IEO

Independent Evaluation Office
of the International Monetary Fund

EVALUATION REPORT

IMF Exchange Rate Policy Advice

2007

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The following conventions are used in this publication:

- In tables, a blank cell indicates "not applicable," ellipsis points (. . .) indicate "not available," and 0 or 0.0 indicates "zero" or "negligible." Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2005–06 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2005/06) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2006).
- "Billion" means a thousand million; "trillion" means a thousand billion.
- "Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. Under the current policy on public access to the IMF's archives, some of these documents will become available five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other documents are to become available 10 to 20 years after their issuance, depending on the series.

Foreword

Exchange rate surveillance lies at the core of the IMF's responsibilities. This report concludes that the IMF was simply not as effective as it needs to be to fulfill this core responsibility. While acknowledging the progress made in some areas over the period reviewed (1999–2005), the report identifies an "effectiveness gap" in the Fund's performance, suggests reasons for its existence, and points to a number of measures to help remedy it. In this context, the report calls for a major refocus of efforts aimed at enhancing the effectiveness of the IMF's analysis and advice as well as reenergizing its contribution to policy dialogue with member countries—a view broadly endorsed by the IMF Executive Board.

The problems highlighted cannot be solved overnight, and it will take time to implement the report's recommendations. In the period between the inclusion of the topic in the IEO's work program in June 2005 and its discussion at the IMF Executive Board in May 2007, the IMF has pursued several policy initiatives related to its exchange rate policy advice. These initiatives include reviewing the 1977 Surveillance Decision (culminating in approval of a new Decision in June 2007); considering a new "remit" for surveillance; and undertaking a multilateral consultation on global imbalances. By design, the IEO evaluation was based on the record through 2005 and did not deal directly with these current policy discussions. It focused instead on issues of both the substance and procedure of surveillance over exchange rate policies. In particular, while the report argues that a revalidation of the fundamental purpose of surveillance is warranted, no direct connection was made between the shortcomings noted in this report and the review of the 1977 Decision. Indeed, the report highlights that there are problems to be addressed, without delay, irrespective of whether or when changes are made to the Surveillance Decision. The key to solving these problems lies in ensuring the trust of countries and willingness to cooperate within whatever legal framework is in place, and this will take time and concerted efforts.

The report contains tough messages. It is a strength of the IMF that it allows such a frank and independent assessment to be made. As there is no professional consensus on many of the analytical issues involved, it is perhaps not surprising that staff and management have a different perspective from that taken in the report, as is apparent from their responses. Nevertheless, the IEO maintains that, no matter how complicated the issues, the performance bar for the IMF must be set very high. Fortunately, there is agreement that the issues covered in the report are important, and that further improvements are necessary. It is hoped that the IEO's findings will contribute to discussions on how these are to be accomplished.

Thomas A. Bernes
Director
Independent Evaluation Office

IMF Exchange Rate Policy Advice

This report was prepared by an IEO team headed by Shinji Takagi and John Hicklin, and including Nils Bjorksten, Mariano Cortes, Ingo Fender, Emily Ku, Halim Kucur, and Allen Stack. It also benefited from contributions by Ozlem Arpac, Markus Berndt, Ramya Ghosh, Javier Hamann, Martin Kaufman, Steve Kayizzi-Mugerwa, Roxana Pedraglio, David Peretz, Joanne Salop, Reza Siregar, and Scott Standley. Jack Boorman, Scott Clark, Jeffrey Frankel, Carlos Massad, and Edwin Truman acted as senior advisors to the evaluation. Administrative assistance was provided by Annette Canizares, Arun Bhatnagar, and Jeanette Abellera, and editorial assistance by Rachel Weaving and Esha Ray. The report was approved by Thomas A. Bernes.

In cases of potential conflict of interest, team members recused themselves from interviews with country officials or staff. In addition, John Hicklin recused himself from judgments on various countries and issues with which he had been associated closely as an IMF staff member.

The IEO's findings were discussed by the Executive Board on May 9, 2007. In keeping with established practice, the report and its background documents are being published as they were submitted to the Executive Board, except for minor formatting changes. The published volume also includes the official staff and management responses to the evaluation, the IEO's reaction to these responses, and the Summing Up of the Executive Board discussion.

Abbreviations

AREAER	*Annual Report on Exchange Arrangements and Exchange Restrictions*
BEER	Behavioral equilibrium exchange rate
BIS	Bank for International Settlements
BSR	Biennial Surveillance Review
BTO	Back-to-office report
CEMAC	Central African Economic and Monetary Community
CFF	Compensatory Financing Facility
CGER	Consultative Group on Exchange Rate Issues
COFER	Composition of Foreign Exchange Reserves
DEER	Desired equilibrium exchange rate
DC	Developing country
DSGE	Dynamic Stochastic General Equilibrium (Model)
EBM	Executive Board minutes
ECB	European Central Bank
ECCU	Eastern Caribbean Currency Union
EME	Emerging market economy
EMU	Economic and Monetary Union
ERER	Equilibrium real exchange rate
ERM	Exchange Rate Mechanism
FEER	Fundamental equilibrium exchange rate
FSAP	Financial Sector Assessment Program
G-7	Group of Seven
GEM	Global Economy Model
GFSR	*Global Financial Stability Report*
IT	Inflation targeting
MCM	Monetary and Capital Markets Department (IMF)
MFD	Monetary and Financial Systems Department (IMF)
MTS	Medium-Term Strategy
MULTIMOD	Multi-Region Econometric Model
NATREX	Natural real exchange rate
NFA	Net foreign assets
OECD	Organization for Economic Cooperation and Development
PEER	Permanent equilibrium exchange rate
PDR	Policy Development and Review Department (IMF)
PPP	Purchasing power parity
REARM	Review of Exchange Arrangements, Restrictions, and Markets
REER	Real effective exchange rate
RES	Research Department (IMF)
SDDS	Special Data Dissemination Standard
STA	Statistics Department (IMF)
TA	Technical assistance
TGS	Technology and General Services Department (IMF)
UIP	Uncovered interest rate parity
WAEMU	West African Economic and Monetary Union
WEO	*World Economic Outlook*

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).

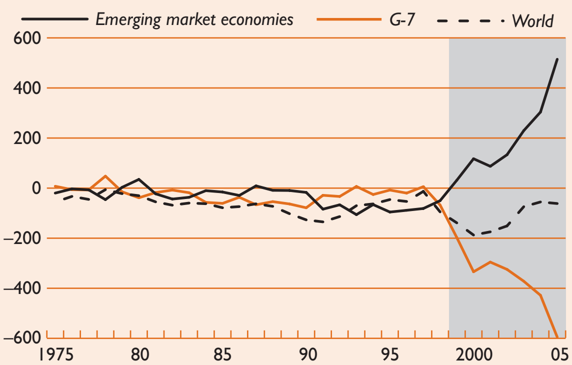
Box 1.1. The Global Context

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.

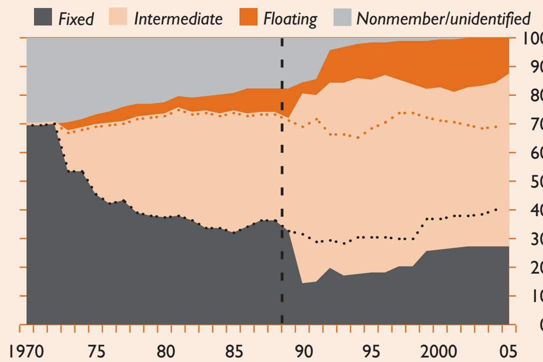
Against this backdrop, the evaluation period was characterized by growing U.S. current account deficits that were no longer offset by corresponding surpluses in other advanced economies, but increasingly instead by surpluses in the emerging markets—particularly in Asia and among the major oil producers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

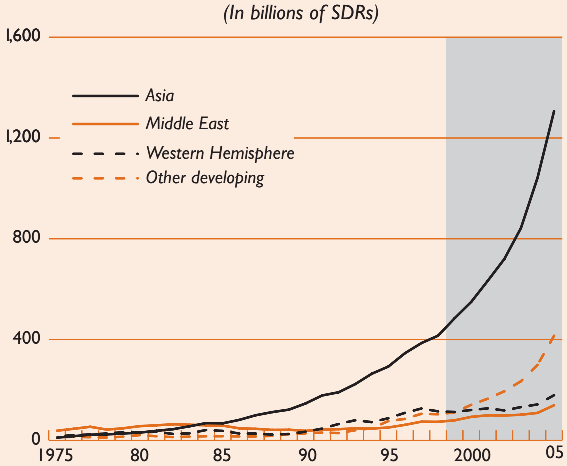
A. Current Account Balances, 1975–2005
(In billions of U.S. dollars)



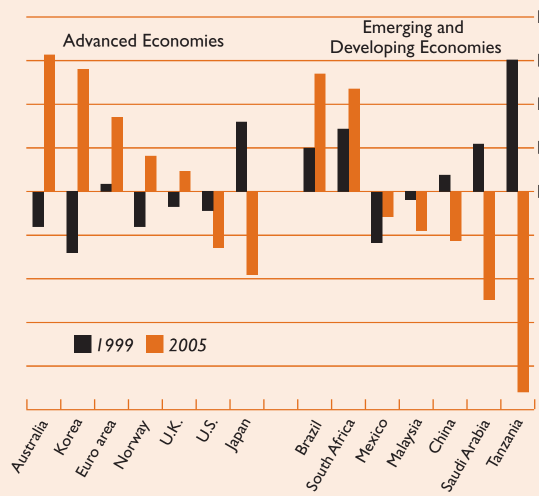
B. Distribution of Exchange Rate Regimes, All Members, 1970–2005[1]



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



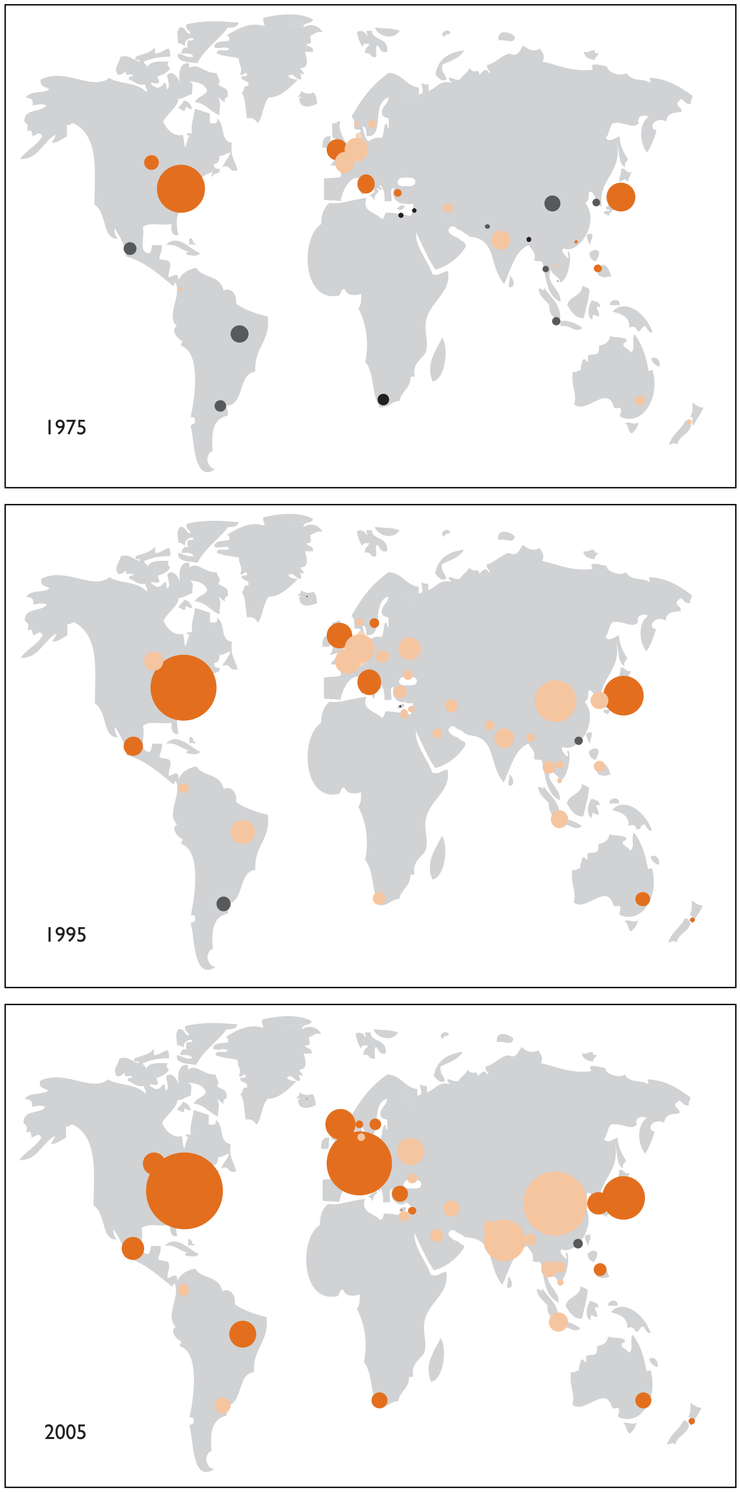
D. Real Effective Exchange Rates for Selected Economies, 1999–2005
(In percent of period average)



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 longstanding 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

Proportions of authorities' responses about the degree to which the IMF has played the role of:
(In percent)

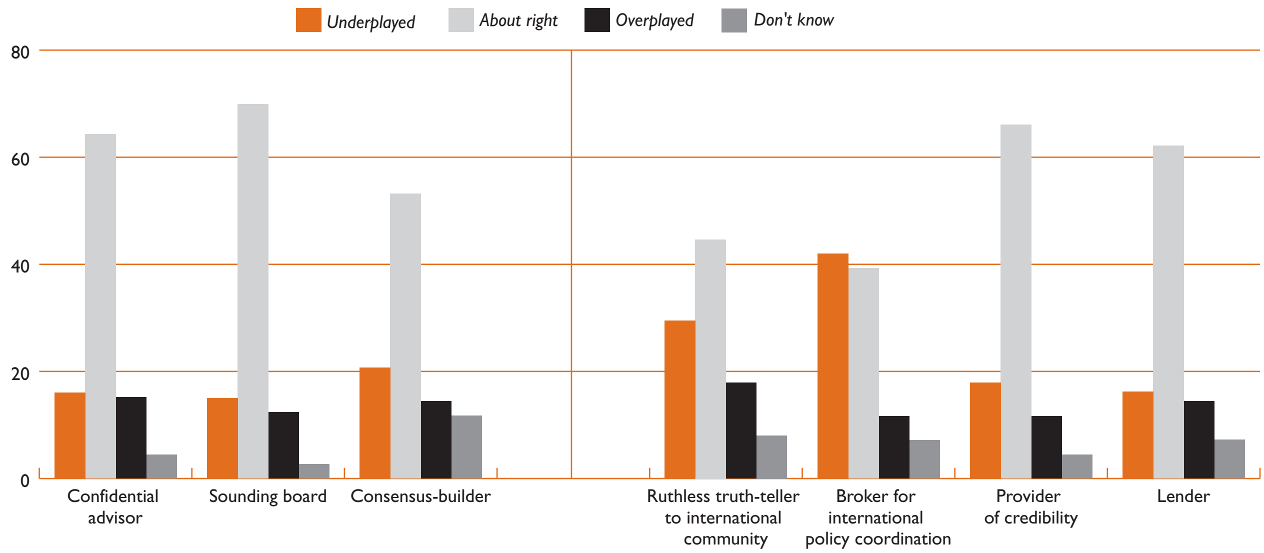
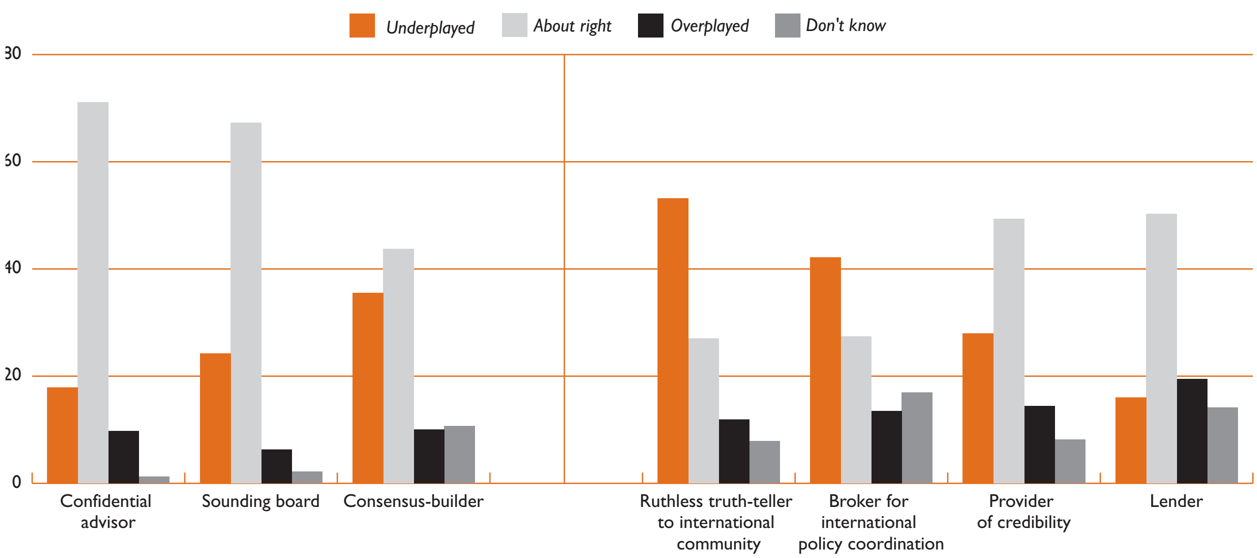


Figure 2.2. Staff's Views on Different Roles the IMF Has Played in the Area of Exchange Rate Policy

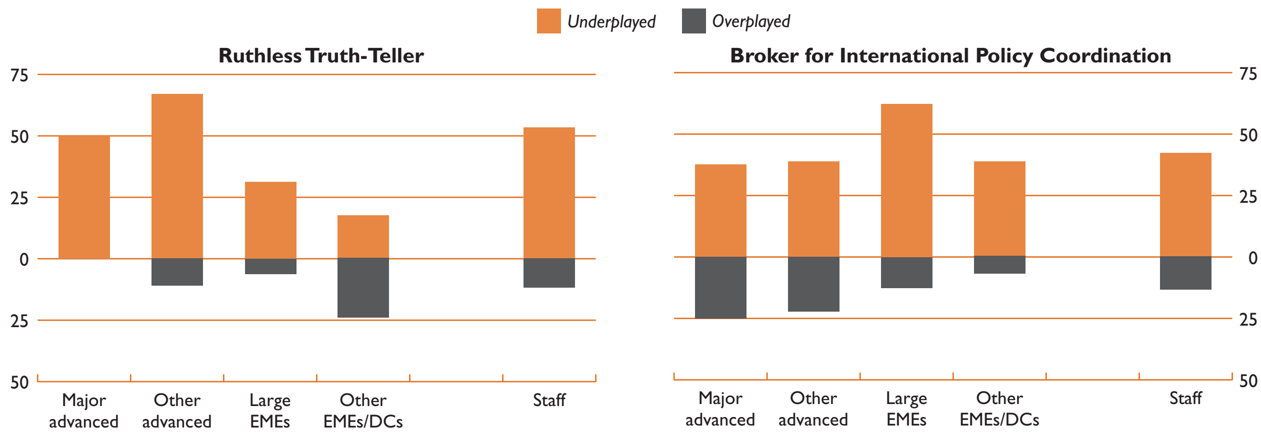
Proportions of IMF staff responses about the degree to which the IMF has played the role of:
(In percent)



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

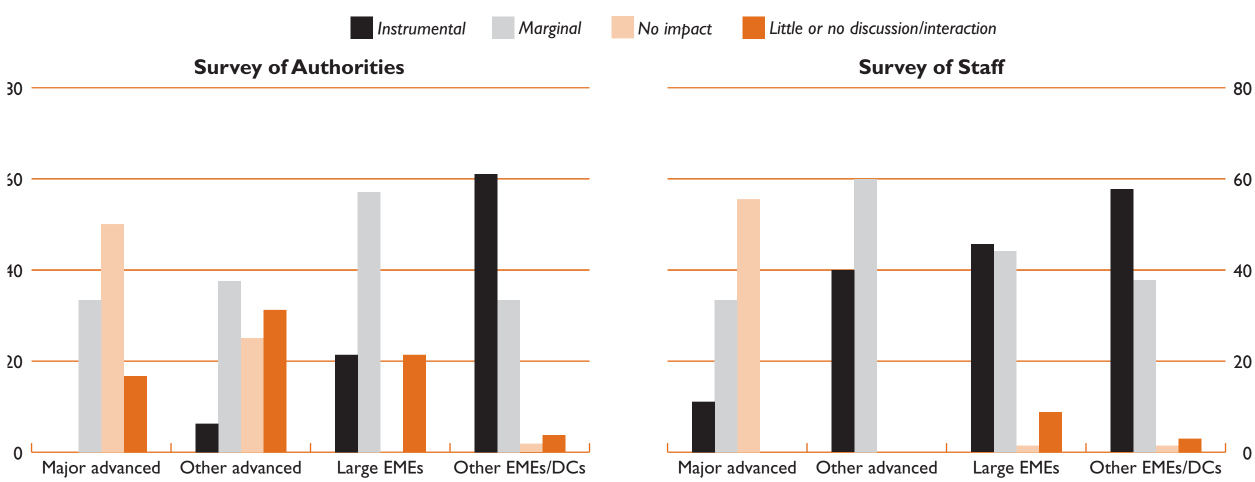
Proportions of authorities' and IMF staff's responses about the degree to which the IMF has either overplayed or underplayed the role of:[1]
(In percent)



[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.

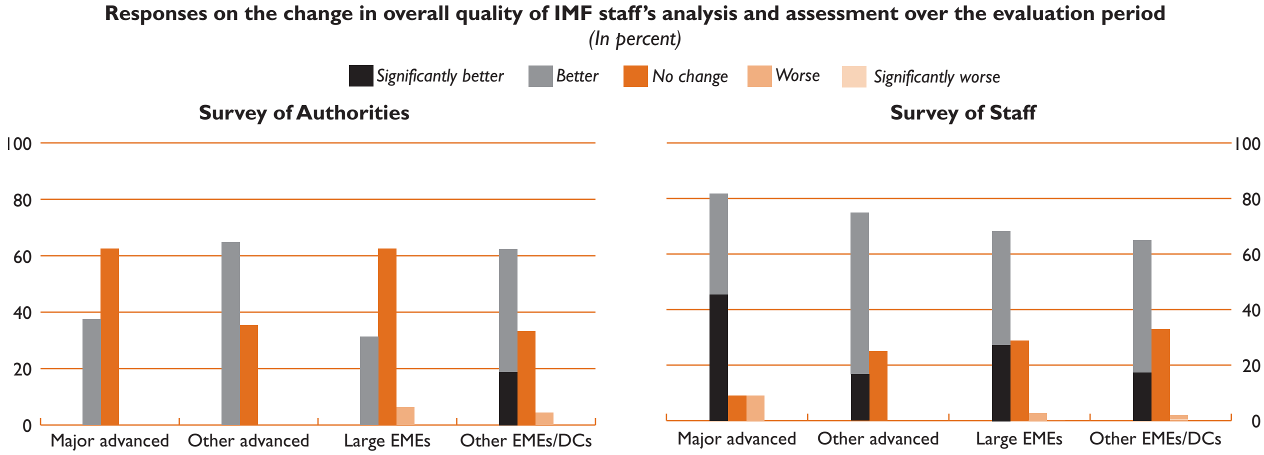
All in all, the results were indicative of a gap between the existing quality of advice and that which would be found useful by many authorities, especially in advanced and emerging market economies. Interviews with country authorities gave credence to this finding. While some officials stressed that 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

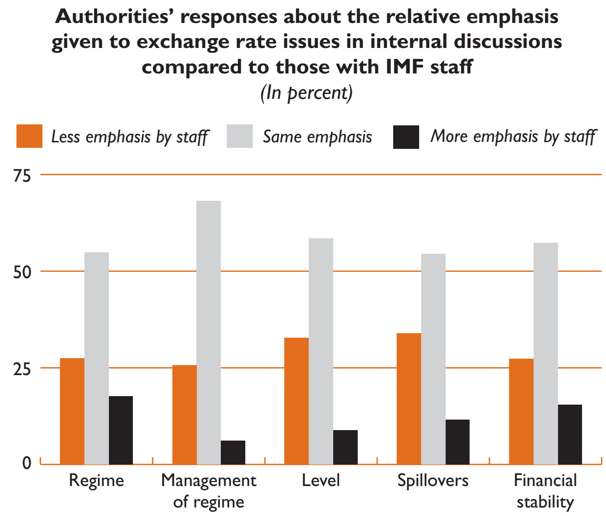
some cases, IMF staff did not deal in a substantive way with possibly contentious issues (such as assessments of the appropriateness of a country's exchange rate level, regime choice, or limits to accumulating international reserves). Staff interviewed by IEO explained that the reasons for not being 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



- 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.

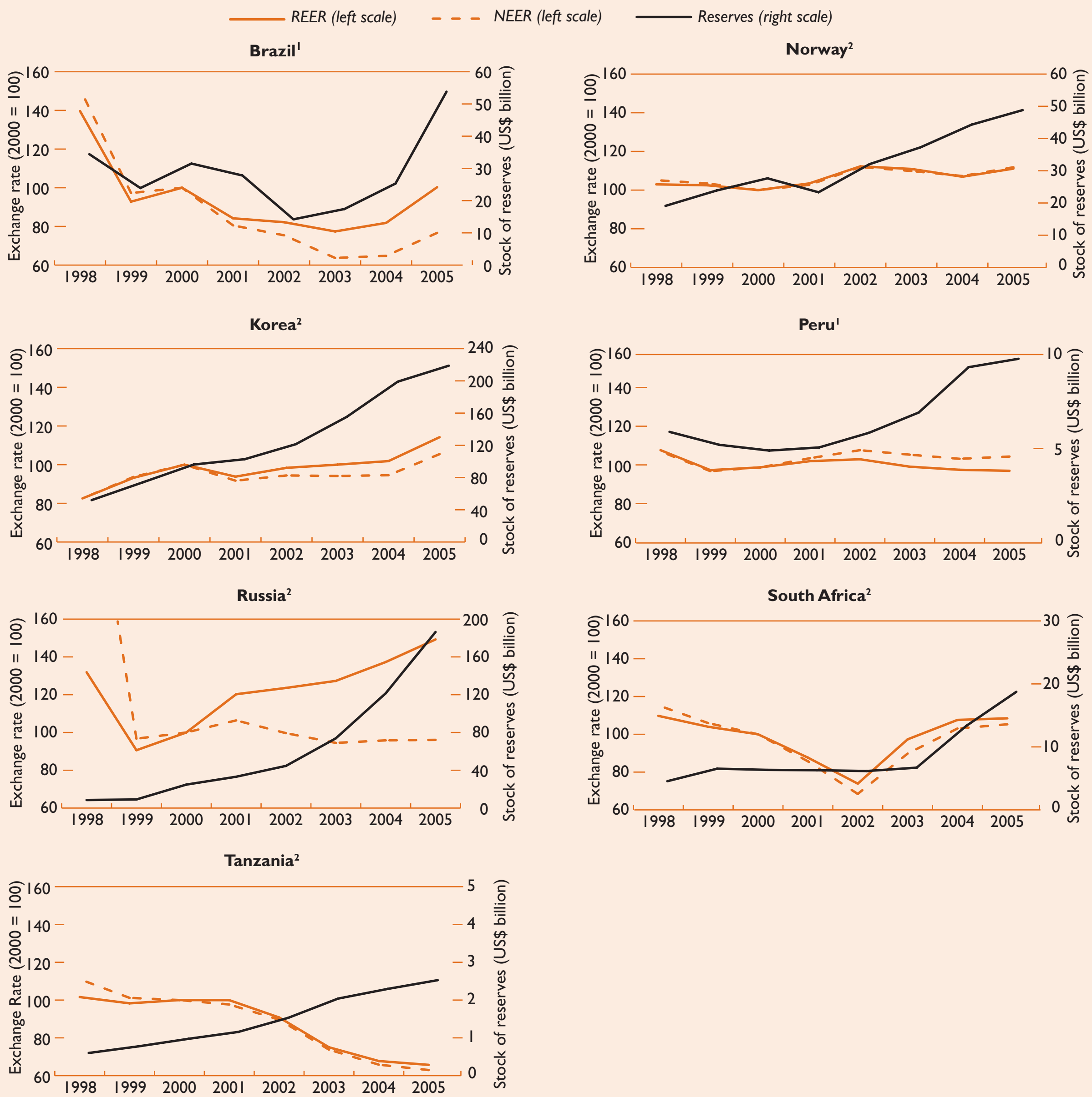
merits.[14] Further analysis should be worthwhile to draw out the different implications for policy advice, depending on the source of the inflow—whether aid, private capital, or income from natural resource exports.

[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]

		Instances of Staff Use			
Year	Number of Countries	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*.

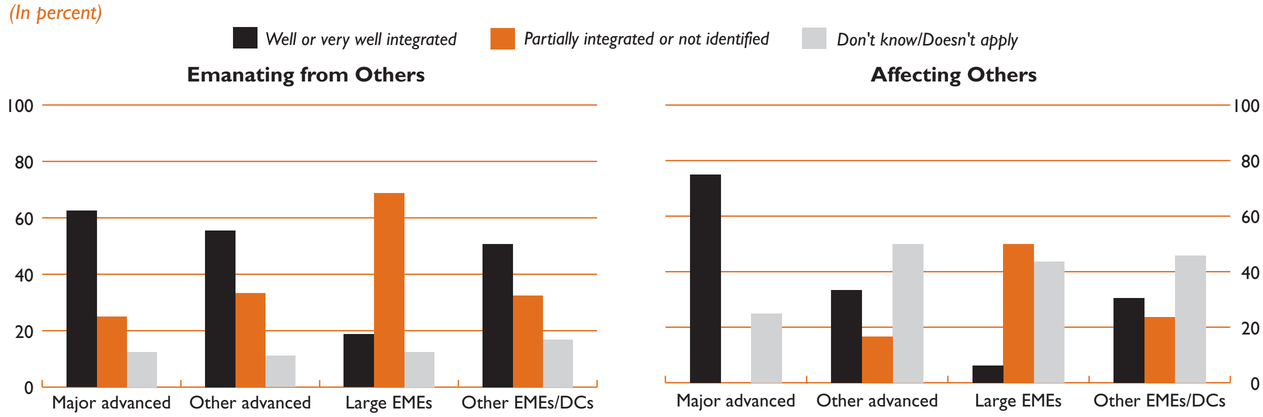
identified, or sufficiently integrated into their analysis, spillovers affecting their countries. The authorities were roughly split on whether or not spillovers emanating from their countries had been sufficiently integrated. In both cases, dissatisfaction was felt particularly among the large emerging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

[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.

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

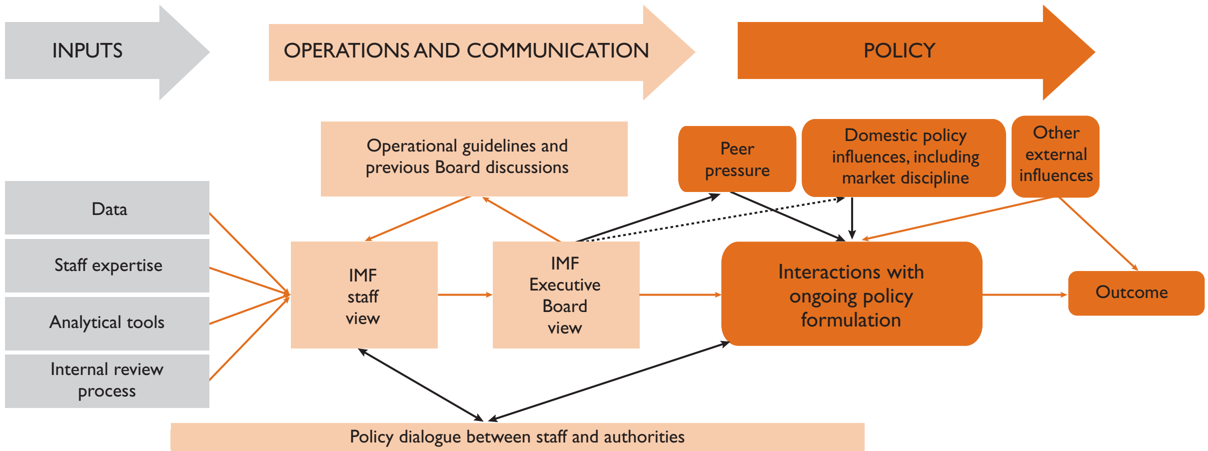


Figure 4.2. Areas of Possible Improvement in IMF Exchange Rate Advice, as Identified by Country Authorities

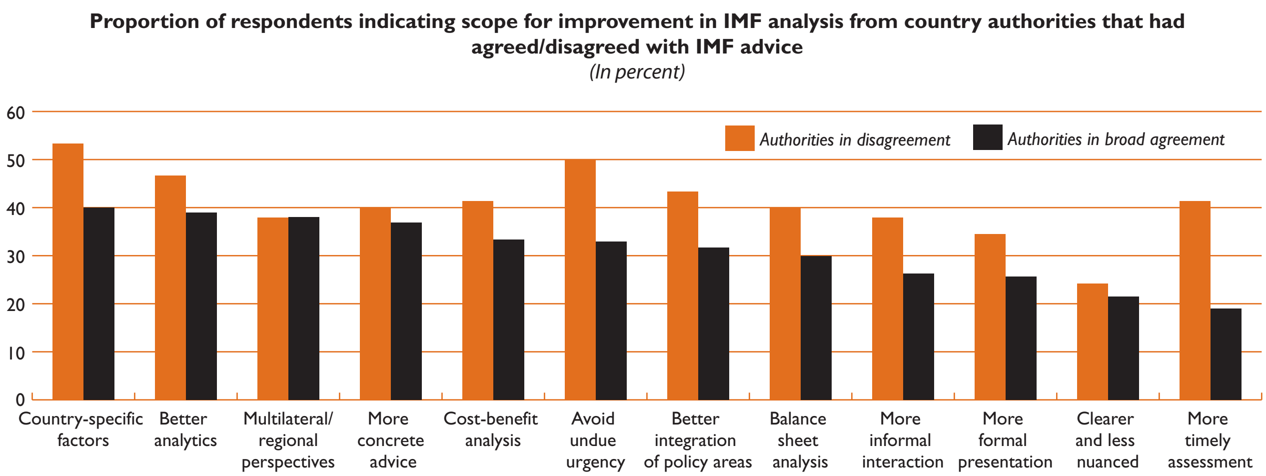


Table 4.1. Survey of Authorities: Limits to IMF Impact

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.

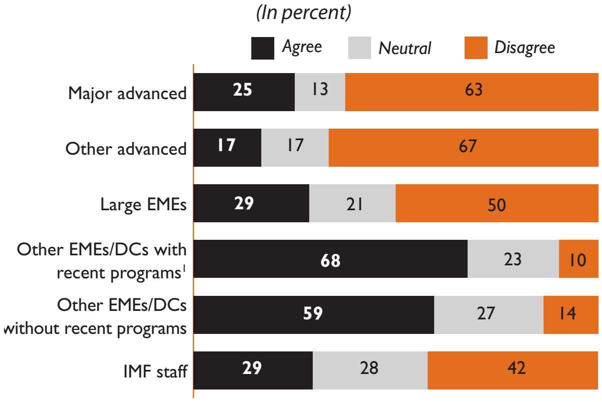
Did the IMF have a view on the relevant exchange rate developments at the time and the possible actions to be taken? Did it communicate these views to the relevant authorities? And did its views have any impact? In both cases the IMF staff did have a view on exchange rate developments and possible policy 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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Background Documents

BACKGROUND DOCUMENT

I Principles and Procedures of IMF Exchange Rate Surveillance

The Legal Foundation of IMF Surveillance

1. One of the key purposes in establishing the IMF was to promote "exchange stability" through a system of pegged but adjustable exchange rates. Article IV of the IMF Articles of Agreement initially stipulated that member countries consult with the IMF before adjusting the par values of their currencies beyond certain limits. The IMF, in turn, would concur only if it was satisfied that the proposed change was necessary to correct a "fundamental disequilibrium."

2. In formally abolishing the par value system in 1978, however, the Second Amendment of the Articles allowed each member considerable (although not unlimited) freedom in choosing its "exchange arrangement"—the overall framework that a member uses to determine the value of its currency against other currencies (e.g., a decision to peg or float its currency). A member's principal obligation under the amended Articles became that of collaborating "with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates" (Article IV, Section 1).

3. In addition to this general obligation, members must observe four specific undertakings, two of which concern their domestic economic and financial policies, and two of which address their "exchange rate policies."[1] The two specific obligations respecting domestic policies are of a soft nature, requiring efforts rather than the achievement of results. They require the member to "endeavor to direct its economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability," and to "seek to promote stability by fostering orderly underlying economic and financial conditions." In contrast, the obligations respecting exchange rate policies require the achievement of results. In particular, these provisions require members to "avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members" (Article IV, Section 1).[2] The provisions of the amended Article IV recognize that the promotion of a "stable system of exchange rates" is most effectively achieved by members implementing appropriate exchange rate policies and domestic policies.

4. Article IV establishes obligations for the IMF as well. Under Article IV, Section 3(*a*), the IMF was given the responsibility to "oversee the international monetary system in order to ensure its effective operation," and to "oversee the compliance of each member with its obligations under Section 1 of this Article." Moreover, Article IV, Section 3(*b*) requires the IMF to "exercise firm surveillance over the exchange rate policies of its members." Thus, the IMF was given the dual responsibility of exercising oversight over both the international monetary system and members' obligations with respect to the conduct of their exchange rate and domestic economic and financial policies. Article IV also requires the IMF to "adopt specific principles for the guidance of all members with respect to" exchange rate policies. The first set of such principles was provided in the Executive Board's 1977 Surveillance Decision, which took effect when the Second Amendment came into force.[3]

Guidance for the Implementation of IMF Surveillance

5. The 1977 Surveillance Decision provides guidance to members in the conduct of their exchange rate policies under Article IV, Section 1 and to the IMF in the exercise of surveillance over those policies. It states, among other things, that the "surveillance of exchange rate policies shall be adapted to the needs of international adjustment as they develop" and that the "Fund's appraisal of a member's exchange rate policies shall be

[1]The four specific obligations are examples of the general obligation to collaborate but do not exhaust its scope.

[2]For greater details, see "Article IV of the Fund's Articles of Agreement—An Overview of the Legal Framework" (SM/06/216), June 2006.

[3]See "Surveillance over Exchange Rate Policies," Executive Board Decision No. 5392-(77/63), April 29, 1977, as amended.

based on an evaluation of the developments in the member's balance of payments, including the size and sustainability of capital flows, against the background of its reserve position and its external indebtedness." The IMF Executive Board has since elaborated on the 1977 Surveillance Decision on several occasions, including during a discussion on "Exchange Rate Regimes in an Increasingly Integrated World Economy" held in 1999. The Chair's Summing Up of the discussion stated that "the Fund should offer its own views to assist national authorities in their policy deliberations" on exchange rate policy and "seek to ensure that countries' policies and circumstances are consistent with their choice of exchange rate regime."[4]

6. A number of basic concepts may be derived from Article IV and the 1977 Surveillance Decision, which may be summarized as follows:

- First, no single exchange rate regime is best for all countries in all circumstances.
- Second, a member country may choose the exchange rate regime that it intends to apply to fulfill its obligations under Article IV, Section 1, subject to a few limitations; and the IMF generally abides by the member's regime choice.
- Third, while considering the choice of regime to be a matter for each member country, the IMF seeks to provide clear and candid advice to members on the consistency of that regime with the member's national policies and circumstances as well as with members' obligations under the Articles of Agreement.
- Fourth, analysis and policy advice on exchange rate matters should be framed in the context of the general economic situation and policy strategy of the member.

