Independent Evaluation Office
of the International Monetary Fund

INTERNATIONAL RESERVES: IMF ADVICE AND COUNTRY PERSPECTIVES

ISSUES PAPER FOR AN EVALUATION BY THE INDEPENDENT EVALUATION OFFICE (IEO)

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I. BACKGROUND AND MOTIVATION

1. The IEO will undertake an evaluation of the policy advice the IMF offers to member countries on international reserves in the course of its multilateral and bilateral surveillance. Under its Articles of Agreement, the IMF is tasked with overseeing that (i) the policies of its member countries help achieve their own domestic and external stability (i.e. bilateral surveillance), and that (ii) the international monetary system functions effectively (i.e., multilateral surveillance). More specifically, several provisions of the 2007 Surveillance Decision, particularly those related to its principles, modalities and analytical methodologies, clearly support the relevance of a member's reserves in both of these contexts. Thus, the IMF's assessment of the adequacy and pace of accumulation of a country's international reserves and its advice in this regard are germane for how it discharges its obligations towards bilateral and multilateral surveillance.

2. Globally foreign exchange reserves have grown rapidly in the last decade at an annually compounded rate of about 18 percent per year. International reserves of emerging market economies have grown even faster.[1] In some cases, the accumulation of reserves has been the result of a conscious decision to build up precautionary reserve levels whereas in others it has been a by-product of the pursuit of other policy objectives. In the aftermath of the global crisis, the pace of accumulation has continued and has also been evident in economies which traditionally have not emphasized the need for international reserves. This has led to renewed debate about the need, costs, and benefits of reserve accumulation from both bilateral and multilateral perspectives.[2]

3. Large reserves have come to be viewed as an insurance against external shocks in a world where financial, goods, and asset markets are increasingly integrated, and where capital flows are increasingly volatile. This insurance is not costless, however. As foreign exchange reserves are often invested in relatively low-yielding assets, they can entail an opportunity cost of foregone returns from alternative investments. Moreover, reserve accumulation could complicate the conduct of domestic monetary policy.

4. This evaluation will seek to determine what role IMF advice has played in countries' decisions to accumulate reserves. It will note similarities and differences in the analytical frameworks used by Fund staff and authorities in different member countries, as well as any differences of views about the nature and relative magnitude of the costs and benefits. In so doing, it will strive to assess whether the advice has been evenhanded across members.

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[1] Global international reserves increased from US$2 trillion in 2000 to US$ 9.5 trillion by end-2010. The reserves of emerging market economies went from less than US$0.75 trillion to more than US$6 trillion in this period, representing an annual growth rate of over twenty percent. These data refer to total reserves (excluding gold).

[2] See, for example, IMF, "Reserve Accumulation and International Monetary Stability, April 13, 2010 (www.imf.org/external/np/pp/eng/2010/041310.pdf).

5. Attention will be given to situations where countries' interventions could have a significant influence not only for the member's own domestic and external stability, but also on global stability.

6. Issues related to intergenerational equity have been the main reason for the buildup of substantial foreign asset positions by some countries, notably by commodity/energy exporters. In some cases these assets are held in a sovereign wealth funds (SWFs) rather than in the central bank or the treasury. As SWFs play a role in investing reserves that are considered in excess of what is needed for precautionary purposes, their asset holdings have increased with the rapid accumulation of international reserves. This raises important questions with respect to the definition of international reserves, about the macroeconomic impact of such SWFs, and about what advice Fund staff has provided to the member countries on these topics. The evaluation will seek to evaluate this advice against the perspectives of the national authorities.

II. Objectives, Scope, and Evaluation Questions

7. The objective of the evaluation is to assess the nature and usefulness of IMF advice to member countries on international reserves taking into account the perspective of country authorities. It will cover both bilateral and multilateral surveillance.

8. The evaluation will ask the following specific questions.

A. Does the IMF Have Clearly Articulated Policies Regarding International Reserves?

9. IMF policy is determined by its Articles of Agreement and decisions by the Board. In addition, guidelines, which have an impact on advice, are issued by IMF Management to staff and are often disseminated among member countries. The evaluation will ask:

- Has the Fund established policies and guidelines enabling staff to carry out bilateral and multilateral surveillance with respect to reserve holdings and accumulation? The evaluation will document existing Fund policies that explicitly or implicitly deal with international reserves and highlight gaps and inconsistencies, if any.

- What are the perceptions among IMF staff and country officials about the IMF's policy guidelines with regard to international reserves?

