different roles assigned to the exchange rate, authorities could be asked during Article IV consultations to describe the range of reserves holdings/public net foreign positions they expect to hold over the period ahead, and the reasons for establishing such a range. Discussion could then take place both on the range presented and on the arguments to justify it, which would provide a benchmark for subsequent discussions. Guidance would reflect various considerations, including precautionary motives for reserves, intertemporal savings of natural resource incomes, and potential problems for monetary management and competitiveness, as well as the implications for adjustment in the world economy.

60. *Management should give much greater attention to ensuring effective dialogue with authorities.* This task should be assigned as much weight as developing the right advice.

(1) Management should develop a strategic approach to identify opportunities to improve the effectiveness of the dialogue, involving senior management and with support, when necessary, from Executive Directors. This would also involve ensuring the staff team has the right kind of expertise; planning whom to engage in discussions and when; calibrating the format of the message to particular needs. In the performance appraisal process, the success in ensuring effective dialogue would be defined and rewarded.

(2) Management and the Executive Board need to adjust the incentives to raise controversial issues. They need to send staff a clear signal that they will be supported when they take time to understand the authorities' views, when

they have difficult messages to deliver, both to the authorities and back to the Board, and when there are difficulties with the provision of information by the authorities.

Problems in Implementing Existing Policy Guidance

Findings

61. *Clear descriptions of exchange rate regimes have remained elusive.* The inconsistencies among de facto regime classifications, as well as between de jure and de facto classifications, were allowed to drag on for the whole period covered by this evaluation, contributing to a lack of clarity in analysis. There has been a failure to build consensus at the Executive Board to resolve this.

62. *Staff and management too often failed to provide analytical backing for their recommendations for regime shift; and on other occasions they missed opportunities to give a clear view on the regime choice made by the authorities.* The lack of analysis supporting regime advice gave support to the notion that the IMF's advice, at times, was based on fashion rather than tailored to the country-specific circumstances. Too often, also, staff assessments of existing regimes stopped at the backward-looking statement that "the regime in place had served the country well," with insufficient analysis to back this up.

63. *On exchange rate levels, while analysis has improved, there were too many cases where staff's assessments were not stated clearly.* Quantitative analysis of exchange rate levels increased but was still far from universal, and the choice of methodology sometimes appeared arbitrary. For developing countries, greater attention to cost and other data would have strengthened the analysis of exchange rate levels.

64. *Data provision for the purpose of exchange rate surveillance was a serious problem.* Staff appear not to have flagged to the Executive Board the full extent to which the data shortcomings hampered the conduct of exchange rate surveillance, including when authorities were unwilling to provide data, and in cases when Executive Board discussion may have been materially affected. In not pursuing data issues more forcefully, including those related to intervention, staff gave high weight to maintaining smooth relations with the authorities and/or perceived a lack of support by management and the Executive Board for a stronger stance.

65. *Discussion of policy spillovers, including the regional or systemic impact of large countries' policies (as well as the effects of intervention activities on those countries in whose currencies such interventions take place) remained infrequent.* Multilateral and financial surveillance had not been well integrated with bilateral surveillance during the evaluation period. Analysis of spillovers remained spotty for most countries, and attempts to assess the effects of intervention activities on other members in the context of Article IV consultations remained limited.

Recommendations

66. *Management and the Executive Board should resolve inconsistencies and ambiguity over the issue of regime classification.* Whatever solution is found would benefit from being approved by the Executive Board and would involve removing the stigma of particular labels. For Article IV staff reports for countries with intermediate regimes (all but independently floating rates and hard pegs), the priority should be to have an unambiguous description of the authorities' regime, including how it works in practice. The description could be agreed to by the authorities and staff, or differences of view should be described clearly to the Board. Subsequent Article IV consultations could revalidate the existing description, or revise it.

67. *IMF advice on exchange rate regimes should be backed up more explicitly by analytic work.* Analysis Fund-wide could be improved by strengthening the framework for considering regime choice, building on work already done in some departments. For regimes in place, in Article IV staff reports it could be helpful to describe concisely the policy assumptions underlying a forward-looking staff assessment that the chosen regime will remain appropriate. Any differences of view on the assumptions would be reflected in the report. The assumptions laid out in one Article IV consultation would then provide markers for discussion at the next. When little had changed, the discussions on this issue would be appropriately short.

68. *To improve assessments of the exchange rate level, the IMF should be at the forefront of developing the needed analytical framework, while more successfully translating existing methodologies into advice that is relevant to discussion of individual country cases.* The genuine difficulty in doing this is no excuse for not making more progress. While improvements in methodology are often considered for the advanced and emerging market economies, scope exists for improving data and analysis for developing countries. (For example, thought could be given to working with other agencies to assemble cost data.)

69. *Management and the Executive Board should consider further what lies behind the apparently serious problems of data provision for surveillance, and how incentive structures can be improved.* A full analysis lies beyond the scope of this evaluation.

70. *Incentives should be given to develop and implement guidance for the integration of spillovers into bilateral and regional surveillance.* In addition to inter-

departmental work to improve existing methodologies, a panel of senior officials in member countries could be asked to give advice on policy feedbacks—the "what if" question—that they would find useful to explore. In many cases, greater financial market expertise may be required to inform staff advice and contribute to discussion with authorities.

Management of Work on Exchange Rates

Finding

71. *The work on exchange rates has not been as well organized and managed as it should have been.* An enormous amount of activity on exchange rate issues was not well integrated. Despite some progress made (including the CGER), research—from inside and outside the IMF—and multilateral studies were not consistently distilled and absorbed into frontline operational work. Both country authorities and staff would have welcomed more practical help on analysis, cross-country comparisons, and financial market and foreign exchange market experience.