7. Providing advice on the basis of these principles necessarily requires analysis of two closely related issues: (1) exchange rate regime choice and suitability, and (2) appropriateness of exchange rate levels.[5] This, in turn, covers the following dimensions, as recognized in recent Biennial Surveillance Reviews:

- *Regime identification.* It is essential for staff to accurately identify and describe the de facto exchange rate regime in place in a particular country, as regime identification is a prerequisite for providing the right context for policy advice. For their part, members are required under Article IV, Section 2 to notify the IMF of their "exchange arrangements" and of any changes thereto.
- *Regime assessment.* Assessment of the (continued) suitability of the chosen regime, given policy objectives and the economic environment, on the basis of certain criteria; staff would assess regimes in all cases and would be expected to discuss the appropriateness of an exchange rate regime if there were doubts about its conduciveness to macroeconomic stability.
- *Level assessment.* Assessment of the exchange rate level, regardless of the exchange rate regime in place, including a thorough assessment of external competitiveness.
- *Consistency.* Both exchange rate regime and valuation are to be discussed in terms of consistency with other economic policies, external stability considerations, and the country's external and domestic policy goals.

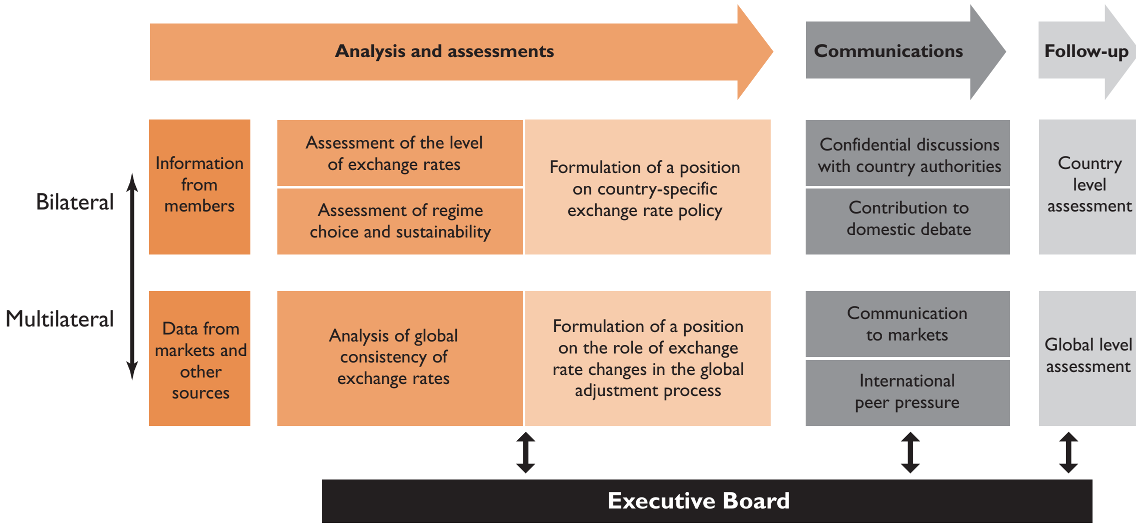
8. The Policy Development and Review Department's Surveillance Guidance Notes provide principal guidance for the practical implementation of these surveillance principles. These notes incorporate the 1977 Surveillance Decision and the results of any subsequent surveillance reviews and are intended to make them operational. The latest note was issued in May 2005 and superseded the previous guidance notes. While the first of PDR's guidance notes had emphasized the need to focus staff reports on the core area of exchange rate policies, the subsequent notes elevated the need to pay selective attention to other relevant macroeconomic and structural policies as equally important. The 2004 Biennial Surveillance Review added to previous attempts to prioritize by calling for a focus on issues at the "apex of the Fund's hierarchy of concerns," such as external sustainability, vulnerability to balance of payments crises, and international spillovers of policies in large economies. As critical steps of exchange rate surveillance, moreover, it underscored "clear identification of the de facto exchange rate regime in staff reports; more systematic use of a broad range of indicators and other analytical tools to assess external competitiveness; and a through and balanced presentation of the policy dialogue between staff and the authorities on exchange rate issues."[6]

[4]Summing Up of the Board discussion on "Exchange Rate Regimes in an Increasingly Integrated World Economy," September 31, 1999; reproduced in Michael Mussa and others, *Exchange Rate Regimes in an Increasingly Integrated World Economy,* IMF Occasional Paper No. 193 (Washington: International Monetary Fund, 2000), pp. 55–58.

[5]See, for example, "Summing Up of the 2000 Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision" (SUR/00/32), which stated that "an assessment of both exchange rate level and exchange rate regime is to be made in all cases."

[6]See "Surveillance Guidance Note," May 2005; and "Review of the 1977 Decision on Surveillance over Exchange Rate Policies—Background Information" (SM/06/227), June 2006.

Figure A1.1. The Provision of IMF Exchange Rate Policy Advice



The Process of IMF Surveillance

9. Exchange rate surveillance is conducted through various vehicles, most frequently the IMF's regular Article IV consultation process.[7] Surveillance is continuous. For each "cycle," however, the process of analyzing and providing advice on members' exchange rate policies can be represented by a stylized, multi-stage "results chain" that connects "inputs" with IMF activities and their outcomes. Figure A1.1 depicts the three main (partially overlapping) stages of this process: (1) analysis and assessments; (2) communication of policy advice (including review by the Executive Board); and (3) follow-up, including continuous monitoring between cycles. Each stage embodies bilateral and multilateral components, which are considered to be two complementary perspectives inherent in any surveillance activity.

10. At the first stage, IMF staff assess the appropriateness and sustainability of a country's exchange rate policy (e.g., both the regime and the prevailing level), by taking into account its compatibility with the country's overall policy environment and external conditions. Staff also analyze the global and regional implications of policies pursued by systemically more important countries, as well as resulting implications for individual member countries. Bilateral and multilateral assessments inform each other. In this, the IMF's dual mandate (as overseer of members' compliance with their obligations and of the international monetary system) effectively requires consistency between the two types of assessments.

11. Once staff and management have come to a particular view, their assessment is provided to the Executive Board for its consideration under the Board's surveillance responsibility; ultimately, the views expressed by the Board become "official" IMF views for the purposes of surveillance. A key input into these assessments, and the starting point of the surveillance process, is the provision of relevant information by national authorities—including information that is required under Article VIII, Section 5—the availability and quality of which may affect the overall effectiveness of policy advice. Another requirement is the correct identification by staff of the exchange rate regime in place, which is a prerequisite for providing the right context for accurate policy advice.

12. At the second stage, once a position on a particular issue is formed, it needs to be communicated to the relevant audience. Unless engaged in a program relationship with the respective country, the IMF relies largely on persuasion and peer pressure to influence national policies, using different channels: bilateral discussions at the staff level, review at the Board level, national and international policy debate, and—possibly—through publication of the channel of accountability via public opinion and the disciplining role of markets. To be effective, the IMF must use the most appropriate channel(s)

[7]Although the 1977 Surveillance Decision established annual Article IV consultations as the main vehicle of IMF surveillance, it also provided for special consultations on a confidential basis should the Managing Director determine that a member's exchange rate policies might not be in accordance with the principles laid out in the decision. In addition, a 1979 decision introduced a supplementary procedure that requires the Managing Director to initiate confidential and informal discussions with a member if he "considers that important economic or financial developments are likely to affect a member's exchange rate policies or the behavior of the exchange rate of its currency." The first procedure—special consultations—has never been applied by the IMF, while the second—supplementary consultations—has been used only twice, in the 1980s.

for a particular message, recognizing that communication with the authorities of members is the primary channel; that some information is market sensitive; and that analytical and practical difficulties in generating reliable assessments of exchange rate issues invariably lead to significant margins of error.

13. At the third and final stage, the advice given must be followed up, in view of the actual or prospective actions taken by national authorities and in light of subsequent domestic and international developments. These assessments will feed into the next surveillance cycle and may also be reflected in other aspects of IMF operations, such as technical assistance or IMF-supported programs. To follow up on its advice for greater exchange rate flexibility, for example, the IMF may provide technical assistance on developing an appropriate institutional framework, possibly including any legal and operational aspects of implementation. Regardless of whether specific advice is given, the IMF must monitor developments continuously until the next "cycle" begins.

BACKGROUND DOCUMENT

2

Executive Board Guidance on Exchange Rate Surveillance, 1999–2005

1. Beyond Article IV itself, the 1977 Surveillance Decision, as amended, remains the foundation of modern IMF exchange rate surveillance. Over the period 1999–2005, however, the Executive Board provided additional guidance, mainly through the Summings Up of discussions of periodic reviews of surveillance and selected policy papers.

The Content of Exchange Rate Surveillance

Exchange rate regime

2. Board views cover several aspects of exchange rate regimes, including regime choice, regime classification, preferred regime, and inflation targeting.

- *Choice*. During the 2002 Biennial Surveillance Review (BSR), Directors welcomed the increased candor with which "soft" exchange rate pegs were assessed in countries with access to international capital markets. They noted, however, that exchange rate arrangements were not questioned in many other cases, and urged the staff to treat "exchange rate issues" candidly in all countries.[1]
- *Classification*. In the 1999 *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*), the IMF staff changed its regime classification from a de jure (as reported by the members) to a de facto basis. The Executive Board, however, made no call for using the *de facto* classification in Article IV consultations until 2004.[2] Directors noted that a clear and candid treatment of exchange rate issues remained a challenge, and recommended the identification of de facto regime as a first step to address this challenge.
- *Preferred regime*. During the evaluation period, the Executive Board did not fully endorse the bipolar view of exchange rate policy that management and staff seemed to express from time to time.[3] The Board, while acknowledging the challenges posed by increasing capital mobility, supported intermediate regimes as viable alternatives.[4] In the context of the 2004 BSR, Directors reiterated the idea that "no exchange rate regime is appropriate for all countries or for all circumstances" and stressed that discussion of exchange rate issues should permit consideration of a variety of options and take full account of country-specific circumstances.
- *Inflation targeting*. The Board has not fully endorsed the merits of greater exchange rate flexibility with inflation targeting—a monetary policy regime that management and staff has pursued in more recent years.[5] In discussing the paper "Inflation Targeting and the IMF," the Board as recently as 2006 noted that a number of preconditions remained important for success; many Directors,

[1]Summing Up by the Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 02/37 (April 10, 2002).

[2]This de facto classification was introduced in the 1999 Review of Exchange Arrangements, Restrictions and Current Account Regulations. A recent MCM report proposed refinements to the methodology and broader use within the IMF. The report was discussed in an Executive Board seminar. See "Review of Exchange Arrangements, Restrictions and Markets" (SM/06/358), October 2006.

[3]For example, the First Deputy Managing Director, addressing the 2001 American Economic Association Meetings, noted a secular trend toward polar regimes among developed and emerging market economies and attributed this to the fact that "soft peg systems have not proved viable over any lengthy period, especially for countries integrated or integrating into the international capital markets." See Distinguished Lecture on Economics in Government, American Economic Association and the Society of Government Economists, New Orleans, January 6, 2001 (available via the Internet: www.imf.org/external/np/speeches/2001/010601a.htm).

[4]Such a view was expressed, for example, in a 2003 informal seminar in which the Board discussed a paper prepared by the IMF's Research Department. The seminar paper, based on a de facto classification called "Natural Classification," showed that polarization was not as clear as had been thought and that intermediate regimes remained prevalent.

[5]See, for example, A. Singh and M. Cerisola, "Sustaining Latin America's Resurgence: Some Historical Perspectives," IMF Working Paper No. 06/252 (Washington: International Monetary Fund).

moreover, stated that "adoption of inflation targeting should not be seen as a macroeconomic panacea" and that inflation targeting may not be appropriate in all cases.[6]

Exchange rate level

3. The views of the Executive Board on exchange rate level refer both to the need for level assessment and to the CGER methodology used by the staff for such assessment.

- *Assessing the level*. In discussing the 2000 BSR, most Directors "stressed that an assessment of . . . the exchange rate level is to be made in all cases," while recognizing the risk that explicit judgments in staff reports on the exchange rate level could exert an undue and disruptive influence on markets.[7] During the 2004 BSR, the Board called for the use of a broad range of indicators and other analytical tools to assess external competitiveness.[8]
- *Methodology*. In the discussion of a methodological note[9] produced by the Consultative Group on Exchange Rate Issues (CGER) in 2001, the Board welcomed the improvement made since 1997 and its prospective extension to emerging markets. While noting the contribution of the CGER methodology as a tool of ensuring global and temporal consistency, however, it recognized the dominant role of subjective judgment and therefore called for a judicious use of equilibrium exchange rate estimates in Article IV consultations.[10] Directors also stressed that further work was needed before CGER assessments could be used consistently in emerging markets.

Spillover issues—intervention and exchange rate manipulation

4. The Executive Board increasingly stressed the need to pay attention to global and regional spillovers, but gave little guidance on issues related to official foreign exchange market intervention during this period.

- *Global and regional issues*. Though not specific to exchange rate issues, the Executive Board on several occasions called for greater attention to cross-country issues and policy interdependence. During the 2002 BSR, for example, many Directors stressed that "the spillover effects of policy changes in systemically important countries on other economies need to be more carefully explored." The discussion of the 2004 BSR called for fuller treatment of the global impact of domestic policies in the largest members.
- *Intervention and exchange rate manipulation*. Both the Articles of Agreement and the 1977 Surveillance Decision contain a specific provision prohibiting members from manipulating exchange rates in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members.[11] It is not easy to make a case for exchange rate manipulation because it would require the IMF to establish the intent of a particular exchange rate practice. The Board, however, has not made use of the procedures to discuss such issues—special and supplementary consultations—that could have been used during this period.[12]

Financial stability

5. Financial stability issues assumed greater importance during the period, with balance sheet analysis becoming part of the toolkit of IMF surveillance. During the 2000 BSR, Directors noted that "all issues related to external sustainability and vulnerability to balance of payments or currency crises will continue to be at the apex of this [surveillance] hierarchy." During the 2004 BSR, Directors stressed that the "current strategy to improve vulnerability assessments and balance sheet analysis is having a positive impact, and urged staff to continue refining the analytical techniques, while recognizing data constraints."[13]

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[6]The Acting Chair's Concluding Remarks, Inflation Targeting and the IMF, Executive Board Seminar 06/1 (February 17, 2006).

[7]Summing Up by the Acting Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 00/24 (March 21, 2000).

[8]Summing Up by the Chairman, Biennial Review of the Implementation of the Fund's Surveillance and of the 1977 Surveillance Decision, Executive Board Meeting 04/72 (August 2, 2004).

[9]See "Concluding Remarks by the Acting Chairman: Methodology for Current Account and Exchange Rate Assessments," BUFF/01/89, June 19, 2001.

[10]A similar view was expressed during an informal Board seminar on "Methodology for CGER Exchange Rate Assessments" (SM/06/283), held on September 8, 2006.

[11]Article IV, Section 1(iii) states: "each member shall . . . avoid manipulating exchange rates to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." To help identify such practice, a set of indicators was suggested by the 1977 Decision, including "protracted large-scale intervention in one direction in the exchange market."

[12]For details, see Background Document 1.

[13]During an informal Board seminar on "The Balance Sheet Approach and Its Applications at the Fund" (SM/03/227) held in July 2003, Directors welcomed the approach and its increasing use at the IMF but did not reach consensus on country coverage. While some Directors stated that the analysis should be confined to emerging markets, other Directors saw merit in extending the methodology to industrial countries.

The Process of Surveillance

The locus of surveillance

6. Despite the fact that the Executive Board is the main locus of surveillance, market sensitivity and other confidentiality concerns may dictate that the Board is kept out of some issues that are being discussed between staff/management and national authorities. This issue was raised during the 2000 BSR, when some Directors suggested that the staff should explore using an alternative mechanism (such as oral presentation) to communicate their views to the Board when an explicit statement in a staff report could lead to market instability. In subsequent Board discussions, the concerns of Directors have focused more narrowly on point estimates of equilibrium exchange rates or the size of currency misalignment. Directors have also expressed concern about the de facto classification of exchange rate regimes in some cases.

Transparency policy

7. Although Board advice on transparency became increasingly detailed during 1999–2005, some tension between transparency and candor persisted. During the 2005 Review of the IMF's Transparency Policy, most Directors were satisfied with the finding that an increased rate of publication of Board documents had not led to a significant erosion of candor,[14] but other Directors interpreted the finding as "distinct evidence of a loss of candor associated with the current publication policy." Although the majority of the Directors agreed with staff recommendations for improving the timeliness of publication, preserving candor, and reducing implementation costs, other Directors were concerned that some of the proposed changes could undermine the efforts to increase the publication rate or that strict enforcement of the publication guidelines could affect the balance between candor and greater openness or else compromise the quality of staff reports.

8. The policy on deletions in Board documents remained broadly unchanged during the period. The deletions policy, however, was occasionally challenged by some Directors, particularly regarding politically sensitive material (which is not contemplated in the policy). During the 2003 Review of Transparency Policy, many Directors favored the extension of the deletions policy to politically sensitive material but the Board did not approve the move; the majority of Directors pointed to the difficulty of designing an objective test of what is "highly politically sensitive" and to the risk of undermining the candor and comprehensiveness of Board documents. During the 2005 Review of Transparency Policy, some Directors considered that the deletion of politically sensitive issues that fall outside the current policy would "help better reconcile the objectives of candor and transparency"—although no amendment to the policy was made.[15]

Policy dialogue and outreach

9. Though not specific to exchange rate issues, Directors stressed during the 2004 BSR the importance of a close and frank policy dialogue between the IMF and its members, and encouraged countries to prepare policy statements (which would be an input to policy discussions); frequent contacts outside the Article IV consultations; and greater continuity of staff assignments to promote the accumulation of country-specific knowledge. Directors also supported the staff proposal to produce a one-page note to enhance communications with senior policymakers as a complement to the Article IV mission's concluding statement. At the same time, Directors encouraged staff to develop outreach programs and enhance contacts with local think tanks.

The Provision of Data for Exchange Rate Surveillance

10. Although the Articles of Agreement (Article VIII, Section 5) remain the basis for members' obligations in furnishing data to the IMF, the Executive Board, in early 2004, approved an important decision that was designed to strengthen the effectiveness of the information reporting regime set out in Article VIII, Section 5.[16] This 2004 Board decision essentially expanded the scope of data that members are required to report under Article VIII, Section 5 and, in particular, added "any reserve assets which are pledged or otherwise encumbered as well as net derivative positions." The Board also put in place a procedural framework governing cases of noncompliance to provide the IMF with a more graduated set of responses,[17] in line with

[14]In 2003 the Executive Board agreed to move to a policy of voluntary but presumed publication for all Article IV staff reports, Article IV Public Information Notices, and other Article IV-related papers.

[15]While accepting the language proposed by staff for the definition of "high market sensitivity," the Board acknowledged that judgment must continue to be made on a case-by-case basis. Directors agreed, however, that the deletion of references to a policy that is not yet in the public domain and that the authorities of a member country intend to implement could be permitted when the premature disclosure of the operational details of the policy would undermine the ability of the authorities to implement it.

[16]Executive Board Decision No. 13183-04/10, January 30, 2004.

[17]The sanctions for noncompliance as stipulated in the Articles include declaration of ineligibility to borrow, suspension of voting rights and, in the event of persistent noncompliance, compulsory withdrawal.

the institution's preference for a cooperative mechanism, to strengthen transparency in the diffusion of national data by members.[18]

11. Guidelines on the provision of data, established pursuant to the Board discussions in the 2000 and 2002 BSRs, go beyond the core data specified in Article VIII, Section 5 and the 2004 Board decision. According to these guidelines, staff are expected to assess, in the context of Article IV consultations, whether the quality of the data provided by national authorities is adequate for surveillance purposes and to discuss the implications of any data deficiency for effective surveillance.[19] Further details on the requirements for staff to discuss the quality of data were provided in early 2005.[20]

[18]Another type of cooperative mechanism (in the context of dissemination of data to the public) is the Special Data Dissemination Standard (SDDS), introduced in 1996, which relies on the voluntary subscription of member countries. Upon subscription, however, a country agrees to observe the standard and its underlying principles.

[19]See "Operational Guidance Note for Staff," SM/02/292, September 2002.

[20]See "Guidance Note on Data Provision to the Fund for Surveillance Purposes," SM/05/39, January 2005.

BACKGROUND DOCUMENT

3

The Equilibrium Exchange Rate: Alternative Concepts and Their Applications in IMF Surveillance

Introduction

1. This background document surveys major recent approaches to modeling an equilibrium exchange rate,[1] and reviews how IMF economists applied these approaches in their exchange rate surveillance during 2000–05. Although there are a number of approaches to modeling exchange rate determination, most notably including monetary and portfolio balance models,[2] the focus here is on recent empirical models that are designed to assess the level of exchange rates relative to some equilibrium value. For the purpose of this review, the term *equilibrium exchange rate* is used to refer to the exchange rate that is consistent with a given set of fundamentals over the medium to long term. The concept of equilibrium exchange rate thus presupposes a stable long-term relationship between exchange rates and a set of fundamentals.[3]

2. At the outset, it should be noted that no consensus exists in the literature on the "correct" concept of equilibrium exchange rate and that, depending on which concept is used, estimates of the equilibrium level for a given set of fundamentals can vary widely. One way to make sense out of the divergence of approaches suggested in the literature is to think of each concept as corresponding to a particular policy question one is interested in addressing. No single model is expected to answer all relevant policy questions. In view of this, the Policy Development and Review Department's 2005 Surveillance Guidance Note suggests that IMF staff should apply "a broad range of indicators and other analytical tools" to make "a forthright assessment of the exchange rate level."

[1]For a similar review of the literature, see Driver and Westaway (2004).

[2]For a survey of other approaches to exchange rate determination that are not reviewed here, see Frankel and Rose (1995).

[3]Although the ability of economic fundamentals to forecast exchange rates over the short term has proven to be rather poor (see Meese and Rogoff, 1983), recent research points to limited evidence that exchange rates are linked with permanent movements in the fundamentals (Engel and West, 2005; also Mark, 1995).

Alternative Approaches to Modeling the Equilibrium Exchange Rate

3. Broadly speaking, two classes of empirical exchange rate models have been used in empirical work that relates the equilibrium real exchange rate to a set of economic fundamentals: (1) models that are based on the notion of internal and external balance; and (2) models based on the estimation of a reduced-form equilibrium real exchange rate regression. In what follows, as an example of the first class of models, we review the fundamental equilibrium exchange rate (FEER) model and its close variant, the desired equilibrium exchange rate (DEER) model; and as an example of the second class of models, the behavioral equilibrium exchange rate (BEER) and its close variant, the permanent equilibrium exchange rate (PEER) model. We also review the natural real exchange rate (NATREX) model separately. Although the NATREX is often indistinguishable from the BEER when applied in empirical work, in terms of the selection of explanatory variables, it has a longer-term orientation; it also imposes a particular theoretical structure to interpret the empirical results.

The fundamental equilibrium exchange rate (FEER)

4. The FEER is defined to be the exchange rate that is consistent with both internal and external balance simultaneously (see Williamson, 1994, for details). Internal balance is reached when the economy in question is at the full-employment level of output at stable prices, while external balance is characterized as a balance of payments position sustainable over a medium-term horizon. Because it is difficult to identify the level of potential output, it is often assumed that the adjustment process assures internal balance when external balance is achieved. Then, the FEER is found by a two-step procedure: (1) identifying the components of the current account balance as a function of the real effective exchange rate; and (2) solving for the equilib-

rium real effective exchange rate by imposing macroeconomic balance.

5. As an illustration of the FEER approach, let us decompose the current account (*CA*) into two components: the net trade balance (*ntb*) and returns to net foreign assets (*nfa*), where *ntb* is a function of the real effective exchange rate (q^{REER}) and the outputs of the domestic and foreign economies (y_d and y_f); and *nfa* is also influenced by the real effective exchange rate (because an accumulation of net foreign liabilities would have to be financed). It will be necessary under these assumptions for the currency to depreciate in order to improve the trade balance and the net foreign asset position. Assuming full employment, we have:

$$CA = ntb + nfa = f(q^{REER}, \bar{y}_d, \bar{y}_f), \tag{1}$$

where $\bar{y}_d$ and $\bar{y}_f$ are the full employment outputs of the respective economies. On the capital flow side, most applications of the FEER assume that the equilibrium capital account over the medium term, denoted as $\overline{KA}$, is exogenously determined (Williamson, 1994; Bayoumi and others, 1994). Then, by imposing external balance ($CA = -\overline{KA}$), we obtain the equilibrium real exchange rate (q^{FEER}) as:

$$q^{FEER} = f(\overline{KA}; \bar{y}_d; \bar{y}_f). \tag{2}$$

6. Additional factors can easily be accommodated in this framework. For example, the FEER can incorporate the impact of a potential difference in productivity growth between the two economies. This is the well-known Balassa-Samuelson effect. In this case, it becomes similar to the so-called adjusted purchasing-power-parity (PPP) approach (which adjusts the simple PPP approach for changes in the relative price of traded and nontraded goods, commodity terms of trade, or net foreign asset position). The key point is that, unlike the simple PPP approach, the FEER approach allows the equilibrium exchange rate to move as fundamentals change.

An extension of the FEER: the desired equilibrium exchange rate (DEER)

7. As an alternative to external balance, we can consider a current account target set by policymakers as part of overall macroeconomic policy. Then, we have a variant of the FEER called the DEER. The DEER makes explicit the normative nature of the assumptions underlying macroeconomic balance, particularly external balance. As a close variant, the calculation of the DEER methodically follows that of the FEER, except that the estimates of the DEER are driven by the preference of policymakers regarding internal and external balance.

8. Bayoumi and others (1994), for instance, estimated the DEERs of major currencies for 1970, assuming that the targeted current account surplus was equal to 1 percent of GDP.[4] The authors viewed the DEER as consistent with (and necessary for achieving) the "desired" positions of internal and external balance over the medium term, which they claimed was "in the range of four to six years" during which output was expected to return to its potential and changes in competitiveness to be reflected in trade volumes. As in the case of the FEER, different assumptions are used to generate different estimates of the DEER for policy simulation purposes.

The behavioral equilibrium exchange rate (BEER)

9. The BEER approach decomposes the variables that determine the real exchange rate into long-term economic fundamentals (Z_t) and short-term real interest rate differentials. Unlike the FEER approach, it does not consider macroeconomic balance and therefore uses the current values (rather than full employment values) of economic fundamentals in defining the equilibrium real exchange rate. The key elements of the BEER approach are: (1) a set of long-term economic fundamentals (which could include the terms of trade, net foreign assets, relative government debt, productivity, and the like); and (2) uncovered interest rate parity (UIP), which is assumed to determine the short-term (cyclical) behavior of the exchange rate.

10. To see how the model works, let us express UIP as follows:

$$E_t(e_{t+1}) - e_t = i_t - i_t^*, \tag{3}$$

where $E_t(e_{t+1})$ denotes the expected value formed in period *t* of the nominal exchange rate in period *t*+1; e_t is the nominal exchange rate in period *t*, defined in terms of domestic currency per unit of foreign currency; and i_t and i_t^* refer to the domestic and foreign nominal interest rates, respectively. By subtracting the expected inflation differential from both sides, equation (3) can be rearranged to yield the observed real exchange rate (q_t) as a function of the expected real exchange rate $E_t(q_{t+1})$ and the current real interest rate differential ($T_t - r_t^*$). Assuming that the unobservable expected real exchange rate $E_t(q_{t+1})$ is determined solely by long-run economic fundamentals (Z_t), one can then estimate the BEER (q_t^{BEER}) by making use of its functional relation-

[4] The authors selected the current account balance equal to 1 percent of GDP as the target because it was the stated objective of the U.S. administration during the Smithsonian discussions leading to a realignment of the central rates for major currencies in 1971.

ship to the vector of the chosen fundamentals and the real interest rate differential:

$$q_t^{BEER} = f(Z_t,\, r_t - r_t^*). \tag{4}$$

11. Several studies have applied the BEER approach in recent years, including Clark and MacDonald (1998); Koen and others (2001); Detken and others (2002); and Maeso-Fernandez, Osbat, and Schnatz (2002). Clark and MacDonald (1998), for example, used three variables as long-run economic fundamentals (Z_t): the terms of trade, the relative price of nontraded to traded goods (which captures the Balassa-Samuelson effect), and the balance of net foreign assets. These authors, however, modified UIP by adding a risk premium, which they assumed to be time-varying depending on the ratio of domestic to foreign government debt. Because the BEER uses the current values of economic fundamentals (without making a distinction between short-term and long-term equilibrium values), any identified exchange rate misalignment is often referred to as the *current* misalignment.

An extension of the BEER: the permanent equilibrium exchange rate (PEER)

12. A major weakness of the BEER is that it does not distinguish between the long-term and short-term values of economic fundamentals. An extension of the BEER that is based on the consideration of the long-run "sustainable" levels of economic fundamentals is called the PEER. Decomposing the real exchange rate into temporary and permanent components is a critical step in the PEER approach. The techniques introduced by Beveridge and Nelson (1981), Clarida and Gali (1994), Stock and Watson (1988), and Gonzalo and Granger (1995) are some of the tools that are frequently used in the PEER approach to make the decomposition. Under the PEER approach, the difference between the current real exchange rate and the estimated equilibrium real exchange rate is referred to as the *total* misalignment.

13. Comparing the BEER and the PEER in the context of estimating the real equilibrium effective exchange rate of the euro[5] for 1975–98, Maeso-Fernandez, Osbat, and Schnatz (2002) found that the PEER was smoother and less volatile than the BEER. Both the BEER and PEER approaches indicated that the euro was close to the equilibrium value in the 1970s and during the first half of the 1990s, but that it was undervalued in the first half of the 1980s. In contrast, Clark and MacDonald (2000), in estimating the equilibrium real effective exchange rates of the U.S. dollar, the Canadian dollar, and the U.K. pound, observed that the BEER and the PEER moved closely, implying that the temporary component was very small. These examples suggest that the BEER and PEER deviate from each other substantially only when economic fundamentals display considerable short-term variability.

[5]The "synthetic" euro was computed as a geometric weighted average of the EMU currencies.

The natural real exchange rate (NATREX)

14. The NATREX is defined as the exchange rate that would prevail if speculative and cyclical factors were removed while unemployment was at its natural rate (Stein, 1994; Allen, 1995). As a distinguishing feature, the NATREX approach explicitly considers exchange rate dynamics. In particular, it postulates that the real exchange rate, observed at time t, consists of the following three components:

$$\begin{aligned} q_t(k_t,F_t,\varepsilon_t{:}Z_t) = {} & \{(q_t(k_t,F_t,\varepsilon_t{:}Z_t) - q(k_t,F_t{:}Z_t))\} \\ & + \{q(k_t,F_t{:}Z_t) - q^*(Z_t)\} + \{q^*(Z_t)\}, \end{aligned} \tag{5}$$

where k is the stock of capital, F is the stock of external debt, ε is a random error (which is assumed to capture speculative forces), and Z is a vector of fundamentals. The first term on the right-hand side represents the deviation of the current (short-term) exchange rate from the medium-term value; the second term denotes the deviation of the medium-term real exchange rate from the long-term equilibrium value; the last term is the long-term equilibrium exchange rate that is determined solely by economic fundamentals, which are defined as productivity and time preference (or "social thrift") at home and abroad.

15. The NATREX corresponds to the medium-term real exchange rate, given by $q = q(k_t, F_t{:}Z_t)$. Unlike the short-term rate, it is independent of speculative factors; it is, however, specific to the given stocks of capital and debt. In contrast, the long-term real exchange rate is represented by $q^* = q^*(Z_t)$. This is the rate that materializes when the stock of capital and the stock of debt converge to their steady-state values consistent with the prevailing economic fundamentals. The fundamentals are the only exogenous variables in the long run.[6] The fundamentals, however, may not be stationary. They can also change, thus affecting not only the levels of desired investment, saving, and the current account, but also the trajectory of the NATREX by bringing about changes in capital formation, the rate of debt accumulation, and the interest rate.

16. In considering the determination of the medium-term real exchange rate, the NATREX approach pays particular attention to investment, saving, long-term

[6]In a large economy, the only exogenous variables are shocks to productivity and time preference. In a small economy, however, there are additional exogenous variables, including the terms of trade and the world interest rate.

capital flows, and the resulting changes in the stocks of real physical capital, wealth, and net debt to foreigners. In the hypothetical medium run, it is assumed that prices have adjusted, output has returned to its potential level, and desired national investment equals desired national saving, which depends on the stocks of capital, wealth, and debt. To the extent that these stocks change, the NATREX is a moving equilibrium. The architects of this approach claim that the NATREX is "an artificial construct" toward which the actual exchange rate tends to adjust. It is not observable, and it "never actually prevails" (Allen, 1995).

17. The empirical application of the NATREX approach is much simpler than the theory implies and, as stated earlier, is often indistinguishable from the BEER approach. The NATREX is estimated by identifying a long-run cointegrating relationship between the real exchange rate and a set of fundamentals (usually productivity and time preference), for which appropriate proxies are selected; an error correction term is included to capture the trajectory of the real exchange rate toward the NATREX. In actual estimation, no distinction is made between the medium run and the long run, because the fundamentals never obtain their steady-state values. The theory is then used to explain why the real exchange rate has moved in a certain way and to predict how it might yet change over time. For example, a medium-term appreciation of the real exchange rate might be consistent with a rise in government expenditure, which raises aggregate demand and worsens the current account position. The theory then suggests that a *depreciation* of the real exchange rate is needed to stabilize the balance of net foreign assets in the longer run.

Comparing Alternative Concepts of Equilibrium Exchange Rate

18. The major advantage of these equilibrium exchange rate models over the simple PPP framework is that they all relax the assumption of static equilibrium and allow the equilibrium exchange rate to change as economic fundamentals change. These frameworks have provided policymakers with a tool to assess the level of exchange rates in terms of specific policy objectives—such as internal or external balance. Each has its strengths and possible weaknesses.

19. A key policy question the FEER approach is designed to address concerns how much the domestic currency is misaligned relative to its medium-term equilibrium value consistent with external balance (e.g., Akram (2003) for the Norwegian krone). The FEER can also be calibrated to work under an explicitly multilateral setting. Coudert and Couharde (2005), for example, have investigated the possible misalignment of the Chinese renminbi and how its correction might impact the U.S. current account deficit.

20. The FEER approach, however, has some limitations. First, it does not specify how the exchange rate moves from the current level to the long-term equilibrium rate. In this context, Bayoumi and others (1994) and MacDonald (2000) noted the possibility that different equilibrium values might correspond to different dynamic adjustment paths, such that there is a "hysteresis" effect in the real exchange rate. For example, depreciation could improve the current account balance and net foreign asset position of a country in the short run but, given the country's medium-term capital accumulation, could imply a subsequent appreciation. Such exchange rate behavior may be dictated entirely by hysteresis and may not have much to do with the fundamentals specified by the FEER approach.

21. Second, another limitation of the FEER approach comes from its focus on the long run. Because the FEER approach removes speculative capital flows from the medium-term capital account, it is difficult to account for the impact of short-run changes in the interest parity condition on the dynamic path of adjustment toward the FEER. By its very nature, the FEER approach assumes that the interest rate remains at the long-run equilibrium level, implying severe restrictions on how monetary policy can be modeled.[7]

22. Finally, the long-run estimates are critically sensitive to how the trade elasticities are estimated (MacDonald, 2000; and Driver and Wren-Lewis, 1999). It is well known that most empirical studies estimate the trade elasticities to be very low (Goldstein and Khan, 1985), but use of such an elasticity estimate may in practice lead to an inaccurate projection of the FEER trajectory. The vulnerability of long-run estimates to trade elasticity estimates, however, is not specific to the FEER but is common to all empirical exchange rate models that are based on the notion of macroeconomic (or external) balance.

23. Unlike the FEER, the BEER (or PEER) and the NATREX take account of the impact of exchange rate changes over the adjustment path. The BEER attempts to capture the sources of changes in the capital account that may also affect the current account and the "behavior" of the exchange rate itself. This may be especially important for countries that are experiencing substantial variation in short-term fundamentals (for relatively stable economies operating in the neighborhood of internal and external balance, the BEER would converge toward the FEER). For this reason, policymakers in several developing countries have used the BEER to assess the appropriateness of

[7]It is a complex task to make distinction between the structural and speculative components of capital flows. Standard approaches have relied on alternative econometric techniques to decompose a time-series variable into a temporary (or speculative) and permanent components.

exchange rate levels. In considering the cases of Estonia and Botswana, for example, the BEER methodology allowed Hinnosaar, Kaadu, and Uusküla (2005), and Iimi (2006), respectively, to analyze the dynamics of exchange rate behavior.

24. At the same time, the BEER approach relies critically on the assumption that the stable long-run relationship can be derived from historical data. This makes use of the BEER approach difficult for countries that have undergone substantial structural change or for which longer-term data are not available. The sensitivity of estimates to the choice of data is a common problem for all empirical equilibrium exchange rate models, but this problem may be more serious for the BEER approach because it is an entirely empirical model in which no structure (such as long-run macroeconomic balance) is imposed. As a result, in the presence of sustained misalignment, time-series techniques may yield misleading results. One possible way to get around this problem is to estimate equilibrium relationships within a cross-country panel framework, so as to incorporate a wider range of country experiences (though at the risk of making country-specific inferences more difficult). As another drawback, no theory guides the choice of fundamental variables in the BEER approach.

25. When a longer time horizon is involved, the question of dynamic exchange rate adjustment may be best addressed by the NATREX approach. As explained in the previous section, the NATREX model allows us to consider the determination of the real exchange rate in terms of short-term, medium-term, and long-term factors. The NATREX converges to a static long-term rate only when there are no changes in the stocks of capital and debt. It is for this reason that a number of recent studies have applied the NATREX approach to analyze the long-term implications of monetary and exchange rate policies in the context of crisis vulnerability in Asia or economic integration in Europe (e.g., see Rajan and Siregar (2002) for an analysis of the pre- and post-crisis misalignments of the Hong Kong dollar and the Singapore dollar;[8] and Stein (2002) on the impact of EU expansion on the equilibrium real exchange rate).[9]

26. While these equilibrium exchange rate models have been used to address a number of policy questions, none claims to be perfect. Given the particular orientation of each approach, it has increasingly become standard practice in the literature to use multiple methods and to interpret each result carefully by taking into consideration the structures and assumptions of each model as well as the country-specific circumstances. Those recent studies that have applied multiple approaches include Husted and MacDonald (1998 and 1999); Rajan and Siregar (2002); Rajan, Sen, and Siregar (2004); Lim (2000 and 2002); and Montiel (1997). These studies have used different combinations of the BEER, PEER, NATREX, and other methods to assess the misalignment of currencies against the U.S. dollar, the euro, or the yen.

The IMF's Approach to Exchange Rate Assessment: The CGER

27. In 1995, the Consultative Group on Exchange Rate Issues (CGER), an interdepartmental working group, was established within the IMF to strengthen its capacity to assess the current account positions and exchange rate levels of major countries.[10] Extending the notion of macroeconomic balance, the CGER approach added global consistency in an explicitly multilateral framework. More recently, the CGER added another pillar of exchange rate assessment, namely, a cross-country application of a reduced-form exchange rate equation, called the adjusted PPP approach.[11] Although this is similar to an application of the BEER model, the rest of this discussion continues to call it the adjusted PPP approach (in line with IMF terminology) in order to emphasize its multilateral orientation designed to ensure global consistency.[12] Although the CGER exercise is being extended to include a number of emerging market economies with updated methodologies,[13] this section discusses the CGER framework (and its estimates) as used during 2000–05.

[8]Rajan and Siregar (2002) argue that the exchange rate regimes of Hong Kong SAR and Singapore performed equally well in the precrisis period but Singapore's more flexible exchange rate policy performed better than Hong Kong SAR's currency board in the postcrisis period. See Rajan, Sen, and Siregar (2004) for a similar analysis of Thailand.

[9]Other studies estimated the trajectory of the exchange rate from the medium-term to long-term equilibrium position in selected European countries (e.g., Crouhy-Veyrac and Saint Marc, 1995; Detken and Marin-Martinez, 2001; Federici and Gandolfo, 2002; and Detken and others, 2002).

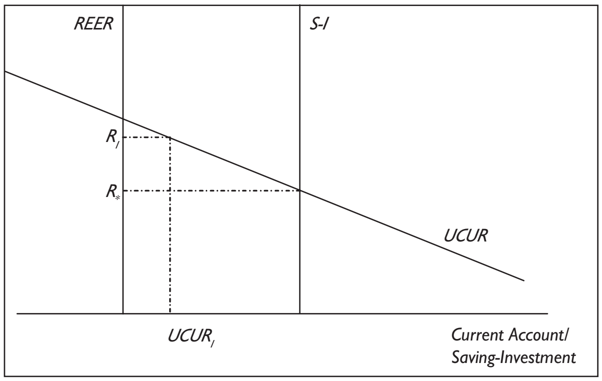
[10]The original name was *Coordinating* Group on Exchange Rate Issues.