B. Is IMF Analysis and Advice Based on Appropriate Definitions of International Reserves?

10. In the sixth edition of the IMF's Balance of Payments Manual, reserve assets are those external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for interventions in exchange markets to affect

the currency exchange rate, and for other related purposes. Typically they include a country's holding of foreign currency and deposits, securities, gold, IMF special drawing rights (SDRs), reserve position in the IMF, and other readily available claims. This definition measures gross claims of the monetary authorities on nonresidents.

11. In situations of stress in international markets, it is important that reserves be rapidly accessible. This puts a premium on the liquidity of the reserve assets held by the authorities, and since not all components of the traditional definition of reserves are equally liquid, it suggests that for some purposes it may be useful to contemplate alternatives. Moreover, countries may have access to international lines of credit or swap arrangements which they consider substitutes for owned reserves.

12. Both the Fund and member countries have used a number of different (but related) measures of international reserves in analytical and policy documents, e.g., net international reserves, net foreign assets of the public sector, net foreign assets of the economy as a whole, as well as definitions of international reserves inclusive or exclusive of assets held by SWFs. The evaluation will ask:

- Does the Fund use a clearly articulated definition of reserves consistently in its analysis and policy advice?

- Are the concepts used by the Fund in its policy advice considered by member countries to be the most useful and relevant for the circumstances facing them?

- Is the definition of reserves used in analytical work and in policy discussions adequate in relation to the questions being asked?

- Has the Fund requested the necessary information and has this been provided?

C. Has IMF Advice Been Consistent, Evenhanded, and Useful?

13. Countries accumulate international reserves for a number of reasons and the emphasis placed on each factor is likely to differ according to country-specific circumstances, characteristics and vulnerabilities which may change over time. The evaluation will ask:

- To what extent has IMF bilateral and multilateral surveillance focused on issues related to reserves? Do member countries consider that the IMF has paid an appropriate amount of attention to this issue in the context of its surveillance, both bilaterally and multilaterally?

- According to country authorities, has the IMF's advice on reserves had the appropriate focus, balancing precautionary and non-precautionary motives, and domestic and international stability? What has been the rationale for the IMF's emphasis?

- Do member countries regard discussions with the IMF about reserve policies to have been useful and placed in the context of their country?

- Has the IMF message regarding reserves been analytically coherent and consistent over time and across its membership?

- Has the recent crisis influenced the IMF's and country officials' views about their policies regarding international reserves?

- In discussions related to reserve adequacy, is there a common understanding between IMF staff and country authorities on the tradeoff between the costs and benefits of holding reserves? What are the most important costs and benefits of holding reserves as perceived by the country authorities and the IMF?

- When the buildup of reserves has been a byproduct of non-precautionary motives, what have been the IMF's views about accumulation? How have these views differed from those of country officials, and why? In particular has the IMF's advice on exchange rate policy, international reserves and capital account liberalization been well integrated?

- Does the IMF have a view on the establishment of SWFs as a tool for macroeconomic policy management? What has been the focus of its policy advice with regard to SWFs and has it been evenhanded, consistent across member countries, and mindful of their objectives?

D. What is the Analytical Basis for the IMF's Policy Advice?

14. Analytical work on assessing the costs and benefit of holding reserves has evolved both in academia and within the Fund. In this regard, the evaluation will assess:

- What is the analytical basis for the IMF's assessments regarding optimal reserve levels for a member country? Is it consistent with the academic literature in this area? Is it based on country circumstances and empirical findings?

- To what extent is the IMF's analysis informed by cross-country perspectives?

III. Evaluation Period, Country Coverage, and Sources of Information

15. Evaluation period. The analysis will cover the period from the beginning of 2000 to mid-2011. The beginning of the evaluation period corresponds to the start of a substantial buildup of reserves in a number of member countries, which continued uninterrupted until the onset of the recent financial crisis, and which has resumed in its aftermath. The end-period for the evaluation is chosen to elicit views on reserve accumulation resulting from experiences during the recent financial crisis and to take into account the perspectives of

country authorities on the new reserve adequacy indicator proposed by staff in a paper entitled 'Assessing Reserve Adequacy" which was discussed by the IMF Board in March 2011.

16. Country selection. The evaluation will be based on the experience of some forty economies chosen to reflect a variety of characteristics that are likely to be important in the context of the evaluation. The selection criteria consist of the following country characteristics: the absolute size of reserves relative to global reserves; the size of reserves relative to the size of the domestic economy; the magnitude and speed of reserve accumulation during the evaluation period; the exchange rate regime; the size of the financial sector, particularly the existence large cross-border exposures; large commodity or energy exporters and importers; the existence of SWFs; and experience with IMF-supported programs. Regional balance in the choice of countries has also been a criterion.

17. Sources of information. The evaluation will be based on interviews and document review:

- Interviews will be conducted with current and former senior country officials and policymakers, and IMF senior staff and Management and Executive Board members. In addition, the evaluation may canvas the views of relevant think tanks and academics. Semi-structured interviews will be conducted on the basis of questionnaires, to ensure comparability and comprehensiveness.