(1) Responsibility for exchange rate issues is scattered throughout the IMF. Area departments lead the discussion with authorities, and develop their own analysis; INS (training), MCM (classification issues and exchange market expertise, and the *Global Financial Stability Report*), PDR (policy development and review), RES (*WEO* and research), and STA (data issues) are all involved. The structure diffuses responsibility and accountability for prioritizing, pursuing, and disseminating work on exchange rate matters.

(2) Lack of understanding of financial markets has been identified as a factor that in the past limited the value of IMF advice. As suggested in the IEO evaluation of Multilateral Surveillance (IEO, 2006c), part of the problem may be that knowledge that resides in ICM (and now MCM) may not yet be well integrated into the work of the rest of the IMF. Another problem may be the scarcity of practical experience among IMF staff. Country officials interviewed for this evaluation attached particular weight to advice, and wanted more of it, from those who have practical experience in handling foreign exchange market and financial market issues.

Recommendation

72. *Management should address how to bring better focus to the analytical work on exchange rates.*

(1) Management should clarify responsibility and accountability for exchange rate policy issues and actively use a forum like the Surveillance Committee to ensure proper focus on key issues, and to discuss a variety of different views and perspectives. The integration of financial sector work would be an important element. A key role of the structure should be to prioritize exchange rate policy issues and initiatives from across the IMF, including a multiyear agenda for policy, research, and statistical work.

(2) The structure of staff teams could be reconsidered. Better integration of financial market and foreign exchange market expertise at headquarters would be a start. But it is unlikely that this could bridge entirely the "expertise and experience gap" that was identified in this evaluation as a factor in some cases. Perhaps, on limited occasions, consultants or senior officials from a pool of foreign exchange market practitioners could join Article IV mission teams (in addition to TA missions, as now) to provide relevant expertise and cross country experience that would directly add value to the discussions with the authorities.

Confidentiality and Executive Board Oversight

Finding

73. *There have been some limited cases where keeping the Board fully informed of the engagement of staff and management on an exchange rate policy issue would have been incompatible with being an effective interlocutor.* In some instances, country authorities are simply not willing to discuss issues candidly with the IMF, in either bilateral or multilateral settings, if they believe the content of such discussions would be revealed to the Executive Board (and hence, potentially, to officials in all member countries), let alone markets. Yet it is clearly in the interests of the IMF (and the broader international community) that staff and management be engaged. This poses a real dilemma for accountability. While such instances may be relatively few, it is important that the Executive Board, management, and staff agree on new procedures to respect the very real confidentiality concerns that exist, while ensuring that steps are in place to provide adequate accountability. Simply pretending that no issue exists is not a responsible response.

Recommendation

74. *An understanding is needed on what are the expectations for inclusion in the Article IV staff report,*

what may be mentioned orally at Board meetings, and what may be understood to have been discussed between staff and the authorities on the clear understanding that it would not be revealed to the Executive Board. The aim would be to clarify the accountability of the Board and management for what happens, while defusing what is obviously a major tension and a barrier to effective dialogue.

(1) *Confidential policy discussions about possible policy actions in the case of contingencies should be a regular feature of the dialogue with member countries.* Such discussions are likely to become more important since the speed required to respond to capital market events requires any preparations to be accomplished in advance. It should be understood that, for at least a subset of countries, staff would be expected to conduct "what if" scenario exercises looking at contingent plans for domestic policy shifts (including exit strategies), as well as for exogenous developments, and policy shifts and different exchange rate paths in other countries. While the staff report for a country might not discuss such scenarios, the Board would need to be assured that such exercises had been discussed.

(2) *How can the Board exercise its accountability and oversight functions in this area?*

- The IEO evaluation of the IMF's engagement with Argentina (IEO, 2004) made some suggestions that might be relevant, including:

  "Establish guidelines whereby the Board could explicitly authorize management to withhold certain issues from discussion in a full Board meeting, with a presumption that, once the sensitivity is no longer present, management's decision is ex post subjected to Board scrutiny."

- A further option, which could avoid information being conveyed in any way to the Executive Board, would be to charge an independent party with the task of periodically reviewing all IMF activities on exchange rates not reported to the Board, and to provide the Board with a regular report certifying that necessary work had been done (for example on contingencies); assessing the effectiveness of such activities (without revealing countries or details); and giving a ruling on whether the information not shared with the Board was withheld for good reason.

Facilitating Multilateral Policy Coordination

Finding

75. *Over the evaluation period, the scope for countries to act in concert to deal with "global imbalances" was not fully explored and alternative analysis of these imbalances, and related adjustment scenarios, could have received more attention*. The following lessons can be drawn from earlier episodes of exchange rate policy coordination that may still have relevance. Success is made more likely by:

(1) Advance planning of various scenarios, and constantly validating conclusions against new information.

(2) Explicitly recognizing policy interdependencies and countries' appropriate reactions to policy decisions taken by others.

(3) Supplementing regular staff discussions with policy dialogue between management and the highest political levels, and building up ways to communicate collectively with relevant groups of countries.

Recommendation

76. *Opportunities for potential multilateral concerted action deserve to be a key strategic management focus.* This work should, for the most part, be based on rigorous and compelling analysis of scenarios and involve a strategic plan to build consensus amongst key players. To highlight and learn more about policy interdependencies, this could involve alternative sets of scenario-based policy recommendations at the individual country level that are explicitly conditional on policy actions taken in other countries.

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