[11]Prior to 2003, the adjusted PPP approach used the deviations of real multilateral exchange rates from trend to estimate an equilibrium exchange rate. The approach now allows productivity differentials, net foreign assets, terms of trade changes, and the like. Although this is called the reduced-form equilibrium real exchange rate approach, we refer to it here as the adjusted PPP approach without distinguishing between the pre-2003 and post-2003 methodologies.

[12]The adjusted PPP approach has also been applied to single countries. In such cases, unlike most applications of the BEER approach, but similar to the CGER version, it uses the actual (as opposed to long-run) values of the explanatory variables, which generally do not go beyond the terms of trade, relative productivity, and net foreign assets.

[13]The extended CGER exercise consists of three complementary approaches: (1) macroeconomic balance; (2) equilibrium real exchange rate (or adjusted PPP); and (3) external sustainability. For details, see "Methodology for CGER Exchange Rate Assessments," SM/06/283, August 2006.

Figure A3.1. The Underlying Current Account Position and the Saving-Investment Balance



Source: Isard and others (2001).

The CGER framework

28. As one of the two pillars of the CGER exercise, the macroeconomic balance approach is based on the concept of equilibrium that is similar to that of the FEER, that is, the achievement of internal and external balance.[14] Internal balance means full employment with stable prices, while the notion of external balance relates to the link between the current account and the saving-investment balance, as follows:

$$S - I = CA = X - M. \quad (6)$$

The key objective of the CGER macroeconomic balance model is to assess whether the outlook for the underlying current account (*UCUR*) position, captured by the net trade balance ($X–M$) at the prevailing exchange rate, is consistent with the "normal" or equilibrium saving-investment balance ($S–I$). If the current account position corresponds to the equilibrium saving-investment balance, the prevailing exchange rate is the "medium-term" equilibrium exchange rate. Otherwise, there is a possible misalignment of the currency.

29. This CGER framework can be depicted in a simple diagram (Figure A3.1). The *UCUR* line slopes downward, indicating that the current account position improves when the domestic currency depreciates (captured by a lower real effective exchange rate level). The slope of *UCUR* also reflects the degree of economic openness. Countries with a high ratio of exports and imports to GDP should have a relatively flat *UCUR* line, indicating that a small percentage change in the real effective exchange rate can bring about a large change in the underlying current account position.

30. The medium-term saving-investment balance (S-I), on the other hand, is not a direct function of the real effective exchange rate. If the economy is at R_1, the underlying current account position is less than the saving-investment balance position. The real effective exchange rate then must depreciate to R^* in order to improve the current account position to the medium-term equilibrium level. In other words, given the current economic fundamentals, the prevailing real effective exchange rate is overvalued, and is expected to depreciate to R^*. In addition, driven by shocks to their fundamental variables, both the *UCUR* line and the S-I line may shift to the right or the left.

The CGER estimation

31. Four steps are involved in calculating the medium-term misalignment of a currency. The first step is to estimate the *underlying* current account (*UCUR*) position that would emerge at the prevailing exchange rate if all countries were producing at their potential output levels and the lagged effects of past exchange rate changes had been fully realized. Here, we focus on the right-hand side of equation (6).

32. As an estimate of *UCUR*, the CGER uses forecasts obtained from the *World Economic Outlook* (*WEO*) exercise. For most countries, the *WEO* forecasts the underlying current account balances by assuming that the real exchange rate will remain unchanged and that the economy will be operating at potential output at the end of the five-year *WEO* horizon. The primary advantage of the *WEO* approach is that it incorporates the country-specific knowledge and judgments of the IMF's area department staff.

33. Once the underlying current account is obtained, the second step involves generating the "medium-term" equilibrium saving-investment balance or "norm." Two alternative estimating approaches are used. First, the saving-investment balance is regressed against a set of commonly considered fundamental determinants over a number of years. The fundamental determinants for industrial countries include fiscal balance, income per capita, output gap, and a demographic factor. For the developing economies, a more extensive set of fundamental variables is considered (see Chinn and Prasad, 2003). The estimated regression coefficients would yield the average medium-term equilibrium saving-investment balance. Second, as an alternative method, the "norm" saving-investment balance is obtained by estimating the current account balance required to maintain a constant ratio of net foreign liabilities to GDP.

34. The third step is to calculate how much the exchange rate would have to change, other things remaining unchanged, in order to equilibrate the underlying current account to the medium-term equilibrium

[14]In highlighting the key features of the CGER macroeconomic balance approach, we rely on Isard and Faruqee (1998) and Isard and others (2001).

saving-investment balance. Incorporating the coefficient estimates from the first two steps, a globally consistent framework is used to calculate the required changes in the multilateral or bilateral exchange rate.

35. The last step involves comparing the results with those from the adjusted PPP approach which has also been applied multilaterally by using panel data. The staff then use subjective judgment to assess whether or not the currency is misaligned and the extent of misalignment when identified. Considerable uncertainty surrounds the estimates of the CGER or any other equilibrium exchange rate models. If there is a large discrepancy between the results obtained from the competing approaches, a range of values is provided for the potential deviation of the currency from the equilibrium level.

Features of the CGER approach

36. Undoubtedly, the single most important advantage of the CGER approach over other equilibrium exchange rate models in the literature is its explicitly multilateral character, which imposes global consistency. At the same time, the multilateral orientation comes with a cost, because it becomes more difficult to understand how a particular result is being generated. There is considerable uncertainty about the estimates generated from any equilibrium exchange rate model. But given the additional multilateral layer, uncertainty is likely greater in the CGER approach.

37. Some limitations of the CGER exercise are well known (Isard and others, 2001). First, the CGER exercise, unlike the NATREX model, is not explicit about the dynamics of exchange rate adjustment from the current value to the longer-term equilibrium. Second, the CGER exercise, given its global orientation, does not consider country-specific factors. The limitations are true of both the macroeconomic balance approach and the adjusted PPP approach, both of which rely on the cross-country estimates generated from panel data regression (which render the estimated relationship an average relationship across countries).[15]

38. Third, the CGER's macroeconomic balance model assumes that countries have unlimited access to international capital markets at a constant premium over the world interest rate, which may become a particularly serious problem in estimating a medium- to long-term equilibrium exchange rate for an emerging market economy. Fourth, the assumption that the "norm" saving-investment balance is independent of the current exchange rate is also restrictive, especially for emerging market economies.[16] Fifth, the underlying model assumes that, for the purpose of estimating the size of possible misalignment, the real exchange rate is the only mechanism to bring about current account adjustment. This may create upward bias in the required real exchange rate change because other variables are likely to change in practice to facilitate the adjustment.

39. Isard and others (2001) noted that, as is typically the case with most applications of the FEER-type model, the estimates of the macroeconomic balance model are quite sensitive to small changes in the assumptions. This means that there is considerable uncertainty about the confidence with which one can assess the degree of misalignment of a currency. As the architects of this approach suggest, one would need to exercise judgment in coming to a particular assessment. This is true of all equilibrium exchange rate models, but the sensitivity associated with the CGER's macroeconomic model calls for caution, a point being addressed in part by the complementary use of two alternative methodologies by the exercise.

40. Given not only the limited sample size but also the nature of the exercise, it is not possible to conduct rigorous statistical tests of the CGER estimates.[17] The available evidence, however, suggests that the application of the CGER approach has sometimes yielded a widely divergent set of estimates. A look at the time-series of selected CGER results indicates that the range of estimates for a given currency for a given year can be large in terms of deviation from the equilibrium value, and that the range has increased sharply from around 2004 for most currencies (see Figure A3.2 for examples).[18] Moreover, it has occasionally been observed that the two methodologies can indicate misalignment in two opposite directions (e.g., one showing undervaluation, while the other indicating overvaluation) and that the CGER estimates

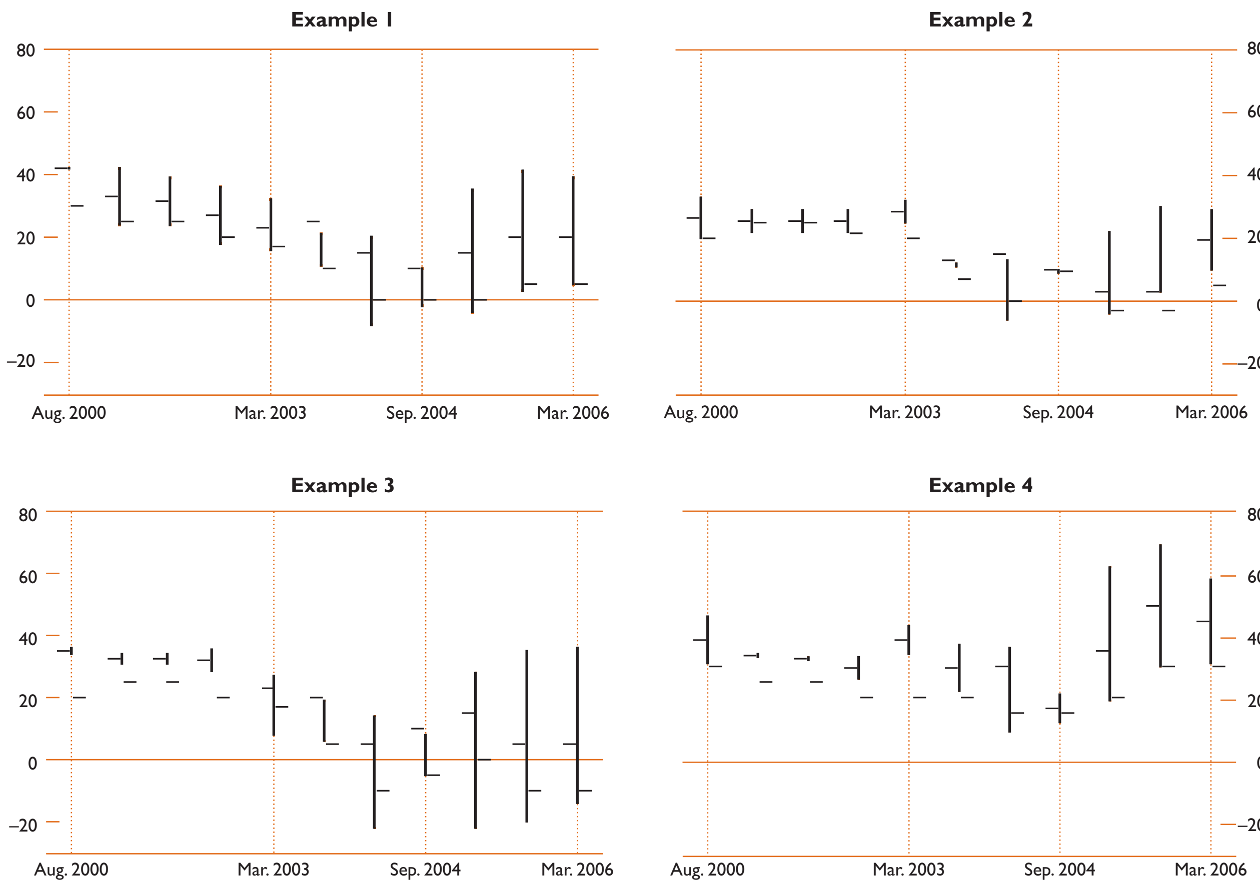
[15]Use of common parameter estimates conceals the heterogeneity of different countries, which may be important in constructing the estimates of bilateral exchange rates.

[16]The cost of capital is highly influenced by expectations about the medium-term exchange rate, which in turn is also influenced by the current exchange rate.

[17]First, the CGER estimates are only available from 1997 for the United States and Japan and from 2000 for other industrial countries. Second, because the estimates have no explicit time dimension, there is no reasonable basis for comparing them with realized future values. In other words, it would not be possible to say whether a particular CGER estimate was right or wrong in the sense of predicting the actual future exchange rate, even if much longer time-series data were available.

[18]The limits indicated by a bar in the figure correspond to the estimates given by the macroeconomic balance and adjusted PPP approaches. The final CGER assessment, as stated by the Research Department, is indicated by (right and left) ticks in the figure, which are always within the overall limits. When the final judgment involves a point estimate (such as "around 10 percent") rather than a range, it is assumed that the implicit range is 5 percent (e.g., "between 7 percent and 12 percent"), subject to the restriction that an end of the range cannot exceed the overall limit.

Figure A3.2. Examples of CGER Estimates, 2000–06
(In terms of percentage deviation from medium-term equilibrium levels)



Note: The limits indicated by a vertical bar correspond to the CGER estimates produced by the two approaches for each year. Each bar has (left and right) ticks that correspond to the final CGER assessment.

even missed the direction of prospective exchange rate movements altogether.

41. The fact that the sets of CGER estimates have sometimes been widely divergent from each other (or even missed the prospective currency movement) does not by itself render them useless. After all, it is well known that exchange rates can deviate substantially from their long-term fundamental values in the short run. The CGER is not a forecasting exercise and does not claim to trace the short-term currency movements. Even so, these factors may explain the skepticism that exists among some IMF staff[19] and the (appropriate) judiciousness with which area department economists have applied the CGER estimates in their country work.

Equilibrium Models in IMF Surveillance: A Review of Country Reports, 2000–05

Exchange rate level assessments

42. The IEO's review of the two most recent Article IV consultation reports for all members through 2005,[20] supplemented by a screening of the remaining staff reports and accompanying selected issues papers for the period 2000–05,[21] indicates REER indices have been the main tool of exchange rate level assessment in IMF surveillance: REER charts were included in all Article IV reports reviewed and, in most cases, there was at least a brief commentary on the movements of

[19]According to the IEO survey of IMF staff, about 30 percent of those who have worked on CGER-covered countries responded that they viewed the exercise as of little usefulness (though 40 percent considered it useful). For details, see Background Document 6 (Figure A6.26).

[20]See Background Document 4 for details.

[21]The cut-off date for staff documents was December 31, 2005. In the case of program countries, the relevant program documents were also reviewed.

Table A3.1. Use of Multiple Methods in the Assessment of Exchange Rate Levels by the IMF, 2000–05

	Number of Methods			
Year	1	2	3	Number of Countries
2000	14	0	0	14
2001	15	2	0	17
2002	21	2	0	23
2003	12	6	0	18
2004	22	3	1	26
2005	16	7	2	25

Note: Based on staff papers and related documents *issued* between January 2000 and December 2005. The coverage thus differs slightly from the review of country documents presented in Background Document 4. See Annex A3.1 for details.

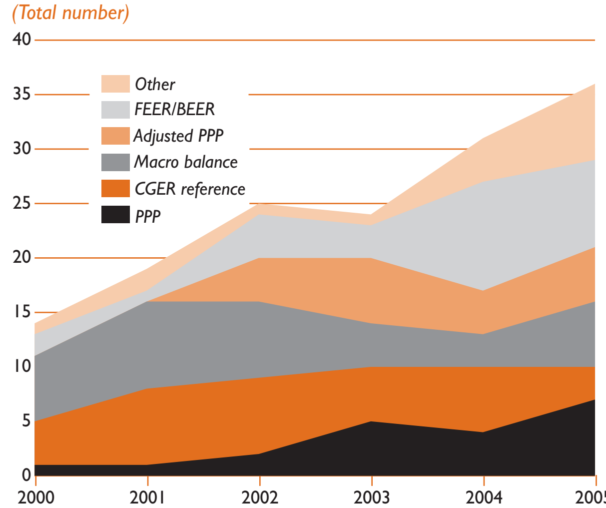
the REERs. Going beyond the REER charts, IMF staff provided additional exchange rate level analysis for up to 14 percent of the Fund membership in any given year since 2000 (see Table A3.1 and Figure A3.3). The documents covering the remaining countries did not explicitly use quantitative approaches to estimate the equilibrium exchange rate. A few of the documents, however, cited the findings of separate analyses, including the IMF's own working papers, central bank studies, and periodic reports of investment banks, in making exchange rate level assessments.[22]

43. Besides the ubiquitous REER charts, the most commonly applied tools were the simple PPP approach and the adjusted (or augmented) PPP approach; the latter was usually used as part of a CGER exercise. The estimates from the CGER approach were frequently reported, particularly in most discussions of the currencies of industrial countries, but also increasingly in the case of some emerging and developing countries. Among the equilibrium exchange rate models that were reviewed in the section "Alternative Approaches to Modeling the Equilibrium Exchange Rate" above, the BEER and its variants appear to be the most frequently employed by the IMF staff, particularly for the currencies of emerging market economies. A test of long-run cointegration between the real effective exchange rate and a selected set of fundamentals is usually carried out to estimate the equilibrium exchange rate and the degree of misalignment. In some cases, an error correction term is added to explain the short-term deviation of the exchange rate from its equilibrium value.

44. For example, IMF staff used a BEER model to assess the level of the Tanzania shilling in 2002 (supplemented by the PPP approach) as well as in 2004. The staff specified the BEER as a function of the terms of trade, productivity, government consumption, trade openness, and foreign capital flows and concluded that the shilling, slightly overvalued at end-2001, gradually moved toward equilibrium and, by 2003, was broadly in line with the equilibrium level. For Madagascar in 2005, IMF staff used both FEER and BEER models. The staff specified the long-run FEER in terms of three fundamentals: productivity, net wealth, and the terms of trade, and considered that shocks to these fundamentals and the stance of monetary and fiscal policies determined the deviation of the actual real exchange rate from the FEER. In this framework, the BEER was estimated as the sum of the FEER and the deviation explained by the nonfundamental variables. Based on data for 1980–2003, the staff concluded that, at the end of 2004, the real effective exchange rate of the Malagasy franc was below both the FEER (by about 20 percent) and the BEER (by about 27 percent). For Hungary in 2004, the staff specified the equilibrium real exchange rate as a function of net

Figure A3.3. Methodologies Used in the IMF's Exchange Rate Level Assessment, 2000–05

(Total number)



Note: See Annex A3.1 for details.

[22]Examples include the 2005 Article IV consultations for Singapore and the Czech Republic.

foreign assets and industrial sector productivity,[23] and used this model to conclude that the Hungarian forint, undervalued in the second half of the 1990s, became overvalued in the early 2000s but returned to its equilibrium level in late 2003.[24]

45. Figure A3.3 indicates that, regardless of which methodology was used, use of quantitative models in the IMF's exchange rate surveillance has increased over the period. The increasing sophistication of exchange rate level assessments by the IMF staff has largely reflected the greater use of the PPP or adjusted PPP approach and the FEER/BEER methodologies. On the other hand, there has been little change in the frequency of references to CGER estimates or use of macroeconomic balance approaches (other than the FEER).[25] A closer look indicates that the use of multiple methods has increased somewhat over the years, though it remains rather limited in absolute terms (see Table A3.1).

The characteristics of the IMF's exchange rate level assessment

46. The IMF's country documents reviewed here differ widely in their quality, rigor, and comprehensiveness of analysis. In most cases, the IMF's exchange rate level assessment primarily attempts to identify evidence of improvement or deterioration in competitiveness on the basis of consumer-price-index-based REERs or, in a few cases, other REER indices (such as those adjusted for relative normalized unit labor costs). In a subset of these cases, the staff also attempt to establish how much, if any, the currency concerned is misaligned. In general, assessment is made in terms of a trade-weighted effective exchange rate. Only in rare cases is the level assessed in terms of a bilateral exchange rate against the U.S. dollar, the euro, or some other major currency.[26] With some notable exceptions,[27] country documents generally do not explain the causes of the misalignment when identified.

47. IMF staff, in using equilibrium exchange rate models, has selected a wide range of long-term economic fundamentals to determine the equilibrium exchange rate, often reflecting its understanding of the country-specific conditions. Among others, the following three factors have most frequently been selected in the construction of equilibrium exchange rate models.

- The Balassa-Samuelson effect, which has been found relevant in explaining exchange rate behavior in emerging market economies that are growing faster than their main trading partners.[28] Reliable data, however, are often not available.
- The terms of trade, which are often associated with supply-side shocks. A rise in the world prices for key export commodities, for example, has been found to improve the terms of trade and in turn appreciate the currency.[29]
- The role of wealth or access to international capital markets. Such factors have been found to influence the exchange rate, particularly in a highly indebted developing country.

In addition, the staff has selected such short-term factors as cyclical measures of monetary and fiscal policy and changes in net international reserves. Exchange rate regime and trade openness have extensively been considered as structural determinants.

48. When estimates from CGER or other macroeconomic balance applications are reported, the accompanying analysis tends to share the following characteristics:

(1) There is only a limited discussion of fundamental factors or specific policy issues.

(2) There is a trade-off between achieving global consistency and accounting for country-specific economic conditions.[30] For such countries as Canada, New Zealand, and Norway, the staff noted that failure to take account of key com-

[23]Although the staff argued that the first variable is associated with "external equilibrium" (and the second with "internal equilibrium"), the model does not define the equilibrium exchange rate in terms of a sustainable balance of payments position. For this reason, we consider this specification to be a BEER/PEER model broadly defined, and not a FEER model. This judgment is reflected in Figure A3.3.

[24]In contrast, in 2005, the staff applied an entirely different approach (that does not fall under any of the equilibrium exchange rate models considered in the section "Alternative Approaches to Modeling the Equilibrium Exchange Rate") to the Slovak Republic, another transition economy in similar circumstances. Focusing on the role of productivity in real exchange rate determination, the staff concluded that, though the koruna's equilibrium rate would be expected to appreciate by about 3 percent a year (in line with expected productivity growth relative to the euro area), this could be mitigated somewhat by fiscal consolidation.

[25]It is often the case that staff, in reporting its estimates of equilibrium exchange rates, did not explicitly spell out the specification of the underlying models. When the staff refer real to the macroeconomic balance identity ($S-I = CA$)—equation (6) in the text—but without specifying a FEER-like framework, the underlying model was considered as a macroeconomic balance approach.

[26]For example, such assessment was made for the Eastern Caribbean Currency Union, the Gulf Cooperation Council, and the euro area.

[27]Such country cases include Argentina, Malaysia, Russia, and South Africa.

[28]In the case of industrial countries, the Balassa-Samuelson effect may not be as relevant. In the selected issues paper for the 2001 Article IV consultation with the United Kingdom, for example, staff found another relative productivity term (manufacturing productivity vis-à-vis trading partners) to be a significant determinant of the real exchange rate.

[29]Notably, staff have considered the impact of oil prices on Yemen and Russia, and the impact of other commodity prices on Argentina and Kenya.

[30]See, for example, the staff reports for the Article IV consultations with Canada, Indonesia, Mexico, New Zealand, and Switzerland.

modity price developments was a weakness of the CGER exercise.[31] For Mexico, the staff noted that the macroeconomic balance approach failed to take into account the impact of several structural reforms.

(3) Estimates are sensitive to key parameters, including trade elasticities and the saving-investment norm.[32] The documents for China and Egypt, for instance, show that the results from the macroeconomic balance approach critically depend on which methodology is used to estimate the medium-term saving-investment balance.[33]

49. Often the discussion of misalignment is disconnected from the empirical analysis presented in the same document. For example, the fundamental determinants used to estimate the equilibrium exchange rate may not form part of the discussion on misalignment. Several factors seem to contribute to this outcome:

- The exchange rate assessment is focused on identifying the degree of any misalignment.
- Data limitations and the resulting lack of confidence in the estimates obtained mean that any identified misalignment is therefore subject to considerable uncertainty.
- As noted before, the choice of some models (such as the CGER methodology) is not amenable to country-specific policy analysis.

As a result, the reported estimates serve only as a point of reference for policy discussions.

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[31]This may explain why only one reference to the CGER estimate is found in the staff reports for Article IV consultations with Norway over the sample period (in 2005).

[32]See, for example, the staff reports and selected issues papers for Article IV consultations with Brazil, China, Egypt, and Indonesia.

[33]In the case of China, for example, if the medium-term equilibrium saving-investment balance was estimated in terms of structural macroeconomic balance relationships (Chinn and Prasad, 2003), depreciation was found necessary to run a larger current account surplus. In contrast, if the equilibrium saving-investment balance was chosen so as to maintain the ratio of net foreign liabilities to GDP constant, appreciation of the currency was found necessary to reduce the current account surplus.

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Annex A3.1

Methodologies Used in IMF Exchange Rate Level Assessment, 2000–05

	Reference to CGER Estimates	Adjusted PPP	PPP	FEER	Other Macro Balance	BEER	Other Approaches	Reference to External Studies
Algeria		2004						
Australia	2000, 2003, 2004	2002			2005		2001	2002
Bangladesh			2001					
Benin						2004		
Brazil		2003			2003			
Bulgaria			2000, 2003					
Canada	2001, 2002	2004						2003
CEMAC			2005			2005		
China		2003–2005			2003–2005		2004	2005
Congo, Republic of			2002					
Costa Rica						2004		
Cyprus			2005		2000			2005
Czech Republic							2005x2	2004
Denmark	2002							
Dominican Republic		2003						
ECCU						2004		
Egypt		2002			2002			2002
Estonia			2003			2003		2004
Euro area	2000, 2001, 2003, 2004				2002			
Germany			2004	2004	2002			
Greece		2003			2003			
Guinea						2005		
Hong Kong SAR	2004							
Hungary					2003	2004		
Iceland					2001			
India					2000, 2001			2005
Indonesia					2001, 2002	2005		
Japan	2000, 2002–05							
Kazakhstan		2005						
Kenya						2004		
Korea					2001, 2002			
Latvia			2003, 2004			2003		2004
Lithuania			2003			2003		
Madagascar				2005		2002, 2005		
Malawi						2002		
Malaysia		2005			2000, 2001, 2005		2001, 2003, 2004	
Mali						2005		
Malta								2005
Mauritius					2005			
Mexico					2001			2002
Moldova			2005				2005x2	
Morocco			2005		2000		2005	
Mozambique						2000		
New Zealand	2001–2003				2005			2001
Norway	2005		2005					
Pakistan			2005					
Paraguay						2004		
Romania		2002						
Russia	2003	2005		2001				
São Tomé and Príncipe						2000		
Singapore				2000, 2001			2005	
Slovak Republic						2005		
South Africa					2002, 2005			
Spain	2001							

Annex A3.1 *(concluded)*

	Reference to CGER Estimates	Adjusted PPP	PPP	FEER	Other Macro Balance	BEER	Other Approaches	Reference to External Studies
Sri Lanka					2002			
Sweden		2004			2004			2003
Switzerland		2005		2004, 2005	2005			
Tanzania			2002			2002, 2004		
Thailand	2002							
Tonga					2000			
Tunisia		2002						
Turkey					2004		2002	2002
Uganda						2004		
Ukraine			2004				2004	2004
United Kingdom	2000–02, 2004–05					2001		2000, 2002
United States	2000, 2001–04		2003					
Uruguay		2005						
Venezuela, República Bolivariana de					2002			
Vietnam		2003						
WAEMU		2004						
Zambia							2004	
Zimbabwe						2000	2005	

Note: Based on IEO judgments (the cut-off date for the screening of staff documents was December 31, 2005); in some cases the IEO classification differs from that used by IMF area department staff.

BACKGROUND DOCUMENT 4

Characteristics of IMF Exchange Rate Surveillance: A Full Review of Country Documents

1. This background document describes how exchange rate issues were treated in the last two Article IV consultations of the 1999–2005 period.[1] For this purpose, the IEO reviewed the following Article IV consultation-related documents:

- Staff reports;[2]
- Those selected issues papers, finalized between 2001 and mid-2006, that primarily addressed exchange-rate-related issues;
- Briefing papers and back-to-office reports;
- In the case of program countries, staff reports, briefing papers, and back-to-office reports for use of Fund resources missions that fall in the same period; and
- Other documents, including comments received from departments and management on draft papers.

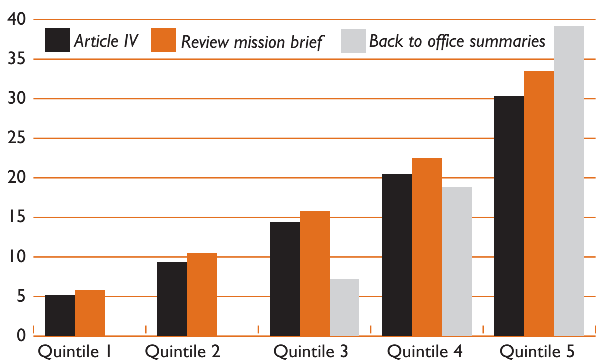
2. In addition to the documents on member countries, the IEO also reviewed the corresponding documents for Aruba—Kingdom of the Netherlands, Hong Kong SAR, Macao SAR, Netherlands Antilles, and West Bank and Gaza, as well as for the Central African Monetary and Economic Union (CEMAC), Eastern Caribbean Currency Union (ECCU), euro area, and West African Economic and Monetary Union (WAEMU). All in all, the assessment included a total of 191 economies.[3] The data sets (constructed as the responses to standard questions) compiled from the review are attached as annexes to this background document.

Coverage of Exchange Rate Issues

3. Every Article IV staff report and mission brief mentioned exchange rates, but the extent of coverage varied (Figure A4.1). Consistent with the standard template, the staff reports always described the exchange rate arrangement in a policy discussion section as well as in an appendix; they often devoted one or more paragraphs to the exchange rate in sections describing economic developments and outlook, as well as in the staff appraisal. The number of paragraphs in staff reports referring to exchange rate issues ranged from 3 percent to 50 percent of total. In contrast to the staff reports and mission briefs, the back-to-office summaries (which were sent to management) show an even greater variation in their treatment of exchange rate issues, because they are less template-driven and tend to highlight those points that the mission chief considers particularly important for management. Exchange rate issues were absent from the back-to-office summaries in 86 cases. Finally, IMF staff prepared at least one selected issues paper on exchange rate issues for 132 (out of the 191) economies during 2001 to mid-2006.

Figure A4.1. Exchange Rate Coverage Across Countries

(Percent of paragraphs)



[1]Most (but not all) of the missions took place in 2004 or 2005.

[2]The document of reference was the latest version of the Article IV report available (i.e., the published version for those that are published); these were then checked for corrections and/or deletions to confirm whether relevant changes had been made from earlier versions.

[3]The assessment excluded entities with which no Article IV consultation took place (Somalia and West Bank and Gaza), but included those for which only one consultation had been completed in recent years (Iraq and Grenada), as well as countries in the process of redefining their political and economic boundaries (Serbia and Montenegro).

Figure A4.2. Elements in Staff Exchange Rate Assessment
(Number of cases)

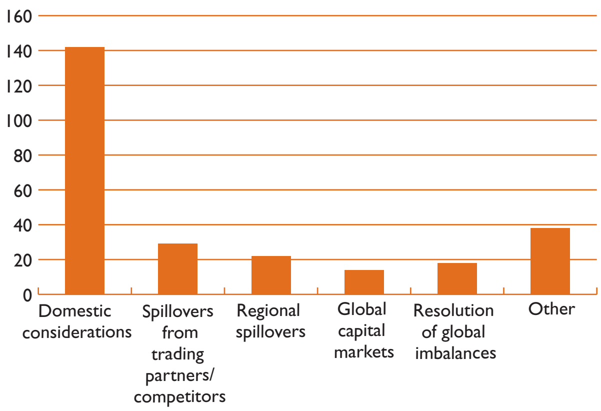
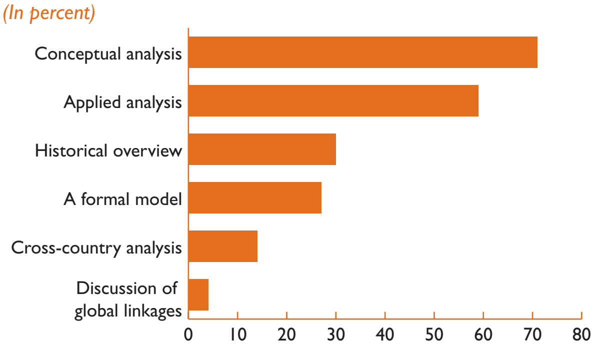


Figure A4.3. Elements in Selected Issues Papers, 2001–06
(In percent)



Content of Exchange Rate Coverage

4. In more than 100 cases,[4] competitiveness considerations prompted a discussion on exchange rate levels. For most of the IMF membership, the staff exchange rate assessments did not focus on spillover effects, global capital markets, or global imbalances (Figure A4.2). Especially for small countries with limited integration into global capital markets, the discussion of exchange rates limited itself to domestic considerations, such as the implications of the prevailing exchange rate regime for fiscal policy or the impact of exchange rate movements on domestic inflation and competitiveness.

5. In a majority of the country cases, the orientation of the exchange rate discussion was predominantly forward looking. For example, such discussion included projections or scenarios of possible exchange rate developments, with associated upside and downside risks to the economy. Only in two cases was the discussion exclusively backward looking. The discussion was frequently linked with other elements of macroeconomic policy, in many cases exploring either the likely implications of various domestic developments for the exchange rate or pointing out the implications of an exogenous exchange rate development for fiscal and monetary policy.

6. Similar patterns were observed in the selected issues papers. A large majority (about 70 percent) contained conceptual analysis that outlined a framework for thinking about the issue at hand (Figure A4.3). This was often linked to specific country circumstances through applied analysis (about 60 percent), in which staff presented empirical data to illustrate an issue or to support arguments. Formal models were used in about 30 percent of the cases. Literature surveys and historical overviews played supporting rather than central roles. The IEO review found only seven papers that contained neither conceptual nor applied analysis. It was, however, rare to find cross-country analysis in selected issues papers that dealt primarily with exchange rates, and in only 4 percent of the exchange-rate-related selected issues papers (11 papers, as listed in Table A4.1) was there a discussion of global linkages.[5]

Description of De Facto Exchange Rate Regimes

7. Eight categories of de facto exchange rate regimes were identified in Article IV documents. In at least 12 country cases (some 6 percent of the sample), the IEO found inconsistencies between MFD/MCM's de facto regime classifications and the descriptions provided in either the body of staff reports or their appendices on IMF relations (Table A4.2).[6] Over the period examined, the review noted changes to de facto exchange rate regimes in 15 countries (or about 8 percent of total).

Exchange Rate Advice

8. In about half of the country cases, the staff appraisal section of Article IV reports suggested that the

[4]In at least one of the two consultations reviewed.

[5]Several global-linkages-related selected issues papers for major countries, particularly the United States, did not focus directly on exchange rate policy. Such papers are not included in Table A4.1 or Figure A4.3.

[6]Of these 12 cases, 8 cases involve retroactive reclassification by MFD/MCM; in many of these, classification lags resulted from a difference of opinion about the appropriate regime classification between departments or between staff and the authorities.

Table A4.1. Global Linkages in Selected Issues Papers, 2001–06

Economy	Year	Paper Title	Description of Contents
Canada	2005	The Effects of U.S. Shocks on the Canadian Economy: Results from a Two-Country Model	Minimalist presentation that models spillovers
China	2003	Some Implications of China's Growth and Integration with the Global Economy	Sees no sign of misalignment, but links integration with global economy to need for flexibility
China	2006	Implications of Greater Exchange Rate Flexibility in China and Other Asian Emerging Market Economies	Summary of *World Economic Outlook*, GEM model for 5 percent appreciation scenario in China and Asian emerging markets (*WEO* 9/2005)
Euro area	2001	Why Has the Euro Been So Weak?	Explores theories, leans toward shift in portfolio behavior and surge in equity values
Euro area	2002	Euro Area Trade Flows and the Exchange Rate: How Much Disconnect?	Explores why current account did not strengthen during euro depreciation
Euro area	2003	Exchange-Rate Pass-Through and External Adjustment in the Euro Area	Thorough model-based empirical analysis of effects of exchange rate shock in Europe; cross-country comparison, discussion of global imbalances
Euro area	2004	Global Rebalancing of Current Accounts: A Euro-Area Perspective	Euro area should boost domestic demand, attract foreign capital, increase competitiveness through structural reform, ease monetary stance
Japan	2001	Japan and Asia: Policies and Prospects	G-Cubed regional model used to assess transmission of shocks and policies (including quantitative easing and yen depreciation) between Japan and neighbors
Japan	2005	The Domestic and Global Impact of Japan's Policies for Growth	Extended version of GEM model used to generate baseline plus two alternative scenarios assessing impact of fiscal, structural reforms on Japanese and world economies
Mexico	2003	Explanations for the Recent Behavior of the Mexican Peso	Surveys global exchange rate links. Cross-country analysis and policy shock of change in reserve management strategy
Thailand	2005	The Role of Interest Rates in Business Cycle Fluctuations in Emerging Countries: The Case of Thailand	Uses GEM to argue that more exchange rate flexibility helps economy to better absorb U.S. interest rate shocks

Table A4.2. Cases of Inconsistent De Facto Exchange Rate Regime Classifications

	Classification (2004–05)			
Economy	MFD/MCM classification[1]	Description from staff report[2]	Description from appendix on Fund relations[2]	Reference document
Argentina	Managed float	Peg	Managed float	2005 staff report
Azerbaijan	Peg[3]	Peg	Managed float	2004 staff report
Egypt	Peg[3]	Not explicit	Managed float	2005 staff report
Ethiopia	Managed float	Crawling peg	Managed float	2005 staff report
Iran, Islamic Republic of	Crawling peg[3]	Managed float	Managed float	2005 staff report
Liberia	Managed float[3]	Not explicit	Independent float	2005 staff report
Madagascar	Managed float[3]	Managed float	Independent float	2005 staff report
Nigeria	Managed float	Horizontal band	Managed float	2005 staff report
Pakistan	Peg[3]	Peg	Managed float	2005 staff report
Papua New Guinea	Managed float[3]	Independent float	Not explicit	2005 staff report
Tanzania	Independent float	Managed float	Not explicit	2004 staff report
Yemen	Managed float[3]	Not explicit	Independent float	2004 staff report

[1]IMF, Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) database, March 2006; regime classification corresponds to year of IMF staff report.

[2]As inferred by the IEO from the description in the text of the staff report or the appendix on Fund relations.

[3]De facto regime was retroactively reclassified by MFD/MCM; information in table thus differs from the classification published at the time.

Table A4.3. Exchange Rate Advice and Its Analytical Basis

(Number of cases)

Nature of Staff Advice	Number of Cases With/Without Staff Advice[1]	Regime Sustainability or Suitability Analyzed[2]	Formal Exchange Rate Level Analysis[3]	Currency Deemed Overvalued or Undervalued 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)
No specific advice	128	14	38	8 (4)

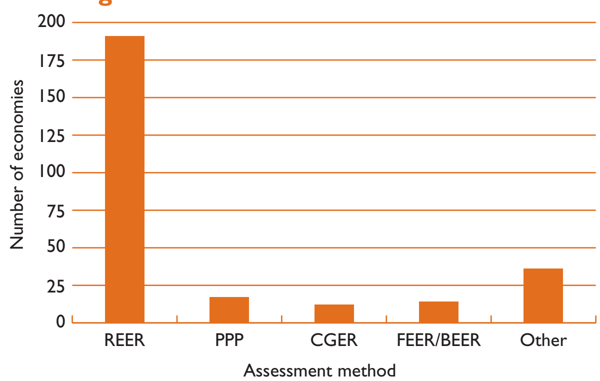
[1]Advice has been given to 63 economies overall (in 13 cases, advice on flexibility and management of the regime was given simultaneously), of which 2 were advanced economies, 10 were large emerging market economies, and 51 were other emerging market and developing economies.

[2]Based on tools such as optimum currency area criteria and analysis of economic shocks.

[3]Analysis of exchange rate level explicitly involved tools other than interpretation of real effective exchange rate charts.

exchange rate was a live policy issue. In 63 out of the 191 economies (about one-third of the sample), IMF staff provided country authorities with exchange rate advice, overwhelmingly in favor of greater exchange rate flexibility (Table A4.3). In part, advice for greater flexibility appeared to amount to advice for exchange rate adjustment.[7] Such advice was provided in 11 out of 19 cases (net of double counting) where the exchange rate was deemed overvalued, and in 10 out of 15 cases where the exchange rate was deemed undervalued. In about half of these cases, the IMF advice was not accompanied by formal analysis, either of exchange rate regime sustainability or appropriateness of the exchange rate level.