- Documents: The evaluation will consult a wide variety of IMF documents related to the conduct of (i) bilateral surveillance and program review (mission briefings, mission minutes, staff reports, back to office reports, selected issues papers, other internal memoranda, and Executive Board discussions); (ii) multilateral surveillance (the *World Economic Outlook*, the *Global Financial Stability Report*, and *Regional Economic Outlooks*); (iii) IMF strategy, policy papers and guidelines; (iv) *Data Template on International Reserves and Foreign Currency Liquidity*; (v) *International Reserves and Foreign Currency Liquidity: Guidelines for a Data Template*; and (vi) IMF communications with country officials. The evaluation will also consult documents issued by member countries (e.g., annual reports of central banks and relevant government ministries) as well as studies and official speeches by country officials and think tanks and other relevant stakeholders.

- Previous evaluations. The evaluation will also incorporate and build on relevant findings of previous IEO evaluations, notably "IMF Exchange Rate Policy Advice" and "The IMF's Approach to Capital Account Liberalization." See Annex.

Annex. Advice on Reserves Figuring Significantly in Previous IEO Evaluations

IMF Exchange Rate Policy Advice (2007)

In 2007, the IEO published an evaluation of IMF advice on exchange rate policy covering the period from 1999 to 2005. Desk studies of the entire membership were conducted for the last two of these years and in-depth studies were carried out for 30 selected countries for the full period.

The evaluation investigated issues related to interventions in the foreign exchange market. The evaluation found the analysis of intervention policies incomplete in a number of dimensions; insufficient analysis of intervention episodes; incomplete analysis of the effects of intervention; almost no attention paid to the implementation of intervention; little attention to how a central bank might 'exit' from a prolonged period of intervention; and incomplete analysis of changes in net foreign assets of the official sector as opposed to simply changes in official reserves.

The evaluation also investigated advice given on the accumulation of reserves. It found that reserves are accumulated based on several motives including for self-insurance against shocks, Dutch disease or intergenerational considerations, and concerns about competitiveness. Staff was found generally to endorse interventions for the first two of these reasons, but took a more negative view of interventions to influence competitiveness.

Typically staff did not support interventions in economies which experience large capital inflows (whether due to official aid or private flows). This view appears to have been based on two premises; first that the appreciation of real exchange rate consequent to such flows would be the same whether the nominal exchange rate was allowed to change or domestic inflation would materialize, and second that it would be less costly to adjust to the capital inflow by allowing the nominal exchange rate to appreciate. The evaluation argued that both of these premises could be incorrect in certain circumstances.

The evaluation noted that analysis and advice suffered from lack of data on intervention, and suggested that staff could do more to secure such data.

The evaluation recommended that practical policy guidance should be developed on key analytical issues among them the use and limitations of intervention.

IMF Approach to Capital Account Liberalization (2005)

The evaluation documented the IMF's approach to capital account liberalization and identified areas for improvement. It concluded that:

Throughout the 1990s, the IMF undoubtedly encouraged countries to move ahead with capital account liberalization, especially before the East Asian crisis. However, there is no evidence to suggest that it exerted significant leverage to push countries to move faster than they were willing to go.

The process of liberalization was often driven by the authorities' own economic and political agendas, such as accession to OECD, the EU, and commitments under bilateral or regional trade agreements.

In encouraging capital account liberalization, the IMF pointed out the risks inherent in an open capital account as well as the need for a sound financial system. The problem was that these risks were insufficiently highlighted, and the recognition of the risks and preconditions did not translate into operational advice on pace and sequencing until later in the 1990s (and even thereafter the policy advice has often been of limited practical applicability).

In multilateral surveillance, the IMF's policy advice was directed more toward emerging market recipients of capital flows, and focused on how to manage large capital inflows and boom-and-bust cycles. Little policy advice was offered on how source countries might help to reduce the volatility of capital flows on the supply side. Even in more recent years, the focus of policy advice—beyond the analysis of macroeconomic policies covering large current account imbalances—remains on the recipient countries.

In country work there was apparent inconsistency in the IMF's advice on capital account issues. The inconsistencies to a large extent reflected reliance on the discretion of individual IMF staff members. Sequencing was mentioned in some countries but not in others; advice on managing capital inflows was in line with standard policy prescriptions, but the intensity differed across countries or across time (with no clear rationale provided for the difference).

The IMF's weak mandate to promote capital account liberalization, along with the lack of a formal IMF position on the issue led to some inconsistencies in country work, although in recent years greater consistency and clarity appeared and suggested an improvement.