Figure A4.4. Analytical Tools Used to Assess Exchange Rate Levels



Analytical Basis for Exchange Rate Advice

9. A standard feature of every Article IV staff report is a plot of the real effective exchange rate (REER) index. It is rare, however, to use a more analytical tool of exchange rate level assessment, such as purchasing power parity (PPP), fundamental equilibrium exchange rate (FEER), and behavioral equilibrium exchange rate (BEER) models. In the Article IV staff reports for 191 economies, the IEO review found 17 cases of PPP-based econometric assessments, 12 cases citing the results of the regular CGER exercise,[8] 14 cases using FEER or BEER models, and 36 cases used other methods (Figure A4.4). Multiple methodologies were used in 15 cases, including for Germany, China, Malaysia, and the CEMAC.[9]

Topics in Selected Issues Papers

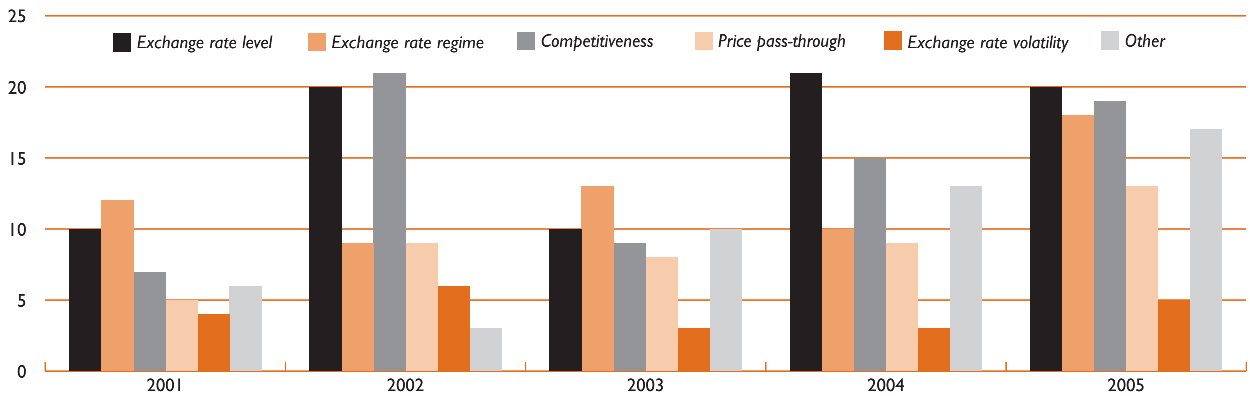
10. The most frequent topics in the selected issues papers reviewed were exchange rate level and competitiveness, followed closely by exchange rate regime; less attention was paid to considerations of exchange rate volatility, and exchange rate pass-through into inflation—possibly reflecting the absence of major inflation episodes in recent years (Figure A4.5). While the total number of selected issues papers on exchange-rate-related issues more than doubled

[7]A similar interpretation was suggested in a recent Board paper prepared by staff. See "Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking," EBS/06/107, August 2006, footnote 26.

[8]The Consultative Group on Exchange Rate Issues, an interdepartmental working group within the IMF, produces a semiannual report on the exchange rates of the euro area and 10 industrial countries. For greater details on the CGER exercise, see Background Document 3.

[9]See Background Document 3 for a more detailed analysis, though based on a slightly different coverage of country documents.

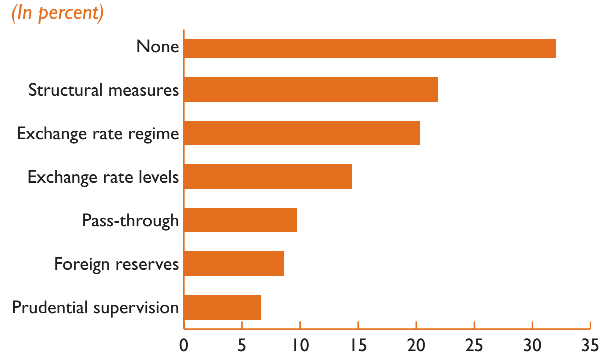
Figure A4.5. Exchange-Rate-Related Topics in Selected Issues Papers, 2001–05
(Number of cases)



between 2001 and 2005, the distribution of topics discussed did not change markedly.

11. Although selected issues papers are not meant to be the main vehicle for delivering policy recommendations, they drew policy inferences in about two-thirds of the cases (Figure A4.6). The most common policy inferences concerned structural measures in the context of the need to increase competitiveness. Many of them suggested exchange rate adjustment (devaluation or revaluation), and they generally made a theoretical case for greater exchange rate flexibility. Of the 175 selected issues papers in which staff drew policy inferences, fewer than half spelled out alternative policy options.

Figure A4.6. Policy Inferences in Selected Issues Papers, 2001–06
(In percent)



Reaction of Authorities to IMF Advice

12. Finally, the IEO tried to ascertain from the documents whether national authorities agreed or disagreed with the staff's exchange rate advice. The review of the documents suggests 39 cases of agreement (out of 191), 26 cases of agreement with qualifications, and 14 cases of disagreement. How to interpret these results, however, is not straightforward. Staff advice on exchange rates cannot be distinguished cleanly from other advice on fiscal, monetary, and structural policy. Even when there is broad agreement on risks, desired reforms, and the overall stance of macroeconomic policy over the medium term, IMF staff and national authorities may disagree over a specific policy action in the short run, and such disagreement is documented with varying degrees of clarity.

Annex A4.1

Exchange Rate Surveillance in Article IV Consultations

(Full sample of 191 economies for two consultations through 2005)

1. How many paragraphs (percent of total) mention exchange rates?

Article IV staff reports:	16 percent
Mission briefing notes	18 percent
Back to office	13 percent

2. Were there any exchange-rate-related selected issues papers?

Yes (99)
No (92)

3. What is the current "de facto" exchange rate regime?

Independent float (30)
Managed float (49)
Crawling band (4)
Crawling peg (4)
Horizontal band (9)
Other fixed peg (42)
Currency board (9)
Monetary union (44)

4. What is the monetary framework?

Exchange rate anchor (92)
Monetary targeting (28)
Inflation targeting (22)
Other (52)

5. Does the staff appraisal in Article IV reports identify the exchange rate as a live policy issue?

No (99)
Exchange rate regime issues (46)
Exchange rate level issues (45)
Volatility issues (14)
Other (22)

6. Is the overall exchange rate discussion forward looking?

Mostly forward looking (105)
Mostly backward looking (39)
Exclusively backward looking (2)
Not clear/can't tell (45)

7. How intensively does the appraisal discuss exchange rate issues?

Prominently (54)
Briefly (121)
Not at all (16)

8. Does the prominence of coverage in the Article IV report differ noticeably from coverage in internal documents?

Yes (12)
No (175)

9. The staff exchange rate assessment mentioned the following elements:

Resolution of global imbalances (17)
Global capital markets (14)
Prospective spillovers from trading partners/competitors (31)
Prospective regional spillovers (23)
Domestic considerations (144)
Other (20)
None of the above (21)

10. In the discussions of exchange rate issues, is there explicit reference to:

Fiscal policy (53)
Banking/corporate balance sheets (44)
Monetary policy (121)
None of the above (48)

11. In the discussions of which other policy areas is there explicit reference to implications for exchange rates?

Fiscal policy (51)
Structural (43)
Monetary policy (94)
None (60)
Banking/financial (35)
Other (18)

12. Did the Fund advise a regime change/adjustment? If so, in what direction?

No (128)
Inflation targeting (8)
More flexibility (51)
Monetary targeting (5)
Less flexibility (1)
Other (11)

13. In 2004–05, was the economic environment calm or turbulent?

Calm (122)
Turbulent (31)
Can't tell (38)

14. Have there been changes to the de facto regime over 2003–05? What was the old exchange rate regime?

No (176)
Crawling band (1)
Managed float (5)
Horizontal band (5)
Other fixed peg (4)

15. If the answer under 14 is yes, what was the old monetary framework?

Exchange rate anchor (9)
Inflation targeting (0)
Monetary targeting (3)
Other (3)

16. Is there any formal analysis of regime sustainability/choice? If yes, on what basis?

No (167)
Optimum currency area (5)
Analysis of economic shocks (10)
Cost-benefit analysis (4)
Other (13)

Annex A4.1 *(concluded)*

17. At any stage in the process, are there any changes in regime-related issues identified?
No changes across documents (168) | Particular issues dropped (11) | Other changes (3)
Particular issues added (8)

18. The exchange rate has been explicitly identified in the text as:
Overvalued (19) | Fairly valued (87) | Undervalued (15)
Misalignment not assessed (70)

19. At any stage in the process, are there any changes in levels-related issues identified?
No changes across documents (169) | Particular issues dropped (8) | Other changes (4)
Particular issues added (7)

20. What are the analytical tools used to discuss exchange rate levels?
REER charts (191) | PPP estimates (17) | Other (36)
FEER/BEER (14) | CGER estimates (12)

21. Does Fund analysis point out the limitations/caveats of its tools?
No (159) | Yes (32)

22. What prompts the discussion on exchange rate levels?
Current account developments (46) | Competitiveness considerations (107)
Capital account developments (22) | Appears to be template driven (48)
Fiscal developments (27) | Other (38)

23. Is there any reference to the "pointers"/procedures in the 1977 Surveillance Decision?
None (172)
Exchange rate manipulation, protracted interventions (3)
Interventions to counter disorderly conditions (16)
Explicit policy action for balance of payments purposes (0)

24. Was there a discussion of alternative exchange rate policy options?
No (134) | Yes (57)

25. Where is any formal analysis on levels/regimes reported?
Article IV reports (19) | Pre-mission briefings (5) | Other (15)
Issues papers (42) | Back-to-office reports (0) | N/A (123)[1]

26. How did the authorities react to any policy advice on exchange rates given?
Agree (39) | Agree, but with qualifications (26) | Disagree (14) | Can't tell/doesn't apply (112)

27. Does the country have a Fund-supported program?
Yes (68) | No (123)

If yes, are exchange-rate-related issues part of conditionality?
Yes (9) | No (59)

28. Was data availability an issue?
Yes (90) | No (101)

[1]The code N/A refers to a situation where no formal analysis was reported in the documents reviewed.

Annex A4.2

Selected Issues Papers on Exchange Rate Issues

(Full sample of 256 papers)

1. How long is the paper?	
<5 pages (5)	2 percent
5–9 pages (61)	24 percent
10–14 pages (83)	32 percent
15–19 pages (55)	21 percent
20+ pages (52)	20 percent
2. The paper contains the following elements:	
Literature survey (33)	13 percent
Conceptual analysis (183)	71 percent
Applied analysis (152)	59 percent
REER- or PPP-based analysis (100)	39 percent
A formal model (69)	27 percent
Formal cross-country comparative analysis (37)	14 percent
Discussion of global linkages (10)	4 percent
Historical overview (76)	30 percent
3. The paper materially deals with:	
Exchange rate regime (69)	27 percent
Exchange rate levels (92)	36 percent
Exchange rate volatility (25)	10 percent
Price level pass-through/inflation (46)	18 percent
Competitiveness (78)	30 percent
Other (51)	20 percent
4. Any policy inferences that are drawn deal materially with:	
Exchange rate regime (52)	20 percent
Exchange rate levels (37)	14 percent
Exchange rate volatility (6)	2 percent
Foreign reserves (22)	9 percent
Price level pass-through/inflation (25)	10 percent
Structural measures (56)	22 percent
Prudential supervision (17)	7 percent
Other (24)	9 percent
No policy inferences drawn (82)	32 percent
5. Are there explicit caveats to the analysis?	
Yes (85)	33 percent
No (171)	67 percent
6. Does the selected issues paper analysis take account of country-specific factors in its bilateral assessment?	
No (37)	14 percent
Structure of the economy (112)	44 percent
Institutional frameworks (80)	31 percent
Political constraints (15)	6 percent
Trade patterns (69)	27 percent
Extent of integration into global capital markets (29)	11 percent
Balance sheet characteristics (29)	11 percent
Dollarization (34)	13 percent
Policy shocks (37)	14 percent
Other (39)	15 percent
7. Is there evidence of policy dialogue between the IMF and authorities?	
Yes (17)	7 percent
No (239)	93 percent
8. Does the paper spell out alternative policy options?	
Yes (84)	33 percent
No (172)	67 percent

BACKGROUND DOCUMENT

5 A Review of IMF Exchange Rate Surveillance in 30 Economies, 1999–2005

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

Design and Implementation

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

3. Second, the team considered additional economies from a list of 78 economic areas that met two or more of the following criteria, which were thought to identify cases where exchange rate issues might be particularly relevant:[1]

- Largest multiperiod current account imbalance, both in percent of GDP and U.S. dollars, during 1999–2005 (measured on the basis of rolling, two-year averages);
- Percentage change in and coefficient of variation for the real effective exchange rate during 1999–2005;
- Change in foreign exchange reserves over 1999–2005, in percentage terms and in relation to the M2 money stock at end-1998;
- Average trade openness, measured as the sum of exports and imports divided by GDP, during 1999–2005;
- Exchange rate regime change (based on the IMF Monetary and Capital Markets Department's de facto classification of exchange arrangements); and
- De facto dollarization (countries with a score of 10 or more on IMF staff's composite dollarization index).[2]

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

5. The 30 economies selected for review can conveniently be grouped on the basis of type of country or exchange rate regime (Table A5.2).[3]

6. To give a thorough and consistent treatment to each of the economies, a detailed set of questions was prepared, for which answers were based on all relevant documents for the 1999–2005 period,[4] including communications with the authorities and internal memorandums or analytical documents on issues related to exchange rate policies. Because of the deliberate selection process (and the greater weight of advanced economies and larger emerging market countries in the sample),[5] the evaluation team designed the questions in such a way as to allow a consistency check with the full review. This allowed the team to draw any generalizations from the findings with greater confidence.

[1]For more details, see the IEO issues paper at www.ieo-imf.org/pub/issues.html.

[2]See "Macroeconomic Policies in Dollarized Economies," SM/03/126, April 2003. The classification is based on data for 1996–2001.

[3]The country groups follow the IMF's *World Economic Outlook*, except that "Other emerging market and developing economies" are further broken down by size.

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

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

Table A5.1. Economies Selected for Detailed Analysis [1,2]

Africa	Asia-Pacific	Europe	Middle East and Central Asia	Western Hemisphere
WAEMU	Australia	Bulgaria	Egypt	Brazil
Guinea	China	*Euro area*	Morocco	Ecuador
Rwanda	Hong Kong SAR	Iceland	Saudi Arabia	El Salvador
South Africa	Japan	Lithuania		Jamaica
Tanzania	Korea	Norway		Mexico
	Malaysia	Russia		Peru
	Singapore	Ukraine		United States
		United Kingdom		

[1]Italicized entities refer to regional monetary unions.
[2]The regions correspond to the geographical jurisdictions of IMF area departments.

Main Findings

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

Coverage of exchange rate issues

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

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

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

Integration of exchange rate and other policies

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

Table A5.2. Features of the 30 Sample Economies

Exchange Rate Regime (As of 2005)	Major Advanced Economies[1]	Other Advanced Economies[2]	Other Emerging Market and Developing Economies: Large emerging[3]	Other Emerging Market and Developing Economies: Other emerging and developing	Total
Independent float	4	4	3	1	12
Managed float		1	2	4	7
Other fixed peg			4	2	6
Currency board		1		2	3
No separate legal tender				2	2
Total (percent of total)	4 (13)	6 (20)	9 (30)	11 (36)	30 (100)

[1]Includes the euro area, Japan, the United Kingdom, and the United States.
[2]Includes Australia, Hong Kong SAR, Iceland, Korea, Norway, and Singapore.
[3]Includes economies with GDP (PPP basis) of more than $250 billion.

with measures in other policy areas. For most countries reviewed, integration with monetary and fiscal policies was found to be good overall (e.g., on the monetary policy implications of intervention and sterilization operations, the importance of pass-through effects for inflation and monetary policies, the extent to which exchange rate developments should be factored into monetary policy decision making, and in assessing the effects of debt indexation and fiscal dominance considerations for exchange rate and monetary policies);[6] and, for most countries, there was a good integration of exchange rate policies with structural policies (though with the coverage of mutual implications more vague and less detailed than for other policy areas). Integration was judged to be somewhat lacking relative to financial sector and financial stability issues, though coverage and integration across countries clearly improved over time—and significantly so in the case of those receiving FSAP and related technical assistance missions (e.g., due to better availability of data on financial sector exposures, and a richer knowledge and coverage of institutional detail). This finding is consistent with the IEO's recent FSAP evaluation.[7]

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

13. An area that, despite recent improvements, remains insufficiently integrated is regional and global spillovers.[8] Although substantial progress was found in the treatment of international ramifications of U.S. policies and of possible regional spillover effects from antideflationary measures in Japan,[9] progress was much less pronounced in the treatment of the policies of other advanced economies. An example of asymmetric treatment is given by the staff reports for the Article IV consultations with the euro area. Although the analysis covered issues such as the implications of a possible disorderly adjustment of the U.S. dollar, there was only limited coverage of the implications of euro area policies for the global economy or individual countries (such as those in Eastern Europe). This was despite exhortations, in the internal review process, to "cover more the Eastern European countries" and to explore "the risks of reversal of the strong capital flows into Eastern Europe" along with any implications of adverse developments in this region for euro area policies. A similar lack of coverage was identified with respect to the regional implications of policies in such countries as Brazil and Russia. In the case of China, the analysis of spillovers focused largely on the regional implications of a possible slowdown in GDP growth, with exchange-rate-related spillovers analyzed only recently—having been mentioned in earlier years.[10]

Integration of multilateral and regional perspectives into IMF policy advice

14. Multilateral issues were covered in most bilateral surveillance discussions, but not always in depth.[11] Depth of coverage was found lacking even in countries for which multilateral and regional issues were identified as important. Even when global developments and related concerns were addressed, references to such issues may on occasion have been inserted into the staff reports largely for compliance reasons (e.g., in response to comments received in the internal review process), and not because they had been discussed with the authorities in any material way.[12]

15. The IMF's treatment of global imbalances is a case in point. Global imbalances were identified in multilateral surveillance as an issue involving non-G-3

[6]An exception concerns the fiscally induced accumulation of net foreign assets—an issue that should be more fully integrated into discussions of intervention policies, broadly defined (see separate section below).

[7]See IEO, *Financial Sector Assessment Program* (Washington: International Monetary Fund, 2006).

[8]This has been identified as a weakness in IMF surveillance at least since 1999. See J. Crow, R. Arriazu, and N. Thygesen, "External Evaluation of IMF Surveillance—Report by a Group of Independent Experts" (Washington: International Monetary Fund, 1999); also see IEO, *Multilateral Surveillance* (Washington: International Monetary Fund, 2006).

[9]Examples include selected issues papers on the United States in 1999 and 2000, based on the IMF's MULTIMOD, which were followed in later years by similar analyses using the Oxford Economic Model (OEM) and the IMF's new multicountry GEM DSGE model. Similar simulation exercises were employed for Japan.

[10]See the 2006 selected issues paper on "Implications of Greater Exchange Rate Flexibility in China and Other Asian Emerging Market Economies."

[11]Multilateral assessments feed into country-level assessments for about two-thirds of the economies in the sample, which include all but one of the advanced economies.

[12]In the case of Malaysia, for example, where staff had long argued for greater exchange rate flexibility (at least since 1999, though with changing rationalizations), the staff report for 2003 argued that "greater exchange rate flexibility would be consistent with the process of an orderly adjustment of global imbalances." Yet, the reference to global imbalances appears forced and is not backed up by anything in the remainder of the report, while being somewhat at odds with the finding in the same document that the exchange rate is not substantially misaligned. Importantly, global imbalances are neither mentioned in the 2003 briefing paper, nor in that year's back-to-office report, nor in the concluding mission statement, suggesting that the topic did not play a significant role during the consultation discussions with the authorities.

economies as early as 2003,[13] and the topic began to appear consistently in Article IV reports for a number of Asian countries in 2003 and for major oil producers in 2005. Coverage of the issue at the individual country level, however, generally lacked depth; any implications did not appear to have been suitably integrated into staff analysis and thus did not discernibly influence the "policy line" for the countries concerned. Policy linkages across countries were not sufficiently pointed out, with cyclical, country-level considerations dominating the (largely unchanged) advice given at the individual country level.[14] During the period, scope for active policy coordination—for example, by making alternative sets of policy recommendations that are conditional on policy actions taken in other countries—was insufficiently exploited, and the IMF failed to take an institutional stance on how to bring about coordinated policy responses.[15]

Surveillance of intervention policies

16. Coverage of intervention policies in staff reports was found to be insufficient for at least five countries in the sample. Incomplete coverage concerned the past intervention episodes of otherwise floating exchange rate regimes (including an assessment of their effectiveness), as well as a failure to assess whether or not intervention activities had been in line with the authorities' stated intentions or whether there had been effects for other countries (including for intervention activities conducted in the context of fixed exchange rate regimes).[16] As a result, the staff reports did not always give a clear description of the de facto exchange rate regime, and the IEO identified at least three cases,[17] for which staff's classification conveyed, at least temporarily, a misleading impression of the regime in place. The problem in these and other cases appears at least partly to have been a reluctance to challenge the views of the authorities.[18]

17. An aspect of intervention policies that has received little, if any, staff attention is intervention tactics, that is, the specifics of how intervention is to be implemented, and the extent to which such practice is consistent with the stated intervention goals such as the smoothing of short-term fluctuations. Examples include the practice of covert interventions—an arrangement that limits the effectiveness of intervention through the signaling channel (though not through the portfolio balance and liquidity channels). In discussing intervention policies, moreover, staff have narrowly focused on the use and accumulation of international reserves, and tended not to give full attention to economically very similar activities outside the traditional boundaries of intervention policies (e.g., changes in the net foreign asset positions of government agencies or publicly managed investment funds). However, to the extent that these activities are of substantial size and likely (or intended) to affect the real exchange rate, focusing simply on a country's monetary authorities' interventions does not allow a clear understanding of the effects of any changes in public sector net foreign asset positions.

18. Advice on the related issue of reserves accumulation has been linked to the underlying rationale for such activities, with staff generally supporting accumulation for precautionary purposes. Accumulation in the context of competitiveness considerations did not usually find staff support, except perhaps in cases such as Russia's. About half of the 30 sample

[13]Notably, the September 2003 *World Economic Outlook* featured a discussion of the rapid buildup of foreign exchange reserves in emerging economies, and argued that "an eventual narrowing of the U.S. current account deficit from its present unsustainable level will likely require emerging economies in Asia to share in the adjustment, to prevent an undue burden of adjustment on other countries" (p. 91).

[14]Staff policy recommendations remained essentially unchanged across countries, with two exceptions: changes in the urgency of advice to China (in 2003, a change in the policy line that was not endorsed by the Executive Board) and to the United States (in 2005, where staff suggested earlier and stronger fiscal consolidation as a "downpayment" by the U.S. authorities in efforts to tempt other countries into policy action on global imbalances). Attempts to integrate global imbalances into existing policy advice were limited to pointing out the extent to which this advice was consistent with reducing those imbalances.

[15]Executive Directors began to acknowledge explicitly the cross-country linkages of exchange rate policies in 2003, referring to current account imbalances as a "global issue." A few individual Directors raised concerns in particular country cases over the consistency of these countries' policies from a multilateral perspective. However, it was not until 2004 that Directors began to identify clearly the need for "coordinated action," though without offering concrete ideas on how such action could be brought about in practice.

[16]The in-depth review also identified references to surveillance "pointers" from the 1977 Surveillance Decision in staff reports or internal documents, usually in the context of intervention activity countering "disorderly market conditions." In two country cases, explicit references were made to "one-sided, protracted intervention" in internal documents, neither of which was followed up with the authorities or referred to in the staff reports.

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

[18]Another reason may be the difficulty in applying criteria in the classification of exchange rate regimes, and the lack of guidance on how to treat episodic events. Correlations across different de facto classification schemes that are virtually as low as the correlation for any one of these with countries' de jure classifications. See Jeffrey A. Frankel, "Lessons from Exchange Rate Regimes in Emerging Economies," in *Monetary and Financial Integration in East Asia: The Way Ahead*, ed. by Asian Development Bank (New York: Palgrave Macmillan, 2004).

economies accumulated significant reserves during the evaluation period, especially in more recent years. Their motives included: (1) self-insurance against disorderly market conditions and volatility; (2) intergenerational and Dutch disease considerations (in countries with large natural resources or aid flows); and (3) concerns to maintain international competitiveness and export/industrial performance. Because explicit analysis of an adequate level of precautionary reserves (linked to the exchange rate regime, nature of shocks, and country conditions) is not a standard feature of staff reports, assessments of the appropriateness of such policies have remained highly judgmental and, at times, contentious—including among staff and at the Board level.[19]

Issues of data availability

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

[19]In the case of Russia, for example, staff advice—after intense internal discussions—was subject to a major reappraisal in 2002; a process that started in the context of the 2001 staff report, which had supported "the authorities' aim to limit the pace of the real appreciation of the ruble" by arguing that a fairly stable exchange rate was a "reasonable compromise between pressures for nominal appreciation, the authorities' concern that too rapid an appreciation would jeopardize output recovery, and uncertainty surrounding the recovery in money demand." Internal comments, however, expressed doubts about the consistency of such advice with the Board's Surveillance Decision and with the objective of reducing inflation. Reactions by area department staff revealed differences of opinion among staff on the correct policy line, pointing to Russian concerns about Dutch disease and uncertainties about the ruble's real effective equilibrium value. In the wake of large terms of trade changes, staff eventually advised the central bank in 2003–05 to "subordinate its exchange rate target to the inflation target, by standing ready to scale back interventions whenever inflation exceeds the charted course" and that "increased exchange rate flexibility could no longer be delayed now that fiscal policy is being relaxed if inflationary risks are to be contained."

Analysis of exchange rate levels

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

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

Advice on exchange rate regimes

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

the direction of enhanced flexibility, and 8 cases of advice involved the adoption of inflation targeting—at least over the medium term.[20] In all but one case, the exchange rate was either fixed or heavily managed, and in the one case of a nominally floating exchange rate system, staff advised less official intervention.

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

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

[20] The time period over which inflation targeting could possibly be implemented, however, appeared to be extensive. In Russia, for example, staff recommended in 2003 that the authorities consider moving toward the adoption of full-fledged inflation targeting over the medium term. However, given the relative openness of the Russian economy, relatively high exchange rate pass-through, the authorities' preference for relative exchange rate stability, the continuing importance of administered prices, and the prospect of large swings in capital flows, it appeared unlikely that inflation targeting would soon become a serious policy option, which would require fiscal policy to become the key stabilization tool in a context of strong expenditure demands.

[21] These represent a quarter of the 12 economies from the sample that received advice on their exchange rate regime.

Annex A5.1

Summary Descriptive Statistics for the 30 Sample Economies

1. Do reports identify a current "de facto" exchange rate regime or monetary framework? How?

Yes (30)	No (0)	
Exchange rate regime:	Independent float (12)	Managed float/no path (7)
	Other fixed peg (6)	Currency board (3)
	No separate legal tender (2)	
Monetary framework:	Exchange rate anchor (10)	Monetary targeting (4)
	Inflation (forecast) targets (8)	Other (8)

2. Is there any discussion on (real) exchange rate developments?

Yes (30)	No (0)

3. Do multilateral analyses feed into country-level assessments?

Yes (18)	No (12)

4. Do any of the key issues identified by the IMF relate to exchange rate regime or level?

Regime only (1)	Level only (6)	Both (21)
Other (4)		

5. Did the IMF advise a regime change or adjustment?

Yes (12)	No (18)

6. Have there been changes to the de facto regime over 1999–2005? What was the old regime?

Yes (11)	No (19)	
Exchange rate regime:	Independent float (1)	Managed float/no path (2)
	Horizontal band (4)	Other fixed peg (3)
	Currency board (1)	
Monetary framework:	Exchange rate anchor (8)	Monetary targeting (2)
	Inflation (forecast) targets (0)	Other (1)

7. Is there any formal analysis of regime sustainability or choice?

Yes (10)	No (20)

8. Have IMF views or advice on the country's regime changed over the 1999–2005 period?

Yes (13)	No (17)

9. Over the 1999–2005 period, has the real exchange rate been identified as mis- or correctly aligned? Give direction and scope of analysis for the most recent instance.

Yes (27)	No (3)	
Direction:	Overvalued (7)	Correctly aligned (12)
	Undervalued (8)	
Scope:	Detailed analysis (13)	Own results, but no detail (8)
	Research quoted (4)	"Eyeballing" of charts (10)

10. Have there been trends or changes over time in the sophistication of analysis?

More sophisticated (7)	Variation, no clear trend (14)	No change (9)
Gotten worse (0)		

11. Do IMF documents report any level estimates by the authorities or third parties?

Yes (10)	No (20)

12. Is there any reference to the "pointers"/procedures in the 1977 Surveillance Decision (e.g., reserve accumulation and interventions)?

Yes (10)	No (20)

13. Is advice on exchange rates sufficiently detailed to be implementable?

Yes (18)	No advice or no detail (12)

14. If advice (on regime or level) is provided, is there discussion of alternative policy options?

Yes (17)	No advice or no options (13)

15. At what frequency is formal analysis on level or regime reported?

Regularly (11)	Occasionally/issues driven (7)	One-off (6)
Not at all (6)		

16. Is a proposed policy action followed up over various surveillance cycles?

Yes (26)	No advice or follow-up (4)

17. Overall, have recommended policy actions been carried out by the authorities?

Yes (16)	No advice or not carried out (13)

18. Is TA requested or offered in the context of IMF advice on exchange rates?

Yes (15)	No advice or no TA (15)

19. For IMF-supported programs, are exchange-rate-related issues part of conditionality?

Yes (8)	No program or no exchange rate conditions (22)

BACKGROUND DOCUMENT

6 IEO Survey of the Authorities and Staff

1. This background document summarizes the results from the IEO survey of country authorities and IMF staff. The first section sets out the methodology. The second section summarizes the main survey findings. The third section presents some analysis of the survey results. The fourth section presents a further analysis of the survey responses for large emerging market economies. Annex A6.1 provides additional detail on the methodology. Annex A6.2 lists the economies surveyed. Finally, Annexes A6.3 and A6.4 reproduce the survey questions for national authorities and for IMF staff, respectively.

Survey Methodology

2. The survey was conducted in late 2006 and early 2007. The survey module for the authorities was managed by an outside company,[1] while the module for IMF staff was managed by the IMF's Technology and General Services Department. All survey recipients were advised that their responses would be treated as confidential and that individual countries and staff members would not be identified.

Populations surveyed

3. A single survey questionnaire was sent to all member countries through the offices of IMF Executive Directors. Also surveyed were the central banks of four regional monetary unions[2] and the European Commission. In total, 192 questionnaires were sent out. For reporting purposes, the economies were classified into four categories: "Major advanced;" "Other advanced;" "Large emerging market economies" ("Large EMEs"); and "Other emerging market economies/developing countries" ("Other EMEs/DCs").[3] See Table A6.1 for details.

4. A single questionnaire was also sent to current IMF staff at the senior economist level and above in all area departments and in selected functional departments. The staff members at these levels were targeted because of their longer experience in dealing with exchange rate issues and their greater access to confidential discussions and material. Some 791 staff members received the survey.

5. The response rates from both populations (59 percent and 47 percent, respectively) were high enough to yield statistically meaningful inferences (see Annex A6.1 for details).[4]

Main features of the survey questionnaires

6. The two survey modules were structured according to the main questions guiding the evaluation, as presented in the Issues Paper. Particular emphasis was placed on certain aspects of the process of surveillance, such as the nature of the dialogue between staff and authorities and the impact of IMF activities on member countries' policies, where the survey (along with the direct interviews of authorities and staff) would be the main source of evidence. In addition, for triangulation purposes, questions in both surveys explicitly incorporated hypotheses regarding the quality of Fund advice and analysis developed on the basis of the IEO's two desk reviews.

7. Each survey module contained 15 sets of questions.[5] Many questions were the same for both popula-

[1]Fusion Analytics L.L.C., Washington, D.C.

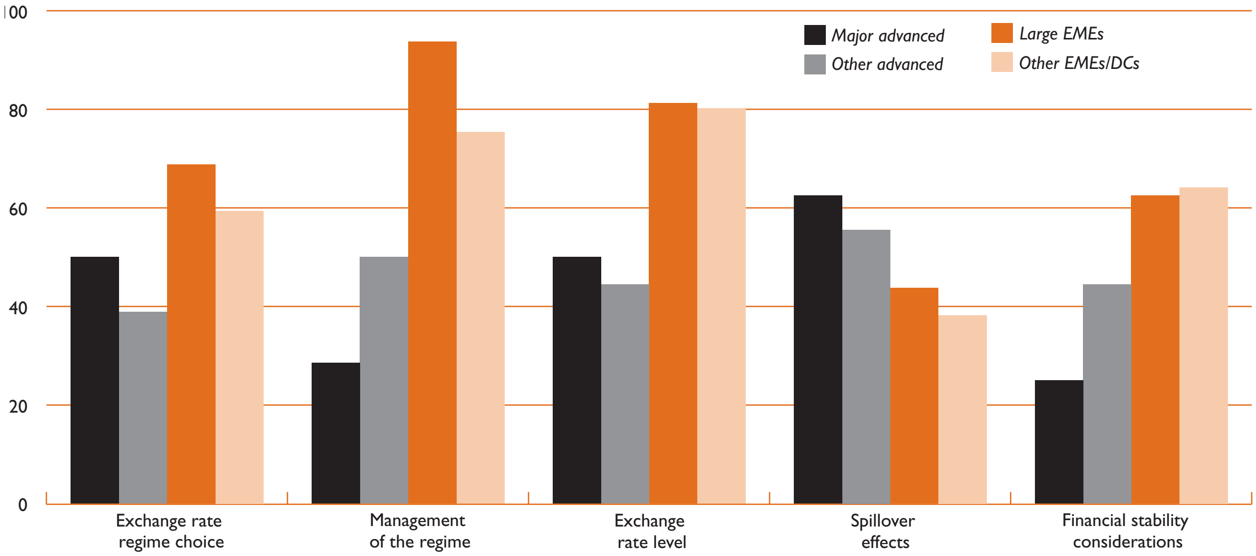
[2]The European Central Bank, the Eastern Caribbean Central Bank, the Central Bank of West African States, and the Central Bank of Central African States. The survey responses of countries belonging to a regional monetary union and that of the central bank were separately included in the results and tabulations presented below.

[3]"Major advanced" and "Other advanced" follow the *World Economic Outlook* classification. All other countries are grouped as "Large EMEs" or "Other EMEs/DCs" on the basis of PPP-adjusted GDP for 2004, with $250 billion as the cut off.

[4]The response rate for the authorities' survey was high across all four country groups (at more than 80 percent among the advanced and large emerging market economies, and 50 percent for other emerging market and developing countries), arguing against any significant self-selection bias. Responses in both surveys were checked for plausibility by combining answers across questions, yielding mutually consistent results (see Tables A6.2 through A6.5 and Figures A6.29 through A6.34 for examples).

[5]See Annexes A6.3 and A6.4 for the list of survey questions.

Figure A6.1. Survey of Authorities: Relevance of Issues for Internal Discussions
(In percent)



tions, although a few questions (such as those concerning the internal review process of the IMF) were specific to one survey module. Several of the questions asked respondents to rate, on a five-point scale, their level of agreement with particular statements.[6] Other questions asked respondents to select from a range of options the one that best described their views.

8. Respondents to the staff survey were given the option of selecting either a particular country or "no country" at the outset of the survey, based on their level of interaction with country authorities on exchange rate matters during the evaluation period. If a country was selected, it was used as a reference point for subsequent country-specific (but not general) questions. Staff who did not select a country (as in the case of staff involved largely in a reviewing capacity), received only a subset of the subsequent questions. Staff were also given the option to select "No involvement" with exchange rate matters, in which case the survey was not pursued further with them.

Major Findings

Areas of exchange rate policy for discussion

9. The survey first asked both the authorities and IMF staff a series of five questions about areas of exchange rate policy selected for discussion. For convenience, the survey considered five exchange rate policy areas: regime choice, regime management, exchange rate level, cross-border effects of policies (spillovers), and financial stability considerations.

10. As a starting point, the survey asked the authorities to identify the areas of focus in internal policy discussions (Figure A6.1).[7] The results show that the five areas of exchange rate policy received varying degrees of focus in internal discussions during the 1999–2005 period. There were important differences across the four country groups: for "Major advanced" countries, spillover effects received the most attention, with over half of the respondents identifying the topic; for "Large EMEs," management of the exchange rate regime was the most prevalent topic in internal policy discussions, being identified as a focus by nearly all respondents.

11. The survey then asked the authorities how they viewed the importance given to the different exchange rate areas in their discussions with IMF staff (Figure A6.2). Here, we observe some interesting differences both across country groups and from the previous survey question. For example, 40 percent of the respondents from "Major advanced" countries thought that spillover effects were a focus of discussions with IMF staff (whereas in the previous survey question some 60 percent had identified the topic as a focus in internal discussions). And for financial stability concerns, the authorities of "Large EMEs" saw these as far more important in internal policy discussions (about 60 percent) than in their dialogue with the IMF (about 30 percent).

[6]For example, a "1" corresponds to "strongly agree," while a "5" corresponds to a "strongly disagree." A "don't know/does not apply" option is also given.

[7]Unless otherwise noted, the figures derived from rating questions depict the percentage share of those selecting "1" or "2," typically corresponding to "agreed" or "strongly agreed." Also unless otherwise noted, the percentage shares in the figures exclude those who selected the "don't know/does not apply" option.

Figure A6.2. Survey of Authorities: Coverage of Discussions with IMF
(In percent)

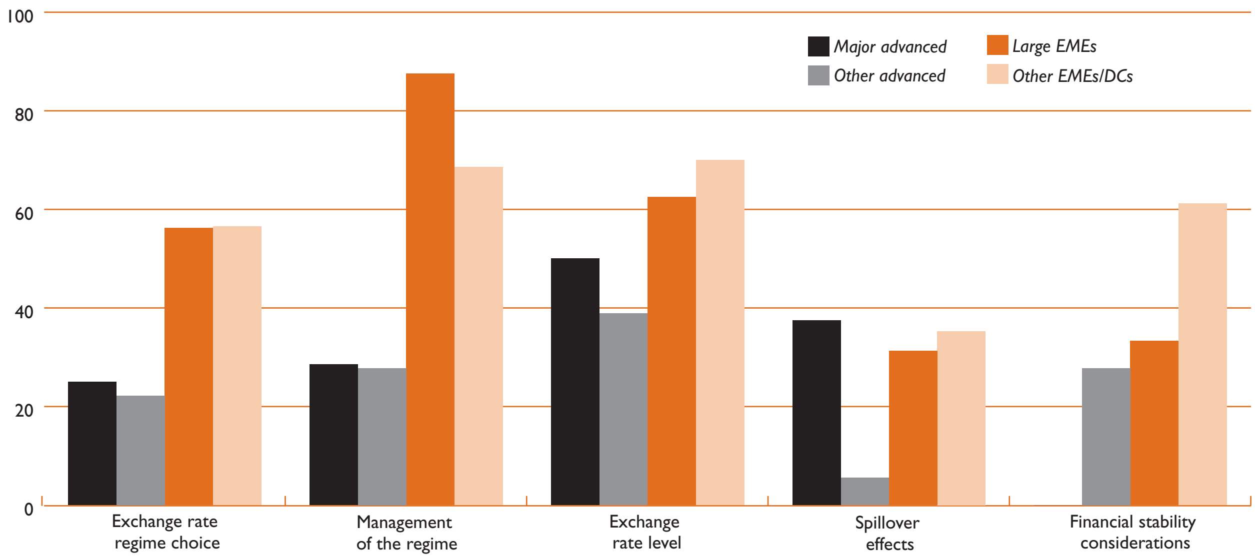
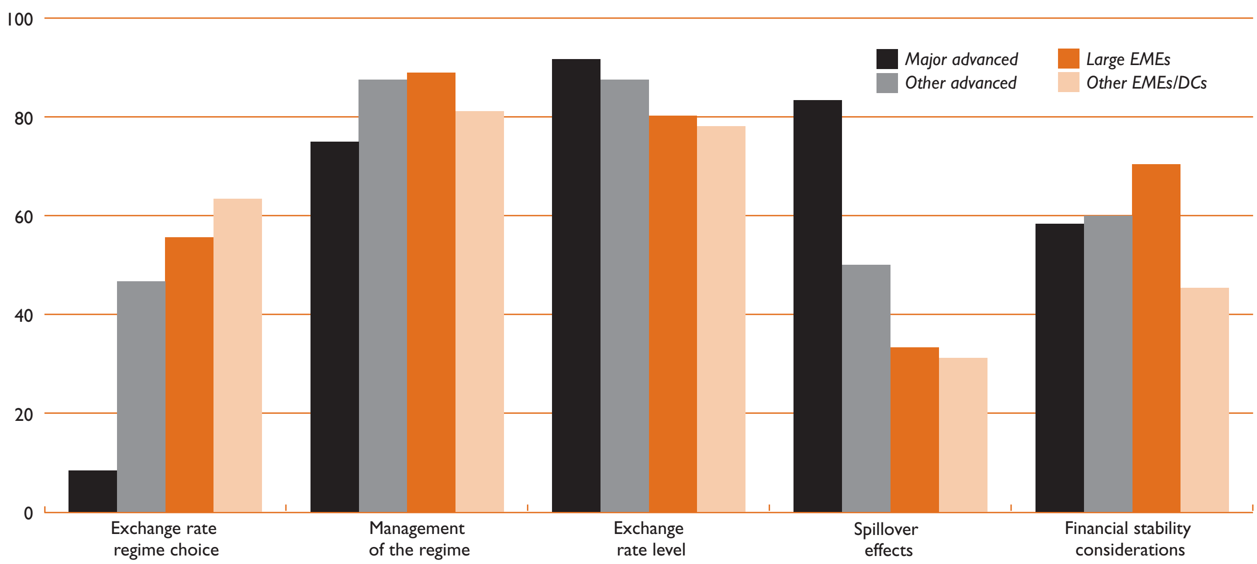


Figure A6.3. Staff Survey: Coverage of Discussions with Authorities
(In percent)



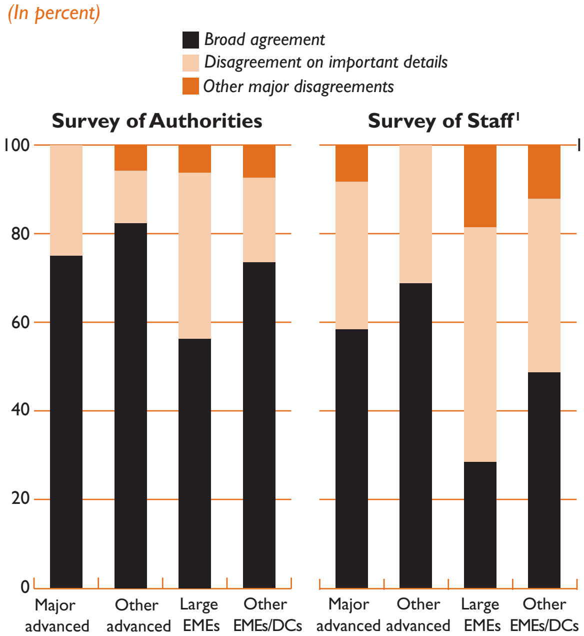
12. Being asked the identical question, the staff respondents saw different areas of emphasis (Figure A6.3). The contrast is particularly pronounced for both "Major advanced" and "Other advanced" economies. For example, among staff respondents who worked on "Major advanced" countries, almost 60 percent saw financial stability considerations as an area of focus, whereas no country respondents did so. Likewise, some 80 percent of the staff identified management of the exchange rate regime and spillover issues as areas of focus (whereas only 30 percent and 40 percent of the country respondents did so for these two issues, respectively).[8]

13. The survey asked both the authorities and staff for their views of how the authorities agreed with the staff's analysis and assessments of exchange rate issues

[8]In a follow-up question, both authorities and staff were asked to identify who had taken the initiative to raise issues in the five policy areas. Staff respondents generally saw themselves as the more proactive of the two in the dialogue on exchange rate issues.

Figure A6.4. Staff's Analysis and Assessment

(In percent)



[1]Staff's perceptions on the extent to which the authorities agreed with staff's analysis and assessment.

Figure A6.5. Staff Analysis and Assessment: Major Areas of Disagreement

(In percent)

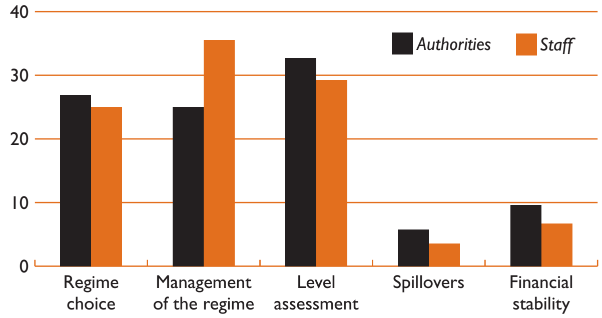
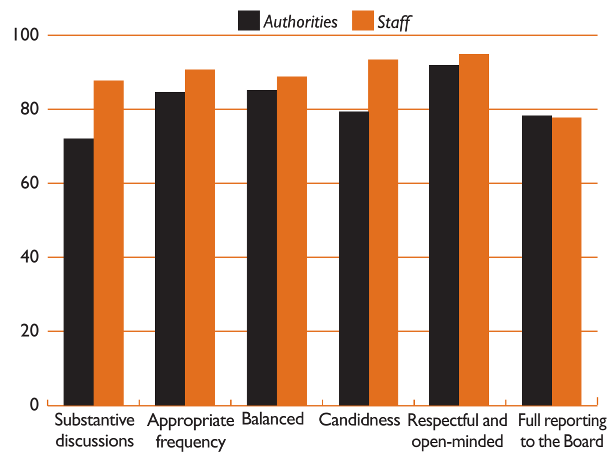


Figure A6.6. On the Nature of the Dialogue: Interactions Between Authorities and Staff

(In percent)



(Figure A6.4). A large majority of the surveyed authorities (more than 70 percent for most country groups) said they were in broad agreement with the staff analysis and assessments, though the percentage was somewhat lower (less than 60 percent) for "Large EMEs" (left-hand panel). For each country group, a smaller percentage of the staff respondents saw broad agreement (right-hand panel). For example, about 70 percent of the staff respondents who worked on "Other advanced" countries saw broad agreement, compared with about 80 percent of the authorities; for "Large EMEs," the share of the staff seeing agreement was only 30 percent, compared with the authorities' 60 percent.

14. Figure A6.5 indicates where disagreement lies. About 25–35 percent of both populations indicated disagreement in the areas of regime choice, management of the regime, and level assessment, and virtually no one identified disagreement in the other two policy areas.

Quality of the dialogue

15. The second part of the survey (consisting of six questions) probed aspects of the dialogue on exchange rate issues and the role of the IMF Executive Board, by asking both the authorities and staff to rate their level of agreement with a series of statements.

16. First, in terms of the broad nature of the dialogue, the findings are positive on many dimensions, with similar responses across the two populations (Figure A6.6). Of the country respondents, 70–90 percent appear satisfied with many process-related aspects of their interaction with IMF staff. In particular, close to 75 percent agreed that discussions with staff were substantive and two-way, but close to 30 percent of the respondents from "Other advanced" economies disagreed. On other issues—such as the appropriate frequency of discussions, balance among informality, confidentiality, and the requirements to report to the Executive Board, candidness and willingness to raise politically sensitive issues, and respectfulness and open-mindedness—80 percent or more were positive about staff performance. The authorities and staff share the perception that Board documents generally do a good job in reflecting the authorities' policy discussions with staff (about 80 percent of each population).

17. Second, the next question asked the authorities and staff how they perceived the handling of such sensitive policy matters as foreign exchange market intervention and exchange rate regime selection (Figure A6.7). There is a major difference between the authorities and

Figure A6.7. On the Nature of the Dialogue: Off-the-Table Issues and Leaks
(In percent)

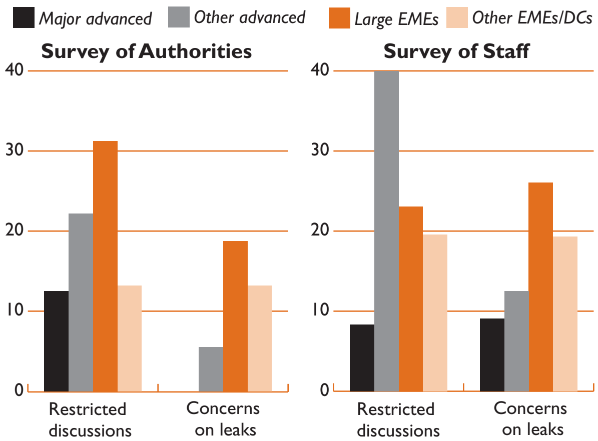
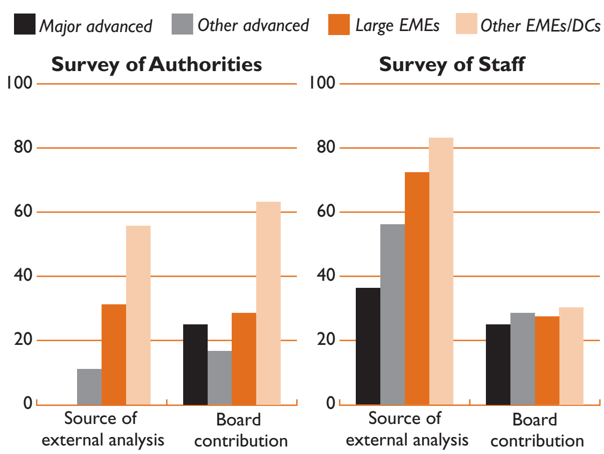


Figure A6.8. On the Nature of the Dialogue: Sources of Analysis and the Executive Board Contribution
(In percent)



the staff, especially for "Other advanced" countries and "Large EMEs." For "Other advanced" countries, 40 percent of the staff respondents thought that the authorities restricted discussion of certain sensitive matters, whereas about 20 percent of the country respondents thought that they did. For "Large EMEs," on the other hand, sensitivity is recognized more by the authorities (about 30 percent of total) than the staff (about 20 percent). About a third of the 19 countries that reported excluding sensitive policy issues from the discussion said they did so based on concerns about leaks.[9]

18. Third, the survey asked the authorities and staff about the sources of external exchange-rate-policy-related analysis and the contribution of the Executive Board to the development of policy (Figure A6.8). Across both populations, the percentage of those who think that the IMF is the main source of external analysis rises as the country concerned is smaller and less advanced. For example, no respondents from "Major advanced" countries said that the IMF was the main source of external advice, whereas more than half of those from "Other EMEs/DCs" said so. For each country group, moreover, a larger share of the staff respondents than of the country respondents saw the IMF as the main source of external analysis. As to the contribution of the IMF's Executive Board, except in "Other EMEs/DCs," fewer than 30 percent of the authorities or staff respondents thought that the Board was consequential in the development of country policy. The large share of respondents from the "Other EMEs/DCs" who thought otherwise may partly reflect the fact that this group includes a number of countries with IMF-supported programs; in these countries, close to 70 percent saw the Board as consequential in the development of country policy.

19. The last three questions sought to identify which aspects of the IMF's staff work should be strengthened to help improve the substance and usefulness of the dialogue. For presentational purposes, the three questions address the following three sets of issues:

- *Analytics.* The analytical or empirical underpinnings of staff assessments and advice; multilateral and regional perspectives informing the work; integration of exchange rate policy advice with advice in other policy areas; and the sectoral balance sheet implications of exchange rate movements.
- *Implementability.* Whether country-specific factors and constraints are taken into account when formulating advice; whether general advice is developed into more concrete implementation issues; the cost and benefits of policy options; and the sense of urgency given to certain policy actions.
- *Delivery.* The modalities of interaction between authorities and staff; the clarity and nuance of views; the documentation provided to the authorities; and the timeliness of the analysis.

20. Across the three sets of issues, sizable minorities of the authorities saw room for improvement (Figures A6.9, A6.10, and A6.11). Moreover, the share of those who saw room for improvement is considerably larger among the country respondents (about 30–40 percent for analytics and implementability) than for the staff respondents (about 10–20 percent). The gap in perception seems to be particularly large overall for all aspects of implementability, and to a lesser extent analytics.[10]

[9]In total, there were 13 countries that reported concerns on leaks.

[10]In a follow-up question, the staff respondents identified the lack of an analytical framework and of relevant inputs from the multilateral surveillance products (e.g., the *World Economic Outlook*

Figure A6.9. Improving the Substance and Usefulness of Discussions: Analytics
(In percent)

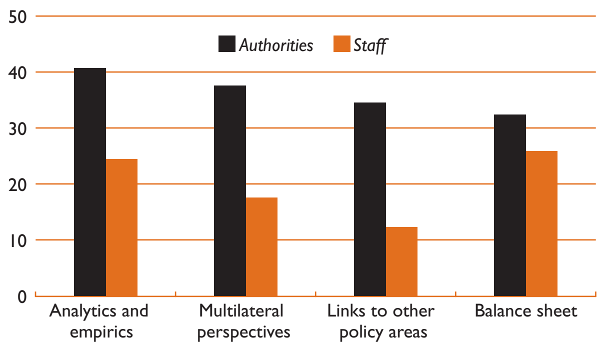


Figure A6.10. Improving the Substance and Usefulness of Discussions: Implementability
(In percent)

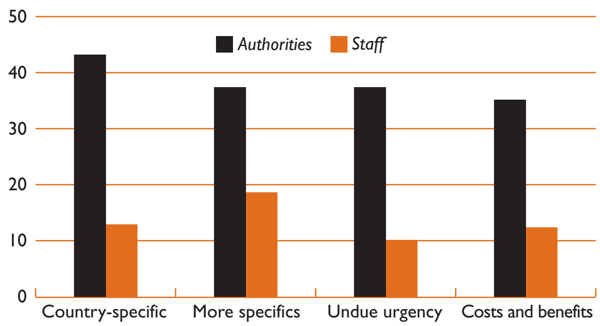
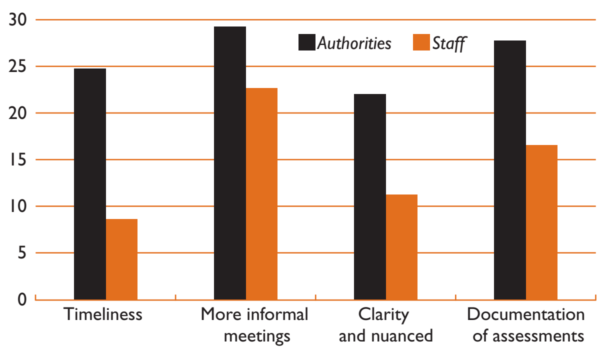


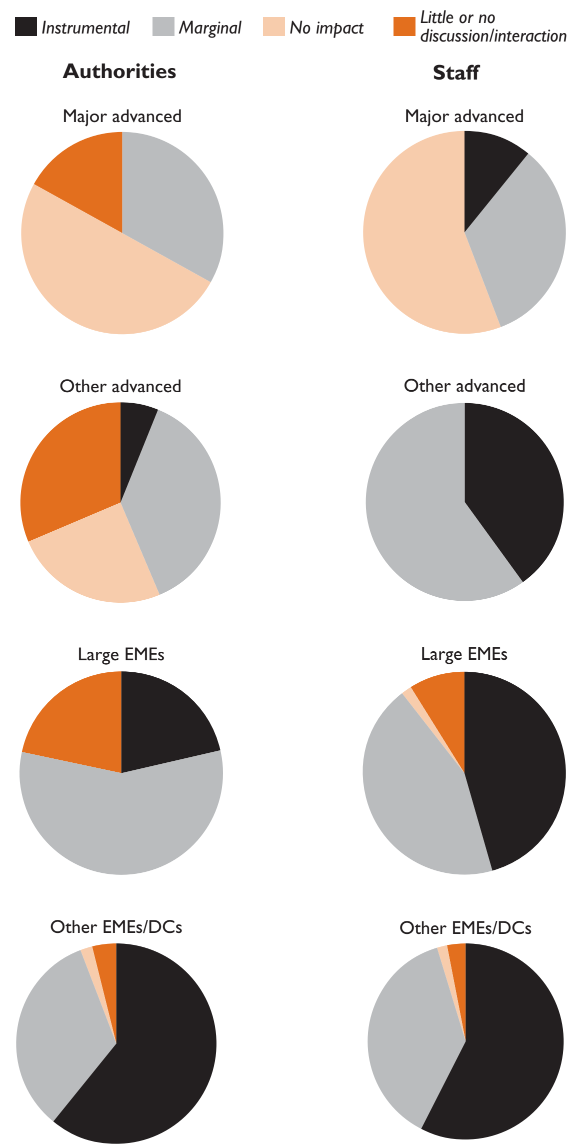
Figure A6.11. Improving the Substance and Usefulness of Discussions: Delivery
(In percent)



Although this same pattern is also observed for the third area (delivery), a smaller share of the authorities identified room for improvement (20–30 percent).

and the *Global Financial Stability Report*) as important reasons for the poor integration of multilateral perspectives into exchange-rate-related analysis and policy advice at the country level.

Figure A6.12. Opinions About IMF Impact on Countries' Major Decisions on Exchange Rate Policy
(In percent)

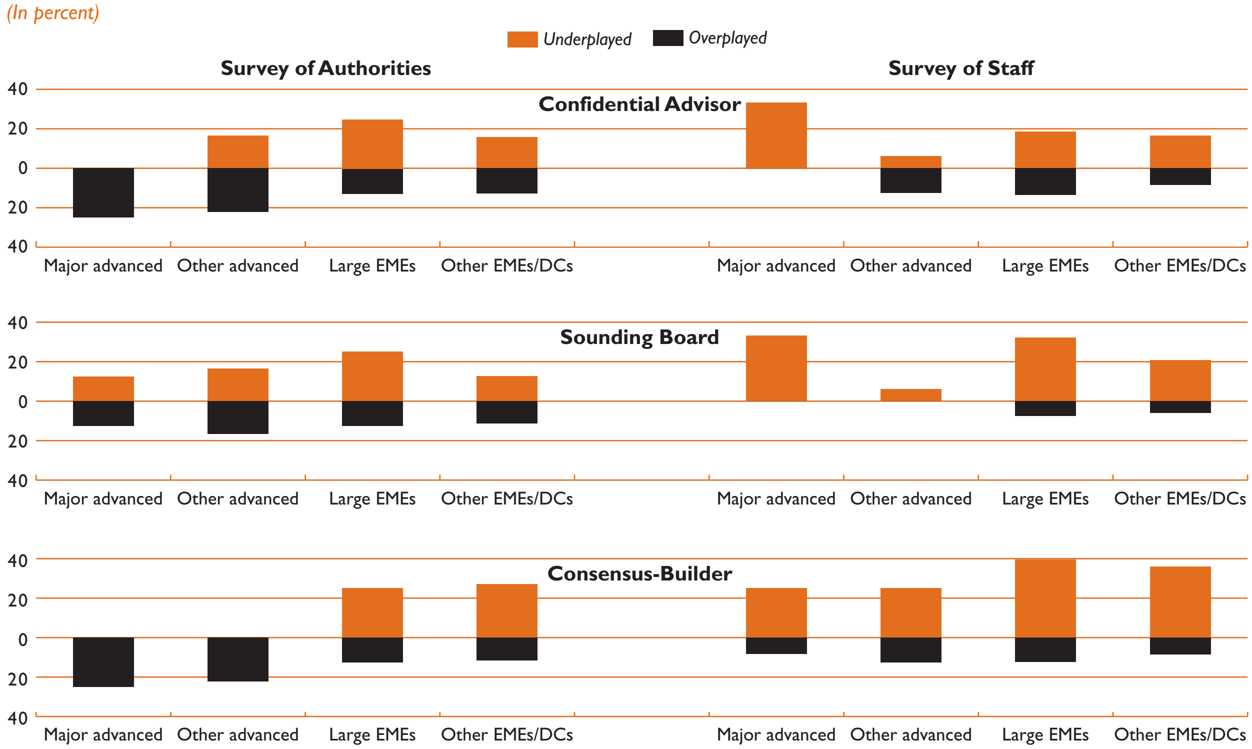


Impact of IMF work

21. The survey tried to ascertain the impact of IMF work on the exchange rate policies pursued by member countries during the 1999–2005 period (Figure A6.12). An interesting pattern of responses emerged. Except for "Other EMEs/DCs," the IMF's impact, as perceived by both populations, diminishes as the country in question is larger and more advanced. For example, none of the respondents from "Major advanced" economies considered the IMF as having been instrumental in major

Figure A6.13. Survey of Authorities and Staff: Views on the Role of the IMF[1]

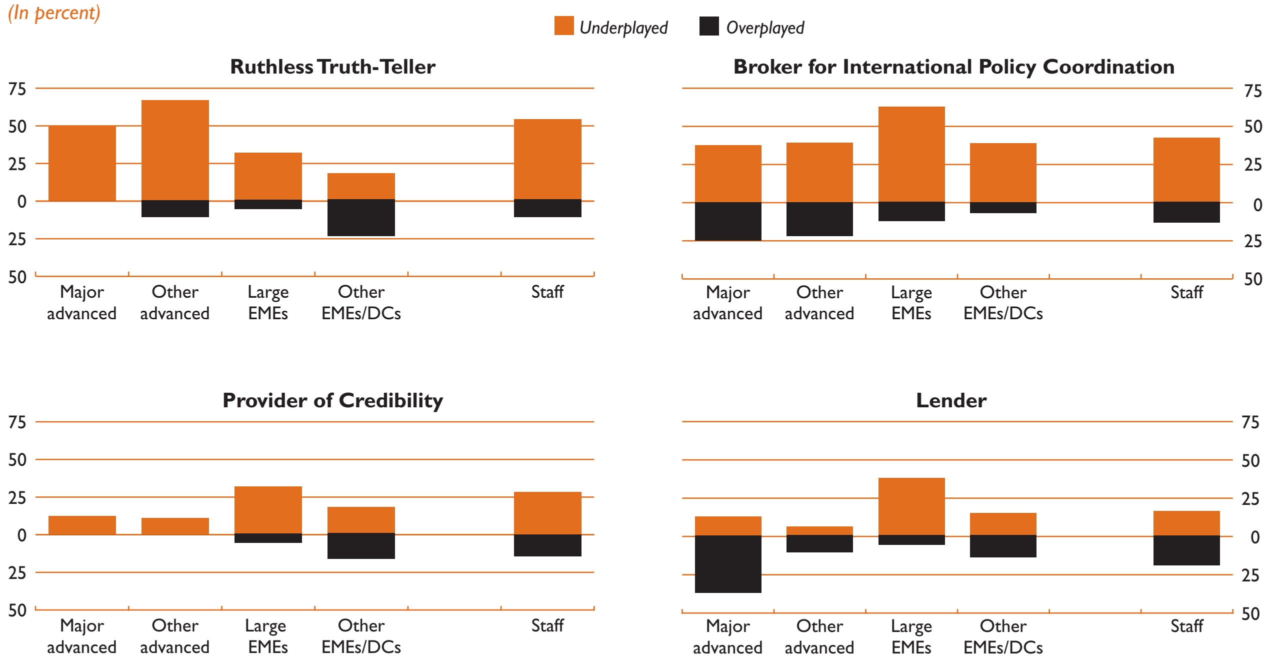
(In percent)



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

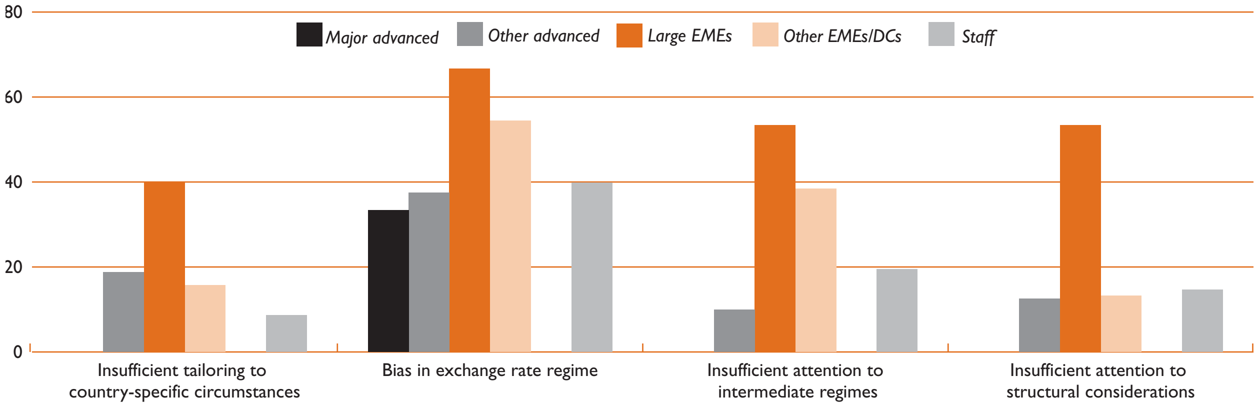
Figure A6.14. Survey of Authorities and Staff: Views on the Role of the IMF[1]

(In percent)



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

Figure A6.15. Authorities' Concerns on the Approach the IMF Used to Assess Regime Choice or Suitability
(In percent)



exchange rate policy decisions. The staff respondents, however, tended to regard the IMF's impact as somewhat greater than the authorities did: in particular, for the "Large EMEs," close to half of the staff thinks that the IMF affected these countries' major decisions, which is double the authorities' percentage. As with a number of previous questions, however, the views of the authorities and the staff converge for "Other EMEs/DCs."

Role of the IMF

22. The next set of questions addresses the role of the IMF by asking the authorities and IMF staff to rate the extent to which the IMF had played different roles in relation to exchange rate matters—both in the context of country-specific discussions and for the IMF membership as a whole. For the purpose of these questions, the middle point of the scale was considered to represent "about right," while the end points represented "missed opportunities" (or "underplayed") and "overplayed."[11]

23. Concerning the role of the IMF vis-à-vis individual countries, more than two-thirds of the surveyed authorities agreed that the IMF was getting it "about right" in its roles as "confidential advisor" and "sounding board" and just above half agreed that that was also the case in its role as a "consensus builder" among domestic policymakers (Figure A6.13).[12] There are differences across country groups, however, with respondents from the "Large EMEs" most likely to see "missed opportunities."

24. As to the IMF's role vis-à-vis the entire membership, roughly two-thirds of the country respondents saw the IMF as getting it "about right" on its roles as "provider of credibility" (through assessment of national policies) and as contingency "lender" (Figure A6.14) On the other hand, fewer than half of the surveyed authorities gave the same rating for the IMF's roles as "ruthless truth-teller" to the international community and "broker" for international policy coordination, with a significant number seeing scope for the IMF to be more proactive. About 40 percent of the staff shared the latter view. Some country differences are striking. For example, while more than 40 percent of the country respondents from "Large EMEs" saw missed opportunities for the IMF's role as lender, a similar percentage of those from "Major advanced" countries thought that the IMF had overplayed this role.[13]

Content of IMF analysis

25. The survey asked the authorities and the staff to identify how they viewed the various dimensions of the content of IMF analysis: (1) the tailoring of advice to country-specific circumstances; (2) bias in exchange rate regime selection; (3) attention given to intermediate regimes; and (4) attention given to structural (as opposed to cyclical) factors in exchange rate regime selection (Figure A6.15). For the most part, only the minority of both populations expressed concerns about the approach the IMF uses to assess regime choice and suitability. The most prevalent concern of the authorities related to bias in regime selection, with 30–60 percent of the respondents raising this concern, depending on the country

[11]The percentages reported in Figures A6.13 and A6.14 include the answers of those respondents who selected the "don't know" option.

[12]Concerning the role of the IMF as consensus builder, 12 percent of the country respondents and 11 percent of the staff respondents selected the "don't know" option.

[13]Overall, between 4 percent and 8 percent of the authorities selected the "don't know" option when it came to the IMF's roles vis-à-vis the entire membership, percentages that rise to 7 percent and 17 percent ("broker" for international policy coordination) for staff.

Figure A6.16. Authorities' Views on the IMF's Methodologies in the Assessment of the Equilibrium Level of Exchange Rates
(In percent)

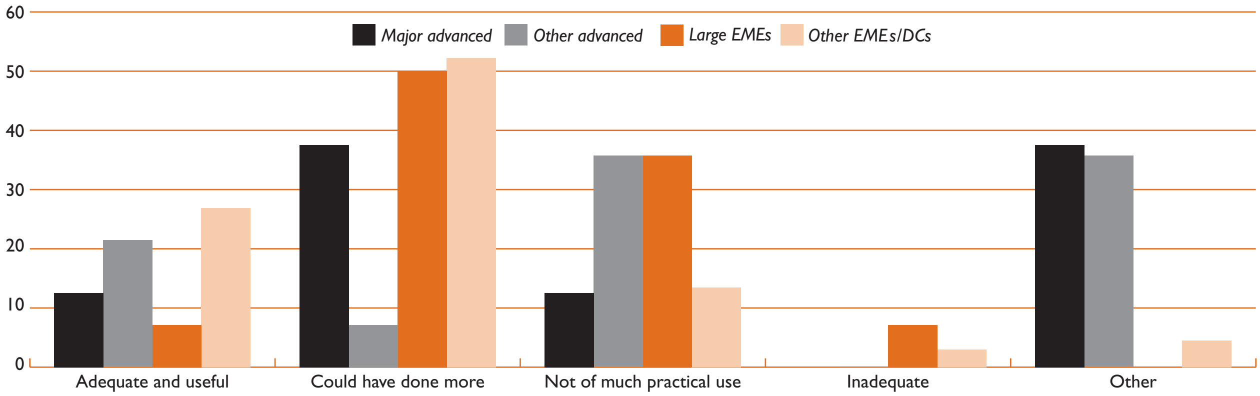
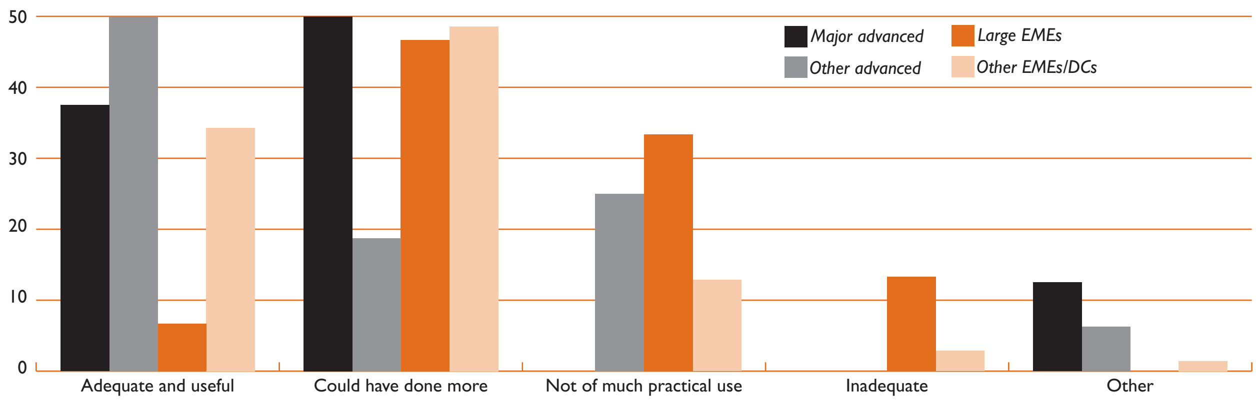


Figure A6.17. Authorities' Views on the IMF's Methodologies in the Assessment of External Competitiveness
(In percent)



group (even 40 percent of the staff respondents identified the concern). The proportion of those expressing concerns is by far the highest for "Large EMEs."

Authorities' views

26. The next five survey questions asked the authorities for their views of selected aspects of IMF analysis.[14] First, as to the IMF's methods to assess the level of exchange rates, about 20 percent of the respondents found them adequate and useful (Figure A6.16). An additional 45 percent thought that more could have been done, while still finding the analysis useful. The country respondents from "Large EMEs" tended to see more problems: about half of them saw the methodologies as either impractical or inadequate.

[14]Except for the final question, the remainder of the survey proceeds separately for the authorities and staff.

27. Second, as to the methods used by the IMF to assess external competitiveness, a similar pattern emerged (Figure A6.17). More than 75 percent of the country respondents saw the methodologies as adequate and useful, or indicated that, while more could have been done, what was done was useful. Once again, about half of the respondents from "Large EMEs" find these methods to be either inadequate or of little practical use.

28. Third, the survey asked the authorities how they view the usefulness of IMF analysis drawn from the experience of other countries (Figure A6.18). About three quarters of the respondents said that the IMF's analysis was at least somewhat useful for decision making. The majority of the respondents from "Other advanced" and "Large EMEs" identified a problem, reporting that cross-country analysis was either not provided by IMF staff or not useful for decision making when provided.

Figure A6.18. Authorities' Views on the Usefulness of the IMF's Analysis Based on the Experience of Other Countries
(In percent)

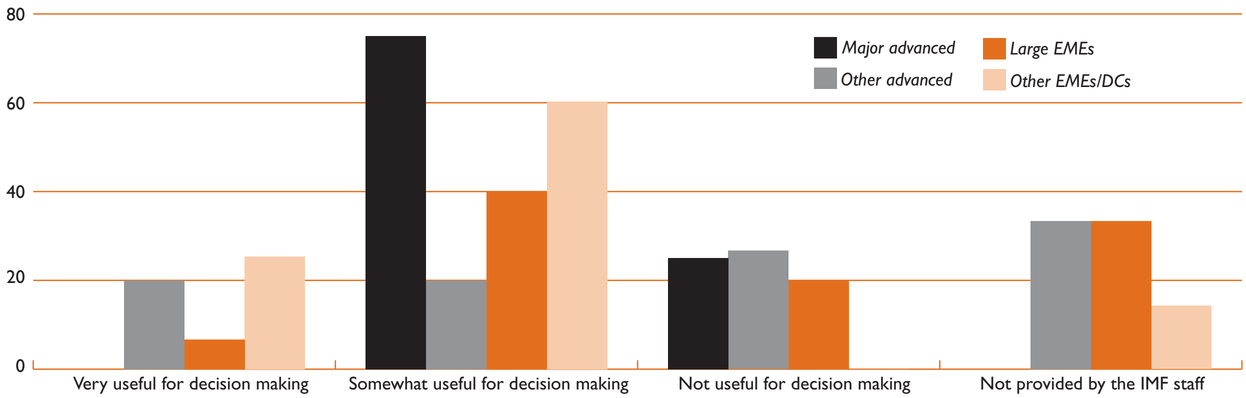


Figure A6.19. Survey of Authorities: Global or Regional Spillovers Affecting Your Country's Exchange-Rate-Related Developments
(In percent)

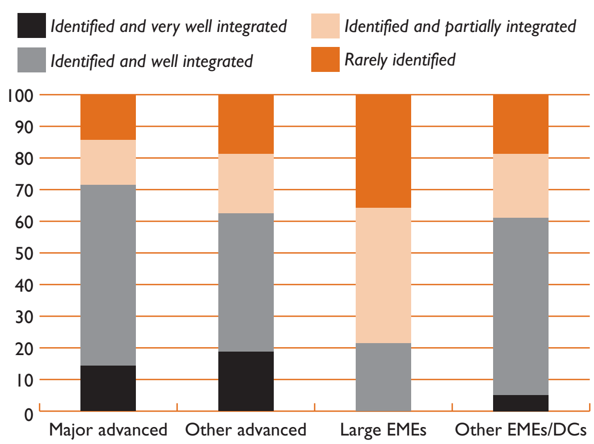
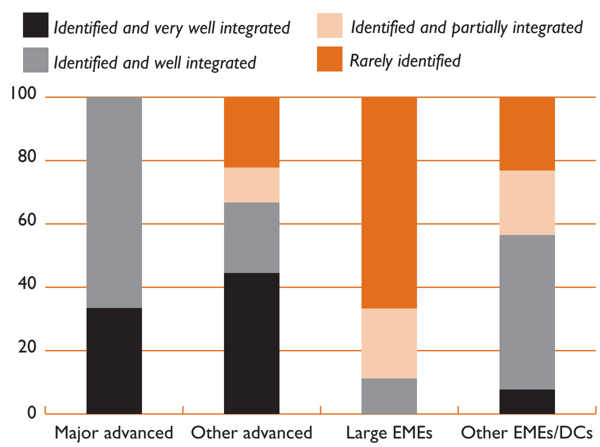


Figure A6.20. Survey of Authorities: Global or Regional Impact of Your Country's Exchange Rate Policy
(In percent)



29. Fourth, the authorities were asked to select one statement that best characterized the staff's analysis of global and regional spillovers, global imbalances, and the interaction between bilateral and multilateral analysis (Figure A6.19). On average, about half of the country respondents considered that the staff had done a reasonable job of integrating the analysis of spillover effects impacting their economies, but this assessment is much more pronounced among the authorities from "Major advanced" countries than for those from "Large EMEs."

30. Finally, the authorities were asked whether the regional and global impact of their policies was considered (Figure A6.20). Overall, about 40 percent of the country respondents said that this was not a relevant issue for their countries. Among those who said it was relevant, the assessments varied quite drastically: in the "Major advanced" group, all of them found the issues well integrated into the analysis, but in the "Large EMEs" about 90 percent of the respondents indicated that the staff either rarely identified the issue or that it was not well integrated.

Staff views

31. The next six questions asked the staff about aspects of IMF analysis. First, the survey sought to understand why, as identified by the Executive Board, clear and candid treatment of exchange rate issues in IMF reports remains a challenge, by suggesting nine possible reasons (Figure A6.21). More than 40 percent

Figure A6.21. Staff Survey: Impediments to Clear and Candid Treatment of Exchange Rate Issues
(In percent)

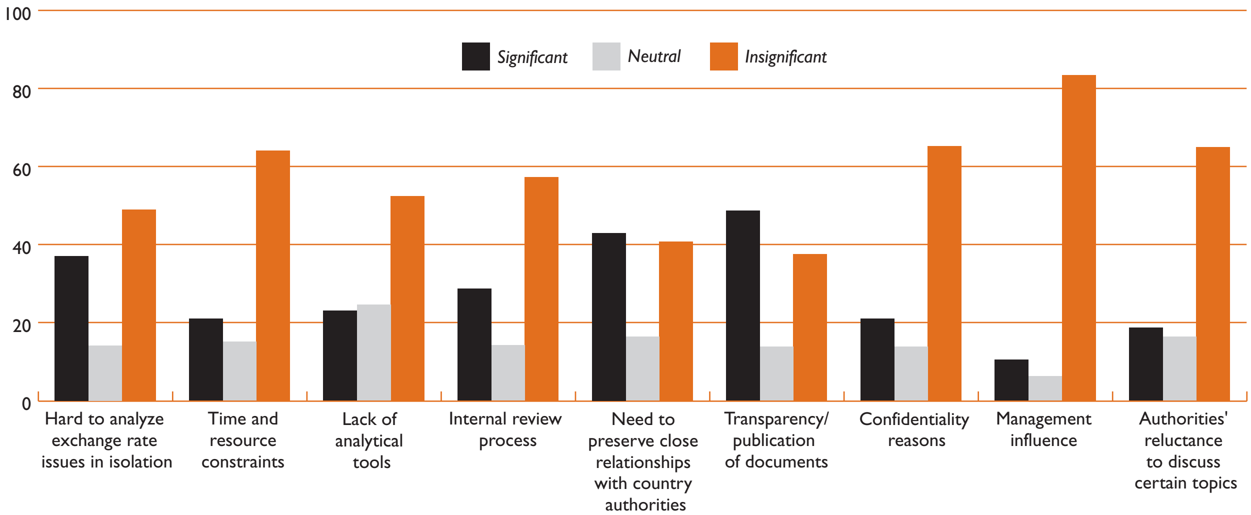
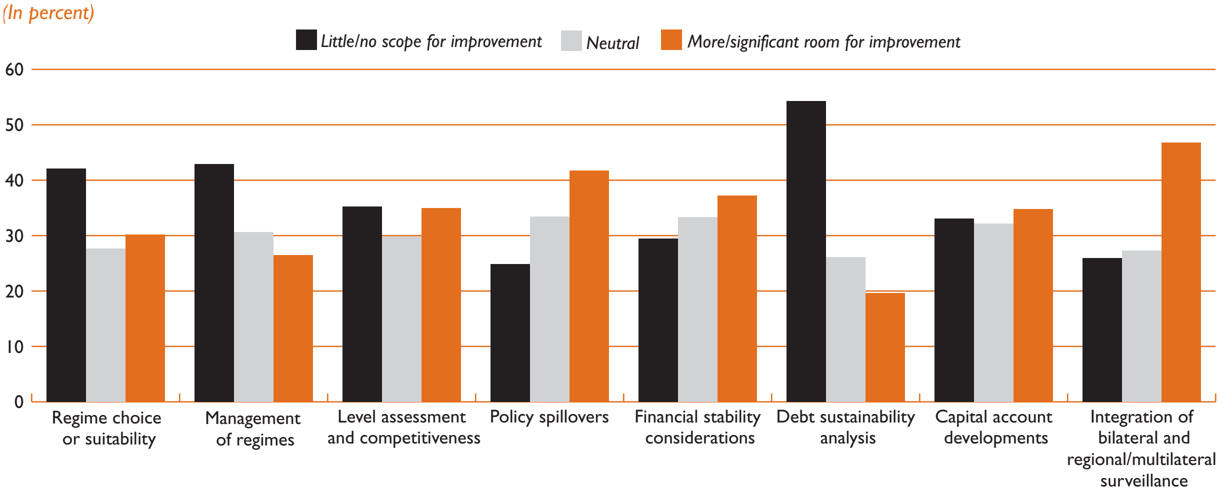


Figure A6.22. Staff Survey: Quality of IMF Analysis
(In percent)



of the staff respondents pointed to the expectation that their analysis would be published and the need to preserve close relationships with country authorities as important factors; almost as many respondents, however, said that these were not the issue. A somewhat smaller share (about 37 percent) of the respondents considered the interlinkage of exchange rate policy issues with other macroeconomic policy areas as posing difficulty, and almost 30 percent pointed to the IMF's internal review process as a significant influence on clear and candid treatment (presumably by creating more cautious language and diluted coverage).

32. Second, staff were asked to identify the scope for improvement in the analysis of eight exchange-rate-related policy areas (Figure A6.22). Debt sustainability analysis is the only area that was seen by the majority of the staff respondents (more than 50 percent) as offering little or no scope for improvement. The largest share of the staff respondents (more than 40 percent), on the other hand, saw room for improvement in the analysis of policy spillovers and the integration of regional and multilateral perspectives.

33. Third, staff were asked to identify the areas of significant room for improvement that would raise the

Figure A6.23. Staff Survey: Areas of Significant Room for Improvement
(In percent)

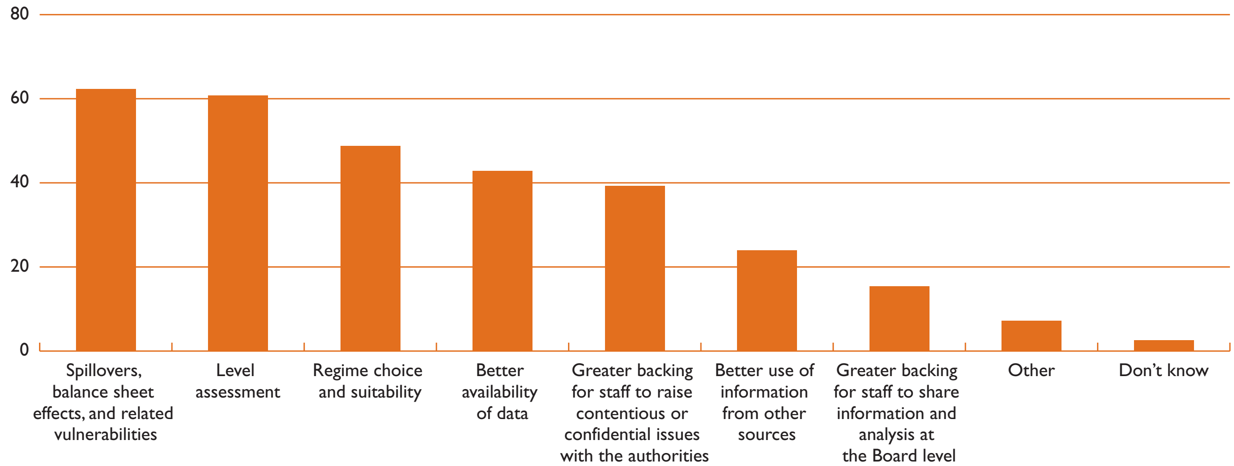
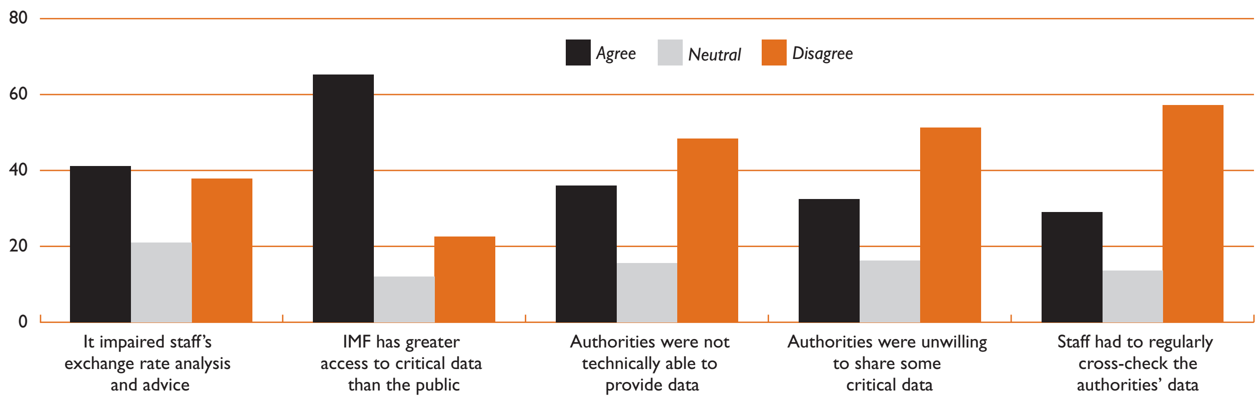


Figure A6.24. Staff Survey: Agreement with Selected Statements on Data Quality
(In percent)



overall quality of analysis (Figure A6.23). Consistent with the previous answers by staff, more than half of the respondents recognized that improving the analysis of policy spillovers would help in that regard. The majority also recognized exchange rate level assessment as a promising area for improvement (this is somewhat surprising given that in answering the previous question, only 35 percent had identified room for improvement there). Around 40 percent of the staff respondents identified "regime choice and sustainability" and "better availability of data" as the next two most promising areas.

34. Fourth, as a follow-up question, those who identified "better availability of data" as a promising area for improvement (about 40 percent of the staff respondents) were asked to rate their level of agreement with a series of data-related statements (Figure A6.24). The staff had a split view on whether data availability problems had impaired analysis, but about 65 percent saw the IMF as having an informational advantage over the public. Almost 40 percent said that the authorities were *technically unable* to provide data, while more than 30 percent considered them *unwilling* to share some critical data.

35. Fifth, the staff respondents were asked to rate the extent of help they received from various internal sources on exchange rate policy matters (Figure A6.25). Seventy percent of them saw area departments' analysis as helpful, and 45 percent cited significant help from the Research Department. More than 70 percent of the respondents did not regard as significantly helpful the 1977 Surveillance Decision.[15]

36. Finally, the last of the staff-directed questions asked those respondents who were involved in work on CGER-covered countries to rate the usefulness of the

[15]The share falls from 70 percent to 60 percent if we include those who selected the "don't know" option (who amount to about 20 percent of the total).

Figure A6.25. Staff Survey: Internal Sources of Help for Staff's Work on Exchange Rate Issues
(In percent)

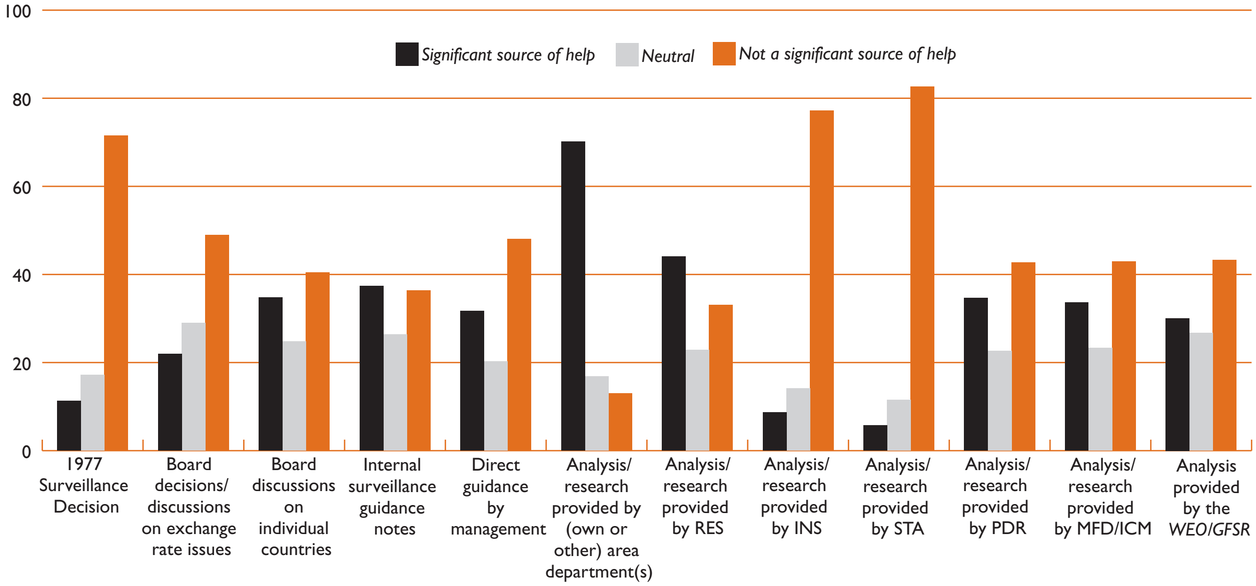
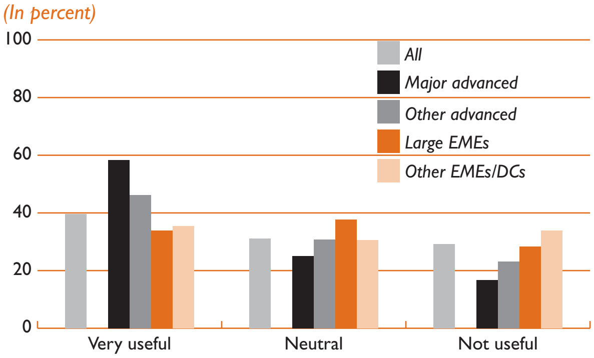


Figure A6.26. Staff Survey: Overall Usefulness of the CGER Exercise
(In percent)



CGER methodological approach (Figure A6.26).[16] On average, 40 percent of this group saw CGER work as very useful, including 60 percent of those working on "Major advanced" economies.

Did the quality of IMF analysis improve?

37. The survey concluded by asking both the authorities and staff whether the overall quality of the staff's exchange rate analysis and assessment had changed, and to what extent, from about 1999 to the end of the evaluation period (Figure A6.27). Overall, a slight majority of authorities saw improvements in the overall quality—albeit with sizable percentages of the respondents from "Large EMEs" thinking that it was unchanged and those from "Other advanced" and "Other EMEs/DCs" thinking that it had improved, and in some cases significantly. On the issue of quality improvement, there was a significant gap in the perceptions of the authorities from "Major advanced" economies and "Large EMEs" relative to those of staff, while perceptions for the other country groups were about the same.

Analysis of Survey Findings

38. This section takes a deeper look at (1) the authorities' perceptions of IMF impact on their major exchange rate decisions and (2) the authorities' assessment of how the overall quality of IMF staff analysis and advice has changed over time.[17] First, as to the IMF's impact, we examined the 90 economies in which, in the views of the authorities, major decisions had been taken during the 1999–2005 period (Table A6.1). As noted earlier (see Figure A6.12), the impact was more often seen as instrumental in other emerging and developing economies than in advanced and large emerging market economies.

39. As highlighted above, the level of attention given to a topic in internal discussions did not always correspond to the attention given in the authorities' dis-

[16]For details on the CGER methodology, see Background Document 3.

[17]The seniority of the respondent did not appear to affect the conclusions drawn in this section, either for the authorities or for IMF staff.

Figure A6.27. Perceived Change in the Overall Quality of IMF Staff's Analysis and Assessment over the Evaluation Period
(In percent)

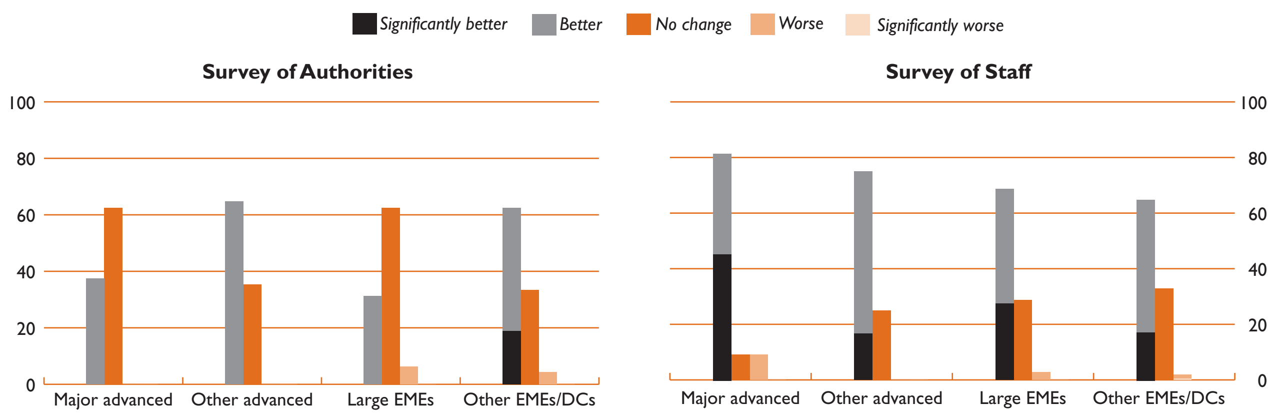


Table A6.1. Authorities' Views of IMF Impact on Major Exchange Rate Policy Decisions
(Number of economies)

Extent of Impact	Advanced	Large EMEs	Other EMEs/DCs	Total
Instrumental	1	3	33	37
Marginal	8	8	18	34
No impact	7	0	1	8
Little/no discussion with IMF	6	3	2	11
Total	22	14	54	90

cussions with the IMF. In 37 cases, mainly smaller emerging and developing economies, the authorities saw the IMF as instrumental in helping shape major policy decisions. By contrast, in 11 cases, mostly advanced economies, the authorities reported that, to the extent that major decisions were taken related to exchange rate policy in 1999–2005, there was little or no discussion with the IMF. In most of these latter cases, given the country's own technical capacity, no follow-up support was requested or received.

40. There was some evidence of a correlation between the extent to which the authorities took sensitive policy issues off the table, and the impact the IMF had on their policy decisions (Table A6.2). For example, almost 70 percent of the country respondents who said that the IMF's impact was instrumental did not exclude or restrict issues for discussion, whereas the share was down to about 40 to 50 percent for those who saw no impact or had little or no discussion with the IMF. The evidence was mixed with regard to the links between the authorities' agreement/disagreement with staff analysis and IMF impact. A large share (more than 80 percent) of those who said that the IMF was instrumental agreed with the findings of staff analysis, but the same was true for those who said the IMF had no impact (Table A6.3).

41. Impact also appeared to be correlated with the perceived quality of the dialogue, the importance of the IMF as a source of external advice, and the significance of Executive Board contributions (Table A6.4). Among the country respondents who said that the IMF was instrumental, only 8 percent *disagreed* with the statement that their discussions with IMF staff had been substantive and two-way; only 22 percent *disagreed* with the statement that the IMF was the principal source of external advice; and no one *disagreed* with the statement that the Executive Board made a significant contribution to policy development. The percentage of respondents that disagreed with those statements in general rises with a fall in impact.

42. Analysis of the survey data also indicates a correlation between the respondents who said that the IMF was instrumental and those who said that the quality of IMF analysis had improved (Table A6.5). Indeed, 70 percent of the country respondents who said that the

Table A6.2. Impact and Restrictions on Issues for Discussions
(In percent)

Extent of Impact	Sensitive Issues Excluded or Restricted	Neutral	No Exclusion or Restrictions
Instrumental	19	11	69
Marginal	22	19	59
No impact	63	. . .	37
Little/no discussion with IMF	45	. . .	55

Table A6.3. Impact and Agreement with Staff Analysis
(In percent, unless otherwise noted)

Extent of Impact	Agreement	Disagreement	Area of Greatest Disagreement[1]
Instrumental	81	19	Regime choice/level assessment
Marginal	59	41	Level assessment
No impact	88	13	Regime choice
Little/no discussion with IMF	64	36	Regime choice

[1]The area that was selected by the highest number of respondents among those who indicated that they disagreed with staff's analysis.

Table A6.4. Impact and Aspects of the Authorities' Interactions with the IMF
(In percent)

	Disagreement That:		
Extent of Impact	Discussions were substantive, two-way	IMF was principal source of external analysis	Executive Board provided an important input
Instrumental	8	22	0
Marginal	9	36	30
No impact	50	88	88
Little/no discussion with IMF	45	55	90

Table A6.5. Impact and Views of How the Quality of Analysis Has Changed
(In percent)

Extent of Impact	Better	About the Same	Worse
Instrumental	70	30	. . .
Marginal	44	50	6
No impact	50	50	. . .
Little/no discussion with IMF	45	36	18

IMF was instrumental also said that the overall quality of IMF analysis had improved, whereas half or less of those from the other groups saw improvement.

43. The fact that the overall quality of analysis has remained the same would not be a cause for concern if the staff's work had been perceived as satisfactory to begin with. This, however, does not appear to have been the case along various dimensions. For example, many of the country respondents who saw quality remaining the same agreed that staff could have done more in the area of analytical and empirical underpinnings for their assessments and advice (Table A6.6) and could have better integrated country-specific factors and constraints into their analysis (Table A6.7). Moreover, even among those country respondents who saw the overall quality as improving, the evidence suggests that about half felt that more could have been done, in particular with regard to the integration of regional and multilateral perspectives and the sense of urgency given to the policy advice. The authorities did not equate statements that quality had improved or remained the same from 1999–2005 with the view that no further improvements could have been made. In many cases, the authorities saw room for improvement.

Table A6.6. Views on Overall Quality Change and Staff Analysis[1]
(In percent unless otherwise noted)

Overall Quality Has Become:	Analytical Underpinnings			Multilateral			Integration with Policy Areas			Balance Sheet		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Better	36	33	31	44	34	22	35	18	47	34	26	39
About the same	49	22	29	29	24	48	35	19	47	33	20	48
Memorandum item												
Worse (number of economies)	1	0	2	2	0	2	1	0	2	1	1	1

[1]Respondents were asked to rate the extent of agreement with the statement that IMF staff could have done more to improve the usefulness and substance of discussions in the respective areas.

Table A6.7. Views on Overall Quality Change and Implementability[1]
(In percent unless otherwise noted)

Overall Quality Has Become:	Country-Specific			Implementation			Undue Urgency			Cost-Benefit		
	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree	Agree	Neutral	Disagree
Better	43	30	28	44	25	31	50	22	28	37	33	30
About the same	45	19	36	31	31	38	23	18	60	33	18	50
Memorandum item												
Worse (number of economies)	2	0	2	1	0	2	1	1	1	2	1	1

[1]Respondents were asked to rate the extent of agreement with the statement that IMF staff could have done more to improve the usefulness and substance of discussions in the respective areas.

44. The survey of authorities suggests that the level of attention given to exchange-rate-related topics in authorities' discussions with staff does not always correspond to the attention given internally (Figures A6.1 and A6.2 above). At the same time, the IMF's impact on major policy decisions taken by the authorities was found to differ substantially across country groupings (Figure A6.12). Information from all three of these survey questions can be combined to assess the relationship between "gaps in coverage," as suggested by the relative emphasis placed on different exchange rate issues internally and in discussions with IMF staff, and IMF impact, as perceived by the authorities. Figure A6.28 shows a positive correlation between these gaps and the extent of impact: the larger the number of countries with perceived "gaps in coverage,"[18] the smaller the perceived IMF contribution to the authorities' policy decisions across countries.[19]

[18]For each exchange rate topic, this expression is meant to capture the difference in emphasis given to that topic by the authorities in their own internal discussions to their discussions with the IMF, as reported by country respondents.

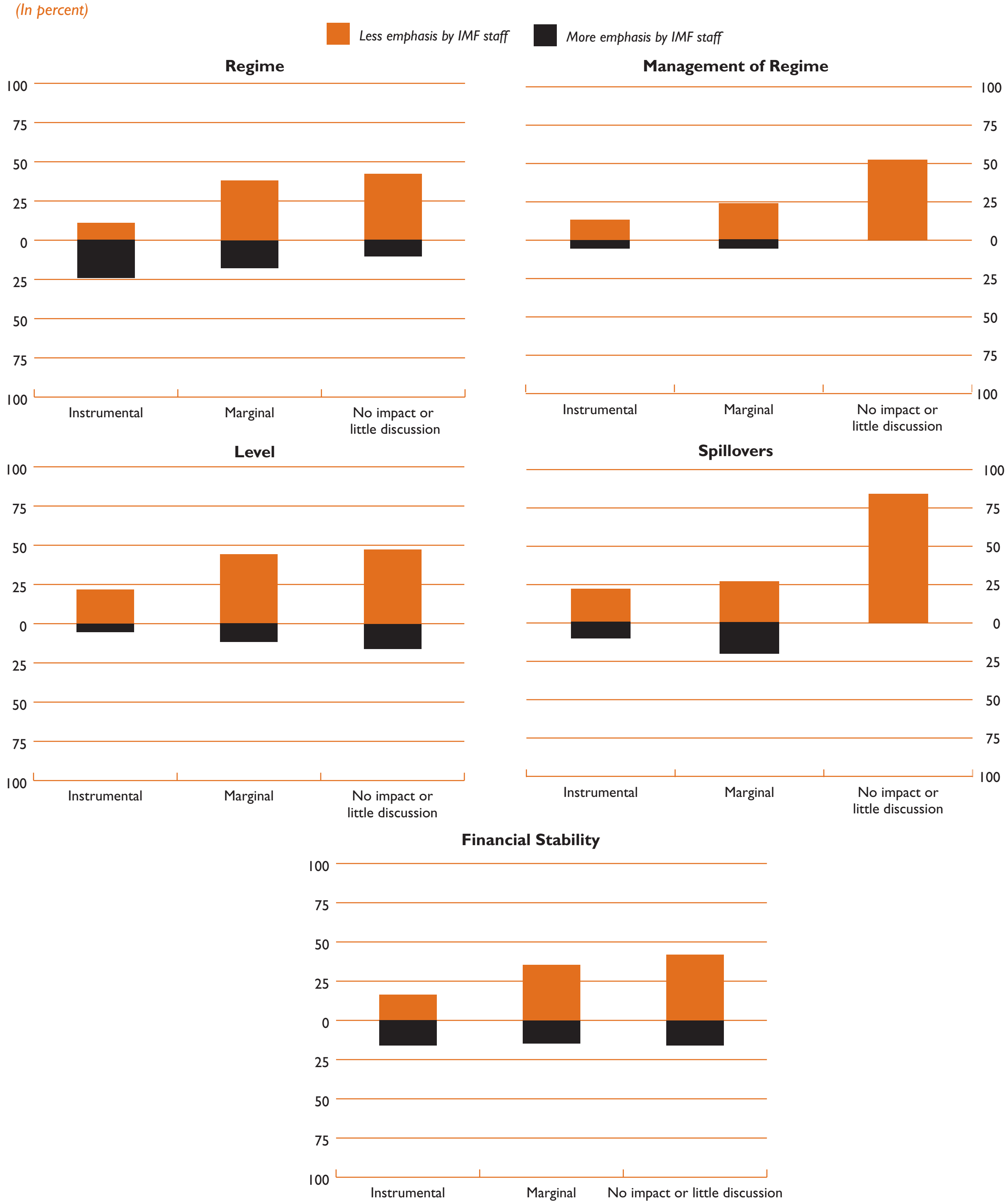
[19]Regression analysis suggests evidence of a relationship between "gaps in coverage" and IMF impact for three of the five policy areas (regime choice, regime management, and spillovers) covered in Figure A6.34, when controlling for whether or not policy issues have been taken "off the table" by the authorities (Figure A6.7). Given the nature of the control variable, causality may therefore run from the "gaps in coverage" to impact, suggesting that efforts to address these gaps are likely to increase the impact of IMF advice.

Further Analysis of Survey Responses for Large EMEs

45. This section provides a detailed analysis of the survey data for large EMEs by comparing, for each economy, the survey responses from the authorities with the "matched" answers from the corresponding staff respondents. When there are more than one staff respondent for a country, the staff responses were averaged. Specifically, for rating questions, the staff response was the simple average of all responses; for questions that ask for the selection of an option, the staff response is given by a simple majority view (in the case of a tie between two or more options, we choose the one that is judged to reflect the majority view more closely on the basis of how all the respondents have selected the available options).[20] The numbers reported in the figures below refer to the large EMEs for which matched responses are available; these matched results support the findings of the overall surveys.

[20]When this failed to break the tie, we took as the staff response the option that most closely matched the authorities' response.

Figure A6.28. IMF Impact on Major Exchange Rate Policy Decisions and Differences in Emphasis in Policy Discussions[1]
(In percent)



[1]Authorities' responses (in percent of economies reporting a given degree of impact) regarding the relative emphasis given to exchange rate issues in internal discussions compared to those with IMF staff.

Figure A6.29. Focus of Discussion with the IMF[1]

(Number of economies)

A. Regime Choice

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	3	5	0	8
	3	1	1	1	3
	4+5	0	2	2	4
	Total	4	8	3	15

B. Regime Management

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	13	0	1	14
	3	0	0	0	0
	4+5	1	0	0	1
	Total	14	0	1	15

C. Level Assessment

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	7	2	0	9
	3	3	2	0	5
	4+5	1	0	0	1
	Total	11	4	0	15

D. Spillovers

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	2	1	1	4
	3	1	2	4	7
	4+5	1	2	1	4
	Total	4	5	6	15

E. Financial Vulnerability[2]

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	4	1	0	5
	3	3	1	0	4
	4+5	4	1	0	5
	Total	11	3	0	14

[1] 1+2 = A focus; 3 = Neutral; and 4+5 = Not a focus.
[2] One authority respondent chose the "don't know" option.

On the focus of discussions

46. The staff and the authorities differ significantly in their perception of the focus of their exchange-rate-related discussions (Figure A6.29). In terms of the five policy areas identified in the surveys, there is a high level of agreement (in 13 out of 15 countries) on the area of exchange rate regime management, whereas the level of agreement is low for policy spillovers (4 out of 15 countries—counting diagonally from the north-west corner) and for financial vulnerability assessment (5 out of 14 countries). The average or representative staff responses for large EMEs are similar to the overall survey results, except on the issue of regime choice. The "representative" staff identified regime choice as a focus of discussion in only 4 out of 15 countries (26 percent), whereas 56 percent of the staff respondents in the overall survey made that same assessment.

Figure A6.30. Authorities' Agreement with Staff Analysis[1]

(Number of economies)

		Staff				
		b+c	d	a+e	f+g	Total
Authorities	b+c	3	5			8
	d	3	3			6
	a+e					
	f+g		1			1
	Total	6	9			15

[1] b+c = Broadly agree; d = Disagreements on important details; a+e = No dialogue or not clear/inconsistent; and f+g = Major disagreements.

On staff analysis

47. The authorities' agreement with staff analysis coincided with a similar perception from staff in only 6 out of 15 economies (Figure A6.30).[21] This supports the findings from the overall survey, namely, staff have a somewhat guarded view of the authorities' agreement with their analysis. For example, staff saw the authorities disagreeing on important details of their analysis in 5 out of 15 cases where the authorities said they agreed.

On restricting discussions

48. Staff's perception of the extent to which the authorities restricted the discussion of sensitive issues differed considerably from the authorities' own assessment (Figure A6.31). Staff consider that the authorities restricted discussions in only one of the seven cases where the authorities reported having done so. There are only six countries where, according to the authorities, the discussion of issues was unrestricted. Relative to the findings from the overall survey, the country-matched data indicate a greater perception gap of the staff from the authorities' own assessment.

[21] Again counting diagonally from the north-west corner.

Figure A6.31. Off-the-Table Issues[1]

(Number of economies)

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	1	2	4	7
	3		1	1	2
	4+5		1	5	6
	Total	1	4	10	15

[1]1+2 = Restricted; 3 = Neutral; and 4+5 = Unrestricted.

Figure A6.32. The IMF's Impact on Major Exchange Rate Decisions[1]

(Number of economies)

		Staff					
		a	b	c	d	f	Total
Authorities	a	2	1				3
	b	3	4			1	8
	c						
	d		2		1		3
	f		1				1
	Total	5	8		1	1	15

[1]a = Instrumental; b = Marginal; c = No impact; d = Little/no discussions; and f = No major decisions taken.

On impact on major decisions

49. Concerning the impact of IMF advice on major exchange rate policy decisions, there is agreement between the staff's perception and the authorities' stated assessment in 7 out of 15 countries (Figure A6.32). Also, staff tended to overestimate (relative to the authorities' assessment) their impact by a large margin: 6 countries are found below the diagonal elements of the matrix, with only 2 countries found above. Relative to the overall survey findings, however, the "representative" staff working on a large EME tends to have a less sanguine assessment of their impact. For example, they see the IMF's impact as instrumental in 27 percent of the cases (5 out of 15 countries), whereas 39 percent of the surveyed staff in the overall survey considered their impact to be instrumental for large EMEs. From the authorities' side, major decisions were taken in more than 90 percent of the cases (14 out of 15), and among them 60 percent (8 out of 14) saw the IMF's impact as marginal.

On the role of the IMF

50. In terms of three roles the IMF can play vis-à-vis member countries, staff's perception again differs widely from the authorities' assessment (Figure A6.33). Both agreed on the extent to which the IMF plays the respective roles in less than half the cases. In particular, they agreed that the IMF plays these roles "about right" only in 4 out of 13 countries for the "confidential advisor" role; 7 out of 15 countries for the "sounding board" role; and 4 out of 10 countries for the "consensus builder" role.

Figure A6.33. The Role of the IMF[1]

(Number of economies)

A. "Confidential Advisor"[2]

		Staff			
		1+2	3	4+5	Total
Authorities	1+2		3	1	4
	3	2	4	1	7
	4+5		2		2
	Total	2	9	2	13

B. "Sounding Board"

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	2	2		4
	3	2	7		9
	4+5		2		2
	Total	4	11		15

C. "Consensus Builder"[3]

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	1		1	2
	3	2	4		6
	4+5	1	1		2
	Total	4	5	1	10

[1]1+2 = Too little; 3 = About right; and 4+5 = Too much. Two country respondents and three groups of staff chose the "don't know" option.
[2]Two country respondents chose the "don't know" option.
[3]Two country respondents and three groups of staff chose the "don't know" option.

Figure A6.34. Perceived Change in the Overall Quality of IMF Analysis[1]

(Number of economies)

		Staff			
		1+2	3	4+5	Total
Authorities	1+2	4			4
	3	8	2		10
	4+5	1			1
	Total	13	2		15

[1]1+2 = Better; 3 = About the same; and 4+5 = Worse.

On overall quality changes

51. Regarding the change in the overall quality of IMF analysis and assessment, the perceptions of staff and the authorities matched in 40 percent of the cases over the 1999–2005 period. The country-matched survey data reinforce the overall survey finding that, for large EMEs, staff see improvement in more cases than the authorities (13 out of 15 versus 4 out of 15; Figure A6.34).

Annex A6.1. Features of the Survey Responses

As noted in the text, the response rates from the two populations were high enough to yield statistically meaningful inferences. Specifically, about 60 percent of the authorities responded to the survey. Across the four country groups, the response rate ranged from just below 50 percent to close to 90 percent (Table A6.1a). All four regional central banks also responded to the survey.

The response rate by staff was also significant, but somewhat lower at 47 percent, with about half of the staff who were targeted in area departments taking the survey. Fewer than 10 percent of the respondents did not select a country (Table A6.1b).

About 90 percent of the country response submissions came from central banks, although this ratio was smaller for "Major advanced" economies. A significant fraction (two-thirds) of the respondents were above the level of senior advisor or department head, with a significant majority also indicating they were directly involved in policy discussion, both internally and with IMF staff. Close to 70 percent of all respondents had been involved in discussions throughout the period. Except for institutional affiliation, the respondents' characteristics were broadly similar across country groups.

Among the respondents to the staff survey, more than 90 percent selected a country, and more than a third of these respondents reported having led missions. The staff respondents tended to have recent involvement in the selected countries, typically for about two to three years.

In total, the staff respondents selected 115 countries, of which 80 had corresponding survey responses from the authorities (Table A6.1c). This overlap serves as a quality control device in drawing inferences from some questions, particularly for the group of "Large EMEs" where the overlap was particularly significant.

Table A6.1a. Survey of Authorities' Responses

(Number of economies unless otherwise noted)

Economy Type	Economies Surveyed	Respondents	Response Rate[1]
Major advanced[2]	9	8	89
Other advanced	21	18	86
Large EMEs	20	16	80
Other EMEs/DCs	142	72	51
Total	192	114	59

[1]In percent.
[2]Includes the European Central Bank as well as the European Commission.

Table A6.1b. Staff Survey Responses

(Number of staff unless otherwise noted)

	By Departmental Affiliation			By Economy Selection	
	Staff surveyed	Responded	Response rate[1]		
Area	436	230	53	Major advanced	12
Functional	355	140	39	Other advanced	16
Total	791	370	47	Large EMEs	81
				Other EMEs/DCs	187
				No country identified	22
				No involvement	52
				Total	370

[1]In percent.

Table A6.1c. Authorities' Response and Staff's Country Selections
(Number of economies)

	Staff		
	Selected	Not selected	Total
Authorities			
Responded	80	34	114
Of which:			
Major advanced	4	4	8
Other advanced	9	9	18
Large EMEs	15	1	16
Other EMEs/DCs	52	20	72
No response	5	43	78
Of which:			
Major advanced	1	0	1
Other advanced	0	4	3
Large EMEs	4	0	4
Other EMEs/DCs	30	39	70
Total	115	77	192

Annex A6.2

List of Economies Surveyed

Large Advanced	Other Advanced	Large Emerging	Other Emerging and Developing	
Canada	Australia	Argentina	Afghanistan, Islamic Republic of	Cambodia
Euro area	Austria	Bangladesh	Albania	Cameroon
France	Belgium	Brazil	Algeria	Cape Verde
Germany	Cyprus	China	Angola	Central African Economic and Monetary Community
Italy	Denmark	Colombia	Antigua and Barbuda	Central African Republic
Japan	Finland	Egypt	Armenia	Chad
United Kingdom	Greece	India	Aruba	Chile
United States	Hong Kong SAR	Indonesia	Azerbaijan	Comoros
	Iceland	Iran, Islamic Republic of	Bahamas, The	Congo, Democratic Republic of the
	Ireland	Malaysia	Bahrain	Congo, Republic of
	Israel	Mexico	Barbados	Costa Rica
	Korea	Pakistan	Belarus	Côte d'Ivoire
	Luxembourg	Philippines	Belize	Croatia
	Netherlands	Poland	Benin	Czech Republic
	New Zealand	Russia	Bhutan	Djibouti
	Norway	Saudi Arabia	Bolivia	Dominica
	Portugal	South Africa	Bosnia and Herzegovina	Dominican Republic
	Singapore	Thailand	Botswana	Eastern Caribbean Currency Union
	Spain	Turkey	Brunei Darussalam	Ecuador
	Sweden	Ukraine	Bulgaria	El Salvador
	Switzerland		Burkina Faso	Equatorial Guinea
			Burundi	

Other Emerging and Developing *(concluded)*

Eritrea	Kiribati	Micronesia, Federated States of	Rwanda	Timor-Leste
Estonia	Kuwait	Moldova	Samoa	Togo
Ethiopia	Kyrgyz Republic	Mongolia	São Tomé and Príncipe	Tonga
Fiji	Lao People's Democratic Republic	Morocco	Senegal	Trinidad and Tobago
Gabon	Latvia	Mozambique	Serbia	Tunisia
Gambia, The	Lebanon	Myanmar	Seychelles	Turkmenistan
Georgia	Lesotho	Namibia	Sierra Leone	Uganda
Ghana	Liberia	Nepal	Slovak Republic	United Arab Emirates
Grenada	Libyan Arab Jamahiriya	Netherlands Antilles	Slovenia	Uruguay
Guatemala	Lithuania	Nicaragua	Solomon Islands	Uzbekistan
Guinea	Macao SAR	Niger	Sri Lanka	Vanuatu
Guinea-Bissau	Macedonia, FYR	Nigeria	St. Kitts and Nevis	Venezuela, República Bolivariana de
Guyana	Madagascar	Oman	St. Lucia	Vietnam
Haiti	Malawi	Palau	St. Vincent and the Grenadines	West African Economic and Monetary Union
Honduras	Maldives	Panama	Sudan	Yemen, Republic of
Hungary	Mali	Papua New Guinea	Suriname	Zambia
Iraq	Malta	Paraguay	Swaziland	Zimbabwe
Jamaica	Marshall Islands	Peru	Syrian Arab Republic	
Jordan	Mauritania	Qatar	Tajikistan	
Kazakhstan	Mauritius	Romania	Tanzania	
Kenya				

Annex A6.3

Survey Questions for National Authorities

Q1. Please rate the degree to which the following exchange-rate-related issues have been a *focus of internal policy attention in your country/economy* at some point during 1999–2005.

1—2—3—4—5—0
1—"Significant focus," 5—"Not at all a focus," 0—"Don't know"

(a) Exchange rate regime choice (e.g., peg, monetary union, floating, choice of nominal anchor), including contingency planning
(b) Management of the regime(s) in place over the period (e.g., inflation targeting, intervention, international reserves levels, currency auction systems)
(c) Exchange rate level (e.g., competitiveness, sustainability, impact on inflation)
(d) Effects of other countries' policies on your country; or of your country's policies on others (e.g., regional spillovers, global imbalances, contagion)
(e) Financial stability considerations (e.g., currency mismatches and other potential balance sheet vulnerabilities)

Q2. For the same set of exchange-rate-related issues asked in the previous question, please rate the level of *focus on these issues in discussions with IMF staff* during 1999–2005.

1—2—3—4—5—0
1—"Significant focus," 5—"Not at all a focus," 0—"Don't know"

(a) Exchange rate regime choice (e.g., peg, monetary union, floating, choice of nominal anchor), including contingency planning
(b) Management of the regime(s) in place over the period (e.g., inflation targeting, intervention, international reserves levels, currency auction systems)
(c) Exchange rate level (e.g., competitiveness, sustainability, impact on inflation)
(d) Effects of other countries' policies on your country; or of your country's policies on others (e.g., regional spillovers, global imbalances, contagion)
(e) Financial stability considerations (e.g., currency mismatches and other potential balance sheet vulnerabilities)

Q2a. If you answered **"1" or "2"** to any of the statements listed in the previous question, please indicate *who took the initiative* to raise the respective issue (please select **one**):

1—"Raised by staff," 2—"Jointly raised," 3—"Raised by the authorities," 0—"Don't know"

(a) Exchange rate regime choice
(b) Management of the regime(s) in place
(c) Exchange rate level
(d) Effects of other countries' policies on your country; or of your country's policies on others
(e) Financial stability considerations

Q3. Please indicate the authorities' overall *level of agreement* with the IMF staff's analysis and assessment in the policy area(s) that have been a *focus of internal policy attention in your country/economy* at some point during 1999–2005 (as you identified in **Q1**). Please select the ONE statement that **best** describes your opinion.

The authorities in my country . . .

(a) . . . did not have any dialogue of substance on exchange-rate-related matters during the period
(b) . . . agreed with all aspects of the IMF staff's analysis and assessment;
(c) . . . broadly agreed, except for minor differences in emphasis, detail, or timing
(d) . . . agreed on some aspects, but disagreed on important details (e.g., emphasis, timing, or political feasibility)
(e) . . . found the IMF staff's analysis and assessment not clear enough or too inconsistent to form a clear view
(f) . . . disagreed on important aspects of analysis and assessment and did not follow the staff's recommendations
(g) . . . disagreed on important aspects of analysis and assessment, but felt obliged to follow the staff's recommendations

If answer under **Q3** was d, e, f or g, please answer **Q3a**; otherwise skip to **Q4**.

Q3a. You indicated in the previous question that there was a lack of agreement or clarity with the IMF analysis. In the question below, please indicate in which areas there was lack of agreement or clarity (check **all** that apply):

(a) Exchange rate regime choice
(b) Management of the regime(s) in place
(c) Exchange rate level
(d) Effects of other countries' policies on your country; or of your country's policies on others
(e) Financial stability considerations
(f) None of the above

Q4. Please rate your level of agreement with each of the following statements about the *nature of your interaction* with the IMF on exchange-rate-related policy issues:

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know"

(a) IMF staff conducted substantive, two-way policy discussions with the authorities in your country
(b) Discussions with IMF staff were held with appropriate frequency
(c) Discussions with IMF staff had the right balance between informality, confidentiality, and requirements of reporting to the Executive Board
(d) The IMF was the principal source of external analysis and assessment

Annex A6.3 *(continued)*

(e) The authorities at times excluded certain sensitive policy issues (e.g., foreign exchange market intervention, choice of exchange rate regime from substantive discussions with IMF staff
(f) The authorities excluded or restrained consideration of certain issues because of concerns about possible dissemination of information, including to the IMF Executive Board
(g) The IMF mission teams approached discussions with candor and were willing to raise politically sensitive issues
(h) The IMF mission teams approached discussions in a respectful and open-minded way
(i) Policy discussions with IMF staff were fully reflected in documents subsequently sent to the IMF Executive Board
(j) Considerations at the level of the IMF's Executive Board provided an important input into the development of policy

Q5. Please rate your level of agreement with each of the following statements about the *substance and usefulness* of the IMF's exchange-rate-related discussions with your country:

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know"

IMF staff could usefully have . . .
(a) . . . provided its analysis and assessment in a more timely fashion
(b) . . . focused more on country-specific factors and constraints
(c) . . . provided a better analytical/empirical underpinning for its views on exchange rate issues
(d) . . . developed broad points of view more concretely into issues of implementation
(e) . . . been more careful in advocating certain policy actions as urgent
(f) . . . better considered the costs and benefits of policy options
(g) . . . brought in more multilateral or regional perspectives
(h) . . . better integrated exchange-rate-related advice with advice in other policy areas (e.g., monetary policy, financial stability)
(i) . . . explored more fully the sectoral balance sheet implications of exchange rate changes
(j) . . . engaged in more informal interaction with the authorities (e.g. through workshops)
(k) . . . formulated its views in a clearer and less nuanced fashion
(l) . . . provided written documentation of its assessments (e.g., for the authorities to study and share with others)

Q6. To the extent that the authorities in your country have taken major decisions related to exchange rate policy in 1999–2005, please identify how the *contribution made by the Fund* can be best characterized. Please select the ONE option that **best** reflects your views.

(a) Fund assessments were instrumental in helping shape policy decisions
(b) Discussions with Fund staff were helpful at the margin
(c) Fund assessments had no impact on the decision taken
(d) Policy decisions were taken with little or no discussion/interaction with the Fund
(e) Discussions with Fund were unhelpful or counterproductive
(f) No major decisions were taken during this period
(g) Don't know

Q7. To the extent that a major policy decision was being considered or taken in 1999–2005, please identify the extent to which the Fund provided *adequate follow-up support* (e.g., through the provision of technical assistance). Please select the ONE option that **best** reflects your views.

(a) Fund support was instrumental for implementation
(b) Practical assistance by the Fund was helpful at the margin
(c) Fund support had no influence on implementation
(d) Fund support for implementation was unhelpful or counterproductive (e.g., insufficient understanding of operational realities)
(e) Given my country's own technical capacity, no follow-up support was requested or received
(f) No major decisions were implemented during this period
(g) Don't know

Q8. The IMF is sometimes characterized as having *various roles*. Please rate the degree to which, in your opinion, the IMF has played the roles specified below on matters related to members' exchange rate policies:

1—2—3—4—5—0
1—"Too little (missed opportunities)," 3— "About right," 5—"Too much (role is overplayed)," 0—"Don't know"

In the context of your own country:
(a) "Confidential advisor" to the authorities in your country
(b) "Sounding board"/intellectual partner for discussing the authorities' policy views
(c) "Consensus-builder" among domestic policymakers

For the Fund membership as a whole:
(d) "Ruthless truth-teller" to the international community
(e) "Broker" for international policy coordination (e.g., resolution of global imbalances)
(f) "Provider of credibility" (e.g., in capital markets, to the donor community) through assessment of national policies
(g) "Lender" in the event of possible adverse contingencies

Q9. Please rate the level of your agreement with **each** of the following options regarding the *approach* IMF staff used to assess the *choice* or *suitability* of the exchange rate regime in your country:

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know"

(a) Tailored to country-specific circumstances (e.g., extent of financial integration in global/regional capital markets, degree of openness)

Annex A6.3 *(concluded)*

(b) Did not favor any particular exchange rate regime (or combination of exchange rate and monetary regimes) over others
(c) Sufficient attention was paid to intermediate regimes (i.e., it did not present the options available as only a flexible exchange rate regime or a hard peg)
(d) Sufficient attention was given to structural considerations (as opposed to cyclical ones, e.g., impact of any exchange rate misalignments on inflation)

Q10. Please indicate which of the following options **best** describes your view on the methodologies the IMF used to assess *the equilibrium level* of exchange rates (e.g., macroeconomic balance, fundamental or behavioral exchange rate equilibria). (Please select only **one**.)

(a) Adequate and useful
(b) Could have done more, but still useful
(c) Interesting, but not of much practical use
(d) Inadequate
(e) Other (please specify:___________________________________)
(f) Don't know

Q11. Please indicate which of the following options **best** describes your view on the methodologies the IMF used to assess *external competitiveness* (e.g., real effective exchange rate indices, export market shares). (Please select only **one**.)

(a) Adequate and useful
(b) Could have done more, but still useful
(c) Interesting, but not of much practical use
(d) Inadequate
(e) Other (please specify:___________________________________)
(f) Don't know

For **Questions 12–14**, please indicate your opinion on particular *aspects of the Fund's coverage of exchange rate issues* by selecting the ONE statement that **best characterizes** your view, or check "Don't know" or "Doesn't apply."

Q12. In the discussion of policy options for your country, analysis based on the **experience of other countries** was . . . (please select only **one**).

(a) . . . very useful for decision making
(b) . . . somewhat useful for decision making
(c) . . . not useful for decision making
(d) . . . not provided by the IMF staff
(e) Doesn't apply
(f) Don't know

Q13. Global or regional spillovers **affecting your country's** exchange-rate-related developments were . . . (please select only **one**).

(a) . . . identified by the IMF staff and very well integrated into policy discussions
(b) . . . identified by the IMF staff and reasonably well integrated into policy discussions
(c) . . . identified by the IMF staff but only partially integrated into policy discussions
(d) . . . rarely identified by the IMF staff
(e) Doesn't apply
(f) Don't know

Q14. The global and regional **impact of your country's** exchange rate policy was . . . (please select only **one**).

(a) . . . identified by the IMF staff and very well integrated into policy discussions
(b) . . . identified by the IMF staff and reasonably well integrated into policy discussions
(c) . . . identified by the IMF staff but only partially integrated into policy discussions
(d) . . . rarely identified by the IMF staff
(e) Doesn't apply
(f) Don't know

Q15. In summary, how do you rate the *overall quality* of IMF staff's analysis and assessment at the end of the evaluation period (in 2005) *in comparison* to a few years ago (from about 1999)?

(a) Significantly better
(b) Better
(c) About the same
(d) Worse
(e) Significantly worse
(f) Don't know

Annex A6.4

Survey Questions for Staff

Q1. Please rate the degree to which the following exchange-rate-related issues have been a *focus of attention in staff's discussions with the authorities* in [country name, as specified] at some point during your involvement.

1—2—3—4—5—0
1—"Significant focus," 5—"Not at all a focus," 0—"Don't know"

For [country name, as specified . . .] the following issues have been a focus:

(a) Exchange rate regime choice (e.g., peg, monetary union, floating, choice of nominal anchor), including contingency planning;
(b) Management of the regime(s) in place over the period (e.g., inflation targeting, intervention, international reserves levels, currency auction systems);
(c) Exchange rate level (e.g., competitiveness, sustainability, impact on inflation);
(d) Effects of other countries' policies on the country/economy under consideration; or of that country's policies on others (e.g., regional spillovers, global imbalances, contagion);
(e) Financial stability considerations (e.g., currency mismatches and other potential balance sheet vulnerabilities).

Q1a. If answer under any of the options in **Q1** is "1" or "2," please indicate *who took the initiative* to raise the respective issue:

1—"Raised by staff," 2—"Jointly raised," 3—"Raised by the authorities," 0—"Difficult to say/Don't know"

(a) Exchange rate regime choice;
(b) Management of the regime(s) in place;
(c) Exchange rate level;
(d) Effects of other countries' policies on the country/economy under consideration; or of that country's policies on others;
(e) Financial stability considerations.

Q2. Please indicate the authorities' overall *level of agreement* with the IMF staff's analysis and assessment in the policy area(s) that have been a *focus of policy attention* at some point during your involvement (as identified under **Q1**). Please select the statement that **<u>best</u>** describes your opinion for the country/economy selected above.

The authorities in [country name, as specified . . .]

(a) . . . did not have any dialogue of substance on exchange-rate-related matters with IMF staff during the period;
(b) . . . agreed with all aspects of the IMF staff's analysis and assessment;
(c) . . . broadly agreed, except for minor differences in emphasis, detail or timing;
(d) . . . agreed on some aspects, but disagreed on important details (e.g., emphasis, timing or political feasibility);
(e) . . . disagreed with the IMF staff's analysis and assessment, but their own position was not clear enough or too inconsistent to judge why;
(f) . . . disagreed on important aspects of analysis and assessment and did not follow the staff's recommendations;
(g) . . . disagreed on important aspects of analysis and assessment, but nonetheless followed the staff's recommendations.

Q2a. If answer under **Q2** is (d), (e), (f) or (g), please indicate in which areas there was lack of agreement or clarity (check **<u>all</u>** that apply):

(a) Exchange rate regime choice;
(b) Management of the regime(s) in place;
(c) Exchange rate level;
(d) Effects of other countries' policies on your country; or of your country's policies on others;
(e) Financial stability considerations.

Q3. Please rate your level of agreement with each of the following statements about the *nature of staff interaction with the authorities* in [country name, as specified] on exchange-rate-related policy issues:

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know/Doesn't apply"

In [country name, as specified . . .]

(a) . . . IMF staff conducted substantive, two-way policy discussions with the authorities;
(b) . . . discussions with the authorities were held with appropriate frequency;
(c) . . . discussions with the authorities had the right balance between informality, confidentiality, and requirements of reporting to the Executive Board;
(d) . . . the IMF was the principal source of external analysis and assessment for the authorities;
(e) . . . the authorities at times excluded certain sensitive policy issues (e.g., foreign exchange market intervention, choice of exchange rate regime) from substantive discussions with IMF staff;
(f) . . . the authorities excluded or restrained consideration of certain issues because of concerns about possible dissemination of information, including to the IMF Executive Board;
(g) . . . the IMF mission team approached discussions with candor and was willing to raise politically sensitive issues;
(h) . . . the IMF mission team approached discussions in a respectful and open-minded way;
(i) . . . policy discussions between the authorities and staff were fully reflected in documents subsequently sent to the IMF Executive Board;
(j) . . . considerations at the level of the IMF's Executive Board provided an important input into the development of policy advice (e.g., changes to the policy line or to the urgency of proposed actions at Board level).

Annex A6.4 *(continued)*

Q4. Please rate your level of agreement with each of the following statements on how the *substance and usefulness* of IMF staff's exchange-rate-related discussions with the authorities in [country name, as specified] could *realistically have been improved?*

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know"

IMF staff could have . . .
(a) . . . provided its analysis and assessment in a more timely fashion;
(b) . . . focused more on country-specific factors and constraints;
(c) . . . provided a better analytical/empirical underpinning for its views on exchange rate issues;
(d) . . . developed broad points of view more concretely into issues of implementation;
(e) . . . been more careful in advocating certain policy actions as urgent;
(f) . . . better considered the costs and benefits of policy options;
(g) . . . brought in more multilateral or regional perspectives (e.g., regional spillovers, global imbalances, contagion);
(h) . . . better integrated exchange-rate-related advice with advice in other policy areas (e.g., monetary policy, financial stability);
(i) . . . explored more fully the sectoral balance sheet implications of exchange rate changes;
(j) . . . engaged in more informal interaction with the authorities (e.g., through workshops);
(k) . . . formulated its views in a clearer and less nuanced fashion;
(l) . . . provided better written documentation of its assessments (e.g., for the authorities to study and share with others).

[If answer under option (g) was "1" or "2," please continue with **Q4a**; otherwise skip to **Q5**]

Q4a. Why was it that staff's *treatment of multilateral or regional perspectives* in the context of [country name, as specified] left room for improvement? Please select **<u>all</u>** that apply:

(a) There is always room for improvement;
(b) Coverage of these issues was pushed back by the authorities;
(c) Staff did not raise these issues with the authorities;
(d) The analytical framework for analysis of these issues was lacking;
(e) Multilateral surveillance tools (such as the WEO and GFSR) didn't provide relevant inputs.

Q5. To the extent that the authorities in [country name, as specified] have taken major decisions related to exchange rate policy during the period of your involvement, please identify how the *contribution made by the Fund* can be best characterized. Please select the option that **<u>best</u>** reflects your views.

For [country name, as specified . . .]:

(a) Fund assessments were instrumental in helping shape policy decisions;
(b) Discussions between Fund staff and the authorities were helpful at the margin;
(c) Fund assessments had no impact on the decision taken by the authorities;
(d) Policy decisions were taken with little or no discussion/interaction between Fund staff and the authorities;
(e) Discussions between Fund staff and the authorities appear to have been unhelpful or counterproductive;
(f) No major decisions were taken during this period;
(g) Don't know.

Q6. To the extent that a major policy decision was being considered or taken by the authorities in [country name, as specified] during your period of involvement, please identify the extent to which the Fund provided *adequate follow-up support* (e.g., through the provision of technical assistance). Please select the option that **<u>best</u>** reflects your views.

(a) Fund support was instrumental for implementation;
(b) Practical assistance by the Fund was helpful at the margin;
(c) Fund support had no influence on implementation;
(d) Fund support for implementation turned out to be unhelpful or counterproductive (e.g., insufficient understanding of operational realities);
(e) Given the country's own technical capacity, no follow-up support was requested or received;
(f) No major decisions were implemented during this period;
(g) Don't know.

Q7. Do you believe that IMF staff advice was *not acted upon by the authorities in* [country name, as specified . . .]? If so, what accounts for this *lack of responsiveness* by the authorities? Please check **<u>all</u>** that apply:

(a) Fund "leverage" outside of program relationships is too limited;
(b) Political realities didn't allow for implementation;
(c) Fund advice wasn't time sensitive (e.g., no immediate need to respond);
(d) Fund staff didn't have access to policymakers at the appropriate level;
(e) The staff work was restricted by management or other departments;
(f) The analysis provided by staff failed to convince the authorities;
(g) The authorities' own capabilities made it difficult for staff to add value;
(h) With hindsight, the authorities' judgment appears to have been validated;
(i) Other [please specify: . . .];
(j) Don't know;
(k) Doesn't apply (i.e., the authorities did act on the advice).

Annex A6.4 *(continued)*

Q8. The IMF is sometimes characterized as having *various roles*. Please rate the degree to which, in your opinion, the IMF has played the roles specified below on matters related to members' exchange rate policies:

1—2—3—4—5—0
1—"Too little (missed opportunities)," 3—"About right," 5—"Too much (role is overplayed)," 0—"Don't know"

In the context of the countries you have worked on [or country name, as specified]:

(a) "Confidential advisor" to the authorities;
(b) "Sounding board"/intellectual partner for discussing the authorities' policy views;
(c) "Consensus-builder" among domestic policymakers;

For the Fund membership as a whole:

(d) "Ruthless truth-teller" to the international community;
(e) "Broker" for international policy coordination (e.g., resolution of global imbalances);
(f) "Provider of credibility" (e.g., in capital markets, to the donor community) through assessment of national policies;
(g) "Lender" in the event of possible adverse contingencies.

Q9. *Clear and candid treatment of exchange rate issues is a challenge.* To what extent have each of the following possible explanations been factors in making this so?

1—2—3—4—5—0
1—"Very significant," 5—"Insignificant," 0—"Don't know"

(a) It was difficult to separate exchange-rate-related issues from countries' overall macroeconomic policies and developments;
(b) Time and resources constrained the amount of attention paid to exchange-rate-related issues;
(c) There was a lack of adequate and readily available analytical tools;
(d) The internal review process tended to produce more cautious language and/or diluted coverage in staff reports;
(e) The need to preserve close relationships with country authorities tended to produce more cautious language and/or diluted coverage in staff reports;
(f) The expectation of publication of staff reports tended to produce more cautious language and/or diluted coverage in staff reports (e.g., because of possible adverse market reactions);
(g) For confidentiality reasons, certain information could not be passed on to the Executive Board;
(h) Management limited the range of issues that the staff could freely discuss with national authorities;
(i) National authorities took certain issues "off the table."

Q10. On the basis of your experience between 1999–2005, please indicate your opinion on the *quality of Fund analysis* in the following areas:

1—2—3—4—5—0
1—"No scope for further improvement," 5—"Significant room for improvement," 0—"Don't know"

(a) Assessment of exchange rate regime choice and suitability;
(b) Management of the regime(s) in place;
(c) Assessment of exchange rate levels and competitiveness;
(d) Assessment of policy spillovers;
(e) Financial stability considerations;
(f) Debt sustainability analysis;
(g) Capital account developments;
(h) Integration of bilateral and regional/multilateral surveillance.

Q11. On the basis of your experience between 1999–2005, in which of the following areas do you see *significant room for improvement* insofar as it would raise the overall quality of exchange-rate-related analysis (including subsequent reporting to the Executive Board)? Please check **all** that apply:

(a) Analytical methods for assessing exchange rate levels and misalignments;
(b) Analytical methods for assessing regime choice and suitability;
(c) Analytical methods for assessing spillovers across countries, balance sheet effects and related vulnerabilities;
(d) Better use of information from other sources (e.g., BIS, OECD);
(e) Better availability of data (e.g., on intervention activities);
(f) Greater backing for staff to raise contentious or confidential issues with the authorities;
(g) Greater backing for staff to share information and analysis at the Board level;
(h) Other [please specify: . . .];
(i) Don't know.

[If answer includes option (e) and respondent has selected an individual country at the start of the survey, follow up with **Q11a**; otherwise skip to **Q12**].

Q11a. Please rate the level of your agreement with the following statements about the *availability of data* for IMF exchange rate analysis in [country name, as specified].

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know"

For [country name, as specified], . . .
(a) . . . , the availability and quality of data has *impaired staff's ability* to conduct exchange rate analysis and provide related advice;
(b) . . . , Fund staff tended to have *greater access* to critical data on exchange rate matters than the public;

Annex A6.4 *(concluded)*

(c) . . . , the authorities were technically *not able* to provide staff with some critical data needed for exchange rate analysis and related advice;
(d) . . . , the authorities were *unwilling* to share some critical data/information needed for exchange rate analysis and related advice;
(e) . . . , staff had to regularly cross-check the authorities' data with information from other sources.

Q12. Please rate the degree to which each of the following has been a *source of help in your work on exchange rate policy issues*:

1—2—3—4—5—0
1—"Significant source of help," 5—"Not at all a source of help," 0—"Don't know/Doesn't apply"

(a) 1977 Surveillance Decision;
(b) Board decisions/discussions on exchange rate issues;
(c) Board discussions on individual countries;
(d) Internal surveillance guidance notes;
(e) Direct guidance by management;
(f) Analysis/research provided by (own or other) area department(s);
(g) Analysis/research provided by RES;
(h) Analysis/research provided by INS;
(i) Analysis/research provided by STA;
(j) Analysis/research provided by PDR;
(k) Analysis/research provided by MFD/ICM;
(l) Analysis provided by the WEO/GFSR.

Q13. Please rate the level of your agreement with **each** of the following statements regarding the *approach* IMF staff used to assess the *choice* or *suitability* of exchange rate regimes:

1—2—3—4—5—0
1—"Strongly agree," 5—"Strongly disagree," 0—"Don't know/Doesn't apply"

(a) Tailored to country-specific circumstances (e.g., extent of financial integration in global/regional capital markets, degree of openness);
(b) Did not favor any particular exchange rate regime (or combination of exchange rate and monetary regimes) over others;
(c) Sufficient attention was paid to intermediate regimes (i.e., staff did not present the options available as only a flexible exchange rate regime or a hard peg);
(d) Sufficient attention was given to structural considerations (as opposed to cyclical ones, e.g., impact of any exchange rate misalignments on inflation).

Q14. For those countries that are covered by the CGER exercise, how do you rate the overall usefulness of this exercise for staff's country work. Please use the following scale and choose "Don't know/Doesn't apply" in case you have never worked on countries covered by CGER:

1—2—3—4—5—0
1—"Very useful," 5—"Not at all useful," 0—"Don't know/Doesn't apply"

Q15. In summary, how do you rate the (a) *overall quality* and (b) *impact/traction* of IMF staff's analysis and assessment at the end of the evaluation period (in 2005) *in comparison* to a few years ago (from about 1999)?

1—2—3—4—5—0
1—"Significantly better," 3—"About the same," 5—"Significantly worse," 0—"Don't know"

(a) The overall *quality* of staff's analysis and assessment in 2005 was . . . ;
(b) The overall *impact/traction* of staff's analysis and assessment in 2005 was . . . .

BACKGROUND DOCUMENT 7

Assessing the Effectiveness and Impact of IMF Exchange Rate Surveillance

1. This background document presents a framework for assessing the effectiveness and impact of IMF exchange rate surveillance and related IMF advice and provides the basis for some of the conclusions drawn in the main report. For this purpose, it is helpful to think of the process of IMF surveillance in terms of a results chain that connects inputs to outcomes (Figure A7.1). A critical element of surveillance concerns how IMF staff performs analysis, forms a view, and communicates the resulting advice to national authorities.

Effectiveness at Each Stage

2. Although Figure A7.1 does not fully represent the complex nature of what the IMF does in practice, it is sufficient to show that the impact of IMF surveillance on member countries' policies depends on effectiveness at different stages of the results chain. At the "inputs" stage, for example, effectiveness is determined by such factors as the accuracy, timeliness, and comprehensiveness of data, the adequacy of staff expertise and analytical tools, and how well the internal review process works.

3. In this connection, the evaluation finds that a data deficiency of one type or another has been a factor in 90 of the 191 economies for which the documents for the last two Article IV consultations of the 2002–05 period were reviewed. Specifics of the data problems vary across countries, but some could certainly weaken the effectiveness of exchange rate surveillance. Indeed, some 40 percent of the staff surveyed by the IEO identified better availability of data as an area where significant improvement could be made to raise the overall quality of exchange rate analysis (see also Background Document 6).

4. How to address data deficiencies is a difficult issue. When the authorities themselves do not have the data, which is found to be the case in several countries, technical assistance may be a solution. In other cases, as documented in Background Document 6, the authorities have the data but are unwilling to share them, often on grounds of market or political sensitivity. Such data may include details of official foreign exchange market intervention, composition of foreign exchange reserves, foreign exchange transactions of government-affiliated entities, and the like. Although access to these data may not always be necessary for high-quality surveillance, the IEO has found several cases where IMF staff appeared to be conducting discussions with national authorities from a position of substantial informational disadvantage.

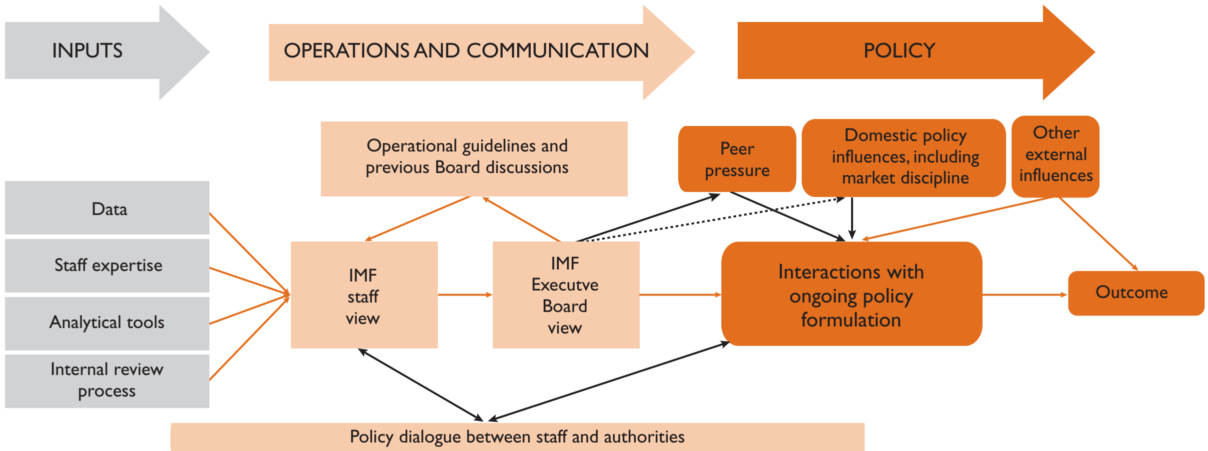
5. At the "operations and communications" stage, effectiveness might be influenced by such attributes of staff views and analysis as accuracy, feasibility, and candor. A regular criticism that the IEO has heard from country officials is that the analysis underlying staff advice is not transparent or the advice is not detailed enough for implementation (see also Background Document 6). It appears that authorities often judge the usefulness of advice, not just in terms of accuracy, but also on the basis of how the advice is derived and how practical and feasible it is in the specific country context.

6. How to treat market or politically sensitive material would also condition the IMF's potential influence on countries' policies. Sometimes sensitive material is "sanitized" in an attempt not to offend the authorities or upset the markets, but such practice may compromise effectiveness by diluting the sharpness and clarity of the message. The evaluation finds that sensitive issues are sometimes not discussed at all. About 20 percent of the senior staff surveyed noted that the authorities' reluctance to discuss certain topics was an impediment to clear and candid treatment of exchange rate issues (see Background Document 6). When such issues are discussed, they may not be reported to the Executive Board (see below). Although the desk review found very few cases of explicit deletions from staff reports, IEO interviews with mission chiefs suggest that self-censorship may be at play in some cases.

Impact at the Final Stage

7. IMF surveillance may help influence member countries' policies through four broad channels: (1) direct communication to authorities of IMF Executive Board

Figure A7.1. How IMF Views Connect to Outcomes: A Closer Look



views; (2) peer pressure exerted by other members, occasioned by IMF Executive Board views; (3) pressure from the public or markets; and (4) advice delivered by IMF staff in policy discussions with the authorities. A series of interviews have suggested that, of the four channels, national authorities and IMF mission chiefs seem to value advice delivered by IMF staff as particularly effective. In part, this reflects the confidential nature of many of the topics that are bound to come up in the area of exchange rate policy. IMF mission chiefs have indicated to the IEO incidences where sensitive exchange rate issues were discussed on the understanding that the substance of the discussions would remain confidential.

8. Impact through the policy discussions channel may be indirect and may not necessarily show up as a policy decision. A number of officials, including from major advanced countries, have told the IEO that even when discussions do not change their prior views, they nonetheless appreciate the opportunity to interact with IMF staff, as such interactions allow their views to be tested and verified.

9. In contrast, Executive Board deliberations appear to have had only a limited influence. However, some mission chiefs indicated to the IEO that prospective support from the Executive Board could strengthen their position in policy discussions with authorities. In other words, the existence of the Executive Board as a review body could lend credibility to a view expressed by staff, to the extent that it also represents the Board's view.

10. As to the IMF's potential influence through public policy debate, some officials have expressed misgivings about the IMF actively using this channel. The IMF's influence is limited in any case if the authorities do not agree to the publication of an Article IV consultation report. On the other hand, when the IMF's assessment of domestic policies is positive, authorities are typically eager to publicize such endorsement. First, endorsement by the IMF of a country's exchange rate regime or economic policies adds to the authorities' credibility, which may in turn facilitate access to capital markets. Second, endorsement by the IMF of certain policies can support decision making within the country by helping to overcome differences of view among different branches of government. IEO interviews of country authorities suggest that these channels of influence occasionally operate.

11. The impact the IMF has on the markets is difficult to assess. Indeed, the IEO did not find a convergence of views among the large number of market participants it interviewed.[1] Perception seems to matter. In countries with poor transparency, for example, IMF views may affect markets to the extent that market participants perceive such views to be based on superior information. Likewise, in countries pursuing IMF-supported programs, market participants take IMF views seriously because they perceive the IMF to have influence on economic policy decisions. In countries for which information is readily available, on the other hand, almost all market participants took the view that published IMF assessments could not provoke significant market reaction, except in the very short run or if supported by market positioning.

12. Officials indicated to the IEO two opposing views about the potential impact of IMF statements on the level of exchange rates. Some said that, given the well-known margin of error in any exchange rate level assessment, IMF views would be treated as just another view and would not trigger market reaction; others argued that, given its well-established reputation as a neutral international body, the IMF's views would be treated differently and would therefore impact the markets.

[1]An overwhelming majority of them, however, suggested that the IMF has a constructive role to play in making more information available and communicating its analysis to the public.

BACKGROUND DOCUMENT

8 List of Interviewees

International and Regional Organizations

Bank for International Settlements

Claudio Borio
Gabriele Galati
Stefan Gerlach
Mar Gudmundsson
Alexandra Heath
Corrine Ho
Robert McCauley
Ramon Moreno
Eli Remolona
William White

Central Bank of West African States

Bassambie Bationo
Jean Claude Brou
Khady Biye Camara
Ismaila Dem
Papa Lamine Diop
Samuel Meango
Paul Martial Sarr
Nestor Wadagni

European Central Bank

Michele Ca'Zorzi
Gabriel Fagan
Hans-Joachim Klockers
Gerard Korteweg
Theodore Martens
Reiner Martin
Francesco Mazzaferro
Erwin Nierop
Chiara Osbat
Francesco Papadia
Georges Pineau
Lorenzo Bini Smaghi
Christian Thimann
Regine Wolfinger

European Commission

Servaas Deroose
Klaus Regling

Organization for Economic Cooperation and Development

Randall Jones
Val Koromzay
Benedicte Larre
Pierre Poret
Robert Price
Sebastian Schich
Hannes Suppanz
Peter Tulip

Member Country Officials

Australia

Roger Brake
Guy Debelle
Mandy Fitzpatrick
Martin Parkinson

Barbados

Daniel Boamah
Marion Williams

Brazil

Afonso Bevilaqua
Henrique de Campos Meirelles

China

Ze Dai
Jianxiong He
Qui Jin
Yang Luo
Yujuan Ma
Jianqui Song
Benhua Wei
Jiandong Wen
Hong Zheng

Ecuador

Patricio Rivera Yanez
Armando J. Rodas Espinel
Galo Mauricio Valencia Stacey

Egypt

Youssef Boutros Ghali
Farouk El-Okdah

France

Gerard Belet
Ambroise Fayolle
Ramon Fernandez

Hong Kong SAR

Lillian Cheung
Carmen Chu
Dong He
Kitty Lai
Frank Leung
Julia Leung
Joseph Yam
Eddie Yue

Iceland

Lilja D. Alfredsdottir
Ingimundur Fridriksson

Jamaica

Colin Bullock
Omar Davies
Wesley Hughes

Japan

Kazumasa Iwata
Hiroshi Watanabe

Korea

Dongchul Cho
Heenam Choi
Hee Jae Kim
Tae-Kyun Kwon
Soo-Hyon Lim
Inseog Oh
Gwang-Ju Rhee
Byungdoo Sohn

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Statement by the Managing Director

Staff Response

IEO Comments on Management and Staff Responses

The Chairman's Summing Up

Statement by the Managing Director on the Evaluation of the Independent Evaluation Office of IMF Exchange Rate Policy Advice, 1999–2005

Executive Board Meeting
May 9, 2007

1. Exchange rate policy advice is at the core of the Fund's mandate. We are aware of the challenges facing the institution in providing high-quality, high-impact exchange rate policy advice to our members. We have recently undertaken many important initiatives to enhance effectiveness in this area, including those identified in the Medium-Term Strategy.

2. While we are always looking for improvements, it is critical to recognize the progress already made and what is working well. Most members surveyed by the IEO viewed positively the Fund's work in many aspects of exchange rate policy advice, including the quality of analysis, the honesty and constructiveness of discussions with members, and the impact on key policy decisions. This reality is not appropriately reflected in the report.

3. The IEO report contains a great deal of valuable information, but the way it analyzes this information limits its usefulness in helping us identify and address the most critical areas of remaining weakness—the main task. As noted in the staff comments, in many key areas the report presents a narrow interpretation of the evidence, does not recognize progress made over time, and therefore does not offer a balanced perspective in identifying remaining weaknesses and their relative importance.

4. I look forward to the Board's reflections on how best we can advance this core mandate of the institution. While it is the IEO's job to identify any possible remaining weaknesses, the Board will need to provide guidance as to just how significant these are and whether they warrant new initiatives. Our priorities include strengthening further the analysis of exchange rate levels backing up our advice to members; improving the treatment of spillover issues; and consolidating progress in a number of other areas. To achieve this, initiatives are already under way, including revalidating the fundamental purpose of surveillance through a revised Surveillance Decision. There may be merit in refinements to some of them, and we will consider this carefully in light of the Board discussion of this report. However, I believe new major initiatives would best be considered after the completion of the review of the 1977 Decision.

Staff Response to the Evaluation of the Independent Evaluation Office of IMF Exchange Rate Policy Advice, 1999–2005

Executive Board Meeting
May 9, 2007

Key Points

- This report provides a wealth of information that is helpful to appraise the Fund's performance in the critical area of exchange rate policy advice.
- The IEO's report, however, disregards much of its own positive evidence on the quality of the Fund's work, ignores the progress made during the sample period, and is sometimes premised on unrealistic expectations of the Fund's role. All in all, the report's consistently negative tone crowds out much valuable information and some useful conclusions.
- An objective analysis of the evidence gathered by the IEO leads to more comforting conclusions: significant improvement in the treatment of exchange rate issues over time; coverage of several exchange rate issues that is adequate in most cases; and generally good integration between exchange rate and other policy areas. Moreover, country authorities across the membership seem satisfied with the policy dialogue with staff and with the way the Fund plays most of its roles. And the Fund's work on exchange rate policy decisions has some impact.
- In other areas, the IEO's findings confirm earlier staff assessments that further improvements are needed, with priority to be assigned to improving assessments of exchange rate levels, and of spillovers. Data differences should also be addressed.
- A number of initiatives under the aegis of the Medium-Term Strategy are well under way to address improvement needs and consolidate progress.

1. Exchange rate policy advice is at the core of the Fund's work, and an area where the Fund has long been aware of special challenges. Indeed, improving exchange rate surveillance was identified as a priority objective by both the 2004 Biennial Surveillance Review (BSR) and the Managing Director's Medium-Term Strategy (MTS). Considerable efforts are under way in this area.

2. Thus, the Independent Evaluation Office's (IEO) report provides a welcome opportunity to consider in more depth the quality of the Fund's work in this area, and to assess whether the initiatives under way are likely to achieve their goals.

3. While it contains a wealth of helpful information, the report unfortunately does not portray accurately either the Fund's past or its current work in the exchange rate area. First, the report's conclusions disregard much of its own positive evidence on the quality of the work of staff, management, and the Executive Board, while magnifying any perceived shortcoming. Second, the report is outdated. In part, this is because the sample period (1999–2005) is inevitably some way in the past, but it is unfortunate that the report did not focus on what its own data reveal about trends *during* the sample period. Moreover, further progress has been made since 2005. Finally, the report is sometimes premised on unrealistic expectations of what the Fund can reasonably achieve, both in terms of its output and its impact. All in all, the report's consistently negative tone crowds out much valuable information and some useful conclusions.

4. The report's focus on shortcomings is understandable given the IEO's brief to help the Fund strengthen its performance, but a broader perspective is needed as a basis for action. There is no doubt that, in spite of significant progress, we need to do more. The challenge, however, is to rank the issues in order of seriousness, as a basis for the Board's judgments on what more is needed.

The Record

5. We will first try to provide a more balanced presentation of the evidence included in the report, before turning to its recommendations. We focus on: (1) the quality of the Fund's analysis and advice; (2) its interaction with member countries; and (3) its overall role and impact on policy decisions. Most of the evidence comes from the report itself, including the in-depth review of 30 countries (henceforth "IEO in-depth review"), the review of staff reports for the entire membership ("IEO SR review"), and responses to the IEO questionnaires. Particular attention is paid to assessing quality in more recent work, as the 2004 BSR prompted a wave of new initiatives in the exchange rate area.

Quality of analysis and advice

6. For most of the quality dimensions of exchange rate analysis and advice, results are quite comforting, although there is also room for improvement. We focus broadly on the same quality dimensions identified in the report (see paragraph 19 of the report).[1]

7. *Coverage of exchange rate issues.* This seems to have been adequate in the vast majority of cases, particularly in recent years. The IEO in-depth review finds only five cases (out of 30 countries over seven years) where certain exchange rate issues had not been covered for part of the period. Only one of these cases is recent (Saudi Arabia).[2] More generally, the amount of analytical work produced by the Fund on exchange rate issues is extensive, and has increased further recently. During 2001–05, the Fund issued annually over 30 Working Papers on exchange rate issues (34 in 2006 and 6 in just the first two months of 2007), typically drawn from selected issues chapters prepared for Article IV consultations.

8. *Integration between exchange rate and other policy areas* (excluding spillovers, see below). Generally good. IEO questionnaire responses show that "coverage of linkages [between exchange rate issues and other policy areas] in discussions was good overall" (paragraph 22). The IEO in-depth review also finds that integration was good with respect to monetary, fiscal policies, structural policies, and that integration of financial sector and financial stability issues, while "somewhat lacking," has improved over time (paragraph 11, BD 5).

9. *Description of de facto regimes.* Generally accurate. The IEO in-depth review finds only three cases (out of 30 countries for seven years) in which the regime description is regarded as inappropriate (staff disagrees on two of these cases, see Annex II). Discrepancies between the description in staff reports and the Monetary and Capital Markets Department's (MCM) classification—a possible indicator of problems—are also rare (6 percent of cases), and often explained by inevitable lags in the revision of the MCM classification.

10. *Intervention policies.* The report distinguished several dimensions:

- *Overall coverage.* Generally adequate, but there is room for further improvement. The IEO in-depth review finds only five cases (out of 30 economies for seven years) in which the coverage of intervention policies was incomplete (paragraph 24). In three of these cases staff does not agree with this assessment (Annex III). None of the five cases refers to the post-2004 BSR period. This said, the Fund should aim at the highest standard in assessing intervention policies, and staff's own analysis also points to room for improvement.[3]
- *Coverage of intervention tactics.* Limited, but this should be expected. Most staff reports for surveillance and program work focus on the macroeconomic aspects of intervention, rather than the specifics of how intervention is implemented. This is to be expected given the nature of these reports. More technical aspects are dealt with in the provision of technical assistance to countries that require it.[4]
- *Assessments of the adequacy of reserves.* A difficult area for the economics profession as a whole, but staff has generally used available techniques appropriately. Staff has often conducted in-depth analyses of the adequacy of reserves (Table 1.1 of the report lists 15 of them), and in cases of extensive reserve accumulation has generally taken an adequate country-by-country approach (Box 3.2 of the report). Various kinds of indicators are routinely used in staff reports to assess the adequacy

[1]For brevity, we do not compare point by point our conclusions with those of the IEO, which are essentially fairly negative across the board. Paragraph numbers without further reference refer to the main report; otherwise the number of the corresponding Background Document (BD) is reported.

[2]The report notes that the level of the exchange rate was not reassessed in the 2005 Article IV staff report for Saudi Arabia in spite of the terms of trade shock. Such a reassessment was included in the 2006 staff report. The alleged shortcoming identified for China dates back to 2001–02. Indeed, the treatment of exchange rate issues in the 2006 Article IV report is widely considered best practice (Annex I).

[3]"Treatment of Exchange Rate Issues in Bilateral Surveillance—A Stocktaking," EBS/06/107, August 7, 2006 (henceforth the "Stocktaking Paper"), notes the need to improve the description of the accumulation in reserves of official public sector inflow. Another aspect that should be regarded more closely is the effect of intervention on the intervention currencies (see discussion on spillovers below). The forthcoming Review of Exchange Rate Arrangements, Restrictions, and Markets (REARM) discusses how analysis of intervention can be strengthened.

[4]In 2005–06 at least eight technical assistance reports have dealt in detail with the tactics of intervention.

of reserves. We should be under no illusion that "highly judgmental" assessment can be avoided in this difficult area (paragraph 25), but staff is at the forefront of related research,[5] and training in this area is regularly provided to Fund economists.[6]

- *Staff position on intervention.* No evidence it was inappropriate. It is true that staff has generally supported reserve accumulation for precautionary purposes, but not for purposes of maintaining competitiveness. Indeed, intervention for the purpose of maintaining competitiveness may contravene the spirit, and possibly the letter, of Article IV whenever it aims at keeping the exchange rate artificially undervalued, a strong reason why this kind of intervention should not be supported. At the same time, staff has typically been open-minded on the possibility of using sterilized intervention to respond to capital inflows. There is no a priori assumption that sterilized intervention is always ineffective (as argued in the report, paragraph 26), although, the cost of intervention is often regarded as problematic.

11. *Data availability.* This is an area for improvement. The report suggests that in 37 percent of countries data problems impaired the staff's ability to conduct exchange rate analysis and provide related advice. This partly reflects capacity constraints, which can be addressed through technical assistance. More worrisome are the fairly frequent cases when data shortcomings appear to reflect the authorities' unwillingness to share them.[7]

12. *Assessment and analysis of the exchange rate levels.* Assessments are regularly provided but in several cases the quality of the analysis should be improved. The IEO in-depth review noted that the "sophistication of exchange rate level assessments, as indicated by the use of empirical methods, was good overall" (BD 5, paragraph 20). But it also finds cases in which the treatment was inadequate. The staff's Stocktaking Paper found that in one-third of its sample the analysis of exchange rate levels was not sufficiently sophisticated. There are, however, signs of recent improvement. This includes, inter alia, the recent broadening to emerging markets of the exchange rate assessments conducted by the Consultative Group on Exchange Rates (CGER) and improved analysis in several reports (for example, China, Colombia, Mexico, Malaysia, Mauritius, CEMAC, and WAEMU).[8]

13. *Assessments of countries' exchange rate regimes.* These are "a standard feature of Article IV reports" (paragraph 31). In addition:

- *Quality of the analysis.* Usually adequate—when closely scrutinized. The broader—less in-depth—IEO SR review suggests that the suitability of the regime was not assessed in detail in many cases. However, as the report notes, it is often difficult in practice to separate the assessment of regimes from the assessment of exchange rate levels, when the latter results in findings of misalignments. In those cases, staff's call for increased flexibility may have been tantamount—admittedly with less than complete candor—to a call for an appreciation. Moreover, an in-depth discussion of pros and cons of a regime change may be less warranted whenever staff is simply calling for the authorities to implement *de facto* their *de jure* regime. On this account, only a close review of staff reports can lead to the conclusion that shortcomings were present. It is thus reassuring that the IEO in-depth review regarded the regime analysis as inadequate in only three cases.[9] In all these cases more recent reports have addressed these problems.[10] The report also notes that staff advice in recent years has leaned toward increased exchange rate flexibility. Conjunctural factors—as well as increased capital mobility—probably played a large role here. First, inflation has been relatively low, so a key reason to peg (the need to lower inflation expectations) has not been present. Second, many countries with inflexible exchange rate policies were facing large balance of payments surpluses: as noted, in these countries the call for more flexibility was often tantamount to a call for an appreciation.

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[5]See, for example, Olivier Jeanne and Romain Ranciere, "The Optimal Level of International Reserves for Emerging Market Countries: Formulas and Applications," IMF Working Paper No. 06/229; and Joshua Aizenman and Jaewoo Lee, "Financial Versus Monetary Mercantilism: Long-Run View of the Large International Reserves Hoarding," IMF Working Paper No. 06/280. The *WEO* has also focused on this issue (see, for example, the September 2003 *WEO*, Chapter II ("Are Foreign Exchange Reserves in Asia Too High?")).

[6]Two seminars on this issue were held just this month ("Foreign Exchange Reserves in Emerging Market Countries" and "Accumulation of Official Reserves—Trends and Challenges").

[7]Assessing whether staff has adequately flagged these shortcomings in staff reports would require more in-depth analysis. Staff reports typically discuss data problems. It is true that the bottom line assessment is usually that data are "adequate for surveillance." But it is not obvious that, where data problems have "impaired" the ability to conduct exchange rate analysis, the data are necessarily "inadequate" to exercise surveillance.

[8]The IEO staff questionnaire shows that 30 percent of the staff surveyed does not find CGER useful. However, CGER has recently been strengthened, not only in terms of country coverage, but also of methodologies. See Annex IV for a broader discussion of the treatment of CGER in the IEO report.

[9]The Stocktaking Paper had also found that, while calls for exchange rate flexibility were often not backed up by a complete set of pros and cons, only in some cases a more comprehensive discussion was needed.

[10]One of these three cases is Morocco, for which the IEO report mentions the 2005 staff report as an example of good practice (Chapter 3, footnote 25; this footnote lists other examples of recent improvements including Ukraine).

- *Excessive urgency in advocating regime changes.* The report cites only two cases.
- *Implementation issues.* A sizable minority of members believes that attention to implementation issues could be improved, but this need can be addressed more through technical assistance than better surveillance. As noted above, detailed implementation issues are hard to address in the context of surveillance work, which has a macroeconomic focus. They can, however, be addressed through technical assistance. What is perhaps needed is to promote technical assistance more actively.

14. *Spillovers.* Consistent with the MTS, this is an area for improvement. The authorities' responses to the IEO questionnaire show that over 60 percent of the respondents from large emerging markets and over 80 percent of respondents from other country groups perceive that global and regional spillovers affecting their exchange rate developments had been identified in staff reports. Moreover, multilateral surveillance has paid considerable attention to these issues, as shown by the lengthy—and yet incomplete—list of *WEO* features on exchange-rate-related issues (Table 3.5 of the report). This said, we would agree with the IEO that integration of spillovers in surveillance is still insufficient, as confirmed by the IEO in-depth review.

15. *Overall improvement.* There is clear evidence of significant improvement in the treatment of exchange rate issues during 1999–2005. Over 55 percent of authorities surveyed saw improvement, with almost no one seeing a deterioration. Results are less favorable for large emerging market countries—perhaps reflecting the fact that, in the most recent period, the Fund often took views on their exchange rate policies that were not fully shared by the authorities. However, even among these countries, over one-third reported improvements, with almost no one signaling a deterioration.

Interaction between the Fund and member countries

16. *Policy dialogue.* Country authorities seem to be generally satisfied. Interviews revealed some cases of dissatisfaction. But 75–90 percent of the authorities responding to the IEO questionnaire were satisfied with their interactions with staff, and thought discussions: were substantive and two way; their frequency was appropriate; had the right balance between informality, confidentiality, and requirements of reporting to the Executive Board; and were fully reflected in documents subsequently sent to the Fund Executive Board. They also agreed that staff approached the discussions with candor and in a respectful and open-minded way; and were willing to raise politically sensitive issues.

17. *Evenhandedness.* The IEO in-depth review finds "no clear cut cases of uneven treatment," nor does the IEO SR review find a pattern that would question evenhandedness.[11] On the contrary, the positive results mentioned above regarding policy dialogues emerge across *all country groups.*

The overall role of the Fund and its impact on policy decisions

18. *How members perceive how the Fund plays its various roles.* Satisfactory results, in most respects. Based on the responses to the authorities' questionnaire, the Fund is judged to have played the roles of confidential advisor and sounding board "about right" by about two-thirds of the members, and even in the large emerging market group this proportion exceeds 50 percent (once those answering "don't know" are excluded). High levels of appreciation are also found for the Fund as provider of credibility, lender, and, albeit to a lesser extent, consensus builder. The results for the roles of "ruthless truth-teller" and "broker for international policy coordination" are not as positive. The role of the Fund with respect to the latter is being enhanced through the introduction of multilateral consultations.

19. *Impact.* There is evidence of impact, although the authorities' responses to the IEO questionnaire show that 79 percent of countries who took major exchange rate policy decisions considered the Fund's assessment instrumental or "helpful at the margin" in shaping their decisions (based on Table A6.1, BD 6). The percentage rises to 90 percent when the few countries that had little or no discussions on these decisions with the Fund are excluded. Even in advanced and large emerging market countries, when there were substantive discussions with the Fund, 74 percent found the Fund's assessment to be either instrumental or "helpful at the margin." These numbers are reasonably high, especially considering that absence of impact may simply reflect the absence of an *ex ante* divergence of views.

Key Findings and Recommendations

20. The above discussion highlights both areas of strength and areas for improvement. Among the priorities seem to be: (1) strengthening further the analytical discussions backing up views on exchange rate levels; and (2) improving the treatment of spillover

[11]Of the two examples mentioned in the report to illustrate *possible perceptions* of lack of evenhandedness, one—the United Kingdom—is only one of five cases of alleged lack of forthrightness, but the remaining cases are emerging market countries. The second one—Greece, where staff is faulted for allegedly not challenging the authorities' unwillingness to share information needed for surveillance—is, likewise, only one of several such cases (the breakdown by country grouping is undisclosed in this case).

issues. Improving data availability (e.g., regarding intervention) is also important. Finally, there is also a need to consolidate the progress made in other areas, and reduce remaining shortcomings. Many initiatives—which partly overlap with the report's recommendations—are already under way and are discussed below (see also Table 1). New initiatives could of course be considered and costed. But, before doing this, it seems appropriate first to assess whether the current efforts have borne fruit. The 2008 Surveillance Review will do this (improving the treatment of exchange rate issues is one of the monitorable objectives to be reviewed).

21. In presenting our conclusions, we will also comment on the recommendations offered by the report. We therefore follow the sequential presentation followed in the latter.

Rules of the game and guidance to staff

22. Reforms to the surveillance framework are critical in consolidating progress and dealing with remaining problems. A revision of the 1977 Surveillance Decision to bring it in line with best practice could also help raise the average practice of surveillance. The proposed revision would underscore the importance of the analysis of exchange rate levels and of spillovers, which the above discussion highlighted as priority areas. While the above discussion did not suggest major problems regarding the focus of exchange rate surveillance and evenhandedness, any remaining weaknesses need to be addressed. A revised Decision would also help consolidate progress and foster focus and evenhandedness in surveillance overall, not just in exchange rate policy analysis. We therefore concur with the recommendation in paragraph 58 on the need for "a revalidation of the fundamental purpose of surveillance."

23. In contrast, we do not think that the definition of "practical policy guidance" (paragraph 59) is a priority. The current surveillance guidance note does deal with exchange rate issues in fairly general terms, but we regard this as appropriate, at least for the moment. Given the "lack of professional consensus" in this area (page 9), distilling summary prescriptions would be unrealistic. Indeed, such summary prescriptions would risk undermining, rather than promoting, analytically sound advice, given the variety of country-specific features, data availability problems, and the complexity of the issues in question. Thus, staff has preferred to follow an approach based on knowledge dissemination and incentive mechanisms. Close to 400 Fund economists a year participate in seminars on exchange rate issues, and 50–70 in related multiday training (with both numbers growing recently). In addition, new exchange rate workshops have been introduced since 2005 with the goal of motivating performance and better disseminating best practice. Finally, PDR has introduced an internal assessment system to sharpen the internal review of the quality of exchange rate surveillance.[12]

24. With respect to the specific initiatives proposed by the IEO in paragraph 59:

- A review of the stability of the system of exchange rate regimes and exchange rates: we do not see this as a priority at this stage. The *WEO* regularly assesses the consistency of major countries' policy mixes, including their *de facto* exchange rate regimes. However, this issue may be reassessed in light of the description of trends in regimes presented by the forthcoming REARM.
- A guidance note on analysis of intervention based on information provided by the authorities in Article IV consultations on their reserve goals: we do not see the casting of the current state of knowledge into a guidance note as a priority, but continued research into issues of reserve adequacy is needed. And while discussions of the authorities' intentions regarding reserve accumulation should remain a feature of Article IV discussions, systematically seeking precise quantitative information from the authorities in this regard would be an undue imposition.

25. The effectiveness of staff's dialogue with the authorities is crucial. The report does not present sufficient evidence to justify new initiatives in this area (paragraph 60). Judgments on the effectiveness of the dialogue are already a regular part of surveillance reviews and staff performance assessments. Individual cases of lack of forthrightness do point again to the long-acknowledged need for candor in all cases, and we agree that staff, management, the Executive Board, and member countries should work together to ensure that candor is always encouraged and rewarded.

Implementing existing policy guidance

26. The efforts to ensure an adequate description of *de facto* regimes in Article IV reports are bearing fruit. There is evidence that these descriptions are now adequate in the large majority of countries, and the completion of the work on the REARM should consolidate the progress made and facilitate addressing remaining shortcomings. Thus, new initiatives in this area (paragraph 66) do not seem to be warranted.

27. Providing strong analytical backing to advice on the choice of regimes remains critical, but does not call for new actions. The dissemination of best practice in this area will continue. But it seems excessive to require

[12]Other activities aimed at sharing best practices include the forthcoming publication of a book collecting the best in exchange rate analysis at the Fund, and the focus of the 2007 Annual Research Conference on Exchange Rate Issues.

staff reports to lay out explicitly the forward-looking assumptions on which staff advice on the regime is based (paragraph 67). Regimes do not, and should not, change frequently, and in most cases the staff's advice will not, and should not, do so either.

28. More analytical discussions of exchange rate levels are needed in many countries (paragraph 68). As noted, through 2005 shortcomings persisted in a sizable number of countries. We have provided examples of further progress since then, but more is needed. We would expect that the initiatives initiated since early 2005 will take some time before they are fully effective. Other initiatives are in progress (including work to assess better the elasticity of trade balances to exchange rate movements and a further broadening in CGER coverage). New steps may be needed and developments will be monitored closely by PDR. In particular, it may be useful to conduct more in-depth work on assessing equilibrium exchange rates for countries in which manufacturing exports are only a small fraction of the commodity (e.g., oil) exports.

29. Data problems continue to deserve attention (paragraph 69). To some extent they reflect capacity constraints in member countries. The report does not offer firm recommendations in this area, noting that there is a need for management and the Executive Board to consider further what lies behind the existing problems. The planned review of data provision to the Fund later this year will constitute an opportunity to do this.

30. Improving the treatment of spillover issues is a goal set by the MTS. As an implementation step, management has recently instructed staff that "Staff reports for systemically important countries . . . should include a substantive analysis and discussion of spillover issues, drawing the implications of the country's developments, policies, and vulnerabilities both generally for the international community and specifically for neighboring countries and other affected groups. Whenever relevant, spillover issues should be discussed for other countries." Staff has also proposed to clarify the importance of spillover issues in a revised Surveillance Decision. We regard these initiatives as adequate at this stage. The recommendation to set up a panel of senior officials who would offer questions to explore in this area (paragraph 70) seems gratuitous, when the Fund already benefits from the advice of capitals through various channels.

Management of work on exchange rates

31. We do not see a clear need to modify the current departmental responsibilities for exchange rate work (paragraph 71(1)). The report notes that these responsibilities are scattered across many departments, but this reflects the fact that exchange rate work permeates many of the Fund's activities. The Surveillance Committee and the CGER already provide fora for developing Fund-wide perspectives on these issues, and their roles have been strengthened as a result of the MTS.

32. It is well understood that financial sector work needs to be integrated better into surveillance, and it may be worth considering the inclusion in surveillance teams, on limited occasions, of foreign exchange market practitioners (paragraph 72(2)). However, both resource constraints and the need for focus in surveillance dictate that we distinguish carefully between issues that it is essential for surveillance to cover, and issues that belong more to the realm of technical assistance.

Confidentiality and Executive Board oversight

33. We agree that there is need to examine carefully issues related to confidentiality vis-à-vis the Board. The report's proposals (paragraph 74) involve complex governance issues: since it is the Board that is in charge of conducting surveillance, any arrangements along the proposed lines would need to ensure that the Board had the information necessary for it to fulfill this obligation to conduct surveillance. Similar issues have been discussed by the Ad Hoc Committee on Confidential Information (see FO/DIS/06/138, Revised), and a staff paper reflecting these discussions will be issued for Board consideration shortly.

Facilitating multilateral policy cordination

34. We agree on the importance for the Fund of strengthening opportunities "for potential multilateral concerted action," based on "rigorous and compelling analysis of scenarios and [involving] a strategic plan to build consensus amongst key players" (paragraph 76). Multilateral consultations are an initiative contained in the MTS aimed at achieving that.

Annex I. Coverage of Exchange Rate Issues in China Reports

35. The report takes the view that in 2001–02 the coverage of exchange rate issues for China was inadequate—more specifically: "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" (Chapter 3, footnote 3). The report also states that in assessing exchange rate levels, "some traditional indicators of exchange rate misalignment were not brought to bear on the issue through 2005, clouding the overall assessment of renminbi levels" (Chapter 3, footnote 16).

36. However, the 2001 staff report noted in specific terms the policy advice provided to the authorities (including on sequencing) and its rationale, and referred to the previous year's report for additional

details on modalities. The 2002 staff report did contain a short discussion of exchange rate issues, but the recommendations were backed up with a selected issues paper ("Exchange Rate Policy"), and a text box described the functioning of China's foreign exchange market. All in all, every selected issues volume for China between 2002 and 2006 contained at least one chapter dealing with exchange rate issues (including level assessments, reasons for and modalities of moving to greater flexibility, and spillovers). The 2006 staff report and background papers include a thorough discussion of all relevant exchange rate issues, including the exchange rate policies *de facto* pursued by the Chinese authorities, the level of the exchange rate (using a wide range of applicable indicators and methodologies), the adequacy of the exchange rate regime, the implications of exchange rate policies for the Chinese economy, as well as the spillovers of those policies for the rest of the world.[13] Finally, considerable TA on foreign exchange markets was also provided by the Fund (March and May 2001, June 2002, April and May 2004, and May 2005).

Annex II. Description of Exchange Rate Regimes

37. The report found three cases—not mentioned by name—in which "the staff's classification of the de facto regime conveyed, at least temporarily, a misleading impression of the regime in place . . ." (paragraph 23). In staff's view, the criticism is unjustified in two cases.

Country A

38. The 2003 staff report clearly stated that country A had increased its intervention activity and that part of the motivation was to maintain competitiveness. It then went on to urge the authorities to "maintain their flexible exchange rate policy." The discussion was accompanied by both bilateral and multilateral exchange rate charts. Thus—although there was some uncertainty at the time as to the exact amounts of intervention—the staff report did give a broadly accurate description of the *de facto* regime. It is true that at the time the report was issued, the MFD/MCM classification, which had not yet been updated, was "independent float." This discrepancy should have been avoided, but did not impair the description of the policies provided in the Article IV report.

[13]See SM/06/248 (7/12/06) (www.imf.org/external/pubs/cat/longres.cfm?sk=20060.0), especially paragraphs 7–9, 23–31 (including Box 3), and 54–59.

Country B

39. Both the 2003 and 2004 Article IV staff reports were very clear that large-scale intervention was occurring, and staff recommended that these interventions could be increased and that sterilization should be avoided in order to provide additional liquidity to the economy. Both reports also discussed the likely effect of such intervention on the exchange rate, and that this effect was intended. It can be argued that the Fund relations annex was misleading in that it stated that "country B maintains a floating exchange rate," although the existing criteria for classification as a floating regime do actually allow for this kind of intervention. In any event, the discussion in the text of the staff report made clear what the authorities were *de facto* doing.

Annex III. Cases Cited as Involving Incomplete Coverage of Intervention Policies

40. The report (paragraph 24) finds coverage of intervention policies to have been incomplete in five cases. In staff's view, there is no basis for criticism in three of these cases.

41. *Japan*. It is not clear which staff reports are regarded as providing an incomplete coverage, and why. The 2003, 2004, and 2005 reports provided thorough assessments of intervention policies in Japan, leading, particularly in 2003, to extensive discussions at the Executive Board. The 2004 Article IV report agreed with the authorities that intervention in 2003 had prevented an undue tightening of monetary conditions and concurred that if such pressures reemerged and threaten to stall the recovery, further intervention could be warranted (paragraph 25 of the staff report). The 2005 report discussed the role that intervention had played in policymaking in Japan and, when assessing its effectiveness, cited the most recent academic research at that time (Box 1). The 2005 report also suggested that the authorities could resume the intervention, if necessary to combat the deflationary spiral (paragraph 28). Earlier reports had also dealt with this issue (e.g., a 2000 Selected Issues chapter assessed the effectiveness of past intervention on the yen-dollar rate).

42. *Norway*. The only intervention was the accumulation of NFA in the Petroleum Fund. Staff reports did note explicitly that the real exchange rate was affected by this accumulation policy. Indeed, the risk of Dutch disease (i.e., the undesirable effects of rapid real exchange rate appreciation) was discussed in a selected issues paper in 2005 (listed in Table 1).

43. *Singapore*. The IEO report does not say why coverage of intervention policies was regarded as incomplete. Staff reports do describe the exchange rate and monetary framework. The 2003 and 2004 Article IV

reports note that the nominal effective exchange rate (NEER) is targeted by the Monetary Authority of Singapore (MAS) to achieve its inflation target. In the 2003 report, the Fund Relations annex states that the Singapore dollar is "permitted to float" but adds immediately after that "the MAS monitors its value against an undisclosed basket of currencies and intervenes in the market to maintain its value within an undisclosed band." In the 2004 staff report, the Fund Relations annex states "Singapore's exchange rate regime is a managed floating regime" and then continues with the same description of intervention policy as the 2003 report. Both reports discuss the path of the NEER in light of this monetary framework centered on it. In this context, it is well understood that intervention in the foreign exchange market is the primary instrument by which the MAS ensures that the target path of the NEER is in line with the inflation objective.

Annex IV. Staff Analysis on Exchange Rates—The Role of CGER

44. The extension of CGER analysis to include several emerging markets and the associated substantial methodological refinements are an important part of the strengthening of exchange rate surveillance outlined in the Medium-Term Strategy. Yet the main report pays scant attention to CGER. One of the benefits of CGER analysis is its consistency and evenhandedness—assessments for advanced economies and emerging markets are obtained by applying the same analytical framework. If a criticism of the IEO report is that the analytical basis of staff assessments across the membership suffers from arbitrariness, the CGER framework seem to provide an appropriate remedy.

45. Our sense from the outreach staff has done with officials, market participants, and academics is that, while margins of uncertainty remain significant, the methodology is currently at the frontier. Furthermore, the response of area department staff has been encouraging: indeed RES has been approached by desks of several countries not included in the exercise who wished to apply these methodologies to their respective countries. If the CGER results were not useful as an input to staff assessments, it would be necessary to explore which other available methodologies that satisfy the criteria of cross-country consistency are superior, and it would have been helpful had the IEO identified them.

46. Finally, in reference to BD 3, the description of CGER analysis is seriously incomplete. It gives the impression that CGER consists mainly of the macroeconomic balance approach, with just a passing reference to the equilibrium real exchange rate (ERER) approach (a third approach was added more recently). This characterization comes after a (quite weak) discussion of available methodologies for estimating equilibrium real exchange rates, which emphasizes primarily methods analogous to the ERER. Moreover, as recognized in the report, CGER analysis aims at assessing the medium-term consistency of the exchange rate with economic fundamentals. Its assessments should, therefore, be compared to actual exchange rate developments over the course of 3–5 years, and not to actual exchange rate changes at very short horizons. Yet BD 3 refers to CGER estimates having missed the direction of prospective exchange rate changes (paragraph 40).

Table 1. Summary of Staff's Conclusions Based on the Evidence Included in the IEO Report

Issue	Staff Reading of IEO Evidence	Actions Taken or Ongoing
1. General coverage of exchange rate issues	Adequate in vast majority of cases. Need to avoid isolated cases of lack of coverage of relevant issues.	Revision of the 1977 Decision. Various initiatives for better knowledge dissemination (see point 11 below).
2. Integration between exchange rate and other policy areas (excluding spillovers)	Generally good.	
3. Description of de facto exchange regimes	Good, with only a few exceptions. Need to ensure appropriate "labeling" and full consistency with MCM classification in a few cases.	The forthcoming Report on Exchange Arrangements, Restrictions, and Markets (REARM) will reassess classification criteria and discuss how to best ensure consistency with staff reports in all cases.
4. Intervention policies	Broadly adequate, with some room for improvement particularly with respect to spillover effects.	The upcoming REARM will reassess the issue of data availability regarding intervention and make proposals on how analysis of intervention can be strengthened. See point 8 below on spillover effects. Staff missions ensure countries are aware of availability of technical assistance (TA) in this area.

Table 1 *(concluded)*

Issue	Staff Reading of IEO Evidence	Actions Taken or Ongoing
5. Data availability	Deficiencies remain for several countries including for intervention data. Need to continue to support availability of technical assistance and explore extent of cases where authorities seem unwilling to share relevant information.	The forthcoming REARM and the Review of Data Provision to the Fund will reassess this issue.
6. Assessment and analysis of the exchange rate level	Almost always included in staff reports, but in a sizable minority of cases, in spite of recent progress, need to further strengthen the analytical underpinning of assessments.	The CGER coverage has been broadened and is expected to be further broadened this year; new analytical work on trade elasticity and equilibrium exchange rates in low-income countries has been completed and more is under way. Various knowledge dissemination initiatives are under way (see point 11).
7. Assessments of exchange rate regime	Regularly included. Quality of analysis generally adequate. Need to strengthen the assessment in some cases. No excessive urgency in advocating change except in rare cases, but need to ensure countries are aware of availability of TA to address implementation issues.	Various knowledge dissemination initiatives are under way (see point 11).
8. Integration of multilateral (spillover) issues in bilateral surveillance	A strengthening is needed, in spite of some recent progress.	Progress in analyzing spillovers is a monitorable target from the 2004 BSR, and will be reviewed in the 2008 review. Guidance to staff on implementation of the Medium-Term Strategy (MTS) specifically instructed departments to enhance coverage of spillover issues. Staff Briefings to disseminate the findings of the *WEO* and *GFSR* across departments have been organized. The role of the Surveillance Committee is being revived.
9. Evenhandedness	No evidence of lack of evenhandedness is found; nevertheless, need to remain vigilant in this critical area.	Revision of the 1977 Decision.
10. Improvement	Clear evidence of improvement during 1999–2005.	To be reassessed by the 2008 Triennial Surveillance Review (TSR).
11. Approaches for consolidating progress achieved and further strengthening exchange rate advice across all areas	Need to clarify general principles for best practice. No clear need for additional detailed guidance notes on all dimensions of exchange rate work. Need to continue information dissemination processes.	Enhanced training, best practice workshops, forthcoming book on the best on exchange rate analysis, enhanced review process, 2007 Research Conference.
12. Policy dialogue	A large majority of countries are satisfied. Need to ensure remaining shortcomings are addressed.	Revision of the 1977 Surveillance Decision. (A revised Surveillance Decision would underscore the criticality of effective policy dialogue.)
13. Overall assessment of how the Fund plays its various roles	Adequate in most dimensions. Need to strengthen the role of the Fund as "broker for international policy coordination." Some evidence of lack of agreement on how the Fund should play the role of "ruthless truth-teller."	Multilateral consultations have been introduced, strengthening the role of the Fund as broker for international policy coordination. The revision of the 1977 Decision is an opportunity to clarify the expectations of the membership.
14. Impact on policy decisions	Evidence of some impact in the large majority of cases. However, there is scope for improvement.	Same as above. Enhanced methodology for assessing the effectiveness of surveillance, to be implemented in the 2008 TSR, will review impact (among other dimensions).

IEO Comments on Management and Staff Responses to the Evaluation of IMF Exchange Rate Policy Advice, 1999–2005

Executive Board Meeting
May 9, 2007

The IEO report concluded that there was an effectiveness gap over the period 1999–2005 in the IMF's core responsibility for providing exchange rate policy advice. It is clear from the responses of management and staff that there is a very different perception to that of the IEO of the scale and nature of that gap, and of the steps needed to close it. Rather than respond in detail to staff's and management's interpretation of the IEO report, which in our view downplays the significance of survey evidence and of the examples intended to illustrate issues based on the totality of evidence gathered by the IEO, we think it is more constructive to highlight three key factors that seem to drive the different perceptions, in the hope that this will facilitate a better understanding of the issues at stake.

The Need for Additional Action

Management and staff comments have raised the possibility that ongoing initiatives will address most problems, with apparently little or no need for further intervention, at least in the short run. The IEO could not conclude that the effectiveness gap had narrowed significantly over the period through 2005, even though improvements in analysis in some areas are recognized in the report. The important judgment was that the gap at the end of the sample period remained significant and needed to be addressed. Of course, by design, the IEO did not evaluate effectiveness since the end of the sample period in 2005 and, thus, cannot assess the impact of new initiatives. Nonetheless, it is clear that some of the issues flagged, to the extent that they reflect the need for changes in incentive structures or other actions, remain unaddressed. In one important respect, we view the responses of management and staff as providing continuing evidence of a problem that surfaced in the IEO report, namely the failure to distill lessons from the critiques from authorities and some staff on how the IMF's work could be improved. A greater willingness is required to reach out, including to large emerging market economies, to establish what underlies the concerns raised.

The Appropriate Benchmark for Performance

We make no bones about the need to set a high bar in terms of effectiveness of exchange rate policy advice. A high bar is needed to ensure that the surveillance function is conducted effectively and with evenhandedness. The IMF has an obligation to each and every one of its members both to assess their policies and to bring to the table the best policy advice based on the wide experience within the membership. In the IEO's view, therefore, noting that in a majority of cases there were some positive signs, or concluding that the situation was "generally adequate" is an inadequate bar. What management and staff may view as unrealistic in some respects, we view as increasingly challenging but necessary. Examples of shortcomings in the IMF's work in a significant minority of economies, including some of the largest, should prompt, as a matter of urgency, efforts to resolve the problems that have been identified. This is critical not only for the impact on the IMF's effectiveness in those economies, but also to protect the integrity of the system as a whole.

The Importance of Policy Dialogue

The IEO report distinguishes between the strong evidence of a polite to-and-fro and more troubling evidence that the policy dialogue was not as effective as it needs to be in many parts of the membership, especially in the advanced and large emerging market economies that have the most impact on the system. Our recommendations suggest ways to address this deficiency, including by having the first full Executive Board review of exchange rate policy since 1999, to allow the underlying problems to be better defined and to provide guidance to staff in key areas; and to assign a much higher weight to ensuring that dialogue is effective. The latter would involve listening more carefully to authorities' views, and designing the staff and management engagement in a way that would maximize relevance and usefulness to the authorities and to the Executive Board. We maintain that the judicious integration of surveillance and technical assistance activities, greater integration and management of relevant activities within the Fund, and a greater appreciation of the specific concerns of policymakers, would need to be key components of a response.

The Chairman's Summing Up

IEO Report on the Evaluation of the IMF Exchange Rate Policy Advice, 1999–2005

Executive Board Meeting
May 9, 2007

Executive Directors welcomed the report by the Independent Evaluation Office (IEO) assessing the Fund's exchange rate policy advice during the evaluation period 1999–2005. The evaluation provides a wealth of information on the strengths and weaknesses of the Fund's exchange rate policy advice. Directors strongly concurred with the statement by the Managing Director that exchange rate policy advice lies at the core of the Fund's mandate, and that the IEO evaluation will be an important input into ensuring that the Fund remains responsive to the rapidly evolving world economy.

Directors broadly endorsed the IEO's conclusion that during 1999–2005 the Fund was not as effective as it needs to be in some important aspects of the Fund's exchange rate policy advice, and that the Fund should aim at enhancing the effectiveness of its analysis, advice, and dialogue with member countries, as well as address any perception of asymmetry in its exchange rate surveillance. Directors stressed the shared responsibility of the Board, management, and staff—as well as national authorities—in carrying forward these objectives and in responding constructively and openly to the challenges laid out in the report.

Directors recognized that the practice of exchange rate surveillance is constrained by the intrinsic complexity of exchange rate analysis. This includes the conceptual and practical difficulties in estimation, the lack of empirical models that are applicable or appropriate in all cases, and the constant evolution of exchange rate regimes and financial markets. In this respect, some Directors felt that these constraints had not been adequately taken into account by the IEO evaluation.

Directors noted that, for many countries, progress has been made in recent years in strengthening the Fund's coverage of exchange rate policy issues, including in particular in its focus and analytical content. Directors noted that, since the end of the evaluation period, a further strengthening of exchange rate surveillance has been identified as a priority in the implementation of the Fund's Medium-Term Strategy, and pointed to the initiatives under way to enhance the effectiveness of the Fund's work in this area. Against this background, Directors had an extensive and frank discussion of the report's assessments, findings, and recommendations, and several were of the view that further measures would need to be considered in response to the report.

Rules of the Game and Guidance to Staff

Most Directors concurred with the IEO's finding that the rules of the game for exchange rate surveillance remain unclear in some important areas, and that this lack of clarity can impair the effectiveness of the Fund's engagement with members, as well as management's and staff's ability to fulfill their responsibilities. Accordingly, most Directors agreed with the IEO's recommendation that a revalidation of the fundamental purpose of surveillance is an important goal, although views differed on the best vehicle through which this revalidation could occur. In this connection, most Directors noted that the update of the 1977 Decision currently under way should help toward achieving the goal of revalidating the objectives of surveillance. Some Directors stressed that such a revalidation would also enable members to clarify their commitments in the realm of exchange rate policy, as called for by the report. Some Directors suggested that a periodic statement of priorities and responsibilities would usefully complement a revised Decision. A number of Directors were not convinced that an updated Decision is needed, and considered that the rules of the game would best be clarified through a compendium of best practices or similar tools. Several Directors stressed the importance of strengthening the implementation of Fund surveillance over exchange rate policies.

Directors took note of the IEO's call to develop clear practical policy guidance on certain key analytical issues. They had diverse views regarding the need for such guidance and on the feasibility of developing it. To provide an updated framework for guidance to staff and given the Board's responsibility for oversight over the international monetary system, a number of Directors saw merit in a Board discussion on the stability of the system of exchange rates, similar to the one undertaken in 1999. A number of other Directors, however, noted that the *WEO* already provides a useful platform for such an assessment. Many Directors saw the need for practical policy guidance on specific aspects of exchange rate policy advice, while some Directors underscored the practical difficulties in formulating such guidance. Although many Directors noted that Fund staff is at the forefront of research in this difficult area, more effort needs to be put into integrating cutting-edge techniques into the Fund's country work, and in disseminating such knowledge within the Fund. Some Directors also underscored the practical difficulties in formulating guidance and the limitations in prescribing optimal reserve levels. Other Directors saw scope for guidance, particularly on intervention. On balance, Directors encouraged staff to discuss the uses and limits of intervention whenever relevant from the macroeconomic perspective in Article IV consultations, bearing in mind the importance of flexibility and of tailoring advice to country circumstances and of avoiding an overly prescriptive approach. Efforts will also be needed to ensure greater consistency across the membership in this area.

Policy Dialogue

Directors discussed extensively the IEO's recommendation that management should give much greater attention to ensuring effective dialogue with country authorities. It was noted that the IEO survey showed that national authorities across all country groups were generally satisfied with the policy dialogue with the Fund, and that a majority felt that the Fund had played the roles of confidential advisor and intellectual partner adequately. Nevertheless, the evidence provided by the IEO evaluation supports the conclusion that many countries seek still greater value added from their dialogue with the Fund. It was noted in this context that both Fund staff and management and country authorities have a responsibility to engage constructively in surveillance discussions. In particular, country authorities should be sufficiently forthcoming in the provision of information to allow surveillance to be effective. Directors agreed that there remains scope to explore further ways to improve the dialogue with member countries, and to address any perception of lack of evenhandedness. They underscored in this context the considerable importance of ensuring that the relationship between the Fund and member countries—as well as the Fund's policy advice—is, and is perceived to be, evenhanded, and called for further efforts in this area.

Directors agreed with the recommendation that management has a key role to play in ensuring effective dialogue with the authorities, and that this is no less important than developing the right advice. Directors encouraged management to give consideration to the IEO recommendations in this area, particularly to a strategic approach to identifying opportunities to improve the effectiveness of the dialogue. Ensuring that missions have the right mix of skills and expertise, in particular, was seen by many as requiring further efforts. Staff should be encouraged to raise controversial issues with the authorities, to better understand the viewpoint of national authorities, and to ensure evenhandedness.

Implementing Existing Policy Guidance

Directors concurred with the IEO that, over the review period, there had been problems in implementing various aspects of existing policy guidance. Most Directors agreed that there remains scope for improvement in several areas.

Directors reaffirmed the importance of a clear description of the *de facto* exchange rate regime. Many Directors also underscored the need to better understand the factors underlying differences between the *de facto* and *de jure* classifications. Regarding the assessment of members' choices of exchange rate regimes, Directors saw scope for more candid staff assessments while avoiding a mechanistic approach. Directors noted the report's finding that staff advice in recent years has leaned toward increased exchange rate flexibility. In general, Directors agreed that staff's views on a member's choice of exchange rate regime should, whenever warranted, be explicitly underpinned by more comprehensive analytical discussion of the pros and cons, taking into account country circumstances, the authorities' views, and implementation issues when macroeconomically relevant. Staff advice should be informed by the Fund's considerable cross-country experience.

Directors welcomed the finding that analysis of exchange rate levels had improved, although in several cases there remained scope for improvement in the quality of the analysis. Many noted positively that staff's work in this area had been strengthened in recent years, with more sophisticated analytical tools being applied—including with respect to the emerging markets. At the same time, Directors recognized that methodological uncertainties remain daunting in this area, and should not be discounted in Fund assessments of exchange rate levels. Directors generally agreed with the IEO that the Fund should stay at the forefront of developing the analytical framework in this area, including with respect to developing countries. Several Directors advocated caution in the Fund's public communications on its findings on equilibrium exchange rates and misalignments, including those based on CGER assessments. In this context, a few Directors cautioned against overreliance on model-based estimates of equilibrium exchange rates.

Directors underscored the importance of better incorporating the analysis of policy spillovers into regional and bilateral surveillance and welcomed the initiatives recently taken in this area under the aegis of the Medium-Term Strategy.

Directors expressed concern at the IEO report's finding that data availability remained a challenge in many cases, and welcomed the recommendation to consider further the scope of the problem and possible remedies. Thus, they looked forward to the upcoming review of data provision to the Fund.

Management of Work on Exchange Rates

Directors agreed with the recommendation that management should ensure that exchange rate work across the Fund is organized and managed effectively, in tandem with ongoing work to integrate financial sector issues into Fund surveillance. They encouraged further strengthening of the existing coordinating mechanisms (including the Surveillance Committee and the CGER), as envisaged by the Medium-Term Strategy.

Confidentiality and Role of the Executive Board

Directors considered the concerns received by the IEO regarding the potentially difficult trade-offs between staff's and management's role as confidential and trusted advisor—and the critical importance of ensuring that the Executive Board has all the information that it needs to enable it to carry out its surveillance responsibilities. Indeed, because it is the Executive Board that is ultimately responsible for the conduct of surveillance, many Directors had concerns with the IEO suggestion to have an independent party periodically review Fund staff activities that are not reported to the Board. Most Directors emphasized that management is responsible for providing the Executive Board with all the information that it needs to conduct surveillance, and is accountable to the Executive Board for how it combines this duty with the need for the staff and management to serve as a confidential advisor to members.

Facilitating Multilateral Policy Coordination

Directors noted the IEO's finding that the Fund had not explored sufficiently, over the evaluation period, the scope for countries to act in concert to deal with global payments imbalances. Most Directors considered multilateral consultations to be a useful addition to the surveillance toolkit because they helped to improve policymakers' understanding of each other's objectives. In this context, they took note of the recent multilateral consultation on global imbalances, under which policy plans set out by the participants represent further progress with the shared responsibility for the implementation of the International Monetary and Financial Committee strategy.

Follow-Up

Directors looked forward to considering soon a follow-up implementation plan to be prepared by staff in line with the guidance from today's discussion. Given the initiatives directly relevant to the IEO findings launched under the Medium-Term Strategy, as well as the resource constraints, Directors felt that the implementation plan should be comprehensive, while leveraging existing and planned initiatives to the greatest possible extent to address the IEO recommendations endorsed by the Board. In this respect, some Directors suggested that follow-up actions may require the reallocation of resources from areas less central to the Fund's mandate.

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